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Lessons from Germany: Improving on the U.S. Model for Corporate Governance

*Tien Glaub**

I. INTRODUCTION

Since the collapse of Enron, a cloud of suspicion and mistrust has loomed over corporate America.¹ The Enron debacle proved to be just the tip of the corporate fraud iceberg.² Evidence of fraud in all major industries exposed the “hidden fundamental weaknesses” of many American companies.³ Enron’s shareholders, typical of millions of defrauded investors, had no idea what was happening behind the scenes until the company’s \$90 stock became worthless.⁴ The scandals scarred both the lives of individual investors, who saw their wealth disappear overnight, and capital markets as a whole.⁵

These scandals highlighted the ineffectiveness of corporate governance rules throughout the United States. Since 2001, the U.S. legislature and public have cried out for changes to corporate governance rules to prevent continued abuses.⁶ In response to the crisis, Congress passed the Sarbanes-Oxley Act of 2002, the most significant public company securities legislation since the Securities Act and the Securities Exchange Act of the 1930s.⁷ On the public

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1. David S. Ruder, *Lessons from Enron: Director & Lawyer Monitoring Responsibilities* (Oct. 10, 2002) (unpublished manuscript, available at http://www.law.northwestern.edu/professionaled/documents/Ruder_Lessons_Enron.pdf).

2. Cherie J. Owen, Comment, *Board Games: Germany’s Monopoly on Two-Tier System of Corporate Governance and Why Post-Enron U.S. Would Benefit from Its Adoption*, 22 *PENN ST. INT’L L. REV.* 167, 169 (2003) (listing WorldCom, Adelphia, Tyco, Global Crossing, and K-Mart as other prominent examples).

3. Carrie Johnson & Brooke A. Masters, *Fraud Cases Focus on Top Executives*, *WASH. POST*, Jan. 18, 2005, at A01.

4. Joel Seligman, *No One Can Serve Two Masters: Corporate & Securities Law After Enron*, 80 *WASH. U. L.Q.* 449, 453–54 (2002).

5. Del Quentin Wilber, *Turbulence Over Executive Pay: Airline Workers Question Leaders’ Bonuses After Rank-and-File Pay Cuts*, *WASH. POST*, May 22, 2007, at D01.

6. *See infra* note 7.

7. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat 745 (2002) (codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.) (increasing accounting transparency of corporate audit systems, mandating independence in audits, setting ethical standards for accounting and key executives, enhancing financial disclosure to prevent self-dealing, insider trading, abusive pension plans, and increasing liability for failure to comply).

side, the American Bar Association urged reform of the governance structure of American corporations and autonomy of the board of directors.⁸ Some legal commentators advocated adoption of a modified version of the German two-tier board structure as the best model for corporate governance.⁹ Others remained loyal to the traditional one-tier board, after which the American corporate governance system is modeled.¹⁰

Based on the current post-Sarbanes-Oxley state of U.S. corporate governance, this Comment recommends American adoption of some characteristics of the German governance model and rejection of others. After a short historical background of comparative corporate governance, Part II recommends that the American board incorporate two components of the German model: its two-tier board structure and its externally controlled auditing procedure. Part III advocates that the American board diverge from the German model with regard to two other components by granting more authority to the supervisory board and eliminating labor participation in corporate governance. American corporate governance can be greatly improved through selective adoption of the German two-tier board structure and externally controlled auditing procedures, while further legislation can address concerns with the German model by increasing the authority of the supervisory board and eliminating labor participation.

II. COMPONENTS OF THE GERMAN MODEL TO BE ADOPTED

While the goal of any corporate governance scheme is to ensure the corporation's well being, considerable debate continues to exist over whether the German two-tier board is superior to the American one-tier system.¹¹ Rather than a wholesale adoption of the German two-tier board model, this Part suggests that the American board incorporate the German board structure and audit system and

8. AMERICAN BAR ASSOCIATION, PRELIMINARY REPORT OF THE ABA TASK FORCE ON CORPORATE RESPONSIBILITY, (2002), available at http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

9. See Lauren J. Aste, *Reforming French Corporate Governance: A Return to the Two-Tier Board?*, 32 GEO. WASH. J. INT'L L. & ECON. 1 (1999) (comparing changes of the French one-tier board model to the German two-tier board).

10. See Florian Stamm, *A Comparative Study of Monitoring of Management in German and U.S. Corporations After Sarbanes-Oxley: Where Are the German Enrons, WorldComs, and Tycoos?*, 32 GA. J. INT'L & COMP. L. 813 (2004).

11. Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 252 (2002).

explains how these components will improve corporate governance in America.

A. Two-Tier Board Structure

One major difference between American and German business models is the structure of a corporation's board of governance.¹² The one-tier board, which has been adopted by a majority of European countries and the United States, has roots stretching back to the structures of European companies incorporated in the 17th century.¹³ The one-tier board includes both executive directors who manage the business of the corporation and non-executive directors who indirectly oversee management of the corporation and involve themselves in only the corporation's major transactions.¹⁴ The executive directors hire corporate officers (such as president, vice-president and treasurer) to manage the corporation's day-to-day activities.¹⁵

The two-tier model has an upper tier, the supervisory board, which oversees a lower tier of management composed of senior executives.¹⁶ Unlike the one-tier board, the German supervisory board typically has no authority even in major transactions of the corporation, although specific transactions may be subject to the approval of the supervisory board if the articles of the corporation so provide.¹⁷ Because of its supervisory nature, members are excluded from the management board. This exclusion gives the German board an advantage over the self-supervising relationship between the non-executive and the executive directors in the American one-tier board.

There are two major differences between the two-tier board and one-tier boards. First, because the board of directors oversees the senior executives who are often the executive directors themselves,

12. Owen, *supra* note 2, at 175.

13. Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe: Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, (European Corporate Governance Inst., Law Working Paper No. 18,2004), available at <http://ssrn.com/abstract=487944>.

14. DEL CODE ANN. tit. 8 § 141(a) (1999) (stating that business and affairs of every corporation "shall be managed by or under the direction of a board of directors, except as may otherwise provided in this chapter or in its certificate of incorporation"); MODEL BUS. CORP. ACT § 8.01 (1984) (stating that all corporation powers "shall be exercised by or under the authority of its boards of directors . . .").

15. Owen, *supra* note 2, at 172.

16. Hopt & Leyens, *supra* note 13, at 5.

17. *Id.*

the one-tier board provides opportunities for self-dealing.¹⁸ For example, Ken Lay was both CEO and chairman of the board of directors of Enron, which created an atmosphere of inadequate oversight.¹⁹ The two-tier board structure excludes all executives from its supervisory board and thus the supervisory board cannot become directly involved in managing the company.²⁰ This separated structure and its associated efficiencies, now adopted in many European countries, allows for more independent supervision of the management.²¹ Another advantage of the two-tier structure is procedural efficiency. For instance, the supervisory board can hold private meetings for matters such as management compliance and compensation.²² The separate supervisory board structure offers advantages compared to that of the combined one-tier board such as a clearer scope of duties and a better application of any measures of a director's independence.²³ The smaller size of the supervisory board also facilitates compliance with the British "independence test"²⁴ or American civil and criminal liabilities laws.²⁵

One weakness of the American system is difficulty in enforcement of liabilities laws. The recent repetition of Enron-type scandals in companies across the American markets demonstrated that American liabilities laws did not deter "arrogant, greedy, selfish and heartless" executives from violating their fiduciary duties.²⁶ Additionally, rules excluding executive directors from compensation committees or including a majority of independent directors on the one-tier board are criticized as being both ineffective and a cause of the public's "distrust of corporate managers."²⁷ This is arguably because independent directors will "rarely if ever act to change the management."²⁸ Adoption of the German two-tier board structure

18. Owen, *supra* note 2, at 185.

19. *Id.* at 185 n.121.

20. Hopt & Leyens, *supra* note 13, at 5.

21. *Id.*

22. *Id.*

23. Owen, *supra* note 2, at 184.

24. Hopt & Leyens, *supra* note 12, at 13 (listing seven indicators of director's independence from British Combined Code).

25. MODEL BUS. CORP. ACT § 8.33 (2003).

26. Wilber, *supra* note 5.

27. Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 49 (1987) (noting that the American Law Institute's approach to corporate governance continues to reflect distrust of corporate managers).

28. Alfred F. Conard, *Comparative Law: The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L.

will be a significant step toward a truly independent supervisory board and will help overcome problems with conflicts of interest.

B. Audit System

Compared to other countries' auditing systems, the German system has a number of significant advantages. The primary advantage is that the two-tier structure allows the German supervisory board to have complete independence in performing its audits. The German audit system strikes a balance between the Italian version of the two-tier model and the British and American one-tier models.

Italian corporate law takes audits for listed companies very seriously.²⁹ It mandates that the supervisory board serve an internal auditing function while the management board runs the company.³⁰

In the United States, Enron's collapse exposed the conflicts of interest involved in corporate auditing and prompted the enactment of the Sarbanes-Oxley Act.³¹ The Act does not change the board structure, but focuses on protecting investors by "improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws,"³² including the empowerment and protection of whistleblowers.³³ Even so, the criminal liability provided in the Act to punish whistleblower retaliators is "in some ways more limited than the corresponding civil liability provisions."³⁴

In Britain, legislators proposed removal of the shareholders' power to choose auditors and fix their remuneration, giving this power instead to their one-tier board.³⁵ Hence, British rules create a potential conflict of interest in which the directors have power to

REV. 1459, 1472 (1984) (stating that a director "must be willing to take on the unpleasant assignments that can go with the position, such as getting rid of incompetent management," and that "[t]he ultimate protest of a director, of course, is to resign from the board").

29. Legislative Decree No. 58 (Feb. 24, 1998); Gazz. Uff. No. 71 (Mar. 26, 1998). An English translation of the law is available at http://www.ecgi.org/codes/documents/testo_unico_eng.pdf.

30. *Id.* art. 149.

31. Seligman, *supra* note 4, at 515-16.

32. Sarbanes-Oxley Act of 2002 pmbL, Pub. L. No. 107-204, 116 Stat 745 (2002).

33. *Id.* § 1107.

34. Dennis Block & Jonathan Hoff, *Whistleblowers Protection Under The Sarbanes-Oxley Act*, N.Y. L.J., June 26, 2003, at 2, available at <http://www.cadwalader.com/assets/article/BlockHoff062603.pdf>.

35. Secretary of State for Trade and Industry, *Modernising Company Law*, Presented to Parliament by Command of Her Majesty (July 2002).

hire and fire auditors who would audit the directors themselves or their fellow board members.

By contrast, in the German two-tier board model, the supervisory board handles the audit completely and exclusively.³⁶ Auditors submit their report directly to the supervisory board and participate in meetings concerning approval of annual accounts.³⁷ This structure ensures a truly independent audit process by eliminating potential conflicts of interest. The German audit system also maintains the auditing report's confidentiality and preserves any evidence of managerial misbehavior.³⁸

One concern with the German system is that exclusion of the supervisory board from management may limit its right to obtain information directly and prevent members from developing an "objective picture of the company's performance."³⁹ This concern is based on the mistaken assumption that obtaining information directly from the management board is the only way to learn about a company's performance. To the contrary, board members can glean information regarding company performance through due diligence and regular meetings with employees, corporate auditors, customers, government auditors, suppliers, or creditors and can exercise significant control over the flow of information by simply being actively involved.⁴⁰

Adoption of the German audit system would help eliminate potential conflicts of interest inherent in the American system by allowing for an independent audit. Concerns about the supervisory board's limited right of access to company information may be overcome through the board's active oversight or by increasing board authority as explained below.

III. COMPONENTS OF THE GERMAN MODEL TO BE AVOIDED

Despite the advantages afforded by the German corporate governance model, there have been several attempts in Germany to adopt the American one-tier model.⁴¹ For example, Joseph Ackermann, the leader of Deutsche Bank, which has operations in

36. Hopt & Leyens, *supra* note 13, at 10.

37. *Id.*

38. *Id.* at 6-8.

39. *Id.* at 9.

40. *Id.*

41. *Id.* at 9-10.

the United States, has diverged from the two-tier model by taking positions on both the supervisory and executive boards.⁴² Nevertheless, mainstream European corporate governance continues to move toward elimination of mandated employee board participation and a clearer distinction between the two tiers of the corporate board.⁴³ As discussed above, this Comment concurs with the general European trend and suggests that the American board should adopt the two-tier structure and the German auditing system. However, it should diverge from the German model by increasing the authority of its supervisory board and eliminating employee participation.

A. Supervisory Board Authority

There are two concerns with the authority of the supervisory board in the German two-tier board model. The first, as addressed in Part II, is the limitation of the supervisory board's right to information regarding company performance. Without sufficient information, the supervisory board may not have enough power to take a stand against the management.⁴⁴ Paradoxically, the second concern revolves around the possibility that the supervisory board will wield too much power—a balance of power that can negatively interfere with management's business judgment.⁴⁵ While the balance of power should be continually assessed, the best way to resolve concerns regarding supervisory board authority is by granting it increased authority.

Although the supervisory board can access essential information from various parties external to the corporation, without a formal grant of power from the legislature it may encounter significant resistance from these entities. A greater extension of power will

42. Ackermann's application of the American concepts of executive compensation to the German system brought him into the center of Germany's most high-profile corruption case in decades. See *Mannesmann Defendants Not Guilty*, British Broad. Corp. (22 July, 2004), available at <http://news.bbc.co.uk/2/hi/business/3915717.stm> (reporting bonus payments worth \$74 million (£40 million) to executives); see also Igor Reichlin, *On Trial: Whither Germany? The Trial of Deutsche Bank CEO Ackermann Reflects a Battle Over Whether German Companies Can Become More Global*, The Chief Executive, Dec. 2003, available at <http://www.encyclopedia.com/doc/1G1-111737855.html>.

43. See, e.g., Hopt & Leyens, *supra* note 13, at 16–18.

44. *Id.* at 9.

45. Aste, *supra* note 9, at 36 (reciting Paul Le Cannu's concern that the "power imbalance" between the two boards resulted from the supervisory board's greater power over the management).

enable it to extract all information necessary to effectively carry out its audit function. Whereas a lack of explicit authority may discourage cooperation between the supervisory board and the previously mentioned entities, a formal grant of power would serve to enhance collaborative efforts between the supervisory board and those entities privy to important information.

Additionally, though purported to be strictly separate from corporate management, the lack of sufficient authority in the German model may render the German supervisory board a mere “Potemkin Village,” similar to the purported independence of American board directors.⁴⁶ In fact, Gerd Weisskirchen, a senior legislator of the German Social Democratic Party, commented on the 2008 Volkswagen corporate corruption scandal: “We’re in a painful transition from the old corporate Germany toward one with a new face.”⁴⁷ Referring to the alignment of the German corporate governance model with the American one-tier board model, the “new face,” as the Director of the Volkswagen Center for Automotive Research predicted,⁴⁸ would be a Potemkin façade made of ineffective independent directors and would “block judicial control of mismanagement.”⁴⁹

When greater power is bestowed upon the supervisory board, the second concern that it has too much authority becomes paramount. But a system of checks and balances adequately resolves this concern.⁵⁰ Indeed, governments could more effectively implement these checks and balances under a separate two-tier structure where the supervisory board has authority independent from the executives, so that executives do not otherwise “set, mark, and report on their own exam papers.”⁵¹

Nevertheless, American proponents of the one-tier board model

46. Conard, *supra* note 28, at 1468 (citing Victor Brudney, *The Independent Directors: Heavenly City or Potemkin Village?* 95 Harv. L. Rev. 597 (1982)). “Heavenly City” is an allusion to the dream of a rational society, while “Potemkin Village” is an allusion to false facades constructed by General Potemkin to please Catherine the Great in her tours of the countryside. *Id.*

47. Mark Landler, *German Court Returns First Jail Term in VW Corruption Scandal*, INT’L HERALD TRIB., Feb. 22, 2008, <http://www.iht.com/articles/2008/02/22/business/vw.php>.

48. *Id.* (citing the director’s fear that they were not addressing the underlying issues).

49. Conard, *supra* note 28, at 1468.

50. Owen, *supra* note 2, at 184.

51. Roberto Herrera-Lim, *The Case for Two-Tier Boards in the Modern Corporation*, Securities and Exchange Commission of Pakistan (2009), *available at* <http://www.sec.gov.pk/rc/RoleOfDirectors/CaseTwo-TierBoards.pdf>.

consider the two-tier model outdated.⁵² For instance, in a 1997 corporate symposium, Patrick Speeckaert, then Managing Director of the International Division of Morrow & Company, stated that “European corporate governance is where American corporate governance was five to seven years ago.”⁵³ Regardless of whether Mr. Speeckaert’s perception was based on the two-tier board model as a whole or, more specifically, its mandatory employee participation, he was unsuccessful in personally proving the superiority of the one-tier board model due to his own corporate failures.⁵⁴

Although valid concerns regarding authority of the supervisory board in the German two-tier model exist, a robust system of checks and balances is an effective deterrent against the threat of too much power. At the same time, this system allows for the increased authority necessary for the supervisory board to effectively carry out its auditing function.⁵⁵ Even though a system of checks and balances is theoretically possible within the framework of the American one-tier model, the German two-tier board model, where real authority is reserved for the upper tier, is likely a better conduit for the effective implementation of a balanced system of power distribution.

B. Employee Participation

The German board model allows employee participation in corporate governance. The United States would be wise to avoid such schemes. In Germany, employees participate in corporate governance by electing half of the members of the upper-tier board of directors.⁵⁶ This type of employee participation or worker consultation can facilitate the flow of information needed for an independent advisory board,⁵⁷ thereby making it more effective. However, this system would not work well in the United States due

52. See, e.g., Patrick Speeckaert, *Corporate Governance in Europe*, 2 FORDHAM FIN. SEC. & TAX L. FORUM 31 (1997).

53. *Id.*

54. See Odyssey Pictures Corp., Current Report (Form 8-K), at 2 (Dec. 27, 2004), available at <http://www.secinfo.com/d12PMe.11z.htm>. Until Speeckaert’s 2004 resignation as director “without comment,” Odyssey suffered a number of financial setbacks. Odyssey Pictures Corp., Current Report (Form 8-K) (Feb. 15, 2008), available at <http://www.secinfo.com/d13Ka8.t1.htm?Find=Speeckaert&Line=258#Line258>.

55. Herrera-Lim, *supra* note 51.

56. Henry Hansmann & Reinier Kraakman, Essay, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 445 (2001).

57. DIRK VAN GERVEN & PAUL STORM, *THE EUROPEAN COMPANY* 17 (Cambridge University Press, 1st ed. 2006) (noting the structural effects of employee participation).

to its business culture and labor policies such as employment-at-will and collective bargaining.⁵⁸

Some observers have criticized the ineffectiveness of labor participation in corporate governance.⁵⁹ Others have predicted that participation will become a European trend, as many European states are satisfied with labor's involvement.⁶⁰ The European Union Directive deals with the split by leaving decisions on labor participation to individual states.⁶¹

A country's history and culture create different priorities in its legal system. For instance, German employee participation in corporate governance and unionism is deeply ingrained in the country's culture, with historical roots dating back to the Weimar Republic of the 1920s.⁶² In the United States, on the other hand, a system has developed that includes shareholders and lenders in its corporate governance.⁶³ U.S. corporations must also embrace a national free-market economy⁶⁴ and a flexible labor law system, which allows an employer to dismiss an employee at any time for "a good reason, a bad reason, or for no reason at all."⁶⁵

Thus, in the American system, employees do not have voting rights in the corporation unless they themselves are shareholders. A lack of equity interest excludes employees from voting in the corporate general election in order to ensure the integrity of corporate governance. As such, mandated employee participation in electing the board would not mesh with American free market principles. Finally, required employee participation would conflict

58. Tom Werner, *The Common Law Employment-At-Will Doctrine: Current Exceptions for Iowa Employees*, 43 *DRAKE L. REV.* 291, 293 (1994).

59. Hopt & Leyens, *supra* note 13, at 22 (citing recent scandals in F.R.G. as evidence of co-determination as ineffective both as a guarantee against excessive remuneration of management and as a safeguard against costly strikes).

60. Hildegard Waschke, *Workers' Participation in Management in the Nine European Community Countries*, 2 *COMP. LAB. L.* 83, 101 (1977) (describing workers' participation in management in Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands and the United Kingdom); see Dieter Sadowski, Joachim Junkes & Sabine Lindenthal, *Employees and Corporate Governance: Germany: the German Model of Corporate & Labor Governance*, 22 *COMP. LAB. L. & POL'Y J.* 33, 66 (2000) (stating that codetermination may promote positive changes).

61. Hopt & Leyens, *supra* note 13, at 22 (observing that the 5th Directive leaves the decision on labor participation to member states' discretion).

62. Hansmann & Kraakman, *supra* note 56, at 444.

63. Stamm, *supra* note 10, at 834.

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

65. Werner, *supra* note 58.

with U.S. labor laws that allow corporations to fire an employee for any non-discriminatory reason. Employers might exercise this power to control whether and which employees actually participated in corporate governance.

Several countries have discovered that employee and labor union participation in corporate governance cannot coexist. Italian, Belgian, and French unions came to suspect that employee participation diluted their unions' impact on management.⁶⁶ In the United States, employee participation attracted attention in the 1970s, when adversarial unionism lost its role in dealing with labor contracting.⁶⁷ The attention soon waned, but, unlike calls for employee participation, unions did not disappear.⁶⁸ Indeed, they maintain a significant role in contractual negotiations and collective bargaining.⁶⁹

Unions and employees participating in corporate governance affect each other in a variety of ways. First, employee participation undermines the role of the union if an employee can work in tandem with the boss on corporate governance issues without union involvement. Second, the union may taint the independence of employee board members because they may "qualify as being free from any direct business relationship but are bound to the union's members, i.e. the employees."⁷⁰

Although the employee participation system has a unique historical significance in Germany, its application to American corporate governance is complicated by differences in American culture and labor policy concepts. Furthermore, the potential conflicts inherent in employee union affiliations may harm rather than benefit the American board's independence. Accordingly, the United States should avoid adopting the employee participation aspects of the German board model.

IV. CONCLUSION

As Paul Davis has observed: "There is no 'one best' system of corporate governance. Rather, each system has different

66. Waschke, *supra*, note 60, at 97.

67. *See* O'Connor, *supra* note 64.

68. *Id.*

69. *Id.*

70. Hopt & Leyens, *supra* note 13, at 22 (stating that these members would not pass the directors' independence test).

advantages.”⁷¹ Compared to the existing U.S. one-tier model, the German two-tier board better equips the supervisory board to check and balance corporate management. The German audit system is superior because it produces an authentic picture of company performance without any conflict of interests. Despite these two distinct advantages, the German supervisory board does not have enough authority to ensure its independence. The German model also mandates employee participation, which would likely not work in the American business environment. For these reasons, the United States should adopt the German two-tier board structure and its audit system but should avoid German policies of limited supervisory board authority and employee participation in corporate governance. By implementing these aspects of the German system, the American corporate governance system could more properly balance the many competing interests necessary to secure a corporation’s success.

71. Paul Davies, *Employee Representation & Corporate Law Reform: A Comment from the United Kingdom*, 22 COMP. LAB. L. & POL’Y J. 135, 136 (2000).