

# **CORPORATE GOVERNANCE IN POST-PRIVATIZED SLOVENIA**

## **Rado Bohinc**

Professor of Business and Labor Law, Faculty of Social Sciences, University of Ljubljana, Slovenia; Visiting Scholar, UCLA School of Law, 1999

## **Stephen M. Bainbridge**

Professor, UCLA School of Law

Professor Rado Bohinc UL  
Faculty of Social Sciences,  
Dunajska 104, 1000 Ljubljana, Slovenia;  
Rado.Bohinc@guest.arnes.si  
386 61 1881 260 (voice)  
386 61 1881 263 (fax)

Professor Stephen M. Bainbridge  
UCLA School of Law  
405 Hilgard Avenue  
Box 951476  
Los Angeles, California 90095-1476  
bainbrid@law.ucla.edu  
310.206.1599 (voice)  
310.825.6023 (fax)



# **Corporate Governance In Post-Privatized Slovenia**

1999 Rado Bohinc and Stephen M. Bainbridge

## **ABSTRACT**

The basic building blocks of post-privatization Slovenian corporate governance differ rather dramatically from those of the United States. Slovene corporations are characterized by highly concentrated ownership dominated by state-controlled funds and other institutional investors. In addition, Slovene corporation law provides for a two-tier board of directors (similar to the German codetermination system) in which employees are entitled to representation on both the management and supervisory boards. This article provides an analysis of these features, exploring possible reforms in Slovenian law that might enhance the effectiveness of Slovene boards of directors.

JEL Classification Codes: G30, G38, K22, P31



# Corporate Governance In Post-Privatized Slovenia

by

Rado Bohinc\*

and

Stephen M. Bainbridge\*\*

I. Post-Privatization Slovenia.....	4
A. The Slovene Economy in Transition.....	4
B. The Privatization Process: Creating Shareholders.....	5
C. Employee Corporate Governance Rights.....	11
II. The Costs and Benefits of Concentrated Ownership.....	14
III. Who Decides? The Two-Tier Board and the Powers of Directors.....	21
A. Two-Tier Boards: An Economic Analysis.....	21
B. Options.....	26
IV. Conclusion.....	29

In May 1993, the Parliament of Slovenia adopted a new corporation law—the Law on Commercial Companies<sup>1</sup> (“LCC”)—one of the most important laws enacted post-independence. LCC replaced the former Enterprise Law, enacted in the last years of former Yugoslavia (1988), which had attempted to reintroduce—after five decades of state and social ownership—a capitalist, free market, property rights-based corporate law.<sup>2</sup> The new LLC was modeled on European law, rather than the Anglo-American model;<sup>3</sup> specifically, the German Aktiengesetz statute.<sup>4</sup>

---

\* Professor of Business and Labor Law, Faculty of Social Sciences, University of Ljubljana, Slovenia; Visiting Scholar, UCLA School of Law, 1999.

\*\* Professor, UCLA School of Law.

<sup>1</sup> Official Gazette of the Republic of Slovenia (hereinafter RS), No. 30/93 [hereinafter LCC].

<sup>2</sup> Enterprise forms under the former system were labor-managed or self-managed and, as such, were not comparable with capitalist-owned corporations. *See, e.g.*, Law on Associated Labor, Off. Gazette SFRJ No. 53/1976 [hereinafter LAL], and Law on Enterprises, Off. Gazette SFRJ No. 77/88, 40/89, 46/90 [hereinafter LE]. On the Enterprise law, see See on Enterprise law: Rado Bohinc, *Nova slovenska podjetni\_ka zakonodaja (New Slovene Enterprise Legislation)*, Podjetje in delo 6/91 (1991).

<sup>3</sup> In contrast, Slovene securities legislation is more closely-patterned on a U.S. model. *See, e.g.*, Law on Take Over, Off. Gazette of RS, No. 47/1997; Law on Dematerialized Securities, Off. Gazette of RS, No.23/1999; Law on Securities Market, Off. Gazette, No. 56/1999; Law on Investment Corporations and Investment Funds, Off. Gazette, No. 6/1994.

<sup>4</sup> According to the German Stock Corporation Act, (Aktiengesetz (AktG)), *see also* Act on Control and Transparency of Companies—Gesetz zur Kontrolle und Transparenz im Unternehmensbereich—KonTraG Act, 1998, which amends AktG), a two-tier board of directors is compulsory for a stock corporation (Aktiengesellschaft (AG)). The AG’s board consists of the

Accordingly, Slovene corporate governance includes many features of German or Austrian corporations, especially a codetermination-based system of corporate governance that includes a two-tier governance system with employee participation on both the supervisory board and management board.<sup>5</sup>

Enactment of a new corporation law, of course, scarcely sufficed. Slovenia also needed to go through a process of privatizing its social-owned enterprises. Privatization was effected by a mandatory allocation of shares to a combination of public funds, employees, former employees, plus a public sale of shares. As a result, Slovene corporate share ownership is now bifurcated between large and potentially influential institutional shareholders and relatively powerless diffuse small holders.<sup>6</sup> At the same time, however, in most companies the privatization process created important employee-shareholder ownership blocks. In addition, Slovenian law granted employees substantial corporate governance rights.<sup>7</sup>

The basic building blocks of Slovene corporate governance thus differ rather dramatically from those of the United States. As Berle and Means famously demonstrated, U.S. public corporations are characterized by a separation of ownership and control: the firm's nominal owners, the shareholders, exercise virtually no control over either day to day operations or long-term policy.<sup>8</sup> Instead, control is vested in the hands of professional managers, who typically own only a small portion of the firm's shares.<sup>9</sup> This separation is carved into stone by U.S. corporate law—under all corporation statutes, the key players in the formal decision making structure are the members of the board of directors. As the Delaware code puts it, the corporation's business and affairs “shall be managed by or under the direction of a board of directors.”<sup>10</sup> The vast majority of corporate decisions accordingly are made by the board of directors or their subordinates acting alone. Shareholders essentially have no power to initiate corporate action and, moreover,

---

executive or management board (Vorstand, AG, par.: 6.-94.), and a separate supervisory board (Aufsichtsrat, AG, par.:94.-117.). The supervisory board concept is difficult to translate into terms familiar to those trained in U.S. forms of corporate governance. Its statutory mandate is primarily concerned with the appointment and supervision of the managing board. Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT'L REV. L. & ECON. 203, 204 (1994). In theory, employees and shareholders are equally represented on the supervisory board. In practice, however, the board is often controlled either by the firm's managers or a dominant shareholder. Id.

<sup>5</sup> On the distinction between management and supervisory boards, and employee entitlement to representation thereon, see *infra* notes 42-49 and accompanying text.

<sup>6</sup> See *infra* Part I.

<sup>7</sup> See *infra* Part III.

<sup>8</sup> ADOLF A. BERLE AND GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

<sup>9</sup> Id. at 2-5.

<sup>10</sup> Del. Code. Ann., tit. 8, § 141(a) (1998).

are entitled to approve or disapprove only a very few board actions.<sup>11</sup> The statutory decisionmaking model thus is one in which the board acts and shareholders, at most, react.

At the same time, however, U.S. employees have no formal corporate governance role. Only shareholders are entitled to elect directors and no corporation statute mandates employee representation on the board. U.S. corporate law scholarship has thus largely ignored employees.

The distinctions between the U.S. corporate governance model and that of Slovenia thus pose a number of interesting questions. Comparing the respective roles of directors, shareholders, and employees sheds light on basic theoretical issues. At the same time, a comparison of the two models has immediate practical law reform implications. As a legal regime matures, the costs of drastic change rise. Settled expectations, long-standing investments, and vested political interests with a stake in preserving the status quo can all give rise to a lock-in effect that precludes major reform. As with other transition economies, Slovenia's relatively young corporate governance model presumably is more open to reform than the well-settled U.S. one. Given that it has been 5 years since the LLC was adopted, it is thus time to reassess the decisions Slovenia made in the post-privatization period.

In this article, accordingly, we use the comparative law method, so as to explore the differences and the similarities between US and Slovene corporate governance, and to identify possible societal and economic reasons for their divergences. The study of comparative law has a stronger tradition in European legal scholarship than in U.S. scholarship.<sup>12</sup> In the European tradition, comparative law connotes a process of comparison rather a method of legal analysis, and a process of studying the relationships of legal systems rather than a free-standing system of rules

---

<sup>11</sup> Under the Delaware code, shareholder voting rights are essentially limited to the election of directors and approval of charter or by-law amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolutions. As a formal matter, only the election of directors and amending the by-laws do not require board approval before shareholder action is possible. See Del. Code Ann., tit. 8, §§ 109 and 211 (1998). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board.

<sup>12</sup> Kai Schadbach, *The Benefits Of Comparative Law: A Continental European View*, B.U. INT'L L.J. 331 (1998), observes:

Learning another system not only increases the quantity of knowledge, but also adds a qualitatively different type of knowledge. Specifically, comparative law challenges the lawyer's knowledge about her own system with the different results and approaches of the foreign system. For example, the foreign system may offer different rules and approaches to deal with the same legal problem, such as frustration of contract. In analyzing the underlying policies of the different systems, or the reasoning of the two approaches, the lawyer gains a more comprehensive understanding of both her particular system, and the law in general. Furthermore, the simple awareness of alternatives enlarges the lawyer's intellectual stock, making her analytically better trained and more adept in dealing with complex legal questions within her own legal system.

and principles. Mere description of foreign legal institutes and systems is not regarded as comparative law, but rather as international or foreign law. Instead, our focus is on comparisons of the spirit and style of legal regulation of the same issue in different countries.

Because relatively few American scholars or lawyers are familiar with Slovenia, Part I of this Article devotes some attention to Slovenia's progress through the transition to a market economy and towards European Union (EU) membership, with particular emphasis on the process by which state-owned enterprises were privatized and the rights of employees under the LLC. Part II explores the director—shareholder relationship, focusing on the potential benefits and costs of the highly institutionalized ownership that resulted from the privatization process. Part III explores employee representation on the board, both as a counterweight to the influence of institutional owners, but also on its own merits.

## I. POST-PRIVATIZATION SLOVENIA

### A. The Slovene Economy in Transition

Slovenia is a parliamentary democracy in which “supreme power is vested in the people.”<sup>13</sup> One of the youngest European countries, Slovenia became an independent state in 1991, after the collapse of the Yugoslav federation.<sup>14</sup> Slovenia became the 176th member of the UN and is a full member of the Central European Free Trade Agreement, a participant in NATO's Partnership for Peace, a founding member of WTO, and an associate member of the EU. It is located between the southeastern reaches of the Alps and the northern Adriatic Sea. With a GNP per capita of U.S. \$9,680 in 1997, Slovenia is one of the most prosperous transition economies.

Slovenia's Constitution, adopted on 23 December 1991, exactly one year after the plebiscite approving an independent state, provides a parliamentary system of government. The highest legislative authority is the National Assembly (*Državni zbor*) consisting of 90 deputies elected for a term of four years by secret ballot, on the basis of universal adult suffrage.

---

<sup>13</sup> Article 3, Constitution of the Republic of Slovenia.

<sup>14</sup> The history of Slovenia begins in 7th century, when Western Slavic tribes formed an alliance with the Slavic Duchy of Carantania. In 745, Carantania became a part of the Frankish empire. The Slavs converted to Christianity and gradually lost their independence. During the 14th to 16th centuries, The House of Habsburg extended its control over most of Slovenia. In 1918, Slovenia was liberated from the former Austro-Hungarian monarchy. In December of that year, the Kingdom of Serbs, Croats and Slovenes was established. That entity later became the Kingdom of Yugoslavia, which in turn (during the Second World War) became the Democratic Republic of Yugoslavia and, subsequently, the Socialist Federal Republic of Yugoslavia. On June 25, 1991, The Republic of Slovenia officially declared its independence, separating from Yugoslavia. Slovenia then began an on-going process of entering the global market and undertook substantial political reforms.

The vast majority of the population are Slovenes (87.84%-1991 census). Italians and Hungarians are considered indigenous minorities with rights protected under the Constitution. The majority of the religious population is Roman Catholic, although there are small communities of other Christian denominations (in particular Protestants in the eastern parts of the country) and of Muslims and Jews.

In June 1993, the European Council approved a process by which Slovenia (along with other Central and Eastern European states) would progress towards EU membership.<sup>15</sup> At present, despite some unfavorable assessments by the IMF and EU of the pace of reform,<sup>16</sup> Slovenia is on its way towards full integration into the European economy and a plausible candidate for early accession to the EU. Slovenia has the highest per capita GDP among applicant countries; indeed, Slovenia's per capita GDP is higher than EU-member Portugal and close to that of Greece.<sup>17</sup> Nonetheless, further reform and economic growth will be necessary before Slovenia can accede to full EU membership. Hence, our interest in assessing whether Slovenia's corporate governance model promotes or retards economic efficiency.<sup>18</sup>

## **B. The Privatization Process: Creating Shareholders**

Prior to privatization, all enterprises in Slovenia were socially (not state) owned. Social ownership was a nonownership concept based on a self-management system of corporate governance. In practice, firms were run by executive managers and controlled by boards composed of employees (worker's councils). These social (self-management) enterprises had been created out of so-called Organizations of Associated Labor, a pre-existing enterprise form.<sup>19</sup> Social ownership sought to replace market mechanisms with societal agreements and self-management contracts. This model was replaced in 1988 by a law on enterprises,<sup>20</sup> which for the first time in 50 years enacted property rights-based forms of business organizations.

---

<sup>15</sup> II AGENDA 2000: THE EFFECTS ON THE UNION'S POLICIES OF ENLARGEMENT TO THE APPLICANT COUNTRIES OF CENTRAL AND EASTERN EUROPE, <<http://www.europeonline.com/search/index.htm>>.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> We assume that efficient corporate governance can promote overall economic efficiency, while recognizing that the economic impact of corporate governance reform will often (perhaps typically) be swamped by other economic factors. *Cf.* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 140-47 (1993) (criticizing claims that corporate governance has measurable effects on national competitiveness and productivity).

<sup>19</sup> Law on Associated Labor, Off. Gazette SFRJ, No. 53/1976.

<sup>20</sup> Law on Enterprises, Off. Gazette SFRJ, no. 77/88, 40/89, 46/90 and 61/90.

Slovene social enterprises privatization legislation, enacted in 1992,<sup>21</sup> was based on two core principles: partial (free) distribution of shares to employees and partial allocation of shares to state funds. A Privatization Fund was established to oversee the process of privatizing socially owned property, including business enterprises.<sup>22</sup> By 1998 most of the socially owned companies had been privatized.<sup>23</sup> Three distinct mechanisms were used to effect that process:

- Privatization by public sale of shares: Forty percent of the privatized corporation's shares was offered to the general public; twenty percent was distributed free to employees, former employees, and their relatives; and forty percent was allocated to three state funds (a state development fund received 20%, while state indemnification and pension funds received 10% each). Corporations privatized by this method began with relatively diffuse ownership, although there has been increasing institutionalization of their ownership. (See Figure 1.)<sup>24</sup>

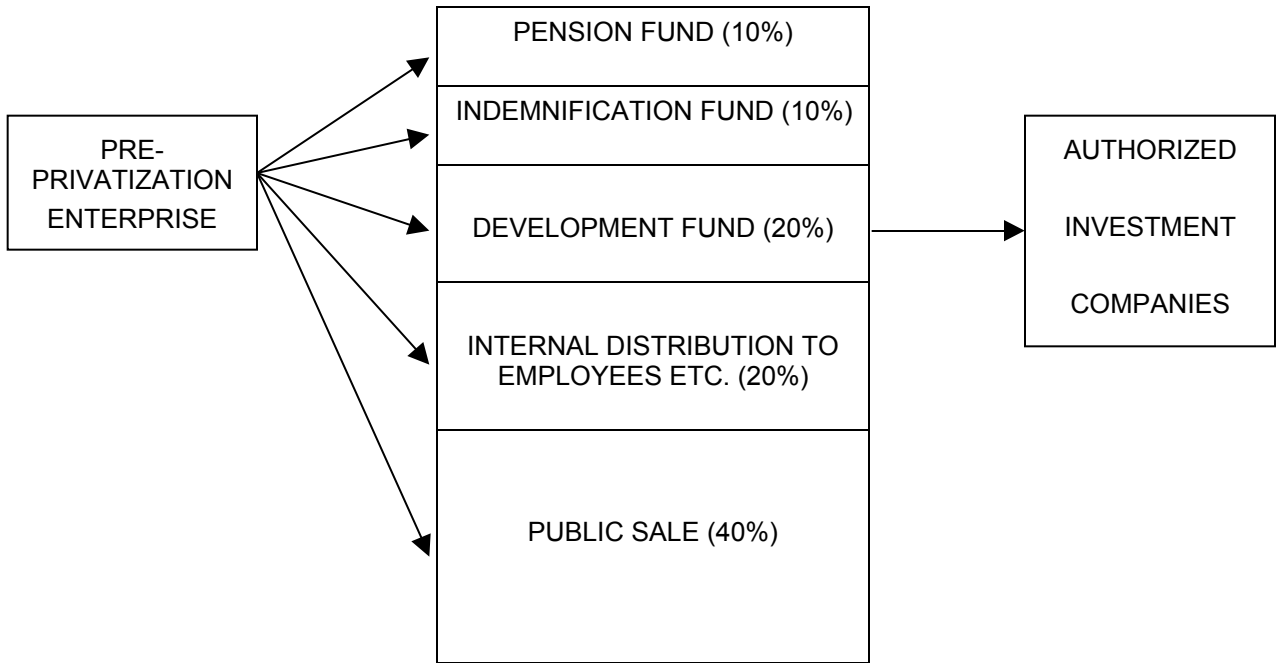
---

<sup>21</sup> Law on Ownership Restructuring of Social Enterprises, Off. Gazette of RS, no. 55-2514/1992, S7-290/1993, RS31-1309/1993, RS43-1736/1993, RS32-1332/1994, RS43-2049/1995, RS1-3/1996, RS30-1224/98 [hereinafter LORSE].

<sup>22</sup> JASNA FISCHER ET AL., THE ECONOMIC HISTORY OF SLOVENIA (1750-1991) 235 (1999).

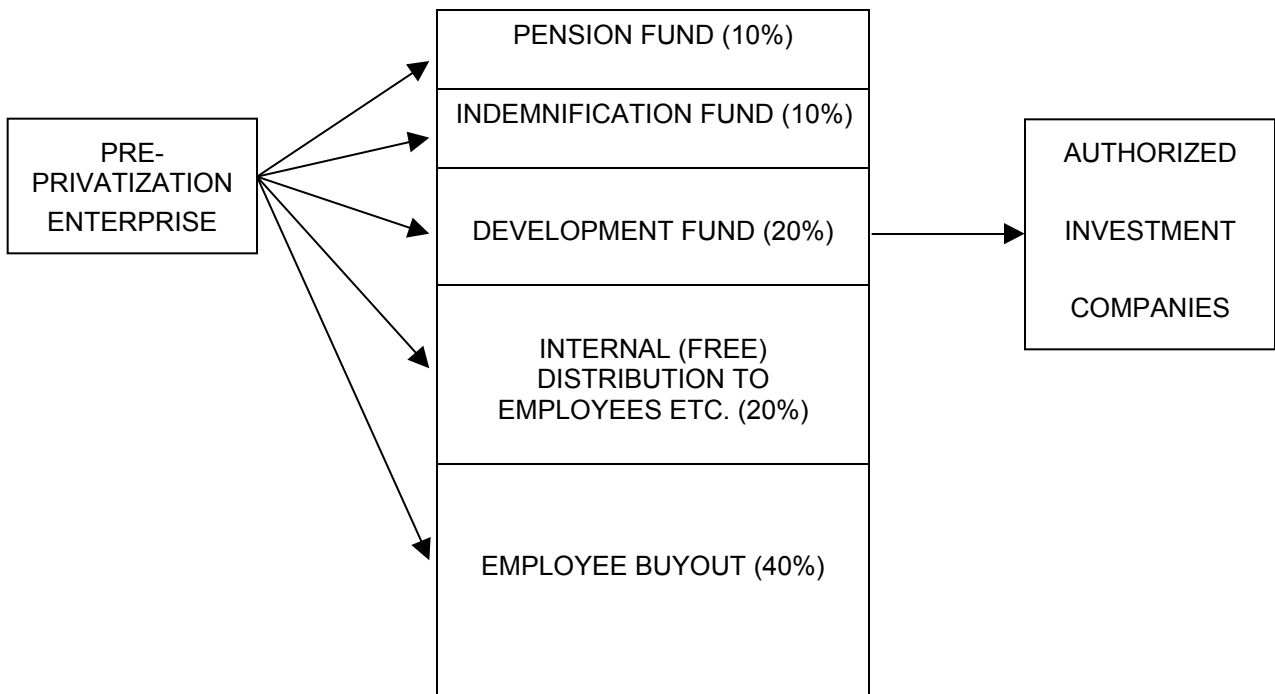
<sup>23</sup> Id. at 236. Certain industries have not been privatized, including: broadcasting, the national newspapers, energy, transportation, postal and telecommunications, steel, iron and aluminum, major banks and investment companies. LORSE, art. 2. Hence, public (state or municipal) ownership remains widespread in key economic sectors, notwithstanding privatization.

<sup>24</sup> LORSE, art. 26.



**Figure 1. Privatization by Public Sale**

- Privatization by employee buyout: Forty percent of the privatized corporation's shares were sold to employees on a deferred payment basis; twenty percent was distributed free to employees, former employees, and their relatives; and forty percent was allocated to three state funds (a state development fund received 20%, while state indemnification and pension funds received 10% each). (See Figure 2.)<sup>25</sup>

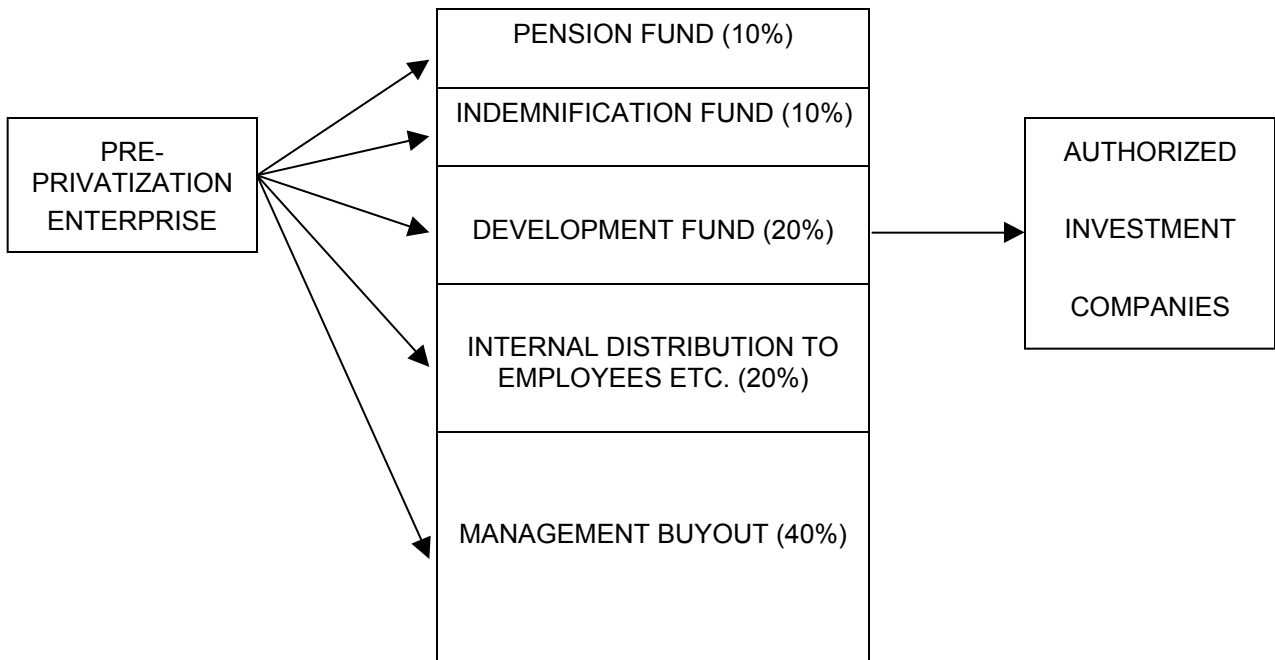


**Figure 2. Privatization by Employee Buyout**

---

<sup>25</sup> Id., art. 24.

- Privatization by management buyout: Forty percent of the privatized corporation's shares was sold to a group of managers or to a separate corporation formed for this specific purpose (usually called a bypass corporation); twenty percent was distributed free to employees, former employees, and their relatives; and forty percent was allocated to three state funds (a state development fund received 20%, while state indemnification and pension funds received 10% each). (See Figure 3.)<sup>26</sup>



**Figure 3. Privatization by Management Buyout**

Roughly equal numbers of corporations were privatized by each of these methods, although the value of firms privatized by public sale substantially exceeded that of those privatized by the other two methods. The managing bodies of each social enterprise decided the most appropriate type of privatization for their firm, subject to approval by the state privatization agency.

---

<sup>26</sup> Id., arts. 27-28.

In each case, ownership certificates formed the basic mechanism by which shares in the previously socially owned enterprises were distributed.<sup>27</sup> A special registration account was opened for each citizen and the monetary value of his/her share of social capital was allocated to that account. The registration accounts could only be used for purchasing shares of transformed enterprises or for investments in special authorized investment corporations, which were established to buy social property on behalf of investors.

Simultaneously with the registration account process, investment funds were established as either mutual funds or as investment corporations, both types being operated by management corporations.<sup>28</sup> Whereas an investor may redeem mutual fund shares, this is not possible with an investment corporation. In the latter case, an individual may sell his/her share in the investment corporation on the capital market where the shares are listed. (In this sense, the investment corporations are analogous to U.S. closed-end mutual funds.) The basic purpose of these investment funds is to spread risk. An investors saving through an investment fund owns, indirectly, many different securities and, hence, reduces risk through diversification.

Privatization resulted in substantial institutional ownership of Slovene corporations.<sup>29</sup> First, all three privatization methods required issuance of 40% of the corporation's shares to three state-controlled funds. Second, as required by the laws governing the privatization process, the state development fund subsequently exchanged a substantial amount of ownership certificates to the investment companies that had been expressly formed to trade in privatized corporation shares. Finally, institutions have been actively acquiring shares originally issued to the public and employees.

Although precise data on the degree of institutional ownership is not available,<sup>30</sup> the ownership structure of Slovene corporations entails a far higher concentration of ownership than is the case with U.S. corporations.<sup>31</sup> Although about

---

<sup>27</sup> Regulation on the Way of Raising of Ownership Certificates, Off. Gazette No. 72/1993; Regulation on Issue, Distribution and Use of Ownership Certificates, Off. Gazette No. 40/1993; Law on Privatization of Real Estate in Social Ownership. Off. Gazette No. 44/1997.

<sup>28</sup> Law on Investment Funds and Management Corporations, Off. Gazette No. 6/1994 [hereinafter LIFMC].

<sup>29</sup> A very large number of new corporations were formed during the transition process, but none have the economic significance of the privatized enterprises.

<sup>30</sup> Precise data on concentration of ownership in the hands of institutional owners is not available, but preliminary assessment of a questionnaire mailed to the 100 largest publicly-held corporations in November 1999 by the Research Center for Legal Comparative and Development Studies, Faculty of Social Sciences, University of Ljubljana, shows substantial decrease of number of shareholders in each corporation, which seems to be explained by selling of shares by dispersed shareholders.

<sup>31</sup> It is conventional to bifurcate corporate governance systems between a market-oriented model with an active capital market and diffuse ownership and a bank-oriented model with a less active capital market and highly concentrated ownership (mainly by banks). The U.S. falls well within the first model, while Germany is a good example of the bank-centered model. Gustavo Visentini,

50% of the latter's stock is owned by institutions,<sup>32</sup> large blocks held by a single investor are rare. Few U.S. corporations have any institutional shareholders who own more than 5-10% of their stock.<sup>33</sup> In contrast, a relatively small number of institutions—pension funds, banks, insurance and investment companies, and state-controlled funds—own most of the stock of Slovene corporations and large block ownership is common.

A further distinction is to be found in the behavior of institutional investors. In the U.S., despite increased activism in recent years, institutions still are mostly passive.<sup>34</sup> In contrast, Slovene institutional investors pursue an active role in corporate governance and decisionmaking. Indeed, these institutions are becoming increasingly aggressive, in the sense of intervening even in how management boards make day-to-day business decisions. They participate actively in shareholder meetings, choose candidates for the supervisory board, *de facto* control selection of management board members, and bring a variety of informal pressures to bear on how the management board conducts the business.

In addition to the sheer size of institutional holdings, two further factors enhance the power of Slovene institutional investors. First, it has become commonplace for large holders to enter into informal shareholder agreements.<sup>35</sup> This effectively further concentrates ownership by linking large block holders. Second, small holders have no experience, knowledge, or tradition of ownership. They simply do not participate at shareholder meetings, even by proxy, and thus lack any meaningful voice.

### C. Employee Corporate Governance Rights

Under U.S. corporate law, only shareholders are entitled to elect directors.<sup>36</sup> As a result, employee representation on U.S. corporate boards is quite rare.<sup>37</sup> The most famous U.S. example remains UAW president Douglas Fraser's 1979 election

---

*Compatibility and Competition Between European and American Corporate Governance: Which Model of Capitalism?*, 23 BROOKLYN J. INT'L L. 833 (1998). By virtue of its high degree of institutional ownership, Slovenia's current system is closer to the bank-centered model. A principal difference between the Slovene and German models, however, is that in the former banks are only one category of important institutions.

<sup>32</sup> MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 223 (1994).

<sup>33</sup> Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 568 (1990).

<sup>34</sup> ROE, *supra* note 32, at 223-25.

<sup>35</sup> Employee shareholders rarely enter into such agreements. Instead, they typically function as an opposition block. As discussed below, however, employees can obtain influence when employee-shareholders join forces with labor representatives on the boards. *See infra* Part III.A.

<sup>36</sup> MODEL BUS. CORP. ACT ANN. § 7.28 cmt. (1997).

<sup>37</sup> Everett M. Kassalow, *Employee Representation on U.S., German Boards*, MON. LAB. REV., Sept. 1989, at 39.

to Chrysler's board of directors, which did not meet with enthusiastic endorsement by other union leaders or managers.<sup>38</sup> As the Chrysler example suggests, employee representation is almost always the result of concessionary bargaining with a union.<sup>39</sup> The number of representatives typically is a very small minority (typically one to three) of the available seats.<sup>40</sup> These facts strongly suggest that the primary function of employee board representation is to enhance employee access to information and bond the accuracy of the information disclosed to employees as part of the concessionary bargaining process. The employee representatives can verify that the original information about the firm's precarious financial situation was accurate and are well-positioned to determine whether the firm's prospects have improved sufficiently to justify an attempt to reverse prior concessions through a new round of bargaining. According to most scholars, employee representation thus creates a significant role conflict: when an employee representative is seated on the board, his strongest ties are to the workers he represents, but under current U.S. corporate law his fiduciary duties *qua* director run solely to shareholders.<sup>41</sup>

In contrast, Slovenia has adopted a two-tier board of directors for larger corporations, largely modeled on the German Aktiengesetz codetermination statute.<sup>42</sup> The supervisory board must consist of at least 3 persons.<sup>43</sup> In companies with fewer than 1000 employees, at least one-third of the supervisory board's members must be employee representatives.<sup>44</sup> In companies with more than 1000 employees, at least half of the members must be employee representatives.<sup>45</sup> The employee

---

<sup>38</sup> Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. COMP. CORP. L. & SEC. REG. 155, 155 (1982).

<sup>39</sup> Kassalow, *supra* note 37, at 39.

<sup>40</sup> *Id.* at 40.

<sup>41</sup> See generally Helen S. Scott, *Union Directors and Fiduciary Duties Under State Corporate Law*, in LABOR LAW AND BUSINESS CHANGE: THEORETICAL AND TRANSACTIONAL PERSPECTIVES 115, 116-26 (1988) (overview of the conflict of interest and other corporate law doctrines posing problems for labor representatives on the board of directors). *But see* Summers, *supra* note 38, at 169-70 (denying the importance of the role conflict, claiming that the conflict of interest faced by employee representatives on the board is no more pronounced than that faced by directors who *de facto* represent other constituencies).

<sup>42</sup> Under German law, a two-tier board is compulsory for an AG (Aktiengesellschaft). The board consists of an executive or management board (Vorstand), and the supervisory board (Aufsichtsrat). The management board has principal operational responsibility, while the supervisory board exercises oversight and broad policymaking. For an overview of German codetermination, see Theodor Baums and Anja Birkenkaemper, *Corporate Governance in Germany* (October 1998), <[http://papers.ssrn.com/paper.taf?abstract\\_id=158038](http://papers.ssrn.com/paper.taf?abstract_id=158038)>.

<sup>43</sup> LCC, art. 262. RADO BOHINC ET AL., KOMENTAR ZAKONA O GOSPODARSKIH DRU\_BAH (THE COMMENTARY TO LAW ON COMMERCIAL COMPANIES) cmts. art. 260-280 (Rado Bohinc ed. 1994).

<sup>44</sup> Law on Participation of Employees in Corporate Governance art. 79/1, Off. Gazette No. 42/93 [hereinafter LPECG].

<sup>45</sup> *Id.*

representatives are chosen by the works council of each enterprise. The remaining supervisory board members are elected by shareholders.

The management board may consist of one or more members.<sup>46</sup> As with its German model, the management board runs the corporation on a day-to-day basis. The supervisory board's main role is to appoint and remove the management board's members, elect its president, and set compensation. The supervisory board's other functions are largely limited to that of oversight and review—the supervisory board can be thought of as representing the corporation against the members of the management board. Management responsibilities are not to be conferred on the supervisory board, although the articles of incorporation may provide that specific transactions may be entered into only with the consent of the supervisory board. If the supervisory board refuses to grant such consent, the management board may request that the shareholders approve it. The management board is obliged to give regular reports to the supervisory board, so that the supervisory board may perform its monitoring and oversight duties. The supervisory board must provide an opinion on the management board's annual report and submit it to the shareholders.

The law on worker participation mandates a labor representative on the management board of all corporations with more than 500 employees.<sup>47</sup> The labor representative is nominated by the corporation's employees through their works council, although he or she is formally elected by the supervisory board. The labor member is specifically charged with representing workers' interests with respect to personnel and social matters.<sup>48</sup> In other respects, however, the labor member's legal responsibilities are the same as those of the other management board members. There is a general understanding that this law refers only to publicly-held stock corporations, although the statute is not entirely clear on this point. Another unresolved issue is how this statute relates to the provision of the LLC allowing the management board to have a single member. In practice, few corporations have complied with this mandate and, hence, few labor management board members have been appointed.

The two-tier model is mandatory only for large corporations.<sup>49</sup> In smaller corporations (fewer than 500 employees and 100 named shareholders, not listed on stock exchange) the shareholders may prescribe in the articles of incorporation

---

<sup>46</sup> LCC, art. 246/2. If the corporation has no supervisory board, the management board must have at least three members. *Id.* See generally RADO BOHINC, DIREKTOR GOSPODARSKE DRU\_BE (THE DIRECTOR OF A BUSINESS CORPORATION) (1999); BOHINC ET AL., *supra* note 43, cmts art. 246-260.

<sup>47</sup> LPECG art. 81/1.

<sup>48</sup> For discussion of U.S. corporate law statutes allowing directors to consider nonshareholder interests in making corporate decisions, see Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPPERDINE L. REV. 971 (1992).

<sup>49</sup> LCC, article 261, provides that the corporation is required to have supervisory board: if its capital stock attains SIT 300 000 000; if the average annual number of employees is in excess of 500; if the corporation was established successively; if the corporation's shares are listed on the stock exchange; or if the number of holders of registered shares is above 100.

whether to adopt the supervisory board model. Nonetheless, the two-tier system prevails in Slovenia, because the great majority of privatized corporations were large enough to be subject to the two-tier system.

## II. THE COSTS AND BENEFITS OF CONCENTRATED OWNERSHIP

The separation of ownership and control characteristic of U.S. corporations has costs, as Berle and Means recognized more than 6 decades ago: “The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge . . . .”<sup>50</sup> Modern scholars refer to the consequences of these divergences as agency costs,<sup>51</sup> defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents.<sup>52</sup> In turn, shirking is defined to include as any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.<sup>53</sup> In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships.

A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor’s optimal trade-off between labor and leisure is, by definition, the same as the firm’s optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. Alchian and Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck.<sup>54</sup> The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components. In such situations, obtaining information about a team member’s productivity and appropriately rewarding each team member are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual’s reward is unlikely to be closely related to conscientiousness.

Although agents ex post have strong incentives to shirk, ex ante they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking.<sup>55</sup> Bounded rationality, however, precludes firms and agents from

---

<sup>50</sup> BERLE AND MEANS, *supra* note 8, at 6.

<sup>51</sup> Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

<sup>52</sup> Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 304 (1983).

<sup>53</sup> Michael P. Dooley, *Two Models of Corporate Governance*, 47 Bus. Law. 461, 465 (1992).

<sup>54</sup> Armen A. Alchian and Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972), reprinted in *The Economics of Legal Relationships* 555 (Henry G. Manne ed. 1975).

<sup>55</sup> *Id.*

entering into the complete contract necessary to prevent shirking by the latter. Instead, there must be some system of ex post governance: some mechanism for detecting and punishing shirking. Accordingly, an essential economic function of management is monitoring the various inputs into the team effort: management meters the marginal productivity of each team member and then takes steps to reduce shirking.<sup>56</sup>

The existence of such monitoring systems is obvious in M-form corporations, the characteristic form of U.S. public corporations. This firm type has two defining characteristics: many distinct operating units and management by a hierarchy of salaried executives.<sup>57</sup> Just as a branching corporate hierarchy facilitates the flow of information within such firms, it also facilitates monitoring.<sup>58</sup> It would be difficult, at best, for a plant manager with hundreds of employees to determine which deserve rewards and which deserve reprimands. Such a task obviously becomes impossible long before we reach the board of directors of a large public corporation. A branching hierarchy provides a ready solution. The board delegates responsibility to senior management and monitors their performance.<sup>59</sup> The senior managers in the firm's central office delegate responsibility to managers of operating units. In turn, the managers of each operating unit are responsible for monitoring the productivity of their unit.<sup>60</sup> The process continues down to the foreman on the shop floor. Creating such a branching hierarchy addresses the problems of uncertainty, bounded rationality, and shirking faced by monitors in all team situations by breaking the firm team into discrete segments, each of which is more readily monitored than the whole. At each hierarchical level, the responsible monitor is responsible for supervising only a few individuals, which usefully limits and focuses his task.

The structure just described, of course, raises the question of who will monitor the monitors?<sup>61</sup> In any team organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never ending series of monitors monitoring lower level monitors. Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.<sup>62</sup> According to Alchian and Demsetz, if the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by

---

<sup>56</sup> Id. at 794.

<sup>57</sup> ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 1 (1977).

<sup>58</sup> OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 289 (1985) ("the organizational logic of the M-form structure runs very deep—serving, as it does, both to economize on bounded rationality . . . and safeguard the internal resource allocation process against the hazards of opportunism").

<sup>59</sup> Oliver Williamson, *Corporate Governance*, 93 *YALE L.J.* 1197, 1225 (1984).

<sup>60</sup> Id. at 1219-20.

<sup>61</sup> Alchian and Demsetz, *supra* note 54, at 782.

<sup>62</sup> Id. at 781-83.

the firm's other inputs because his reward will vary exactly with his success as a monitor.

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly-held U.S. corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors. But while U.S. law provides shareholders with some enforcement and electoral rights, these are reserved for fairly extraordinary situations.<sup>63</sup> In general, shareholders of public U.S. corporations have neither the legal right, the practical ability, nor the desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.

Institutional investors, at least potentially, may behave quite differently than dispersed individual investors. Because they own large blocks, and have an incentive to develop specialized expertise in making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks will have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, will enable them to more actively monitor the firm's performance and to make changes in the board's composition when performance lagged.<sup>64</sup> Corporations with large blocks of stock held by institutional investors thus might come to resemble Alchian and Demsetz's firm, in which the residual claimants act as the ultimate monitor of the firm's agents. As a result, concentrated ownership in the hands of institutional investors might lead to a reduction in shirking and, hence, a reduction in agency costs. In turn, that should lead to a more efficient economy.

The difficulty is that the benefits of institutional control come at a high cost. There is good evidence, for example, that bank control of the securities markets has harmed that Japanese and German economies by impeding the development of new businesses.<sup>65</sup> Instructively, although a large number of new corporations have been formed in Slovenia post-privatization, they are economically insignificant both individually and collectively.<sup>66</sup> If that trend continues, it may suggest that the high

---

<sup>63</sup> Derivative suits and proxy contests, for example, constrain managerial behavior to some extent. These remedies are so costly and their outcome so uncertain that they are invoked only episodically. Moreover, many aspects of the legal rules governing these devices (such as the derivative suit demand requirement, the federal proxy regulations, and state rules governing reimbursement of expenses) seem calculated to discourage frequent recourse to them. *See* Dooley, *supra* note 53, at 525.

<sup>64</sup> ROE, *supra* note 32, at 235-37.

<sup>65</sup> *Id.* at 194-95.

<sup>66</sup> *See supra* note 29.

degree of institutionalization of the Slovene markets will impede its development of the sort of active venture capital market that drives the U.S. economy.<sup>67</sup>

Because we are concerned with the governance of privatized publicly-held corporations, however, we focus on a different concern: namely, the risk that institutional investors may abuse their control by self-dealing and other forms of over-reaching. In his important study of institutional ownership, Roe contended that large block holders can improve firm performance by personifying the shareholder community. He contends that loyalty to real people may be a better motivator than loyalty to an abstract collection of small shareholders.<sup>68</sup> The trouble, of course, is that the interests of large and small investors often differ.<sup>69</sup> As management becomes more beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.

An initial source of concern is the continuing presence of state-controlled funds as very large shareholders in nominally privatized Slovene corporations. As an owner, the state acts in much the same way as other institutional owners; i.e., it is an active participant, especially in industrial sectors having a public interest. In such firms, the state combines its function as a stockholder with its role as regulator. As one might expect, this subordinates corporate decisions to political goals, including the individual goals of political parties that control particular fields. There is great danger of political interference to day-to-day business and personnel questions. The adverse economic impact of continuing state ownership is evidenced a recent empirical study of several Central and Eastern European nations, including Slovenia, finding that enterprises that had been privatized for at least 4 years increase their productivity 3-5 times faster than enterprises that are still state-owned.<sup>70</sup>

The U.S. experience with social investing by public pension funds likewise suggests that politicization of stockownership will be an economic drag. Some U.S. scholars have gone so far as to suggest that “the road to socialism, or some substantial socialization of the investment process, might lie through an expanded, publicly regulated system of pension finance,”<sup>71</sup> a perspective of obvious concern to transition economies, such as Slovenia, that have only recently emerged from socialism. Somewhat to the right of that position was President Clinton’s 1992 call

---

<sup>67</sup> On the necessity for Slovenia to promote higher economic growth, *inter alia*, so as to qualify for EU membership, see FISCHER ET AL., *supra* note 22, at 236. On the importance of venture capital as an engine of economic growth, see Bernard Black and Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 J. FIN. ECON. 243 (1998).

<sup>68</sup> ROE, *supra* note 32, at 237-38.

<sup>69</sup> Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445, 466-68 (1991); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163, 176-79 (1991).

<sup>70</sup> Gerhard Pohl et al., *Privatization and Restructuring in Central and Eastern Europe*, World Bank Technical Paper No. 368 (May 1997), <[http://papers.ssrn.com/paper.taf?abstract\\_id=37369](http://papers.ssrn.com/paper.taf?abstract_id=37369)>.

<sup>71</sup> William H. Simon, *The Prospects of Pension Fund Socialism*, in CORPORATE CONTROL AND ACCOUNTABILITY 165, 166 (Joseph McCahery et. al ed. 1993).

for a “Rebuild America Fund,” which would leverage federal funding by tapping “state, local, private sector, and pension fund contributions.”<sup>72</sup> Clinton’s Department of Labor in fact encouraged pension funds to make “economically targeted investments” in such areas as infrastructure, housing and job creation.<sup>73</sup> Unfortunately for President Clinton and like-minded Slovene politicians, social investing has substantial costs in the form of reduced returns to investors. In general, the greater the extent to which a public pension fund is subject to direct political control, the worse it’s investment returns.<sup>74</sup>

In light of these concerns, boards composed of independent professionals would be a welcome reform. In view of the brief experience Slovenia has with capitalist private enterprise, one cannot take director professionalism and expertise for granted. In order to ensure professionalism on the part of independent directors, it thus may be appropriate to develop training programs and licensing by examination. Just as auditors must be certified in order to carry out their monitoring roles, perhaps directors should likewise be certified as competent to carry out their supervisory functions.

A second (and more general) concern is that institutional investors will be tempted to use their position to self-deal; i.e., to take a non-pro rata share of the firms assets and earnings. We have evidence that the risk of self-dealing by large institutional investors is a very serious one. In the United States, for example, there was considerable looting in the turn of the century insurance industry, as insurance company managers obtained low-interest loans and jobs from portfolio firms.<sup>75</sup> In Russia, privatization during the 1990s resulted in a “kleptocracy” of controlling investors who have engaged in rampant self-dealing.<sup>76</sup> In the Czech Republic, post-privatization consolidation of stock ownership likewise has led to widespread looting of privatized enterprises by their controlling shareholders.<sup>77</sup>

Slovenia has a couple of options for dealing with the self-dealing problem, which may prove complementary rather than competing. First, it can strengthen

---

<sup>72</sup> BILL CLINTON AND AL GORE, PUTTING PEOPLE FIRST: HOW WE CAN ALL CHANGE AMERICA 144 (1992).

<sup>73</sup> Jim Saxton, *A Raid on America’s Pension Funds*, WALL ST. J., Sept. 29, 1994, at A20.

<sup>74</sup> Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 825 (1993).

<sup>75</sup> ROE, *supra* note 32, at 67.

<sup>76</sup> Bernard S. Black et al., *Russian Privatization and Corporate Governance; What Went Wrong?* (Sept. 1999), <[http://papers.ssrn.com/paper.taf?abstract\\_id=181348](http://papers.ssrn.com/paper.taf?abstract_id=181348)>. The Russian experience differs dramatically from the Slovene one, of course, because the structure of Russian privatization permitted a sale of control to crooks who financed their purchases by cheating the government. Id.

<sup>77</sup> Id. at 58. For an argument that the economic benefits of concentrated ownership in the German economy have outweighed its costs, see Jeremy Edwards and Alfons Weichenrieder, *Ownership Concentration and Share Valuation: Evidence from Germany* (July 15, 1999), <[http://papers.ssrn.com/paper.taf?abstract\\_id=175333](http://papers.ssrn.com/paper.taf?abstract_id=175333)>.

corporate law rules governing minority shareholder protections. Under U.S. law, a controlling shareholder has fiduciary obligations to the minority.<sup>78</sup> A controlling shareholder who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority.<sup>79</sup> A controlling shareholder who uses its influence to effect a freeze-out merger in which the minority shareholders are bought out at an unfairly low price likewise faces liability.<sup>80</sup>

The adoption of minority shareholder protections ought to be uncontroversial.<sup>81</sup> Yet, it may be doubted whether that legal change standing alone will suffice. As one recent study of transition economies concluded, “investor protection is indeed very important,” but because legal systems are complex and legal rules complementary, investor protection can “be achieved only by reforming the entire legal system.”<sup>82</sup> Even limited corporate law reform, moreover, may be subverted or precluded by politically influential large block holders.<sup>83</sup> These generic problems are compounded in Slovenia’s case by the weakness of small holders. In Slovenia, the property rights-based model corporate governance is a new theoretical and legal concept. There is no tradition or culture of property rights and shareholders have little experience either with participating in the corporate dialogue or using the legal system to vindicate their rights.<sup>84</sup>

Measures intended to enhance minority shareholder protection thus perhaps should be coupled with other approaches, such as restrictions on institutional ownership and activism. In the U.S., regulation of financial institutions has been blamed<sup>85</sup> for the failure of institutional investors to function as Alchian and Demsetz’s residual claimants. In the 19<sup>th</sup> century, banks were kept small and localized by laws prohibiting branching and interstate banking.<sup>86</sup> The lack of a central bank throughout most of the 19th century further limited the potential for bank financing of large corporations, as did the New Deal banking legislation.<sup>87</sup>

---

<sup>78</sup> See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947).

<sup>79</sup> See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

<sup>80</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>81</sup> Erik Berglof and Ernst-Ludwig von Thadden, *The Changing Corporate Paradigm: Implications for Transition and Developing Countries* 5 (June 1999), <[http://papers.ssrn.com/paper.taf?ABSTRACT\\_ID=183708](http://papers.ssrn.com/paper.taf?ABSTRACT_ID=183708)>. See also Black et al., *supra* note 76, at 63 (“strong controls on insider self-dealing are a necessary precondition for successful large-firm privatization”).

<sup>82</sup> Berglof and Thadden, *supra* note 81, at 5.

<sup>83</sup> *Id.*

<sup>84</sup> *Cf. id.* at 19 (noting that in post-privatization Russia “cumbersome procedures and weak enforcement powers of the courts deter investors from bringing suits”).

<sup>85</sup> Or credited, depending on your point of view.

<sup>86</sup> ROE, *supra* note 32, at 54-59.

<sup>87</sup> *Id.* at 57-59.

Insurers long were barred from owning corporate common stock.<sup>88</sup> Private pension funds were not an important source of equity capital until quite recently and are regulated in ways that give their managers little incentive to play an active corporate governance role.<sup>89</sup> All institutional investors are subject to securities laws that deter formation of large blocks and inhibit communication between holders of small blocks.<sup>90</sup> In sum, the U.S. legal system as a whole did nothing to impede the development of the Berle-Means corporation, perhaps facilitated its evolution, and certainly helped sustain it by preventing financial intermediaries from taking active governance roles.

Because its securities laws were more closely modeled on U.S. law than was its corporation law, Slovenia already has a framework for imposing similar restrictions on institutional ownership.<sup>91</sup> The Securities Market Act prohibits insider trading and imposes reporting duties on corporation insiders for transactions of securities.<sup>92</sup> The Takeover Act imposes disclosure obligations on large shareholders. A person who, directly or indirectly, acquires 5% or more of a corporation's shares must notify the issuer and the Slovene Securities and Exchange Commission (SEC) within three days.<sup>93</sup> Additional disclosure is necessary for further increases in ownership. A person who intends to acquire more than 25% of the voting stock of an issuer is obliged to make a public tender offer for the rest of shares.<sup>94</sup> All of these are precisely the sorts of securities regulations that have helped limit the power of U.S. institutional investors.

Finally, while some contend that "foreign ownership is no panacea,"<sup>95</sup> others argue that foreign investors have proven to be "crucial in bringing about active and deep restructuring."<sup>96</sup> In any case, Slovenia is well-positioned to take advantage of any potential positive influence by foreign investors. The 1999 Securities Market

---

<sup>88</sup> Id. at 60-66, 78-91.

<sup>89</sup> Id. at 124-127, 138-43.

<sup>90</sup> Id. at 273-75. Mutual funds are further deterred from holding large blocks of stock in any particular firm by tax regulations. Id. at 102-110.

<sup>91</sup> The current legal regime governing the capital market in Slovenia was established in March 1994, when the Securities Market Law replaced the two federal laws on securities and capital markets. The Securities Market Law regulates the issuance and trading of securities and defines the roles of the stock exchanges, SEC, and securities market participants. The law is based on Anglo-American legislative models, although it also accords with EU Directives. Within the framework of the Securities Market Law, the Ljubljana Stock Exchange (LSE) and the SEC have developed their own regulations.

<sup>92</sup> Law on Securities Market, Off. Gazette, No. 56/1999, art. 275-278 (hereinafter LSM).

<sup>93</sup> Law on Takeovers, Off. Gazette, No. 47/1997 art. 59/2 (hereinafter LTO).

<sup>94</sup> Id., arts. 4 and 7.

<sup>95</sup> Black et al., *supra* note 76, at 66. "Foreigners can strip assets as well as locals, if not well-chosen." Id.

<sup>96</sup> Beglof and Thadden, *supra* note 81, at 20.

Law clarified the rights of foreign investors.<sup>97</sup> Foreign portfolio investment is authorized, albeit regulated, the Foreign Exchange Act of 1999.<sup>98</sup> Under the 1998 Banking law, the Central Bank of Slovenia regulates such foreign portfolio investments indirectly through its regulation of Slovene commercial banks.<sup>99</sup> In general, Slovene law in these areas satisfies the EU directives governing foreign investment. The remaining restrictions on foreign ownership include: Full foreign ownership is not allowed in military equipment, insurance, transport, telecommunication, publishing and broadcasting. There is no limit on foreign ownership of banks, subject to the approval by the Central Bank. Foreign ownership is limited to 24% of brokerage firms and 20% of investment management companies, and such investments must be registered with the Central Bank. Foreign investors can acquire 25% or more of large companies privatized under one of mass privatization schemes described in Part I only if they acquire the approval from the Slovene Government.

Taken together, these restrictions establish a regulatory framework for constraining controlling shareholder self-dealing. Will it suffice? A country needs not only the legal infrastructure, but also the will to control self-dealing. In that respect, the continued state ownership and the political influence of large holders are significant sources of concern.

### **III. WHO DECIDES? THE TWO-TIER BOARD AND THE POWERS OF DIRECTORS**

#### **A. Two-Tier Boards: An Economic Analysis**

The chief economic virtue of the U.S. corporate governance model is not that it permits the aggregation of large capital pools, as some suggest, but that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."<sup>100</sup> U.S. corporate governance, with its separation of ownership and control, responds to this necessity by vesting ultimate decisionmaking authority in the board of directors.

Because only shareholders are entitled to elect directors, boards of U.S. public corporations are somewhat insulated from pressure by other corporate constituencies, such as employees or creditors. At the same time, the diffuse nature of U.S. stockownership and the regulatory impediments to investor activism tend to

---

<sup>97</sup> LSM arts. 42-49.

<sup>98</sup> Law on Foreign Exchange, Official Gazette 23/1999, art. 26.-32.

<sup>99</sup> Banking Law, Official Gazette, 7/1999, art. 52.-27.

<sup>100</sup> KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 69 (1974).

insulate directors from shareholder pressure. As such, the directors typically have substantial (albeit not unconstrained) freedom to exercise business judgment.

To be sure, it is this very freedom that generates agency costs. Insulated from many forms of constituency pressure, directors may pursue their own self-interest at the expense of the shareholders and/or other corporate constituencies. Yet, the agency cost problem easily can be over-stated. Indeed, a narrow focus on agency costs can distort one's understanding of the firm. Corporate managers operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. Important constraints are provided by a variety of market forces. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.

An even more important consideration, however, is that agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant. Society could substantially reduce, if not eliminate, agency costs by eliminating discretion; that we do not do so suggests that discretion has substantial virtues. A complete theory of the firm thus requires one to balance the virtues of discretion against the need to require that discretion be used responsibly.<sup>101</sup> Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Yet, they are ultimately antithetical—one cannot have more of one without also having less of the other.<sup>102</sup> Ultimately, the power to hold to account *is* the power to decide.<sup>103</sup> Managers cannot be made more accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question. Given the survival value of board discretion, as evidenced by its persistence and success, preservation of managerial discretion should always be the null hypothesis.

Slovene corporations lack much of the protective infrastructure that insulates U.S. boards from shareholder pressure. Hence, while large institutional holders may deter managerial self-dealing, checks on controlling shareholder self-dealing are necessary. By mandating employee representation, the Slovene two-tier board system potentially serves as one of those checks.

Employees have strong incentives to resist looting and other forms of shareholder self-dealing. Most obviously, the firm provides its employees' livelihood, aligning their self-interest with perpetuation of the firm as a viable economic entity. Some workers also make substantial investments in firm-specific human capital, which would be lost if the firm fails as a result of insider or shareholder self-dealing. Finally, many workers derive substantial psychological benefits from their employment. One cannot plausibly describe a large corporation as a community of shared values—diffuse shareholders, employees, creditors, and

---

<sup>101</sup> Dooley, *supra* note 53, at 464-71.

<sup>102</sup> *Id.* at 470.

<sup>103</sup> ARROW, *supra* note 100, at 78.

customers almost by definition cannot form a community. Yet, within its workforce the corporation harbors sub-groups that frequently evolve into close-knit communities:

In the economic sphere today sociality seems far more prevalent than individualism. In democratic capitalist nations various social organisms, including the business enterprise and the corporation, have replaced or supplemented old loyalties to family and clan. Some persons today are closer to their colleagues in the workplace than to their family.<sup>104</sup>

Taken together, these factors give employees a strong interest in ensuring the enterprises' continuing viability.

Employee representatives on the management and supervisory boards thus can be expected to resist overt self-dealing by controlling shareholders and even to ferret out covert efforts at self-dealing. Their powers of resistance are strengthened by the fact that all of the mass privatization schemes created blocks of employee-shareholders through the mandatory free distribution of 20% of the firm's shares to current and former employees. Employee interests are especially dominant in those firms privatized by employee buyouts. In those firms, substantial internal ownership coupled with organized labor's has given employees considerable influence over managerial decisions and, in some settings, subordinated business decisions to the interests of organized employee-shareholders. In these firms, the supervisory board can become a vehicle for enforcing the will of those employee-shareholders.

The question, however, is: at what cost? Employee representation on the board may have a variety of benefits, but it also has costs. Many studies have shown that codetermination has negative productivity effects.<sup>105</sup> One recent meta-analysis of numerous codetermination studies confirmed "that worker participation in decision making imposed by government decree is negatively associated with productivity."<sup>106</sup>

Why might codetermination not lead to efficiency gains?<sup>107</sup> There appear to be several answers, which likely are complementary rather than competing. First, by virtue of the board's position at the apex of the corporate hierarchy, employee representatives on the supervisory board are inevitably exposed to a far greater amount of information about the firm than is the case in the United States or the United Kingdom. One result likely is that workers in codetermination systems are better positioned to demand higher wages than those in the U.S. or United Kingdom.

---

<sup>104</sup> MICHAEL NOVAK, *TOWARD A THEOLOGY OF THE CORPORATION* 29 (2d ed. 1990)

<sup>105</sup> JOHN L. COTTON, *EMPLOYEE INVOLVEMENT* 119 (1993).

<sup>106</sup> Chris Doucouliagos, *Worker Participation and Productivity in Labor-Managed and Participatory Capitalist Firms: A Meta-Analysis*, 49 *IND. & LAB. REL. REV.* 58, 69 (1995).

<sup>107</sup> For an analysis of whether codetermination can be justified on noneconomic normative grounds, see Stephen M. Bainbridge, *Corporate Decisionmaking and the Moral Rights of Employees: Participatory Management and Natural Law*, 43 *VILLANOVA L. REV.* 741 (1998).

This prediction is supported by an empirical study finding that provision of financial and other business information to employees of non-unionized U.S. firms had a negative effect on firm profitability, which was attributed to higher wages demanded by the informed employees.<sup>108</sup> Indeed, British employers reportedly are reluctant to provide employees with access to financial information for fear of stimulating workers to make demands with respect to pay and working conditions.<sup>109</sup>

German managers sometimes deprive their supervisory boards of information, because they do not want the board's employee members to learn it.<sup>110</sup> Alternatively, the board's real work may be done in committees or *de facto* rump caucuses from which employee representatives are excluded.<sup>111</sup> In response, German employee representatives on the supervisory board frequently hold their own pre-meeting caucuses, which contributes to difficulty in building consensus across interest groups by hardening positions. Indeed, labor representatives often act and vote as a block. In response to these problems, many German firms use various corporate governance devices to limit the power and function of the supervisory board on which labor representatives sit. Employee representation thus may slow the finding of a consensus on the supervisory board and create a built-in polarization problem.<sup>112</sup> The risk for Slovenia thus is that its two-tier board system will raise the costs of decisionmaking, reducing corporate efficiency, but not have much effect on substantive decisionmaking or act as much of a constraint on insider and controlling shareholder self-dealing.<sup>113</sup>

A second concern with respect to codetermination is the conflict between employee and shareholder interests.<sup>114</sup> Although small block Slovene shareholders and employees have a common interest in constraining self-dealing by insiders and large block shareholders, their interests otherwise may diverge. In the U.S. literature, this potential conflict of interest is usually analyzed in terms of a role conflict: when an employee representative is seated on the board, his strongest ties are to the

---

<sup>108</sup> Morris M. Kleiner and Marvin L. Bouillon, *Providing Business Information to Production Workers: Correlates of Compensation and Productivity*, 41 IND. & LAB. REL. REV. 605, 614-15 (1988).

<sup>109</sup> Stuart Ogden, *The Limits of Employee Involvement: Profit Sharing and Disclosure of Information*, 29 J. MGMT STUD. 229 (1992).

<sup>110</sup> ROE, *supra* note 32, at 177; Hopt, *supra* note 4, at 206.

<sup>111</sup> Hopt, *supra* note 4, at 208; Summers, *supra* note 38, at 166.

<sup>112</sup> Hopt, *supra* note 4, at 207.

<sup>113</sup> Cf. Tove H. Hammer et al., *Worker Representation on Boards of Directors: A Study of Competing Roles*, 44 IND. & LAB. REL. REV. 661, 663 (1991) (Scandinavian codetermination systems have little substantive effect on corporate decisionmaking).

<sup>114</sup> For a defense of the proposition that corporations ought to be managed so as to maximize shareholder wealth, see Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993).

workers he represents, but under current U.S. law he is obliged to prefer the interests of shareholders.<sup>115</sup>

Slovene labor directors naturally tend to engage in greater labor advocacy than do shareholder-appointed directors. As is the case with the continental European laws on which it is based, however, Slovenian law does not regard the resulting role conflict as source of concern. The concept of shareholder sovereignty was abandoned by the German Aktiengesetz of 1937, which treated the interests of the enterprise as distinct from and superior to the interests of shareholders. The Austrian Aktiengesetz is especially interesting in that it obliges the management board to conduct the corporation in the interests of the enterprise as a whole, including the interests of its shareholders, its employees, and the public. The management board's independence from the shareholders is intended to be preserved by the fact that the supervisory board, not directly by the shareholders. Because it was modeled on these predecessors, Slovenian law likewise assumes that labor representatives on the boards legitimately will be concerned with the interests of the workers.

Codetermination thus may result in a substantial increase in agency costs. "The inclusion of multiple groups (say employees in addition to shareholders) would be a source of agency costs. People who did not receive the marginal gains would be influencing corporate discretion, and the influence would not be expected to maximize the wealth of the participants as a group."<sup>116</sup> Corporate employees have an incentive to shirk so long as their compensation does not perfectly align their incentives with those of the firm's shareholders. In turn, knowing of this phenomenon, the firm's shareholders should expect management to reduce the compensation of the firm's employees by the amount necessary to off-set the expected degree of employee shirking. Because ex ante wage adjustments rarely are fully compensatory,<sup>117</sup> the firm's shareholders should expect management to monitor the employees and punish ex post those who shirk. Does it not seem odd that those who are to be monitored should be allowed to choose the monitors?

The concern that employee representatives will be too lax in supervising workers is potentially compounded in Slovenia's case by the strong continuing role of the state and state-controlled funds even in privatized corporations. Politicians in any country rarely have much enthusiasm for corporate cost-cutting measures that reduce wages or result in lost jobs. Politically-motivated meddling in corporate decisions seems likely.

Allowing employee representation on the supervisory board thus necessarily reduces the likelihood that the board will be an effective monitoring device. Yet, the

---

<sup>115</sup> See *supra* text accompanying note 41.

<sup>116</sup> Frank H. Easterbrook and Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 405 (1983).

<sup>117</sup> Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J. L. & ECON. 367, 368 n.2 (1983).

problem is not only that the board will be ineffective in monitoring workers,<sup>118</sup> but also that employee representation makes the board a less effective monitor of management.<sup>119</sup> Because shareholders “could seek profits by getting highly motivated managers who sweat the labor force,” workers have an interest in supporting rules that free management from accountability to shareholders.<sup>120</sup> Managerial shirking of its monitoring responsibilities thus will often redound to the workers’ benefit, which suggests that employee representatives on the board of directors are less likely to insist on disciplining lax managers than are shareholder representatives.<sup>121</sup>

The prediction that agency costs rise when employees are represented on the board is supported by evidence from the German experience with codetermination. It is widely reported, for example, that labor’s presence on the supervisory board impedes cost cutting measures that adversely affect workers.<sup>122</sup> Codetermination is also said to impede the market for corporate control as an accountability mechanism by making hostile takeovers more difficult.<sup>123</sup> Indeed, this is cited as one explanation for the failure of German firms to reincorporate elsewhere despite the inefficiencies of codetermination.<sup>124</sup>

## B. Options

Moving Slovenia to a U.S.-style single board elected solely by shareholders appears politically unrealistic. It also may be undesirable in light of the current distribution of stockownership, which a small number of large institutions dominate. Nonetheless, there are a number of available alternatives that may be superior to the present mandatory two-tier system. In this section, we consider whether Slovene corporate governance legislation should adopt an enabling, or freedom of contract, approach that allows firms to modify the board’s composition and structure.

---

<sup>118</sup> Of course, the supervisory board does not directly monitor workers. With respect to nonmanagerial employees, the supervisory board’s role is indirect—they monitor the management board, which monitors the workers. The point is that labor representation on the supervisory board may discourage that board from holding the management board accountable with respect to worker performance.

<sup>119</sup> In many Slovene firms privatized by sale, management boards are *de facto* independent of the supervisory boards. Quite the opposite is true in corporations with prevailing internal ownership, where supervisory boards are a mechanism for the transmission of organized interests of employee-shareholders.

<sup>120</sup> ROE, *supra* note 32, at 44.

<sup>121</sup> A related problem is the possibility that employee representation will permit management to pursue its own self-interest at the expense of both shareholders and employees by playing worker and shareholder representatives off against each other.

<sup>122</sup> ROE, *supra* note 32, at 214; Hopt, *supra* note 4, at 208; Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L. J. 2021, 2031 (1993).

<sup>123</sup> ROE, *supra* note 32, at 214.

<sup>124</sup> Hopt, *supra* note 4, at 213.

Several statutory models exist in which corporations are allowed to elect between a single board and the two-tier board. The much-discussed but never adopted EU Fifth Directive,<sup>125</sup> for example, would allow Member States to permit their corporations to select between these two models. The directive recognized that the laws of certain Member States provide for employee participation within a supervisory board, while others did not. The directive posits that provision for such participation should be made by all Member States, but does not mandate uniformity with respect to the form of the requisite employee participation. Instead, four distinct methods of employee participation are authorized: participation through the appointment of employee representatives (a minimum of one third and a maximum of one half) to a supervisory board (in a two-tier system) or as non-executive members of a single board; participation in the appointment of members of a supervisory board; participation through representative bodies, such as works councils having rights to information and consultation; or participation through collectively agreed procedures. Whatever participation model is chosen, however, the directive mandates that all directors shall carry out their functions in the interest of the corporation, having regard to the interests of both shareholders and employees. The EU directive thus retains some of the problematic features of current Slovenian law.

Another possible model is that of the French SA (*Societe anonyme*), which is allowed to opt between the single board and two-tier board models.<sup>126</sup> A single board SA is overseen by a *Conseil d'administration* (board of directors) headed by a *President Directeur Général* (PDG). By law, the board has full powers to act for the corporation (art. 98). In practice, however, an SA typically is managed by the board's president. The board effectively delegates nearly all its powers to the president (arts 110-113).

Alternatively the corporation may have a form of management split between two different boards, the so called *directoire*, which is an executive board, and the *conceill de Surveillance*, a supervisory board. The executive board is overseen by the supervisory board, whose members are appointed by the shareholders. The supervisory board is not concerned so much with the general day-to-day management of the corporation as with the setting of policy and oversight of managers. The supervisory board, for example, authorizes significant transactions and appoints the members of the executive board.

French corporate and labor law (with some exceptions for corporations having a public interest) allows but does not mandate employee representation, although employee rights otherwise are very extensive.<sup>127</sup> Not more than one-third of

---

<sup>125</sup> 15 J.O. C 131 at 49 (1972).

<sup>126</sup> Loi No. 66-537 du 24 juillet 1966; Decret No.67-236 du 23 mars 1967.

<sup>127</sup> Employee representation on the board of an SA is governed by Law 4611056 of 16 May 1946, as amended by Law 66-427 of 18 June 1966 and Law 72-1225 of 29 December 1972.

the directors may be employees of the corporation; moreover, employees are eligible to the board only after two years service (art. 93).

In theory, future corporate governance developments in Slovenia ought to track these alternative models, providing greater flexibility in board composition, by leaving to management and shareholders the decision whether to have one or two boards and how to structure them. At present, the same mandatory rules apply to, but have radically different effects on, small corporations and on large firms with thousands of shareholders and employees. Differences among corporations with regard to institutional, internal, or closely-held ownership control, for example, are substantial and should be taken into consideration on a case-by-case basis. In other words, Slovenia should extend to all corporations the same flexibility it now extends only to smaller post-privatization corporations.

An economic justification for this enabling approach is found in the nexus of contracts theory of the corporation. Contractarian scholars model the firm not as an entity, but as an aggregate of various inputs acting together to produce goods or services.<sup>128</sup> Employees provide labor. Creditors provide debt capital. Shareholders initially provide equity capital and subsequently bear the risk of losses and monitor the performance of management. Management monitors the performance of employees and coordinates the activities of all the firm's inputs. The firm is simply a legal fiction representing the complex set of contractual relationships between these inputs. In other words, the firm is not a thing, but rather a nexus or web of explicit and implicit contracts establishing rights and obligations among the various inputs making up the firm.

This model has important implications for a range of corporate law topics,<sup>129</sup> the most obvious of which is the debate over the proper role of mandatory legal rules. Contractarians contend that corporate law ought to consist mainly (if not entirely) of default rules, from which shareholders are free to depart, rather than mandatory rules.<sup>130</sup> A critical advantage of default rules is that it relieves policymakers of the necessity of determining whether one size fits all. They need not determine either that all firms need employee representation or that all should be insulated from employee representation. If some firms will operate more efficiently with employee participation and some will operate more efficiently without it, an enabling approach lets firms sort themselves out.

---

<sup>128</sup> See generally Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-28 (1993).

<sup>129</sup> One of the more surprising implications of the contractarian model, from the point of view of transition economies that have just implemented the idea of private ownership structures in the economy, is that shareholders do not own corporation because a nexus of contracts by definition is not a thing or object capable of being owned.

<sup>130</sup> See, e.g., Larry E. Ribstein, *The Mandatory Nature of the ALI Code*, 61 GEO. WASH. L. REV. 984, 989-91 (1993).

This is a central tenet of the nexus of contracts theory of the firm.<sup>131</sup> According to the contractarian model, the corporation's various constituencies will trade rights and duties among themselves, creating a complex bargain in which claims on the corporation are sold to their highest high-valuing user.<sup>132</sup> The bargain struck will vary from firm to firm, depending on a variety of factors, including the risk preferences of each of the firm's constituencies and the thickness of the markets in which the bargain is struck.<sup>133</sup> Because the various contracts making up the firm thus result from the same process of voluntary exchange as any other contract, they have a presumption in their favor, and ought to be enforced in the same way as all other mutually beneficial contracts are enforced.<sup>134</sup>

To be clear, we are not arguing that an enabling approach is perfect. Under an enabling approach, corporate managers may exploit their workers and/or stockholders. Under an enabling approach, given the current distribution of stockownership in Slovenia, a large institutional investor may be able to tilt the corporation's internal governance rules in its favor. One can readily imagine a 20-40% holder directing management to comply with its will.

In practice, given the current economic conditions in Slovenia, some regulation is clearly necessary to enhance competition in the financial markets. While the dearth of large block ownership in U.S. public corporations is partially attributable to the regulatory framework described above, it is also in large measure the result of fierce competition between U.S. institutional investors. In an economy with thousands of mutual funds, pension funds, and other institutional investors, large block holdings will always be rare. Reforms designed to encourage dispersal of ownership among a increased number of actively competing institutional investors appear necessary in order to limit the risk of self-dealing by large institutional holders. Despite the theoretical merits of an enabling approach, until the power of the present large institutional holders is limited by such reforms, it may be desirable to preserve a two-tier system in hopes that independent professional directors chosen both by employees and shareholders will act as a check on the large institutions.

#### IV. CONCLUSION

Slovenia is faced with the challenge of adopting reforms to its economic and legal system, in order to both improve the living standards of its citizens and meet the conditions for accession imposed by the EU. One of the more important instruments to increase the economy's efficiency is its corporate governance system, with regard to which Slovenia must continue to take a number of decisions. Should

---

<sup>131</sup> See *id.* at 991-93 (firms are highly adaptive, developing various governance forms in response to different conditions).

<sup>132</sup> Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 179.

<sup>133</sup> *Id.*

<sup>134</sup> Ulen, *supra* note 128, at 322.

Slovenian legislation continue to follow the German model with its mandatory two-tier board system, or should Slovenia allow corporations the freedom to introduce the single board model where appropriate? Should Slovenian corporate legislation allow shareholders to modify employee participation rights and other aspects of corporate governance? In seeking to answer these question, we have taken into account both comparative analyses and domestic economic, political and cultural (behavioral) circumstances. We conclude that Slovenia should pursue a range of reforms designed to limit the power of large institutional investors and, perhaps only then, move towards an enabling approach in which corporations are freed to set their own corporate governance policies within very broad guidelines.