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NEVER WASTE A GOOD CRISIS:  
AN HISTORICAL PERSPECTIVE ON COMPARATIVE CORPORATE GOVERNANCE

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Never Waste a Good Crisis: An Historical Perspective on Comparative Corporate Governance  
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**ABSTRACT**

Different economies at different times use different institutional arrangements to constrain the people entrusted with allocating the economy's capital and other resources. Comparative financial histories show these corporate governance regimes to be largely stable through time, but capable of occasional dramatic change in response to a severe crisis. Legal origin, language, culture, religion, accidents of history (path dependence), and other factors affect these changes because they affect how people and societies solve problems.

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## **1. Varieties of Corporate Governance**

Businesses allocate an economy's resources. How efficiently they do this depends on their governance. Corporate governance differs fundamentally across countries. In Britain and most American states, officers and directors owe a qualified fiduciary duty to shareholders or other investors (Easterbrook and Fischel 1991 c. 6; Cheffins 2009), though dissenters question its efficacy (Bebchuk 2007) and wisdom (Stout 2007). Their Germany peers must balance the interests of stakeholders – shareholders, creditors, employees, the public, the government, and others (Fohlin 2005). Canadian directors' duty is to the legal person of the corporation, and explicitly not to shareholders or any other stakeholders (Lee 2005). Belgian boards' duty can be to a business group that includes their firm (Johnson & et al. 2000). Superficialities like board committees, director independence, and the like unfortunately divert attention from these more profound differences.

The “varieties of capitalism” literature links such differences to underlying distributions of economic power (Hall & Soskice 2001). Most large American and British listed firms are owned by multitudinous small shareholders seeking optimal returns on their investments, and thus optimal resource allocation (Jensen & Meckling 1976).

Corporate governance reforms there thus rightly stress empowering shareholders relative to groups with other interests, such as self-interested CEOs. Elsewhere, many large listed firms have controlling shareholders, whose private interests can distort resource allocation (Dyck & Zingales 2004; Rajan & Zingales 2004), and courts struggle to define “shareholders' interests”. Elsewhere, listed companies also often belong to business groups, whose member firms share a common controlling shareholder – usually a wealthy family, and Business Group Law governs conflicts between a firm's interests and its group's interests (Bebchuk et al. 2000). In America, where true business groups are vanishingly rare (Villalonga & Amit 2008), such issues seldom arise.

Other differences reflect labor laws. In many countries, works councils have real power (Roe 2003). In Germany, labor representatives sit alongside shareholders' on large firms' supervisory boards (Roe & Blair 1999). Labor's voice cannot be ignored in these countries.

Yet other differences reflect financial architecture. Banks long dominated German capital allocation, while British firms raised capital on stock markets (Levine & Zervos 1998). Clearly, a German board must weigh creditors' interests more heavily.

These differences are fundamental. Capitalism, for many Americans, means rival firms competing for consumers' business and investors' savings. For others, capitalism means handing the economy to a few oligarchic families. To Americans, the others sound paranoid; to others, Americans sound stunningly naïve. In fact, each should take the other seriously.

Whether capitalism is an innovative dynamo or an oppressive feudalism depends, remarkably, on differences in corporate governance. Section two details these, and how they arose from different responses to crises. Section three concludes, describing how legal, historical, and cultural factors shape countries' responses to crises; and how differences thus formed persist.

## **2. Variegating Capitalism**

Corporations are governed remarkably differently across countries (Barca & Becht 2001; Hall & Soskice 2001; Denis & McConnell 2003). Brief historical accounts of how these differences arose follow. Space constraints necessitate oversimplifications and reliance on illustrative bellwether economies. Also, many countries' institutions are in flux, and our focus is systems in place for

long stretches, not countries' most recent reforms or proposals. Apologies are offered in advance to specialists. Our hope is to illustrate broad patterns in the evolution of institutions.

We begin with Britain, which illuminates the very different paths of America, Canada, India, and other countries with "Anglo-Saxon" institutions. Italy illuminates another set of countries; while Germany, Scandinavia, and Japan have uniquely interesting lessons<sup>1</sup>.

## 2.1 Britain

"The typical British listed corporation has widely dispersed ownership and is run by professional managers who collectively own too few shares to control the outcome of shareholder votes" (Cheffins 2009, p. 1).<sup>2</sup> But, as Adam Smith (1776, bk. V, c. 1) writes "[shareholders] seldom pretend to understand anything of the business ... but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them." An agency problem results from their conflicting objectives: value-maximizing shareholders delegate corporate governance to agents – utility-maximizing managers.

Britain's corporate governance can be summarized thus: While the diffusely-owned firms Smith describes persisted throughout, most listed firms had controlling shareholders – usually wealthy families – until roughly the 1970s, whereafter diffuse ownership predominates (Cheffins 2009). Business groups of listed firms, mentioned in accounts of 19th century business (Jones 2000, c. 6), gain prominence in the 1960s and all but disappear after the 1970s (Franks et al. 2005). Many groups exhibit a pyramidal structure: an apex firm holding equity control blocks in a first tier of listed firms, each holding control blocks in a set of second-tier listed firms, each holding control blocks in a set of third tier firms, and so on (Franks et al. 2005).

Mid-20th century Britain survived successive crises – the Great Depression, two world wars, and the postwar disintegration of its Empire – with its traditional institutions badly shaken and successive Labour governments bent on remaking the country. Three sequential Labour reforms fixed the path of British capitalism.

First, shortly after World War II, new disclosure rules radically enhanced transparency, rendering governance problems more obvious. This invited raiders to take ill-governed firms over, replace their management, refloat the better-run firms on the stock market at higher prices, and pocket the profit (Franks et al. 2005). Britain has no antitakeover laws and forbids classified boards and poison pills (Cheffins 2009). The only takeover defense available to a widely held listed firm is a large equity block in friendly hands, and pyramidal groups apparently stepped forward to provide this service (Franks et al. 2005).

Second, successive Labour governments, using tax incentives and socialist rhetoric, built workers' pension funds into major corporate shareholders. Figure 1 tracks their extraordinary rise. Pension fund managers objected to pyramiding, which they correctly saw sheltering corporate executives behind complicated shareholding structures and depressing the values of workers' pension funds by precluding value-increasing takeovers.

Third, and in response to intense lobbying by pension funds, the London Stock Exchange established its 1968 Takeover Rule, mandating that any bid for over 30% of a listed company be for 100% (Franks et al. 2005). This made pyramiding untenable as a takeover defense, for target managers could only stop a raider by inviting a higher going-private bid. Consequently, firms could either have no impregnable blockholder or delist.

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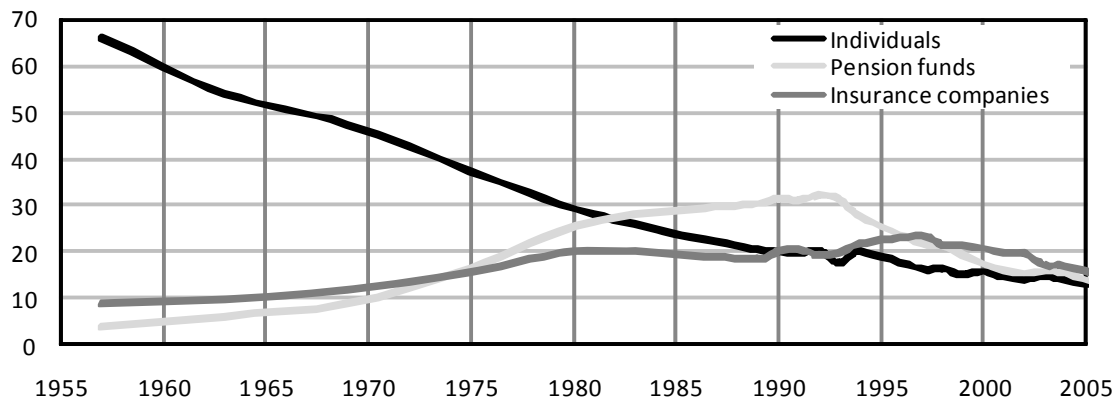
<sup>1</sup> Space limitations preclude discussing China, Russia, and other transition economies; many of which have substantial procommunist economic histories. On China's first attempt at capitalist institution building, and its failure in the hands of corrupt bureaucrats, see Goetzmann and Köll (2005).

<sup>2</sup> This section draws heavily from Franks et al. (2005) and Cheffins (2009).

Thus arose two key features of British corporate governance - a perennial takeover threat and powerful institutional investors.

Ill-governed firms' sagging share prices make them bargain takeover targets; and ill-governed acquirers become bargain targets too. In theory, this market for corporate control accumulates the economy's resources under the stewardship of the most efficient managers.

**Figure 1. Shareholdings of individuals and institutions**  
 Fractions of British stock market capitalization owned by individuals, pension funds, and insurance companies. The total of the three declines over time primarily because of rising foreign ownership.



Source: UK National Statistics DEYG SRS, DEYH SRS and DEYI SRS from [www.statistics.gov.uk](http://www.statistics.gov.uk).

The Takeover Rule thus undermines pyramids in two ways. First, raiders, or controlling shareholders preempting raiders, trigger mandatory 100% bids. Second, raiders, issuing shares to finance takeovers, dilute their control blocks. Of course, all this hinges on takeover activity: Many European countries enacted similar Mandatory Bid rules that languish as dead letters absent active stock markets raiders can use to raise capital.

Pension funds also intervene in specific firms they deem misgoverned. Black and Coffee (1994) document how the most over-represented fund – whose stake is largest relative to its portfolio – is expected to press management to change course, and how others are expected to support the leader. Though none commands a control block, their collected stakes can oust an unresponsive board. Black and Coffee report this “behind the scenes” pressure to be effective, at least in some cases.<sup>3</sup>

Powerful institutional investors can thus set meaningful standards – a practice called *self-regulation*. Codes of best practice, beginning with the 1986 Cadbury Code, recommend independent directors, board committees, and the like. Compliance, though voluntary, avoids upsetting powerful institutional investors, and is the path of least resistance for most firms.

## 2.2 America

Large American firms have also been far more diffusely owned than elsewhere – at least since the late 1930 (Holderness et al. 1999). Becht and DeLong (2005) look further back, estimating Standard Oil's shares to have been widely distributed a century ago.

Controlling shareholders were a concern nonetheless. By the late 19th century, “robber baron” tycoons ran huge corporate empires through “trusts”, often set up by the Morgan Bank (Josephson 1934). The tycoons used these to launch takeovers, paying for targets' shares with

<sup>3</sup> For a less flattering perspective on British corporate governance, see Franks et al. (2001).

trust units (Markham 2002). By the 1890s, the Rockefeller family's Standard Oil Trust so dominated oil production, refining, and distribution that it was considered a monopoly (Laughlin 2004). Other major companies of the era – Edison General Electric, US Steel, and Morgan's railroad empire – were also built with takeovers (Moody 1904). Trusts' unit holders, like modern preferred shareholders, had no votes. They bore downside risk and reaped upside benefits, but the trusts' directors – the robber barons, their relatives, and Morgan's men – exercised control.

De Long (1991) argues that Morgan's men exercised a monitoring and control role that protected public investors. Firms with a Morgan man on the board had elevated valuations – perhaps they acted like postwar British pension funds. Certainly, a reputation for treating investors well was critical to the bank's continued business of organizing trusts,, and the presence of Morgan men on boards everywhere suggests an interventionist governance philosophy (Ramirez 1995). Becht and De Long (2005) further argue that, despite few statutory rights specific to shareholders, American courts penalized fraudsters sufficiently that, by the late 19th century, household saving flowed into stocks. Of course, monopolistic trusts' robber barons and financiers might just have shared their rents with trust unit holders.

By the late 19th century, the robber barons' vast wealth was fuelling popular support for a new Progressive Movement. The 1890 Sherman Antitrust Act precluded price fixing, but trusts with 65% (U.S. Steel Trust) to 90% (American Tobacco Trust) market shares remained untouched until 1904 (Shleifer & Vishny 1990). That year, in a major Progressive victory, the Supreme Court reinterpreted the act to forbid building a monopoly with takeovers, a reading Congress affirmed in the 1914 Clayton Antitrust Act. Building large corporate empires via trusts now risked attracting an antitrust investigation – monopoly or not.

By the 1920s American tycoons were building pyramidal business groups instead (Berle & Means 1932; Bonbright & Means 1932). The 1920s takeover wave built huge pyramidal groups – some containing hundreds of distinct companies organized into a dozen or more tiers. The robber barons were back in business.

America's formative crisis was the Great Depression, when a 90% stock market drop wiped out middle class savings and a 25% unemployment rate reduced millions to penury. Amid this economic devastation, Franklin Delano Roosevelt led Progressives back into power; and Progressive civil servants rallied.<sup>4</sup>

The Internal Revenue Service saw pyramidal groups as tax cheats. In a 1935 Senate Finance Committee hearing, Robert Jackson, the Assistant General Counsel to the Treasury Department, described a pyramidal group with “approximately 270” companies, holding companies, sub-holding companies, etc.<sup>5</sup> The companies all reported “no tax due in any of the years 1929 through 1933” despite the large profits disclosed in their annual reports each year. Jackson describes the adventures of the sixteen full time IRS auditors and 108 field agents chasing taxable income from firm to firm, always several steps behind. The testimony suggests group firms did business with each other at artificial *transfer* prices to shift income away from audited firms.<sup>6</sup>

Shareholder democracy advocates attacked pyramidal groups for inducing an extreme separation of ownership from control. Thus, Berle and Means (1932, p. 69) write “In the effort to maintain control of a corporation without ownership of a majority of its stock, various legal devices have been developed. Of these, the most important among the very large companies is

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<sup>4</sup> The following draws heavily from Morck (2005).

<sup>5</sup> Senate Finance Committee Hearings, pp. 223-224.

<sup>6</sup> Such transfers are called *self-dealing* in Business Group Law, and *tunneling* in the finance literature (Johnson & et al. 2000). *Transfer pricing* by multinationals is similar, but hides income from tax authorities. Tunneling hides income from public shareholders, tax authorities, or both.

“pyramiding.” This involves the owning of a majority of the stock of one corporation, which in turn holds a majority of the stock of another – a process which can be repeated a number of times. An interest equal to slightly more than a quarter or an eighth or a sixteenth or an even smaller proportion of the ultimate property to be controlled is by this method legally entrenched. By issuing bonds or nonvoting preferred stock of the intermediate companies the process can be accelerated. ... The owner of a majority of the stock of the company at the apex of the pyramid can have almost as complete control of the entire property as a sole owner even though his ownership interest is less than one percent of the whole.”

Antitrust advocates saw pyramidal groups, through the good offices of a common controlling shareholder, organizing collusion between seemingly distinct companies. Addressing the American Economic Association, President Roosevelt (1942) writes “close financial control, through interlocking spheres of influence over channels of investment, and through the use of financial devices like holding companies and strategic minority interests, creates close control of the business policies of enterprises which masquerade as independent units. ... Private enterprise is ceasing to be free enterprise and is becoming a cluster of private collectivism; masking itself as a system of free enterprise after the American model, it is in fact becoming a concealed cartel system after the European model.”

Underlying all this was a renewal of the Progressive populism that led to the Sherman and Clayton acts. Roosevelt’s New Dealers recalled the previous Progressive president, Woodrow Wilson, admonishing that “no country can afford to have its prosperity originated by a small controlling class. The treasury of America does not lie in the brains of the small body of men now in control of the great enterprises ... It depends upon the inventions of unknown men, upon the originations of unknown men, upon the ambitions of unknown men. Every country is renewed out of the ranks of the unknown, not out of the ranks of the already famous and powerful in control.”<sup>7</sup>

Rather than mounting a direct attack, like the antitrust acts of previous decades, the New Dealers attacked pyramiding via a series of mid 1930s income tax reforms. These subjected intercorporate dividends to double taxation – in both the payers’ and recipients’ income taxes. Although the rate was ultimately only fifteen percent of the regular rate, this sufficed to disadvantage large multi-tiered pyramids relative to freestanding firms. Consolidated group filing was abolished, and capital gains holidays encouraged the absorption or divestment of controlled listed subsidiaries.

On top of these changes, the Public Utilities Holding Companies Act explicitly banned large pyramidal groups from controlling public utilities companies – on the grounds that utility firms’ cost-plus pricing and regulated returns made them cash cows to unfairly subsidize group firms in competitive industries. The 1940 Investment Company Act also weighed in, subjecting listed firms whose assets are primarily shares in other firms to additional regulations. The explicit goal of these and other policies was to break up large US business groups. The Securities and Exchange Commission, established about this time, made firms more transparent to public investors, likely reducing insiders’ scope for self-dealing (Burkart et al. 2003) and established most of the shareholder rights La Porta et al. (1998) enumerate (Lamoreaux & Rosenthal 2006).

Roosevelt’s attack succeeded, for business groups all but vanished. Late 1930s press accounts describe dozens of groups reorganizing themselves into unitary corporations (Morck 2005), and late-1930s data reveal widely diffused shareholdings (Holderness et al. 1999), which persists (Villalonga & Amit 2008).

Intercorporate dividends remain subject to double taxation. Dividends are currently

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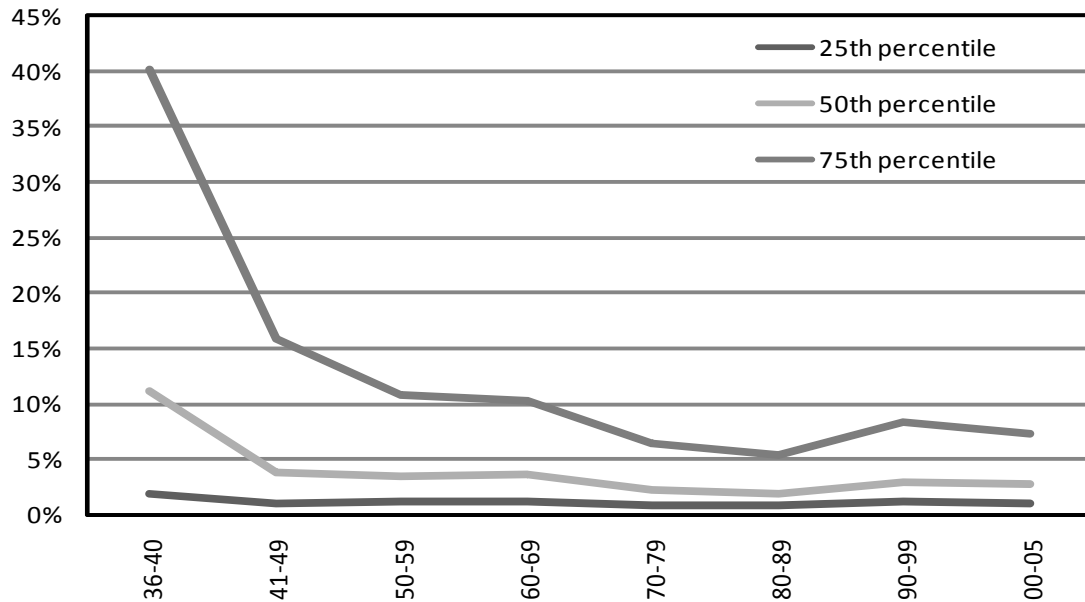
<sup>7</sup>Quoted in Brandeis (1913, p.223).

taxed at 35% in the initial payer’s corporate income tax and at 7% in the corporate income taxes of successive recipients if the recipient’s stake is less than 80%. Large stakes eliminate the tax. Virtually all other countries exempt intercorporate dividends – either entirely or if the recipient has a minimal block, such as 20%, in the payer.<sup>8</sup>

Figure 2 documents the decline of control blocks as a fraction of shares outstanding in the increasingly widely held US economy. The recent upsurge in insider stakes likely reflects executive stock options.

**Figure 2. Declining Insider Control Blocks in US Firms**

Percentiles are for mean combined holdings of the three highest paid insiders. Sample is the 50 largest listed firms, ranked by market capitalization, in 1940, 1960, and 1990, with a mean 5-year window sample size of 76 firms.



Source: Frydman and Saks (2007).

Until the late 1980s, America’s market for corporate control resembled Britain’s: raiders acquired ill-run firms sufficiently often to constitute a pressure for good governance (Jensen & Ruback 1983). Underperforming targets’ ex-CEOs seldom attained top jobs again (Agrawal & Walkling 1994), most (though not all) mergers created value (Morck et al. 1990), and merged firms’ operating performance improved (Healey, Palepu, and Ruback, 1992; Andrade, Mitchell, and Stafford, 2001).

Subsequently, takeover defenses proliferated: poison pills (Davis 1991), classified boards (Bebchuk & Cohen 2005; Faleye 2007), and state anti-takeover laws (Bebchuk & Cohen 2003). Using these is largely a CEO’s choice, and performance sags in shielded firms (Gompers et al. 2003; Lucian et al. 2009). Now, most mergers are ‘friendly’, with target CEOs who lower takeover defenses receiving golden parachutes (Mikkelson & Partch 1997; Hartzell 2004) and most mergers destroying value (Moeller et al. 2005).

<sup>8</sup> One exception is South Korea, which has large business groups, yet levies a small tax on intercorporate dividends. Italy briefly levied such a tax, and then abolished it with no apparent effect on pyramiding (Aganin & Volpin 2005). French and Belgian attempts to levy such taxes ended with the European Commission’s Parent-Subsidiary Directive, which forbids the taxation of intercorporate dividends within the European Union. For details, see Morck (2005).



Criticism of these developments (MacAvoy & Millstein 2003) and several prominent governance scandals precipitated the widely panned Sarbanes-Oxley Act, which imposed internal accounting and reporting standards and restated CEOs' responsibility for the books (Romano 2005). This failed to prevent a spate of major bank failures a decade later. While banking crises are more than governance failures, something is amiss when leading banks lose fortunes in Ponzi schemes.<sup>9</sup>

As takeover pressure wanes, substitutes arise. Some institutional investors now denounce underperforming management, perhaps spurring improvement (Gompers & Metrick 2001). However, corporate pension trustees are usually appointed by sponsoring firms' CEOs, and public sector pension trustees are usually political appointees. Both systems induce conflicts of interest that blunt pension funds' efficacy as governance champions (Romano 1995). In contrast, British pension trustees typically have clear duties to beneficiaries, whose retirement incomes are at risk (Black & Coffee 1994). Consequently, pension funds' role in American corporate governance is murkier.

### **2.3 Other Common Law Countries**

America and Britain are now economies of freestanding firms, not business groups; and most large firms in both lack controlling shareholders. America and Britain are sometimes taken as representing a broader category of countries with legal systems based on British Common Law, but this is incorrect. While diffuse ownership is slightly more familiar in other Common Law countries, control blocks and pyramiding both persist too (La Porta et al. 1999). We therefore examine other Common Law countries before looking farther afield.

#### **Canadian Corporate Governance**

Canada has a Common Law legal system for the most part. The country was a French colony from 1608 to 1759, and a variant of French Civil Law largely persists in Québec, though not for Corporations Law. The mixed heritage also affects politics: compared to America and Britain, Canada's government is more interventionist (Porter 1965), and Canadians may tolerate more corruption in government and business (Francis 1988).<sup>10</sup>

Family controlled pyramidal groups comprise about forty percent of the assets of domestically controlled private sector firms among the top 100 in the mid 1990s – about the same fraction as a century earlier (Morck et al. 2005). Although different business families enter and exit, about ten typically control most or all of the pyramidal group firms at any point in time.

Canada's big business sector escaped the transformations that remade many British and American big businesses into diffusely owned professionally managed freestanding firms. Figure 3 shows something more interesting: pyramidal groups wane steadily until the 1970s, and then resurge dramatically.

Although its Great Depression was as severe as in America, Canada had no New Dealers like Berle and Means. It launched no attack on business groups; but energetically fought deflation with state-enforced "price stabilization" cartels (Bliss 1987). Business groups were partners, not foes. Intercorporate dividends remain tax exempt if the parent holds 20% or more of the subsidiary, and public utilities remain prominent in large pyramidal groups. Large shareholders could hold any stake they like without triggering a mandatory bid for 100%.

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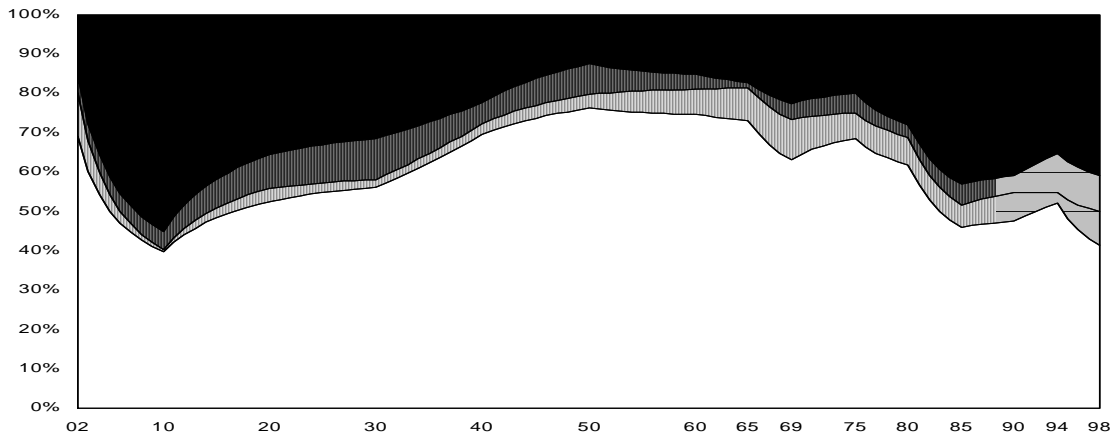
<sup>9</sup> Bernard Madoff's \$50 billion Ponzi scheme, exposed in 2008, listed among its major "investors" J.P. Morgan Chase, Bank of America, and Citigroup. See "Madoff Client List Is Disclosed in Filing" *Wall Street Journal* (electronic edition) Feb. 5<sup>th</sup> 2009.

<sup>10</sup> This section draws heavily from Morck et al. (2005).

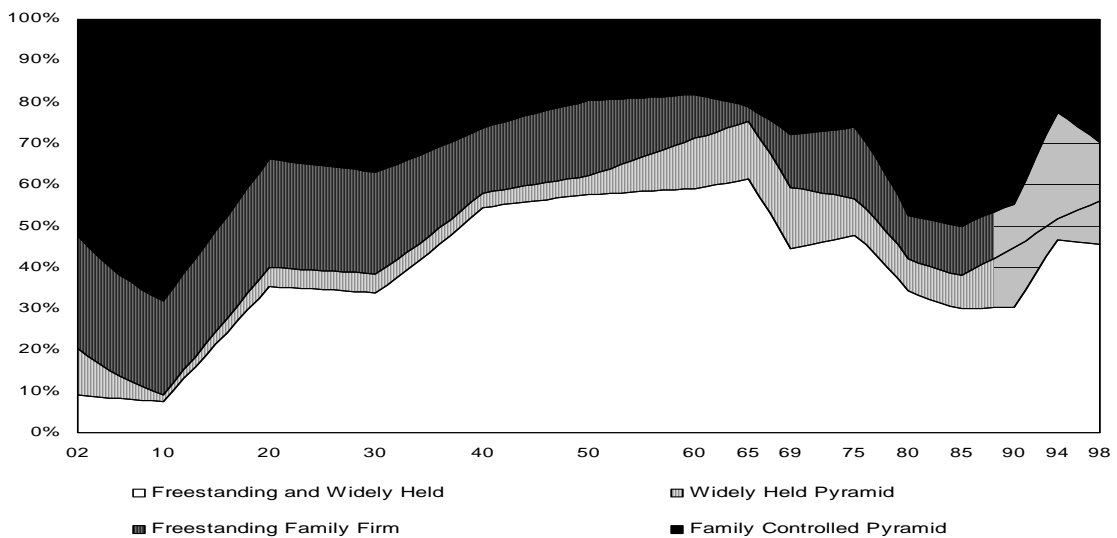
### Figure 3. Evolution of Control

The importance of different categories of controlling shareholders in the top 100 firms from 1902 to 1998, weighted by total assets and by number of firms. State-owned enterprises, multinational subsidiaries, and firms whose control is unclear are excluded. Data from 1965 on are from Statistics Canada, and include complete pyramiding information. Group membership in earlier years is inferred from director interlocks and corporate or business family histories. Consequently, earlier data may be incomplete.

Panel A. Asset Weighted



Panel B. Equally Weighted



Source: Morck et al. (2005).

What then explains the erosion of pyramiding in century's first half? Shareholder rights did not, for few or none of those La Porta et al. (1998) enumerate were enacted until the 1960s. It is tempting to argue that the rise of middle class shareholders led to these rights, but scams based in Canada that targeted US investors were the proximate cause. American pressure led Ontario to empower a provincial securities commission and establish disclosure rules (Armstrong 2001).<sup>11</sup>

<sup>11</sup> The other provinces have relatively powerless securities commissions, and the federal government remains aloof, despite unambiguous constitutional jurisdiction. Financial markets and institutions gravitated to Ontario, whose Securities Law now has a status similar to Delaware Corporations Law. Federal securities law is under consideration.

Some business families sold out into the 1920s boom, others lost their empires in the Depression; but a substantial inheritance tax was also a major factor (Morck et al. 2005). Heirs sold much or all of their fathers' business groups to pay this tax, and patriarchs bequeathed wealth to charities to preempt it. Although we lack definitive evidence, equity issues to finance takeovers likely also eroded control blocks.

Certainly, merger waves swept the country in the gilded age and the 1920s (Bliss 1987; Walid & Paul 2006)). Common Law principles and precedents gave shareholders substantial rights during takeovers. As in Britain, their right to replace directors precludes staggered boards; and the principle of equal treatment across shareholders emasculates poison pills. Takeover threats may well discipline professional managers running widely held firms, for target CEOs are clearly at risk in takeovers (George & Bin 2007).

The resurgence of pyramidal groups after the late 1960s is more intriguing. The 1940s and 1950s saw neither radical Labour governments, nor powerful pension funds, nor a takeover law like Britain's disrupting business groups. Acquirers remain free to bid for as much of a target's stock as they want.

But the 1960s brought an existential crisis. Québec's *révolution tranquille* brought francophone intellectuals national prominence, and real political power; the *front de libération du Québec* took to bombing, kidnapping and murder; and Québécois support for "sovereignty" (though not independence) grew. Prime Minister Pierre Eliot Trudeau, a Civil Code law professor, responded with aggrandized Canadian nationalism, official bilingualism and biculturalism, and overt emulation of continental European corporatism (Nemni et al. 2006) with huge federally funded social programs, high taxes, and extensive business subsidies (Swatsky 1987). This had several seemingly unintended consequences for corporate governance.

Nationalist rhetoric focused negative media attention on foreign acquisitions, and ultimately begat federal anti-foreign takeover laws (especially for media firms) and tax advantages for locking in Canadian control. Large pyramidal groups controlled by Canadian families could thus bid more for control blocks, perhaps inducing an expansion of pyramiding.

In 1972, Prime Minister Trudeau repealed the federal inheritance tax. Although revised rules trigger capital gains upon death, trusts can shield large estates for up to two generations. This eviscerated a key pressure on pyramidal groups in previous decades – inheritance taxes. Although we lack explicit confirmation, this reform was plausibly designed to solidify business families' control blocks.

After 1975, all acquirers (foreign or domestic) buying over 20% had to extend the offer to all shareholders, and prorate the purchase across the block seller and all interested public shareholders (though numerous exemptions exist). This lets astute small shareholders participate in control block sales; but also leaves block sellers with leftover public shares, cuts their proceeds from selling out, and thus impedes control changes.

This era's massive state intervention made political connections indispensable business assets (Swatsky 1987), and the business groups' controlling families were very well-connected (Morck et al. 2000a). Business families' political connections, their groups' relative opacity, and economies of scale in lobbying may disadvantage freestanding diffusely owned firms in such an economy (Högfeldt 2005).

Finally, courts, exchanges, and legislatures are increasingly ambivalent about shareholder rights. Canada has convicted no-one for insider trading (Bhattacharya & Daouk 2002). Insider trading is probably not unknown, for takeover targets exhibit a large price run-up prior to the announcement day, and little or no change on that day itself (Eckbo 1986; Bris 2005). Shareholder derivative lawsuits are possible, but suing hired CEOs misses the point if the problem is a pyramidal business group's controlling shareholder (Griggs & Lowry 1994). An

oppression remedy (Anisman 1987; Kerry Shannon 2002), developed as case law and later encoded, lets public shareholders reach up a chain of control to sue a group's controlling shareholder. But, a recent Supreme Court ruling redirects directors' fiduciary duties to the legal person of the corporation, explicitly obviates duties to shareholders and stakeholders, and diffuses the oppression remedy by opening it to all stakeholders.<sup>12</sup> Exchanges and regulators value their relationships with listed firms: disclosure is "comply or explain", and annual reports are thickets of footnotes arguably obscuring more than they reveal (Allen et al. 2007; Hockin et al. 2009). Ontario's remains the only somewhat active securities commission (Armstrong 2001).

America's proximity is of ambiguous value. Its courts prosecute an occasional Canadian tycoon (Paris et al. 2004), but Canadian firms predominate among cross-listings in America (Doidge et al. 2004), and entrepreneurs often do initial public offerings there exclusively, since valuations are typically higher there than on any Canadian exchange (King & Segal 2008).

### **Indian Corporate Governance**

India, even more than Canada, entrusts its great business to wealthy families.<sup>13</sup> The Tata family, of priestly Parsi origin, runs India's greatest pyramidal group. Close to the colonial government, they grew wealthy behind the Imperial tariff. That proximity became a liability after independence in 1947. The Tata group not only survives, but retains top rank.

Jawaharlal Nehru's Congress party took charge, and the Tatas were eclipsed by the Birla family – of Marwari descent. The Birla's financed both Mohandas Gandhi and the Congress Party generously – provoking the poet Sarojini Naidu's alleged quip "it took all Birla's millions to enable Gandhi to live in poverty" (Khanna & Palepu 2005). The Birla adroitly built a vast new pyramidal business group that, by 1969, was India's second largest.

The histories of both business groups suggest government ties underlay their early success. However, business groups might also possess genuine economic advantages in emerging markets (Ghemawat & Khanna 1998). Either possibility aligns with evidence Indian group firms outperform (Khanna & Palepu 2000c).

Nehru led India into socialism, though private business continues beneath a regulatory maze of regulation – the License Raj. Nehru's motive, partly at least, was large business groups' evident monopoly power. His daughter, Indira Gandhi, built the License Raj higher and denser.

Ironically, neither apparently grasped how regulation becomes an entry barrier (Djankov et al. 2000), for the large business groups soon ran virtual "embassies" in New Delhi, staffed with former officials familiar with every nuance of the bureaucracy. Smaller businesses, and potential upstart businesses, without such resources, were at the mercy of growing legions of increasingly corrupt and inept bureaucrats (Das 2000). The License Raj almost certainly concentrated growth opportunities, capital, and labor within the business groups.

In a seeming *entente* with Congress, the *Bombay Plan*; Tata, Birla and business family patriarchs "called on government support for industrialization, including a direct role for the government in the production of capital goods, foreshadowing post-independence Indian planning, typically considered an outgrowth of socialist ideas drawn either from the Soviet Union or the so-called Fabian socialists" (Mody 2005). Perhaps the families realized the advantage extensive state intervention accorded them, even if Congress officials did (or pretended) not. Others argue the families foresaw Congress policies and sought to make the best of a bad situation (Khanna & Palepu 2005).

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<sup>12</sup> *Ibid.*

<sup>13</sup> This section draws heavily from Khanna and Palepu (2005).

By the mid-1980s, the License Raj yoke grew unbearable, and a slow deregulation began, accelerating after a 1990s financial crisis. Throughout, Khanna and Palepu (2005) show the Tata and Birla groups remaining dominant, while smaller pyramidal groups rose and fell. Thus, while business groups as an organizational form persisted, many individual ones, especially smaller ones, did not.

Much work on Indian business groups, especially the Tatas, argues they aid growth by bridging institutional voids due dysfunctional markets and corrupt courts (Khanna & Palepu 2000a, b, c). However, other work detects extensive wealth transfers from listed group firms to controlling families (Bertrand et al. 2002). The groups' net contribution to growth is unclear.

### Others

Other Common law economies tend to resemble Canada, pre-1920s America, or India, not America and Britain. Australia (Gillooly 1993; Kluver 2000), Israel (Daniel 1999, 2002; Kosenko & Yafeh 2009), Hong Kong (Cheung et al. 2006; Claessens et al. 2006), Pakistan (Ikram et al. 2005), Singapore (Tsui-Auch & Toru 2009), and South Africa (Goldstein 2009) retain pyramidal business groups. The Anglo-American freestanding, professionally managed, widely held firm has yet to become prevalent conquer in most Common Law countries.

Generalizing from these accounts, we postulate that Common Law countries in the early 20<sup>th</sup> century shared a common governance regime of powerful tycoons or business families governing large, mostly pyramidal, business groups; which differentiated as different countries responded differently to major crises.

## 2.4 Latin Model

A century ago, countries with legal systems derived from France's Napoleonic Code boasted financial systems as dynamic as America's or Britain's (Rajan & Zingales 2003); and France, in many ways, had more sophisticated business laws than America (Lamoreaux 2005).

Interwar hyperinflations and the Great Depression uniquely devastated the European middle class (Perotti & von Thadden 2006). The 1917 Bolshevik Revolution transformed the Russian Empire into the Soviet Union, committed to exporting socialism to faltering European democracies. Different parts of Europe responded differently to these crises.

Italy's institutions softened first, and Benito Mussolini reshaped them into a model imitated throughout Southern Europe, Latin America, and even the Muslim world. Mussolini's *Fasci Italiani di Combattimento* (Italian Combat Band) rejected class for national solidarity, and adopted Corporatism as economic policy.<sup>14</sup>

Proposed by 19<sup>th</sup> century literary critic Adam Müller (1807), championed by Pope Leo VIII, and made official Catholic social doctrine under Pius XI, Corporatism envisioned industrial organization inspired by medieval guilds.<sup>15</sup> Economies were to be divided vertically into *Corporations* – one for each major industry – rather than horizontally into classes. Each corporation had state-enforced cartel rights, with pious Catholics fixing wages and prices. Workers deserved “fair” wages and owners deserved absolute loyalty.

This doctrine seemed to Rome a safe passage between the “twin evils of liberalism and socialism”, and the clergy had already induced broad popular support for it (Fanfani 1935). All Mussolini did was to put loyal Fascists, rather than pious Catholics, in charge of the Corporations.

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<sup>14</sup> *Fasci*, bundled sticks, represented “strength through unity” in ancient Rome.

<sup>15</sup> First articulated in Leo's 189X *Encyclical Novum Revaram*, Corporatism became Vatican doctrine in Pius' 1931 *Quadragesimo Anno*.

## Italy

Italy industrialized rapidly from 1895 to 1907.<sup>16</sup> Banks served as holding companies for groups of industrial firms, often organized as pyramids, but augmented by extensive cross holdings and supervoting shares. The Panic of 1907 ended this boom, and “a general market perception that universal banks and managers like Agnelli used the investment boom to pump and dump their shares” (Aganin & Volpin 2005) cut public shareholders’ valuations thereafter, as did corporate and personal dividend tax hikes (Aleotti 1990).

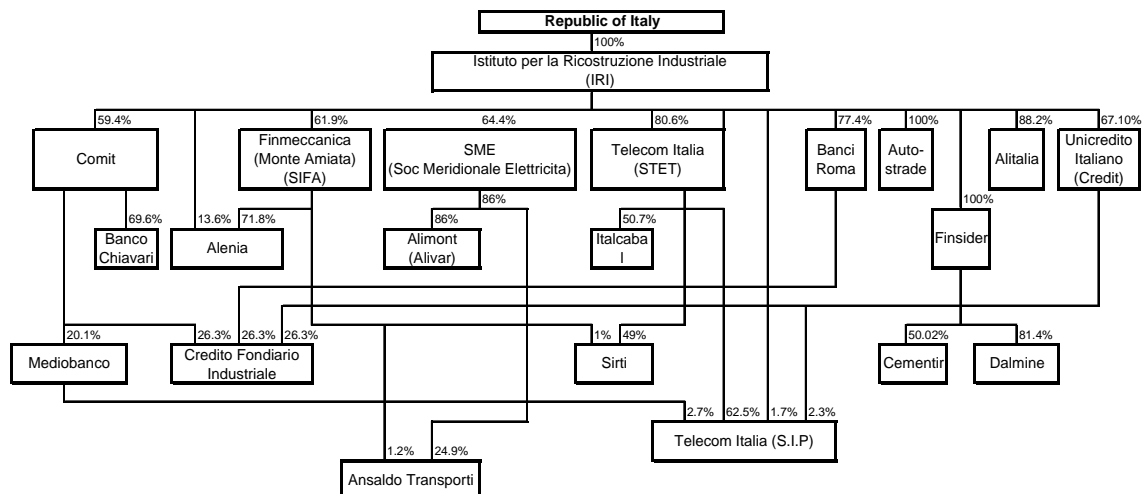
Two waves of bank failures – one culminating in 1924 and another in the Great Depression, presented opportunities for Mussolini. The Fascist State bailed out failing banks, accumulating hugely depreciated industrial shares in state-controlled “autonomous” investment firms – *Societa` Finanziaria Industriale Italiana (Sofindit)*, *Istituto Mobiliare Italiano (IMI)*, and *Istituto per la Ricostruzione Industriale (IRI)*. These became apex SOEs of new pyramidal groups containing key industrial firms that survived until the 1990s. Figure 3 graphs the largest, IRI, as of 1987.

This neatly preserved a fiction of private ownership, for the firms remained listed limited companies. But chains of control ultimately led to SOEs, cementing Party control over the economy. Since these groups contained the country’s major banks, other firms entered the Corporatist circle – some enthusiastically, others for fear of losing access to capital. Where this failed, militia and state violence succeeded.

Central economic control was necessary to lock in Fascist political control and coordinate investment and wage and price fixing across Corporations. Perhaps because Party control relied on shareholdings, shareholder rights developed (Aganin & Volpin, 2005, p. 332). Fascist reforms improved shareholder protection, forbade banks from owning nonfinancials’ shares, enhanced disclosure, and simplified pyramidal groups by stripping certain crossholdings of voting rights.

**Figure 3. Istituto per la Ricostruzione Industriale (IRI) in 1987**

**The IRI, a state controlled pyramidal business group constructed by Mussolini, remained a fixture of the Italian economy until the 1990s, when it was broken up and its component firms were privatized.**



Source: We are grateful to Paulo Volpin for providing the data used in assembling this diagram.

<sup>16</sup> This section draws heavily on Franks et al. (2005).

These rules affected all limited liability firms, listed or private, and remained on the books until 1974. In practice, postwar exchanges and firms set their own standards, and a lowest common denominator prevailed. Edison, Pirelli, and Snia Viscosa did not even disclose sales. This changed in 1974 with the creation of an SEC analog, the *Commissione Nazionale per le Società e la Borsa (CONSOB)*, to supervise augmented disclosure requirements for listed firms and reforms mandating the disclosure of stakes above two percent, legalizing nonvoting shares, and (a year later) mandating external audits. This mixed bag prevailed until 1990s reforms brought European Union harmonization, consolidated business group balance sheets, and detailed ownership structure disclosure.

In 1991, Italy adopted an anti-combines law, and in 1998 forbid managers from opposing takeovers without shareholder approval. In 1998, roughly three fourths of the large corporate sector had controlling shareholders – business families or state organs – so managers disobeying shareholders was not a major problem.

Also during the 1990s, a mass privatization dismantled the state controlled groups Mussolini established (and postwar politicians augmented). Italy came full circle. With only the Agnelli group persisting, new groups recreate the model of a century ago.

### **Corporatist Corporate Governance**

The Italian model attracted worldwide interest as a genuine “third way” – evading the harsh creative destruction of liberal capitalism and the class conflict of socialism; and leaving traditional national elites secure. Catholic Corporatism was soon adopted by Austria’s theocratic dictator, Engelbert Dollfuß; Spain’s Falangist dictator, Francisco Franco; and Portugal’s Estado Novo dictator, António de Oliveira Salazar. All attracted Catholic support by stressing their obedience to Corporatist papal teachings, and secular support by stressing their respect for Italian Corporatism. One by one, interwar dictatorships adopted Corporatism in Estonia, Latvia, Lithuania, Poland, and the Balkans. Atatürk’s Turkey drew inspiration from the Corporatist model, and Arab Nationalist movements even adopted the Falangist name in the Levant. Marshal Petain brought a staunch Catholic Corporatism to Vichy France; and country by country, Latin America exchanged democracy for Corporatist dictatorships on the Falangist model.

The common theme across these otherwise quite different countries was a vertical organization of the economy into officially designated *Corporations*, or vertical production chain cartels (Sorel 1908; Duguit 1923; Mussolini 1936). Great store was put upon the high ethical or spiritual qualifications of the wise men appointed by the State, though often with input from owners and official labor representatives, to administer these Corporations. These stewards of a Corporation were charged with safeguarding the spiritual and temporal wellbeing of the owners and workers of all firms in its chain of industries. To do this, they were empowered to set all prices and wages relevant to those firms at “just” levels, control entry, and call upon the police powers of the State to punish competition. Entry and competition were thus effectively both not just outlawed, but rendered immoral, for these threatened the temporal and spiritual welfare of workers and owners alike. Nation-building directed by the benevolent dictator was, of course, the ultimate unifying goal of the Corporatist State, and the dictator determined how the Corporations worked together towards national prosperity and greatness.

Financial markets, especially, were roundly condemned – by both religious and secular fascist rulers, as nests of unethical speculation. Moreover, financial markets were now unpleasant relics. With entry essentially controlled by the incumbents in each Corporation, there was need for neither initial public offerings nor share issues by established firms. The Corporations’ control of entry prevented entry, precluding a need for initial public equity

offerings, fixed wages and prices made retained earnings a reliable source of profit for incumbents.

Under these conditions, the directors and officers of individual business corporations and member firms in pyramidal corporate groups became subservient to the Corporations to which their firms belonged. The share price was genuinely unimportant, as were developing new technologies, entering new markets, or designing new competitive strategies. Directors and officers were cogs in the workings of a Corporation.

After World War II, Corporatism persisted in Iberia (Zaratiegui 2004; Acena and Comin 1995), Latin America (Morse 1964; Veliz 1979; Wiarda 1974), Turkey (Parla and Davison 2004), and the Arab world (Jaber 1966). In Western Europe, the doctrine's totalitarian roots were forgotten, and Corporatist institutions found their way into both Social Democratic and Christian Democratic agendas. Freestanding, professionally managed, or widely held firms remain the rarest of curiosities in these countries. Thus, old-moneyed family controlled pyramidal groups dominate big business in most onetime Corporatist economies: continental Europe (Barca & Becht 2001; Faccio & Lang 2002), Argentina (Fracchia et al. 2009), Brazil (Da Silveira et al. 2007; Rogers et al. 2007), Chile (Khanna & Palepu 2000), Mexico (Hoshino 2009), Taiwan (Chung & Mahmood 2009), Thailand (Bertrand et al. 2008; Suehiro & Wailerdsak 2009), and Turkey (Hakan & Yurtoglu 2006; Melsa & Yurtoglu 2006; Colpan 2009); augmented by occasional SOEs and, very rarely, widely held firms – usually recently privatized SOEs.

With some exceptions, Corporatism ran deepest in Catholic countries, whose legal systems also usually derive from the Napoleonic Code. We posit a Corporatist legacy of hierarchically organized economic activity, pervasive cartelization, and an ethical opprobrium for markets underlying findings linking French legal origins to family controlled pyramidal groups (La Porta et al. 1999), weak investor protection (La Porta 2000; Djankov et al. 2008), small lethargic stock markets (La Porta & et al. 1997), low market valuations (La Porta & et al. 2002), barriers to entry (Djankov et al. 2000), and pervasive distrust for market solutions (La Porta et al. 2008)

## **France**

The French experience illustrates the strains afflicting Corporatist corporate governance over the longer run. Postwar France remained essentially Corporatist through its three decade postwar reconstruction boom, *les trente glorieuses* (Fourastié 1979). Although the state nationalized numerous firms, especially public utilities, most firms remained privately owned. However, bureaucrats orchestrated labyrinthine taxes and subsidies that largely determined the capital investment budgets of every large firm. Cartels remained legal, though competition was permitted. Industry associations representing owners and workers still set prices and wages in accordance with national policies conveyed by government representatives.

In retrospect, Corporatism may suit postwar reconstruction. Innovation is not a priority, and existing companies know how to rebuild their physical capital. The security Corporatism provides workers may be genuinely valued after the trauma of war and interwar crises. However, the system proved less adept at maintaining French prosperity after reconstruction, when further growth required innovation.

Most French officers and directors were former officials, usually from the government bureaucracy regulating the firm's industry. Most officials, and hence most corporate officers, attended five elite schools – *les grandes écoles*. Their graduates, mostly from upper middle class backgrounds, formed a tight network governing the State and large businesses – public and private sector, listed and unlisted. Sociological research confirms that corporate governance



remains entrusted to this small and tight elite (Kramarz & Thesmar 2007). This enshrined elitism attracts growing criticism.

A listed firm is run by its *Président Directeur Général* (PDG), who is seldom challenged by the directors, whom he appoints and shareholders merely confirm. The PDG effectively appoints his own successor. The directors have leverage over older PDGs, for boards can waive mandatory PDG retirement at 65. Shareholders interference in governance is not expected.

The PDG typically chairs the board, and independent directors are unnecessary, though recent guidelines recommend them. Independent directors come from the same tight network, making genuine independence problematic. Committees are not mandatory, though new guidelines recommend audit, nominating, and compensation committees with independent members. Directors have no specific legal duty to shareholders.

Firms have *works councils*, or *comités d'entreprise*. These contain labor representatives and may veto policies affecting workers. Often, such policies are negotiated at the industry level and then approved by firms or plants. Rigid labor laws enshrine basic job protection, benefits and social programs; but many entitlements remain Corporatist legacies – varying across industries, inapplicable to entrants, and not portable across jobs. This provokes charges that France is an economy of entitled insiders – managers and workers – and powerless outsiders – immigrants and the young.

As in other Corporatist legacy countries, price fixing has long been accepted. Resulting rents flow to privileged stakeholders – employed workers, controlling shareholders, and perhaps the State – at the expense of others – consumers and perhaps shareholders (Roe 2003). Large controlling shareholders may persist because these rents augment other private benefits of control. European Union anti-combines reforms threaten these rents, and thus may erode concentrated corporate control.

Another issue is the sustainability of France's intensive taxes and subsidies, and state-selected winners. Markets solutions remain politically unpopular to a degree foreigners have difficulty comprehending. Murphy (2005) explains this as path dependence: most countries suffer periodic financial crises, but the 1720s Mississippi Bubble, a post-Revolution financial collapse, bouts of hyperinflation, and high profile banking scandals left France uniquely traumatized. Kindleberger (1984, p.99) writes that such events “embedded paranoia about paper money and banks more deeply in the French subconscious.” Murphy (2005) describes periodic crises leaving French savers quite literally burying coins in their gardens as Britain developed banks and stock markets. Kindleberger (1984, p. 113) concludes “France lagged behind Britain in financial institutions and experience by a hundred years or so”. French businesses grew with retained earnings, and business families retained control generation after generation. These attitudes remain conducive to Corporatism.

French Civil Codes preserve ownership concentration by making it virtually impossible not to bequeath a family business to one's son. French tycoons with families could not leave their fortunes to charities, in marked contrast to other Civil Code economies, such as like Denmark (Thomsen & Rose 2004), which encourage this. Landes (1949) argues that France fell behind Victorian Britain because family control kept large French corporations conservative and reliant on government connections.

How financial trauma affects financial development is insufficiently explored. Psychologists have only the vaguest understanding of why similar traumas can shatter one individual, yet barely affect another. Given the Depression Era provenance of the institutions that shape corporate governance now, and the current financial crisis, economists need a deeper understanding of how economic trauma shapes institutional development.

## 2.4 German Corporate Governance

Germany differs from most of the rest of continental Europe in two fundamental ways. Germany's Civil Code differs fundamentally those of French derivation; and Germany accords workers and banks genuine corporate governance influence – at least potentially.<sup>17</sup>

Germany's Civil Code is justifiably called a distinct “legal origin” in the Law and Finance literature (La Porta et al. 1998), despite its borrowings from the Code of Justinian and Napoleonic Code. Germany was a region, not a country, until Bismarck united its numerous principalities in 1871. Each microstate had a legal system – some mixture of Roman Imperial law, Canon Law, French Civil Codes, and Germanic traditions. A unified Civil Code, the *Bürgerliches Gesetzbuch* (BGB), would unify the nation by harmonizing local legal systems.

This contrasts starkly with the Napoleonic Code, based on what Seagle (1946, c. 18) calls French jurists' “strange delusion” that the Law was “not only discoverable but immutable, it could be reduced to a permanent body of rules, known and accessible to all and sundry, and would never be in need of change.” Indeed, §4 criminalized denying this: “The judge who shall refuse to render decision under pretext of the silence, obscurity, or insufficiency of the law is to be prosecuted as guilty of denial of justice.”

The BGB has no such delusion. Though long, precise, and ‘scientific’; it mentions “requirements of good faith, giving consideration to common usage” (§157 for contracts; §242 for debts) and instructs “that in construing legal texts the true underlying intention and not the literal meaning of the words should prevail” (§133). These sections echo British Common Law principals that shield a defendant who, for example, acted like a “reasonable man” and Common Law juries that weigh the spirit of a law, not its letter.

The second great difference between Germany and most other countries is Germany's tradition of stakeholder rights in corporate governance, design by Bismarck to preempt democracy (Bismarck 1898; Meerhaeghe 2006). The 1870 Company Law gave each large listed company two boards – a *supervisory board*, or *Aufsichtsrat*, of shareholder representatives charged with setting broad strategic goals and a *management board*, or *Vorstand*, of top corporate officers charged with implementing those goals. The 1884 Company Law forbade anyone sitting on both boards, and assigned supervisory board members a “duty to become informed”. In the two decades before World War I, managerial turnover was sensitive to firm performance, suggesting some form of disciplinary governance mechanism. Firms listed in Berlin were reputed more widely held, and also appear to have ousted underperforming top managers more readily. In short, Germany looked like other countries.

Banks also played a more direct role in capitalizing industrial firms than in Britain, for Germany was catching up. Industrialization was by then a well beaten path. Capital needs and earnings were foreseeable, making bank financing more viable (Kleeberg 1988). Nonetheless, the Second Reich (1871 – 1918) was a liberal era: families and banks operated a dual system of corporate oversight in an essentially competitive economy (Fohlin, 2005).

Under the Weimar Republic, control blocks apparently eroded, and controlling families adopted a variety of takeover defenses, notably dual class shares and voting caps on non-family shareholders. Pyramiding was likely also used, but is hard to detect because large shareholders could remain anonymous. Fohlin (2005) shows business families more important through these decades, and banks less, than generally realized.

In contrast, labor's importance is undisputed. Bismarck built the world's first social safety net in the late 19th century, thinking enhanced workers' economic security would blunt

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<sup>17</sup> This section draws heavily from Fohlin (2005). We thank Katharina Pistor for information about the German Civil Code and its operation. All errors are the authors'.

their demands for democracy and social mobility, which he considered profoundly dangerous (Ashley 1912).

Germany endured a triple crisis in the first decades of the 20th century: Its defeat in 1918 discredited traditional institutions, opening doors for pro-Soviet agitators. A subsequent hyperinflation destroyed savings, leaving the middle class entirely dependent on wage and job security (Perotti & von Thadden 2006). The Great Depression undermined both.

The Weimar Republic's *Arbeitsgemeinschaft*, or "workers' corporation" system gave Socialist labor unions real influence over wage and price setting fixing. But the prolonged economic disaster triggered civil disorder. With private militias in the streets, a minority government fell and Adolf Hitler's National Socialist German Workers' Party (Nazis) took power.

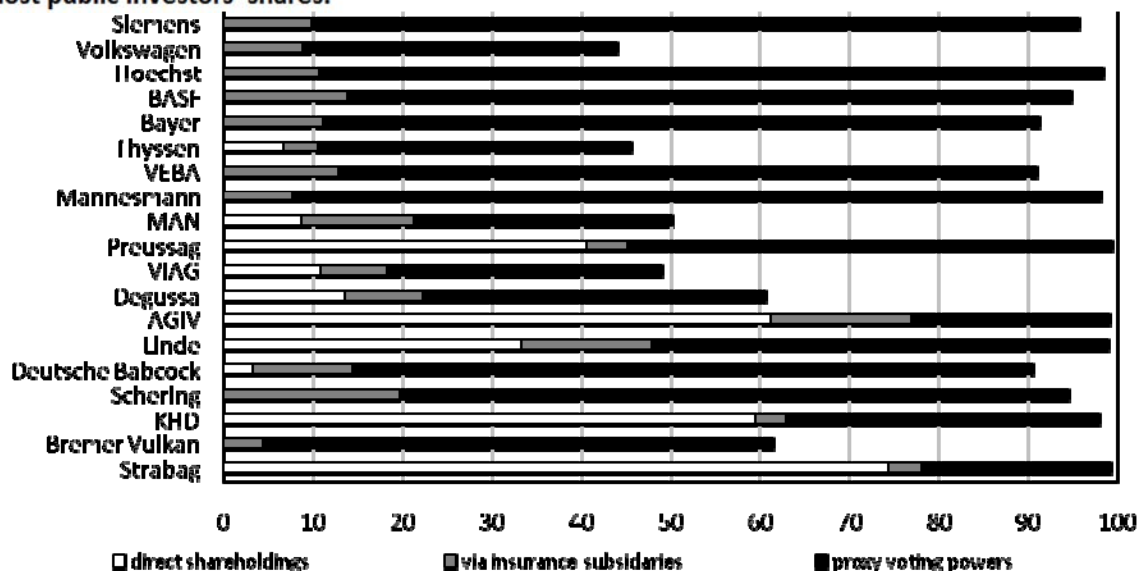
Seeking support from nationalists and industrialists, Hitler preserved private ownership, using the banks to cement Party control over industry. Germany's 1897 Company Law undermined stock exchanges, driving equity trading inside large banks, which held small investors' shares in trust. To ensure quorums at shareholder meetings, the banks obtained proxy voting rights over many of these shares. Hitler put Nazis in charge of the banks, banned voting by mail, and assigned default proxy rights to the banks. Previously passive public shareholdings became Nazi voting blocks.

The Party now appointed most large firms boards, but directors' duty remained to shareholders. To sever this, the Nazi's took the vertical organization of Corporatism to a unique extreme. The 1937 Shareholder Law freed officers and directors of a duty to shareholders, substituting one to stakeholders – especially the Reich. Under the new *Führerprinzip* or *leader principle* – workers obeyed managers, who obeyed Party officials, who obeyed the Führer.

The wartime government established much of what still makes German corporate governance distinct. After 1945, the banks became banks again; but diffuse stakeholder rights and proxy voting by banks persist.

**Figure 4. Major Banks' Voting Power in Major Nonfinancial Firms**

Banks voting power in shareholder meetings consist of there directly owned shares, the shares of bank subsidiaries or affiliates (primarily insurance companies), and banks' proxy voting rights over most public investors' shares.



Source: Baums (1998).

Figure 4 illustrates - the big banks own no shares in Siemens, a large industrial firm, though their insurance subsidiaries own a combined 9.87%. However, the banks vote a further 85.81% of Siemens' stock as small shareholders' trustees, bringing their combined total voting power to 95.48%. The figure shows top bankers' immense potential corporate governance influence over many large firms, and de facto sovereignty since they collectively vote majorities of their own shares.

Postwar codetermination again gave labor leaders real input, letting them select half the supervisory boards of large firms – though (Roe 2003) argues this simply shifted decisions out of the supervisory boards. Reforms in 1965 abolished the *Führerprinzip*, but retained a generalized duty to all stakeholders and also required that banks have written permission to vote proxies and inform shareholders of how they voted – however this was readily countered by having investors sign away voting rights in the banks standard forms. Further reforms in 1998 abolished voting caps, and affected firms' stock prices rose sharply.

Pyramiding expanded after the war, possibly to strangle a nascent market for corporate control. Households, owning 48.6% of all shares in 1950, held only 17% by 1996 – even as intercorporate equity holdings rose from 18% of all shares in 1950 to 41% in 1996. German corporations thus belong to large business groups, but those built around big banks differ from pyramidal groups in other countries in that the banks wield control by voting shares actually owned by small investors.

Modern German family controlled pyramidal groups, of course, resemble similar structures elsewhere. Germany's *Mittelstand* – its small and medium sized firms – tend to be multigenerational family firms, in which bank control is less evident. Smaller firms can also avoid the codetermination requirements mandated for large firms. However, even modestly large firms must have a *works council*, or *Betriebsrat*, or several if the firm operates in multiple locations. These have great power, for they vet decisions that affect labor – including hiring and firing.

Recent events may be changing this system. Very high capital gains taxes previously deterred control block sales, but tax reforms have changed this. Banks can now sell shares they own directly, but these reforms leave their proxy voting powers untouched. A more jarring change was Germany's first hostile takeover – by Vodafone, a UK firm, of Mannesmann. Originally, the widely held Mannesmann's managers ignored Vodafone's hostile tender offer because the bankers assured them they would vote with management. Vodafone launched a major advertising campaign, explaining to German shareholders how much money their banks' decisions were costing them. Public outrage forced the government to force the banks to flip-flop, and the shareholders approved the takeover. The banks must now erect Chinese Walls around proxy voting decisions, and some argue the banks might best shed this responsibility.

Fohlin (2005) summarizes the above history as “a string of disastrous political institutions and movements in the aftermath of World War I, culminating in the Nazi regime, [that] dismantled the rich, highly functioning, hybrid financial system of the Second Reich. The post-war political and legal climate, one that continues to suppress the liberal tradition of the pre-World War I era, seemingly prevents the old dual system from reemerging.”

## 2.5 Scandinavian Corporate Governance

Swedes are justly proud of their egalitarian income distribution, yet the country has perhaps the least egalitarian system of corporate governance among industrialized countries.<sup>18</sup> One large

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<sup>18</sup> This section draws heavily from Högfeldt (2005).

pyramidal group, controlled by the Wallenberg family, accounts for about half of total market capitalization, and a few others account for most of the rest.

Högfeldt (2005) describes how this contradiction arose during the Great Depression: The Wallenberg bank accepted equity for nonperforming loans; and reorganized these into a huge pyramidal group under an apex closed-end fund. Sweden's political reaction to the Depression was social democracy: generous social programs and business subsidies in return for high taxes and extensive regulation.

Although the families initially opposed social democracy, Högfeldt argues that they soon reached an accord. The families came to appreciate regulation and high taxes as barriers to entry; and Social Democrats found dealing with "business" by phoning a few patriarchs convenient. Ultimately, he discerns a sort of symbiosis: the families business groups helped implement social policy in return for subsidies, tax breaks, and regulatory favor.

The other Scandinavian economies similarly entrust much of their large business sectors to remarkably few families and tycoons. Charitable foundations are also important controlling shareholders in Denmark (Thomsen & Rose 2004), and Norway has two large sovereign wealth funds. One, *Statens pensjonsfond – Utland*, invests abroad only; while the smaller *Statens pensjonsfond – Norge* holds large blocks of major Norwegian firms.

The Scandinavian social democracies are arguably corporatist, in that domestic competition was long thought unimportant. However, early openness to world trade likely provided market checks on rent-seeking. Also, as in postwar Germany, labor leaders were insiders crafting policy; not outsiders demanding concessions. Transparency is paramount, and limited liability imposes meaningful disclosure requirements, even on unlisted firms.

Finally, the Scandinavian countries share a unique legal system: though they lack a comprehensive Civil Code along the French or German models, they have negotiated common codifications of specific bodies of law. Reminiscent of Common Law countries, judges assisted by panels of citizen judges apply common sense and fill in gaps in the codes. Respect for the Rule of Law is thoroughgoing, and corruption is apparently rare.

These factors limit pecuniary private benefits of control (Holmen & Knopf 2004), so the persistence of family pyramidal groups likely reflects nonpecuniary benefits to the families.

## 2.6 How Japan Became Unique

Japan's legal system derives from Germany's, but its corporate governance has a unique and remarkable history. The country has, at one time or another, tried virtually every system described above.<sup>19</sup> Before 1868, a profoundly traditional and isolationist society made merchants the bottom caste in a rigidly hereditary system – beneath priests, warriors, peasants, and craftsmen. Nonetheless, merchant families, the Mistui and Sumitomo especially, prospered.

After Admiral Perry's gunboats opened Japan to Victorian globalization, a clique of infuriated samurai seized power. This Meiji Restoration, named for a figurehead emperor, sought to expel the foreigners; but soon realized this required learning foreign ways. The junta sent young Japanese abroad to study foreign technologies, businesses, and governments; and to report home.

Thus informed, they rebuilt Japan, combining what they saw as global best practice in legal, economic, and social institutions. They founded state-owned enterprises to bring modern industry to Japan, and inevitable governance problems soon induced fiscal and monetary crises.

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<sup>19</sup> This section draws heavily on Morck & Nakamura (2005).

To rescue itself, the government conducted a mass privatization, ultimately transferring major SOEs to leading business families, like the Mitsui and Sumitomo.

From the late 19<sup>th</sup> century though to the 1930s, these families used huge public equity issues to build these nascent corporate groups into vast pyramidal groups called *zaibatsu*, similar to those found elsewhere at that time.<sup>20</sup> Most had closely held family firms at their apexes, though Nissan's capstone was widely held. These huge business groups transformed Japan into an industrial economy on par with much of Europe by 1920.

Most pyramidal groups contained a bank, but only the small Yasuda *zaibatsu* was built around one. The Mitsui pyramid began with silk manufacturing, and the Sumitomo with copper mining. Though Japan's resource wealth was largely exhausted by the 1950s, cash cow mines financed control blocks as groups entered successive new industries (Morck and Nakamura, 2008). Group banks were either arm's-length operations, like Mitsui Bank, or subordinated to the needs of the group, like the Suzuki *zaibatsu*'s Taiwan Bank. The former strategy proved superior, for the Suzuki, like others with distressed captive banks, ultimately collapsed.

The 1923 Great Kantō Earthquake destroyed much of Japan's modern economy, undermining once powerful liberal voices and plausibly paving the way for a 1930s military takeover (Hammer 2006) that brought Corporatism to Japan. The military freed directors of their duty to shareholders – meaning the business families – and regulated dividends. Military directors on all major firms' boards set wages and prices, and enforced output quotas.

Ownership remained private *de jure*, but the economy the American army found in 1945 resembled 1990s post-socialist economies. General MacArthur's military government included Roosevelt New Dealers, fresh from dismantling American pyramids in the 1930s. Family and intercorporate equity blocks were seized and either sold to public shareholders or assigned to employees, who then sold them. The families' compensation was bonds, rendered worthless by inflation; and they essentially bowed out. By 1952, the occupation's end, most large corporations were freestanding and widely held – like America's.

Other aspects of Anglo-Saxon corporate governance – like hostile bids and greenmail – followed (Sheard, 1991, 1994). As elsewhere, these were relatively rare, but drew disproportionate publicity. A favored defense – the *keiretsu* – soon arose. American target firms sometimes block hostile raids by placing an equity block with a friendly *white squire*; or by inviting a rival bid from a friendly *white knight*. The *keiretsu* defense is a variant of these, wherein a group of firms place small blocks of stock with each other. Though each holds a tiny stake in every other firm, their stakes collectively sum to control blocks.<sup>21</sup> Every firm in the *keiretsu* is thus controlled collectively by the others – a uniquely Japanese governance structure.

*Keiretsu* arose in two waves – in the 1950s and then the 1960s. Japan's experiment with Anglo-American shareholder democracy was thus brief, and the *keiretsu* system remains in place today, augmented by a few new family pyramids, rechristened *vertical keiretsu*. Perhaps because large banks organized the *keiretsu*, many students of postwar Japan assign them a strong governance role (Kaplan & Minton 1994), despite their equity stakes in nonfinancial firms being capped at five to ten percent, as in America; and their having no German-style proxy voting power.

Although most *zaibatsu* and *keiretsu* were unambiguously designed to secure control, *zaibatsu* are also plausibly rational responses to institutional infirmities. The *zaibatsu* appear to have coordinated their entry and expansion in various industries in ways consistent with

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<sup>20</sup> *Zaibatsu*, or 財閥, means “business clique”.

<sup>21</sup> Individual stakes are often so tiny they need not be disclosed. However, the total of all corporate stakes is always disclosed.

capturing cross-industry spillovers from a Big Push industrialization (Morck & Nakamura 2007). Certainly, zaibatsu member firms were star performers, and family controlled pyramids may well be a good corporate governance choice for “catch-up” industrialization. The keiretsu led postwar reconstruction, suggesting that business groups and, perhaps, bank influence, work well for that task. However, zaibatsu and keiretsu were also astute political rent-seekers. For example, corporate bonds were illegal for much of the postwar period, apparently in response to bank and keiretsu lobbying. Though problematic as public policy, this surely erected barriers to entry favoring banks and incumbents.

As the postwar reconstruction boom ended, stock market and real estate bubbles expanded into a late 1980s financial crisis. By now, banks played no detectable role in improving governance, and keiretsu firms’ performance lagged (Morck & Nakamura 1999). With takeovers a historical footnote, insider entrenchment was widespread (Morck et al. 2000). Weak governance misallocating capital is a prime suspect for the “lost decade” – zero-growth through the 1990s.

The main banks associated with the *keiretsu* did not survive the crisis, and intercorporate equity stakes are unwinding. Hostile bids are back, with poison pills displacing *keiretsu* as the preferred defense. If this trend persists, large firms’ governance would revert to the postwar Anglo-American model.

However, this is unlikely. Throughout the postwar period, family firms, small family pyramidal groups, and a few large family-controlled *vertical keiretsu* prospered. Japanese business families are unique in occasionally adopting highly educated tested adults as “new” heirs if their biological progeny appear inadequate. Japanese are typically surprised that family firms elsewhere fail to do this. Perhaps because of this unique succession system, Japanese family firms perform exceptionally well.

### **3 Conclusions: Patterns amid Variation**

Governance problems are as old as capitalism: investors who entrust their savings to specialized entrepreneurs must somehow constrain the entrepreneurs’ self-interest. Abstracting from obvious national differences, we postulate a *standard model* of corporate governance fitting most newly industrializing economies and the histories of most, perhaps all, developed economies.

This model has a few wealthy business families, tycoons – for brevity, we use the American term “robber barons” – each controlling a huge group of separately listed firms, usually via pyramiding, that spans. Because robber barons wield enormous economic and political clout, and sometimes act above law, the model is also called *crony capitalism*. Controlling shareholders call the shots and others are bystanders.

This model’s ubiquity suggests an economic *raison d’être* – at least early in economic development. Robber barons with reputations for treating investors fairly might attract savings on advantageous terms, letting them build business empires. Large business groups may substitute for dysfunctional markets and institutions. Their controlling shareholders might provide essential economic coordination weak governments cannot. Or, they might capture the state, and twist government policy to their service.

The differences between developed economies’ corporate governance systems, which help distinguish the so-called varieties of capitalism (Hall & Soskice 2001), arose during severe economic and political crises. Crises rendered institutions temporarily malleable; perhaps by weakening previously invulnerable interest groups (Olson 1984b, a, 2000). The robber barons

succumbed to new models that, partly by design and partly as unintended consequences, sent countries down different paths.

We postulate that robust empirical correlations between economic institutions and factors like legal origin, dominant religion, early land distribution, and the like reflect common forces shaping the response to crises in different countries, and perhaps common unintended consequences of those reforms.

With qualifications, countries with Common Law legal sustain large stock markets and professionally managed freestanding widely held firms. The longer lists of shareholder rights La Porta et al. (1997) enumerate in these economies are historically recent (Franks et al. 2005; Lamoreaux & Rosenthal 2006), and thus unlikely to explain such longstanding differences. But other characteristics of the different legal systems might.

Legal origins capture the distinctly different ways society solve problems. First, to vastly oversimplify, English courts exist to rein in the powerful; French courts to apply State power dispassionately (Watson, 1981; Pistor et al. 1999). English law gelled after Royalists lost the Civil War, and an independent judiciary – the Courts of Common Law – developed in opposition to Royal power (Hayek 1960; Glaeser & Shleifer 2002). France’s Wars of Religion and its Revolutionary Tribunals’ enthusiasm for the guillotine left Napoleon distrusting decentralized power and judicial discretion; and the Napoleonic Code reflects this.

Second, Merryman (1966, p. 586) sees Civil Codes enshrining doctrine over judgment. French codes, especially, seek to eliminate all judicial discretion by fully anticipating all possible disputes and their resolutions. This arguably favors wealthy insiders, who can afford legal guidance. Common Law courts apply general “principles” – *reasonable man* or *prudent man* standards. Insiders found unreasonable or imprudent by a jury risk jail, even if they meticulously avoid breaching the letter of the law.

Third, Civil Code magistrates are political appointees, and thus subject to political pressure (Hayek, 1960; Mahoney 2001; and La Porta et al. 2004). Coffee (2001) argues that more independent Common Law courts better support self-regulation – whereby insiders precommit to high standards and privately enforced penalties for breaching those standards. Civil codes, in contrast, better support crony capitalism.

Still, these differences can be overblown. American law matches any Civil Code in lengthy impenetrability; Germany’s opening for judicial discretion is increasingly emulated, if little used (Weiss, 2000; Enriques, 2002); and politics taints American judicial appointments. Some thus regard legal origin as a historical footnote (Markesinis, 2000; see also Posner 1996). Others concede persistent differences (Weiss, 2000), and support in empirical evidence that legal origins capture something relevant to current corporate governance (La Porta et al. 2008).

Our historical vignettes point to Common Law principals in Britain and Canada preventing takeover barriers like staggered boards and effective poison pills. This encourages the market for corporate control that also characterizes Common Law countries. America’s courts also shaped its corporate governance regime. Roosevelt’s First New Deal, a corporatist cartelization imitating Mussolini’s reforms, was ruled unconstitutional by the Supreme Court. This forced him to launch a Progressive Second New Deal that broke up the pyramidal groups and enhanced shareholder protection (Black 2003).

However, these principles are honored to different degrees in different countries at different times, and patterns of corporate governance change accordingly. Canada, despite a Common Law heritage, fought 1930s deflation with cartelization (Bliss 1987) as French Canadian scholars and clerics touted Corporatism (Nemni et al. 2006). In 1970s, Canada’s national unity crisis induced nationalist policies: heavy state interventionism, foreign takeover restrictions, and subsidies to Canadian controlled firms – unintentionally resurrecting the robber baron model. In



independent India, the Rule of Law eroded and the Anglo-American firm never emerged. In contemporary America, takeover defenses are weakening these principles, and corporate ownership is concentrating. In Britain, they remain strong and ownership remains diffuse. But this occasional backsliding proves the rule: takeovers are rare and old-moneyed families' pyramidal groups contain most large corporations in most Civil Code countries.

Still, legal origins might fortuitously proxy for something else. Weber (1930) links Protestantism to entrepreneurial ideals. Certainly, the interwar Vatican touted Corporatist teachings that downplayed competition, sidelined small shareholders, and organized economies into Corporations – business-run collectives charged with setting “fair” prices and wages, and with regulating entry. Perhaps the correlation found between Roman Catholicism and financial asthenia (La Porta et al. 1997; Stulz & Williamson 2003) is a Corporatist residue. Cultural precursors of Asian corporate governance merit study (Huntington & Harrison 2000).

Another latent factor may be language, or language of elite education. English is the language of higher education, government, and business in Common Law countries and northern Europe. Education in the language of Adam Smith may create more market-friendly ideals than education in the languages of Jacques Derrida or Raoul Prebisch.

Yet another is political economy. Former French, Portuguese, and Spanish colonies – all with legal systems derived from the Napoleonic Code – were all initially slave plantations or mines, and remain organized to preserve elites; while many yeoman farmers settled British colonies, and demanded property rights and the rule of law. Perhaps crises, like the Great Depression, expose these roots – diminishing other interest groups relative to deeply entrenched elites in the former and stirring up populism in the latter. Thus we observe old moneyed family controlled business groups throughout Latin America and widely held firms in America.

Still another factor is globalization. Rajan and Zingales (2003) document a remarkable mid-20th century financial atavism in many Civil Code economies. They argue a first cadre of successful business families undermined their countries' financial systems and corporate governance to deny potential competitors easy capital. This reversal is attenuated in more open economies, where foreign entrants and foreign capital are present. A growing body of evidence links openness to financial development (Rajan and Zingales, 1998; Bekaert et al. 2005; Henry, 2007). Some argue that cross listings lets firms “rent” better corporate governance rules (Coffee, 1999; Doidge et al. 2004); though Siegel (2005) contests this. Triumphalism about the world converging to American corporate governance was never convincing (Khanna et al. 2006), but further work on globalization, broadly interpreted, and the evolution corporate governance would be useful.

Neither our historical survey nor the empirical literature reveals any corporate governance regime clearly superior. Rather, some seem better attuned to certain tasks. For example, robber baron capitalism accompanies most (all?) rapid industrializations. Corporatism brought France a rapid postwar recovery, as did the unique systems of Japan and Germany. American capitalism led the recent IT revolution. This perhaps explains why German, Japanese, and then American institutions successively became the “flavor of the month” and then revealed weaknesses. Politics, technology, and tastes change, and reveal each system's strengths and weaknesses in turn. We see no clear trend towards convergence or divergence.

Academic studies of corporate governance tend to originate from American and British business schools, and many take Anglo-American ambient institutions for granted. Even the term corporate governance implies the corporate to be a meaningful unit of governance – an entirely unwarranted assumption in countries dominated, say, by family controlled pyramidal corporate groups. Copying American or British reforms limiting directors ties to the corporations

they govern may be unhelpful if they are beholden to other firms controlled by the same family. In such countries, directors, and even CEOs, may be little more than “hired help” to a powerful business family; and their pay, incentives, and duties may be second order effects at best.

Corporate governance transcends corporations. It is about how the economy’s capital and resources are allocated; and about information asymmetries, moral hazards, and other market or government failures affecting people who specialize in these allocation decisions – whether Indian business family members, German bankers, or British professional CEOs. Comparative corporate governance should be about how different institutions reshape these problems, and thus affect the economy’s efficiency, flexibility, innovative capacity, and contribution to social welfare.

National institutions empirically swamp firm-level effects, like board structure, (Doidge et al. 2007); especially in developed economies (Durnev and Kim, 2005). This is unsurprising, for “institutions” are about the distribution of economic power (Olson, 2000); and what is economic power but controlling capital and resource allocation?

The major differences in corporate governance institutions across countries arose when major crises, especially the Great Depression, briefly liquefied institutions (Olson, 1884ab). Legal systems, cultures, languages, and institutional path dependencies affect countries responses to crises because they affect how people solve problems. Clearly, no one factor is singularly critical, for wide variation exists across categories of countries; and competition between national economies surely culls deeply dysfunctional institutions, at least in open economies. This path dependence may itself be a survival trait, for studies of legal transplants show high failure rates, and argue that national institutions are highly interdependent webs; with institutional innovations only “taking” if they fit into this interdependency. Thus, America’s attempt to impose its vision of shareholder democracy on postwar Japan quickly developed into a system more aligned with Japan’s prior path and quite different from America’s model. Likewise, America’s attempt to reform its own system via the Sarbanes Oxley Act, like Germany’s *Neuer Markt*, confronts immense institutional momentum. Real reforms, it would seem, await the next Great Depression.

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