

# **The Contractual Turn: How Legal Academics Shaped Corporate Law Reforms in Germany**

## **Abstract**

This paper contributes to an ongoing debate about the drivers and mechanism of corporate law reforms which have put greater emphasis on shareholder rights and shifted the legal framework of corporate governance towards market control in many advanced capitalist countries. Supplementing existing research on corporate law reforms I highlight the impact of legal ideology on political decision making and the role German law professors have played in corporate law reforms.

After a theoretical introduction about the role of law professors as institutional entrepreneurs, the paper examines how the underlying assumptions in academic writings about basic concepts and principles of German corporate law have evolved over the last 30 years. It is shown that “corporatist” theories which had been prominent in the 1970s were outcompeted by a contractarian style of legal reasoning in the 1990s. After contractarianism had gained intellectual authority its scholars became involved in parliamentary hearings and Commissions on corporate law reform. Picking up the ideational templates provided by “law & economics” the legislators created a securities exchange agency, extended disclosure requirements, banned insider deals, legalized shareholder oriented practices, introduced takeover regulation, and thereby shifted corporate law from state control to capital markets.

## **Philipp Klages**

Max-Planck-Institute for the  
Study of Societies  
Paulstr. 3  
50676 Köln  
Germany  
Email: [klages@mpifg.de](mailto:klages@mpifg.de)

## *I. Introduction*

In the wake of the internationalization of financial markets, the German corporate governance regime has undergone a series of transformative processes which have changed who shareholders are, what kind of interests prevail, and how large corporations are run. In the 1990s banks and insurance companies sold large parts of their industrial shareholdings and left the supervisory boards of non-financial companies (Beyer 2004). The realignment of bank strategies has led to the unravelling of the network of interlocking directorates and capital ties which had shielded managers from market control (Höpner/Krempel 2004). The internationalization of financial markets made German banks and insurance companies internationalize their portfolio while foreign investors sank large amounts of capital into German companies. This has changed the relation between business corporations and shareholders and has increased the importance of capital markets for corporate governance. While national block holders protected industrial companies and each other from market forces, international portfolio investors use markets to discipline managers. Another difference between the old and the new owners concerns their willingness to negotiate and to find a compromise with other constituencies in and outside the firm. While German banks and insurance companies were committed to their industrial partners and employees, portfolio shareholder put a stronger emphasis on their individual financial interests.

Paralleling the shift from a “relational contracting” to an “arm’s length bargaining” mode of financial relations, managers were brought in line with portfolio shareholders: The erosion of institutions that protected German managers from hostile takeovers and the formation of a market for corporate control have exposed them to a higher degree of market discipline (Höpner/Jackson 2006). The spread of stock

options has driven managerial incentives towards shareholders' interests (Sanders/Tuschke 2007). At the same time changing managerial education and recruitment patterns have made their cognitive frameworks shift to a "shareholder value conception of control" (Beyer 2006; Fligstein 2001). With the realignment of owners and managers the "corporatist agreement", which had combined private benefits of control and employment security to the detriment of financially oriented minority shareholders (Pagano/Volpin 2005), became precarious. This is indicated by the co-occurrence of skyrocketing managerial remuneration, mass-layoffs and booming stock markets.<sup>1</sup>

How does the transformation of corporate control connect with the institutional environment companies operate in? What consequences did the erosion of the post-war settlement have for the formal institutions that govern the behaviour of business corporations? While the shaping of organizational behaviour by formal institutions has become an important field of study for organizational sociologists (Fligstein 1990; Sanders/Tuschke 2007) and political economists (Hall/Soskice 2001; Gourevitch/Shinn 2005), the question how corporate law, and more particularly legal thinking has responded to shareholder value-oriented organizational practices has remained largely unexplored.<sup>2</sup>

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<sup>1</sup> While networks have been dissolving and market forces have been unleashed, other elements of the German corporate governance regime have remained largely intact. The most prominent examples for the institutional resilience of the German corporate governance system are the co-determined supervisory board and the enduring family control in some German corporations like Porsche or BMW. With regard to the distinction between liberal market economies and coordinated market economies, this mix of institutional change and inertia has been described as "negotiated shareholder value" (Vitols 2004) or "hybridization" between liberal and coordinated market economies (Klages 2006).

<sup>2</sup> Broadly speaking the legal infrastructure of corporate control has responded to the changing corporate practices and thereby has legitimated their diffusion across the organizational field. There is a great deal of literature which shows how and why legal norms matter for organizational behaviour (Fligstein 1990; Gourevitch/Shinn 2005; La Porta/Lopez-de Silanes/Shleifer 1999; La Porta, et al. 1998; Roe 1994; Roy 1997; Sanders/Tuschke 2007). From a neo-institutionalist perspective it is particularly important that legal reforms legitimize organizational practices and thereby support their diffusion across the organizational field. As Sanders and Tuschke (2007) nicely demonstrate with respect to the Control and Transparency Act (KonTraG) and the spread of stock options in Germany,

This paper highlights the role of legal scholarship for corporate law reforms in Germany and reconstructs its evolution during the last 30 years. As will be seen the development of corporate law scholarship in this period can be characterized as a *contractual turn* which means that intellectual authority shifted from corporatist theories to economic analysis of law. Secondly, the paper tries to explain why contractarian scholars could become so influential in the 1990s. As I will argue, the rise of law & economics was facilitated by the discrediting of the corporatist doctrine and the reactivation of dormant alternatives from the late 19<sup>th</sup> century. After shareholders and managers had broken out of the corporatist compromise the social substratum of corporatist theories eroded. The ensuing mismatch between legal thinking and economic practices increased the prestige of law & economics scholars because their concepts seemed to depict the marketized corporate reality more accurately than corporatist theories. Moreover, this paper suggests that the permeation of the nexus of contracts doctrine could build on a historical predecessor. In fact, the contractual turn can be characterized as a reactivation of a dormant meaning resource which, after having been suppressed during the period of organized capitalism, could reemerge after the corporatist compromise had become fragile. By the reactivation of a temporarily unpopular meaning resource legal scholars reinterpreted legal concepts in line with available interpretative approaches. Finally, the paper examines how the contractual turn has influenced legislative reforms. I show that contractarian scholars could use their prestige to become involved in the political decision making process.

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“when and if laws and regulations are amended to permit easier adoption of a contested practice, such legal sanctioning is likely to ‘open the floodgates’ (...) and rapid diffusion will result” (ibid.: 39.).

At the same time, law can also be considered as being conditioned by organizational practices. This has been demonstrated by Dobbin and Kelly (2007) with respect to organizational solutions against sexual harassment which have been endorsed by the Supreme Court *after* organizations – initiated by personnel experts – had already started to implement them (Dobbin/Kelly 2007). Another way in which law is dependent on organizational behaviour is mentioned by Lauren Edelman (1992). As law is highly ambiguous and has to be specified organizations also play an active role in giving legal norms their precise meaning (Edelman 1992).

By means of parliamentary hearings, the Deutscher Juristentag and Commissions they provided legislators with ideational templates for reforms and thus became consequential for the institutional regulation of business corporations in Germany.

In the following part I will highlight the role of legal scholars for legal development and their relation to policy-makers and other actors within the legal field. In the third part I will demonstrate how corporate law scholarship has changed over the last decades, how the contractual turn has responded to economic change and (in) how (far) it has influenced corporate law reforms.

## *II. The Role of Legal Scholars for Institutional Change*

To the extent that the question about law's adaptation to shareholder capitalism has been dealt with, attention has focused on an ostensible dichotomy between stability and change. In fact the debate about which direction the evolution of corporate law will take in the context of internationalized capital markets (a survey: Gordon/Roe 2004) has largely revolved around this dichotomy. While Bebchuck and Roe (1999) present a functional and a power-related argument for the path dependence of corporate law (see also: Roe 1996), Hansmann and Kraakman (2001) have famously argued that functional pressures, changing interests and the diffusion of shareholder value ideology drive civil law systems towards the US "standard shareholder-oriented model" of corporate law (see also: Hansmann 2006).<sup>3</sup>

Hansmann and Kraakman's claim gains support from the growing literature on the worldwide *diffusion of American law and corporate law reforms* (Siems 2005). Considering the legal system, particularly with respect to corporate law, there is

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<sup>3</sup> Paralleling the debate about the evolution of corporate law, there is a debate about the importance of legal transplants for legal change and their preconditions (Legrand 1997; Pistor, et al. 2002; Ruskola 2000; Teubner 1998; Watson 1993 ).

growing evidence for the Americanization of civil law systems (Fleischer 2004; Fleischer 2005; Hopt 2004; Kelemen 2006; Kelemen/Sibbit 2004; Milhaupt 2003; Pistor, et al. 2002; Pistor/Xu 2003; Quack/Djelic 2005; Siems 2005; Stürner 1989; Wiegand 1991; Wiegand 1996). In many countries policy-makers have responded and contributed to the emergence of shareholder value practices by a series of *corporate law and capital market reforms*, including the creation of enforcement agencies, stricter control on market manipulation and insider trading, extension of disclosure requirements, regulation of takeovers, equalization of voting rights and the legalization of shareholder oriented practices like stock options and share-buy backs (Cioffi 2002; Cioffi/Höpner 2004; Goergen/Martynova/Renneboog 2005; Gourevitch/Shinn 2005; Lütz/Eberle 2005; Ziegler 2000).

The general thrust of corporate law reforms can be described as *delegation of corporate regulation from politics to capital markets*. As will become clearer below, the traditional goal legal scholars had ascribed to corporate law in Germany in the 1970s was to regulate the business corporation in order to protect the weak and precipitate a fair balancing of interests between all interest groups affected by business corporations. The corporatist compromise became institutionalized as a set of indispensable legal norms which rested on generally agreed upon conceptions of justice. As I will argue in this paper the institutionalization of the corporatist agreement in corporate law was facilitated by the authority of a corporatist type of legal reasoning among leading corporate law scholars. The corporate law reforms which occurred in the 1990s, however, follow a different logic. Corporate law today primarily seeks to enable market actors to discipline managers in a way which forces them to increase shareholder value. This means that the aim of corporate law has

shifted to the facilitation of market efficiency and the creation of wealth, while other issues are being delegated to different areas of law.

While law certainly seems to accommodate to the changing reality inside large corporations it is crucial to emphasize the limits of law's responsiveness. In fact law is an inert and path dependent phenomenon. As will be seen law is grounded in its own traditions and internal logic and therefore cannot be reduced to economic imperatives. It might respond to changing interests and structures but, as I will try to show does so according to its internal logic. As will become clear below the adaptation of law to societal change is limited by and takes place within a repertoire of finite interpretative approaches which co-exist over time and compete for intellectual prestige with varying success. While the repertoire of interpretative approaches itself stays stable the reconfiguration of its parts makes legal reasoning adaptable to social change.

The recent literature on *institutional change* (Crouch/Farrell 2002; Hall/Thelen 2005; Streeck/Thelen 2005; Thelen 2003) has highlighted the role of *institutional entrepreneurs*. In this strand of literature institutional change is conceived as a gradual reinterpretation of rules, which nevertheless can have transformative effects. In line with this strand of literature I refer to *institutions* as sanctioned formal rules, that is legal norms.

Because legal norms are intrinsically underspecified, the argument goes, they have to be interpreted. This is where *legal actors* come in. With regard to labor law Britta Rehder (2006) has forcefully argued that judges served as groundbreakers for the decentralization of the German wage bargaining system. Concerning transnational law, the increasing role of practicing lawyers has been highlighted by Sigrid Quack (2005).

While judges and particularly practicing lawyers are important actors for corporate law as well, in this particular area the influence of *legal scholars* on the development of law has been more important than elsewhere (Wiedemann 1980). The relative influence of each type of legal actor on the development of law also varies with the legal culture: While common law systems assign a decisive function to judges and practicing lawyers, legal scholars are of much greater importance for the interpretation and adjustment of law in the civil law systems (Caenegem 1987; Weber 1972).

Law professors do not act independently from other types of actors within the legal system. In fact they interact with judges and the legislator and have interdependent relations with both. Legal change is not exclusively driven by legal scholars but is more adequately depicted as interplay between legislators and different kinds of legal actors (judges, law professors, civil servants and practicing lawyers) (Halliday/Carruthers 2007). Legal actors communicate about the meaning of law in a legal discourse. Collectively, legal academics, judges and practicing lawyers shape the character of law. Each group of legal actors follows their own specific logic of action (Rehder 2007). Legal scholars do not only discuss judicial opinions and deploy them to legitimize their views but in turn provide judges with interpretative templates which help them to bridge the gap between norms and reality. Their relation to the legislator is also interdependent. Obviously legal scholars depend on the normative material produced by the political system. In this respect they are fundamentally dependent on policy-makers. However, an argument can be made for the influence of legal scholars on political decision-making. Not only does their engagement as experts in committees and commissions allow them to directly contribute to the political decision-making process. At the same time they provide the legislator with

legal ideas which can not only be deployed to justify political reforms in legal terms *but which can also shape policy-makers' perception of problems they try to solve and the goals which need to be pursued*. This thought goes back to Max Weber's famous metaphor of ideas as "switchmen" of interests and is manifested in the literature on the impact of ideas on policy-making (e.g. Blyth 2002; Campbell 2004: Chp. 4; Hall 1993; Schmidt 2001). The impact of *legal* ideas is particularly endemic to policy areas which fall under the jurisdiction of the ministry of justice as is the case with corporate law reforms. As legal historians have shown, in many cases legal scholars and their ideas provided the intellectual ground for legislative reforms (Horwitz 1992; Wieacker 1967).

Generally speaking, law professors systematize legal norms around general concepts and construction principles of the legal order. Law's equivocal character gives rise to different views and interpretations of its meaning. As there are different kinds of interpretations of legal norms and concepts, *legal discourse is a highly contested terrain*. In interpretative struggles about the right meaning of law different factions of legal scholars compete for interpretative authority (Bourdieu 1987) and for influence on the judiciary and policy-making. Thus to a great extent the generally agreed upon concepts of law – the legal zeitgeist – depend on how interpretative authority is allocated within the legal system. If the authority structure within the legal field shifts from one type to another type of thinking the ideas which are offered to policy-makers will have a different character and political decision making can be driven into a new direction.

Even though the legal discourse is relatively autonomous from its societal environment, it is not completely separated from actors and interest groups outside the legal field. To a certain extent law professors operate as *intermediaries between*

*society and politics*. They mediate social change, translate it into the language of law and infuse their ideas into the political decision making process. In fact, an argument can be made that the battle within the legal discourse to some extent reflects cleavages in the political economy and that there is an elective affinity between interest group preferences outside the legal field and schools of thought inside the legal field (Bourdieu 1987). Legal scholars have debated about how closely certain types of legal reasoning are coupled with preferences of interest groups outside the legal field. Dewey (1926) and Millon (1990) have emphasized the “indeterminacy of legal concepts” and shown that at different historical stages one and the same approach can be deployed in different ways and thus is not exclusively associated with one particular interest group. However, other scholars have argued that legal ideas are situated within a specific historical context which reduces their ambiguity and thereby limits the scope of their manipulability (Horwitz 1985). Hence certain legal ideas can be expected to be in some way associated with specific interests at a certain point in history even if the same concept might be deployed to serve different interest groups under other historical circumstances.

As will be seen below the structure of the legal discourse about corporate law is characterized by an antagonism between corporatist and contractarian approaches. With regard to the connection between legal discourse and interest group preferences it can be argued that corporatist notions had been supported by unions and managers before they became aligned with portfolio shareholders, and that the diffusion of “law & economics” was supported by investment banks and shareholder-oriented managers.<sup>4</sup>

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<sup>4</sup> There is some anecdotal evidence for the influence of organized interest groups on the legal discourse which will be elaborated in my final chapter. The corporatist conception of corporate law had support from the German peak labor organization, the Deutsche Gewerkschaftsbund (DGB). This is indicated by the role of the legal scholar Otto Kunze, who worked as legal counsel for the DGB, participated in

Notwithstanding the influence of interests on the legal discourse, legal scholars cannot arbitrarily reformulate the meaning of law. They are constrained by the meanings and concepts they have inherited from the past and need to accommodate their concepts according to law's internal logic. The interpretative battle produces a repertoire of co-existing approaches. As I will demonstrate, it is this pool of distinctive meaning resources which enables legal actors to reinterpret basic concepts in a way which accommodates to social change *in concert with the traditional meaning system of law*. Even when one view becomes influential at one point, rivalling views do not cease to exist. Building on Crouch and Farrell (2002) I argue that alternative resources remain within the interpretive repertoire, shadow the dominant opinion, and can resurface when accommodation is required. When legal scholars adapt legal concepts and principles to society they can resort to *dormant interpretations* which have temporarily become unpopular but are available for reactivation. This argument will be illustrated in the next section with respect to the jurisprudential controversy about the nature of the corporation which has fascinated legal scholars for a long time and which, as I will argue afterwards, became consequential corporate law politics in the 1990s and 00s.

### *III. The Contractual Turn in Corporate Law Scholarship*

To find out how legal thinking about corporate law has responded to the reconfiguration of corporate interests I conducted background interviews with

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the legal discourse in favour of a corporatist approach (e.g. Kunze 1980) and who chaired the Enterprise Law Commission set up by the social democratic Federal Government in 1972. With regard to the spread of contractarianism, the European Corporate Governance Institute which can be considered as the culmination of "law & economics" in Europe was founded – among others - by the investment bank Goldman Sachs in 2002. Recently Theodor Baums, a leading law & economics scholar has established the "Institute for Law and Finance" in Frankfurt. For this he was supported by investor oriented banks. His professorship is sponsored by the Deka Bank. Since 2004 Professor Baums is adviser for the Deutsche Bank which turned towards investment bank strategies in the 1990s. Klaus Hopt served as director of the supervisory board of the Deutsche Börse from 2003 on.

corporate law scholars and – following their advice – looked at key publications in the two most relevant corporate law journals (*Zeitschrift für Unternehmens- und Gesellschaftsrecht* and *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht*), important textbooks and commentations of the stock corporation act (*Aktiengesetz*). My analysis covers the time-period from 1975 through 2005. I extracted the underlying assumptions concerning basic concepts and principles of corporate law and examined to what extent and how they have changed over the last 30 years. Following the advice of the experts I analyzed the following aspects of corporate law: the concept of the corporation (1), the corporate purpose (2), mandatory and enabling law (3), capital market law (4) and the goal of corporate law (5).

### *1. The Nature of the Corporation*

Even though my main focus is on the time period between 1975 and 2005 this section goes back to the late 19<sup>th</sup> century in order to identify the intellectual roots of “law and economics” thinking in German legal history.

As will be seen, the way the corporation is conceptualized co-varies with regard to how the relation between shareholders and the company is depicted, what kind of status is ascribed to employees (are they members or merely contractual partners?) and how managerial responsibilities are specified (are they trustees for the corporation or merely for shareholders?).

In 1870 corporations whose foundation until then had depended on concession by administrative authorities were given the freedom to incorporate, and therefore for the first time in history appeared as private organizations separated from the state. In legal thinking the corporation was referred to as a contractual arrangement between shareholders with the function to collect capital (“Kapitalsammelbecken”). In the first

German corporate law text book which was published in 1898 by *Karl Lehmann*, the corporation was described as existing only in the interest of its shareholders (Lehmann 1964 [1898]). Employees were not considered as members of the corporation but rather as contractual partners comparable to creditors. Consequently managers were seen as directly bound to shareholders' interests.

In opposition to this liberal approach a corporatist theory of the corporation began to become popular after WWI. Its main proponent was *Wather Rathenau* (Rathenau 1917). In response to the growing importance of big business corporations he conceptualized the corporation as an enterprise ("Unternehmen") with a distinct interest separated from its shareholders. His theory became very popular in the Weimar Republic and served as an ideational template for the creation of the *stock corporations act* in 1937. The "Gemeinwohlklausel", stipulated in paragraph 70, section II, of the stock corporations act, gave managers considerable independence from shareholder interests but at the same time tied them to the interests of workers and the public. In response to the stock corporations act legal scholars increasingly defined the corporation in a way that considers *workers as members* of the corporation (Fechner 1942).

The idea of the corporation as a social association consisting of shareholders and employees again served as a guideline for the legislator after WWII. In 1951 the co-determination of German supervisory boards was introduced in the steel and coal industries, and one year later it became extended to all companies with more than 2000 employees. While the coal and steel industries had 50 % of their supervisory board members being worker representatives, in the remaining sectors worker representatives could only appoint one-third of all supervisory board members. In 1976, however, the corporatist theory of the corporation reached its peak when the

legislators extended co-determination to a one-half-parity level *for all sectors*. After employer associations had filed a constitutional complaint, in 1979 the Federal Constitutional Court endorsed the co-determination act. The introduction of co-determination was in line with the discursive reality of corporate law and the authority structure within the legal field in the 1970s. When the Brandt administration set up the Enterprise Law Commission in 1972 to work out proposals for corporate law reforms corporatist scholars were setting the tone of the legal debate. Accordingly, it was the legal counsel of the Confederation of German Trade Unions (Deutscher Gewerkschaftsbund), Otto Kunze who was appointed to chair the Commission. It almost goes without saying that he was in favour of corporatist ideas (cf. Kunze 1980). This is also true for the chief of department for corporate law in the ministry of justice, Ernst Geßler (cf. Geßler 1979). And in fact, the report of the Enterprise Law Commission happens to be a manifesto of corporatist thinking (Bundesjustizministerium 1980).

While the corporatist theory turned out to be influential it never became universal. In fact, throughout its establishment the corporatist theory of the corporation was challenged by scholars who were closer to the individualist notions from the 19<sup>th</sup> century and who did not consider workers as members of the corporation. One criticism that emerged in the early 1980s relates to the question of the legal subject of the corporation (Rittner 1980; Wiedemann 1980). According to the corporatist theory, the enterprise, including the workers, is its own legal subject. This idea was heavily criticized by shareholder-oriented scholars who saw the general meeting of shareholders as the legal subject and the enterprise, including the workers, as its object.

But it was not before the introduction of “law & economics” in the 1990s that contractarian thinkers regained their authority. Inspired by Jensen and Meckling (Jensen/Meckling 1976), Easterbrook and Fischel (1989) and Romano (1993), a group of transatlantic German law professors advocated a strictly contractarian view of the corporation. Authors like Rainer Walz (1993), Friedrich Kübler (1999) and Klaus Hopt (1998) conceptually dissolved the corporate entity, which corporatist thinkers had successfully placed between managers and shareholders, into a “nexus of contracts”. Compared to the corporatist concept of the corporation, the nexus of contracts doctrine implies that shareholders are merely connected by contractual bonds, managers primarily serve shareholders’ interests (*see next section*) and workers – along the line with creditors – are rather contractual partners than members. In all these features the nexus of contracts-concept reveals its kinship with Lehmanns’s concept of the “Anlegerverband”.

The nexus of contracts concept has implications for basic principles of corporate law. In all these aspects we find that the corporatist manner of thinking has come under attack throughout the 1990s and has given way to economic considerations which are more consistent with the contractual view of the corporation. This does not necessarily mean that there is a causal relation between the concept of the corporation and the structural features discussed below. What is suggested here is that the five aspects of corporate law make up two competing paradigms which are each characterized by a considerable degree of internal consistency.

## *2. The Goal of the corporation*

Regarding the goal of the corporation, the corporatist concept implies that the corporation has its own interest distinct from the interest of individual shareholders. In

legal writings this has been referred to as the interest of the enterprise (“Unternehmensinteresse”). With respect to managerial duties this way of specifying the goal of the corporation means that managers are not primarily regarded as trustees for shareholders but that they are held responsible for the corporate entity, including all its shareholding and non-shareholding members. To some extent the legal concept of the “Unternehmensinteresse” can be seen as a juristic symbol for the post-war settlement between managers, shareholders and workers which characterized the traditional corporate governance system.

When this compromise was challenged by the realignment of managers’ and shareholders’ interests legal scholars increasingly criticized the concept of the “Unternehmensinteresse” for its vagueness and propagated *shareholder value* as a more precise way of specifying the corporate purpose (Mülbert 1997). Other scholars have argued that the intensification of competition and the threat it posed for unprofitable companies have led to a convergence of the enterprise interest – the bottom line of which was seen in the preservation of the corporation – and shareholder value (Schilling 1997). In concert with the dissolution of the corporate entity, the relation between managers and shareholders was reformulated as principal-agent relation (Hopt 1993), indicating a direct relation between managers and shareholders.

Politically, these attacks had a powerful impact. The *Control and Transparency Act* (KonTraG) which introduced the one-share-one-vote rule and legalized stock options and share buy backs in 1998 (Cioffi 2002) is imbued with a shareholder driven interpretation of the corporate purpose. The draft law argues that German companies nowadays compete for increasingly scarce capital and therefore turned to shareholder centred strategies. According to the draft, the Control and

Transparency Act provides active support for these strategies (cf. Bundestag 1998b: 11). Even more important, in 2005 the Bundestag passed the „Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), a bill which – inter alia – aims at facilitating shareholder derivative suits against board members and managers who have breached their duty. In order to protect managers from inappropriate suits of individual shareholders the bill inserts a second sentence into paragraph 93 section I, stock corporations act which exempts the managers from liability if they could assume to have acted in a reasonable way, based on appropriate information *and, most importantly, in the interests of the shareholders (“Gesellschaft”) and not the enterprise.*<sup>5 6</sup> With this provision the legislator has adopted the critique against the enterprise interest as leading principle of managerial actions and has narrowed down the acceptable managerial behaviour to the interests of shareholders alone.

### *3. Mandatory law and enabling law*

Concerning the balance between mandatory and enabling law the contractual turn implies a shift from mandatory to enabling norms. Mandatory law prescribes the formal organizational structure in an indispensable way, while enabling law is made up of default rules which contractors can resort to if they wish to. For the allocation of lawmaking capacities this means that mandatory provisions leave the function of

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<sup>5</sup> Paragraph 93 Section I, sentence 2 of the revised stock corporations act stipulates: “Eine Pflichtverletzung liegt nicht vor, wenn das Vorstandsmitglied bei einer unternehmerischen Entscheidung vernünftigerweise annehmen durfte, auf Grundlage angemessener Information *zum Wohle der Gesellschaft* zu handeln“ (emphasis added).

<sup>6</sup> I thank Alexander Hellgardt (Max Planck Institute for International and Private Law in Hamburg) for pointing this out to me.

corporate law regulation to the state while enabling rules endow contractual partners with self-regulatory capacities.

In Germany, corporate law was primarily made up of mandatory rules. In line with the dominance of corporatist thinking in German jurisprudence, paragraph 23, section IV, of the 1965 stock corporations act prescribes the structure and content of the corporate charter in its very details, leaving only limited room for contractual deviations. From the early 1980s on this norm has been attacked. Instead capital markets were propagated as functional equivalent for rigid mandatory law (Hirte 1998; Hopt 1998; Mertens 1994; Spindler 1998). The argument that private contracting can – under a set of circumstances – yield results at least as efficient as regulations connects to Ronald Coase's seminal article *The Problem of Social Costs* (1960) in which he demonstrated that *assuming the absence of transaction costs* market actors can produce equally much or even more wealth than under a legal regime (with property rights, liability rules, etc.).

The legislator picked up these considerations in the 1990s by passing a series of deregulation bills. In 1994 the Small Corporation Act enabled corporations with less than 2000 employees to opt out from co-determination. In 1998 the Control and Transparency Act (KonTraG) expanded contractual freedom for larger corporations especially with regard to shareholder oriented practices (Cioffi 2002). The draft law makes an unambiguous statement against rigid regulatory rules and expresses its support for capital market oriented solutions (Bundestag 1998b). It is remarkable that law & economics scholars were involved in the drafting of the KonTraG. As an official document from the German Parliament shows the legal committee had heard seven law professors as experts. Strikingly, among the experts were four

contractarians, namely Klaus Hopt, Theodor Baums, Friedrich Kübler and Michael Adams (Bundestag 1998a).

The most recent, and perhaps most important culmination of the contractarian attack against mandatory corporate law can be seen in the *corporate governance code* which became officially published in 2002. When the Federal Ministry of Justice set up a commission to prepare proposals for the modernization of corporate law in 2000 the authority structure within the legal field had shifted from corporatist scholars to economic analysis of law scholars. This is evidenced by the fact that it was Theodor Baums, a leading economic analysis of law scholar who chaired the Corporate Governance Commission on the modernization of corporate law. The Commission Report rejects mandatory rules for their rigidity and proposes to complement existing statutory law with a voluntary code of conduct. More particularly the Baums Commission recommends introducing a corporate governance code of best practices for listed joint stock corporations (Baums 2001) which is created by private actors, mainly investors and managers, and therefore can be characterized as an act of self-regulation.

By implementing the proposed code of best practices corporations can send positive signals to capital markets demonstrating that they are managed according to generally accepted “good governance” standards. The corporate governance code can be considered a successful effort of liberal scholars to shift the delegation for company regulation from state authorities to private law makers, and ultimately to capital markets.

The involvement of law & economic scholars in the design of the KonTraG and the corporate governance code strikingly evidences that legal scholars and their thinking did play a significant role for corporate law reforms.

#### 4. *The rise of capital market law*

Since the mid-1970s Klaus Hopt has propagated the systematization and extension of existing securities regulation to a new area of law (Hopt 1977). Capital market law depicts shareholders as investors who are bound to the company merely in contractual terms. In contrast to corporate law the notion of membership, which asserts shareholders' willingness and capacity to participate in corporate decision-making, is not existent in capital market law. In the 1990s the corporate law discourse has become penetrated by capital market law (Assmann 2003; Merkt 2003).

In response to the increasing importance of capital market law in legal writings the legislator passed a series of bills in the 1990s which aimed at the modernization of the German financial system (Lütz 2002). Implementing the EU Directive on the harmonization of bank and securities law in 1994 the *Securities Exchange Act* created a monitoring agency for security exchange, banned insider deals and extended disclosure requirements.<sup>7</sup> In 2002 the *Takeover Law* was passed. Its function was to facilitate hostile takeovers by providing legal security to the shareholders of the target company and the bidding company and specifying what the manager of the target company is allowed to do and what he is not allowed to do when its shareholders receive a tender offer. Even though Klaus Hopt's proposal to leave decisions concerning takeover bids to shareholders alone ("Stillhaltepflicht") did not become realized (Hopt 1993), the bill significantly constrains the available takeover defences and binds defences against hostile takeovers to shareholder approval. Again Klaus

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<sup>7</sup> Even though my project does not deal with European law, in this particular case it is useful to note that scholars like Klaus Hopt not only advise policy makers on the national level but operate on the European level as advisors for the EU Commission. Hopt's involvement in the High Level Group of Company law and the two reports it has prepared for EU reforms illustrate this (Winter, et al. 2002a; Winter, et al. 2002b).

Hopt became involved in the hearings of the financial committee which prepared both reforms (BT-Drucks. 12/7918: 94; BT-Drucks. 14/7477).

##### *5. The goal of corporate law*

Perhaps the most fundamental change within legal thinking refers to the underlying assumptions about the goal of corporate law. The corporatist style of legal thinking was mainly driven by ethical considerations directed towards the protection of the weak and the sustainment of legal security. Among the generally agreed upon principles were the protection of creditors, workers and minority shareholders (Wiedemann 1980). The overall goal legal scholars had ascribed to corporate law was to allocate rights and duties among different corporate constituencies in a way that produced a *just* corporate order.

After the corporatist compromise had become fragile traditional conceptions of justice which can be seen as being grounded in the post-war settlement became vague and empty. In this situation economic analysis of law could gain prestige by providing an unequivocal measure for the quality of legal norms. Instead of justice legal economists ascribe the goal of *Kaldor-Hicks efficiency* to law (Eidenmüller 1995 [2005]). In what way does Kaldor-Hicks efficiency differ from Pareto efficiency? A rule can be characterized as Pareto efficient when resources are distributed in a way that no reallocation of resources can make a person better off without making at least one other person worse off. One problem with this standard is that courts and legislatures more often than not make at least one interest group worse off. Therefore Pareto efficiency cannot be a realistic guideline (Allen/Kraakman/Subramanian 2007: 4). There are externalities (costs for third parties) even in case of free contracting. The issue of compensation is not being considered by Pareto efficiency standard. The

economists Nicholas Kaldor and John Hicks tried to address the problem of externalities in the 1930s. According to them a rule is efficient if it makes at least one person better off after everyone who was negatively affected by the rule was (counterfactually) compensated. In other words the beneficiaries could – but would not have to – compensate the damaged party and would still be better off afterwards. The aggregate money gains thusly exceed the aggregate money losses.

Compared to different types of material justice the goal of efficiency has the advantage of manageability and precision. While the particulars of corporate justice had become increasingly vague and unclear efficiency gained attractiveness because it allows judges and legislators to precisely measure the effects of legal norms and thereby to assess their quality. The economic reformulation of (corporate) law asserts that the appropriateness of legal norms can be measured by predicting the ensuing behaviour of the recipients with regard to the question, whether they would allocate resources in a wealth-maximizing way. This manner of legal reasoning is highly consistent with the notion of shareholder value as corporate purpose and the predominance of default rules in corporate law. As shareholders are described as *residual claimants* who are the only corporate constituency whose compensation hinges on the total wealth creation, the goal of corporate law converges with shareholder value (Kübler 1999). Thus, the Kaldor-Hicks standard and the residual claimants theorem have enabled legal economists to realign the particular interest of finance oriented shareholders with the general goal of corporate law.

Economic analysis of law scholars did not hesitate to emphasize that efficiency should not be considered as the exclusive metric for the quality or appropriateness of law. Some even point to the limits of efficiency considerations which they see in the constitutionally guaranteed rights (Schäfer/Ott 2005). It also should be noted that

there was some resistance against the economization of corporate law by more traditionally-minded scholars like Thomas Raiser (2006) or Marcus Lutter (2006).

However, the important point is that the growing attractiveness of efficiency considerations has challenged the traditional normative foundations of corporate law. As a consequence of the growing authority of economic analysis of law traditional concepts of justice are no longer the exclusive normative guideline for legal reform. Since conceptions of material justice became challenged by efficiency considerations they have lost their taken-for-grantedness in legal reasoning.

### *Conclusion*

The marketization of the German corporate governance system and the realignment of interests within large corporations have changed the way interpretative authority is allocated across different modes of legal reasoning. While contractarian notions became unpopular during the heydays of organized capitalism the shifting interests of managers and shareholders have produced a mismatch between corporate reality and the corporatist doctrine. This mismatch provided shareholder oriented scholars an opportunity structure to reformulate basic concepts of corporate law in contractarian terms. Responding to the marketization of corporate governance they have dissolved the “enterprise” into a “nexus of contracts”. Along with the changing concept of the corporation such basic principles of corporate law as the balance between mandatory and enabling law, the relation of corporate law to capital market law and the goal of corporate law and the corporate purpose were driven towards a market-oriented approach. The contractual turn in legal scholarship had important consequences for corporate law politics. Picking up contractarian ideas, the legislator

shifted the overall design of corporate law from political regulation to the facilitation of market control. The political transformation of the legal infrastructure for corporate behaviour can be seen as a response to the changing discourse of corporate law and ultimately goes back to the internationalization of financial markets.

However, the legal and political changes not only respond to the changing corporate reality, but they open and close avenues for subsequent corporate behaviour. The legal institutionalization of contested practices can help to legitimate them and therefore serve as a keystone for the diffusion of corporate practices (Sanders/Tuschke 2007).<sup>8</sup>

Looking back at the intellectual history of corporate law it has become evident that the “nexus of contracts” doctrine is not alien to German thought. In all its defining features it is kindred to the ideas Karl Lehmann formulated in the late 19<sup>th</sup> century.<sup>9</sup> With respect to the debate about the development of corporate law in the context of internationalized financial markets this finding implies that the dichotomy between path dependence and convergence is too rigid to capture the combination of continuity and change exhibited by the reactivation of Lehmann’s concept.

More importantly, the rediscovery of ideational resources can facilitate institutional change and increase its pace (Crouch/Farrell 2002). While the erosion of the postwar-settlement undermined the interpretative power of corporatist approaches the seemingly more appropriate contractarianism could build on its historical predecessor to become (re)established relatively quickly. This serendipitous

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<sup>8</sup> The role of the KonTraG for the diffusion of stock options in Germany is a case in point (ebd.).

<sup>9</sup> Rather surprisingly, German “economic analysis of law” scholars have only in a few cases explicitly mentioned the kinship between the 19<sup>th</sup> century theory and the contractarian conception of the corporation. Even though they could have benefited from the hint that their view is in line with the legal tradition, German contractarians presumably have decided to “market” their view of the corporation as an innovation from the United States thereby exploiting the prestige of the American law to (re) impose their notion on the legal system.

combination of intellectual atrophy and rediscovery of dormant meaning resources might explain why law & economics could become so powerful in such a short time.

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