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# **Competitiveness and Corporate Governance in the EU**

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# **Competitiveness and Corporate Governance in the EU**

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## **Abstract**

It is the objective of this paper to provide insight into the evolving EU-wide corporate governance systems and its impact on firm competitiveness, as well as to discuss changes in the internal management arrangements while keeping the political-institutional, economic settings and changes in the relevant legal and social features in mind. That is, where are they, and where might they be headed? Specific attention is given to the comparison of the German and French system to the U.S. system. Moreover, this article will also briefly examine some evidence that varying legal traditions and rule of law directly impact corporate governance styles and efficiency, and the reaction of capital markets to the results of such systems.

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“[B]eing managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private co-partner frequently watch over their own... Negligence and profusion therefore, must always prevail more or less in the management of affairs of a [joint stock] company’.” (Adam Smith 1776)

## Introduction

### *The Literature on Modern Corporate Governance*

Although there is an extensive literature providing legal, economic and other definitions of governance systems (Shleifer and Vishny 1997, 1986), (La Porta, Lopez-de-Silanes, Shleifer 1999), (La Porta, Lopez-de-Silanes, Shleifer and Vishny 1999, 2000, and 2002), (Hart 1995), (OECD 1998 and 1999a), (Hellwig 1991), (Levine and Zervos 1998), (Coffee 1999), (Demsetz and Lehn 1985), (Rajan 1992), (Rajan and Zingales 1995, 1996, 1998), (Borokhovich, Parrino and Trapani 1996), (Bradly, Schipani, Sundaram and Walsh 1999), (Denis 2001), (Khanna, Kogan and Palepu 2002), and (Cohen and Boyd 2000), to name a few<sup>2</sup>, they mostly take a view only at a given point in time and/or a comparative view. This paper attempts to take a more timeless view on the evolution of European corporate governance and their current status. As such, in this paper such systems are understood in a broader sense, consisting of a set of internal and external arrangements and processes that are shaped by the political, economic, legal and social characteristics and values of societies.

The internal arrangements comprise the type and structure of ownership, company objectives, the nature of the internal decision-making processes, the role of shareholders and other stakeholders, sources of financing, the monitoring, reporting requirements and the managerial incentive system.

The external arrangements consist of the political-institutional features such as the location and distribution of power and the nature of the decision-making processes. They also encompass the economic and, to some extent, the social structures, particularly the degree of competition and flexibility in the product, service, capital and labor markets and the extent of the social safety net. Additional features are the legal traditions, rule of law, and regulatory requirements governing business activities.

Recent corporate governance literature (Andenas and Kenyon-Slade 1993), (Coffee 1999), (Rene and Brierley 1985), (Demsetz and Lehn 1985), (Hay, Shleifer and Vishny 1996), (Hart 1995), (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1996, 1997, 1998, 1999, and 2000), (La Porta, Lopez-de-Silanes and Shleifer 1999), (Levine 1998), (Merryman 1989), (Shleifer and Vishny 1986), (Wymeersch 1997), (Vishny 1994), (Zweigert and Kotz 1987), (Emmons and Schmid 2000), and (Cohen and Boyd 2000), to

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<sup>1</sup> Smith, Adam, *An Inquiry into the Nature and the Cause of the Wealth of Nations*, London: Ward Lock, 1838, p.586.

<sup>2</sup> Shleifer, Andrei, and Robert W. Vishny. “A Survey Of Corporate Governance,” *Journal of Finance*, 52, June 1997, pp.737-783; Shleifer, Andrei, and Robert W. Vishny. “Large Shareholders And Corporate Control.” *Journal of Political Economy*, 94, no. 3, pt. 1, June 1986, pp.461-488; La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. “Corporate Ownership Around The World.” *Journal of Finance*, 54, 1999, pp.471-517; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. “The Quality Of Government,” *Journal of Law, Economics, and Organization*, 1999, pp.; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. “Investor Protection And Corporate Governance.” *Journal of Financial Economics*, 58, 2000, pp.3-27; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. “Investor Protection And Corporate Valuation.” *Journal of Finance*, 2002, pp.; Hart, Oliver. *Firms, Contracts, And Financial Structure*. London: Oxford Univ. Press, 1995; OECD. “Corporate Governance: Improving Competitiveness and Access to Capital Markets.” A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development (OECD), 1998; OECD. “OECD Principles of Corporate Governance,” Paris: OECD, 1999a; Hellwig, Martin. ‘Banking, financial intermediation and corporate finance’, in Albert Giovannini and Colin Mayer (eds), *European Financial Integration*, Cambridge; Cambridge University Press, 1991, pp. 35-63; Levine, Ross, and Sara Zervos. “Stock Markets, Banks, and Economic Growth.” *American Economic Review*, 88, June 1998, pp.537-558; Coffee, J.C. “The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications.” Working Paper, Center for Law and Economic Studies, Columbia University, 1999; Demsetz, Harold, and Kenneth Lehn. “The Structure Of Corporate Ownership: Causes And Consequences.” *Journal of Political Economy*, 93, December 1985, pp. 1155-1177; Rajan, Raghuram G. “Insiders and outsiders: the choice between informed and arm’s-length debt,” *Journal of Finance*, 47 (4) September 1992, pp.1367-1400; Borokhovich, K.A., R. Parrino, and T. Trapani. “Outside Directors And CEO Selection.” *Journal of Financial and Quantitative Analysis*, 31, 1996, pp.337-355; Bradley, M., C.A. Schipani, A. Sundaram, and J.P. Walsh. “The Purposes And Accountability Of The Corporation In Contemporary Society: Corporate Governance At A Crossroads,” *Law and Contemporary Problems*, 62, 1999, pp9-86; Denis, D.K. “Twenty-five Years of Corporate Governance Research ... and Counting.” *Review Of Financial Economics*, 10, 2001, pp.191-212; Khanna, T., J. Kogan, and K. Palepu. “Globalization And Corporate Governance Convergence? A Cross-Country Analysis.” Working Paper, Harvard Business School, 2002; and Cohen, Steven S. and Gavin Boyd, eds. *Corporate Governance and Globalization: Long Range Planning Issues*, Northampton, MA: Edward Elgar Publishing Inc., 2000.

name a few<sup>3</sup>, suggests that the most important cause of the differences in various systems is the existence of distinct legal traditions (i.e. common or civil law traditions) across nations, since the legal system of a country molds investors' rights and protections insofar as their interactions with companies is concerned. Moreover, this literature states that the rule of law (among other things, most importantly, the extent to which contracts are legally enforced) also influences the effectiveness of corporate governance. Of course in most highly industrialized countries, no matter the genesis of their legal traditions, commercial law and the court systems are usually well developed, and contracts are generally respected and enforced to one degree or another.

Furthermore, few question the strong links between corporate governance, corporate finance and corporate performance as it is well documented in the literature (Shleifer and Vishny 1997), (Hart 1995), (Hellwig 1991), (La Porta, Rafael, Lopez-de-Silanes, Shleifer and Vishny 1997, 2002), (Levine and Zervos 1998), (OECD 1999b), (Rajan 1992), (King and Levine 1993), (Levy 1983), (Modigliani and Miller 1958), (Perotti and Von Thadden 2003), and (Wurgler 2000)<sup>4</sup>. Corporate governance in a very real sense, molds the development of a nation's financial market as it provides the framework for the accord between investors and firms, which provides the speed, amount and method to which investors will receive adequate returns on their investments. Moreover, corporate governance styles and efficiency in management decision-making determine to a large degree the extent to which firms have access to outside financing, that is, outside investors either willing to lend to firms or buy their securities. According to this line of research<sup>5</sup>, a firm's ownership structure and its corresponding capital structure directly impact corporate

<sup>3</sup> Andenas, Mads, and Kenyon-Slade, Stephen, eds. E.C. Financial Market Regulation and Company Law. London: Sweet and Maxwell, 1993; Coffee, J.C. "The Future As History: The Prospects For Global Convergence In Corporate Governance And Its Implications." Working Paper, Center for Law and Economic Studies, Columbia University, 1999; David, Rene, and John Brierley, 1985, Major Legal Systems In The World Today, London: Stevens and Sons, 1985; Demsetz, Harold, and Kenneth Lehn. "The Structure Of Corporate Ownership: Causes And Consequences." *Journal of Political Economy*, 93, December 1985, pp. 1155-1177; Hay, Jonathan R., Andrei Shleifer, and Robert W. Vishny. "Toward A Theory Of Legal Reform." *European Economic Review*, 40, April 1996, pp.559-67; Hart, Oliver. Firms, Contracts, And Financial Structure. London: Oxford Univ. Press, 1995; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Law And Finance." NBER Working Paper no. 5661, Cambridge, Massachusetts, July 1996; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Legal Determinants Of External Finance." *Journal of Finance*, 52, 1997, pp.1131-1150; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Law And Finance," *Journal of Political Economy*, 106, 1998, pp.1113-1155; La Porta, Rafael, Florencio Lopez-de-Silanes, and Andrei Shleifer. "Corporate Ownership Around The World." *Journal of Finance*, 54, 1999, pp.471-517; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "The Quality Of Government," *Journal of Law, Economics, and Organization*, 1999, pp.; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Investor Protection And Corporate Governance," *Journal of Financial Economics*, 58, 2000, pp.3-27; Levine, Ross. "The Legal Environment, Banks, And Long-Run Economic Growth." *Journal of Money, Credit and Banking*, 30, no. 3, pt. 2, August 1998; Merryman, John H. The Civil Law Tradition: An Introduction To The Legal Systems Of Western Europe And Latin America, Stanford: Stanford University Press, 1969; Reynolds, Thomas, and Arturo Flores. Foreign Law: Current Sources Of Codes And Basic Legislation In Jurisdictions Of The World, Littleton, Colorado: Rothman and Co., 1989; Shleifer, Andrei, and Robert W. Vishny. "Large Shareholders And Corporate Control." *Journal of Political Economy*, 94, no. 3, pt. 1, June 1986, pp.461-488; Wymeersch, E. "Legal Determinants Of External Finance," *Journal of Finance*, 52, July 1997, pp.1131-1150; Vishny, Paul. Guide to International Commerce Law, New York: McGraw-Hill, 1994; Zweigert, Konrad, and Hein Kotz. An Introduction To Comparative Law, 2d rev., ed. Oxford: Clarendon, 1987; and Emmons, William R. and Frank Schmid, "Corporate Governance and Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, Corporate Governance and Globalization, Northampton, MA: Edward Elgar Publishing Inc., 2000.

<sup>4</sup> Shleifer, Andrei and Robert W. Vishny. "A Survey Of Corporate Governance," *Journal of Finance*, June 1997, pp.737-83; Hart, Oliver. Firms, Contracts, and Financial Structure, London: Oxford University Press, 1995; Hellwig, Martin. "Banking, Financial Intermediation And Corporate Finance," in Giovannini, Albert and Colin Mayer (eds), European Financial Integration, Cambridge: Cambridge University Press, 1991, pp.35-63; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny), "Legal Determinants Of External Finance," *Journal of Finance*, 52, 1997, pp.1131-1150; Levine, Ross and Sara Zervos. "Stock Markets, Banks And Economic Growth," *American Economic Review*, 88, (3), June 1998, pp.537-558; OECD. "International Banking And Financial Market Development," Paris: OECD, 1999b; Rajan, Raghuram G. "Insiders And Outsiders: The Choice Between Informed And Arm's-Length Debt," *Journal of Finance*, 47 (4) (September 1992, pp.1367-1400; King, Robert G. and Ross Levine. "Finance And Growth: Schumpeter Might Be Right." *Quarterly Journal of Economics*, 108, August 1993, pp.717-737; La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. "Investor Protection And Corporate Valuation," *Journal of Finance*, 2002, pp.; Levy, Haim. "Economic Evaluation Of Voting Power Of Common Stock," *Journal of Finance*, 38, March 1983, pp.79-93; Modigliani, Franco, and Merton H. Miller. "The Cost Of Capital, Corporation Finance And The Theory Of Investment." *American Economic Review*, 48, June 1958, pp.261-297; Perotti, E.C. and E. von Thadden. "Will Capital Market Integration Force Convergence Of Corporate Governance?" *Journal of Financial and Quantitative Analysis*, 2003; and Wurgler, J. "Financial Markets And The Allocation Of Capital." *Journal of Financial Economics*, 58, 2000, pp.187-214.

<sup>5</sup> La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny. "Legal Determinants Of External Finance," *Journal of Finance*, 52, 1997, pp.1131-1150; Shleifer, Andrei and Robert W. Vishny. "A Survey Of Corporate Governance," *Journal of Finance*, June 1997, pp.737-783; Levine, Ross and Sara Zervos. "Stock Markets, Banks And Economic Growth," *American Economic Review*, 88, (3), June 1998, pp.537-558; Hart, Oliver. Firms, Contracts, and Financial Structure, London: Oxford University Press, 1995; Hellwig, Martin. "Banking, financial intermediation and corporate finance," in Giovannini, Albert and Colin Mayer (eds), European Financial Integration, Cambridge: Cambridge University Press, 1991, pp.35-63; Rajan, Raghuram G. "Insiders and

performance. For example, if a firm does not generate enough confidence in outside investors, the firm's overall performance will suffer as it will have a difficult time growing or taking advantage of market opportunities due to its need to rely only on internal cash generation and accumulated financial resources. Moreover, corporate performance is further impacted by the availability of financing, i.e., a firm's performance can be negatively impacted if methods of available financing are limited due to lack of financial sector development or systemic rigidity. A firm's efficiency in terms of financial market access, costs, speed of transaction and available financial instruments has a direct impact on corporate performance.

In addition, according to the same type of literature, (Knack and Keefer 1995), (Levine 1996), (Levine and Zervos 1998), (Levy 1983), (Modigliani and Perotti. 1996), (Perotti and Von Thadden 2003), and (Rajan and Zingales 1996 and 1998), to name a few<sup>6</sup>, the overall economic performance of a country is also linked to these issues. It is clear that levels of economic development coupled with a nation's social and political heritage represent factors of crucial importance in the evolution of a country's corporate governance system. Accordingly, even among the more advanced nations, there exist substantial differences in corporate governance.

### Nature, Type, and Objectives of Corporate Governance

Corporate governance can be viewed as the mechanism to minimize the loss of the foregone value of the separation of ownership from the management. Through the institution of the joint-stock company or publicly held corporation, investors are separated from management and while this separation provides benefits such as the specialization of management functions and diversification of risk across the investor-stakeholder base, there are some significant costs due to this separation. These costs are associated with the amount of foregone value due to the separation of ownership from management and minimized through effective corporate governance<sup>7</sup>. Investors and other stakeholders use the governance systems to influence managers to take action that allows such stakeholders to realize their particular goals through effective monitoring and incentive systems that may be economic or social or a combination thereof. It is in this sense that corporate governance systems reflect social values.

A corporation must rely on the board of directors, and the management to watch out for its interests. Without safeguards, managers could use their position to siphon off economic benefits and thereby weaken long-term corporate performance, reducing investment values. The systematic enforcement of safeguards pertaining to corporate activities and governance issues is supposed to shape the business environment and the management ethos of companies. Ideally, managers are motivated to obtain financial and other resources on the best possible terms and to use them in the most efficient manner.

Under the universal concept of the formation and running of a corporation, fairly widely accepted throughout the world, it is through the various legal and economic arrangements and processes that investors and other stakeholders establish firms, select, monitor, reward and otherwise influence managers whom they hire to use, safeguard and augment their capital. It is the responsibility of governments to provide transparent political, legal and economic environments to protect individuals, firms and society against the misuse of corporate resources or from fraud.

The rapidly expanding globalization of competition and the growing diversity of investor ownership structures, financial products, and management methods together with the ongoing differences

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outsiders: the choice between informed and arm's-length debt," *Journal of Finance*, 47, (4), September 1992, pp.1367-1400; OECD. "International Banking and Financial Market Development," Paris: OECD, 1999b; and Rajan, Raghuram G., and Luigi Zingales. "What Do We Know About Capital Structure? Some Evidence From International Data." *Journal of Finance*, 50, December 1995, pp.1421-1460.

<sup>6</sup> Knack, Stephen, and Philip Keefer. "Institutions And Economic Performance: Cross-Country Tests Using Alternative Institutional Measures." *Economics and Politics*, 7, November 1995, pp.207-227; Levine, Ross. "Financial Development And Economic Growth," *Journal of Economic Literature*, 1996, pp.; Levine, Ross, and Sara Zervos. "Stock Markets, Banks, and Economic Growth." *American Economic Review*, 88, June 1998, pp.537-558; Levy, Haim. "Economic Evaluation Of Voting Power Of Common Stock," *Journal of Finance*, 38, March 1983, pp.79-93; Modigliani, Franco, and Enrico Perotti. "Protection Of Minority Interest And Development Of Security Markets," Mimeo, MIT, 1996; Perotti, E.C. and E. von Thadden. "Will Capital Market Integration Force Convergence Of Corporate Governance?" *Journal of Financial and Quantitative Analysis*, 2003; Rajan, Raghuram, and Luigi Zingales. "Financial Dependence And Growth," NBER Working paper 5758, 1996; and Rajan, Raghuram G., and Luigi Zingales. "Financial Dependence And Growth." *American Economic Review*, 88, June 1998, pp.559-586.

<sup>7</sup> For a detailed discussion see "Corporate Governance: Improving Competitiveness and Access to Capital Markets," A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development, 1998.

in how societies and economies are organized and managed, hinder the formulation of a generally accepted corporate governance system world-wide. Even so, international investors and expanding capital markets are gradually bringing about a degree of convergence. Flexibility, transparency and accountability, for example, are by now generally recognized as crucial governance features. But the political, economic, legal and social contexts still vary from country to country or region to region.

In a general sense, in the American view, the primary purpose of the corporation is to make money and increase shareholder value. However, for the majority of the rest of the world, corporate governance has a much broader stakeholder<sup>8</sup> point of view. This view is reflected in the recent OECD report on corporate governance (OECD 1998).<sup>9</sup> In that report, the general objective of corporate governance is to align the interests of firms with those of society, to balance entrepreneurship with accountability and to enable companies to earn a rate of return on investment that generates additional capital.

In the narrow sense, corporate governance deals with the relationships among corporate management, the board of directors and the investors, or shareholders. But it can also concern itself with the relationship between the corporation and other stakeholders, in addition to investors. In a broader sense, corporate governance is formulated and disciplined by laws, regulations, stock market listing rules, commercial customs and public opinion.<sup>10</sup> Differences exist from country to country as to how companies are governed, and the question "who do we govern the corporation for?" is answered differently.

The corporate governance systems used throughout the world are generally rooted in either the stock-market based Anglo-Saxon (outsider) or the more traditional bank-based (insider) European and Japanese governance systems.<sup>11</sup> At present, the Anglo-Saxon system is primarily used in the United States and, with modifications, in the United Kingdom and Ireland. The European system, with country-to-country variations, is practiced in the other EU nations while different versions of the Japanese system are used throughout the Pacific Basin Region.<sup>12</sup> Again it should be mentioned that the concept of corporate governance in the United States, or even in the United Kingdom, that is, in the Anglo-Saxon type of system, is considerably narrower than that in many other countries, especially that of Europe.

The main features of the Anglo-Saxon system are dispersed ownership and detailed legal provisions. The rights and responsibilities of investors and other stakeholders are defined by formal rules and applied through contracts relying on competitive and transparent market transactions. As already alluded to, the primary responsibility of management is to maximize shareholder value. With management compensation tied to profits and stock options, managers are under constant pressure to realize this goal. Failure to do so is quickly reflected by declining share prices in the deep and liquid capital markets. Thus failure is generally visible, and either the shareholders, through voting at the annual meeting, or the Board of Directors, by chastising or replacing management, attempt to correct problems as they arise. The major strengths of the system are its flexibility, transparency and accountability, enabling corporate managers rapidly to respond to competitive challenges and shareholder demands. Its disadvantages are the limited influence of stakeholders other than shareholders and the income and wealth gap between managers and workers on the one hand and shareholders and the rest of society on the other hand. Labor unions in particular clamor about this.

The traditional European style corporate governance system has a desire for economic stability and social safety as reflected by the widespread acceptance of welfare states in continental Europe. European welfare states provide a broad and deep social safety net that includes, among other things, relatively secure employment, generous unemployment and other benefits, regulated working conditions and extensive public pension system benefits, all financed through high taxes. The system is characterized by inflexible economic structures comprised of regulated product-service, capital and labor markets, high taxes, generous public spending and managerial systems that are risk averse. Over time, this had brought

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<sup>8</sup> Stakeholder reflect the interests of all the major players associated with a firm i.e. shareholders, suppliers, employees, trade unions, etc..

<sup>9</sup> "Corporate Governance: Improving Competitiveness and Access to Capital Markets." A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, Paris: Organization for Economic Co-operation and Development, 1998.

<sup>10</sup> Holly J. Gregory, "The Globalization of Corporate Governance", (Weil, Gotshal & Manges: New York 2003), law firm publication, p. 5.

<sup>11</sup> For more details see, Paul J.N. Halpern, " Systemic Perspectives on Corporate Governance Systems," in Steven S. Cohen and Gavin Boyd (editors) *Corporate Governance and Globalization: Long Range Planning Issues* (Northampton, MA.: Edward Elgar Publishing Inc., 2000) pp. 1-58.

<sup>12</sup> The dominant types of corporate government systems have been extensively discussed in the literature. See, for example, Schleifer, Andrei and Robert W. Vishny (1997) and Cohen and Boyd (2000) as cited previously. For a discussion of some of the changes in the Pacific Basin Region, see, "The End of Tycoons," *The Economist*, April 29, 2000, pp.67-69.

about a corporate governance system that sustains and, in turn, is sustained by such economic features and managerial practices.

The Japanese corporate governance system is bank- and stakeholder based with the "keiretsu," a unique form of industrial organization, playing a major role. A "keiretsu" is a network of businesses made up of a core company and/or a main bank and associated firms that maintain concentrated cross-ownership arrangements.<sup>13</sup> It represents a coalition of stakeholders without carefully delineated authority lines among, for example, suppliers, lenders, customers, shareholders holding a complex blend of senior, junior, short-term and long-term implicit and explicit claims against the firm. Its advantage is stability, however, this feature can turn into inflexibility, as seen in Japan since the early 1990s.

### ***Implications of Legal Traditions and Rule of Law***

A further factor important in the examination of the principles of corporate governance, and the very concept of the corporation itself lies in the system of law that a particular country adheres to. Although there are, of course, a variety of legal systems or families of laws, the two major systems that are accepted in the major trading and industrialized nations today are the Romano-Germanic family (commonly referred to as the Civil Law system) and the Common Law Family (commonly referred to as the Common Law system.<sup>14</sup>) Although other religious and other quasi-legal traditions exist, they are primarily of rule-based systems of law – such as Hindu law, Canon law, Jewish law, and Muslim law, for the purpose of this study they are not considered as their importance in understanding the relationship between national investor protection and corporate governance is thought to be less important<sup>15</sup>.

Civil Law is based on written legal codes, with disputes being settled by reference to such written legal code.<sup>16</sup> Commentators, or legal scholars write treatises on the law, and scholars thus expand upon the Codes. The Civil Law system attempts to create a unified legal system.<sup>17</sup> In the Common Law system, scholarly writing is often merely interesting and used to educate, though it may be used to persuade a judge in a specific case. It often is not used in this way. Judge-made law, based on previous judicial decisions, called precedent, characterizes the Common Law. Of course today there are many statutes, but the judges always interpret and give life to the law, and judge-made law, unless overturned by a higher court, or the same court in a later case, is the law of the land. On the other hand, a court decision in a Civil Law Jurisdiction is only dispositive of the case at hand and has no precedential effect.

The Civil Law tradition's origins are found in old Roman law and are therefore much older than Common Law tradition. As mentioned, Civil Law "utilizes comprehensive codes and statutes as the principal method to systematize its legal principles. The system tends to rely on legal scholars to interpret the code and draft new interpretations and rules rather than building on judicial precedents alone."<sup>18</sup>

The Common Law tradition is primarily found in the United States, United Kingdom, and Canada (and other English speaking nations and/or nations whose post-World War II development was heavily impacted by other English-speaking nations<sup>19</sup>). The Civil Law or Roman-Germanic tradition is primarily

<sup>13</sup> In times of high economic growth and corporate profits (1970-1990) the system had worked well because it insured stability in all business relations. But in times of low growth and profits (1991-present,) requiring restructuring and other related corporate changes, the systems stability turns into rigidity. Consequently, the Japanese are currently reviewing the system as part of an overall examination of their economy. Changes, however, are slow in coming. Following the 1997-1998n financial crises, the same is true in the Republic of Korea and other Pacific Basin nations.

<sup>14</sup> Emmons, William R. and Frank Schmid, "Corporate Governance And Corporate Performance", in Cohen, Stephen S. and Gavin Boyd, *Corporate Governance And Globalization*, 2000 and La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny), "Law And Finance," *Journal of Political Economy*, 106, 1998, pp.1113-1155. See also David, René and John E.C. Brierley, *Major Legal Systems In The World Today, An Introduction To The Comparative Study Of Law*, London: The Free Press, 1968.

<sup>15</sup> La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, "Law And Finance," *Journal of Political Economy*, 106, 1998.

<sup>16</sup> Merryman, John Henry. *The Civil Law Tradition: An Introduction to the Legal Systems of Western Europe and Latin America*, Second Edition, Stanford: Stanford University Press, 1990.

<sup>17</sup> See Fred, B. *The German Civil Code*, Littleton, Colorado: Rothman & Co, 1994; Peltzer, M., J. Doyle and E.A. Voight, *German Commercial Code/Handelsgesetzbuch*, 4<sup>th</sup> Revised Edition, Munich: Otto Schmidt Verlag, 2000; and West, Andrew, *The French Legal System: An Introduction* (German-English Text), London: Fourmalt, 1992.

<sup>18</sup> Emmons, William R. and Frank Schmid, "Corporate governance and Corporate Performance", in Stephen S. Cohen and Gavin Boyd, *Corporate Governance and Globalization*, 2000, p.69 and Rafael La Porta, Florencio Lopez de Salinas, Andrei Shleifer and Robert Vishney. "Law and Finance," *Journal of Political Economy*, 106, 1998, pp.1113-1155.

<sup>19</sup> The common-law group includes all the English-speaking members of the OECD as well as former British colonies and protectorates. A sampling of these nations would include, among others, Australia, Ireland, New Zealand, Hong Kong, India, Israel, Pakistan, Kenya, Thailand and South Africa. Emmons, William R. and Frank Schmid, "Corporate governance and Corporate Performance", in Stephen S. Cohen and Gavin Boyd, *Corporate Governance and Globalization*, 2000.

found in continental Europe (and other nations who were heavily influenced by continental Europeans, such as Latin America.) However, there are three main subdivisions within the civil-law tradition: the German<sup>20</sup>, the French<sup>21</sup>, and the Scandinavian<sup>22</sup> civil-law tradition<sup>23</sup>. It should be noted that the English and French legal groupings are the largest in terms of number of nations. While the German and Scandinavian legal traditions are not as wide spread globally as their colonial power was relatively small in comparison to the English and the French and also geographically more restrictive. On an interesting note, the current trends seem to indicate that China, Russia and most of Central and Eastern Europe are developing legal and financial systems along the lines of the German legal tradition<sup>24</sup>.

Legal traditions are important as they are systematically related to the types of legal rights and protection provided to investors i.e. creditor rights and shareholder rights, respectively. These rights and protections, in turn affect the types and availability of financing to firms and determine which category of investors (banks, or non-financial institutions or individuals) are more active in the marketplace. Furthermore, legal rights of shareholders and creditors, for example, cash payments and/or participation in firm decision-making, are “necessary but not sufficient conditions for effective corporate governance. As such, a climate of respect for the rule of law is also needed.”<sup>25</sup> In order to show that different types of corporate governance systems create variances in financial markets one could adopt the premise that the more superior a nation is on (a) shareholder rights, (b) creditor rights and the (c) rule of law, the more financial stable its financial markets are, which, in turn, positively influences corporate efficiency in terms of access and use of financial markets<sup>26</sup>. There are many studies that have proven the relationships between relative importance of debt and equity markets based on Common-law versus Civil-Law traditions for corporate governance systems (La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 1998), (Shleifer and Vishny 1998), (Levine and Zervos 1998), (Hart 1995), (Hellwig, 1991), (Rajan 1992) and (OECD 199b). The overall picture that emerges from these studies is that Common Law nations have much larger markets for outside equity, and for some nations, also for corporate bonds<sup>27</sup> and that for most firms in Civil Law countries public equity and bond markets are relatively unimportant. In Civil Law nations, most external financing done by firms is in the form of banks loans. The smaller, more underdeveloped public equity and bonds markets in nations under the Civil Law tradition imply that the firms in these nations are restricted to insider (or “near-insider”) financing consisting of owner-contributed funds, retained earnings or bank debt. The negative implications of these restrictions i.e. lack of access to external financing, are many, for example, fewer new firms (less competition and market growth), existing firms are smaller or more fragile, business cycles determine timing of financing, insufficient retained earnings, banks having undue influence over firms, and ownerships is less diversified.

## The European System of Governance

The corporate governance systems used throughout the EU nations vary. They are rooted in two broad European corporate law traditions; the company- and the enterprise-law based legal systems.<sup>28</sup> In the company-based legal system the emphasis is on the firm as a legal entity and the relationship between it

<sup>20</sup> The German Commercial Code, written in 1807, includes, besides from Germany, a sampling of the following nations, among others: Austria, Japan, South Korea, Switzerland, Netherlands, and Taiwan.

<sup>21</sup> The French Commercial Code was written during the Napoleonic era, in 1807. It spread initially due to military conquests. Besides from France, a sampling of these nations would include, among others, Belgium, Greece, Italy, Mexico, Spain, Turkey, Argentina, Brazil, Chile, Indonesia, Jordan, Egypt, Philippines, and Venezuela.

<sup>22</sup> These nations include Denmark, Finland, Sweden and Norway.

<sup>23</sup> La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, “Law And Finance,” *Journal of Political Economy*, 106, 1998 and Emmons, William R. and Frank Schmid, “Corporate Governance and Corporate Performance”, in Cohen, Stephen S. and Gavin Boyd, *Corporate Governance and Globalization*, 2000.

<sup>24</sup> Emmons, William R. and Frank Schmid, “Corporate Governance and Corporate Performance”, in Cohen, Stephen S. and Gavin Boyd, *Corporate Governance and Globalization*, 2000.

<sup>25</sup> La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, “Law And Finance,” *Journal of Political Economy*, 106, 1998, p.74 and Emmons, William R. and Frank Schmid, “Corporate Governance and Corporate Performance”, in Cohen, Stephen S. and Gavin Boyd, *Corporate Governance and Globalization*, 2000, p.74.

<sup>26</sup> Emmons, William R. and Frank Schmid, “Corporate Governance and Corporate Performance”, in Cohen, Stephen S. and Gavin Boyd, *Corporate Governance and Globalization*, 2000.

<sup>27</sup> This does not imply that banks are not important in Common Law nations.

<sup>28</sup> For a more detailed discussion see, Wymeersch, E. "Elements of Comparative Corporate Governance in Western Europe," in Isaksson M. and R. Skog (editors.) *Aspects of Corporate Governance*, Stockholm: Juristforlaget, 1994.

and its investors. In the enterprise-law system the focus is on the enterprise as a real economic and social unit, which includes the role and relationships of its stakeholders. The definition of investor or shareholder is an easy one. The term stakeholder is another matter, since a stakeholder can be anyone or anything with an interest, broadly defined, in the outcome of a corporation's activities, such as the environment, the community, vendors, employees, lenders, customers, the country as a whole, to name a few. In the EU, the company-based corporate legal system is used in the United Kingdom and Ireland; the enterprise based legal arrangements are applied primarily in Germany, the Netherlands and most other member nations.

On continental Europe, in the enterprise system, concentrated ownership by banks or other firms and complicated stakeholder relations are common features throughout the region. Banks may be major equity owners and lenders at the same time, raising the specter of moral hazard through conflicts of interest. The banks however do not see it this way. They are privy to a great deal of information—many bankers are on the boards of corporations to which they are tied—and they are thus better able to ensure the health of their lending relationship, sometimes at the expense of their shareholders. Labor unions and/or governments often influence management to achieve political and social goals such as stable employment, sometimes regardless of economic performance. The stakeholder-based, consensus decision-making process tends to be opaque and hard to penetrate for outsiders. The use of stock options and other financial incentives tied to profits are new phenomena and limited. Moreover, capital markets do not consistently sanction management for not maximizing shareholder value. The strength of the systems is that it focuses not only on shareholder interests but also considers the goals of other stakeholders. These may include the protection of jobs, a reasonably equitable income and wealth distribution and economic and social stability. Its weakness lies in its limited flexibility, limited transparency and limited accountability. Consequently, firms find it difficult quickly and decisively to respond to changing market conditions, particularly competitive challenges.

### ***The German and French System***

EU nations vary in size, legal systems, forms of industrial organization and social traditions. Some nations such as Germany, Italy, France, Belgium, Greece, Portugal and Austria reflect the traditional welfare state values. Others as, for example, the United Kingdom, Sweden, Denmark, Finland, the Netherlands, Ireland and Spain have already introduced more competition oriented economic policies that have reduced the scope of the welfare state. Ireland, for example, through sound economic policies has experienced almost 20 years of rapid growth achieving a per capita GNP that is now even with that of the United Kingdom. The different national economies also dominate different industrial niches. Italy, for example, maintains large financial-industrial groups and clusters of family firms. Germany is characterized by mid-sized family owned and large engineering companies, while Sweden and Finland by high-tech communications multinational corporations.

As a consequence, the current EU corporate governance systems are a patchwork of arrangements. At one end of the continuum are Germany, France and Italy with concentrated ownership, a bank oriented financing system, relatively illiquid capital markets and enterprise-based corporate laws that place moderate emphasis on the monitoring of corporate performance by stock-markets. At the other end are the United Kingdom and Ireland with their dispersed ownership, liquid capital markets and corporate laws that rely heavily on the stock market—and the value reflected thereby-- to monitor the performance of firms. The other member states are in between the two extremes.

Concentrated ownership is widespread, with reasons and structures differing from country to country. Except for the United Kingdom and Ireland, in most nations concentration is seen as supportive of long-term orientation that benefits all stakeholders, including society as a whole. In contrast, widely dispersed ownership is viewed as too focused on short-term objectives, such as shareholder value maximization. In Germany, for example, more than 80% of publicly listed companies have a single shareholder, owning more than 25% of equity.<sup>29</sup> Cross-ownership in unrelated companies is prevalent. Other nations with major ownership and voting blocks include Italy, Austria and Belgium. In France, domestic investors own large companies as a matter of government policy, a feature enhanced by the lack of institutional investors. In Italy, banks and holding companies own networks of firms through pyramids

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<sup>29</sup> Rehman, Scheherazade and Peter Lauter, "Corporate Governance Developments In The European Union," *Hungarian Economic Forum*, University of Budapest, Hungary, Fall 2003 (interview with Dresdner Bank official, Frankfurt, Germany, September 26, 2001.)

of cross-shareholdings. Elsewhere, as, for example, in Sweden several large companies are owned by business dynasties rooted in the late 19<sup>th</sup> or the early 20<sup>th</sup> centuries. It should be noted that in some countries disclosure laws are either not fully developed or are still not working, well thus it is difficult to find out what real ownership structures are.

Other internal features also vary. The Netherlands shares elements of its corporate law with France but uses the two-tiered German corporate management structure that in firms with more than 500 employees comprises a supervisory board (*Aufsichtsrat*) and a management board (*Vorstand*) consisting of inside directors. The supervisory board is made up of outside directors and members elected by the employees and/or appointed by the labor unions, thereby realizing the objectives of "co-determination," i.e. the involvement of workers in management. The supervisory board appoints and oversees the management board that runs the day-to-day activities. The supervisory board is prohibited by law from taking part in the management of the corporation. Unlike under the one-tiered board structure used by French firms, German and Dutch companies thus practice a form of collective leadership. To emphasize this, German firms have "speakers of the boards" (*Sprecher*) rather than "chairmen" as in France. For a number of years, the EU Commission tried to introduce the German-Dutch system in all member countries. But most of them, in particular the United Kingdom and Ireland, strongly objected to the proposal; thus nothing came of it.

### Germany

A closer look at the German system is warranted. Germany's cultural and social attitudes are based on cooperation rather than confrontation, the collective good, rather than the individualism so popular in the Anglo-Saxon system. Co-determination helps both to ensure and to interpret that attitude. As has already been alluded to, no one is concerned with short term accounts, certainly not more frequently than quarterly accounts, and the so-called "flash reports" often required by US-based multinationals of their German subsidiaries are viewed with xenophobic resentment and the feeling that the Americans are crazy. Further, German management often thinks of its employees and customers first.<sup>30</sup>

Germans have long considered that there is already effective accountability in the governance of German corporations. However the way in which this accountability system works is considerably different from what an observer in the United States or the United Kingdom would call adequate accountability. Because of the German penchant for cooperative action, the concept of accountability is rooted in the idea that all critical players already know what is going on: labor, the banks, management and the *Aufsichtsrat*, since they are all involved in decision making. Of course the shareholders, to the extent that they are not the bankers, are relegated to a status of fair ignorance. The financial statements have typically been opaque; profitability is reported differently than in the Anglo-Saxon system. Excess profits have often been squirreled away for leaner times. Long term survival is more important than short term profits or mere growth. After all, the company has a duty to survive not simply for itself or its shareholders, but for workers and the larger community in which it operates.

Section 76 of the German *Aktiengesetz*, or Stock Corporation Code reflects the stakeholder/cooperative culture. Under that section of the law, management is given considerable latitude in directing "the company under its own responsibility", but at the same time, it obliges management to take into account the interests of other stakeholders, to include employees, creditors, and the general public. There is no duty to maximize the value of shares.<sup>31</sup>

In considering the idea of the long term view of German corporate leaders, Jonathan Charkham, former advisor to the Bank of England, a member of a number of prominent corporate boards in his home country, and commentator on international corporate governance issues has said the following:

*"...It is easy to over-simplify as regards investment and the timescale of returns, but it does seem highly probable that the absence of pressure from the German stock market reinforces the natural tendency German management would have anyway to set the balance at the point they feel right to equal the best foreign competition. If this is true one would expect the German system to show good advantage internationally in areas where*

<sup>30</sup> Charkham, Johnathan. *Keeping Good Company: A Study of Corporate Governance in Five Countries*. (New York: Oxford University Press, 1994), p.10.

<sup>31</sup> *Aktiengesetz* of September 6, 1965 (*Bundesgesetzblatt*) Section 76. The basic law on Stock Corporations is supplemented by further legislation such as the Codetermination Act, the Commercial Code, and the Security Trading Act. Further, the Justice Minister in September 2001, appointed a government commission to draft a German Corporate Governance Code, which was adopted on February 26, 2002. See the Electronic Federal Gazette at [www.ebundesanzeiger.de](http://www.ebundesanzeiger.de).

*the balance needed to be set long-term—like engineering. Observation suggests this is so. In industries where the timescale is naturally shorter the comparative advantages are likely to be less marked—and so it seems. But this balance seems on the whole satisfactory to the Germans and there is little urge to change.*<sup>32</sup>

In December 1999, Deutsche Bank's mutual fund (1) espoused the idea of a ranking system for German companies on the quality of disclosure, board governance and shareholder rights and (2) released a study showing a positive correlation between foreign ownership and corporate governance.<sup>33</sup> Strong economic growth, following the enforcement of the fiscal austerity measures mandated by the 1993 Maastricht Treaty's convergence requirements and the necessity to stimulate weakening economies in 2000, prompted several EU governments to change tax laws and to reduce tax burdens.<sup>34</sup> In some countries, the changes have tended to promote the restructuring of company ownership arrangements. Germany, for example, introduced radical personal and corporate income tax reforms in 2001. Aggregate taxes were lowered by an amount equal to 2% of GDP. Top individual tax-rates went from 51% to 42% and corporate rates from 52% to 39%. The change that most profoundly affects corporate governance in the long run is the elimination of the capital gains tax on corporate shareholdings in other companies. The measure is giving corporate restructuring a major boost, although there are good reasons not to expect a sudden rush of sales transactions. Regardless of the tax changes, restructuring of ownership structures has been going on for a while. Moreover, taxes are not the only restructuring consideration; the state of the stock market also matters. As long as Germany's DAX (stock-market index) has not fully recovered from its 2001-2002 decline, companies are not going to engage in a widespread selling of shares. But even with a stronger stock market, firms are likely to be careful about selling equities that perform better than the DAX index benchmark. Companies are also motivated to hold on to certain shares because sales by parent companies will not be tax-free until 2006. In the meanwhile, corporate spin-offs are treated less favorably than the sale of stakes in other companies.

### **France**

The French method of corporate governance, like that of other countries reflects its social and cultural values and its history. France, like Germany takes the social or enterprise view. There is often more cooperation, as in Germany, than confrontation. But in France, the cooperation is much broader and deeper than in Germany; it is also totally different than the Anglo-Saxon system. Even so, what we find in France is a bit of a conflicting paradox. In one sense, at least, the French system is somewhat similar to the American system, inasmuch as the person in charge is really in charge. The French typically give the *Président Directeur-général* (PDG) almost absolute power, much along the lines of the French tradition of strong and centralized leadership in the tradition of de Gaulle, Napoleon or Louis XIV. The state, or “*la France*” and the companies it sanctions, fosters and protects are often intertwined. It is similar to Germany inasmuch as the system, or the community—with a capital C—is very much taken into account. The difference is that, unlike in Germany, there is not much consulting and discussion with the various constituencies before a decision is reached. However, the government and the lending institutions it controls are involved, especially when things go wrong. So unlike the Anglo-Saxon system, or even the German system, there are no real checks and balances on the actions of the PDG. Often, however, the central government, intervenes quickly, actively, and often behind the scenes.

Looking at the involvement of the national government is the place to start in France in order to gain an understanding of corporate governance in the country. It is very closely involved in the organization and governance of business in general, and many, many companies in particular. Because the government wields so much power, the captains of industry—whether in the private or the public sector—try to stay close to it, often, if not asking advice, at least informing before taking decisions with far reaching consequences.

The French Treasury often steps in to save companies in trouble, and a number of government organizations collect and disseminate credit and other types of information about companies. Many very

<sup>32</sup> Markham, Jonathan. *Keeping Good Company: A Study Of Corporate Governance In Five Countries*, (New York: Oxford University Press, 1994), p.52.

<sup>33</sup> Gregory, Holly J. “The Globalization Of Corporate Governance”, *Global Counsel*, September/October 2000.

<sup>34</sup> To join the EMU, by the end of 1998 prospective member nations had had to meet specific annual budget deficit, public debt, inflation, long-term interest rate and exchange rate targets.

large French companies have been through successive waves of privatization and nationalization. Even where privatization has occurred, sometimes the French government retains control. Some state owned business are what one would expect, gas, railways and electricity. Others are more autonomous and compete in the open market, like Crédit Lyonnais, for example.

Few listed companies in France have widely dispersed shareholdings. The vast majority has major shareholders. This is generally so because they are subsidiaries of some other company, or because of institutional holdings or cross shareholdings. Often the original founder has retained a very large holding of company shares, or sometimes it is the state. Traditionally French companies have not favored going to the capital markets to raise money, preferring debt financing. But this has gradually changed, since they have felt themselves exposed to the banks. Generally individuals do not own shares directly in French companies, preferring to own shares in mutual funds as their manner of participation in the equity market.

The French believe in rule by the elite, and the elite are not simply the wealthy, rather they are the ones who are the intellectually superior, those who go to the top few schools. This “class” of elite go from government to business and vice versa.<sup>35</sup> The connections which this phenomenon creates are made even tighter by the links of shareholdings of companies by the financial sector. There is complex web of interlocking company ownership. Under French law, the *Sociétés Anonymes* (“SA”) is the one that can be listed on the stock exchange. Less than 700 are listed in France<sup>36</sup>. Whereas in most countries there is but one corporate governance system for listed companies, in France there are two very different systems. French companies have the choice; one system has a unitary board, the other a supervisory board, somewhat similar to the German system. The traditional French system consists of the unitary board and the PDG. Under French law, the shareholders appoint the board of directors, who in turn elect and appoint the PDG. Of course in reality it often works in reverse, with the PDG picking the directors, and the shareholders ratifying his choices. Under French law, the PDG has sole authority over the corporation; he wields greater power even than his US or UK counterparts. In theory the board can dismiss him or her, but that is the rare case. If he is dismissed, he is not entitled to a large severance package like his Anglo-Saxon counterparts<sup>37</sup>.

The board must have between three and twelve members and at least two thirds must be outsiders or non-executives. The PDG generally selects them, as mentioned above, and if the shareholders are active and strong—as in the case of one or more major shareholder—the PDG will consult them before the annual general meeting, since it is the shareholders who must vote to ratify the board members so selected and nominated for election. Boards are now becoming more and more important in French companies, so selection of good people is important to the PDG and to the company. In France directors must own a certain number of qualifying shares, as set forth in the company’s articles of incorporation. Even so, the board’s role is limited to hiring and firing the PDG, authorizing the raising of new capital—although sometimes a PDG goes around this by going after bank financing, and authorizing mergers or other alliances. When business is good, and the company is running well, boards do not do much; when things go wrong, they often step in, though in France dismissals of PDG, are rare and often occur late in the game.

In 1966, French law introduced an alternative structure, which uses a supervisory system, similar in many respects to the German *Vorstand* and *Aufsichtsrat* mechanism. Under this new system, the management of a company is in the hands of a directorate (“*Directoire*”), comprised of two to five members, appointed for a two to six year term by the supervisory board (“*Conseil de Surveillance*”), comprised of three to twelve members. Any member or all of the members of the directorate may be officers of the company, and one of those members is appointed President by his or her colleagues on the directorate. However neither the president nor any other member of the directorate can be dismissed by the supervisory board. This can only happen through a majority vote of the shareholders. Even so, such a dismissal must be for good cause, or they may be entitled to damages. The directorate has full authority and can take full executive decisions by majority. They need not be shareholders in the company. The directorate must provide a quarterly report to the supervisory board<sup>38</sup>.

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<sup>35</sup> This section is based on Charkham, Jonathan, *Keeping Good Company: As study of Corporate Governance in Five Countries*, New York: Oxford University Press, 1994 and Delldin, Theodore, *The French*, London: Harvill, 1983.

<sup>36</sup> Charkham, Jonathan, *Keeping Good Company: As study of Corporate Governance in Five Countries*, New York: Oxford University Press, 1994 and Theodore Zeldin, *The French*, London: Harvill, 1983.

<sup>37</sup> Charkham, Jonathan, *Keeping Good Company: As study of Corporate Governance in Five Countries*, New York: Oxford University Press, 1994 and Delldin, Theodore, *The French*, London: Harvill, 1983.

<sup>38</sup> Charkham, Jonathan, *Keeping Good Company: As study of Corporate Governance in Five Countries*, New York: Oxford University Press, 1994 and Delldin, Theodore, *The French*, London: Harvill, 1983.

This two-tier system is not overly popular among the French, though for their own reasons some companies choose to use this system. A decision to use one system or another is not permanent, and companies may switch from one to another and back again with a two-thirds majority shareholder vote at an extraordinary general meeting. The overwhelming majority of French SA's use the old unitary board system.

All SA's are required to have an annual general meeting to approve the annual financial statements. One quarter of the outstanding shares voting constitutes a quorum. If a quorum of shareholders is not present at such meeting, the meeting is convened two weeks later and a quorum is not required, with a simple majority vote of those present being all that is required to approve most matters, including the financial statements. For important matters (e.g. amending the articles of association or changing the capital structure), a quorum requires one half of the outstanding shareholdings to be represented at the meeting. If they do not show up, at a meeting two weeks later one quarter of the capital and a two thirds majority is all that is required. Shareholders can attend in person or give a proxy to a spouse, another shareholder or the chairman. Normally proxies are given to the chairman. Shareholder meetings are generally boring and rarely well attended. Proxy fights are very rare, since boards typically have the majority of shares represented on them. In France, nearly all shares are bearer shares, so the company often does not know who the owner of some shares is. It is thus difficult to communicate with certain minority shareholders in France. So annual general meetings are advertised in the newspapers. Shareholders can write in to request a company report, but it is their responsibility to do so, not the responsibility of the company to chase them down. Often financial intermediaries hold the shares for the true owners, and in those instances involving issues regarding dividends and the like, they must be contacted by the corporation, and they, in turn, communicate with the shareholders. National groups of shareholders, such as the Association Nationale de Actionnaires Francais and the Fédération Nationale des Clubs have recently sprung up. The former attends shareholders meetings and voices general concerns, the latter represents shareholders in lawsuits. However, generally shareholders in France have a conservative view when it comes to expecting dividends. Big dividend payments are not, in their view, justified. If a company is not doing well, it cannot afford them; if it is doing well, it should guard its resources and invest them wisely<sup>39</sup>. France, like Germany, also introduced tax reforms. However, the French reforms were more limited, both in terms of magnitude and scope than the German changes. The top personal income tax rate was reduced by 2%, while business income taxes were lowered mainly for small-and medium-sized firms. The chief beneficiaries of the reform are workers at the lowest income levels, which may motivate the unemployed to look for jobs because relative to wages unemployment benefits are now less attractive. While not having a major effect on corporate governance, the reforms in the long run may have a mildly positive impact on the labor markets by somewhat increasing flexibility.

In the United States, the changes to the corporate governance system brought about by the collective outrage after Enron, Tyco and similar scandals was easy compared to what may be required in Germany and similar systems. Even though the Sarbanes-Oxley Act<sup>40</sup> has been touted as "the most important securities legislation enacted by Congress since the 1930's"<sup>41</sup> and "...the most significant changes to the regulation of public companies since Congress passed the Securities Act of 1933... and the Securities Exchange Act of 1934..."<sup>42</sup>, in fact it barely changed the general concept of accountability and transparency, and what the relationship of the corporation to its shareholders/stakeholders is supposed to be. Of course it has seemingly taken away some of the CEO's kingship, and given more power to the board of directors, taking such things out of the traditional province of state law, and it has now made mandatory certain requirements for non-executive or outside directors.<sup>43</sup> However, in reality, it simply made the old system stricter and put in place more safeguards, duties and sanctions to ensure that management and boards of directors do now what everyone thought they should have been doing all along. The emphasis is still on financial disclosure. Germany, on the other hand will require a thoroughgoing

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<sup>39</sup> Charkham, Jonathan, *Keeping Good Company: A Study of Corporate Governance in Five Countries*, New York: Oxford University Press, 1994 and Dellidin, Theodore, *The French*, London: Harvill, 1983.

<sup>40</sup> The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002)

<sup>41</sup> Greene, Edward F., Leslie N. Silverman, David M. Becker, Edward J. Rosen, Janet L. Fisher, Daniel A. Braverman, and Sebastian R. Sperber, *The Sarbanes-Oxley Act: Analysis and Practice*, New York: Aspen Publishers 2003, p.xiii.

<sup>42</sup> Romanec, Broc, Linda L. Griggs and Sandra Leung, "New Compliance Challenges Under the Sarbanes-Oxley Act of 2002", *ACCA Docket*, November/December 2002, p. 23.

<sup>43</sup> See Howell, Joy and Stephen Hibbard, "Navigating the Changed Corporate Landscape," *Harvard Management Update*, December 2002, Cambridge, Massachusetts: Harvard Business School Publications 2002.

transformation of the very concept of corporate accountability, ownership structure and the treatment of shareholders, if its companies are to be swathed in the flexibility and accountability of the Anglo-Saxon system.

Nonetheless, some things in Germany are gradually changing, or at least there is a sense in many circles that things must change, and so there are attempts. In July of 2000, even before the major US scandals, the German Panel of Corporate Governance promulgated a paper entitled “Corporate Governance Rules for Quoted German Companies”<sup>44</sup> The paper, in describing a “Code of best practice for German corporate governance”, amounted basically to a group of cheerleaders extolling the German system, explaining how it equaled or exceeded the OECD Principles of Corporate Governance of May 1999.<sup>45</sup> The panel stated that:

*“...The purpose of corporate governance is to achieve a responsible, value-oriented management and control of companies. Corporate governance rules promote and reinforce the confidence of current and future shareholders, lenders, employees, business partners and the general public in national and international markets. The Supervisory board, Management Board, and Executive Staff of the Company identify themselves with these Rules and are contractually bound by them. They are part of the general obligation to observe other interests related to the corporate activity.”<sup>46</sup>*

In France the gradual restructuring of some industries that began a few years ago attracted billions of dollars in investment capital, much of it from U.S. and United Kingdom pension funds. This sparked a series of debates about the relationship between French cultural values and the demands of the international capital markets. French President Jacques Chirac was quoted as complaining that: “...French workers were being asked to sacrifice simply to safeguard the investment benefits of Scottish widows and California pensioners.”<sup>47</sup> It is interesting to note that when in 1999 the partly state-owned car manufacturing company, Renault, eliminated 20,000 jobs at the Japanese car manufacturing company, Nissan, no one in France took notice of the job cuts. On the contrary, French politicians and the media praised the acquisition of a majority 37% stake in Nissan by Renault and the subsequent restructuring as a prime example of a successful international expansion and management project by competitive French firms. It just depends on whose ox is being gored.

Following the publication of the two so-called “Viénot Reports”<sup>48</sup> by the Mouvement des Enterprise de France along with the Association Francaise des Enterprise Privees, these associations have conducted and widely published such studies as “Transparence des Salaires et des Stock-Options : Initiative MEDEF-AFEP<sup>49</sup>.” They are not ambivalent to either the demands of the capital markets nor the world press covering corporate scandals. French corporate and government leaders are also concerned with the issue of trust in the corporation, and for them:

*“...In Addition to the moral imperative, this represents a key economic requirement for all developed economies, taken both collectively and individually. Ever more initiatives are being launched in both the United States and Europe, as each country understands that what is at stake is the competitiveness of its business and its financial markets.*

*Recent events, particularly revelations of questionable accounting practices, have impacted global companies, ruined shareholders and employees and led to the disappearance of one fo the leading audit firms. This has caused a severe breakdown of trust in the very essence of a market economy, namely the quality of corporate governance and the reliability of financial statements. The latter*

<sup>44</sup> “Corporate Governance Rules for Quoted German Companies,” German Panel of Corporate Governance, Frankfurt am Main, July 2000. See [www.ecgi.org/codes/country\\_documents/germany/code0700e.pdf](http://www.ecgi.org/codes/country_documents/germany/code0700e.pdf)

<sup>45</sup> OECD. “OECD Principles of Corporate Governance,” Paris: OECD, 1999a.

<sup>46</sup> “Corporate Governance Rules for Quoted German Companies,” German Panel of Corporate Governance, Frankfurt am Main, July 2000, p.1.

<sup>47</sup> The New York Times, January 9, 2000, p.10.

<sup>48</sup> “The Board of Directors of Listed Companies in France,” July 10, 1995, hereafter Vienot #1, and “Recommendations of the Committee on Corporate Governance” Chaired by Mr. Marc Vienot, July 1999, hereinafter Vienot #2. Both reports were sponsored by the Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France.

<sup>49</sup> Didier Pineau-Valencienne, alors président de l'AFEP, et Ernest-Antoine Seillière, président du MEDEF, ont présenté, en janvier 2000, une initiative conjointe en faveur de la transparence des rémunérations des dirigeants d'entreprises françaises.

*provide the link between the economic reality of each company and its shareholders, both institutional and individual.*<sup>50</sup>

The First Viénot Report<sup>51</sup> asked the question: “Is existing legislation concerning the functions of the boards of directors in need of change?,” and answered: “...the Committee considers that problems can be resolved under the existing law governing boards of listed companies, with no major amendments<sup>52</sup>. That was in 1995. By 1999, at the time of Second Viénot Report<sup>53</sup>, they said: “...the Committee is favorable to the introduction of French law of an alternative allowing the Board of Directors to opt for combination or separation of the offices of chairman and chief executive officer, which option should always be subject to reversal by a further resolution of the Board of Directors”.<sup>54</sup> The Viénot Reports did two things: they caused certain changes to be made to the French law, yet at the same time, they stood for the proposition that it is not so much the rule of law that makes for good governance, rather the spirit of the norms. The French believe that their system of corporate governance is far superior to the Anglo-Saxon system, or at least, certainly to that of the United States.<sup>55</sup> They smugly declare that unlike what they appear to consider the “cowboy system” in the United States, French law for example requires that “only the general meeting of the shareholders has the power to authorize the granting of options.”<sup>56</sup> Furthermore, the First Viénot Report, in setting forth the duties and powers of directors, and implicitly stating the objective of the corporation said:

*“...In Anglo-American countries, the emphasis in this area is on enhancing share value, whereas in Continental Europe, and particularly in France, it tends to be on the company’s interest.*

*This difference in approach does not amount to a radical contradiction. Demonstrating concern for the company clearly does not mean ignoring the market, which regulates all aspects of economic life. Instead, it means that management and directors must consider the company first and put the general interest ahead of their own at all times.*

*The interest of the company may be understood as the over-riding claim of the company considered as a separate economic agent, pursuing its own objectives, which are distinct from those of shareholders, employees, creditors including internal revenue authorities, suppliers and customers. It nonetheless represents the common interest of all of these persons, which is for the company to remain in business and prosper.”<sup>57</sup>*

According to the First Viénot Report: [the board] is required to act at all time in the interests of the Company.”<sup>58</sup> Partly in response to this report, French law now states: “The board of directors sets the direction for the company operations and oversees the implementation of strategy...it may deal with all

<sup>50</sup> “Promoting Better Corporate Governance in Listed Companies”, report of working group chaired by Daniel Bouton, President of Société Bank, September 2002, sponsored by Association Francaise des Enterprise Privees and Mouvement des Entreprises De France, herein referred to as the “Buonot Report,” p.2.

<sup>51</sup> “The Board of Directors of Listed Companies in France,” sponsored by Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 10, 1995.

<sup>52</sup> Viénot #1, “The Board of Directors of Listed Companies in France,” sponsored by Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 10, 1995, p.3.

<sup>53</sup> “Recommendations of the Committee on Corporate Governance” Chaired by Mr. Marc Vienot, Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 1999.

<sup>54</sup> Viénot #2, “Recommendations of the Committee on Corporate Governance” Chaired by Mr. Marc Vienot, sponsored by Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 1999, p. 3. This is an issue that has been ventilated at great length by Anglo-Saxon writers on the subject. See [Report of the Committee on the Financial Aspects of Corporate Governance](#), London: Gee Publishing Limited, 1992, and also see Cadbury, Adrian. [Corporate Governance And Chairmanship. A Personal View](#), Oxford, England: Oxford University Press, 2002.

<sup>55</sup> The general theme of the Buonot Report was that while the French system could stand some tinkering to make it better, it was in general pretty good, certainly better than that of the Americans, who clearly do not have it right as evidenced by history.

<sup>56</sup> Buonot Report, “Promoting Better Corporate Governance in Listed Companies”, report of working group chaired by Daniel Bouton, President of Société Bank, sponsored by Association Francaise des Enterprise Privees and Mouvement des Entreprises De France, September 2002.

<sup>57</sup> Viénot #1, “The Board of Directors of Listed Companies in France,” sponsored by Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 10, 1995, p.7.

<sup>58</sup> Viénot #1, “The Board of Directors of Listed Companies in France,” sponsored by Association Francaise des Entreprises Privees and the Mouvement des Entreprises de France, July 10, 1995.

issues relevant to the satisfactory running of the company and deliberates and decides upon all matters related thereto.”<sup>59</sup>

The French believe that while certain core legislation is essential, the varied and precise rules for the governance of a corporation should be based on the general principles laid down by the two Viénot Reports and the Buoton Report, and that: “It is not so much the letter of the rules as their spirit, not standards but behavior. Though regulation is of course needed, formal rules and superficial compliance with them cannot be enough. What is needed is for all concerned parties to apply, in good faith, a set of “ground rules”, the aims of which are understood and accepted by all”<sup>60</sup>. This view is reminiscent of Sir Adrian Cadbury’s view<sup>61</sup> on the English system, since he believes that although a certain amount of regulation is imperative, a code of best practices is better, since they set forth the principles and the spirit, which must be followed, rather than a fixed legislation, which can be adhered to in terms of the letter of the law, but the spirit, indeed even if it is clearly articulated, can be circumvented.<sup>62</sup>

The Second Viénot Report, however, called for more expansive disclosure of Executive remuneration policy, stock option plans, the total amount of directors’ remuneration (in France, a total has traditionally been allocated, and then divided up among directors, as the board decides) and individual director’s remuneration for attendance at meetings.

In general, French listed companies now must mention in their annual reports the degree to which they adhere to the principles set down in the Viénot Reports, or explain why they do not. Of course part of the issue is not so much this type of “transparency”, rather who actually reads the annual reports, and what they do with that information once they get it. Presumably large international institutional investors will ensure that they are on the mailing list.

So, while things are still likely to change to one degree or another, because of capital market demands, the French generally believe that: “Following the publication of the two Viénot Reports.....France now has a very extensive set of rules of corporate governance, promoting both efficiency and transparency. The progress that has been achieved since 1995 is reflected in the content of the annual reports of listed companies.”<sup>63</sup>

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<sup>59</sup> French Commercial Code, L 225-35.

<sup>60</sup> Buoton Report, “Promoting Better Corporate Governance in Listed Companies”, report of working group chaired by Daniel Bouton, President of Société Bank, September 2002, sponsored by Association Française des Entreprises Privées and Mouvement des Entreprises De France. p.4.

<sup>61</sup> Sir Adrian Cadbury was Chairman of Cadbury Schweppes from 1975 to 1989, and he has been on the Board of Directors of the Bank of England, IBM UK Ltd., and was Chairman of PRO NED. He was Chairman of the UK Committee on the Financial Aspects of Corporate Governance, and as such has been an influential commentator on the issue of corporate governance in the UK and elsewhere.

<sup>62</sup> Cadbury, Adrian. *Corporate Governance and Chairmanship. A Personal View*, Oxford: Oxford University Press, 2002, pp.28-29.

<sup>63</sup> Buoton Report, “Promoting Better Corporate Governance in Listed Companies”, report of working group chaired by Daniel Bouton, President of Société Bank, September 2002, sponsored by Association Française des Entreprises Privées and Mouvement des Entreprises De France. p.2.

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