Curing American Managerial Myopia: Can the German System of Corporate Governance Help

Robert E. Benfield

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NOTES AND COMMENTS

CURING AMERICAN MANAGERIAL MYOPIA: CAN THE GERMAN SYSTEM OF CORPORATE GOVERNANCE HELP?

I. INTRODUCTION

Between 1983 and 1992, shareholders' rights groups actively lobbied the Tandy Corporation to dismiss its chairman and chief executive officer, John V. Roach.1 During a period in which computer and electronics companies were reporting record profits, Tandy's sales and earnings growth were flat, causing the value of its stock to decrease sixty-six percent.2 Relying on the support of Tandy’s board, however, the embattled CEO was able to resist calls for his dismissal and focus on long-range plans to build a national chain of technology retail stores.3 Based primarily on the strength of sales at its new stores, Tandy’s stock increased fifty percent in 1994, its per-share net income grew by more than one dollar, and sales were projected to reach fifteen billion dollars by 1999.4

The events at Tandy illustrate many of the fundamental problems caused by the separation of ownership from control in American corporations. Having little or no access to corporate “inside” information,5 shareholders are forced to focus on short-term earnings reports and share prices in order to monitor the performance of their investments. Corporate managers necessarily pursue short-term growth strategies in order to appease their shareholder constituencies, increasing significantly the equity cost of capital-to-fund long-term research and development. Had Tandy’s shareholders known of Mr. Roach’s plans to expand

2. Id.
3. Id.
4. Id.
5. Borrowing from analysis under Rule 10b-5, 17 C.F.R. § 240.10b-5 (1994), and Basic, Inc. v. Levenson, 485 U.S. 224 (1988), for purposes of this Comment, inside information is non-public information that a reasonable investor is substantially likely to consider important in making an investment decision.
Tandy's retail business, perhaps they would have been willing to endure a temporary period of stagnant earnings growth. If the CEO had disclosed the corporation's plans, however, he would have risked the possibility that his competitors would obtain the information, jeopardizing his company's planned expansion. Faced with similar alternatives, chief executives of American companies may be inclined to forego pursuit of their long-term plans and the potential benefits that they may confer on the U.S. economy and American workers.⁶

When shareholders have a legitimate basis for their dissatisfaction with management, however, they frequently have no recourse other than to sell their stock. Agency costs of effectuating change are so prohibitive to individual shareholders that they choose to exercise their "Wall Street Option" rather than challenging decisions of incumbent management.⁷ Thus, in the paradigmatic American corporation, which does not possess any institutional investors to monitor inefficient managers, management tends to become entrenched and immune to change.⁸ While the board of directors is intended to fulfill this monitoring role, it typically does no more than ratify management's decisions.⁹ Indeed, Tandy's John Roach could not have remained as CEO without the support of Tandy's board, which is composed largely of his friends and col-

⁶. Traditionally, management's primary responsibility has been to maximize shareholder value. A growing body of scholarly discourse, however, suggests that in making decisions, corporate managers and directors must also consider nonshareholder constituencies such as employees and the economy. Some theorists write that “[t]he ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long term and compete successfully in the world economy.” Martin Lipton & Stephen Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. CHI. L. REV. 187, 189 (1991). Some commentators label this theory the “stakeholder perspective” because it requires managers to “seek to maximize long-term corporate health irrespective of effects on short-term shareholder wealth.” John H. Matheson & Brent A. Olson, Corporate Cooperation, Relationship Management, and the Triological Imperative for Corporate Law, 78 MINN. L. REV. 1443, 1465 (1994).


⁸. For purposes of this Comment, institutional investors include private and public pension funds, insurance companies, mutual funds, and investment funds managed by banks.

In Tandy's case, Mr. Roach was able to bring success to the company by changing its direction. In similar situations, however, many chief executives have severely damaged the companies that they managed before shareholders were able to oust them.

Thus, the American system of corporate governance is inherently flawed: it forces managers to pursue arbitrary short-term objectives and possesses no viable mechanism by which owners can hold management accountable for its decisions. The ideal corporate governance system, in contrast, would "allow management the discretion to act on the shareholders' behalf while at the same time establishing safeguards against the abuse of discretion." Recent scholarship has focused on the German system of corporate governance, in which financial intermediaries participate actively in management decisions, as a practical manifestation of this ideal model.

In the past decade, institutional investors have begun to bridge the gap created by the separation of ownership from control in American corporations. Owning large illiquid blocks of stock,
for which there is a limited secondary market, has prompted these investors to monitor their investments more diligently than individual investors. Moreover, American regulatory bodies are beginning to encourage the institutions that they oversee to become more active shareholders. In particular, the Department of Labor ("DOL") recently promulgated guidelines that encourage corporate pension fund managers to vote the shares they own and to monitor actively the companies in which they invest. Perhaps institutional investors can become to American corporations what financial intermediaries are to German corporations.

This Comment will examine the above-stated proposition. It will ascertain whether the German system of corporate governance or the DOL Guidelines are viable models on which to base corporate reform in the United States. Part II compares corporate governance systems in the United States and Germany, focusing on the institutional relationships between shareholders and managers in each system. Part III explores the increasing activism of institutional investors in governing American corporations, and the DOL's recent attempt to encourage this activism among private pension funds. Finally, Part IV of this Comment asserts that governance in U.S. corporations is moving toward the German model. In discussing whether this trend is desirable, this Comment will conclude that institutional investor activism, in its current form, simply perpetuates the short-term myopia currently plaguing American corporate managers.

II. A COMPARISON OF CORPORATE GOVERNANCE IN THE UNITED STATES, AND GERMANY: SHAREHOLDER MONITORING OF MANAGEMENT

In its simplest form, a system of corporate governance "establishe[s] the ground rules that dictate the relationships among the owners, the boards of directors, and corporate management." Variations in these relationships depend on differences

(1994).

15. See infra notes 113-15 and accompanying text.
in the institutional frameworks and legal rules that define them. Laws in the United States have established a market-based system of control, which contrasts with the bank-based system in Germany.\textsuperscript{18} Yet, "it is now becoming clear that the main differences between countries do not concern the way in which financial systems fund their corporate sectors but the way in which ownership and control is organized."\textsuperscript{19} While the German corporate governance system unifies ownership and control, the American system keeps them separate. This part of this Comment identifies differences in the salient organizational features of American corporations and their German counterparts in order to understand why the German system simply would not work in the United States.

A. Corporate Governance in the United States

1. The Separation of Ownership from Control

Adolph Berle and Gardiner Means first identified the separation of ownership from control in American corporations as a response to the needs of industrial companies in the early twentieth century to raise massive amounts of capital to support their rapid growth.\textsuperscript{20} In order to finance their growing operational costs and expansion, American companies were forced to seek capital from widely diverse investors, each of whom was financially able to purchase only a small portion of a corporation's equity.\textsuperscript{21} While such diversification initially decreased the cost of capital and
promoted efficiency, ultimately it has created a class of passive investors who lack the ability, information, and incentives to monitor actively their corporations. This passive investment phenomenon has allowed American managers to make fundamental decisions without the input of their corporation’s true owners. Moreover, shareholders who indeed choose to become active in management bear all the costs of monitoring corporations but share the gains in value equally with the corporations’ other shareholders. This potential for free-riding by uninvolved shareholders provides a strong disincentive for those who wish to become active. Thus, most shareholders of American companies typically spread their risk across diversified holdings, which they hold for investment purposes, rather than purchasing concentrated blocks for control purposes.

With the enactment of laws that limited large financial institutions’ ability to hold concentrated blocks of stock, the separation of ownership from control became firmly integrated into the structure of authority in American corporations. In the Glass-Steagag Act, Congress separated commercial banks from

22. Franks & Mayer, supra note 18, at 4. Monitoring does not necessarily mean close supervision of management’s daily decisions. Rather, this Comment adopts Robert A.G. Monk’s definition:

What I mean by governance is oversight in those areas where managers, directors, and shareholders have conflicts of interest, including the election of directors, very general supervision of ... [executive compensation], and the overall structure and direction of the company. Shareholders are not there to appoint the CEO or second-guess his decisions. They are there to make sure that the directors perform those functions effectively and in their interests, and to replace them if they fail.


23. Gilson & Roe, supra note 13, at 876. See also Franzen, supra note 7, at 274.


26. Part I of this Comment presents only a survey of applicable laws to illustrate generally that legal rules have created regulatory impediments to institutions’ participating in the control of American public firms. In general, these laws have prevented large financial institutions from owning the concentrated blocks of stock that they would require in order to monitor effectively the corporations in which they invest. See generally John C. Coffee, Jr., The SEC and the Institutional Investor, 15 CARDozo L. REV. 837 (1994). For more detailed discussions of these laws, see Franzen, supra note 7, at 274-79; Roe, supra note 24, at 17-31; and Bill Shaw & John Rowlett, Reforming the U.S. Banking System: Lessons from Abroad, 19 N.C. J. Int’l. & Comm. REG. 91, 97-106 (1993).
investment banks, preventing the former from owning and dealing in securities.\textsuperscript{27} Several years later, Congress enacted the Bank Holding Company Act, which permits banks to conduct only "banking" activities and prohibits bank affiliates from holding more than five percent of a company's stock, unless the shares are nonvoting.\textsuperscript{28}

Several U.S. laws also prevent mutual funds, pension funds, and insurance companies from controlling companies through stock ownership. If mutual funds hold greater than a ten percent stake in any one of the companies in their portfolios, they forfeit their diversified status and, therefore, lose preferential tax treatment.\textsuperscript{29} In various states, regulations prevent insurance companies from owning controlling blocks of stocks.\textsuperscript{30} Finally, the Employee Retirement Income Security Act ("ERISA") ensures that pension funds remain highly diversified.\textsuperscript{31}

Moreover, Securities and Exchange Commission ("SEC") proxy regulations limit the American shareholders' ability to communicate with each other, thus making it difficult for them to exert control through concerted action. Historically, shareholders could not engage in communication that called for any action which was part of a continuous plan; when ten shareholders communicated with each other, without first filing proxy material,

\begin{itemize}
\item \textsuperscript{27} Glass-Steagal Act, 48 Stat. 184 (1933) (codified as amended at 12 U.S.C. § 24 (Supp. II 1990). In response to the bank failures and the stock market collapse, which led to the Great Depression, Congress passed this Act to protect depositors funds and limit conflicts of interest. Franzen, supra note 7, at 274.
\item \textsuperscript{30} See Roe, supra note 24, at 23. New York, California, Illinois, and Texas all closely regulate insurance companies' stock ownership. Id.
\item \textsuperscript{31} Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 10041-11461, and in scattered sections of titles 5, 18, 26, 31, and 42 U.S.C.). In 1974, Congress enacted ERISA to regulate private pension funds. One of Congress' primary goals in promulgating ERISA was to ensure that pension funds diversified their investments. Professor Roe writes:
\begin{quote}
Congress enacted ERISA ... which, with no discernable governance-related motive, confirmed the preexisting structure of corporate governance, by encouraging pensions to adopt the fragmented, passive stockholding structure that the three other big financial institutions—banks, insurers, and mutual funds—usually adopt.
\end{quote}
Mark J. Roe, The Modern Corporation and Private Pensions, 41 UCLA L. Rev. 75, 76 (1993).\
\end{itemize}
they presumptively violated SEC rules.\textsuperscript{32} The tremendous transaction costs associated with filing proposals for consideration by proxy effectively chilled shareholders from attempting to initiate such campaigns.\textsuperscript{33}

In 1992, the SEC amended its proxy regulations to allow stock owners broader latitude to communicate with each other.\textsuperscript{34} The SEC amendments were intended to provide shareholders with a stronger voice in their corporations' affairs.\textsuperscript{35} While the proxy reforms have reduced the cost of shareholder communications, their overall impact on corporate governance in the United States is questionable.\textsuperscript{36} Furthermore, although facilitating greater communication between shareholders is important, it is insufficient to improve shareholder monitoring. In order to become better monitors of management, shareholders need to communicate more with corporate managers than with each other.

The most important consequence of shareholders' inability to assert control is that managers are essentially free to pursue their own agendas unchecked by other corporate constituencies. In other words, the separation of ownership from control creates agency costs because managers of public firms pursue agendas that do not reflect the interests of their companies' owners.\textsuperscript{37} Furthermore, managers frequently tend to place their own interests before those of shareholders.\textsuperscript{38} Thus, the challenge of the American system of governance is to align shareholders' and managers'

\textsuperscript{32} 17 C.F.R. § 240.14a-1(1) (1990). See also Studebaker v. Gitlin, 360 F.2d 692 (2d Cir. 1966).

\textsuperscript{33} Winning a proxy contest not only involves hiring attorneys to prepare mailings to be sent to other shareholders, but also commonly entails purchasing advertising space in major financial newspapers and hiring a solicitation firm. Given many shareholders' lack of interest in voting their shares, the chance of securing a majority of votes is stacked against anyone who challenges management's nominee. JACOBS, supra note 17, at 80.


\textsuperscript{35} See Matheson & Olson, supra note 6, at 1470. It is beyond the purview of this Comment to present a detailed discussion of the SEC proxy reforms. For in-depth analyses of the SEC reforms, see id. at 1469-75; Coffee, supra note 26, at 840 n.17; Justin P. Klein & Gerald J. Guarini, The New Proxy Solicitation Rules, 26 REV. OF SEC. & COMMODITIES REG. 89 (1993); Robert S. Frenchman, Comment, The Recent Revisions to Federal Proxy Regulations: Lifting the Ban on Shareholder Communications, 68 TUL. L. REV. 161 (1993).

\textsuperscript{36} Coffee, supra note 26, at 840-42; Matheson & Olson, supra note 6, at 1447.

\textsuperscript{37} Monks, supra note 22, at 3.

\textsuperscript{38} See, e.g., Roe, supra note 24, at 12.
agendas. When the inevitable conflicts arise between shareholders' objectives and managers' agendas, the system must provide a forum for discussion in which similarly informed, motivated, and empowered participants can agree on resolutions that comport with their objectives.  

2. The Board of Directors Internal Monitoring Role

Because it is both impractical and costly for numerous, widely dispersed shareholders to participate equally in this process, however, the American system has developed internal and external mechanisms to facilitate shareholder monitoring. Within the corporation, a board of directors represents shareholders' interests before management. Ideally, shareholders dictate how the company is run by establishing its charter and bylaws, and entrust to the board the responsibility to see that management effectuates their mandate. By electing outside directors who are not affiliated with the corporation, shareholders can theoretically rely on an impartial party to champion their interests.  

In practice, however, shareholders are not well-protected. Management selects candidates for the board—typically similarly situated chief executives of other companies—and determines their tenure. In general, these directors will not monitor any more diligently than they feel they should be monitored in running their own companies and will rarely risk loosing their jobs by questioning management's decisions. Thus, directors frequently fail to represent shareholders' interests because they become beholden to the managers they are supposed to oversee.  

In theory, shareholders may rely on the courts to ensure that directors fulfill their mandate; however, judges abstain from

40. JACOBS, supra note 17, at 72.  
41. Gilson & Kraakman, supra note 12, at 873 (1991). The rationale for relying on outside directors is simple: because they "do not have a personal financial stake in retaining management, they can act as shareholder surrogates to assure that the company is run in the long-term best interests of its owners." Id.  
42. JACOBS, supra note 17, at 72. Sixty-three percent of the outside directors of public companies are CEOs of other public companies. Gilson & Kraakman, supra note 12, at 875.  
43. Id.  
44. Courts ensure that directors fulfill their legal responsibilities to shareholders. These legal responsibilities include the duty of loyalty and the duty of care. The duty of loyalty prevents directors from serving their own interests at a corporations' expense.
second-guessing business decisions that are made in good faith, even if the decision has proven harmful to the corporation.\textsuperscript{45} A shareholder who brings a claim against a director must meet the substantial, even overwhelming burden of proving that a director's decision was uninformed and the product of fraud, illegality, or bad faith.\textsuperscript{46} Moreover, some jurisdictions now allow corporations to opt out of the informed decision-making standard, and all jurisdictions, in varying degrees, indemnify directors for liabilities incurred while performing work duties.\textsuperscript{47} The net result is that shareholders cannot effectively use judicial action to hold directors accountable for their decisions.

3. The Market for Corporate Control as External Monitor

Perhaps the most effective monitor of American managerial performance, and the primary external source of pressure on management, is the market for corporate control. Market theorists posit that stock prices reflect all available information on a corporation and, thus, are a reliable indicator of managerial efficiency.\textsuperscript{48} An inefficient corporation, whose share price does not reflect accurately the actual or potential value of its assets, is susceptible to a hostile takeover, leading to a likely ouster of management.\textsuperscript{49} Conversely, companies that appear to maximize

\begin{thebibliography}{99}
\bibitem{Maricano v. Nakash} Maricano v. Nakash, 535 A.2d 400 (Del. 1987). "It is a long-established principle of Delaware corporate law that the fiduciary relationship between directors and the corporation imposes fundamental limitations on the extent to which a director may benefit from dealings with the corporation he serves." \textit{Id.} at 403.
\bibitem{Duty of Care} The duty of care ensures that directors are competent, diligent and exercise good faith in their decision-making and supervisory functions. \textit{See generally} Litwin v. Allen, 25 N.Y.S.2d 667 (1940). \textit{See also} JACOBS, supra note 17, at 77.
\bibitem{Business Judgment Rule} \textit{See} id. (holding directors liable for not being adequately informed when they approved a negotiated merger). The "business judgment" rule presumes that: [in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one. \textit{Id.} at 860.
\bibitem{Matheson & Olson} \textit{See} Matheson & Olson, supra note 47, at 1336.
\end{thebibliography}
a shareholder's return on investment attract capital and, therefore, are able to resist unwanted overtures of corporate raiders. The market for corporate control champions the role of the corporate raider who assists shareholders in identifying low corporate valuations that arise from inefficient management. Such corporate raiders theoretically enable normally powerless shareholders to remove poor management by choosing to tender into a hostile bid.

The focus on short-term maximization of shareholder wealth is misguided and potentially detrimental to the American economy. Because the primary indicator of inefficient management is share price, managers attempt to fend off the takeover threat by keeping share prices high in the short-term, at the expense of long-term growth. Management tends to react to market signals by reducing budgetary outlays for investment, advertising, research, and development in order to ensure that quarterly earnings remain high. Such myopia prevents companies from positioning themselves for long-term growth and, thus, adversely affects the competitiveness of the American economy as a whole. Furthermore, management may blame poor performance on short-term pressures when, in fact, management itself may be the primary source of the corporation's problems. Indeed, ousting inefficient management frequently could save the parties to a hostile takeover from incurring substantial transaction costs and prevent local economies from losing jobs as well as revenue.

The market-as-monitor theory presupposes that an active takeover market indicates widespread managerial inefficiency; however, this a questionable assumption. Takeovers are strategic instruments that are more a function of a healthy corporate economy than a mechanism of corporate control. They occur when acquiring companies have enough capital and operational

50. Id.
51. Franks & Mayer, supra note 18, at 5.
52. Franzen, supra note 7, at 291. Shareholders, however, rarely have such benevolent motivations. They choose to tender into a hostile bid only if it will maximize their investment.
53. Id.
55. Id.
56. See Matheson & Olson, supra note 6, at 1454 n.49.
profit to support aggressive growth. For instance, in the 1980s, when the American economy was robust, the takeover market flourished. Following the 1987 market crash, the savings and loan crisis, and the resulting American recession, however, takeover activity all but disappeared. Once the American economy emerged from recession and entered a period of impressive growth in 1993, tender offers resurfaced, particularly in the industries in which growth has exceeded that of the economy as a whole. Because tender offers are a cyclical phenomenon, occurring only when acquiring companies can afford to finance growth primarily through acquisition, shareholders cannot rely on takeovers to exert discipline over managers.

When they have sufficient capital, acquiring companies are motivated more by strategic and competitive concerns than by a desire to oust inefficient management. Hostile bids frequently occur despite good past performance, often in anticipation that the acquiring company will implement a superior policy in the future. The executive dismissals and restructuring that inevitably occur after most takeovers are more a reflection of disputes between new and incumbent management over strategy and style than a need to replace inefficient management. For example, in its recent acquisition of Paramount, Viacom was not motivated by the need to replace Martin Davis and increase share value. Rather, Paramount was the only remaining unaffiliated major

59. Recycling a Favorite From Headier Times: A Recovery in Demand for Public Targets Sparked a Revival of the Tender Offer, MERGERS & ACQUISITIONS, June 1994, at 27. "Tenders took a back seat from 1990 to 1992 as mergers and acquisitions activity crumbled under a mix of pressure ranging from the sour economy to tight financing to a general pullback from deal-making from companies that had loaded up on acquisitions during the 1980's." Id. See also Mergers, Acquisition Activity Fell 18% in 1st Quarter, Hitting an 11-Year Low, WALL ST. J., Apr. 16, 1991, at A2; Mergers at an 11-Year Low, N.Y. TIMES, Apr. 18, 1991, at D10.
60. See Quint, supra note 58, at C3.
61. Franks & Mayer, supra note 18, at 7.
62. Id.
63. Id.
64. In fact, Mr. Davis orginally intended to remain as an employee of the new merged entity; however, he has since changed his mind. See Jonathan Weber, Entertainment Mega Merger: Wall Street Gives Paramount Deal a Rude Welcome, L.A. TIMES, Feb. 16, 1994, at D1.
motion picture studio with which Viacom effectively could combine its cable systems. In 1989, Paramount unsuccessfully attempted to block a planned merger between Time, Inc. and Warner Communications solely because it wanted to prevent Time from gaining a competitive advantage. Acquiring companies’ actions are inherently self-interested and, therefore, are not motivated by the more benevolent desire to correct managerial failure and give shareholders more bang for their buck.

Thus, the American system of corporate governance lacks a viable mechanism to minimize agency costs caused by the separation of ownership from control. Directors are beholden to management and insulated from shareholders. The market serves as a forum for the formation of synergistic partnerships and not as a monitor of management. Share price and quarterly earnings are inadequate barometers of managerial performance because they fail to reflect accurately the long-term value of a corporation and force executives into a state of perpetual myopia. To evaluate the merits of a system that gives shareholders greater access to inside information and more of a vested interest in managing the companies they own, one must look no further than the German system of corporate governance.

B. Corporate Governance in Germany

Unlike American corporations, German public companies rely on banks and not the market as their primary source of external finance. Without the analogue of a Glass-Steagagal Act to segregate their activities, German banks participate actively in governing German corporations as creditors, substantial holders of equity, and on behalf of customers who deposit their shares with banks’ brokerage units. As a result of banks’ extensive role in

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67. JACOBS, supra note 17, at 69. Thus, most German corporations are not public companies. In 1992, of 380,000 total German corporations, only 700 were listed on a public stock exchange. Id.
68. Theodor Baums, Corporate Governance in Germany: The Role of the Banks, 40 AM. J. COMP. L. 503, 506 (1992). Consequently, German banks are multi-dimensional: Most of the 4500 [German] banks are universal banks, which may be active in the classical banking business as well as in the securities and (through subsidiaries) in the investment banking business; trade with real estate; organize rescue
German corporations, German shareholders and managers share a vastly different relationship than their American brethren, and in contrast to the prototypical American Berle-Means corporation, ownership and control are largely synonymous.

1. Concentration of Share Ownership

Because banks control ownership of German corporations, German shareholdings are significantly more concentrated than American shareholdings. German CEOs typically can expect to face two or three large institutional blocks, which together control thirty percent of their firm's voting shares. In contrast, it is rare for an American CEO to face an institutional block that controls even five percent of the vote. Such concentration of ownership accounts for an illiquid German stock market, limits individual investors' role in German corporations, and minimizes the threat that German corporations will be taken over by unwanted buyers.

Dense concentration of shareholdings and German corporations' reliance on banks, and not the market, for external financing has left the German Exchange weak and ineffective as a vehicle for German companies to raise capital. Of the relatively small number of firms that are listed on the German exchange, only a few raise capital by issuing exchange-listed securities. Bank syndicates, which control issuance of new securities, charge high fees for underwriting stock offerings and ensure that prices for first time issues are low. Thus, only widely-held companies can afford to raise capital by issuing securities to the public.

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69. Roe, supra note 13, at 10. In Germany, a small group of institutional investors usually votes 20% of a company's stock, while the largest five holders of an American company's equity together commonly control less than five percent of all shares, even with the recent "institutionalization and concentration" of American holdings. Id.

70. Id.

71. Id.


73. Coffee, supra note 13, at 1302. In 1986, there were only 450 listed companies in Germany, in comparison with 6000 in the United States. Franks & Mayer, supra note 18, at 3.

74. Kallfass, supra note 72, at 780.

75. Id.
Additionally, substantial bank involvement limits individual investors' role in German corporations. The few individuals who do own stock willingly permit banks to administer their shares, adding to banks' influence. Moreover, German companies use the stock market not to disseminate their securities to the public but rather "to build up lasting corporate interdependencies." Therefore, the German market is largely illiquid, because it lacks an active secondary market in which investors readily trade their holdings.

Consequently, the German corporate governance system relies exclusively on internal institutional precautions, and not on a takeover market, as a means of exerting control over management. The concentrated structure of German shareholdings effectively minimizes the takeover threat, and voting rights restrictions allow shareholders to impede attempts by acquirors to gain controlling interests in firms. Furthermore, because the German market is relatively illiquid, individual shareholders rarely have the opportunity to tender into a hostile bid. Unlike American shareholders, German owners cannot readily sell their stocks if they are displeased with management. Therefore, German shareholders are compelled to "exercise voice" over the way in which the firms they own manage their affairs.

Finally, concentration of ownership allows German shareholders to communicate easily with each other without facing the significant transaction costs that diffuse American shareholders.

76. Franzen, supra note 7, at 284. "Corporate management in Germany is monitored by institutional investors (predominantly banks, insurance companies and investment funds), which are the main holders of shares in Germany." Id.
77. Baums, supra note 68, at 506.
78. Kallfass, supra note 72, at 786.
79. Franks & Mayer, supra note 18, at 3. For a more detailed discussion of the mechanics of the German Stock Exchange, see generally Kallfass, supra note 72.
80. Baums, supra note 68, at 505. As of 1992, there had been only four hostile takeovers in Germany since World War II, and, of those, three occurred after 1989. Franks & Mayer, supra note 18, at 8.
81. Franks & Mayer, supra note 18, at 9. Shareholders frequently pass resolutions that limit the voting right of any one shareholder to no more than 15% of total voting shares, regardless of the size of the shareholder's stake. These are not absolute defenses to takeovers, however. Rather, they lead to a slower, two-stage process in which prospective bidders first attempt to have the restrictions removed and then proceed with the usual tender offer process. Id. The voting restrictions do not apply when banks vote as custodians on behalf of their clients. Baums, supra note 68, at 507, 508.
82. See, e.g., Franks & Mayer, supra note 18, at 8.
83. Coffee, supra note 13, at 1304.
face when they attempt to communicate. Furthermore, German laws do not block collective action by German shareholders in the way that SEC proxy regulations block collective action by American shareholders. Thus, when German shareholders disagree with management they can act in unison to achieve their objectives.

2. The German Proxy System

Yet, German banks do not derive their ability to influence corporate management solely from direct ownership of substantial equity stakes in German corporations. Rather, they gain their influence from voting both directly owned stock and shares held as custodians for their clients. In fact, banks typically vote in favor of management's proposals. If the need arises, however, banks can act unilaterally to defeat management proposals that they oppose.

German banks' considerable voting power allows them to place representatives on German supervisory boards, and therein lies one of the most important differences between German and American systems of corporate governance. German supervisory board members are commonly employed by shareholders of the 

84. Baums, supra note 68, at 505. "There is no [German] proxy system comparable to the American practice." Id.
85. Id. Professor Baums details German banks' voting power in the following study conducted in 1984:
All banks together on average represented more than four-fifths (82.67%) of all votes which were present in [company] meetings. With one exception, they always had at least a majority (more than 50%) of the votes present. Consequently, they were able to elect the members of the supervisory boards (so far as these are elected by the shareholders, not the employees). Changes of the articles and bylaws of the corporation could not be effected against their votes. In 22, or two-thirds of the firms the banks voted more than three-fourths of the stock present, and thereby could change the articles and by-laws. No other shareholder could block these decisions.

Id. at 507.
86. Franzen, supra note 7, at 286.
87. See Roe, supra note 13, at 14. "Although no single bank generally controls an industrial firm, . . . together the three German large banks can, if they act in unison, dominate the shareholding side of the supervisory board." Id.
88. Baums, supra note 68, at 505. In public firms with more than 2000 employees, German shareholders appoint half of the supervisory board members, and employees or labor unions appoint the other half. Id. at 510. For a definition of "supervisory board" and a discussion of their role in German corporations, see infra notes 91-101 and accompanying text.
companies on whose boards they serve. Because they are selected by shareholders and not managers, they are able to remain more impartial than American board members when evaluating management decisions.

Consequently, it is difficult for German corporate managers to pursue damaging strategies for extended periods without facing outside intervention from shareholders. Bank control of shareholder voting prevents German managers from dominating the proxy process, as American managers do. Most importantly, limiting corporate managers' roles in the voting process effectively guarantees German shareholders a significant representative voice in German public firms' affairs.

3. The German Codetermination System

In order to monitor management internally, German public firms use a codetermination system in which supervisory boards appoint, dismiss, and oversee management boards, which, in turn, execute corporations' daily affairs. Supervisory boards regularly advise management on major decisions but actually intervene in management only in crisis situations. Thus, they influence German corporate managers but do not control their decisions.

The most important function of the dual board system, however, is that it allows owners to interact regularly with management and to review informally management's performance two to four times a year. To facilitate meaningful interaction, German supervisory boards have access to comprehensive

89. Members of the managing or supervisory boards of banks frequently also serve on the supervisory boards of firms in which they hold substantial equity positions. For example, executives of Deutsche Bank serve on more than 400 corporate boards. Id.
90. JACOBS, supra note 17, at 71.
91. Roe, supra note 13, at 18. "It is doubtful that [German managers] can even lawfully make a proxy solicitation. Instead, German managers must filter proxy solicitations through bankers, who vote their own stock, their mutual funds' stock, and their customers' custodial stock." Id.
92. Baums, supra note 68, at 504.
93. Franks & Mayer, supra note 18, at 11. Supervisory boards "evaluate plans put forward by management and monitor their implementation but in the normal course of events they intervene little in the activities of management." Id. at 11-12.
94. Roe, supra note 13, at 19. "[T]he supervisory board provides shareholders with influence, although not control, in corporate governance. Managers still have the upper hand, but the tilt is not nearly as pro-managerial as is has historically been in the United States." Id.
95. Id. at 18.
corporate information. In addition to receiving periodic reports from management, supervisory boards review annual reports and balance sheets. They possess the authority to compel reports on demand and to require management to obtain their approval before entering into certain transactions. Thus, board membership provides creditors and major shareholders of German corporations with regular access to corporations' long-range plans and managing boards' current weaknesses.

Dialogue between German managers and supervisory board members occurs in a private forum, away from those who are likely to misappropriate it. Supervisory board members must treat the information they receive from management confidentially. Thus, German managers are able to share information with shareholders without risking that it will fall into the hands of competitors or that it will be disseminated to the public. American managers do not share this luxury, because there is currently no private forum in which they can disclose confidential information to shareholders. Indeed, sharing such information with shareholders could potentially subject them to liability under SEC insider trading regulations.

Systematic structured interaction between managers and owners enables German executives to align their agendas with

96. Baums, supra note 68, at 510.
97. Id.
98. For example, a firm's supervisory board may condition extension of credit above a certain level on receipt of its prior approval. Id.
99. Id. at 513. "[I]nformation about the plans and the quality of the firm's management can be disclosed to its main creditor(s) without the need to make the information public." Id.
100. Id. at 510.
101. Until 1994, German shareholders could even trade their shares based on the non-public information they received from management because insider trading was not an enforceable crime under German law; however, German legislators recently enacted a new law that criminalizes insider trading, thus eliminating this possibility. See generally Petra Mennicke, Insider Regulation in Germany: the Change from Self-Regulation to Criminal Law, 15 CO. LAW. 155 (1994).
102. SEC Rule 10b-5, 17 C.F.R. 240.10b-5 (1994). A shareholder in possession of inside information can only trade when there has been wide dissemination of that information on the market. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (1968), cert. denied, 394 U.S. 976 (1969). There is currently no confidential forum in which American managers can share inside information with shareholders. Thus, even if managers provide information only to select shareholders, they risk that it will end up either in the hands of a competitor or an investor who will trade on the information before it has been disseminated to the public.
those of shareholders. Shareholders, in turn, are able to minimize their investment risk and refrain from pressuring managers to meet arbitrary short-term objectives. Establishing in American corporations a similar institutional forum for sharing of information would similarly minimize agency costs and improve the long-range competitiveness of American corporations.

C. Summary

While American corporations are subject to "a continuous auction in which control can at any time be transferred to the highest bidder," German corporations rely on committees to monitor management. Because American shareholders are widely dispersed, they are unable to communicate without incurring substantial transaction costs and, therefore, monitoring managers costs a great deal more than selling their stock. Moreover, there is no guarantee that monitoring will produce favorable results. The structural elements of the committee system, in contrast, provide German shareholders with strong incentives to monitor management that are lacking in American corporations. Concentrated blocks of stock, structured interaction, and voting control allow German shareholders to monitor managers without facing significant costs. Additionally, because German shareholders cannot easily sell their stock, they are compelled to monitor managers to protect the value of their investments.

German banks, in particular, benefit from interacting with corporate management. As shareholders with voting control, banks are able to protect their equity investment without making capital infusions. As creditors with access to corporate inside information, banks can minimize their investment risk and ensure that debtors are able to meet long-term debt obligations.

103. Franks & Mayer, supra note 18, at 12.
104. See, e.g., Roe, supra note 13, at 27.
105. Baums, supra note 68, at 516.
106. Id. at 517.
[1] If a bank holds an equity position of 12% of a firm's stock and commands another 15% through its client's deposited shares, it has a blocking minority against the issuance of new stock and against the elimination of [its] preemptive rights that it would not have as a 12% owner alone.

Id.
106. Id. at 517.
Therefore, it is highly cost-effective for German banks to protect their investments by monitoring management closely.

Thus, bank monitoring and the codetermination system minimize agency costs in German corporations. Such monitoring is effectuated entirely within the structural organs of the corporation; external market forces rarely influence managerial behavior. In contrast, American corporations are monitored almost exclusively by the market for corporate control; internal monitoring mechanisms typically fail to provide an adequate check on managers. Neither system of corporate governance provides a healthy balance. Reliance on internal monitoring mechanisms alone leads to a weak, illiquid stock market. Reliance exclusively on the market for corporate control compels shortsightedness and disfavors long-term growth. In order to permit managers greater freedom to institute growth-oriented policies, yet aligned with shareholders' objectives, the American system must develop a viable internal monitoring mechanism.

III. PRIVATE PENSION FUNDS AS INTERNAL MONITORS

As owners of more than fifty percent of all U.S. equities, institutional investors appear to be the natural choice to fill this internal void. Of the financial institutions that are legally eligible to own equities, insurance companies, private pension funds, investment companies, and public pension funds own the most stock respectively and, therefore, have the greatest potential to influence corporate management. Legal impediments, however, prevent insurance companies and investment holding


That institutional investors are large does not necessarily imply that they will be aggressive monitors. To the contrary, institutional investors (and, more importantly, those who manage them) may have only weak incentives to engage in managerial monitoring of their portfolio companies and thus will form effective shareholder coalitions only under limited circumstances.

Id.

108. The aggregate holdings of institutional investors in 1991 were broken down in the following manner: insurance companies owned 29.7%; private pensions, 26.6%; investment companies, 17.2%; bank trusts, 12.0%; public pensions, 11.6%; and foundations and endowments, 2.9%. Mark R. Wingerson & Christopher H. Dorn, Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective, 92 COLUM. BUS. L. REV. 223, 226 (1992).
companies from assuming an active monitoring role. Thus, the burden of watching management has fallen largely on the shoulders of public and private pension funds. Although public pension funds have garnered the public spotlight with their frequent criticism of corporate management, they do not own sufficient stock to exert appreciable influence over managers' decisions. While private corporate pensions do hold enough equity to have an impact on management, they have been reluctant to do so. Part III. A. of this Comment identifies reasons why private pension funds have practiced passive investment strategies and discusses the DOL's recent attempt to compel them to assume an active monitoring role.

A. Causes of Private Pension Fund Passivity

In theory, owning concentrated shareholdings should provide institutional investors with greater incentives and ability to engage in monitoring activity. For displeased individual investors, disposing of their holdings on the open market costs significantly less than attempting to influence management. In contrast, institutional investors, in contrast, are effectively unable to liquidate their holdings on the secondary market. Selling such large blocks of stock on the open market depresses share price and prevents holders from realizing the stock's true value. Thus, institutional investors should be compelled to participate in corporate governance in order to preserve the long-term value of their investments. Moreover, with concentrated voting power and the ability

109. See supra notes 25-32 and accompanying text.
110. Roe, supra note 13, at 46. In response to the legal suppression of banks and insurance companies, mutual funds and pensions have emerged in this decade as substitutes. Id. Thus, pension funds own much more stock than any other institution. In 1990, public and private pension funds together were “three times as large as their nearest competitor.” Coffee, supra note 26, at 848.
112. In 1993, private pension funds owned 22% of all corporate equity. Coffee, supra note 26, at 849.
113. Coffee, supra note 13, at 1288.
to act collectively with other institutions, it may be less costly for institutions to intervene in management than to sell their shares.

Most institutional investors, however, and private pension funds in particular, have chosen to pursue short-term passive investment strategies. The decision to remain passive is often made by external fund managers hired by corporations to manage their pension funds. These managers frequently possess complete authority both to invest corporations' pension funds and to vote the shares of the companies in their portfolios. Having such considerable power allows them to decide unilaterally on investment strategies for the portfolios they manage.

Fund managers' reasons for adopting passive investment strategies are numerous. Above all, fund managers are not concerned with daily management of their portfolio companies. Rather, their primary objective is to maximize the value of their clients' investments. They decide to act only if the expected benefits of doing so outweigh the costs of engaging in a particular course of action.

115. Franzen, supra note 7, at 294. From 1975 until the beginning of 1992, the amount of U.S. equity assets passively managed increased from under $1 billion to $231 billion. Market 2000 Report, supra note 107, at 8.

116. Coffee, supra note 26, at 860. Most corporate pension funds hire outside money managers to administer their funds and allow the money managers to decide if they want to engage in activism in order to boost their returns. Id. at 861. Not surprisingly, a recent report indicated that only 27% of the 1077 corporate sponsors surveyed managed some of their pension fund money internally. Vineeta Anand, Corporate Funds Still Not Active Investors: DOL Bulletin Expected to Have No Impact, PENSIONS & INVESTMENTS, July 25, 1994, at 35.

117. Coffee, supra note 26, at 860.

118. The power these pension fund managers possess cannot be overstated. Accordingly, Professor Roe writes: "to a large extent, the managerial command structure of private pensions determines American corporate governance." Roe, supra note 31, at 113.


120. Id. at 141. Robert Pozen details the cost-benefit analysis that a fund manager performs in deciding whether to take action:

The costs of activism depend primarily on the tools with which an institution exerts influence: from the high cost of waging a formal proxy fight to the low cost of holding informal discussions with management. The benefits depend partly on the probability of success and partly on the issue at hand, with more potential benefit from proposals directly affecting stock price and less from proposals for procedural reforms.

Id.
Yet, it is impractical for pension fund managers to perform cost-benefit analyses for all of the companies in their portfolios.121 Because the funds they manage are so widely diversified, fund managers simply lack the resources necessary to evaluate carefully the management of the companies in whom they invest.122 Thus, in order to minimize their risk of loss, reduce transaction costs, and efficiently manage large pools of assets, many pension fund managers currently index their funds.123

Indexing consists of building a portfolio of companies that together will mirror the performance of the market as a whole, ensuring that the portfolio will perform no better or worse than average.124 While indexing may be a beneficial long-term investment strategy, managers of indexed funds have no incentive to monitor management because they are guaranteed to do no worse than the market average.125 Indexed investors are interested only in the performance of the market as a whole and not in the performance of any one firm in their portfolios.126 Moreover, in indexed funds, “investment dollars are spread so thinly across a large number of companies that improving the performance of a few would hardly influence their overall return.”127 Thus, indexing promotes passive investment and minimizes managerial accountability, because managers who know that a large proportion of their investors are indexed recognize that those investors possess little incentive to monitor their activities.128

Additionally, fund managers recognize that consistent opposition to management proposals will jeopardize their ability to retain and obtain corporate business. Corporate pension funds typically divide their assets among several professional money managers and
are not hesitant to replace those who do not perform as expected. A fund manager who has a reputation for being an active shareholder is likely to drive potential corporate clients away. Thus, money managers are frequently inclined to vote in favor of management, even if doing so may decrease company value.

Internally managed private pension funds are equally reluctant to oppose corporate managers because they are administered by executives of the corporations that sponsor them. Aware that they may face retribution in the business community for voting against their colleagues, corporate executives prefer to trade a non-performing stock rather than challenge their fellow managers. Moreover, most corporate executives do not want their pensions to be more active in governance than they want their own stockholders to be. Thus, when they do decide to vote, most company pension plans routinely vote in favor of management proposals, even if the proposals are clearly contrary to investor interests.

Finally, ERISA requirements effectively keep fund managers from becoming active investors. To ensure that pension

129. Coffee, supra note 26, at 862.
130. Id.

If the fund manager believes that a stock in its portfolio can be increased in value through proxy voting, there is at least an incentive to undertake such a step in order to increase portfolio return and avoid replacement in the inevitable competition among fund managers. But, if such activism will potentially displease other or future clients, then, unless such activism can be hidden from public view, there is an offsetting disincentive. Better to lose an existing client, it may feel, than to acquire an activist reputation that deters dozens of potential clients.

Coffee, supra note 26, at 862.
133. Id. at C4. This is not true of public pension funds, however. Because they are administered by elected or appointed officials, public pension funds enjoy a degree of independence from the business community. Id. But see Black, supra note 131, at 827 (noting that public funds are forced to yield to political pressure in deciding whether or not to oppose management).
134. Roe, supra note 31, at 77.
135. Id. Surveys conducted in 1990 indicated that institutions supported management between 59% and 74% of the time. Coffee, supra note 13, at 1293.
136. Roe, supra note 31, at 95. "ERISA and trustee doctrine help to fragment pension portfolios, to prevent big blocks, and to keep pension managers out of the boardrooms of portfolio companies." Id. But see Ethan G. Stone, Comment, Must We Teach Abstinence? Pensions' Relationship Investments and the Lessons of Fiduciary Duty, 94 COLUM. L. REV. 2222 (1994) (arguing that ERISA's diversification requirements do not prevent fund
managers do not suffer large losses, ERISA requires them to diversify their investments, unless it is clearly not prudent to do so.\textsuperscript{137} More importantly, ERISA compels fund managers to mimic prevailing practices of portfolio management.\textsuperscript{138} Because most institutional investors are passive owners of diversified investments, a pension fund manager who chooses to purchase concentrated blocks of stock in order to monitor corporate management could face liability for doing so.\textsuperscript{139}

Thus, a multitude of disincentives discourage corporate pension funds from being active shareholders. The resources necessary to permit fund managers to perform cost-benefit analyses for each portfolio firm simply do not exist. And in the competitive world of fund management, fund managers cannot risk becoming disfavored by the corporate community. Moreover, fund managers who are bold enough to ignore these disincentives may be subject to liability under ERISA for flouting current portfolio management standards.

\textbf{B. The Department of Labor Guidelines}

Within the past two years, a few corporate pension funds have nevertheless committed themselves to become active shareholders. Campbell Soup, for example, recently declared that it would vote its pension fund shares to promote independent boards of directors and policies linking executive compensation to performance.\textsuperscript{140} The majority of private institutional investors, however, refuse to assume an active monitoring role.\textsuperscript{141} Perhaps only pressure from outside the business community will compel private institutional investors to shed their passivity and renounce their historical pro-management bias. With this idea in mind, the DOL recently promulgated guidelines clarifying that ERISA does not prevent corporate pension fund managers from actively monitoring their portfolio companies.\textsuperscript{142}

\begin{itemize}
\item 137. Roe, \textit{supra} note 31, at 96.
\item 138. \textit{id.} at 98-99.
\item 139. \textit{id.} at 98. Interestingly, given ERISA's imitation standard, a similar regulation in Germany would require German pension fund managers to purchase concentrated blocks of stock for control purposes. \textit{id.} at 99.
\item 140. Minow, \textit{supra} note 132, at C3.
\item 141. Franzen, \textit{supra} note 7, at 295.
\item 142. \textit{See generally} DOL Guidelines, \textit{supra} note 16.
\end{itemize}
The DOL guidelines generally state that corporate pension fund managers may engage in activities to influence the management of their portfolio companies when such action is likely to increase the value of shares in their pension funds.\textsuperscript{143} In particular, the new regulations require corporate pension fund managers to vote their shares with a view toward increasing the share value of the companies in their portfolios.\textsuperscript{144} Issues that the guidelines identify as most likely to affect share value, and thus deserving of fund managers' careful attention, include the following: (1) independence and expertise of directors, (2) appropriateness of executive compensation, (3) mergers & acquisitions policy, (4) extent of debt financing and capitalization, and (5) long-term business plans.\textsuperscript{145} The DOL asserts that fund managers, in addition to exercising voting rights, should correspond and meet with corporate managers in order to monitor developments concerning these issues.\textsuperscript{146}

Perhaps the most important idea expressed in the new guidelines is that the voting of proxies is a "fiduciary act of plan management."\textsuperscript{147} Thus, fund managers, who vote in favor of management proposals that are likely to decrease share value or who choose to sell their stock rather than confront management, theoretically would breach fiduciary duties owed to the pensioners for whom they manage the funds.

Yet, the DOL guidelines, in their present form, are effectively unenforceable. They merely suggest that it "may be appropriate" for a fiduciary to monitor or influence corporate management when such activities are "likely to enhance the value of the plan's

\begin{footnotesize}
\begin{enumerate}
\item See \textit{id.} at 38,862.
\item Thus, the Guidelines state:
\begin{itemize}
\item where proxy voting decisions may have an effect on the value of the plan's underlying investment, plan fiduciaries should make proxy voting decisions \textit{with a view to enhancing the value of the shares of stock}, taking into account the period over which the plan expects to hold such shares. Similarly, in certain situations it may be appropriate for a fiduciary to engage in activities intended to monitor or influence corporate management \textit{if the fiduciary expects that such activities are likely to enhance the value of the plan's investment}.
\end{itemize}
\textit{id.} at 38,862 (emphasis added).
\item \textit{id.}
\item \textit{id.}
\item \textit{id.} at 38,860. The Guidelines further state that "the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment." \textit{id.} at 38,863.
\end{enumerate}
\end{footnotesize}
investment." The guidelines do not contain language explicitly requiring corporate pension funds to engage in monitoring activity and they contain no penalties for non-compliance. Moreover, proving that a fund manager knew in advance whether certain activities were likely to increase or decrease a company's share value will be difficult. The DOL guidelines fail to indicate how fund managers can ascertain when and whether a given activity is likely to increase share value.

Although no current precedent exists for incorporating into fund managers' fiduciary duties the obligation to vote the shares of the companies in their portfolios, doing so may be one way to enforce the new regulations in order to deter fund managers from practicing passive investment strategies. Indeed, corporate pension fund executives may face liability for breaching their fiduciary responsibilities when they choose to vote non-performing shares instead of selling them. Why, then, should the converse not be true? Managers of indexed pension funds, who are effectively unable to exercise their Wall Street option, should face liability for failing to maximize the long-term value of their portfolio companies' shares. Similarly, pension executives who vote in favor of management proposals that are likely to decrease share value should also face liability. In both scenarios, fund managers who fail to vote their shares would violate their responsibility to maximize the value of pensioners' investments, and, thus, should be liable for their failure to act.

Finally, the guidelines recognize that fund managers may lack experience in evaluating management and, consequently, are unable to determine when activism may produce favorable results. Therefore, they clarify that corporations, which hire independent professional money managers to administer their pension funds, may give the fund managers clear directions on how to vote their proxies. In order to compensate for fund

148. *Id.* at 38,862 (emphasis added).
150. *Id.*
151. The DOL Guidelines state:

A named fiduciary responsible for appointment of investment managers has the authority to condition the appointment on acceptance of a statement of investment policy. Thus, such a named fiduciary may expressly require, as a condition of the investment management agreement, that an investment manager comply with the terms of a statement of investment policy which sets forth guidelines concerning investments and investment courses of action which the
managers' inexperience, the guidelines encourage corporate managers to substitute their judgment on when and how to vote for their fund managers' judgment. Thus, the DOL places the responsibility for deciding when and whether to become active firmly on the shoulders of corporate management.

The DOL asserts that its new bulletin encourages responsible shareholder activism and is a step toward a market with a long-term focus. Yet, the guidelines' failure to prescribe a detailed program of structured interaction between managers and pension fund executives threatens to contribute to, rather than decrease, managerial shortsightedness. Simply suggesting that fund managers and corporate officers correspond and meet with each other is not sufficient. Without regular access to corporate inside information, fund managers, who must vote with a view to maximizing share value, will necessarily continue to focus on share price and quarterly earnings reports. This emphasis on short-term value maximization will continue to force managers to set aside long-term plans and focus on short-term growth. The DOL guidelines, however, are not likely to change investors' behavior in the near future. At most, they will begin to force corporations and fund managers to consider activism as a viable investment strategy.

IV. TOWARD THE GERMAN MODEL

Implicit in the DOL guidelines is the idea that reforming legal rules and business practices, which currently keep institutional investors passive, could invigorate institutional oversight of corporate managers. The increasing competitiveness of German public firms in the global marketplace, in combination with the U.S. takeover market's failure to monitor American managers, suggests that the German system of corporate governance may be

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investment manager is authorized or not authorized to make. Such investment policy may include a policy or guidelines on the voting of proxies on shares of stock for which the investment manager is responsible.

DOL Guidelines, supra note 16, at 38,864.

152. Id.


154. DOL Guidelines, supra note 16, at 38,864. The guidelines state that "active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder." Id.

155. Black, supra note 131, at 896.
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an appropriate model on which to base the institutional reform contemplated by the DOL guidelines.156

Indeed, the DOL's call for American corporate pension funds to become active shareholders is yet another and perhaps the most compelling indicator that U.S. corporate governance is moving toward the German model.157 With the increasing institutional presence in the American market, equity ownership of U.S. public firms is beginning to approach the concentration of German shareholdings.158 Consequently, large institutions are now the major players in the American stock market, relegating individual investors to a relatively insignificant role.

Additionally, proposals to reform the U.S. system of corporate governance increasingly are based on the German system. Among the most prominent of these is the strong movement afoot to repeal the Glass-Steagal Act and allow American banks to enter into the securities business.159 Proponents of this proposal assert that allowing American banks to own securities and monitor managers would minimize agency costs in U.S. corporations, increasing their long-term international competitiveness.160 This argument is founded squarely on the belief that bank ownership and monitoring of corporations in Germany minimizes pressures on managers to achieve short-term objectives.161

Another school of thought holds that giving shareholders greater access to American corporate boardrooms will permit

156. Professor Black notes that "the competitive success of Japanese and German firms adds force to the argument that the U.S. system of strong managers and weak shareholders can be improved." Id.

157. Mark Roe discusses the proposition that our markets and ownership forms are moving toward the concentrated structure of Germany. See Roe, supra note 13, at 37.

158. See Matheson & Olson, supra note 6, at 1464. "Voting power is increasingly concentrated in a small number of major institutions." Id. But see Coffee, supra note 26, at 852-53 (writing that "although institutional investors may control the majority of publicly held equity in the United States, share ownership is broadly dispersed amongst them.")

159. See Steven Lipin & Timothy L. O'Brien, Repeal of Glass Steagal May Hit Wall With Takeover Wave, WALL ST. J., Mar. 27, 1995, at Cl. There is evidence that American commercial banks are already beginning to impinge on investment banks' traditional dominance over the American securities industry. Since 1989, when the Federal Reserve first empowered commercial banks to underwrite corporate debt, commercial banks have captured a significant portion of investment banks' stock and bond underwriting business. Anita Raghavan, Commercial Banks Emerging as Underwriting Force, WALL ST. J., Apr. 3, 1995, at Cl.

160. See generally Franzen, supra note 7.

161. Id. at 299.
managers to adopt a more long-term orientation. For example, some have argued that American corporate directors should be required to hold large equity positions in the companies on whose boards they serve. Advocates of this idea contend that giving directors a personal stake in the companies they oversee will compel them to shed their traditional pro-management bias. Perhaps recognizing that this is not likely to occur, however, others from this school of thought have called on corporations to create "shareholders' advisory committees." Although they would not provide shareholders with direct boardroom access, such committees would create a vehicle for shareholders to initiate regular dialogue with corporate directors. Both suggestions, and shareholder advisory committees in particular, are specifically patterned after the German codetermination system.

Each of these reform proposals seeks to incorporate into American corporate governance an important element of the German model that is currently lacking in most American companies: systematic structured interaction between shareholders and managers. Allowing shareholders regular access to the inside information on which corporate management primarily bases its decisions would permit American managers to focus more on implementing long term plans and less on meeting short-term barometers. Further aligning the U.S. system with the German

162. See Lublin & Duff, supra note 11, at B1, B6.
163. Id. at B6.
164. Matheson & Olson, supra note 6, at 1475-78. Such committees would be composed of select shareholders designated to engage in periodic discussions with corporate managers concerning corporate governance issues. Id. at 1475.

For example, in 1992, Exxon shareholders proposed the creation of a committee that would be responsible for reviewing managerial performance, advising the board of shareholder views, and including in Exxon's proxy statement a statement regarding its activities and its evaluation of management. Owners of at least $10 million worth of Exxon common stock for three years would have been eligible for nomination to the committee. However, Exxon management ultimately defeated the proposal. Charles F. Richards, Jr. & Anne C. Foster, Exxon Revisited: The SEC Allows Pennzoil to Exclude Both Mandatory and Precatory Proposals Seeking to Create a Shareholder Advisory Committee, 43 BUS. LAW. 1509, 1510 (1993).

165. Jayne Barnard, Institutional Investors and the New Corporate Governance, 68 N.C. L. REV. 1135, 1146-48 (1991). "An essential model for the shareholders' advisory committee is the German ... public company which is governed not by a unitary board of directors, as in the United States, but by two separate and distinct bodies." Id. at 1147.
model, however, is not the proper avenue to facilitate such information sharing.\textsuperscript{166}

Significant cultural and political differences between Germany and the United States impact the feasibility of implementing a German-style system of corporate governance in the United States.\textsuperscript{167} In order to maintain political and economic independence from the global economy in the aftermath of World War II, Germany sought to center its economy around a strong central banking system.\textsuperscript{168} Germany was more interested in protecting an entire country than in protecting the rights of individual shareholders.\textsuperscript{169} Thus, today financial institutions are significantly more important than capital markets to the German economy.\textsuperscript{170} In contrast, the capital contributions of widely dispersed individual shareholders were absolutely integral to support the rapid expansion of the U.S. economy following the war.\textsuperscript{171} Regulatory barriers effectively prevented American financial institutions from funding American economic expansion.\textsuperscript{172} Strong capital markets thus evolved into the primary source of funding for American industrial growth, buoyed, in significant part, by the support of individual shareholders.

To proceed further in the direction of the German system of corporate governance, and rely on banks or large institutions to reign in managers, would jeopardize the strength of American capital markets. As the German system illustrates, institutional ownership breeds concentration and concentration compromises stock market liquidity.\textsuperscript{173} Decreasing American capital markets' liquidity would impair American companies' ability to raise capital by selling equity to the public. Moreover, increasing institutional control over American public companies would further disenfran-

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166. Louis Lowenstein notes: "It would be foolish for the U.S. to emulate in some mechanical fashion the German merchant banks . . . through which industrial managers consult with their shareholders and lenders on an informal but continuing basis." Louis Lowenstein & Ira M. Millstein, \textit{The American Corporation and the Institutional Investor: Are There Lessons from Abroad?}, 88 \textit{COLUM. L. REV.} 739, 745 (1988).

167. Franzen, \textit{supra} note 7, at 303.

168. \textit{Id.} at 287.

169. \textit{Id.}

170. Roe, \textit{supra} note 13, at 23.


172. \textit{See supra} notes 25-32 and accompanying text.

173. \textit{See supra} notes 69-79 and accompanying text.
chise the individual investors on which the United States relied to become the most competitive nation in the global marketplace.174

Finally, American institutions are not as qualified as German supervisory board members to monitor American managers. German bankers are trained to be both massive owners of equity and expert monitors, while pension funds and other American institutions lack comparably skilled employees.175 The Glass-Steagal Act has effectively prevented American bankers from investing in American public companies and, thus, from monitoring corporate managers. American fund managers are trained solely to earn money for their clients; they are not equipped to serve as board members of companies. In contrast, because most current outside directors have been or are chief executives of other public companies, they have experience in managing large corporations. Therefore, proceeding further toward the German model would simply permit unskilled fund managers and bankers to replace directors who are infinitely more experienced than they are in making business decisions.

V. CONCLUSION

Bridging the communication gap in American corporations between owners and managers will provide managers with additional freedom to pursue long-term growth policies.

The German dual-board system, in fact, permits managers and shareholders to communicate regularly. However, the German system effectively unifies ownership and control,176 preventing ownership from being regularly traded. The liquidity of American capital markets is integral to the success of U.S. corporations. Therefore, the German system is an inadequate model for American corporate reform.

The DOL Guidelines are equally problematic. Following their prescriptions would increase pressures on corporate managers to meet short-term objectives. Institutions currently decide how to vote by studying exclusively short-term indicators. They must have access to corporate inside information in order to make truly informed voting decisions.

174. See Franzen, supra note 7, at 303.
175. Id.
176. Professors Gilson and Kraakman note that the German model "unifies rather than bridges ownership and control." Gilson & Kraakman, supra note 12, at 878.
The American system of corporate governance must develop a forum in which managers can provide shareholders with regular access to corporate inside information. Regular dialogue between corporate managers and owners bridges ownership and control without compromising stock market liquidity. Most importantly, improving dialogue between shareholders and managers will permit American corporate managers to pursue long-term strategies, thus improving the long-term global competitiveness of the American economy.

Robert E. Benfield*