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ARTICLE

EMULATING THE GERMAN TWO-TIER
BOARD AND WORKER PARTICIPATION
IN U.S. LAW: A STAKEHOLDER
THEORY OF THE FIRM

ERIC ENGLE & TETIANA DANYLIUK*

INTRODUCTION

The U.S. corporate governance system failed in 2002, and again in 2008, leading to the deepest economic downturn in the United States since the Great Depression. Germany, in contrast, suffered neither widespread regulatory failure nor market collapse. Important differences in the U.S. and German corporate structure and capital markets may explain the divergent economic performance. This Article examines whether and how to emulate German corporate governance structures in the U.S. market, a theme which may be of interest to German corporations considering locating operations in the United States, such as Volkswagen in Tennessee.¹

This Article is structured in three parts. In Part I, we present *hypotheses* about the causes of the U.S. market collapse, which we hypothesize was not merely a result of endogenous corruption and fraud but also due to exogenous macroeconomic factors. This Part includes a description of the German capital market and German economic theories. Part II examines theories of the corporation. Part III examines the corporation in

* Many thanks to Professor Christine Windbichler (Humboldt, Berlin) for reading and commenting on an earlier version of this article. Professor Windbichler's comments were insightful and very helpful. The authors also wish to thank the editorial team of the Golden Gate University Law Review for their tireless attention to detail in cite checking.

¹ Justin Bachman, *As Union Moves In, Volkswagen Will Build Its SUV in Tennessee*, BLOOMBERG BUSINESS (July 14, 2014), <http://www.bloomberg.com/bw/articles/2014-07-14/as-union-moves-in-volkswagen-will-build-its-suv-in-tennessee>.

practice. The Article concludes that although restructuring the U.S. legal system is likely impossible due to Weimar-style gridlock, nevertheless German corporate governance models can be emulated in the U.S. market using the corporation's articles of incorporation, bylaws, and contracts as well as through domestic forms such as the cooperative and the limited partnership.

I. THE FINANCIAL CRISIS

The causes of the collapse of U.S. capital markets in 2008 are complex. Monetary policy, lowered lending standards, and reduced regulation of banks are all possible partial explanations² of the collapse. These causes, in conjunction with executive over-compensation,³ resulted in a culture of corruption and fraud. Professor L. Stout argues that the deregulation of purely speculative derivative contracts was both a necessary and sufficient cause of the credit crisis.⁴ While the use of purely speculative derivatives most likely was a contributing cause of the great recession, we would hesitate to consider it both a necessary and sufficient cause, i.e., one without which the crisis would not have occurred and one that was in fact adequate to cause the crisis all on its own. Stout also argues that the economic crisis was caused by *legal* regulatory failure, and *not* material facts⁵ such as exogenous market shocks or wars. That position elevates ideas above the material. If we can learn anything from dialectical materialism, it is that the material forces of production generally predominate in their mutual feedback relation to the ideological superstructure that describes and frames the material forces of production.⁶ Wishful thinking generally does not move the world. Law is not autonomous to the economy, not even relatively.

Although we might ask one of the best minds in corporate law for finer details on those points, lesser lights, perhaps dazzled by the complexity and confusion of the crisis, have outright misstated the law.⁷

² Lynn A. Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 30 No. 12 Banking & Fin. Services Pol'y Rep. (CCH) 13, 22 (Dec. 2011).

³ Lucian A. Bebchuk, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 7 YALE J. ON REG. 257 (2010).

⁴ Stout, *supra* note 2, at 22.

⁵ *Id.* at 14 (“[T]he credit crisis was not due to ‘innovations’ in the markets or the legal system’s failure to ‘keep pace’ with finance. The crisis was caused by *changes in the law*.”).

⁶ Dialectical materialism is the idea that reality is structured through comparison of the material facts that competing viewpoints express. On dialectical materialism, see, e.g., Eric Engle, *MARXISM, LIBERALISM, FEMINISM: LEFTIST LEGAL THOUGHT* 3, 10 (2010).

⁷ Cherie Owen wrote about the Glass-Steagall Act in 2003 as if it were still good law. Unfortunately, the relevant provisions of the Act had been repealed in 1999. She (incorrectly) stated: “The Glass-Steagall Act separates commercial banks from investment banks, and prohibits commercial banks in the United States from entering into the securities business. Under the Glass-Steagall Act, a

These are cautionary tales about the difficulty of correctly analyzing complex economic history. Thus, in this introductory section, we merely present some *hypotheses* regarding the economic crisis. Our hypothesis is that the economic crisis of 2008 was a “perfect storm” for the United States: a confluence of exogenous material facts on the market *and* structural regulatory failure. The crisis was caused by a combination of war debt and broad-ranging, if not systematic, corruption (e.g., Bear-Stearns,⁸ AIG,⁹ Lehman,¹⁰ Madoff¹¹) framed by regulatory failure. This corruption was nothing new; systematic corruption had already characterized U.S. capital markets in the 2002 stock market crash (Enron,¹² WorldCom, Halliburton/KBR¹³ no-bid contracts),¹⁴ which was triggered

bank may not underwrite, distribute, sell, or deal in corporate securities, except on its own account. The Act also states that banks may not affiliate with any company engaged principally in underwriting securities. Commercial banks are prohibited from managing a company engaged primarily in the securities business, and investment banks may not accept deposits. Although there have been movements to repeal this act, and commercial banks have had some success in expanding their powers, the current law forbids the trespass of banks into the securities market.” Cherie J. Owen, *Board Games: Germany’s Monopoly on the Two-Tier System of Corporate Governance and Why the Post-Enron United States Would Benefit from Its Adoption*, 22 PENN ST. INT’L L. REV. 167, 188–89 (2003) (footnotes omitted). We cite her article in this work for some other points, which appear to be valid points of law, however *caveat lector* regarding those citations.

⁸ The Bear Stearns collapse was a contributor to the 2008 market collapse. *See, e.g.*, Robert D. McFadden, *Alan C. Greenberg, 86, Dies; Led Bear Stearns in Good Times and Bad*, N.Y. TIMES, July 25, 2014, <http://www.nytimes.com/2014/07/26/business/alan-c-greenberg-is-dead-at-86-led-bear-stearns-through-its-rise-and-fall.html>.

⁹ Greed all too often leads to short-sighted scandals, and AIG is just one example. *See, e.g.*, *The Ten Worst Corporate Accounting Scandals of All Time*, ACCOUNTING-DEGREE.ORG, <http://www.accounting-degree.org/scandals/> (last visited Oct. 31, 2014).

¹⁰ Ian Salisbury & Paul J. Lim, *6 Years Later, 7 Lessons from Lehman’s Collapse*, MONEY (Sept. 15, 2014), <http://time.com/money/3330793/lessons-from-lehman-brothers-collapse/>.

¹¹ Bernard Madoff perpetrated history’s largest ponzi scheme. A ponzi scheme uses pay-ins from future investors to pay off earlier investors, thus attaining higher-than-market rates of return for initial investors in the pyramid scheme. Eventually, however, there are no more investors and the scam is exposed, leaving later investors defrauded. *See, e.g.*, Nathan Vardi, *The Madoff Tragedy Continues with Andrew Madoff’s Death*, FORBES (Sept. 3, 2014), <http://www.forbes.com/sites/nathanvardi/2014/09/03/the-madoff-tragedy-continues-with-andrew-madoffs-death/>.

¹² Enron was, to that date, one of the largest frauds in corporate history, due to market manipulation and pension fraud. *See, e.g.*, *Behind the Enron Scandal*, TIME, http://content.time.com/time/specials/packages/article/0,28804,2021097_2023262_2023247,00.html (last visited Oct. 31, 2014).

¹³ *See, e.g.*, Pratap Chatterjee, *Dick Cheney’s Halliburton: A Corporate Case Study*, THEGUARDIAN.COM (June 8, 2011), <http://www.theguardian.com/commentisfree/cifamerica/2011/jun/08/dick-cheney-halliburton-supreme-court>.

¹⁴ *See, e.g.*, Owen, *supra* note 7, at 170–71 (2003) (“WorldCom announced in June, 2002, that it had overstated earnings by over \$3.8 billion in the five previous quarters. This overstatement was in part due to a strategy of treating operating costs as capital investments. . . . WorldCom’s market capitalization fell from over \$115 billion to less than \$1 billion. . . . In the spring of 2002, Adelphia Communications admitted that it had guaranteed loans of \$2.3 billion to family members of its controlling shareholders. In June, 2002, Adelphia filed for protection under Chapter 11 bankruptcy laws, causing its stock to fall from a high of nearly \$28 per share to a low of \$0.01 per share. . . . In 2002, the former CEO of Tyco International was indicted on charges of state sales tax

by fraudulent accounting¹⁵ to manipulate share prices¹⁶ via special-purpose entities;¹⁷ this practice continued in the housing market, despite the Sarbanes-Oxley Act, as shown in 2008.¹⁸ Corruption in capital markets led to the collapse of banks, a credit crisis, and a drop in demand for securities,¹⁹ resulting in a lack of capital for business, which in turn caused the economic recession.

Most analyses of the economic crisis consider only the banking aspects thereof, i.e., endogenous microeconomic factors.²⁰ Here, we point out those endogenous microeconomic factors in the crisis. However, we also point out the exogenous and macroeconomic factors: military spending, which led to massive budget deficits, which then resulted in an increase in national debt, leading to inflation, and thus resulting in foreign disinvestment on the U.S. capital markets. We also describe a hypothesized unstated policy of counter-parallel cyclicity in the housing and

evasion. The indictment, coupled with concerns about the use of corporate funds for the personal benefit of the CEO and general counsel of the corporation, caused Tyco International's market capitalization to fall by \$100 billion After Global Crossing Ltd. filed for bankruptcy, the former chairman and founder of the corporation was questioned regarding sales of over \$700 million of his stock in the corporation in 1999. At the time of the sale, the stock had reached a high of \$60 per share. However, by the end of 2001, the company filed for bankruptcy following allegations that the [corporation's] revenues were inflated due to exchanges that were without economic substance." (footnotes omitted)).

¹⁵ "One of the major problems facing corporate governance today is directors' use of accounting methods that, although not wholly illegal, are intended to mislead shareholders into believing that corporate value is greater than it actually is." Lauren J. Aste, *Reforming French Corporate Governance: A Return to the Two-Tier Board?*, 32 GEO. WASH. J. INT'L L. & ECON. 1, 33 (1999).

¹⁶ Margaret M. Blair, *Directors Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 894 (2003) ("[S]hare prices can be manipulated in the short run.").

¹⁷ Special purpose entities "financed Enron's activities, shifted debt from Enron's books, and hid Enron's credit risk. These SPEs were used in many different ways to disguise risk and debt, and to create the appearance of liquidity and profitability." Owen, *supra* note 7, at 169 (footnote omitted).

¹⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 302, 906(a), 116 Stat. 745, 777, 806, codified at 15 U.S.C.A. § 7241 (civil provision); 18 U.S.C.A. § 1350 (providing criminal penalties) (Westlaw 2015).

¹⁹ Corruption reduces demand on the publicly traded stock market. "In the wake of the recent corporate scandals such as Enron and WorldCom, investors have lost faith in the stability of the American securities markets. Consequently, stock prices have rapidly declined over the past year and investors have lost billions of dollars." Owen, *supra* note 7, at 167 (footnotes omitted).

²⁰ Although the EU Larosiere report does consider macroeconomic aspects of the crisis including the role of Chinese and Arab monetary policies and investments, it does not factor in issues such as massive U.S. war deficits and the oil price spike resulting from those wars as causes of the crisis. See JACQUES DE LAROSIÈRE ET AL., REPORT OF THE HIGH LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU 7-8 (2009), available at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf. Anat Admati and Martin Hellwig also do not consider the exogenous facts of costs of the wars and petroleum prices in their analysis of needed banking policy reforms. Anat Admati & Martin Hellwig, *Must Financial Reform Await Another Crisis?*, BLOOMBERG (Feb. 6, 2013), <http://www.bloomberg.com/news/2013-02-05/must-financial-reform-await-another-crisis.html>.

stock markets, which explains why the collapse of the housing market was much worse than a similar housing crash, the savings-and-loan crisis of 1992 (Silverado).²¹ A “trifecta” of regulatory failure, debt, and disinvestment severely damaged the U.S. economy, resulting in the worst global economic downturn since 1929.²²

A. MACROECONOMIC COUNTER-CYCLICITY

Our hypothesis is that the U.S. Federal Reserve Board was following monetarist policies aimed to encourage an alternation of cyclicity in the housing market and the stock market²³ from 1982 to 2008. The objective of counter-cyclical policies was to create out-of-phase cyclicity in the housing and stock markets. Thus, stock market troughs would roughly line up with housing market peaks, and troughs in the housing market cycle would match peaks in the stock market. Such a policy would result in the universally desired goal of *constant* growth: permanent full employment due to a *permanent* boom because stock market busts would roughly coincide with housing booms and lulls in housing starts would be offset by a rising stock market. Either the securities markets or the housing market might be down at any given point in time - but both would never be down simultaneously. This unannounced but observable²⁴ de facto policy of alternating booms and busts in liquid capital markets (debt and equities) and real capital markets (housing) ran successfully from 1982-2008. So, e.g., the stock market crash of 1987 was “out of phase” with the savings and loan crisis of 1990 (“Silver-

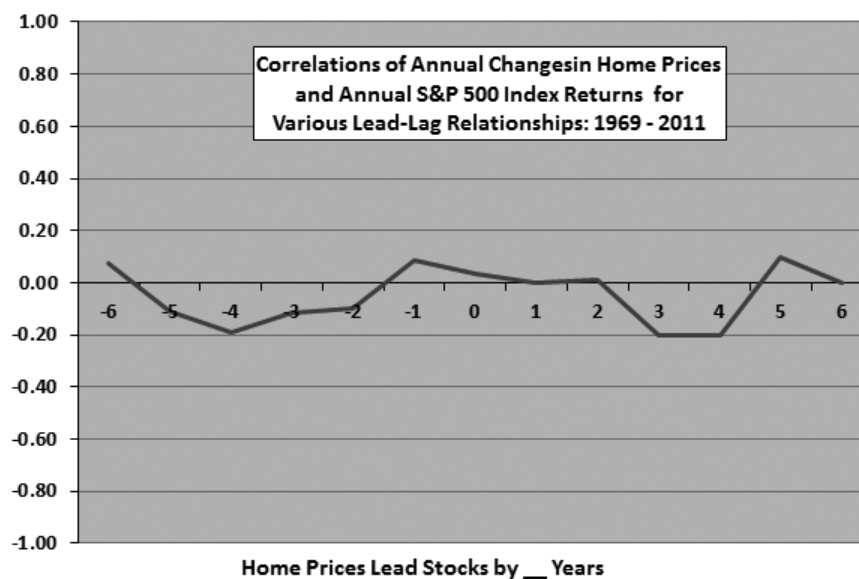
²¹ Stephen Labaton, *F.D.I.C. Sues Neil Bush and Others at Silverado*, N.Y. Times, Sept. 22, 1990, <http://www.nytimes.com/1990/09/22/business/fdic-sues-neil-bush-and-others-at-silverado.html> (“Federal regulators today sued Neil M. Bush, the President’s son, and other directors, officers and lawyers of a defunct Denver savings and loan association, saying their “gross negligence” had led to a collapse that could cost taxpayers more than \$1 billion.”).

²² “Shortly after Sept. 11, George W. Bush interrupted his inveighing against evildoers to crack a joke. Mr. Bush had repeatedly promised to run an overall budget surplus at least as large as the Social Security surplus, except in the event of recession, war or national emergency. ‘Lucky me,’ he remarked to Mitch Daniels, his budget director. ‘I hit the trifecta.’” Paul Krugman, *Hitting The Trifecta*, N.Y. TIMES, DEC. 7, 2001, <http://www.nytimes.com/2001/12/07/opinion/hitting-the-trifecta.html>.

²³ On the stock market, this policy was known as “the Greenspan Put.” See, *The Greenspan Put*, MONEY WEEK (May 24, 2013), <http://moneyweek.com/glossary/greenspan-put/>; INVESTOPEDIA, *The Greenspan Put*, <http://www.investopedia.com/terms/g/greenspanput.asp> (last visited Jan. 30, 2015).

²⁴ “Results suggest a weak cycle of six to eight years for the interaction between home appreciation and stock returns. Specifically, high (low) stock returns three to four years ago suggest weak (strong) home appreciation now. Similarly, strong (weak) home appreciation now weakly suggests low (high) stock returns three or four years from now.” *Real-Estate/Home-Prices and the Stock Market*, CXO ADVISORY (Mar. 13, 2012), <https://web.archive.org/web/20111109173017/http://www.cxoadvisory.com/4106/real-estate/home-prices-and-the-stock-market/>.

ado"). The 2001 stock market crash was similarly coincident with a housing construction boom. The fact that the business cycle of new housing construction and the business cycle of stock market performance are a few years out of phase is empirically observable: peaks in the realty capital market and peaks in the speculative capital market are about two to four years out-of-phase as illustrated in the following chart, although the policy of encouraging that out-of-phase cyclicality to attain permanent growth is only hypothesized here.



*Housing and Stock Markets: Countercyclical with a Wavelength of Six to Eight Years*²⁵

Counter-cyclicity is observed in the housing and stock markets from 1982-2008. However, the stress of massive borrowing to fund a series of expensive endless wars in Southwest Asia and the Horn of Africa, coupled with the securitization of mortgages, meant that while this unannounced policy of counter-cyclicity and constant growth might have been able to operate indefinitely in theory, in practice it could not. This is especially true because the wars for oil did not drive the price of oil down, just the opposite. Petroleum is *the* prime factor in the economy, the raw material that is needed for plastics, explosives, fertilizer, heating,

²⁵ Source: *Id.*

transport, and lubrication. Expensive oil means everything else is also expensive.²⁶

B. EXOGENOUS FACTORS: MILITARY SPENDING LEADING TO INFLATION AND DEFICITS RESULTING IN FOREIGN DISINVESTMENT

The economic problems facing the United States are not only due to irresponsible corporate corruption. The great recession was also caused by the massive war debt the United States incurred and continues to incur,²⁷ illustrated in the following charts:



“Global War on Terror”: More Costly than Vietnam War²⁸

This chart shows that military spending has been a major contributor to the U.S. federal deficit. What about inflation? A debt-driven inflation resulted from the costs of waging an ill-conceived, lawless “global war

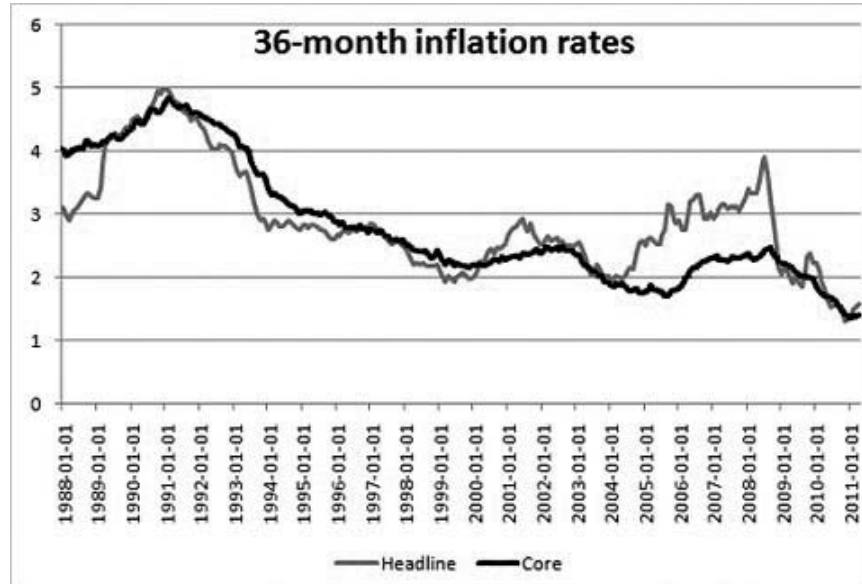
²⁶ (“Natural gas as a fuel is used to produce items such as steel, glass, paper, clothing and brick. It also is an essential raw material for paints, fertilizer, plastics, antifreeze, dyes, photographic film, medicines and explosives.”) *Energy Primer*, FED. ENERGY REG. COMM’N, p. 1, 10 (USGPO, 2012), available at <http://www.ferc.gov/market-oversight/guide/energy-primer.pdf>.

²⁷ Eric A. Engle, *Rethinking the ‘War on Terror’: Legal Perspectives on Containment and Development Strategies*, 2 CITY U. OF H. K. L. REV. 67, 73 (Jan. 1, 2010), available at <http://ssrn.com/abstract=1543267>.

²⁸ Source data: U.S. GPO, <https://web.archive.org/web/20110205031644/http://www.gpoaccess.gov/usbudget/fy11/sheets/hist06z1.xls>; Graphic source: SAN DIEGO VETERANS FOR PEACE, <http://www.sdvfp.org/wp-content/uploads/2014/07/fy13histmilitaryspend.gif> (last visited Jan. 30, 2015).

on terror”, a war which, *fifteen years later*, continues with no end in sight.

The resulting inflation statistics follow:



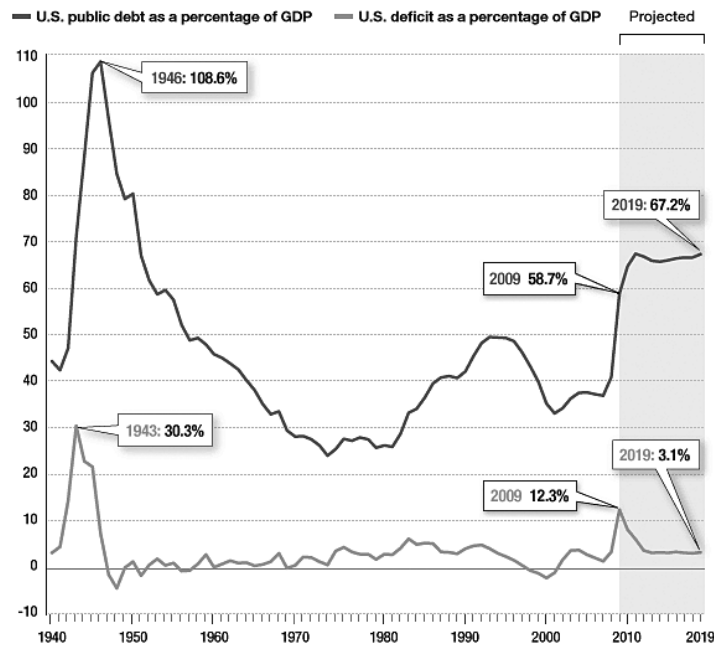
Inflation: Managable and Even Declined after the 2008 Crisis²⁹

We hypothesize that the inflation from 2004-2008 was due to the unexpected costs of the Iraq and Afghanistan wars and an attempt to “monetize” U.S. federal debt, which led to Chinese capital flight from the United States. We likewise hypothesize that the reduced inflation since 2008 is due to economic contraction and an effort to win back Chinese investments in U.S. treasury bills. War is expensive. War may be financed with taxation, sale of state resources, or budget deficits. Raising taxes or user-fees for government services is always unpopular: Consequently, the U.S. federal government did not raise taxes to fund its endless wars. The U.S. federal government has some resources, mostly federal lands and raw materials appurtenant thereto, but environmental considerations lead the Federation to retain its land-holdings. That leaves but one fiscal instrument: borrowing money, i.e. deficit financing. The U.S. federal budget deficit was clearly driven upward by the costs of wars as illustrated in the following chart:

²⁹ Source: Paul Krugman, *The Conscience of a Liberal*, N.Y. TIMES BLOG, (June 2, 2011), available at <http://krugman.blogs.nytimes.com/2011/06/02/core-madness-wonkish/>.



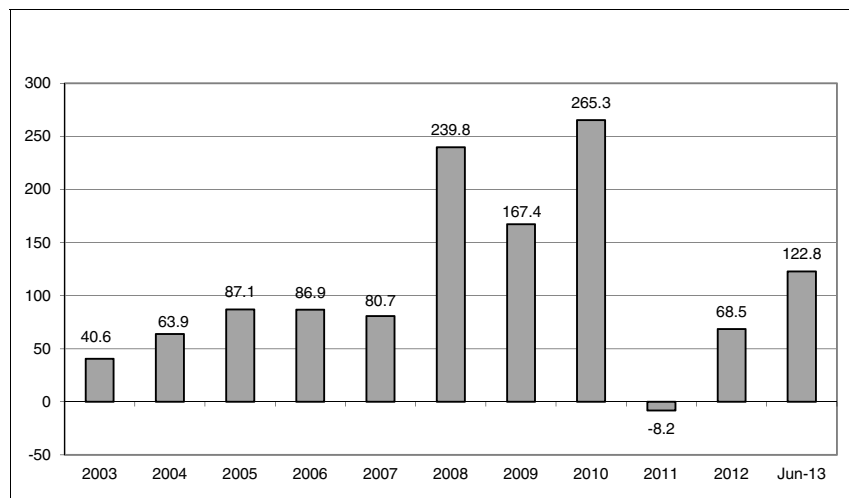
Inflation Adjusted Federal Deficits are Well Above World War 2 Levels³⁰
 Budget deficits, in turn led to increased national debt, illustrated as follows:



Public Debt as a Percentage of GDP is well below World War II Levels³¹

³⁰ Source: RandomNonviolence, *Our Taxes Are Off to War—2011 Edition*, DAILY KOS (Feb. 23, 2011), available at <http://www.dailykos.com/story/2011/02/23/947675/-Our-Taxes-are-Off-to-War-2011-EditionTaxes-are-Off-to-War-2011-Edition>.

Inflation had the effect of devaluing the worth of the U.S. treasury bonds. Inflationary devaluation of U.S. treasury bond obligations finally led foreign lenders investing in U.S. treasury bills such as China³² and Saudi Arabia to switch to other investments, such as real estate³³ and investments in the EU, for fear of a debt default or inflationary destruction of their investments by the United States.



Source: U.S. Department of the Treasury.

Note: Data for June 2013 are year-on-year.

Annual Change in China's Holdings of U.S. Treasury Securities: 2002-2011 and Year-on-Year Change in September 2012³⁴

Although the efficient, i.e. proximate cause of the economic crisis was indeed the burst securitized mortgage bubble, we argue that the great recession was not only the result of irresponsible lending in combination with fraudulent accounting; it was *also* the result of inflation brought about by war debts *and* Arab and Chinese³⁵ disinvestment³⁶ in the

³¹ *U.S. Budget Deficit, Debt Compared With GDP*, NPR, <http://www.npr.org/news/graphics/2009/feb/deficit/> (last visited Jan. 30, 2015).

³² *How China Owns \$1.2 Trillion of American Deficit*, DAILY MAIL (June 4, 2011), <http://www.dailymail.co.uk/news/article-1394315/China-unloads-97-cent-short-term-U-S-Treasury-debt-owns-1-2TRILLION-American-deficit.html>.

³³ Thilo Hanemann, *Chinese Investment: Europe vs. the United States*, RHODIUM GROUP (Feb. 25, 2013), <http://rhg.com/notes/chinese-investment-europe-vs-the-united-states>.

³⁴ Wayne M. Morrison & Marc Labonte, *China's Holdings of U.S. Securities: Implications for the U.S. Economy*, CONGRESSIONAL RESEARCH SERVICE, 9 (Aug. 19, 2013), <http://www.fas.org/sgp/crs/row/RL34314.pdf>.

³⁵ DAILY MAIL, *supra* note 32.

³⁶ Jim Krane, *Sept. 11 Fuels Boom in Gulf: Arabs Divested from American and Reinvested Tens of Billions at Home, Angered by U.S. Hostility*, LAKELAND LEDGER (Aug. 26, 2005), <http://www.lakelandledger.com>.

United States. Macroeconomic exogenous market factors, i.e., war and deficit, as well as endogenous regulatory failure, i.e., corporate corruption, *both* contributed to the economic crisis.

C. ENDOGENOUS REGULATORY FAILURE

The repeal of a portion of the Glass-Steagall Act by the Financial Services Modernization Act of 1999³⁷ enabled commercial banks to enter into the securities business and, in our view, this also contributed significantly to the recession. Under the relevant provisions of Glass-Steagall,³⁸ banks were forbidden to underwrite, distribute, sell, or deal in corporate securities, except on their own account. This prohibition was intended to prevent bank runs.³⁹ The abolition of this separation of investment from commercial banking enabled the securitization of bank mortgages, leading to the sub-prime crisis. “[F]inancial firms purchased mortgages from mortgage brokers, banks, and other lenders, and bundled the mortgages into securitized assets.”⁴⁰ These securitized assets⁴¹ were only as stable as the mortgages underlying them. Securitization allowed mixing properties bearing a high risk of mortgage default with others that had a low risk of default. This was done to enable a higher credit rating

news.google.com/newspapers?nid=1346&dat=20050826&id=PVIJAAAAIBAJ&sjid=H_4DAAAAIBAJ&pg=1866,4888909; *How 9/11 caused an economic boom in the Gulf Oil States from 2003-8*, ARABIANMONEY.NET (Sep. 11, 2011), <http://www.arabianmoney.net/gcc-economics/2011/09/11/how-911-caused-an-economic-boom-in-the-gulf-oil-states-from-2003-8/>.

³⁷ Gramm-Leach-Bliley Act (Financial Services Modernization Act of 1999), Pub. L. No. 106-102, § 101, 113 Stat. 1338, 1341 (1999) (repealing 12 U.S.C. §§ 78, 377).

³⁸ Banking Act of 1933, ch.89, §§ 20, 32, 48 Stat. 162, 188, 194 (1933) (codified as amended in 12 U.S.C. §§ 78, 377 (repealed 1999)).

³⁹ A bank run occurs when many depositors become convinced that their bank is insolvent and seek to withdraw their funds. See “Run: Banking” JOHN DOWNES & JORDAN GOODMAN, *DICTIONARY OF FINANCE AND INVESTMENT TERMS* (2010); *Bank Run*, *INVESTOPEDIA*, available at <http://www.investopedia.com/terms/b/bankrun/asp> (last visited Feb. 18, 2015). Since banks typically only retain around 13% of deposits in liquid form, when enough investors seek to withdraw their funds from the bank the bank collapses. Bank runs were one of the key factors in the 1929 depression. Consequently, the United States, like many other countries, introduced bank insurance for “small” depositors – the FDIC guarantees to cover bank savings up to 100,000 U.S. Dollars, which has prevented bank runs in the United States. See, e.g., *Historical Timeline: The 1930s*, FDIC, <https://www.fdic.gov/about/history/timeline/1930s.html> (Last Updated Jan. 2, 2014). Regarding the restrictions on banking and securities underwriting intended to prevent bank runs see, e.g., David Murphy, *UNRAVELLING THE CREDIT CRUNCH* 123 (2009); Susanna Powers, *ENHANCED TRANSPARENCY OF THE FEDERAL RESERVE: IMPACT ON FEDERAL FUNDS RATE FORECAST ERRORS* 35 (2008); Helen A. Garten, *WHY BANK REGULATION FAILED: DESIGNING A BANK REGULATORY STRATEGY FOR THE 1990S*, 38-39 (1991).

⁴⁰ Z. Jill Barclift, *Too Big to Fail, Too Big Not to Know: Financial Firms and Corporate Social Responsibility*, 25 J. OF CIV. RTS. & ECON. DEV. 449, 455 (2010).

⁴¹ “Securitization is the process of pooling consumer mortgages and selling the pooled mortgages as a separate security.” *Id.* at 456.

of the mortgage package for financing and sale as a security to unsuspecting third parties. The resulting securitization was, moreover, based on a chain of irresponsibility:

“Because financial firms had to sell the securitized assets, the originator of the loan held no responsibility for the *quality* of the loan, and the ultimate owner of the consumer mortgage had no concern for the *consequences* of the loan on the consumer. Moreover, the financial institution selling the mortgage-backed securitized asset took no responsibility for the terms of the underlying loan, and no one in the securitization chain cared about whether the consumer could ultimately afford or repay the loan”⁴² (emphasis added).

To make matters worse, in order to create mortgage based securities that could be sold to Wall Street financial firms, lenders increasingly pushed high-risk mortgages to low-income borrowers in the form of sub-prime⁴³ “liar loans.” Financial fraud by the borrower - and their lender, who obviously knew or should have known that the mortgagee was at serious risk of default, was the bottom line cause of the U.S. economic crisis. On top of all this, the U.S. government policy of encouraging universal home-ownership through favorable credit with government sourced loans, via “FannyMae” and “FreddieMac,” unintentionally encouraged the origination of irresponsible mortgage loans to borrowers who simply could not meet their mortgage payments.

Prior to the housing bubble, people had long thought that one’s own house is the safest and most secure investment of all, especially in the United States, where the norm is universal home ownership. The fact that people’s housing is their most important investment explains why U.S. banks were willing to make risky loans with low or no down payment. The banks believed, whether by hook or by crook, people would make their mortgage payments. However, when housing prices outstripped mortgagees’ ability to pay, loan defaults rendered the securities mortgage “investments” worthless, which led in turn to the collapse of several banks and a global economic crisis.

The sub-prime crisis was thus a chain of debt and default which could be compared to the chain of war reparations debt imposed on Germany after World War I: Germany “owed” France, France owed Britain and Britain owed the United States. This chain finally broke in 1929, resulting in a global collapse and another world war. Fortunately, the world learned the terrible lessons of 1945, and so the 2008 collapse did

⁴² *Id.*

⁴³ “Sub-prime mortgages are loans to borrowers with low credit scores or limited credit history.” *Id.* at 457.

not lead to tariff walls which would, like 1929, have worsened the recession. Consequently, 2008 did not unleash war with China -or Russia, though one can see the case of Ukraine as evidence of the real danger of war resulting from recession coupled with deficits. As in 1929, 2008 was marked by a chain of debt that finally snapped, leading to a chain reaction of defaults. Also as in 1929, the federal government is paralyzed, unable to make decisions, and is trapped in Weimar style gridlock, even having seen a federal spending sequester.⁴⁴

D. EXOGENOUS CAUSES OF THE CRISIS

The collapse of the housing bubble in 2008 might have been offset by a rising stock boom, as happened in cases prior to 2008. The 1987 stock market crash did not result in a global recession because of the housing boom occurring at that time. Likewise, the 1990 housing crash caused by the savings and loan scandal was contemporaneous with a rising stock market. In line with this trend, the 2001 stock market crash was contemporaneous with a housing boom. However, the hypothesized policy of alternating out-of-phase cyclicality in the housing and stock markets was stopped short in 2008 because securitization of mortgages brought the housing and stock markets back in phase, and also because of exogenous factors. The United States had wasted trillions of dollars on wars in the desert which drove the price of oil from as low as 20 dollars per barrel to over 100 dollars per barrel. The endless wars also caused massive federal deficits. At some point, China's domestic investment market became more attractive than the U.S. market.⁴⁵ Consequently, China reduced its holdings in U.S. treasury bills, shifting to European or U.S. real estate or other capital markets. Unlike bonds, real estate cannot be devalued by inflation. Without injections of foreign capital, the bubble burst, the market crashed, and the economy sank into recession.

While the U.S. stock market has since recovered, the United States remains awash in debt and trapped in expensive wars, and political paralysis exemplified by the federal spending sequester. Although employ-

⁴⁴ "The sequester" is the idea that the U.S. Federal Government *cannot lawfully spend* without a Congressional budget, which is basically true because all financing of the federal government must originate in the legislative branch. This constitutional principle, that Parliament holds the power of the purse is rooted in Magna Charta and prevents executive dictatorship. See, e.g., *What is the Sequester*, THE WHITE HOUSE, <http://www.whitehouse.gov/issues/sequester> (last visited Jan. 30, 2015).

⁴⁵ Heleen Mees, *How China's Boom Caused the Financial Crisis and Why it Matters Today*, FOREIGN POLICY (Jan. 17, 2012), http://www.foreignpolicy.com/articles/2012/01/17/how_china_s_boom_caused_the_financial_crisis.

ment figures and productivity are improving in the United States, U.S. enterprises remain underperformers in comparison to economies in East Asia (China,⁴⁶ Southern Korea,⁴⁷ Singapore,⁴⁸ to name a few examples of high-performers) and even Northern Europe.⁴⁹ Thus, although the U.S. tax base is no longer contracting, growth will be marginal as low paying jobs replace high paying ones. Such is the outcome for countries that squander their wealth on wasteful wars for oil, which fail to seize the coveted resources cheaply.⁵⁰

As a result of these events, the U.S. dollar is no longer the world's sole reserve currency: the Euro now is a second global reserve currency.⁵¹ Our hypothesis is that the various stresses on the Euro may be a result of factions within the United States seeking to undermine the Euro because the Euro is the Dollar's only credible competitor for global capital, a second global reserve currency. Regardless of speculation, it is certain that when Iraq redenominated its oil contracts in Euros instead of Dollars, the United States soon thereafter invaded Iraq and deposed Saddam Hussein, Iraq's former head of state, executing him in the process.⁵²

⁴⁶ "Since initiating market reforms in 1978, China has shifted from a centrally planned to a market based economy and experienced rapid economic and social development. GDP growth averaging about 10 percent a year has lifted more than 500 million people out of poverty." *China: Overview*, WORLD BANK (Apr. 1, 2014), <http://www.worldbank.org/en/country/china/overview>.

⁴⁷ "South Korea over the past four decades has demonstrated incredible growth and global integration to become a high-tech industrialized economy. In the 1960s, GDP per capita was comparable with levels in the poorer countries of Africa and Asia. In 2004, South Korea joined the trillion dollar club of world economies, and is currently the world's 12th largest economy." *South Korea*, FORBES, <http://www.forbes.com/places/south-korea/> (last updated Dec. 2014).

⁴⁸ *The Singapore Economy*, MONETARY AUTHORITY OF SINGAPORE, <http://www.sgs.gov.sg/The-SGS-Market/The-Singapore-Economy.aspx> (last visited Jan. 30, 2015) ("over the period from 2000 to 2010, the GDP nearly doubled, rising from S\$163 billion to S\$304 billion. Real GDP per capita also rose rapidly at a compounded rate of nearly 12% p.a., while inflation and unemployment rates averaged less than 2% p.a. and 3% p.a. respectively during this period.").

⁴⁹ Unlike the United States, employment rates in Germany were largely unaffected by the great recession of 2008. See, e.g., Florian Hoffmann & Thomas Lemieux, *Unemployment in the Great Recession: A Comparison of Germany, Canada and the United States* (Sept. 2013), available at http://faculty.arts.ubc.ca/fhoffmann/HL_Great_Recession_Oct13.pdf.

⁵⁰ See, Eric Engle, *Rethinking the 'War on Terror': Legal Perspectives on Containment and Development Strategies*, CITY UNIVERSITY OF HONG KONG LAW REVIEW, VOL. 2, NO. 1, pp. 67-79, (July 2010); Eric Engle, *Managing Pluralism*, 4 BERKELEY J. INT'L L. 37, 40 (2010), available at <http://bjil.typepad.com/publicist/2010/01/managing-pluralism.html>.

⁵¹ Alan W. Cafruny, *A Ruined Fortress? Europe and American Economic Hegemony*, 19 CONN. J. INT'L L. 329, 329 (2004).

⁵² Philippa Winkler, *The War Against Iraq: Whose Ends, Whose Means*, 9 NEXUS 163, 167 (2004). "The deciding factor was when Saddam Hussein pegged the dinar to the dollar bloc's commercial rival, the euro. Something more drastic had to occur: a land grab, 21st century-style. However, it could not look like a land grab. Bombing Iraq to get rid of the imminent threat of Iraqi WMDs became the excuse du jour. When the WMDs couldn't be found, another excuse was offered: bombing Iraq into democracy."

To present, financial crises in Greece, Spain, and Cyprus echo the U.S. real estate crash, but have not split the Atlantic partners or caused the Euro to be abandoned. The Euro survived the economic stresses of 2012-2014 and is very likely here to stay. If the United States were seeking to break the Euro as a viable alternative global reserve currency such a policy would likely end NATO and cause another global recession; it is much more attractive to the United States to maintain NATO and to negotiate toward transatlantic free trade (TTIP) than to break the Euro, especially given Russia's lawless invasion of Ukraine.

Even if the United States were intent on breaking the Euro, despite the obvious implications of that move for transatlantic trade and NATO, Europe itself would seek to maintain the Euro. Germany's tragic historic experience of hyperinflation⁵³ and the terrible wars that caused and followed it are why the European Central Bank (ECB) will never abandon prudent policies. The ECB's prudent monetary policies were modeled on the German post-war Bundesbank, which itself modeled its policies on the U.S. Federal Reserve. Furthermore, the economic efficiencies which result from reduced transaction costs and economic integration also justify the Euro and explain why we expect it to survive the great recession. Finally, the Euro as a reserve currency increases demand for E.U. financial instruments, which also explains why we do not expect the ECB to dissolve the Euro, or that Euro countries will leave the Euro.

Again, these are our hypotheses, and obviously will require further research and the passage of time to prove or refute. However, the competition between the Euro and the Dollar⁵⁴ is not merely for denomination of oil contracts or other financial transactions outside of North America and Europe. It is also to attract capital in the form of bond investments. The United States has never defaulted on its bond obligations, which is why the United States consistently attracted so much foreign capital so cheaply. Thus, the ECB will likely be very cautious, and rightly so, concerning the introduction of Eurobonds. In any case, the presence of the Euro as a real alternative for Russia, China, and the Middle East as a stable international currency will likely reduce demand for the Dollar, and possibly also for U.S. Treasury Bonds. This, in turn, would exacerbate the difficulties facing the United States to attract Arab and Chinese capital.

⁵³ Timothy A. Canova, *Financial Liberalization, International Monetary Dis/order, and the Neoliberal State*, 15 AM. U. INT'L L. REV. 1279, 1297 (2000).

⁵⁴ See, e.g., Robert Fisk, *The Demise of the Dollar*, THE INDEPENDENT (Oct. 6, 2009), <http://www.independent.co.uk/news/business/news/the-demise-of-the-dollar-1798175.html>.

E. THE GERMAN CAPITAL MARKET

The collapse of the U.S. economy can be contrasted with the higher performance of the German economy. For years, U.S. analysts argued that German policies of assuring worker representation and trade union participation in the management of enterprises, known as co-determination, was an underproductive mistake, supposedly resulting in lazy spoiled workers. Rather than thinking about the problem of how best to coordinate labor-management specializations so as to maximize production and attain social well-being,⁵⁵ U.S. corporate theorists fixate on “shirking,”⁵⁶ “rent seeking,”⁵⁷ and “free riding.”⁵⁸ “Efficiency” claims generally, but not always,⁵⁹ focus on “agency costs,”⁶⁰ using shareholder wealth as the measure. However, fixating exclusively on shareholder wealth instead of production, sales, rates of profit, and repeat business, in concert with fixating on the erroneous efficient capital market hypothesis, leads to sub-optimal production.⁶¹

U.S. analyses that rejected co-determination did not understand that trade unions vector worker expertise in workplace safety, as well as working hours and conditions into productive outcomes:⁶² higher quality products at lower prices that consistently exceed customer expectations, which was the formula of Germany’s export driven market, a formula China appears to be following with similar success. Some empirical research on labor unions’ impact on safety in the United States obscures the role of labor unions due to methodological problems.⁶³ Empirical

⁵⁵ Blair, *supra* note 16, at 895-96 (arguing to shift focus from shareholder wealth maximization to long term value creation).

⁵⁶ Lucian Bebchuk, Alma Cohen, & Allen Ferrell, *What Matters in Corporate Governance?* THE REV. OF FIN. STUD., 6 (2008), available at http://www.law.harvard.edu/faculty/bebchuk/pdfs/2008_What-Matters-Review-of-Financial-Studies.pdf; Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 670 (1996); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 24 J. CORP. L. 743, 745 (1999).

⁵⁷ Blair & Stout, *A Team Production Theory of Corporate Law*, at 745.

⁵⁸ William W. Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J. TRANSNAT’L L. 213, 287-289 (1999); Blair, *supra* note 16, at 909.

⁵⁹ Marleen O’Connor, *Labor’s Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL’Y J. 97, 100 (2000).

⁶⁰ Bainbridge, *supra* note 56, at 670.

⁶¹ Blair, *supra* note 16, at 908.

⁶² Regarding the *facts*, Worker participation enables feedback on working conditions: e.g., “these practices are dangerous to life and limb; those tools and precautions are necessary.” Regarding the *law*, Worker feedback also provides supervision to other workers: e.g., “don’t come to work sleepy, ill, or drunk.” Masahiko Aoki, TOWARD A COMPARATIVE INSTITUTIONAL ANALYSIS, 164 (2001).

⁶³ Alison Morantz, *The Elusive Union Safety Effect: Toward a New Empirical Research Agenda*, 137 (June 1, 2009), available at http://assets.conferencespot.org/filesserver/file/120639/filename/2009_369.pdf.

research from South Korea, a country which models its economic and political system on the United States, unequivocally shows the common sense fact that labor unions improve production by preventing accidents at work.⁶⁴

In the United States, safer workplaces are obtained through the Occupational Safety and Health Administrations' standards and workers' compensation. However, labor unions also contribute to the regulation of safety at the workplace by publicizing standards and advocating better enforcement and improvement of safety standards.⁶⁵ In Europe, works councils,⁶⁶ which are worker-teams on the shop floor, exist to identify and solve practical problems of production. Though common in Europe, works councils rarely feature in U.S. enterprises. Shop floor co-determination through works councils (in German: *Betriebsrat*) may also help to ensure compliance with governmental rules, legislation and administrative regulation, as well as internal governance guidelines such as voluntary corporate codes of good conduct.

German corporations are more efficient producers than U.S. corporations due to greater labor participation and better governance mechanisms. Worker and trade union participation in management provides a check to prevent fraud, increases employees' willingness to work well, and enable a longer-term perspective on performance. Investors and employees have a common cause against managerial fraud; therefore, co-determination can contribute to scrutiny and exposure of fraud, whether through self-dealing or financial misrepresentations. Unfortunately, whether due to lack of expertise or recognition of mutual interest, U.S. labor does not always effectively back-stop managerial wrongdoing. However, German corporations, like East Asian companies modeled on the German corporatist cooperative labor-management two-tier model,⁶⁷ are becoming fairly well reputed for transparency of governance and efficiency in production.⁶⁸ The theory underlying co-determination and the

⁶⁴ Kwan Hyung Yi, Hm Hak Cho, & Jiyun Kim, *An Empirical Analysis on Labor Unions and Occupational Safety and Health Committees' Activity, and their Relation to the Changes in Occupational Injury and Illness Rate*, 2(4) SAFE HEALTH WORK 321-327 (2011) available at <http://www.ncbi.nlm.nih.gov/pmc/articles/PMC3430909/>.

⁶⁵ See generally, *Job Safety*, AMERICAN FEDERATION OF LABOR - CONGRESS OF INDUSTRIAL ORGANIZATIONS, <http://www.aflcio.org/Issues/Job-Safety> (last visited Jan. 30, 2015).

⁶⁶ Works council systems are institutionalized bodies for representative communication between employers and employees. See, e.g., Daniel Little, *Works Councils and US Labor Relations*, UNDERSTANDING SOCIETY (Feb. 9 2010, 7:46 PM), <http://understandingsociety.blogspot.de/2010/02/works-councils-and-us-labor-relations.html>.

⁶⁷ "Germany . . . has a corporate structure that separates those who manage the business of the corporation from those who oversee the management." Owen, *supra* note 7, at 168.

⁶⁸ See, e.g., Alice De Jonge, *TRANSNATIONAL CORPORATIONS AND INTERNATIONAL LAW*, 9 (2011).

two-tier board is corporatism,⁶⁹ which we now discuss since corporatism is less well known or understood in the United States than in continental Europe⁷⁰ and since it explains why German unions work.

F. CORPORATISM

Corporatism is the idea that labor and management should interact cooperatively to take advantage of the strengths of workers' shop-floor expertise, i.e., safety and production, and managerial know-how, i.e., accounting and marketing, to generate the most production for the business as a going-concern of society.⁷¹ Corporatism is a model of business enterprise based on a theory that labor and management operate best together cooperatively. In the United States, labor-management relations are all too often cast as competitive and zero sum, resulting in less than productive labor-management combinations, explaining in part the decline and fall of Detroit and its auto industry. Corporatist theory is central to continental understandings of the economy in France and Germany and a strong influence in the many countries that model their law on German or French law, which is much of the world. Corporatism is related to Ordo-liberalism as one of the two main variants of social theories of the market.⁷²

Ordo-liberalism is the idea that a mixed economy, which involves government industry and intervention in areas of public goods and natural monopolies, leads to optimal production and social justice.⁷³ To ordo-liberals, large concentrations of corporate power are inevitable because of natural monopoly.⁷⁴ Monopoly power is inevitable because of economies of scale, entry costs, synergies of specialization, and network

⁶⁹ See, e.g., Maria Brouwer, GOVERNANCE AND INNOVATION: A HISTORICAL VIEW, 144 (2008); Sol Picciotto, REGULARINF GLOBAL CORPORATE CAPITALISM, 123 (2011).

⁷⁰ See, e.g., Howard J. Wiarda, CORPORATISM AND COMPARATIVE POLITICS: THE OTHER GREAT "ISM", 34-35 (1997).

⁷¹ See, e.g., Id. at 57-59.

⁷² "The institutions which underpinned the success of the German model of capitalism, the so-called Sozialmarktwirtschaft or social market economy emerged from a compromise between protestant ordo-liberalism and Catholic neo-corporatism." Alfonso Martinez Arranz, Natalie Doyle, & Pascaline Winand (eds.), NEW EUROPE, NEW WORLD?: THE EUROPEAN UNION, EUROPE, AND THE CHALLENGES OF THE 21ST CENTURY, 53 (2010).

⁷³ Peter Muchlinski, *The Development of German Corporate Law Until 1990: An Historical Reappraisal*, 14 GER. L.J. 339, 370 (2013).

⁷⁴ See, e.g., Frank P. Maier-Rigaud, *On the Normative Foundations of Competition Law: Efficiency, Political Freedom and the Freedom to Compete* (May 2, 2011), in D. Zimmer (ed.), THE GOALS OF COMPETITION LAW, 142-144, (2012) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829023.

effects.⁷⁵ Thus, in ordo-liberalism competition law and corporate law alike seek to regulate the problem of abuses of (inevitably) concentrated economic power.⁷⁶ Likewise, for ordo-liberalism and corporatism, the government's proper role is as the mediator⁷⁷ to resolve and avoid labor-capital conflicts.

Although corporatism became central to French and German understandings of political economy, the corporatist model never really took root in U.S. law. Thus, alternative forms of sustainable enterprise such as the Cooperative form of corporate enterprise (in German: *Genossenschaft*) never became widely adopted in U.S. law, possibly due to an inability to obtain credit, i.e., bank loans.⁷⁸ Can U.S. law somehow take up Germanic conceptions of corporatism in an effort to attain higher productivity and less corruption as a part of its economic recovery?

G. EMULATING THE GERMAN CORPORATION IN THE U.S. MARKET

Legislatively mandated co-determination does not exist in U.S. corporation law.⁷⁹ Unfortunately, in the face of a Weimar-style legislative gridlock, it is unrealistic to expect U.S. law to replace or supplement a one-tier corporate governance system with two-tier governance or co-determination in any other form.⁸⁰ Even if legislative will and no gridlock existed, there is an entrenched Wall Street hostility to labor unions, and a general ideological blindness to anything "collective" or "social" in U.S. individualist liberalism. Co-determination is simply disfavored in U.S. political and corporate culture and is essentially absent in the United States as a matter of positive law.⁸¹ Corporatism and labor unions, as a political or even market force, are essentially absent in the United States. Thus, for all those reasons, co-determination could never arise legislatively in the United States. Although social enterprises, such as co-operatives, (in Russian: *Kolkhoz*, *Sovkhoz*,⁸² in German: *Genossen-*

⁷⁵ See, e.g., Organisation for Economic Co-operation and Development (OECD), BARRIERS TO ENTRY 29-30 (2005), available at <http://www.oecd.org/daf/competition/abuse/36344429.pdf>.

⁷⁶ Muchlinski, *supra* note 73, at 371.

⁷⁷ Blair & Stout, *supra* note 56, at 771.

⁷⁸ Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1226 (June, 1984).

⁷⁹ Bainbridge, *supra* note 56, at 689.

⁸⁰ Marleen O'Connor, *Corporate Malaise - Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 3, 18 (1991) (arguing that there is little possibility that codetermination will be transferred to the United States because of political aversion).

⁸¹ See, e.g. Claude Menard, Mary M. Shirley, HANDBOOK OF NEW INSTITUTIONAL ECONOMICS, 375 (2008); William B. Gould AGENDA FOR REFORM: THE FUTURE OF EMPLOYMENT RELATIONSHIPS AND THE LAW 146 (1993); O'Connor, *supra* note 59, at 99.

⁸² The *kolkhoz* (lit: collective possession) and *sovkhoz* (lit: council possession) were the two principle forms of cooperative enterprise in the Soviet system. The *Genossenschaft* was (and is) a cooperative form of enterprise in Germany. These forms are roughly homologous to the cooperative

schaft) were key producers in Eastern European and even some Western European economies, co-operative forms of enterprise are barely present in the United States.

A question for German corporations seeking to enter into the U.S. market by incorporating or taking over subsidiaries, as well as for U.S. businesses that wish to take advantage of the German model, is how to emulate German corporate governance structures privately within U.S. law.⁸³ The German two-tier corporate board structure⁸⁴ and employee participation in ownership and control of the corporation can be emulated in the corporate charter and through contracts under U.S. law. Through use of the articles of incorporation, by-laws, and contractual agreements, a two-tier corporate board structure with co-determination can be emulated in U.S. common law. To understand how to do that, we need to examine our theories of the corporation, of co-determination, of corporate finance, and of social enterprises.

II. THE CORPORATION IN THEORY

At the root of the questions of co-determination, sustainability, and corporate governance, generally, is the nature of the corporation. There are differing theories regarding the nature of corporate influence over our understanding of the rights and duties the corporation creates, administers, and extinguishes. Thus, we examine the competing theories in order to understand whether, and to what extent, emulating the German AG (publicly traded) or GmbH (close corporation) in U.S. law makes sense and is possible.

enterprise form (“co-op”) in the United States. Chris Hann, *Property Relations: The Halle Focus Group, 2000-2005*, MAX PLANCK INSTITUTE (2005), available at http://www.eth.mpg.de/cms/en/publications/reports/pdf/property_relations_report_2005.pdf.

⁸³ We are not the first to suggest this, see Owen, *supra* note 7, at 189.

⁸⁴ “According to the German Stock Corporation Act of 1965, it is mandatory for all German stock corporations (*Aktiengesellschaften*) to have two boards: the management board (*Vorstand*) and the supervisory board (*Aufsichtsrat*). The supervisory board members are either shareholder representatives or labour representatives. Simultaneous membership of the management board and the supervisory board is not permitted.” Carsten Jungmann, *The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems – Evidence from the UK and Germany*, ECFR 426–474, 432 (2006), available at http://www.jura.uni-muenchen.de/fakultaet/lehrstuehle/eidenmueller/_dokumente/ecil/jungmann_2006.pdf.

A. THE CHARTER THEORY OF THE CORPORATION: THE CORPORATION AS STATE POWER

Historically, the corporation arose as a delegation of state power to private societies⁸⁵ through granting of a corporate charter with an express or implied monopoly power over a given area, whether geographic or economic, which we call *the charter theory*. The prototypical common law examples here are the Massachusetts Bay Company, The Hudson's Bay Company, and the British East India Company; the Dutch East India Company is the prototypical civil law example. These institutions were both private market actors as to their economic functions, *acto iure gestionis*, and institutions of government as to their sovereign functions, *acto iure imperii*.⁸⁶ From its roots as an exceptional instance of delegated state power, the corporation became *de facto* increasingly a matter of "private" enterprise. Eventually the corporation charter became a generalized document that could be obtained by compliance with simple formal requirements.⁸⁷ This theory of the corporation as an instance of state-power corresponds to mercantilism and is a forerunner of later corporatist theories of the company.

B. THE TRUST THEORY OF THE CORPORATION

The *trust theory* of the corporation emerged from the charter theory, as the corporate form became more widespread and taken up for purely economic, and not governance purposes. For the trust theory of the corporation,⁸⁸ like the charter theory, the corporation is a separate legal per-

⁸⁵ Bainbridge, *supra* note 56, at 668 (the delegation of state power to the board of directors then enabled further delegations from the board to employees and agents of the corporation – a finely made chain of delegated state power, subtle and supple in its effects.).

⁸⁶ See, e.g., Bernard Maria Gavouneli & Ilias Bantekas, *International Decision: Prefecture of Voiotia v. Federal Republic of Germany*, 95 AM. J. INT'L L. 198 (2001); ("The distinction between acts *jure imperii* and *jure gestionis* is effected on the basis of the law of the forum and using as a basic criterion the nature of the act carried out by the foreign state, i.e., whether it involves the exercise of a sovereign power.") *Id.* (quoting *Prefecture of Voiotia v. Federal Republic of Germany*, Case No.11/2000 (Areios Pagos (Sup. Ct. of Greece)), May 4, 2000); *Saudi Arabia v. Nelson*, 507 U.S. 349, 360 (1993).

⁸⁷ Tom Campbell & Seumas Miller, HUMAN RIGHTS AND THE MORAL RESPONSIBILITIES OF CORPORATION AND PUBLIC SECTOR ORGANISATIONS 112-13 (2005).

⁸⁸ "The trustee holds legal title to the trust property and the beneficiaries have the equitable, or beneficial, interests. Two categories of issues arise from this splitting of legal and equitable ownership: (1) the powers and duties of the trustee and the corresponding rights of the beneficiary with respect to the trust property and against the trustee (*governance*), and (2) the effect on the rights of third parties with respect to the trust property versus the personal property of the trustee (*asset partitioning*)." Robert H. Sitkoff, *Trust Law as Fiduciary Governance Plus Asset Partitioning*, HARVARD UNIVERSITY LAW & ECONOMICS DISCUSSION PAPER NO. 711, at 429 (Nov. 21, 2011), available at <http://ssrn.com/abstract=1962856>.

son apart from and greater than its members, growing out of and analogical to the common law trust⁸⁹ - a type of property. This theory of the corporation as a synergy is consistent with the charter theory from which it evolved sketched out here in the prior paragraph. The trust theory of the corporation however implies fiduciary duties⁹⁰ of loyalty and trust⁹¹ in lieu of the (mercantilist) command of the state that characterized the charter theory. Historically, fiduciary duties were nearly absolute: today, like so many other rights, they are relativized and contextualized.⁹² Historically, the trustee (in the corporate context, the board of directors) owed fiduciary duties to the trust grantor (in the corporate context, the shareholders). However, the trust theory of the corporation⁹³ is less current today⁹⁴ than in the past.⁹⁵

⁸⁹ Henry Hansmann & Ugo Mattei, *The Functions Of Trust Law: A Comparative Legal And Economic Analysis*, 73 N.Y.U. L. REV. 434, 478-479 (1998).

⁹⁰ Fiduciary duties arose out of the trust. Fides is however more than mere good faith. Mere good faith is but actual honesty. The fiduciary duty in contrast is a higher duty of loyalty: the fiduciary must in fact act on behalf of and for the benefit of the person or persons to whom they owe this duty of highest loyalty. *See, e.g.*, *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (“A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. [internal citations omitted] Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. *But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.*”) (Emphasis added).

⁹¹ Trusting is economically efficient, yet trust cannot be purchased and is difficult to obtain. Robert Cooter & Melvin Eisenberg, *Fairness, Character, and Efficiency in Firms*, 149 U. PA. L. REV. 1717, 1722-1723 (2000-2001) (citing Kenneth Arrow). This asymmetry of market value (measured in cash) versus worth (measured in justified expectations) explains why shareholder wealth maximization is inadequate as the standard of corporate conduct.

⁹² Sitkoff, *supra* note 88, at 432; “Most fiduciary obligations are *default rules* that yield to the contrary agreement of the parties Even the fiduciary duty of loyalty is subject to modification. If the principal gives informed consent to certain self-dealing by the fiduciary, the rationale for the duty of loyalty’s prophylactic rule against self-dealing falls away. In such circumstances, the fiduciary may engage in the specified self-dealing, provided that the fiduciary acts in good faith and that the transaction is objectively fair and in the best interests of the principal. To be sure, there is a mandatory core to fiduciary obligation that cannot be overridden by agreement. A fiduciary may not be authorized to act in bad faith. Even if the principal authorizes self-dealing, fiduciary law provides substantive and procedural safeguards. The fiduciary always must act in good faith and deal fairly with and for the principal, and the fiduciary must apprise the principal of the material facts in securing the principal’s informed consent to a conflicted action or self-dealing transaction.” *Id.*

⁹³ *Id.* at 430; “The traditional but now outmoded governance strategy for protecting the beneficiary’s interests was to negate the agency problem by disempowering the trustee. Under traditional law, the trustee had no default powers to engage in market transactions over the trust property. The trustee’s powers were limited to those granted expressly in the trust instrument. The problem with this disempowerment strategy is that in protecting the beneficiary from mis- or malfeasance by the trustee, the law also disabled the trustee from undertaking transactions useful for the beneficiary. As trusts have come increasingly to be funded with liquid financial assets that require alert management in the face of swiftly changing financial markets, modern trust law has come to give the trustee

The *shareholder primacy theory* arose with modernity and industrialization. The shareholder primacy theory is rightly rooted to the trust theory of the firm, again illustrating the evolutionary nature of corporate theory: the directors, as *fiduciaries* of the shareholder's property (still) have duties of loyalty and fairness. Thus, in the case where the corporation is entirely liquidated, the directors have a fiduciary duty to maximize the profit to the shareholders in the sale of the corporation.⁹⁶ That is the only clear-cut case where the directors must maximize shareholder wealth⁹⁷ – and that case is based on the theory of fiduciary duties, not on contractual obligations.⁹⁸ Note that the shareholder primacy model is inaccurate legally when it ascribes directors' fiduciary duties as owed only to shareholders. The directors also owe fiduciary duties to the corporation as a whole,⁹⁹ but not to the corporation's employees.¹⁰⁰ Em-

broad powers to undertake any type of transaction, subject to the trustee's fiduciary duties. Modern law gives the trustee 'all of the powers over trust property that a legally competent, unmarried individual has with respect to individually owned property.' However, 'in deciding whether and how to exercise the powers of the trusteeship,' the trustee is subject to and must act in accordance with the [trustee's] fiduciary duties." *Id.*

⁹⁴ *Id.*

⁹⁵ For a history of this transformation from the corporation itself as the trust beneficiary to the corporation's directors as trustees of shareholder investment – the definite trend of the era ca. 1600-1900, see Colin Arthur Cooke, CORPORATION, TRUST AND COMPANY: AN ESSAY IN LEGAL HISTORY 69-70 (1950)

⁹⁶ Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

⁹⁷ See, e.g., Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919). Lynn Stout cogently argues that Dodge v. Ford was badly decided and ought not be a part of the U.S. corporate law canon. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, UCLA SCHOOL OF LAW LAW & ECON RESEARCH PAPER SERIES RESEARCH PAPER NO. 07-11, 3 (2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013744. (However the fact is that *Dodge v. Ford* is still good law. The case held that "A business corporation is organized and carried on primarily for the profit of the stockholders. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).") That is, the corporation may do things in addition to making profit but indeed a for-profit corporation is different in kind from a charitable or municipal corporation.)

⁹⁸ Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

⁹⁹ Simon Deakin, *Squaring the Circle? Shareholder Value and Corporate Responsibility in the U.K.*, 70 GEO. WASH. L. REV. 976, 977 (2002); Douglas G. Baird & M. Todd Henderson, *Other People's Money*, JOHN M. OLIN LAW & ECONOMICS WORKING PAPER NO. 359, 2d Series (2007), available at http://ssrn.com/abstract_id=1017615 ("In the last part, we suggested that corporate law might sensibly adopt the principle that directors owe a fiduciary duty to the corporation as a whole."); Andrew Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and All That: Much Ado About Little?*, UNIVERSITY OF LEEDS, SCHOOL OF LAW WORKING PAPER, 11 (Jan. 4, 2010), available at <http://ssrn.com/abstract=1530990>.

¹⁰⁰ Marleen O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1190, 1191, 1194 (1991). (Marleen O'Connor goes on later to argue that fiduciary duties toward employees ought to be imposed by the courts, in order to fulfill "implicit" contracts and "non-contractual expectations." While the imposition or enforcement of fiduciary duty may well be an exercise of the courts exceptional discretionary power to grant equity, fiduciary duties are rooted in proprietary, not contractual relationships. Furthermore, the "implicit" contracts which O'Connor argues for simply lack any judicially determinable objective standards, and could never be proven (or disproven). Since the burden of proof is on

ployee relationships are governed by contract, not trust. They are arms-length self-interested transactions governed by contract, not property relationships governed by trust law. The various corporate corruption scandals sketched earlier explain why the shareholder primacy model is increasingly called into question.¹⁰¹

C. THE NEXUS OF CONTRACTS THEORY OF THE CORPORATION

The corporation is presented most often in current discourse *not* as a mercantilist or corporatist institution of *government*; nor as a variety or outgrowth of the common law trust, i.e. as an instance of *property* law. Instead, most often, the contemporary corporation is currently and inaccurately portrayed as merely a nexus of contracts.¹⁰² Supposedly, the contemporary corporation is but a series of contractual and not fiduciary relationships that are independent and separable elements, and thus, implicitly carry no synergies. According to the nexus of contracts theory of the corporation:

Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is not a thing but rather a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.¹⁰³

When Milton Friedman first, and most famously, argued that the only duty of the corporation is to maximize shareholder wealth, he based his arguments on a theory of the corporation as contract and agency,¹⁰⁴

the moving party, and since equity is an exceptional discretionary remedy the likelihood of the courts imposing "ghost contracts" is just about nil. A better reform effort would be to draft model statutes, model charters, model bylaws, and model proxy statements to represent worker's interests directly, concretely and democratically rather than by the uncertain and unpredictable judicial process. It is also worth pointing out that O'Connor admits that as a matter of existing positive law the directors do not owe fiduciary duties to employees. The reason is because fiduciary duties are in rem, not in personam, and employment contracts are in personam.) Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97, 103 (2000).

¹⁰¹ Blair, *supra* note 16, at 889.

¹⁰² Bainbridge, *supra* note 56, at 660.

¹⁰³ Judd F. Sneirson, *Green Is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 IOWA L. REV. 987, 1016 (2009).

¹⁰⁴ Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES (Sept. 13, 1970), available at <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>.

not on fiduciary duties. Friedman regards directors as *employees* of the shareholders, bound by contract. Coase, like Friedman, also regards the corporation as a contract.¹⁰⁵ Coase states that corporations come into being to reduce transaction costs¹⁰⁶ by entering into one long-term contract rather than dozens or even hundreds of short contracts.¹⁰⁷ Making one large contract rather than hundreds of small ones saves the contracting parties transaction costs¹⁰⁸ and costs associated with uncertainty, opportunism, and complexity.¹⁰⁹ Coase, like Friedman, speaks in terms of agency and contract,¹¹⁰ not in terms of fiduciary duty or trust.

The problem is, the theory that the corporation is but a nexus of contracts and that, consequently, the directors are mere agents, whose only duty is the maximization of shareholder' wealth is *legally inaccurate* and *economically simplistic*.¹¹¹

The nexus of contracts theory is inaccurate *legally*, since it ignores the fiduciary nature of at least some corporate relationships – contract is not trust, and property is not contract. Logically, there can be no “owner” of the corporation under the nexus view,¹¹² because a contract is an executory instrument *in personam*, not a vested title *in rem*. Trust relationships entail fiduciary duties of loyalty. Contractual relationships in contrast are arms-length transactions, with merely the duty of good faith i.e. mere factual honesty, not scrupulous care which places the entrusted interest above one's own personal interest. The nexus theory is also inaccurate legally because it entails as logical consequence the

¹⁰⁵ Ronald Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 391 (1937), available at <http://www.colorado.edu/ibs/eb/alston/econ4504/readings/The%20Nature%20of%20the%20Firm%20by%20Coase.pdf>.

¹⁰⁶ More recent theorists reprise Coase on this point: Bainbridge, *supra* note 56, at 662 (“firms come into existence when the costs of bargaining are higher than the costs of command-and-control.”).

¹⁰⁷ Coase, *supra* note 105, at 390-91.

¹⁰⁸ Bainbridge, *supra* note 56, at 662 (“Organizing economic activity within a firm . . . may lower search and other transaction costs associated with bargaining”).

¹⁰⁹ *Id.* (“Organizing production within a firm can also lower costs associated with uncertainty, opportunism, and complexity.”).

¹¹⁰ Coase, *supra* note 105, at 404.

¹¹¹ Melvin Eisenberg, *The Conception that the Corporation is a Nexus of Contracts and the Dual Nature of the Firm*, 24 *J. CORP. L.* 819, 820 (1999).

¹¹² *Id.* at 825-826.

wrong idea that the principal¹¹³ or even sole¹¹⁴ purpose of the corporation is maximization of profit to shareholders of corporation stock.¹¹⁵

The corporate director in U.S. law is a trustee¹¹⁶ and fiduciary,¹¹⁷ not an employee of the shareholders. Corporate directors are of course agents,¹¹⁸ but they are agents *of the corporation*, not of any shareholder or group of shareholders, and their agency is coupled with fiduciary duties¹¹⁹ as trustees¹²⁰ of shareholders' property and to the corporation.¹²¹ Directors owe fiduciary duties of loyalty¹²² to the corporation and its shareholders.¹²³ Consequently, directors may not engage in self-deal-

¹¹³ "The dominant purpose of corporations is to maximize shareholder wealth." Hope M. Babcock, *Corporate Environmental Social Responsibility: Corporate "Greenwashing" or a Corporate Culture Game Changer?* 21 *FORDHAM ENVTL. L. REV.* 1, 11 (2010).

¹¹⁴ *E.g.*, the "single purpose [of corporations] is shareholder wealth maximization." Ruth O. Kuras, *Corporate Social Responsibility: A Canada - U.S. Comparative Analysis*, 28 *MAN. L.J.* 303, 303 (2002).

¹¹⁵ "Critics of corporate social responsibility (CSR) have asserted that businesses should solely focus on increasing profit, rather than being distracted by social goals" (Friedman 1970; McWilliams & Siegel 2000). Roger Stace, *Triple-Bottom-Line Goals in a Management Control System: Experimental Effects on Commitment and Trust*, AAA 2013 Management Accounting Section (MAS) Meeting Paper, 2 (2012), available at <http://ssrn.com/abstract=2133135>.

¹¹⁶ That the director is a trustee of the corporation is fairly evident. *See, e.g.* *Zweifach v. Scranton Lace Co.*, 156 F. Supp. 384, 396 (M.D. Pa. 1957) ("a director is a trustee" citations omitted). That the director is also a trustee of individual shareholders is less obvious. At its most attenuated is the question whether the corporate director is a trustee of the corporation's creditors, a position we reject, as do the courts with better reasoning. *Sutton v. Reagan & Gee*, 405 S.W. 2d 828, 834-35 (Tex. Civ. App. 1966).

¹¹⁷ *Pepper v. Litton*, 308 U.S. 295, 306 (1939) ("A director is a fiduciary") (citing *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 588 (1876)); *Gearhart Industries, Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723 (5th Cir. 1984); For a cogent argument that the corporation as teamwork, *see* Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 *WASH. U.L.Q.* 403, 424 (2001).

¹¹⁸ *Guthrie v. Harkness*, 199 U.S. 148, 155 (1905) ("The right of inspection rests upon the proposition that those in charge of the corporation are merely the agents of the stockholders, who are the real owners of the property" (citing *Cincinnati Volksblatt Co. v. Hoffmeister*, 56 N.E. 1033 (Ohio 1900)); *Shaw v. Agri-Mark, Inc.*, 663 A.2d 464, 467 (Del. 1995) ("[I]nspection rights have been viewed as an incident to the stockholder's ownership of corporate property. . . . As a matter of self-protection, the stockholder was entitled to know how his agents were conducting the affairs of the corporation of which he or she was a part owner").

¹¹⁹ *See* The American Law Institute, *RESTATEMENT OF THE LAW (SECOND) AGENCY* § 1 (1958) (defining agency as "the fiduciary relation which results from the manifestation consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act").

¹²⁰ *Grognet v. Fox Valley Trucking Service*, 45 Wis.2d 235, 242 (1969) (Majority view: director trustee to corporation; minority view: director trustee to shareholder: argues for minority view); *Selheimer v. Manganese Corp. of Am.*, 423 Pa. 563, 576-77 & note 15 (1966) (director as trustee).

¹²¹ Blair & Stout, *supra* note 56, at 280-81.

¹²² *Id.* at 286-87.

¹²³ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) ("directors owe fiduciary duties of care and loyalty to the corporation and its shareholders").

ing¹²⁴ or exploit corporate opportunities¹²⁵ without permission of a majority of disinterested directors and/or shareholders.¹²⁶ The directors' fiduciary duty of loyalty is not merely the self-interested contractual duty of actual honesty: the fiduciary duty of loyalty commands scrupulous care which places the protection of entrusted property above the trustee's own interests.¹²⁷ This duty of loyalty is owed not only to the shareholders who have entrusted their property but also to the corporation as a whole, because the shareholders' interests will at times conflict with each other. Shareholders' conflicts must be resolved by the trustees in the best interests of the corporate enterprise – and not as may please (or displease) any particular shareholder or block of shareholders. Their discretion to resolve conflicts in the *corporate* interest is their entrusted power.

The shareholder wealth maximization theory is also contradicted by the business judgment rule. Directors are entrusted with the direction of the corporation, and so will not be judged in negligence for their good faith but erroneous business judgments¹²⁸ because it is their duty to balance the competing interests, goals, and desires of shareholders, employees, clients and communities and resolve those conflicts in the best interest of the corporation as a whole.¹²⁹ The existence of the business

¹²⁴ E.g., *United States v. Lee*, 359 F. 3d 194, 204 (3rd Cir. 2004); (“A person who owes a duty of fidelity or loyalty may not engage in self-dealing or otherwise use his or her position to further personal interests rather than those of the beneficiary. For example officers and directors have a duty not to engage in self-dealing”) *In re McCook Metals, L.L.C.*, 319 B.R. 570, 595 (Bankr. N.D. Ill. 2005); *State v. Stoehr*, 134 Wis. 2d 66, 396 N.W.2d 177 (1986).

¹²⁵ *Int'l Bankers Life Ins. v. Holloway*, 368 S.W. 2d 567, 577 (Tex. 1963) (“A corporate fiduciary is under obligation not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so.”); *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955); For theory thereto, see Blair & Stout, *supra* note 56, at 320.

¹²⁶ “A challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of the stockholders.” *Gearhart Indus., Inc. v. Smith Int'l. Inc.*, 741 F.2d 707, 720 (5th Cir. 1984).

¹²⁷ *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (1939) (“A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.”); In other words: Equity delights in justice, and not by halves.

¹²⁸ Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. Pa. L. Rev. 667, 693 (2003) (internal citations omitted).

¹²⁹ *Forinash v. Daugherty*, 697 S.W.2d 294, 304 (Mo. Ct. App. 1985) (“Since directors, with respect to their exercise of their management functions, owe fiduciary duties to the corporation to exercise unbiased judgment in the best interests of the corporation as a whole, any attempt by directors to favor one intracorporate group to the detriment of another breaches such duties to the corpo-

judgment rule contradicts the theory that the directors are mere agents of the shareholders. That the directors are not mere agents of the shareholders is also shown by the fact that directors do not take orders from the shareholders: shareholders may pass resolutions, but generally speaking shareholders cannot command the directorate they elect – that is the “cost” and justification of their limited liability. Although directors must not invade the entrusted capital, as long as they do not engage in self-dealing, waste, fraud, or abuse, *how* they apply the entrusted capital will not be reviewed by the courts of law.¹³⁰

The shareholders’ wealth maximization theory does however have at least one expression in the positive law. Directors have an affirmative duty to maximize shareholder wealth in the case of a complete liquidation of the corporation – the *Revlon* duties.¹³¹ Winding up, i.e. dissolving the corporation, entails maximizing shareholder pay-out because there is no more going-concern that might justify deviations from shareholder wealth maximization as good business judgments.¹³² Similarly, the minority shareholders’ rights of redemption in case of merger, squeeze-out, or freeze-out¹³³ also are partial validations of the shareholder wealth-maximization theory. Those rights too are limited to cases where the shareholder’s interest is completely extinguished. Meanwhile, the corporation is never under an affirmative duty to pay out common dividends; even preferred dividends may be withheld to accumulate, particularly in cases where the corporation did not turn a net profit during the year in question.¹³⁴ Were there a wealth maximization duty, it would be reflected in dividend policy; it is not. The shareholder wealth maximization theory simply has little or no expression as a matter of the positive law.

As a matter of economics, the shareholders’ wealth-maximization theory of the corporation is *economically simplistic* because it says nothing as to *how* wealth should or should not be maximized, and it ignores synergy. If the corporation were merely a nexus of contracts, an atomistically divisible amalgamation of individual relationships, then the disassociation of the group into its compositional elements would not alter the

ration and, in a sense, violates the implied term in the share contract between the corporation and any oppressed shareholder to the effect that corporate affairs will be managed in the best interests of the corporation. . . .”) (internal citation omitted); Blair & Stout, *supra* note 56, at 288 (“Corporate law does not treat directors as shareholders’ agents but as something quite different: independent hierarchs who are charged not with serving shareholders’ interests alone, but with serving the interests of the legal entity known as the “corporation.”).

¹³⁰ See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

¹³¹ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

¹³² *Id.* at 182.

¹³³ *Id.* at 182-83.

¹³⁴ See, e.g., *N.Y., L.E., & W.R. Co. v. Nickals*, 119 U.S. 296, 302-04 (1886).

value which the group creates. However, as Adam Smith showed in *Wealth of Nations*, specialization and standardization are facts which explain why corporations are more productive than the sum of their members' labor.

According primacy to maximizing shareholder wealth ignores the fact that the corporation is a delegation of state power, which entails: 1) legal personality, and 2) investors' limited liability. The corporation is a delegation of state power.¹³⁵ Thus, the state may rightly condition the exercise of corporate power by placing the corporation within the greater social context. The corporation is a productive element of a national, and now global, economy that maximizes *social* wealth, not just the wealth of shareholders or directors, but also of the employees and the community. Thus, companies can lawfully engage in charitable activities¹³⁶ and their actions are not considered to be waste of the entrusted assets unless some form of fraud or abuse of fiduciary duty is shown (e.g. self-dealing). Corporations do, in fact, regularly engage in charitable works, which incidentally generally entail tax advantages to the corporation.¹³⁷

¹³⁵ Janet Dine, *THE GOVERNANCE OF CORPORATE GROUPS*, 124 (2000).

¹³⁶ Model Bus. Corp. Act § 3.02(13) (2008), available at <http://books.google.de/books?id=rfSuHc2aSc0C&pg=SA3-PA6&lpg=SA3-PA6&dq=Model+Bus.+Corp.+Act+%C2%A7+3.02%2813%29&source=bl&ots=errtLdcorz&sig=2ONHanmpczDu3LBhHoBW11cKZyM&hl=en&sa=X&ei=N6ZTVKb9IoHYPIC2gYAH&ved=0CCMQ6AEwAA#v=onepage&q=Model%20Bus.%20Corp.%20Act%20%C2%A7%203.02%2813%29&f=false>.

¹³⁷ 26 U.S.C. §170 authorizes taxpayers to deduct charitable contributions from their taxable income, available at <http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title26-section170&num=0&edition=prelim>; 26 U.S.C.A. § 501(c)(3) (Westlaw 2015) grants tax exemption to charitable organizations (“(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements) any political campaign on behalf of (or in opposition to) any candidate for public office.”), available at <http://uscode.house.gov/view.xhtml?req=%28title:26%20section:501%20edition:prelim%29%20OR%20%28granuleid:USC-prelim-title26-section501%29&f=treesort&edition=prelim&num=0&jumpTo=true>; That corporations may make charitable contributions or enjoy tax exemptions for such donations or activities as a general norm is no longer controverted; (“A corporation can claim a limited deduction for charitable contributions made in cash or other property. The contribution is deductible if made to, or for the use of, a qualified organization. For more information on qualified organizations, see Publication 526, Charitable Contributions. Also see, Exempt Organizations Select Check (EO Select Check) at www.irs.gov/charities, the on-line search tool for finding information on organizations eligible to receive tax-deductible contributions.”) I.R.S. Publication 542, available at <http://www.irs.gov/publications/p542/ar02.html>; I.R.S., INTERNAL REVENUE MANUAL (IRM) ART 7., CHAPTER 25. EXEMPT ORGANIZATIONS, SECTION 3. RELIGIOUS, CHARITABLE, EDUCATIONAL, ETC., ORGANIZATIONS (2014), available at http://www.irs.gov/irm/part7/irm_07-025-003.html; 26 U.S.C. 501(c)(3) has been found to be constitutional by the U.S. Supreme Court. See

Even without tax benefits, incidental charitable works to generate good will, an intangible asset, can be justified economically and fall within the protection of the business judgment rule.¹³⁸

In sum, the nexus of contracts theory of the corporation and its corollary, the shareholder wealth maximization theory, is incomplete,¹³⁹ even incoherent.¹⁴⁰ A stakeholder theory of the corporation more accurately explains the observed phenomena without contradiction between theory and practice.

D. THE STAKEHOLDER THEORY OF THE CORPORATION

Literature critical of the nexus theory and shareholder wealth maximization theory appeared as a response to the weaknesses of the nexus of contracts theory.¹⁴¹ The stakeholder approach,¹⁴² a more accurate theory of the corporation emerged¹⁴³ from the critical literature and takes into account synergies and non-economic data ignored by the nexus of contracts theory. The stakeholder approach can be divided at least into a cooperative communitarian version that can be contrasted against a pluralist version.¹⁴⁴ To pluralists, conflict is inevitable and unavoidable and equilibria emerge only temporarily, if at all, from the conflicted fractious groups which compose the firm. In contrast, to communitarians, like their corporatist predecessors, real long-term consensus is possible and desirable and, thus, to be sought after.

The stakeholder theory better reflects actual market practice than the nexus theory: “Companies, especially those operating in global markets, are increasingly required to balance the social, economic and environmental components of their business, while building shareholder value.”¹⁴⁵ The stakeholder theory also coheres with the legal characterization of the directors’ duties as fiduciary in nature, and not merely contractual. Finally, as well as corresponding to the common law ascription of fiduciary duties to directors, the stakeholder theory is finding its way

Regan v. Taxation with Representation of Wash., 461 U.S. 540 (1983) (finding 2501(c)(3) constitutionally sound).

¹³⁸ A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581 (1953).

¹³⁹ Eisenberg, *supra* note 111, at 820.

¹⁴⁰ *Id.* at 830.

¹⁴¹ Andrew R. Keay, *Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model*, 71 MOD. L. REV. 663 (2008), available at <http://ssrn.com/abstract=1889236>.

¹⁴² Roda Mushkat, *Corporate Social Responsibility, International Law, and Business Economics: Convergences And Divergences*, 12 OR. REV. INT’L L. 55, 67 (2010).

¹⁴³ E.g., Keay, *supra* note 99, at 2.

¹⁴⁴ *Id.* at 6.

¹⁴⁵ Risako Morimoto, John Ash, & Christopher Hope, *Corporate Social Responsibility Audit: From Theory to Practice 1* (University of Cambridge, Judge Institute of Management Working Paper No. 14/2004, 2004), available at <http://ssrn.com/abstract=670144>.

into contemporary corporate legislation,¹⁴⁶ although the legislation has not yet worked its way through the appellate courts.¹⁴⁷

The stakeholder approach is holist, not atomist; accordingly, it considers all factors in the governance equation,¹⁴⁸ the “totality of circumstances.” Thus, the stakeholder approach takes into account synergy and fiduciary relationships. It is coherent with the trust theory of the corporation and, thus, will likely continue to prevail since the nexus of contracts theory of the corporation suffers from legal and economic inaccuracy, unlike the trust theory.

The stakeholder theory is consistent with an emulation of the German corporation (in German: Aktiengesellschaft) in U.S. law and most closely corresponds to commercial facts. It is also consistent with existing corporation law and thus is the theoretical basis of this Article.

For the stakeholder theory, the directors have the discretionary¹⁴⁹ task of balancing competing claims, to attain the optimum wealth distribution for all stakeholders in a sustainable long term prudent view of the business as a going concern.¹⁵⁰ The objective of the firm, according to the stakeholder theory, is maximization of value of the company as a whole - not just the wealth of the shareholders.¹⁵¹ As a matter of law, the stakeholder theory of the corporation is consistent with the business judgement rule.¹⁵²

¹⁴⁶ Key, *supra* note 99, at 15; 15 PA. CONS. STAT. § 516 (1990), available at <http://law.onecle.com/pennsylvania/corporations-and-unincorporated-associations/00.005.016.000.html>.

¹⁴⁷ Key, *supra* note 99, at 16.

¹⁴⁸ “An analysis that seeks to identify which provisions matter should not look at provisions in isolation without controlling for other corporate governance provisions that might also influence firm value. Thus, it is desirable to look at a universe of provisions together.” Bebchuk, Cohen, & Ferrell, *supra* note 56, at 1.

¹⁴⁹ Blair & Stout, *supra* note 117, at 434 (directors in fact and law enjoy autonomy).

¹⁵⁰ Andrew Key, *Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model*, 71 MOD. L. REV. 663 (2008), available at <http://ssrn.com/abstract=1889236>.

¹⁵¹ Douglas G. Baird & M. Todd Henderson, *Other People’s Money* 5 (John M. Olin Law & Economics Working Paper No. 359, 2d Series, 2007), available at http://ssrn.com/abstract_id=1017615 (“The directors must adopt the course that, in their judgment, maximizes the value of the firm as a whole. This principle of value maximization could also be coupled with a strong business judgment rule. Courts lack information and expertise that would allow them to effectively and efficiently police director decisions, and cannot easily determine under any set of facts whether a particular decision was, when made, designed to maximize firm value. Hence, the directors must enjoy a large measure of discretion, and claims by one class of investor against another alleging breach of a fiduciary duty would fail so long as the directors acted reasonably to enhance firm value.”).

¹⁵² “The business judgment rule is the crutch courts use most often to navigate around the maxim that directors owe a fiduciary duty to shareholders, at times in ways that distort the idea of fiduciary duty beyond recognition.” *Id.*

E. THE AGENCY PROBLEM

Conflicts of interest inevitably arise in the corporation because the corporate directors manage other people's money – the shareholders, principally. This is known as the agency problem.¹⁵³ “When outside investors provide capital to a public firm, they face the risk that the insiders who influence the firm's decisions will act opportunistically and advance their own private interests.”¹⁵⁴ The separation of ownership and control, the hallmark of the corporation, also creates an ever present pervasive risk of abuse, e.g. by opportunism.¹⁵⁵ This risk is greater where there is little or no awareness on the part of the shareholder of the risk.

The agency problem “is addressed in all jurisdictions, but what exactly they consider to constitute a conflict of interest varies considerably.”¹⁵⁶ Likewise, most countries seem to recognize the corporate opportunities rule: that a director may face certain economic opportunities, which they must disclose to the company.¹⁵⁷ How we view the agency problem may be influenced by whether we see the corporation as a trust-like body wherein shareholders entrust their capital to the board of trustees, i.e., directors, who then invest on their behalf and for their benefit. In contrast, if we see the corporation as a nexus of arms-length contracts with no fiduciary duties, then that would change resolution of the agency problem. If we see the corporation as an aspect of state power, that too changes how we resolve the agency problem. We argue that a stakeholder theory best solves the agency problem, since the concentration of large amounts of entrusted capital in the hands of a few invites fraud and abuse of the types that we have repeatedly witnessed in the U.S. capital market. The corporation, though still a delegation of state power, is no longer an instance of state governance and retains, now defeasible, aspects of a fiduciary trust, and may legally consider other stakeholders than its shareholders.

III. THE CORPORATION IN PRACTICE

Having understood the theory of the corporation as a stakeholder-trust relationship, we can now look at the German capital markets in

¹⁵³ Lucian Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1280-1281 (2009).

¹⁵⁴ *Id.* at 1281.

¹⁵⁵ Cooter & Eisenberg, *supra* note 91, at 1732.

¹⁵⁶ Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe—Accountability and Convergence*, 61 AM. J. COMP. L. 301, 349 (2013).

¹⁵⁷ *Id.* at 354.

comparison with U.S. capital markets to see if there are relevant differences in those markets that may affect optimal corporate structure.

A. THE GERMAN CAPITAL MARKET

The German capital market is different from the U.S. capital market in that 1) companies tend to be owned by few large shareholders, often financial institutions, as opposed to a dispersal of shares among a greater number of much weaker stockholders and, perhaps at least in part as a consequence, 2) there are fewer hostile takeovers of German corporation, and finally, 3) shareholder rights are somewhat different between the two systems, which also may affect the determination of the optimal corporate structure.

1. *Shareholder Concentration*

Whether the company has many small shareholders (“dispersed”) or concentrated shareholding in a few major blocks¹⁵⁸ is of vital importance to governance questions.¹⁵⁹ “At a very general level, there are two factors that heavily influence the role of the board in public companies. The first is the either dispersed or concentrated nature of the shareholder body. The second is the extent to which corporate law in any particular jurisdiction seeks to address the agency problems of stakeholders other than shareholders, in particular of employees.”¹⁶⁰

In Germany, unlike the United States, the publicly traded Aktiengesellschaft (AG) and the closely held Gesellschaft mit beschränkter Haftung (GmbH) have two-tier boards and tend to have significant blocks of stock owned by a controlling minority shareholder,¹⁶¹ which are often banks;¹⁶² financial institutions are important investors in Ger-

¹⁵⁸ “According to the predominant account, corporate governance systems can be classified in two groups, the *diffuse shareholder model* and the *concentrated blockholder model*.” Martin Gelter, *Review of Political Power and Corporate Control: The New Global Politics of Corporate Governance*, by Peter A. Gourevitch & James Shinn, Independent Review, Vol. 12, No. 1, p. 1 (Summer 2007), available at <http://ssrn.com/abstract=1117267>.

¹⁵⁹ See generally, Bebchuk & Hamdani, *supra* note 153.

¹⁶⁰ Davies & Hopt, *supra* note 156, at 303.

¹⁶¹ “At least traditionally, institutional investors and especially banks have held large proportions of shares in Germany. This was regarded as a major advantage for effective corporate control. However, in Germany as well as in the UK, there is a now general tendency towards a less dispersed ownership.” Jungmann, *supra* note 84, at 434.

¹⁶² *Id.* at 426–74, 457–58 (“The influence of German banks on the composition of the supervisory board is immense. About 12 % of the shareholder seats in supervisory boards are taken by members of private banks. At first glance, this number might not appear to be terribly significant. However, this 12% represents only part of the influence that private banks have. Their total influence is derived from the aforementioned seats in the supervisory boards, from bank proxy votes, and

man corporations.¹⁶³ Corporations with few large shareholders are subject to tighter control over management by shareholders because dispersed shareholders face significant coordination costs and are thus rationally passive¹⁶⁴ due to their lack of power¹⁶⁵ and imperfect information.¹⁶⁶ The question of corporate governance is a question of finding the optimum distribution of imperfect information that is asymmetric in its initial distribution¹⁶⁷ - and is, thus, an example of Hayek's theory of money as a quantum of information. For Hayek, the function of money is to convey information, functioning as a signaling system, thereby channeling patterns of consumption and investment.¹⁶⁸ Contemporary corporate governance recognizes the central role of information flow as a regulatory and managerial control element.¹⁶⁹

In companies with dispersed shareholders, the usual case in the United States, but not Singapore, a wealthy common law country with single boards¹⁷⁰ and concentrated share-holding,¹⁷¹ the conflict of interest is between management and shareholders; in companies with domi-

- notwithstanding a slight trend to the contrary - from their still significant blocks of shares of the largest German stock corporations.”).

¹⁶³ Owen, *supra* note 7, at 179.

¹⁶⁴ Bainbridge, *supra* note 56, at 665-66 (“Corporate shareholders thus are rationally apathetic.”).

¹⁶⁵ Davies & Hopt, *supra* note 156, at 303-04 (“shareholders’ coordination costs, may make the accountability of the board to the shareholders tenuous. By contrast, in a concentrated shareholding structure, the large shareholders are better positioned to make effective decisions themselves. Even if they leave management decisions to the board, for example, in order to be able to incorporate professional management in the decision-making, large shareholders can demand accountability.”).

¹⁶⁶ Bainbridge, *supra* note 56, at 668 (“bounded rationality and complexity . . . make it efficient for corporate constituents to specialize.”).

¹⁶⁷ *Id.* at 682.

¹⁶⁸ M. Bruce Johnson, *Hayek and Markets*, 23 SW. U. L. REV. 547, 548 (1994) (“Hayek argued that markets coordinate the various bits of information and knowledge scattered among individuals spontaneously, without design or comprehension by any human mind.”).

¹⁶⁹ Christine Windbichler, *Zukunft des Gesellschaftsrechts: Orientierungen für die kapitalmarktorientierte Aktiengesellschaft*, in : Grundmann/Kloepfer/Paulus/Schröder/Werle (Hrsg.), FESTSCHRIFT 200 JAHRE JURISTISCHE FAKULTÄT DER HUMBOLDT-UNIVERSITÄT ZU BERLIN. GESCHICHTE, GEGENWART UND ZUKUNFT, 1079-89, 1089 (2010).

¹⁷⁰ Corinne Hui Yun Tan, *The One-Tier and Two-Tier Board Structures and Hybrids in Asia - Convergence and What Really Matters for Corporate Governance*, p. 8 (Sept. 1, 2011), available at <http://ssrn.com/abstract=2140345> (“block-shareholding appears to mitigate one of the structural weaknesses of the one tier board structure discussed earlier, that being the concentration of power in any one person. Despite the legitimate concerns that the block-holders are affiliated to management and thus will be passive in their monitoring roles against management, findings from an earlier study conducted have indicated to the contrary that high block-shareholding has a positive co-relation with board independence.”).

¹⁷¹ (“Corporate governance in Singapore has previously been described to be largely government-based and family-based, as there is high ownership concentration of corporations in Singapore amongst certain family shareholders and the government.”) *Id.* at p. 7.

nant shareholders, however, the agency problem is likelier to be conflicts between dominant shareholders and minority shareholders.¹⁷²

2. *Hostile Takeovers*

Hostile takeovers, a fairly common occurrence on the U.S. stock market, are less common on the German market.¹⁷³ Legal responses to takeovers include law reforms such as the EU Directive on Takeover Bids.¹⁷⁴ At the managerial level, one response by management to the risk of hostile takeover is entrenchment: by way of staggered boards of directors, shareholder rights plans (“poison pills”),¹⁷⁵ supermajority and quorum requirements¹⁷⁶ and managerial severance plans (“golden parachutes”).¹⁷⁷ Entrenchment of the corporation’s board of directors tends to correlate with lower value of the corporation so entrenched,¹⁷⁸ because entrenchment makes hostile takeover more expensive.¹⁷⁹

Although entrenchment of the board of directors behind the articles and/or charter may encourage managerial irresponsibility, “by weakening

¹⁷² Davies & Hopt, *supra* note 156, at 304 (“in dispersed shareholding companies the most pressing agency problem exists between management and shareholders as a class; in concentrated shareholding companies the agency relationship is more problematic between majority and minority shareholders.”).

¹⁷³ Jungmann, *supra* note 84, at 434 (“we have to recognise a lack of hostile public takeover bids in Germany.”).

¹⁷⁴ Directive 2004/25/EC of 21.04.2004 on takeover bids, *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32004L0025:EN:NOT>.

¹⁷⁵ A “poison pill” is an anti-takeover device. Essentially, if a corporate raider acquires a certain percentage of the corporation, the poison pill is “triggered” and permits creation of a new class of share, intended to dilute the raider’s control of the corporation and to make their proposed takeover much more expensive. The first key case litigated on this point is: *Moran v. Household Intern., Inc.*, 490 A.2d 1059, 1065-67 (Del. 1985).

¹⁷⁶ Supermajority requirements mandate that more than 50% of the directors must vote on certain events, e.g. merger or dissolution. Quorum requirements mandate that at least a certain percentage of directors must be present to vote on certain decisions, e.g. dissolution or merger. *See, e.g., Berlin v. Emerald Partners*, 552 A.2d 482, 484-85 (Del. 1988). *See, e.g., Brett W. King, Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 Del. J. Corp. L. 895 (1996). *See also, Petri Mäntysaari, THE LAW OF CORPORATE FINANCE: GENERAL PRINCIPLES AND EU LAW: VOLUME III* 506 (1999).

¹⁷⁷ Golden parachutes are premium severance packages offered to key employees to promise them more than adequate compensation in the event they are fired (e.g. due to a hostile takeover). *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 3-4 (1985).

¹⁷⁸ Bebchuk, Cohen & Ferrell, *supra* note 56, p. 1 (“We put forward an entrenchment index based on six provisions: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. We find that increases in the index level are monotonically associated with economically significant reductions in firm valuation as well as large negative abnormal returns during the 1990-2003 period.”).

¹⁷⁹ (“We find that staggered boards are associated with an economically significant reduction in firm value . . .”) Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 JOURNAL OF FINANCIAL ECONOMICS 409-433 (2005); HARVARD LAW AND ECONOMICS DISCUSSION PAPER NO. 478, *available at* <http://ssrn.com/abstract=556987>.

the disciplinary threat of removal and thereby increasing shirking, empire-building, and extraction of private benefits by incumbents,”¹⁸⁰ entrenchment of the board also enables the directors to consider and implement long-term investments.¹⁸¹ So, to the German perspective, an entrenched board of directors is not the problem: entrenched boards created the economic stability necessary for reconstruction of the entire German economy following its total destruction during the Second World War. To the German perspective, an entrenched board of directors is not the problem. The problem is whether the directorate is *transparent*: The board, whether or not it be entrenched, must decide transparently so as to attract investors and produce efficiently. The board of directors must be able to prevent malfeasance by any actors, implement the day-to-day business operations, and itself be subject to supervision: transparency enables all of that. The company’s directorate is a panopticon, both watching over *and* being watched over. Thus, the German directorate is split into a two-tier board structure. *Oversight* is exercised by a supervisory board of directors, while *management of operations* is implemented by a managerial board of directors.¹⁸²

The two boards are strictly separated, and simultaneous membership on both boards is expressly prohibited by law.¹⁸³ Oversight is strengthened by the fact that larger German corporations are *required by law* to include a significant number of labor representatives on the supervisory board of directors, including trade union representatives.¹⁸⁴ The system works because it is intended to *work*, not to foster labor-management conflict or to favor one group at the expense of another. Co-determination prevents and resolves conflicts, allowing production to go forth.

3. *The Rights of Shareholders*

Shareholders’ rights are also somewhat different in German law and U.S. law. German shareholders elect the supervisory board of directors and the supervisory board of directors, in turn, appoints the executives, i.e., the managerial board.¹⁸⁵ This is also the case in Anglo-American corporate law: shareholders elect the board, and the board selects manag-

¹⁸⁰ Bebchuk, Cohen & Ferrell, *supra* note 56, at p. 6.

¹⁸¹ *Id.*

¹⁸² AktG (German Stock Corporation Act), § 30, available in English translation at <http://www.nortonrosefulbright.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf>.

¹⁸³ AktG §100.

¹⁸⁴ AktG §104(4). Most of the provisions on co-determination are covered by the Gesetz über die Mitbestimmung der Arbeitnehmer (1976).

¹⁸⁵ AktG § 119(1); Owen, *supra* note 7, 178-79.

ers.¹⁸⁶ German shareholders also have the power to amend the articles of incorporation,¹⁸⁷ which is often the case in U.S. corporate law, but not always. Shareholders in German corporations can declare dividends,¹⁸⁸ which is generally not the case in U.S. corporate law.

These differences in the corporate environment partially explain the regulatory divergence and different economic performance of the U.S. and German capital markets of the last few years. We now look at the differences in the internal structure of the corporation itself, which also explain the observed divergent economic performances.

B. THE GERMAN CORPORATION

A two-tier board structure and co-determination are the principal differences between German corporate law and Anglo-American corporation law.¹⁸⁹

The board of directors under U.S. law has two functions: supervision of the management and operation of the daily business of the corporation.¹⁹⁰ That is not the case in German law. In German law, as in the early common law, the supervisory board of directors has only one role: oversight of the management it appoints, who then in fact run the business, i.e., the managerial board. German corporations (AG, GmbH) are constructed on a two-tier board model that separates oversight and supervisory functions. The directorate charged with oversight is known as the Aufsichtsrat,¹⁹¹ which is usually translated as “supervisory board.”¹⁹² Worker representation on the supervisory board of larger companies is guaranteed by law. The directorate charged with the actual management and operation of the business’ day-to-day affairs is known as the Vorstand,¹⁹³ which is usually translated as the “management board.”¹⁹⁴ Workers on the shop floor also form work’s councils, known as the Betriebsrat, which organize production and labor processes.¹⁹⁵

¹⁸⁶ See, e.g., Robert Kleiman, *Board of Directors*, available at <http://www.referenceforbusiness.com/encyclopedia/Assem-Braz/Board-of-Directors.html> (last visited Oct. 31, 2014).

¹⁸⁷ AktG § 119(1); Owen, *supra* note 7, at 178-79.

¹⁸⁸ Owen, *supra* note 7, at 178-79.

¹⁸⁹ Paul L. Davies, *Board structure in the UK and Germany: convergence or continuing divergence?*, 2 INT’L & COMP. CORP. L. J. 435 (2000), available at <http://ssrn.com/abstract=262959>.

¹⁹⁰ Jungmann, *supra* note 84, at 459-60.

¹⁹¹ See, e.g., AktG § 95, § 104.

¹⁹² See, *Aufsichtsrat*, leo.org, available at <http://dict.leo.org/#search=aufsichtsrat>.

¹⁹³ § 30 AktG, § 76 AktG

¹⁹⁴ See *Vorstand*, LEO.ORG, <http://dict.leo.org/#search=vorstand>.

¹⁹⁵ See *Betriebsrat*, LEO.ORG, <http://dict.leo.org/#search=betriebsrat>. Works councils are governed by the provisions of the Works Constitution Act, available in translation at http://www.gesetze-im-internet.de/englisch_betrv/index.html.

The directors of a publicly traded U.S. corporation may also be managers:¹⁹⁶ that is not the case in German law.¹⁹⁷ German supervisory board members may not also be managerial board members.¹⁹⁸ In U.S. law there is no prohibition on managers, directors, or employees from owning shares in the corporation. In practice, U.S. corporate directors are usually also managers, but not always.¹⁹⁹

The differences in structure of U.S. and German publicly traded corporations lead to different practices,²⁰⁰ resulting in different outcomes. The recent outcomes on the U.S. capital market are clearly undesirable and do not seem to have occurred to the same extent, if at all, on the German capital market, partly because closely held businesses are more important on the German capital market. Co-determination and two-tier boards result in greater oversight and appear to have helped to prevent fraud.

As a general principle, the U.S. corporation's internal structure may be established as the incorporators who form the corporation see fit, though naturally, the corporation may not be used for illegal purposes and if it is it faces risk of dissolution.²⁰¹ It is thus possible to emulate the German corporation's two-tier board structure, which separates directors and managers and provides worker representation on the managerial board in U.S. law by way of the corporation's charter. This structure would make it easier for the corporation to avoid questions of conflicts of interest since, in principle, any transaction with a managerial board member is self-dealing. A U.S. corporate charter could also specify that both directors and managers alike owe primary fiduciary duties to the corporation and may also indicate any secondary fiduciary duties owed by the directorates to shareholders, employees, directors or other stakeholders.

1. *The Supervisory Board*

The role of the supervisory board is over-watch; to "keep an eye on" the managerial board and make sure that it operates legally.²⁰² The su-

¹⁹⁶ See, e.g., N.Y. BSC. LAW § 701: NY Code - Section 701: Board of Directors, available at <http://codes.lp.findlaw.com/nycode/BSC/7/701#sthash.513cfcQm.dpuf>.

¹⁹⁷ See, e.g., AktG §105.

¹⁹⁸ AktG § 105.

¹⁹⁹ See, e.g., Mike Volker, *The Board of Directors* (2008), available at <http://www.sfu.ca/~mvolker/biz/bod.htm>.

²⁰⁰ Davies & Hopt, *supra* note 156, at 304-05 ("a board whose function includes the reduction of the agency costs of employees is likely to function differently from one whose function is confined to reducing the agency costs of the shareholders.").

²⁰¹ See, e.g., Brent Fisse, *Reconstructing Corporate Criminal Law: Deterrence, Retribution Fault, and Sanctions*, 56 S. CAL. L. REV. 1141, 1163 n. 96 (1983).

²⁰² AktG § 111(1) (supervisory board supervises the management).

pervisory board has no managing directors. One may either be a supervisor or a manager but cannot be a member of both boards simultaneously.²⁰³ Likewise, no person may simultaneously serve as a director of more than ten different German corporations under German law,²⁰⁴ which is another limitation on board membership. Proposals to impose minimum qualifications on directors such as age, gender, education, or experience meet with the point that sometimes outside, unusual, and/or diverse expertise is desirable on either the managerial or supervisory board.²⁰⁵

The supervisory board has one function - the supervision, i.e. oversight, of the corporation's operations and assets. The Supervisory board usually has 3 members,²⁰⁶ but may have as many as 21 members. However, the number of members must be divisible by three, so as to avoid deadlock.²⁰⁷

The separation of managerial and supervisory functions is one justification of limited liability.²⁰⁸ Investors are not to be held collectively liable beyond their investment because they do not have the final word in how the funds that they have entrusted to the corporation are to be used.²⁰⁹ This logic explains why the limited partners in a U.S. limited partnership may only participate as employees with no decisional power; the silent partner in a limited partnership brings cash to the table, and that is all – and thus the silent partner, i.e., the limited partner, enjoys limited liability and will not be held to answer in contract or tort beyond the extent of their actual investment.²¹⁰ Strictly speaking, shareholders who are also managers and directors ought to be personally liable, as a matter of logic. Thus, separation of managerial and supervisory functions may be an argument to shield corporate personnel from individual liability for the actions of the company. The two-tier board, and possibly also co-

²⁰³ AktG § 105(1); Davies & Hopt, *supra* note 156, at 311.

²⁰⁴ (“A couple of years ago, it was not uncommon to be a member of more than twenty supervisory boards. The number of mandates is now limited to ten by Sec. 100 of the German Stock Corporation Act of 1965 [AktG], and being the chairman of a supervisory board counts as holding two seats.”) Jungmann, *supra* note 84, at 464.

²⁰⁵ *See, e.g., Id.* at 426–74, 468.

²⁰⁶ AktG § 95.

²⁰⁷ AktG § 95.

²⁰⁸ *See, e.g.,* Heinz-Dieter Assmann, Klaus J. Hopt & Herbert Wiedemann (eds.) AKTIENGESETZ: EINLEITUNG; 1-53, Vol. 1 p. 43 Sec.1, Rn. 92 (2004). *See generally*, Prof. Dr. Justus Meyer, HAFTUNGSBESCHRÄNKUNG IM RECHT DER KAPITALGESELLSCHAFTEN 199-558 (Spring, 2000).

²⁰⁹ *Id.*

²¹⁰ *Carden v. Arkoma Associates*, 494 U.S. 185, 205-06 (1990); *Great Southern Fire Proof Hotel Co. v. Jones*, 177 U.S. 449 (1900); *Ruzicka v. Rager*, 305 N.Y. 191, 197-98 (1953); For commentary on the concept, *see* Steven H. Resnicoff & Michael J. Broyde, *Jewish Law and Modern Business Structure: the Corporate Paradigm*, 45 WAYNE L. REV. 1685, 1804 (1997), available at <http://ssrn.com/abstract=1139985>.

determination, are justifications of limited liability: “the mandatory imposition of a two-tier board upon large companies in 1870 [*sic*] was intended to act as an expression of, even a safeguard for, the public interest in how such companies operated. It was the quid pro quo for the provision of a system of formation of companies by registration.”²¹¹ Thus, stakeholder concerns are much more present in the German corporation than in the United States. This appears to be a partial explanation of the greater incidence of corruption in U.S. corporate capital markets than in Germany.

As well as oversight, “the supervisory board from an early stage in the nineteenth century was regarded as having a networking function as well as a monitoring function. Appointments to the supervisory board were a method of establishing and maintaining links between the company and other financial and non-financial institutions.”²¹² The German supervisory board of directors does not have the power to declare dividends.²¹³ Resolutions of the supervisory board are by majority vote of the members of the supervisory board.²¹⁴ The supervisory board appoints the management board.²¹⁵ However, the supervisory board merely selects,²¹⁶ and cannot command, the managerial board.²¹⁷

2. *The Managing Board (Vorstand)*

The supervisory board appoints the managerial board by a resolution.²¹⁸ The managerial board consists of the corporation’s executives.²¹⁹ The managerial board directs the business of the corporation (AG, GmbH) on a day-to-day basis²²⁰ and reports information to the supervisory board.²²¹ In practice, “there is a strong information asymmetry between the two boards.”²²² The fact of asymmetric information²²³ is sometimes coupled with lack of communication between the two boards, resulting in filtering of information to the supervisory board by manage-

²¹¹ Davies, *supra* note 156, at 453; cf. Klaus Hopt (ed.) *COMPARATIVE CORPORATE GOVERNANCE* 230 (1998), available at <http://books.google.com/books?isbn=3110157659>.

²¹² Davies, *supra* note 156, at 453.

²¹³ Owen, *supra* note 7, 176 (2003).

²¹⁴ *Id.* at 178.

²¹⁵ *Id.* at 175.

²¹⁶ AktG § 84(1) (supervisory board appoints management board).

²¹⁷ Davies & Hopt, *supra* note 156, at 311.

²¹⁸ AktG § 84(1) & § 108; Owen, *supra* note 7, at 178.

²¹⁹ Owen, *supra* note 7, at 178.

²²⁰ AktG § 76(1) (managerial board is directly responsible for the management of the company).

²²¹ AktG § 90.

²²² Jungmann, *supra* note 84, at 453.

²²³ Williamson, *supra* note 78, at 1208.

ment.²²⁴ The managerial board promulgates the corporation's bylaws, but only by unanimous vote.²²⁵

3. *Corporate Convergence?*

Corporate governance theories, rules, and outcomes, like law, are converging to common positions.²²⁶ The convergence of the shareholder primacy and the stakeholder models of corporate governance to a consensus of sustainable profitability is one example;²²⁷ convergence of the two-tier structure and one-tier board structure,²²⁸ as exemplified in the European corporation, (*Societas Europaea* - SE) is another example.²²⁹ Legal convergence is a common current theme because of the globalization of trade²³⁰ through improved transit and communication. Not all analysts agree with our hypothesis of norm-convergence.²³¹ Because of a belief in a lack of adequate empirical evidence in comparative corporate governance,²³² most analysts,²³³ including some of the most well

²²⁴ "Direct contact of non-executive board members with executives (who are not board members) is often not allowed or regarded as an unfriendly act by the executive board members. Yet the problem with this practice is that almost all information of the board is filtered by the management." Davies & Hopt, *supra* note 156, at 333.

²²⁵ Owen, *supra* note 7, at 178.

²²⁶ For an early example recognizing convergence of law see Christine Windbichler, *Zur Trennung von Geschäftsführung und Kontrolle bei amerikanischen Großgesellschaften: Eine "neue" Entwicklung und europäische Regelungen im Vergleich*, *Zeitschrift für Unternehmens- und Gesellschaftsrecht (ZGR)* 14(1), p. 50-73 (1985) (functional convergence of two tier and one tier systems de facto).

²²⁷ Christine Windbichler, *Cheers and Boos for Employee Involvement: Co-Determination as Corporate Governance Conundrum*, 6 *EUROPEAN BUS. ORG. L. REV.* 507, 513 (2005).

²²⁸ Davies & Hopt, *supra* note 156, at 312 ("there is considerable convergence between the seemingly divergent one-tier and two-tier boards.")

²²⁹ *E.g.*, the E.U. corporation (*Societas Europaea*) may either have a single or two tier board. Article 38 of the Council Regulation (EC) No. 2157/2001 of October 8, 2001 on the Statute for a European company (SE); *See generally*, Jungmann, *supra* note 84; Aste, *supra* note 15, at 35 (noting that the *societas europaea* permits a single or two tier board).

²³⁰ Bratton & McCahery, *supra* note 58, at 233-35.

²³¹ *Id.* at 213-14 ("This Article advances a case for a third hypothesis. Under this view, which follows from current microeconomic theories of the firm, we cannot safely project either global convergence that eliminates systemic differences or the emergence of a hybrid best practice. This is because each national governance system is a system to a significant extent. Each system, rather than consisting of a loose collection of separable components, is tied together by a complex incentive structure. Interdependencies between each system's components and the incentives of its actors create significant barriers to cross reference to and from other systems. The cross reference hypothesis, in contrast, presupposes divisible corporate governance institutions—a world in which one system's components can be adapted for use in the other system without significant frictions or perverse effects.")

²³² *Id.* at 217 ("Comparative governance has this tentative, reactive quality because no one has any direct, empirical answers to its basic questions. It follows that the principal assertions made in comparative discussions —claims respecting relative competitive advantage, the appropriate course of national level law reform, and the likelihood and shape of systemic convergence—cannot

respected,²³⁴ are non-committal²³⁵ and argue that one cannot say as a general matter whether a two-tier or one-tier structure leads to superior performance,²³⁶ perhaps, due to path dependence²³⁷ and cultural independence, the idea that each legal system is isolated from other legal systems. In fact, there is adequate market data to make well founded judgments regarding most market phenomena, although that does not mean the statistical analysis required is easy.

The two-tier board offers several governance advantages: it clearly delineates directors' duties, and leads to greater diversity and more open discourse due to non-traditional board members, as well as garnering capital and enabling better monitoring of the board by the shareholders.²³⁸ Although two-tier boards may seem excessively formal and administratively burdensome,²³⁹ in the U.S. capital market, the alternative to strict regulation has been repeated fraud.

C. WORKER PARTICIPATION THROUGH CO-DETERMINATION

1. *Co-Determination in Germany and the United States*

Another key difference between larger German corporations (AG) and publicly traded U.S. corporations²⁴⁰ is that under German law, as in many other countries,²⁴¹ workers have a legally *guaranteed* right to rep-

be falsified. They can be evaluated only indirectly, through appraisal of the theories of the firm and of competitive evolution that support them. Unsurprisingly, the comparative governance literature holds out alternative theoretical frameworks that support conflicting hypotheses.”).

²³³ *Id.* at 228 (“Which of the two systems, market or blockholder, has comparative advantage? Most comparative governance discussants decline to answer this question, preferring a working hypothesis of equal competitive fitness.”).

²³⁴ Klaus J. Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1339, 1353 (1984).

²³⁵ For example, Klaus Hopt seems non-committal on this point. *See, id.* at 1353, 1357 (social effects of codetermination are particularly difficult to determine definitively).

²³⁶ Jungmann, *supra* note 84, at 448 (“it is hardly possible to deem one board system superior to the other.”); Corinne Hui Yun Tan, *supra* note 170, at p. 33 (“there is no clear superiority of any board system over another. Political, social, economic, legal and cultural contexts, as well as ownership concentration of corporations, have a large role to play in terms of shaping the effect of any board system on corporate governance practices in a country.”).

²³⁷ Amir N. Licht, *The Mother of all Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance Systems*, 26 DEL. J. CORP. L. 147 (2001).

²³⁸ Aste, *supra* note 15, at 32.

²³⁹ *Id.* at 36.

²⁴⁰ While mandatory employee participation on the board of a U.S. corporation is simply nonexistent, employees of a German SE may elect up to 50% of the administrative organ members. Cornelius Wilk, *U.S. Corporation Going European?—The One-Tier Societas Europaea (SE) In Germany*, 35 SUFFOLK TRANSNAT’L L. REV. 31, 69-70 (2012).

²⁴¹ Co-determination is not unique to Germany: “In half of the Member States of the European Union representation of the employees on the board is mandatory in the private sector. In these

resentation²⁴² on the corporations' supervisory board of directors (in German: Aufsichtsrat). This is known as co-determination (in German: Mitbestimmung)²⁴³ and is an embodiment of corporatism. Co-determination may include worker participation in operations, in management, or worker ownership of the means of production.

The extent of mandatory worker representation on the German supervisory board depends on the size of the business. There is no mandatory employee representation for small businesses with fewer than 500 employees.²⁴⁴ Businesses with between 500 and 2000 employees must allocate one-third of the seats on the supervisory board of directors (Aufsichtsrat) to labor representatives elected by the employees, whether directly or indirectly.²⁴⁵ Businesses with over 1000 employees must allocate an equal number of seats on the supervisory board of directors to employees.²⁴⁶ Finally, "[s]ome board seats are reserved for representatives of the trade unions."²⁴⁷ Labor representatives and shareholder representatives have equal rights on the supervisory board.²⁴⁸ However, in the event of a tie, the vote of the chairman of the supervisory board counts twice.²⁴⁹ Worker representation of larger corporations' supervisory board of directors is thus more accurately described as "quasi-parity." However, the shareholder-elected chairman almost never uses their deciding vote "because of its very negative consequences for the working climate in the company and possible clashes with the unions."²⁵⁰

Some of the advantages of co-determination include:

jurisdictions, therefore, the board has a role in facilitating the company's acquisition of labor input as well as input of capital." Davies & Hopt, *supra* note 156, at 304-05.

²⁴² The relevant German co-determination laws are: Betriebsverfassungsgesetz vom 11. Oktober 1952 (BGBI. I p.681), as amended by Gesetz vom. 14. December 1976 (BGBI. I p. 3341); Gesetz ueber die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorstaenden der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie vom 21. Mai 1951 (BGBI. I S. 347), as amended by Gesetz vom 6. September 1965 (BGBI. I p. 1185); Gesetz zur Ergaenzung des Gesetzes ueber die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorstaenden der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie vom 7. August 1956 (BGBI. I p. 707), as amended by Gesetz vom 27. April 1967 (BGBI. I p. 505) and the Gesetz ueber die Mitbestimmung der Arbeitnehmer vom 4. Mai 1976 (BGBI I p. 1153).

²⁴³ Muchlinski, *supra* note 73, at 371.

²⁴⁴ §1(1) Gesetz über die Drittelbeteiligung der Arbeitnehmer im Aufsichtsrat (Hereafter, Drittelbeteiligungsgesetz - DrittelbG) (May 18, 2004).

²⁴⁵ §1(1), §4(1) DrittelbG (May 18, 2004).

²⁴⁶ Hopt, *supra* note 234, at 1346; § 7 Gesetz über die Mitbestimmung der Arbeitnehmer (Hereafter, Mitbestimmungsgesetz - MitbestG) (May 4, 1976).

²⁴⁷ Davies & Hopt, *supra* note 156, at 342.

²⁴⁸ § 7 MitbestG.

²⁴⁹ Jungmann, *supra* note 84, at 455.

²⁵⁰ Davies & Hopt, *supra* note 156, at 342.

- 1) Workers who are represented at the board of directors will be more effective due to greater commitment and improved communication;²⁵¹
- 2) Added oversight improves corporate transparency;²⁵² and
- 3) Worker representation on the board of directors leads to fewer labor-management conflicts.²⁵³

In practice, whether these possible benefits are in fact obtained will depend somewhat on the actual facts of the business: “one size will not fit all.”²⁵⁴ Empirical evidence regarding the effects of co-determination on productivity is sometimes thought to be uncertain.²⁵⁵ The effect of co-determination on managerial practice is limited to passive reaction, and not dynamic initiative.²⁵⁶ However, although co-determination does not change the specialized roles of labor, i.e., production, and management, i.e., marketing and administration, some studies have in fact shown that co-determination increases productivity by softening hierarchy and improving coordination of productive inputs through better feedback.²⁵⁷

The best structure for the board of directors must thus be contextualized by the question of labor relations, generally²⁵⁸ and the particular business in question. Worker representation on the supervisory board of directors and strong shareholder rights prevent and/or mitigate labor-management conflicts²⁵⁹ and strengthen corporate supervision and transparency as part of the solution to the agency problem. Co-determination

²⁵¹ David B. Reynolds, TAKING THE HIGH ROAD: COMMUNITIES ORGANIZE FOR ECONOMIC CHANGE 45 (2002).

²⁵² Toshio Yamazaki, GERMAN BUSINESS MANAGEMENT: A JAPANESE PERSPECTIVE ON REGIONAL DEVELOPMENT 63 (2013).

²⁵³ Richard M. Buxbaum, Hertig, Hirsch, Klaus Hopt (eds.), EUROPEAN ECONOMIC AND BUSINESS LAW: LEGAL AND ECONOMIC ANALYSES ON INTEGRATION AND HARMONIZATION, Report No. 2, Prof. Dr. Klaus Hopt, 279 (1996).

²⁵⁴ Bainbridge, *supra* note 56, at 704.

²⁵⁵ *Id.* at 677-78.

²⁵⁶ *Id.* at 696 (“Despite the democratic rhetoric of employee involvement, these programs in fact appear to have done little to disturb the basic hierarchical structure of large corporations. Instead, they appear to be simply an adaptive response to certain inefficiencies created by excessive hierarchy - a mechanism for by-passing hierarchy when necessary, but not for overthrowing it.”).

²⁵⁷ Thomas Zwick, *Employee participation and Productivity*, Centre for European Economic Research (ZEW) (2004) (“the introduction of teamwork and autonomous work groups, and a reduction of hierarchies in 1996/1997 significantly increased average establishment productivity in 1997–2000”).

²⁵⁸ Windbichler, *supra* note 227, at 520-21 (“the relationship of the two boards with each other realistically needs to be seen in the context of shop-floor co-determination of works councils. Not only are works councils and representation on the board two completely different forms of employee involvement, albeit at least with overlapping objectives, but, in practice the majority of employees’ representatives are at the same time members or even chairpersons of works councils on several levels (establishment, undertaking or group).”).

²⁵⁹ Yamazaki, *supra* note 252; For the historical evolution of German corporate law, see Peter Muchlinski, *The Development of German Corporate Law Until 1990: An Historical Reappraisal*, 14 GER. L.J. 339 (2013).

is “an early warning system for social conflicts, thereby reducing the probability of strikes.”²⁶⁰ English language literature, when it considers co-determination, tends to be critical of co-determination for slowing managerial decisions²⁶¹ and distorting dividend policies.²⁶² Co-determination is more productive, and thus German management accepts co-determination²⁶³ and co-determination is not a violation of the right to property under German law.²⁶⁴

Given all the contextualizing factors “one cannot generalize whether the representation of trade unions on the board adds good diversity or has negative effects on the coherent work of the board.”²⁶⁵ However, the failure of the U.S. capital markets and repeated instances of U.S. corporate fraud, foreign investors or U.S. entrepreneurs who wish to emulate the German corporation to obtain the benefits of improved oversight through specialization and worker participation can do so via the corporate charter, by-laws, contracts and employee stock ownership plans, to which we now turn our attention.

2. *Co-Determination in the United States: Employee Stock Ownership Plans (ESOPs) and Pension Plans*

The German co-determination system is explained as a reaction to the world wars: labor and capital had to work together to rebuild Germany’s industry.²⁶⁶ Similar conditions currently exist in the United States, which is now severely constrained by foreign debt, trade deficits, and factional congressional gridlock – a sort of “Weimarization” of the U.S. federal government: unproductive political paralysis. If corporatism and ordo-liberalism helped the German federation to emerge from the ashes into economic growth, it may also help the U.S. federation, which currently faces a similar problem.

²⁶⁰ Jungmann, *supra* note 84, at 455.

²⁶¹ Hopt, *supra* note 234, at 1354.

²⁶² *Id.* at 1355.

²⁶³ Jungmann, *supra* note 84, at 455.

²⁶⁴ “In 1979, nine German companies, twenty-nine employer organizations, and the German Association for Securities Ownership Protection [Deutsche Schutzvereinigung für Wertpapierbesitz] filed a complaint to the Federal Constitutional Court claiming that the aforementioned rule unconstitutionally infringed the shareholders’ ownership rights under Basic Law [Grundgesetz] (GG) article 14, paragraph 1. The court rejected the applicants’ arguments because first, the chairman’s second vote guaranteed domination of the supervisory board by the shareholders’ representatives, and second, the employees participated only in the supervision of the company’s business but not in the management organ itself.” Wilk, *supra* note 240, at 81.

²⁶⁵ Davies & Hopt, *supra* note 156, at 341-42.

²⁶⁶ *Id.* at 342.

Worker participation in the United States is most often attained through *Employee Stock Ownership Plans* (ESOPs),²⁶⁷ which in German law are known as *Aktienbelegschaften*. Co-determination makes hostile takeovers less likely. Thus, Employee Stock Ownership Plans (ESOPs) are sometimes used as an anti-takeover device in the United States.²⁶⁸ ESOPs are less frequently used in Germany than in the United States. This may be because there are fewer hostile take-overs on the German capital market and thus the ESOP as an anti-takeover device is less necessary.

As well as ESOPs, U.S. codetermination efforts focus on labor union coordination in the voting of shares of corporate stock held by employee *pension plans*. Employee owned pension funds are a significant and influential part of the U.S. capital market,²⁶⁹ because the U.S. state-sponsored insurance system, known as “social security,” is relatively modest. Thus, U.S. retirement funding is obtained through tax-deferred employee contributions to pension plans, which creates a significant block of worker-owned capital.²⁷⁰ U.S. labor unions seek to coordinate the voting of those shares in blocks to advance workers’ rights.²⁷¹

D. U.S. Forms To Attain Co-Determination: Social Economy Enterprises

Our hypothesis is that the different economic performance in Germany and the United States during the 2008 crisis was partly due to better corporate governance on the German market: co-determination and the two tier board, which result in greater worker participation leading to improved productivity and better oversight thanks to a cooperative model of labor-management relations. We then suggested that these corporate structures can be emulated by U.S. businesses using corporate charters, by-laws, and contracts. We now turn our attention to existing U.S. laws which likewise can be used to strengthen worker participation. In this

²⁶⁷ Bainbridge, *supra* note 56, at 673.

²⁶⁸ E. Richard Brownlie & Robert Bruner, *The Leveraged ESOP as a Takeover Defense: The Case of Polaroid Corporation*, 1 J. OF M&A ANALYSIS 1 (1990), available at http://faculty.darden.virginia.edu/brunerb/Bruner_PDF/Leverage%20ESOP%20Poloroid.pdf.

²⁶⁹ O’Connor, *supra* note 59, at 111.

²⁷⁰ Teresa Ghilarducci, LABOR’S CAPITAL: THE ECONOMICS AND POLITICS OF PRIVATE PENSIONS 117 (1992). *But see*, *Pension Trends Say “You’re On Your Own” For Retirement Socialized Retirement Planning Is Out And Individual Plans Are In. Nobody Wants Responsibility For Your Retirement So They Are Passing The Buck To You. Do You Know How To Benefit From These Changes?*, FINANCIAL MENTOR (2014), available at <http://financialmentor.com/free-articles/retirement-planning/saving-for-retirement/pension-trends-say-youre-on-your-own-for-retirement-planning> (last visited Feb. 16, 2015).

²⁷¹ O’Connor, *supra* note 59, at 111.

section we examine corporate structures to emulate co-determination and implement stakeholder theories of the firm in U.S. law.

As was previously indicated, there is a common misconception that U.S. corporations must maximize shareholder wealth. That is definitively *not* the opinion of the courts, as earlier shown. A better legal argument against corporate charity than a supposed duty of wealth maximization would be that corporate charitable activities constitute *waste* of corporate assets and thus are subject to injunction and equitable accounting for lost profits and invaded capital as remedies in equity for violation of fiduciary duties owed to shareholders. The logic of the argument that the charitable use of shareholder's entrusted property is a breach of directors' fiduciary duty would be coherent in cases where charitable waste *also* be linked to fraud or abuse, i.e. were *inequitable*: Then the court, acting in equity, *could*²⁷² enjoin the inequitable invasion of shareholders capital – presuming the movant had met the procedural preconditions for the court to take jurisdiction in equity.²⁷³ However, as a matter of *law* (lex scripta), not equity it is also clear that the for-profit corporation may undertake charitable activity incidental to the business as a matter of law: is genuinely charitable lawful corporate donation inequitable? Likely it is not.

One can avoid this problem of potential liability for charitable “waste” through the articles of incorporation, or with non-profit and not-for profit corporations,²⁷⁴ which are tax exempt under U.S. law when pursuing a charitable purpose.²⁷⁵ Charitable IRC § 501(c)(3) corporations are not treated here in detail because they do not pursue profit, are not innovations, and have been extensively treated elsewhere by other scholars and practitioners. Co-operatives and a new type of corporation, the Benefits Corporation (“B Corp”), are also social enterprises and are used to introduce co-determination. These are discussed below as ways to avoid the common misconception of the shareholder theory of the cor-

²⁷² Equity is an exceptional discretionary remedy offered by the court in the interest of justice and is subject to several procedural restrictions. *See, e.g.*, Douglas et al. v. City of Jeannette et al., 319 U.S. 157, 163 (1943). The procedural restrictions are summarized as equitable maxims. *See, e.g.*, Precision Instrument Mfg. Co. Et. A. v. Automotive Maintenance Machinery Co., 324 U.S. 806 (1945).

²⁷³ *E.g.*, “He who seeks equity must do equity.”; “Equity regards as done what ought to be done”; “Equity follows the law.” etc. *See*, Richard Edwards & Nigel Stockwell, TRUSTS AND EQUITY, pp. 43-63 (Pearson, 2013), available at http://catalogue.pearsoned.co.uk/assets/hip/gb/uploads/M02_EDWA3458_10_SE_C02.pdf.

²⁷⁴ Unfortunately “non-profit” and “not for profit” are generally used synonymously, although one could imagine a precise distinction that a not for profit pays salary to employees whereas the non-profit does not. This distinction is not however made in practice. *See, e.g.*, *Not for Profit*, INVESTOPEDIA, <http://www.investopedia.com/terms/n/not-for-profit.asp> (last visited Feb. 16, 2015).

²⁷⁵ 26 U.S.C.A. § 501(c)(3) (Westlaw 2015).

poration, that the corporation may only maximize shareholder wealth and cannot engage in charitable activities and to illustrate how greater worker participation in U.S. firms can be attained by private law.

1. *B-Corporations*

In this Article we expose the theory and rules of German corporate governance to determine how to foster U.S. worker participation in productive business as a remedy to the market failure of Wall Street in 2008. In this section, we discuss an innovation on the U.S. legal frontier, which may eventually influence German or European law: the “Benefit Corporation.” We also discuss the co-operative (“co-op”) as another tool to attain greater worker participation in enterprises so as to improve productivity and oversight within the enterprise.

One obstacle to socially responsible business is the shareholder theory of the corporation discussed earlier. The shareholder theory argues that the corporation has, or ought to have, as its primary or even sole purpose the maximization of shareholder wealth. The belief that this shareholder view of the corporation may limit charitable activities of the corporation led to the creation of a new type of for-profit corporation in U.S. law, the Benefits corporation (“B Corp”).²⁷⁶ B Corporations are explicitly permitted to engage in socially beneficial acts that may be detrimental to shareholder’s economic interest in wealth maximization.²⁷⁷ Although we do not regard the B-Corp as legally necessary, such corporations may be attractive to entrepreneurs or investors who wish there to be no doubt as to the legality of the use of the corporation for social purposes beyond the economic profit for the shareholders.²⁷⁸ Benefit corporation laws have been enacted in some U.S. states:²⁷⁹ U.S. corporate law is state law, although U.S. securities law is primarily federal there is at least customary common law state securities law anti-fraud. Tax law in the United States is both federal and state. In Germany, most

²⁷⁶ *Protect Your Mission*, B CORPORATION, www.bcorporation.net/become-a-b-corp/why-become-a-b-corp/protect-your-mission (last visited Feb. 16, 2015).

²⁷⁷ Jerrad Howard, *Benefit Corporations: A New Way Forward?*, DINSMORE (Jan. 2, 2013) (“The benefit corporation presents directors and executives an opportunity to consider interests other than purely shareholder value.”), www.dinsmore.com/benefit_corporations/; Also, see generally, Antony Page, *New Corporate Forms And Green Business*, 37 WM. & MARY ENVL. L. & POL’Y REV. 347 (2013), available at <http://scholarship.law.wm.edu/wmelpr/vol37/iss2/2>.

²⁷⁸ Page, *supra* note 277, at 372-73 (“There are, of course, several general advantages to these new forms. Even if it is possible to duplicate the structure of a benefit or flexible purpose corporation with the traditional corporation, using an off-the-rack standard form will reduce transaction costs. Moreover, the use of the state-sponsored form may serve a valuable signaling function to all stakeholders.”).

²⁷⁹ *E.g.*, Vermont. See, Vt. Stat. Ann. 11A, ch. 21 (2014) *et seq.*

economic laws are federal, not state: most state legislation in Germany is limited to social welfare and educational law.

2. *Co-operatives (“Co-ops”)*

Co-operatives exist both in U.S.²⁸⁰ and German law, and the cooperative in German law is known as the *Genossenschaft*.²⁸¹ Co-ops are one example of a fairly well defined social enterprise. A co-operative is an “association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise,”²⁸² featuring majority decision-making and an elected leadership accountable to its members.²⁸³ Co-operatives are voluntary associations, democratically organized on a stakeholder model. Their primary purpose is not to obtain profit but to provide necessities of living, which are to be fairly distributed to members. Co-operatives are organized on a principle of one vote per person, as opposed to one vote per dollar, as well as mutualism and solidarity.²⁸⁴ Co-operatives are legally recognized in the E.U.,²⁸⁵ as well as in Germany and the United States, but are not as widespread in the United States as in the E.U.

Co-operatives in U.S. law provide necessities such as housing²⁸⁶ and farm goods. Since the cooperative is meant to provide necessities, not profit, co-operative corporations in the agricultural sector in the United States²⁸⁷ are tax-transparent pass-through entities with no tax liabilities

²⁸⁰ *E.g.*, *CCO - Cooperative Corporations*, NEW YORK, available at <http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO>, link: CCO.

²⁸¹ Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften (GenG) (May 1, 1889), available at <http://www.gesetze-im-internet.de/genG/>.

²⁸² European Commission, *Co-operatives*, http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/social-economy/co-operatives/index_en.htm (last visited Feb. 16, 2015).

²⁸³ *See, e.g.*, U.S. Department of Agriculture, *Cooperative Information Report 40* (1990), available at <https://web.archive.org/web/20140813164754/http://www.rurdev.usda.gov/rbs/pub/cir40/cir40rpt.htm>.

²⁸⁴ *See, e.g.*, European Commission, *Social Economy*, <http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/social-economy/> (last visited Feb. 16, 2015).

²⁸⁵ Regulation 1435/2003 on the Statute for a European Cooperative Society (SCE), available at http://europa.eu/legislation_summaries/employment_and_social_policy/social_dialogue/126018_en.htm.

²⁸⁶ Duncan Kennedy, *The Limited Equity Coop as a Vehicle for Affordable Housing in a Race and Class Divided Society*, 46 *HOW. L. J.* 85 (2002).

²⁸⁷ *Cooperative*, UNITED STATES SMALL BUSINESS ADMINISTRATION, <http://www.sba.gov/content/cooperative> (last visited Feb. 16, 2015); I.R.C. § 521 (Exempt Farmers’ Cooperatives) (Westlaw 2015).

of their own,²⁸⁸ a real advantage for any business. Although it is clear the *agricultural* cooperative is a tax transparent entity, the prudent practitioner will *not* presume that the cooperative form itself necessarily implies tax transparency in *other* fields of production.

In a co-operative, realization of income is attributed to the members, not the co-operative itself, avoiding thereby double taxation. While one might at first think the U.S. co-operative corporation, a tax-transparent entity, would be an excellent vehicle for social enterprises, cooperatives in the United States are in practice limited to agriculture, housing, and credit unions. The literal text of the IRS code that grants tax transparency refers only to non-profit *farm* cooperatives housing²⁸⁹ and credit union cooperatives²⁹⁰ as tax transparent pass-through entities. Tax transparency for other fields is questionable, at least as far as the literal text of the IRC goes.

3. *Using the Limited Partnership To Emulate the Co-operative (Genossenschaft): An "Ideal Form" for Business*

In this section we describe how to structure a partnership agreement to enable a limited partnership to emulate a co-operative corporation. This is to enable entrepreneurs several advantages in their business form: limited liability, fiduciary duties, improved wage and remuneration structures as an incentive for productivity, tax transparency, and legal representation of the unincorporated association through an appointed attorney in fact.

The tax advantage of co-ops in the United States is transparency – there is no double taxation on co-ops. However, co-ops as pass-through entities are only recognized by the IRS in farming, housing, and credit unions. Consequently, the co-operative never really took root in U.S. law. However, the common law limited partnership and its statutory equivalent, the limited liability partnership, are well known legal forms

²⁸⁸ Donald A. Frederick, *Income Tax Treatment of Cooperatives*, U.S. DEPARTMENT OF AGRICULTURE, COOPERATIVE INFORMATION REPORT 44 (2005), available at <https://web.archive.org/web/20140823213145/http://www.rurdev.usda.gov/RBS/pub/cir441.pdf>.

²⁸⁹ See, 26 U.S.C.A. § 501(c)(14)(C) (Westlaw 2015) (“Corporations or associations organized before September 1, 2957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).”), available at <http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title26-section501&num=0&edition=prelim>.

²⁹⁰ See 26 U.S.C.A. § 591(c)(14)(A) (Westlaw 2015) (“Credit unions without capital stock organized and operated for mutual purposes and without profit.”), available at <http://uscode.house.gov/view.xhtml?req=granuleid:USC-prelim-title26-section501&num=0&edition=prelim>.

in U.S. law. We argue that partnerships can be used to emulate the cooperative and obtain limited liability, tax-transparency, capital investment, and fiduciary relationships and worker participation in enterprise management.

An ideal tax entity is tax-transparent; that is, the business is not taxed, only the money distributed to the persons working for it, whether as income from labor or dividends of capital. Limited partnerships are a pass through entity: they are tax transparent. That is a real advantage of co-ops and partnerships as compared to corporations. Corporations are in principle taxable entities, which leads to double-taxation of the corporation and its shareholders when dividends are paid out. Sub-chapter S corporations²⁹¹ are the exception of the rule, which is double taxation of the corporation. S Corporations are so called in reference to the Internal Revenue Code. S corporations may have only one class of stock²⁹² and no more than 100 shareholders,²⁹³ who must be U.S. resident aliens or citizens.²⁹⁴ Thus the S-Corp is of limited utility to avoid double taxation.

Another desirable trait of a good business is a fiduciary duty of loyalty among all members. Fiduciary duty is the idea that each person in the business must look out for every other member's interest.²⁹⁵ Partnerships entail fiduciary duty among the partners. All members of the partnership owe each other and the partnership fiduciary duties and that point can be reiterated in the partnership agreement.²⁹⁶

²⁹¹ *S Corporations*, UNITED STATES INTERNAL REVENUE SERVICE (2013), <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/S-Corporations>; *S Corporation*, UNITED STATES SMALL BUSINESS ADMINISTRATION (2013), <http://www.sba.gov/content/s-corporation> (S Corporations are so called because they are recognized by sub-chapter S of the Internal Revenue Code; they have but one class of shareholders, 100 or fewer shareholders, and shareholders may only be U.S. citizens or permanent residents. They are a pass-through entity, that is, only the shareholders and not the corporation are taxed on income realized by the corporation).

²⁹² I.R.C. § 1361(b)(1)(D) (2014) (Westlaw 2015).

²⁹³ I.R.C. § 1361(b)(1)(A) (2014) (Westlaw 2015).

²⁹⁴ I.R.C. § 1361(b)(1)(C) (2014) (Westlaw 2015).

²⁹⁵ *See, e.g.*, *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) ("Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined *the standard of duty owed by partners to one another as the* "UTMOST good faith and loyalty." [internal citations omitted, emphasis added] Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.")

²⁹⁶ *See, e.g.* *Hendry v. Wells*, 650 S.E.2d 338, 346 (Ga. Ct. App. 2007) ("In addition to a limited partner's enumerated and contractual rights, in Georgia partners owe fiduciary duties directly to one another, including a duty to act in the 'utmost good faith,'); *Dymm v. Cahill*, 730 F. Supp. 1245, 1264 (S.D.N.Y. 1990) ("General partners owe fiduciary duties to their limited partners.").

Another thing all businesses want to do is raise capital, either from investors, or by borrowing money. The problem is, small businesses often borrow too much, and then wind up going out of business. So, responsible debt limits should be written into the partnership agreement. If the business can't borrow then it will have to attract new members.

Just as the business has to have sensible limits on its borrowing, the business should also engage in fair business practices: no exploitation by the rich of poor people. Thus, the partnership agreement should specify that the silent partner investments are limited to bond-obligations at fixed interest with maximum payback equal to double the initial investment. This prevents the debt-trap. Silent partners, as passive investors, should be compensated by interest on their investment, rather than profit sharing so as to avoid distortion of production or exploitation of producers.

Wages are another constraint on small businesses. By structuring payments of income as profit sharing, the business legally circumvents minimum wage constraints. Since the business has limited its ability to borrow money or to be used as a cash cow by its passive investors there is no question of the fairness of the operation. The business is thus sustainable, and as profitable as its members make it. There is no exploitation, yet there is also no wage constraint. Compensation is equal-rated profit sharing.

As a *partnership*, the co-operative Company is not a legal person: it is an unincorporated association. A person authorized by the member of the unincorporated association may bring lawsuits on behalf of the partnership.

Often, we think the advantage to a corporation is limited liability. But in the limited partnership the silent partners are only liable to the extent of their investment. Meanwhile, in the real world, when a business goes bankrupt or faces tort liability the employees wind up getting fired or the court simply ignores the corporation under the doctrine of "piercing the corporate veil."²⁹⁷ Limited liability is not that advantageous, and the formal and administrative costs of maintaining the corporate fiction, which might get ignored in the end anyway, definitely outweigh any advantages for small businesses. Furthermore, the liability of the company can be limited by the partnership agreement, which should firmly restrict the ability of the partnership to go into debt.

Thus, through careful structuring as outlined above, the partnership can be used to emulate the advantages of a cooperative and of co-deter-

²⁹⁷ Courts can choose to ignore the corporate form where that form is used inequitably or for abuse of the law. For the various theories and rules of veil piercing *see*, Eric Engle, *U.S. Corporate Liability for Torts of (Foreign) Subsidiaries*, 23 CORPORATE COUNSEL REV. 15 (May 2004), available at <http://ssrn.com/abstract=1655983>.

mination and can contribute to the restructuring of the U.S. market to attain improved productivity as one of the ways out of the economic crisis.

CONCLUSION

In this Article we described the causes and consequences of the financial crisis of 2008 in economic and legal terms. Macroeconomic factors such as monetary policy and exogenous political shocks to the system coupled with regulatory failure resulted in the most severe recession in the United States since 1929. In contrast, the German market largely escaped the great recession. Consequently, we examined German corporate governance rules and institutions in order to determine whether and how German legal structures can be emulated in U.S. markets to attain legal reforms as a private law response to political gridlock. This required an exposition of the history of development of various theories of the corporation and a description of differences in the U.S. and German capital markets. We also examined domestic U.S. rule-complexes which might enable greater worker participation in corporate governance so as to attain improved productivity and better oversight. Employee Stock Ownership Plans, Benefit Corporations and co-operatives were thereby exposed and used as the basis for a proposed limited partnership form which would combine fiduciary duties, tax transparency, and employee participation so as to obtain increased productivity.

The U.S. corporate governance system failed in 2002 and 2008 leading to the deepest economic downturn in the United States since the great depression. Germany, in contrast, neither suffered widespread regulatory failure or market collapse. Thus, we examined whether and how to emulate the two-tier board and co-determination on the U.S. market. This would make U.S. corporations more attractive for affiliation with German companies by increasing oversight and greater transparency so as to prevent further fraud. Important differences in the U.S. and German capital markets may explain divergent corporate structures and economic performance of the U.S. and German capital markets. It is possible to emulate the German corporate form of two tier boards with co-determination in U.S. corporations by writing provisions prohibiting certain directors from serving as active managers, by reserving a certain number of seats on the board of directors to non-managerial employees or their elected representatives, and by indicating specific fiduciary duties in the corporation's charter. Such internal restructuring may prevent fraud, may attract investors, and may be a good structure for forming German subsidiaries on the U.S. market.

