THE POSITION OF THE BUSINESS JUDGMENT RULE IN DIFFERENT CORPORATE CULTURES AND STRUCTURES: A STUDY AND ANALYSIS

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Résume

Les cours américaines ont contribuées au droit des entreprises en élaborant des principes pour rapprocher les actionnaires avec l`équipe de gestion. Un principe important est la Règle de Jugement Commercial (RJC). La RJC occupe présentement une position importante dans le droit corporatif américain. Par contre, il n'occupe pas une position comparable dans les lois d`autres juridictions.

Présentement, lorsque des économies différentes s`intègrent dans un marché international, les corporations sont en train de former des alliances globales. Le projet de mémoire étudiera le rôle de la RJC dans les alliances globales en prenant le cas de la Star Alliance comme exemple et en l`analysant. Il étudiera plus particulièrement la position de la RJC dans le contexte de l`interaction entre des structures et cultures corporatives différentes. Le projet de mémoire analysera les cultures corporatives de l'Allemagne et du Japon. Il arrivera à la conclusion que l`importance de la RJC est en train d`augmenter et qu'elle s`installera dans des juridictions autres que celle des États-Unis.

Abstract

The American courts developed business law by devising principles for resolving the rift between shareholders and the management. An important principle in this respect is the Business Judgment Rule (BJR). The BJR has attained an important position in the American corporate law. However, it has failed to find such position in the laws of other jurisdictions.

In the current era, when different economies are integrating into a global market, corporations are forming global alliances. This thesis will study the role of the BJR in global alliances by examining the case of the Star Alliance as an example. It will focus in particular on the position of the BJR in the interplay of different corporate structures and cultures. The thesis will review corporate cultures of Germany and Japan. It will conclude that the BJR's importance is growing and finding place in jurisdictions other than America.

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INTRODUCTION

The Business Judgment Rule (BJR) is critical to the American Corporate law system. For years, the BJR has been the primary means by which courts have reviewed decisions by corporate directors concerning ordinary day-to-day business matters.[1] It is getting even more important in the present era and indeed is evolving and expanding. A Delaware decision provides interesting figures in this regard.[2] The Court observed:

> [t]he place of this concept in the analysis of corporate law is growing at an impressive rate. ...for the decade starting with 1943 the results areas follows: 16 reported opinions (1943-52); 25 reported opinions (1953-62); 28 opinions (1963-72); 156 opinions (1972-82); 620 opinions (1983-92). The growth continues. In the 18 months since the close of 1992 149 opinions were published that invoked this term.[3]

This thesis will discuss the position of the BJR in a globalized corporate world. The term "globalized corporate world", for the purposes of this thesis, refers not to multinational corporations, but rather to interplay

[1] D.J. Block, N.E. Barton, S.A. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers*, (Clifton: Prentice Hall, 1987) [hereinafter D.J. Block, Business Judgment Rule].
[2] *Cinerama, Inc.*v. *Technicolor, Inc.*, (1994) 663 A.2d 1134 (Del. Ch.).
[3] ibid.

of different corporate governance systems and interplay of different corporate structures.

This thesis will study the position of the BJR in the American system of corporate governance and in corporate governance systems which are significantly different from American model, notably the Japanese and German models. The reasons to select these jurisdictions are both academic and practical. For academic purposes, these jurisdictions are important because America, Japan and Germany cover three very important and different approaches towards running a corporation and correspond to the three most powerful economies in the world. The American economy is considered to be the strongest in the world. Japan also has managed a very strong economy with a quite different approach towards corporate governance. Germany is considered to be somewhere between American and Japanese models. So, for academic purposes, these three jurisdictions command most attention. There are of course other jurisdictions like the UK, China and France etc. that can be of equal interest but due to the limited scope of the thesis we cannot do justice to all the jurisdictions, and, we shall confine our study to those three jurisdictions only.

There are three basic form structures in the law: (1) sole proprietorship, (2) partnership and (3) incorporations.[4] Out of these basic structures other structures have evolved. For purposes of study of BJR, it will be interesting to see how does this entanglement of structures affect the BJR. The entanglement of corporations and partnerships is seen quite often in the form of alliances where different corporations form a partnership.

In this thesis we intend to study the position of the BJR in a structure that involves not only different organizational forms but also different systems of corporate governance as exemplified in cross-border strategic alliances. From the galaxy of strategic alliances we have chosen the Star Alliance as a model for study. Star Alliance is a partnership of different corporations from various jurisdictions including America, Japan and Germany, and it is considered one of the most sophisticated and successful strategic alliances. One of the Star Alliance partners is Air Canada, which has provided the author with a privileged window of the functioning of the Star Alliance and the role of the BJR within it.

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[4] J.A. VanDuzer, *The Law of Partnerships and Corporations*, (Concord: Irwin, 1997) [hereinafter VanDuzer].

The first part of the thesis provides an overview of the BJR in America. Its history, definition, ingredients, scope and current evolution in American corporate law will be explored.

The second part will discuss the approach Japanese and German corporate law regimes take and their response to BJR.

Part three will explain alliances and interplay of corporations and partnerships and jurisprudential issues stemming from this interplay, focusing on the Star Alliance as an example. The governance system adopted by the Star alliance and position of the BJR in it forms the centerpiece of the analysis. The approach adopted by Star Alliance regarding the BJR will be discussed and the reasons for adopting that approach will be analyzed. The conclusion will contain some preliminary analysis of the future of the BJR.

PART 1

BJR AND ITS STATUS IN AMERICAN CORPORATE SYSTEM

I. History, Concept And Evolution

The Business Judgment Rule (BJR) is of significant importance in the American Model of corporate governance that has been part of the common law for at least 150 years.[5] The business judgment rule has remained a jurisprudential tool and not a statutory one". [6] Although, BJR is now recognized indirectly in many legislative enactments[7], it is not defined or recognized explicitly as BJR in those enactments.

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[5] J. Hinsey, "Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine and the Reality" (1984) 52 G.W.L. Rev. 609. [hereinafter J. Hinsey]
[6] C. Jordan, *Modern Company Law For A Competitive Economy, DTI, London, An International Survey Of Companies Law In The Commonwealth, North America, Asia And Europe.*
[7] See e.g., Canadian Business Corporation Act s.182. and American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994) Section 4.01 (a).

Its origin in American legal decisions[8] can be traced as far back as 1829 when in *Percy* v. *Millaudon*[9] the Louisiana Supreme Court observed that:

> [T]he occurrence of difficulties... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions... The test of responsibility, therefore should be, not the certainty of wisdom in other, but the possession of ordinary knowledge; and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.

Since that time, the concept of BJR has evolved, and now involves some additional factors rather than mere reasonable diligence. Presently, the BJR, as stated by Delaware Courts, is "a presumption that in making a business decision the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action taken was in the best interest of the

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[8] Although the concept of Business Judgment rule to an extent was recognized by British courts even before American Courts but that concept was not that developed as in American cases. See for example, *Charitable Corp.* v. *Sutton* (1742), 26 Eng. Rep. 642 in which the Court recognized the reasonable diligence aspect of BJR.

[9] 8 Mart. (n. s.) 68 (La. 1829).

company".[10] This presumption protects decisions taken by the directors.[11] The plaintiff must allege facts sufficient to overcome the initial presumption of the business judgment rule, in order to save a suit from summary dismissal.[12] It must be noted that unavailability of the business judgment rule is not tantamount to liability of the director[13] rather it only entails examination of the directors' decision on merits.

As stated above, the BJR establishes a presumption of reasonableness and the plaintiff must allege facts sufficient to overcome that initial presumption.[14] However there are some situations under which the burden of proof shifts to directors. This shift in burden of proof occurs in cases of takeover attempts. There is an apprehension that in such situations directors' self-interest may overshadow the interest of the corporation[15] as the potential for conflict of interest is at maximum in these situations. American Courts, especially Delaware Courts, have expressed this

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[10] *Aronson* v. *Lewis* (1984), 473 A. 2d 805 (Del. Sup. Ct.) [hereinafter *Aronson* v. *Lewis*]
[11] *Sinclair Oil Corp.* v. *Levien* (1971), 280 A. 2d 717 (Del. Sup. Ct. 1971).
[12] See *Reget* v. *Paige*, 2001 WI App 73 [hereinafter *Reget* v. *Paige*]
[13] B. Manning, "Current Issues In Corporate Governance: The Business Judgment Rule in Overview". (1984) 45 Ohio St. L.J. 615, [hereinafter B. Manning]
[14] *Reget* v. *Paige* supra Note 12.
[15] M. St. P. Baxter, " The Fiduciary Obligations of Directors of a Target Company in Resisting an Unsolicited Takeover Bid" (1988) 20 Ottawa L. Rev. 63.

view in many cases.[16] The leading case in this regard is *Unocal Corp.* v. *Mesa Petroleum Co.*,[17] which developed a test now known as Unocal test. This test provides that the board can only be accorded the protection of the business judgment rule where the board first satisfies a prior two-part burden: (1) the board must show that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed; and (2) that the board of director's defensive response was reasonable in relation to the threat posed. Once the directors have proven that they meet these requirements, the burden shifts back to the plaintiff to rebut the presumptions of the business judgment rule. While justifying the need for this shift of burden of proof, the Court observed:

> When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interest of the corporation and its shareholders. In that respect, a board's duty is no different from any other responsibility it shoulders and should be no less entitled to the respect it otherwise would be accorded in the realm of business judgment. There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholder, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rules may be conferred.[18]

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[16] See generally, *Moran* v. *Household Int'l Inc.* (1985), 500 A.2d 1346 (Del. Sup. Ct.), *Revlon Inc. v. MacAndrews & Forbes Holding Inc.* (1986), 506 A.2d 173 (Del. Sup. Ct.) [hereinafter *Revlon Inc.*], *Ivanhoe Partners* v. *Newmont Mining Corp* (1997), 535 A. 2d 1334 (Del. Sup. Ct.).
[17] (1985) 493 A.2d 946 (Del. Sup. Ct.).

Showing good faith and reasonable investigation can discharge this burden.[19] The approach adopted in this case has been criticized on the ground that on analyzing the reasonableness of a defensive tactic, the courts are effectively making business judgments in the place of directors.[20]

The author personally does not agree with the approach adopted by U.S. Courts and prefers the approach generally adopted by Canadian Courts in this regard. In Canada, we can see two major disagreements with the American approach. First instance, in the leading Canadian case *Teck Corporation Ltd.* v. *Millar*[21], the Court did deviate from the BJR and suggest a two-part test on reasonableness in a takeover setting but the burden of proving unreasonableness was still on the plaintiff. The second major disagreement was expressed in *CW Shareholding Inc.* v. *Western International Communications Ltd.*[22] where the Court applied the regular BJR to assess the response of defendants in a takeover situation. The Court observed:

> .....to impose an evidentiary burden on the directors of a target company to justify their actions and their

[18] ibid.
[19] ibid.
[20] J.F. Bernier, "shareholders' Rights Plans – The Poison Pill in the U.S. and Canada: Background and Legal Considerations" (1990) 21 R.D.U.S. 123.
[21] (1972), 33 D.L.R. (3d) 288 (B.C.S.C).
[22] [1998] O.J. No. 1886 (Ont. Ct. Just.).

> business decisions, I think, respectfully, that it goes too far.... In my view it places the initial burden in the wrong place; and it creates the potential for diluting to a very weak potion, the business judgment approach to review of directors decisions.... I am satisfied that the proper way to address the appropriateness of director decisions in the context of a heated takeover bid situation is through the judicious application of the "business judgment rule"... That is, where business decisions have been made honestly, prudently, in good faith and on reasonable and rational grounds, the Court will be reluctant to interfere and to usurp the board of director's function in managing the corporation.[23]

I agree with the view expressed in CW Shareholding Inc. because in my opinion the BJR's good faith, due care and best interest of company components successfully cover any decision taken by the directors under any circumstances. Furthermore, in my opinion, to place burden of proof on the defendant is against the basic tenets of law.

II. Why Do We Need BJR:

The BJR is grounded at least in part, in the recognition that "[d]irectors are in most cases, more qualified to make business decisions than are judges".[24] The Court's admission that "after-the-

[23] ibid. at para 65-66.
[24] *Federal Deposit Ins. Corp.* v. *Stahl* (1996), 89 F.3d 1510 (11th Cir.).

fact litigation is a most imperfect device to evaluate corporate business decisions."[25], is also a factor.

Different rationales can be offered to justify BJR; the most notable among them[26] are the following:

1. Human Fallibility

The BJR is recognition of the fact that even intelligent, well intentioned and diligent persons can make mistaken judgments[27] that can lead to great losses to the corporation. The recent downturn of Nortel Corporation Stock, falling hard on the.... of a year in which Nortel's senior management was greeted with....., is a striking illustration of this point. The BJR acknowledges this fallible aspect of human nature and encourages otherwise competent and well-intentioned persons to come forward without being afraid of personal liability.[28]

2. Importance Of Taking Risks

[25] *Joy* v. *North* (1982) 692 F.2d 880 (2d Cir.).
[26] As summarized in, D.J. Block, Business Judgment Rule supra note 1.
[27] See *Washington Bancorp*. v. *Said,* 812 F. Supp. 1256 (D.D.C. 1993).
[28] *Air Line Pilots Ass'n* v. *UAL Corp.* (1989), 717 F. Supp. 575 (N.D. Ill.).

Business decisions sometimes involve significant risks. Absent the protection of the BJR no director and senior officer may be willing to indulge in such decisions. In the long run, this can be detrimental to the corporation because risky ventures also have potential for great profits. Furthermore, absence of risk-taking is detrimental to the economy as a whole inasmuch as dynamic changes are the most powerful engines of efficiency and growth. Thus, the BJR encourages competent directors to take risks, which, they honestly believe, can be extremely beneficial for the corporation.[29]

3. Court's Inability

Courts have repeatedly admitted that business decisions can be taken better by directors than the courts because the directors are more qualified, trained and well equipped to take such decisions than are judges.[30] Therefore, by testing a business decision with the standards set by BJR courts can avert entering into unfamiliar areas of business world.

4. Prevention of Abusive Shareholder Litigation

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[29] ibid.

[30] *Federal Deposit Ins. Corp.* v. *Stahl,* 89 F.3d 1510 (11th Cir. 1996).

It is very rare that all the shareholders approve a board decision unanimously. Some shareholders can be found who may disagree with the decision and are willing to challenge it in a court of law. If every decision is examined by a court of law on the merits, it will affect the decision-making process significantly. Under these circumstances directors would become an easy target for exploitation by shareholder, ultimate corporate control would be in the hands of shareholders who are always ready to challenge the decision. [31] The BJR ensures that directors representing the majority rather than disgruntled shareholders manage corporations.[32]

5. Availability Of Other Remedy

The BJR protects honest mistakes in judgment. If the shareholders do not want a director who has made a mistake, they can, in most cases, vote him or her out of office.[33] Directors who make business decisions poorly soon give way to other executives.[34]

III. BJR And Business Judgment Doctrine (BJD):

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[31] Dooley, "Not in the Corporation's Best Interests" (1992) A.B.A.J. at 45.
[32] D. J. Block, Business Judgment Rule supra Note 1.
[33] *Hilton Hotels Corp.* v. *ITT Corp.*, 978 F. Supp. 1342 (D.Nev. 1997).
[34] *Kamen* v. *Kamper Fin. Servs., Inc.*, (1990) 908 F. 2d 1338 (7th Cir.).

As regards business decisions, not only the directors are to be protected but the decisions themselves are also to be protected. The directors are protected by business judgment rule and the decision itself is protected by business judgment doctrine.[35] The essential elements of the rule and doctrine are the same.[36]

The general practice, therefore, is to refer only to "BJR" even when actual reference is to the doctrine i.e., protection of the decision itself.[37]

For the purposes of this thesis, the term BJR will include BJD unless specifically stated otherwise.[38]

IV. <u>Scope Of The BJR:</u>

The BJR performs two types of functions. It not only works as a shield for directors, but also works for the benefit of shareholders.

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[35] J. Hinsey supra Note 5.
[36] ibid.
[37] D. J. Block, Business Judgment Rule supra Note 1.
[38] For detailed discussions on this point see generally, B. Manning supra note 13 and J. Hinsey supra note 5 and D.J. Block, Business Judgment Rule supra note 1.

In words of Manning, the business judgment rule is frequently converted from a "protective shield" into an "aggressive sword".[39]

It protects directors from unwanted litigation and personal liability but at the same time it also sets a limit for director discretion outside of which they cannot act. This limit is set by the requirements or conditions necessary to attract the application of BJR.

<u>Preconditions To Application Of Rule</u>:

As a general matter[40] in order to attract BJR there must be: (a) A business decision[41], (b) the absence of personal interest or self-dealing at the time of decision[42], (c) an informed decision, reflecting a reasonable effort to acquire all relevant information[43], (d) a reasonable belief that the decision is in best interests of the corporation[44] and (e) absence of abuse of discretion[45].

<u>1. A Business Decision</u>

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[39] B. Manning supra Note 13.
[40] See for example *Aronson* v. *Lewis* supra note 10.
[41] *Rales* v. *Blasband* [634 A. 2d 927 (Del. 1993)] [hereinafter *Rales* v. *Blasband*]
[42] *Lewis* v. *Sl & E. Inc.*, 629 F.2d 764 (2d Cir. 1980).
[43] *Casey* v. *Woodruff*, 49 N.Y.S.2d 625 (Sup. Ct. 1994).
[44] *Treadway Cos., Inc.* v. *Care Corp.*, 638 F.2d 357(2d Cir. 1980).

A business decision can be a decision to act in a certain manner or a conscious decision not to act[46]. Where there is no conscious decision by directors to act or refrain from acting, the business judgment rule cannot apply.[47]

2. Disinterestedness

The presumption of the BJR does not apply to a director who has some personal interest in the decision separate from the interest of corporation in general. A director cannot derive any personal financial benefit from a business decision as opposed to a benefit which devolves upon the corporation generally.[48]

3. Informed Decision/Due Care

To come under the protection of BJR, directors must show a reasonable degree of care and caution. The degree of care is generally measured by the endeavor of directors, while in process

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[45] *Cramer* v. *General Tel. & Elecs. Corp.*, 582 F. 2d 259, 275 (3d Cir. 1978) [hereinafter *Cramer* v. *General*]
[46] *Aronson* v. *Lewis* supra note 10.
[47] *Rales* v. *Blasband* supra note 41.
[48] *Aronson* v. *Lewis* supra note 10.

of making a decision, to look for information that could enable them to consider the alternatives to a particular decision.

4. No Abuse of Discretion

Where a decision otherwise qualifies to the protection of BJR but is so unreasonable as to constitute arbitrariness and abuse of discretion, such a decision will not be protected by BJR.[49]

5. Good Faith

A decision taken in bad faith cannot be protected by BJR. Bad faith does not mean bad judgment or negligence. "By bad faith is meant a transaction that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law".[50]

6. Best Interests of The Corporation

The term, "best interests of the corporation" is, probably that which has given rise to the most judicial consideration. The Courts

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[49] See, *Cramer* v. *General Tel. & Elecs. Corp.*, supra note 43.
[50] *Gagliardi* v. *TriFoods Int'l, Inc.*, 1996 Del. Ch. LEXIS 87.

are continuously expanding the meanings of the term. Acts that are not directly related to the shareholders, but are beneficial for them in long run are now being accepted as acts in the interests of the corporation.

By widening the scope of the term, the Courts have contributed to the ongoing debate regarding responsibility of directors to the various constituencies and stakeholders.[51] The argument that corporate management should consider the interests of many constituencies is gaining recognition and acceptance in the world of corporate law.[52] Some courts have expanded the application of the business judgment rule to cover the actions taken for the benefit of other corporate stakeholder groups, especially employees and local communities.[53] For example in the *Revlon* case[54] the Court noted, "a board may have regard for various constituencies in discharging its responsibilities".[55] Similarly in the *Unocal* case the Court recognized that the business judgment rule allows directors to consider, among other factors, the effects of a takeover on "creditors, customers, employees, and

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[51] See, E. M. Dodd, Jr., "For whom are Corporate Managers Trustees?" (1932) 45 Harv. L. Rev. 1145.
[52] R. M. Green, "Shareholders as Stakeholder: Changing Metaphors of Corporate Governance" (1993) 50 Wash & Lee L. R. 1409 [hereinafter R. Green, Shareholders as Stakeholders]
[53] ibid.
[54] *Revlon Inc.* supra Note 16.
[55] ibid at 182.

perhaps even the community generally" when enacting defensive measures.[56]

These decisions, however, require that measures taken on behalf of other constituencies produce "some rationally related benefit accruing to the shareholders".[57]

As Green observes[58]

> [c]ourt decisions have widened the latitude of fiduciary decision-making, but they have not altered its ultimate priorities. In every case, the claims and welfare of other corporate stakeholders must also serve the long-term interests of shareholders.

In summary, while the focus of the American corporate model is on shareholders' benefits, and in order to protect directors from the overwhelming influence of disgruntled shareholders, the BJR is inevitable. Indeed, the protection of shareholders' interests is also effected through the BJR. However, not all jurisdictions share the same context and approach. Japan and Germany, for example, have quite different corporate law cultures. In these cultures, shareholders are of somewhat secondary importance. This leads us to questions such as, if they give only secondary importance to shareholders, do they need the BJR or not? What is their approach

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[56] 493 A.2d 946 Del., 1985.
[57] *Revlon Inc.* supra Note 16.

in redressing concerns related to the BJR? It is to these questions that we now turn.

[58] R. Green, Shareholders as Stakeholders supra note 52.

PART 2

IS THE BJR NEEDED ONLY IN AMERICAN CORPORATE MODEL? THE JAPANESE AND GERMAN CASES

As stated in the introduction, the reason to compare Japan and Germany is their ability to manage sound economies while adopting different models of corporate governance.

In order to study the position of the BJR in these jurisdictions, some level of familiarity with their corporate cultures is imperative. We cannot truly appreciate and understand their approach without first understanding certain peculiarities of these systems and their differences with the U.S. In what follows, the Japanese and German models of corporate governance are treated successively.

I. JAPANESE MODEL OF CORPORATE GOVERNANCE

The Japanese model of corporate governance is fundamentally different from the American model. To some, it is not only different but it is much more complicated than American corporate governance.[59]

The basic difference between two models lies in the approach towards the relationship between the corporation and its stakeholders. It is believed that the success of Japanese corporations in domestic and international markets is due, in part, to the unique design of Japanese corporate governance system.[60] Before discussing the method adopted by the Japanese corporations regarding the BJR, it will be helpful to discuss some salient features of this model briefly. The following are some basic characteristics of the Japanese model of corporate governance.

1. Long-term Vision

The Japanese approach towards corporation is fundamentally different from the American approach and is often identified as a long-term approach or long-term vision. The two factors, which have earned this name for the Japanese approach, are the following:

a- Long-term goals

[59] Z. Shishido, "Japanese Corporate Governance: The Hidden Problems Of Corporate Law And Their Solutions" (2000) 25 Del. J. Corp. L. 189 [hereinafter Z. Shishido, Japanese Corporate Governance]

b- Long-term relationships

a. Long-term Goals

Unlike American managers, Japanese managers are not so concerned with the current movement in their own stock prices. A survey of 1,000 Japanese and American firms by Japan's Economic Planning Agency[61], finds that on a scale of 0 to 3—3 being most important—Japanese firms give "Higher Stock price" a rating of only 0.02. On the other hand "Increasing Market Share" gets a reported rating of 1.43 in Japan, almost twice its rating in the United States.[62]

b. Long-term relationships

The second factor, owing to which the Japanese management is credited with long-term vision, is that of enduring business relationships. American managers believe in a short-term, arm's-length contracting setting, whereas in the Japanese model most contractual relationships are long lasting and durable. Whenever two Japanese institutions enter into a relationship, they intend it to

[60] see ibid.
[61] Reported in Chicago Tribune, August 24, 1992.

last. This factor is often understood to be the soul of the Japanese Keiretsu system.[63]

Lifetime employment can be considered to be a part of this general long-term vision. Not only workers but also managerial staffs enjoy lifetime job security in Japanese corporations.[64]

2. Concentrated Shareholding

Shareholders of a Japanese company can be divided into two categories:

a- Inside shareholders and

b- Outside shareholders [65]

The inside shareholders are cross-shareholding partners and are very unlikely to sell the shares given the nature of their express and implied agreements. Inside shareholders have a voice in corporate governance.[66]

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[62] ibid.

[63] Discussed below in detail under the head of "Keiretsu".

[64] For detailed discussion see, R. J. Gilson & M. J. Roe, "Lifetime Employment: Labor Peace And The Evolution Of Japanese Corporate Governance"(1999) 99 Colum. L. Rev. 508.

[65] Z. Shishido, Japanese Corporate Governance supra note 59.

[66] ibid.

Outside shareholders trade their shares freely. Outside shareholders are not recognized in corporate governance, only in the financial market.[67]

In Japanese corporations controlling shares are generally not widely spread. Unlike American corporations, large Japanese corporations believe in concentrated shareholdings, and the inside shareholders are far more actively involved in the matters of corporations than those of American corporations.

In American corporations ownership is so widely dispersed that shareholders are practically unable to have a say in the decisions of directors.

3. Keiretsu

The Keiretsu is a distinctive feature of Japanese system of corporate governance. It is a complex group of companies built around a major bank, trading company or industrial firm.[68]

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[67] Z. Shishido, Japanese Corporate Governance, supra Note 59.
[68] W. C. Kester, "Governance, contracting and Investment Horizons: A Look at Japan and Germany", Studies in International Corporate Finance and Governance Systems-A Comparison of the US., Japan, and

Keiretsus generally include suppliers, dealers, insurers, service companies, manufacturers and so forth. One-third of Japanese corporate cross-holdings are not held by financial institutions, but by industrial companies, which are often suppliers or customers of the portfolio company.[69]

Keiretsu members have a strong affiliation and loyalty among each other. Group members are usually given preferences over others. If a manufacturing company can get parts and equipment within its own group, it is quite likely to do so.

But this does not mean that Keiretsu members will not deal with any non-member corporation. It can be illustrated as follows: Mitsubishi Motors will get some of its steel and equipment from Mitsubishi Steel and Mitsubishi Heavy Industries. They, in turn, will include Mitsubishi Motor's autos and trucks in their vehicle fleets.[70]

It is possible for companies to take these kind of stable and loyal clients for granted and lose quality control or the need to improve

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Europe, edited by Donald H. Crew, (1997) New York, Oxford University Press, 227. [hereinafter Kester, Governance, contracting and Investment Horizons]

[69] R. J. Gilson & M. J. Roe, "Understanding The Japanese Keiretsu: Overlaps Between Corporate Governance And Industrial Organization" (1993) 102 Yale L.J. 871. [Hereinafter R. J. Gilson, Understanding The Japanese Keiretsu]

[70] Kester, Governance, contracting and Investment Horizons, supra note 68.

performance. There are several different factors that help Japanese companies to cope up with these issues.

a. There is competition even among keiretsu members.

b. The major part of sales is always outside the keiretsu;

c. Owing to reciprocal equity ownership and cross shareholding, members of keiretsu are not always free to make their own decisions and are subject to monitoring by partners.

d. Finally, depending upon the quality and performance of the companies intragroup sales vary between 8% to 30%.[71]

4. Reciprocal Equity Ownership And Cross-shareholdings

On average, individual investors hold less than a quarter of a Japanese corporation's outstanding shares; more than two-thirds are held by other Japanese corporations.[72]

Between 10% and 25% of all the outstanding shares of group members are generally held within the keiretsu itself. These holdings are usually not sold as long as the keiretsu relationship

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[71] Kester, Governance, contracting and Investment Horizons, supra note 68

[72] P. Sheard, *Interlocking Shareholdings and Corporate Governance, in The Japanese Firm: The Sources of Competitive Strength* at 310.

exists. A decision to sell equity held under these arrangements would be viewed as a clear repudiation of the relationship.[73]

One factor that encourages cross-shareholding, is the rigidity of Japanese corporate law. In Shishido's opinion "If Japanese corporate law were flexible enough to allow shareholders to tailor the legal governance structure to better defend against hostile takeovers, then cross-shareholding, which is costly, would not be used in practice."[74]

These cross-shareholdings serve as more than just a tool to avoid hostile takeover; they are very important for proper working of a Keiretsu. They create a blend of stakes held by two companies in one another. Usually, the major lenders of a company are also its major shareholders.

Gilson and Roe summarize the benefits of cross-ownership into

(1) lowering the costs of information transfer by allowing other parties to acquire information as suppliers as well as stockholders,

[73] Kester, Governance, contracting and Investment Horizons, supra note 68.
[74] Z. Shishido, Japanese Corporate Governance supra Note 59.

(2) increasing the incentives to intervene when a firm is in trouble, and

(3) providing added means of intervention since stockholders are both buyers of a product and owners of stock. [75]

In the American system of corporate governance, there is frequently a concern that corporations may breach contracts with suppliers and customers in the interests of transferring value to shareholders, or that they may borrow money and then take extraordinary risks that might benefit shareholders at the expense of lenders. These situations arise much more rarely in the Japanese system of corporate governance because here the stakeholders are the company's own principal shareholders.

Another important benefit of this tendency to hold a blend of different financial and other contractual claims against a company is that it reduces any potential friction that might normally arise

[75] R. J. Gilson, Understanding The Japanese Keiretsu supra note 69.

among various stakeholder groups owning separate and distinct claims.

5. Monitoring And Intervention

The other salient feature of Japanese corporate governance is constant monitoring by group members or stakeholders and the ability to intervene in the business of corporations.

There are different clubs, councils and associations among Keiretsus, consisting of a large number of member corporations. Among their several purposes, these clubs and councils serve as collectors and disseminators of information about members' experiences with each other or, in the case of the supplier organizations, with a common purchaser.[76]

Perhaps the most powerful and distinctive feature of Japanese system of corporate governance is the ability of one or more equity owning stakeholders to intervene in the affairs of another company when necessary to correct a problem. This intervention is not common, and is only done when considered necessary to

[76] Z. Shishido, Japanese Corporate Governance supra note 59.

improve the performance of a company, but when the situation demands, it is generally expected. [77]

Typically, such interventions are undertaken by a company's main bank because it is usually the largest single supplier of capital and has quicker access to more information than most other equity-owning stakeholders. However, this intervention is not strictly limited to the banks. In fact any company that is considered appropriate at that time can be called for helping the effected company.[78]

These interventions are also not limited to financial difficulties. Whenever members of a Keiretsu face problems that they themselves are unable to resolve, other members come to their rescue. For example, a Tokai Bank executive assumed the presidency of a client company, Okuma Machinery Works, in order to resolve a bitter dispute between labour and management over who was to succeed the company's founder-president.[79]

II. BJR In Japan

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[77] Kester, Governance, contracting and Investment Horizons, supra note 68.
[78] ibid.
[79] M. Gerlach, "Business Alliances and the Strategy of the Japanese Firms" (1987) California Management Review pp. 126-142.

As discussed earlier[80], BJR works in two ways; it protects the directors, and it protects the shareholders by checking the authority of the directors. As is apparent from the above-description of Japanese system of corporate governance, Japanese stakeholders are not as vulnerable as American stakeholders. Stakeholders are shareholders in Japan. Because of concentrated cross-shareholding, these shareholders are effectively involved in every major decision taken by the directors.[81] As they have better control over directors including the ability to intervene in the functions of a corporation, Japanese stakeholders are very unlikely to go to court or even to blame directors for any error in judgment.

It must also be kept in mind that shareholders are usually highly skilled business people themselves. Thus, the protection of shareholders is achieved in Japanese corporation through their active participation in, which as business people they are able to do.

[80] See Part 1 above.
[81] See Keiretsu above.

As far as protection for directors is concerned, due to active participation of shareholders and the relatively limited powers of directors, it is quite rare to blame directors for any decision that does not achieve the desired results. Indeed, the Japanese legal community did not recognize any need for deference to the director decisions. The Japanese Commercial Code reflects this, containing no doctrine equivalent to the business judgment rule recognized in U.S. corporate law.[82] However, recently the trend has changed and shareholders are filing suits against corporations more frequently than ever. Commentators point to the 1993 Japanese Commercial Code amendments, introducing the reforms in the shareholder derivative suit mechanism, as responsible for the growing frequency of shareholders litigation.[83] Indeed, Japanese courts and commentators have recently begun to take note of the business judgment rule as a potential means for dismissing abusive suits.[84] Some courts have actually adopted the doctrine. In a case known as *AIC*[85], for example, the Tokyo District Court relied on the kind of deference called for under the business judgment rule to reject a claim that the directors breached their duty of loyalty by investing in an extremely risky

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[82] S. Kawashima & S. Sakurai, "Shareholder Derivative Litigation in Japan: Law, Practice, and Suggested Reforms" (1997) 33 Stan. J Int'l L. 9. [hereinafter Shareholder Derivative Litigation in Japan]
[83] Although abusive litigation was there even prior to changes and the Japanese courts applied the similar anology to dismiss the suits. See AIC infra.
[84] Shareholder Derivative Litigation in Japan supra note 82.
[85] *Sato* v. *Okura* (AIC), 654 HANREI TAIMUZU 231 (Tokyo Dist. Ct., Oct. 30, 1986).

venture.[86] Similarly, in another case[87] the Court used the business judgment rule to reject the plaintiff's claim regarding the breach of duty of care. In both *AIC* and *Nomura Securities*, the court incorporated the business judgment rule into its interpretation of the duties of care and loyalty under the Japanese Civil and Commercial Codes. Both cases concluded that the alleged misconduct was within the scope of managerial discretion.[88] Thus, Japanese Courts are trying to apply the business judgment rule, it is not an established legal concept[89] and the Commercial Code does not explicitly authorize it. [90]

III. <u>The German Model Of Corporate Governance[91]</u>

The German model of corporate governance is similar to Japanese corporate governance in a number of ways, but it is relatively less rigid and has some similarities with the American model as well. The following are some basic characteristics of the German model of corporate governance.

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[86] Shareholder Derivative Litigation in Japan supra note 82.
[87] *Ikenaka* v. *Tabuchi* (Nomura Securities), 1469 HANREI JIHO 25 (Tokyo Dist. Ct., Sept. 16, 1993).
[88] ibid.
[89] Z. Shishido, Japanese Corporate Governance supra Note 59.
[90] Shareholder Derivative Litigation in Japan supra note 82.
[91] Major changes were made in German corporate law in 1998. The changes were intended to make the working of the board more efficient. These changes have tightened the previously existing system of corporate governance but have not introduced any radical change in corporate governance structure as such. For details see, S. Butler, "Models of Modern Corporations infra note 96.

1. Cross Shareholding

It is difficult to give an accurate account of the ownership structure of German corporations as the shares of most German corporations are held in bearer form. According to Kallfass:

> [I]t is never clear who owns all of the outstanding shares of a West German corporation, because securities are issued as bearer shares. West German corporations are not required to keep records of their shareholders. The only information available on shareholder identification must be obtained by tracking the shares which are deposited with banks for safekeeping and by attending annual shareholder meetings to observe the voting.[92]

But the available evidence suggests that as a group, large German companies engage in fairly extensive cross-shareholdings.[93] "Large public firms typically have big blockholders that make the large firms resemble "semi-private" companies".[94] According to reports of a study by the German Monopolies Commission, there were 88 cross-shareholdings among Germany's largest 100 corporations in

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[92] H. H. Kallfass, "The American Corporation And The Institutional Investor: Are There Lessons From Abroad? The German Experience" (1988) Colum. Bus. L. Rev. 775.
[93] Kester, Governance, contracting and Investment Horizons supra note 68.
[94] M. J. Roe, "Corporate Governance: German Codetermination And German Securities Markets" (1999) 5 Colum. J. Eur. L. 199.

1984.[95] Financial institutions are especially large holders of equity in German companies, second only to other business corporations.

2. Company-Bank Relationship

The company-bank relationship in German model of corporate governance is somewhat similar to that of Japanese. Unlike what had until recently bee the case for American banks, German banks have long been permitted by law to operate as commercial and investment banks simultaneously.[96]

Companies have a long history of doing their banking business with a particular bank, called a Hausbank, which is similar to the main bank in Japanese keiretsu. Corporations generally obtain most or all of their financial services from their banks. However, large companies sometimes have multiple main bank relationships and their credit relationships are not always exclusive.[97] Hausbanks are generally the equity-owning banks and the sale of their holding is most infrequent. The same is true for Japan.

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[95] D. Shirreff, "Bankers as Moral Monopolists," Euromoney, March 1987, p 71.
[96] S. Butler, "Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures"(2000) 17 Ariz. J. Int'l & Comp. Law 555. [hereinafter S. Butler, "Models of Modern Corporations]
[97] T. Baums, "Corporate Governance in Germany: The Role of the banks" (1992) 40 AM.J.COMP.L. 503, 508.

3. Share Depository

Share depositing is a distinctive feature of the German system of corporate governance. German banks not only own shares directly, but they also act as share depositories for shares owned by other classes of shareholders. At the end of 1988, nearly 50% of listed German corporate shares were directly or indirectly under the control of banks.

These share deposits add to the power of banks as the banks can vote for the shares deposited with them. The delegation of voting rights to portfolio-managing banks is quite normal among private investors. At the general meetings of widely held corporations, these banks account for over 90% of the voting rights, because of the rights transferred to them by their clients.[98]

This ability to vote the deposited shares is called Vollmachtstimmrecht. [99] Despite some regulatory measures, practically all banks have effective voting control.

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[98] Ibid.

[99] Kester, Governance, contracting and Investment Horizons supra note 68.

4. Supervisory Board (Aufsichtsrat)[100]

At the heart of the German model is a two-tier board of directors. One board actively manages the business and affairs of the company, while the other board, elected in part by shareholders and in part by labour, is responsible for the supervision of the management board. [101] Under the German model of corporate governance the mode of control is different from the Japanese model. Unlike, Japanese direct management intervention, German banks exercise their influence through a supervisory board or Aufsichtsrat.

According to German law[102], the publicly owned listed companies must have a two-tiered board. The managing board is called Vorstand, whereas the supervisory board is known as Aufsichtsrat.[103]

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[100] Presently, supervisory boards are under tremendous criticism due to same recent scandals like KHD and Balsam matters. Different commentators have different views regarding the changes in supervisory board or the two-tiered system itself. For discussion see T.J. Andre, German Supervisory Boards, infra Note 101

[101] T. J. Andre, Jr., "Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards" (1996) 70 Tul. L. Rev. 1819. [hereinafter T.J. Andre, German Supervisory Boards]

[102] Stock Company Act, Aktiengesetz [AktG], 1965 BGB1. I 1089.

[103] T. J. Andre, German Supervisory Boards, supra note 101.

The Vorstand has day-to-day executive authority over the company[104] and is the real decision-making body on most matters. It generally consists of five to fifteen members who are full-time salaried executives of the company, each of whom performs certain administrative functions. The supervisory board appoints the members of Vorstand,[105] generally for three to five years. Although the Vorstand is free to make its day-to-day decisions it requires the consent of the Aufsichtsrat for major financial and investment decisions.

The Aufsichtsrat, or the supervisory board, is usually composed of 9 to 22 members.[106] As a consequence of the Codetermination Act of 1976, half of these members are required to be elected worker representatives (at least one of which, however, must be a member of the company's management). The other half of the board is elected by shareholders and consists entirely of members who are not full-time employees of the company.[107]

The shareholder-elected half of the German Aufsichtsrat is drawn from the executive ranks of other major corporations or financial

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[104] Section 76 AktG.
[105] AktG, section 84.
[106] Kester, Governance, contracting and Investment Horizons, supra note 68.

institutions that have a major stake of some sort in the company in question. That stake may be a substantial equity investment, a long-standing lending relationship, a vertical purchase or supply arrangement, or as in Japan, some combination of these various types of stakes.[108]

Although legally responsible for representing shareholder interests at large, German Aufsichtsrat members also monitor other stakeholders' interests. Bank executives on the boards of industrial corporations are especially well-positioned to act in this capacity.[109] The supervisory board has the right to receive certain information regarding the operation of the company.

The monitoring role played by the supervisory board is believed by some to be similar to that played by the outside directors on a unitary board in American corporations.[110] But there is some dissimilarity between the supervisory board and outside directors. In the U.S., the outside directors have the same responsibilities as the insiders, but in Germany the separation between the Vorstand and the supervisory board is much stricter. Except in rare

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[107] ibid.
[108] ibid.
[109] ibid.

instances, the statute explicitly forbids an individual from serving simultaneously on both the Vorstand and the supervisory board.[111] Moreover, management or executive functions cannot lawfully be delegated to the supervisory board or to any individual member of the board.

IV. Position Of BJR In Germany

So as far as checking the powers of managers is concerned, the German system provides a reasonable answer for it in the form of supervisory board. Shareholders have representation in the corporation in the form of Aufsichtsrat. Although they do not physically intervene in the affairs of the corporation, their consent is always necessary in important business decisions.

The protection of directors from liability is very strong in German law. The theoretical reason might be the limited powers of the Vorstand, but the practical reasons are quite different. The protection comes from the mechanism provided by German law for filing suit against the directors. German law [112]enumerates specific actions that are regarded

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[110] C. J. Meier-Schatz, "Corporate Governance and Legal Rules: A Transnational Look at Concepts and Problems of Internal Corporate Management Control" (1988) 13 J. Corp. L. 431, 443 n.67.
[111] AktG 105, P1.
[112] AktG section 93.

as per se violations of managers' obligations. Under German law, the pursuit of all legal claims is, in principle, left to the managers. The individual shareholders are not able to sue. Under German law, the corporation itself has the ultimate authority to enforce managerial duties.[113]

As a defensive measure, the power to decide whether the company should sue and the responsibility to file the suit, is not left to Vorstand, but rather it has to be exercised by the supervisory board (Aufsichtsrat).[114] It is quite unlikely for the Aufsichtsrat to sue the allegedly faulty managers because practically all the major decisions are made with its consent and by admitting the fault of a director, it may implicate itself as well.[115]

To redress this problem, AktG [116] provides that under such circumstances a shareholders' meeting may be held upon the request of the shareholders. At this meeting, a majority of shareholders can decide that the company should go ahead with an action against the supposed managerial wrongdoers.[117] This is questionable solution because the Aufsichtsrat is mainly elected by shareholders, and thus is

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[113] B. Singhof & O. Seiler, "Shareholder Participation In Corporate Decisionmaking Under German Law: A Comparative Analysis"(1998) 24 Brooklyn J. Int'l L. 493. [hereinafter Shareholder Participation under German Law]

[114] ibid.

[115] A. Barak, "A Comparative Look at Protection of the Shareholder Interest: Variations on the Derivative Suit" (1971) 20 Int'l & Comp. L.Q. 22, 39.

[116] AktG section 147.

supposed already to represent the majority of shareholders. It is therefore quite unlikely that the majority of shareholders will contradict the Aufsichtsrats' decision not to sue and decide to vote in favour of enforcement.

There is yet another option[118] available for shareholders, but it is also not free from impediments.[119] Both the supervisory board's refusal, and the concurring vote of the majority, can be set aside by a group of minority shareholders. But to be heard, such a group must represent at least one tenth of the stated capital for a minimum of three months prior to the date of the shareholders' meeting.[120] Generally it is quite difficult to meet this high capital requirement.[121] Thus, practically speaking, it is extremely difficult to hold the directors liable for any error in judgment; the directors do not need the protection of BJR as such.

A comparison of U.S. and German decisions suggests that the business judgment rule gives the U.S. board of directors broader discretion than to its German counterparts, and given the stakeholder oversight the discretion of management is narrower than under the U.S. business

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[117] Shareholder Participation under German Law supra note 113.
[118] See AktG § 147(1).
[119] Shareholder Participation under German Law supra note 113.
[120] See AktG § 147(1).
[121] Shareholder Participation under German Law supra note 113.

judgment rule.[122] Since German shareholders are the main stakeholders in the corporation and are knowledgeable in business, they are able to protect their interests effectively. So, from the shareholders protection point of view, the supervisory board serves as a substitute for BJR.

We have seen above that different legal corporate cultures treat shareholders and directors differently. The same can be said for different firm structures especially when they intermingle. There are no shareholders in a partnership, but a partnership can involve shareholders, for example, in a partnership of corporations. This phenomenon is quite frequent in strategic alliances. The next part deals with these situations and highlights the complications for an analysis of BJR arising out of these alliances.

[122] S. Butler, "Models of Modern Corporations supra note 96.

PART 3

INTERPLAY OF CORPORATE STRUCTURES AND BJR: ISSUES AND RESPONSE

I. BJR And Business Organizations Other Than Corporations

There are three basic kinds of business organizations.[123]

1. Sole Proprietorship
2. Partnerships
3. Corporations

Since corporations have already been discussed, we shall only discuss sole proprietorships and partnerships below.

1. Sole Proprietorships

[123] VanDuzer, supra note 4.

A sole owner of an unincorporated business faces personal exposure for his business liabilities and is subject to unlimited liability.[124]

Owner of a sole proprietorship is the only person who exercises both the management and control in a sole proprietorship. Typically, BJR has no application where management and control are not separated at least to a minimal level. One can think of employees in a sole proprietorship as persons sharing the management process, but they are not free to make their own decisions. Therefore, BJR has no application to sole proprietorships. The law of agency, generally, serves as a substitute for BJR.

2. Partnerships

In what follows, I treat the common law of partnerships rather than the law of civil law of mandate. The civil law general and limited partnerships nevertheless take on legal ventures similar to those of their common law counterparts, with the exception that distinct legal personality is bestowed to the civilian forms.[125] In partnerships, two issues are of great significance; i.e., who will do what in managing the business of the partnership and who will be

[124] M. F. Crusto "Extending the Veil to Solo Entrepreneurs: A Limited Liability Sole Proprietorship Act (LLSP)" (2001) 2001 COLUM. BUS. L. REV. 381.

responsible if things go wrong.[126] Usually national governing laws set out a framework treating these matters, rules but for the most part they are not mandatory. In practice, these rules are tailored by way of modifications and amendments to fit the needs and desires of partners in partnership agreements.[127] In case of a breach of obligation, a third party may proceed against any or all partners irrespective of any arrangement in the partnership agreement. The affected partner or partners may seek to recover a contribution from the others under the partnership statute or their agreement.

In principle every partner is an agent of the other partners and may bind them while acting in the usual course of partnership business[128]. This principle of mutual agency gives rise to the need for some measures to check unauthorized behaviour by an individual partner. As a step toward checking this unauthorized behaviour, the Courts have held that each partner is under a fiduciary duty to others that involves honesty and good faith. Secondly, formal control and monitoring mechanisms can be

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[125] See, for example, Quebec Civil Code, Ch. 10 articles 2186-2249.
[126] VanDuzer supra note 4.
[127] Ibid.
[128] ibid.

established in the partnership agreement.[129] Again, this measure cannot prevent partners from claims of third parties, however it provides innocent partners with some sort of indemnification. These measures effectively serve as a substitute to BJR in a general partnership.

Limited partnership is the only way that a partner can limit his liability. In limited partnerships, there are two types of partners: general partner and limited partner. Typically, the general partner is the one who runs the affairs of the firm and is completely liable in case of any wrong. The limited partner on the other hand does not play any active role in the day-to-day management of the partnership. He has limited liability to an extent predetermined in the partnership agreement and cannot be sued for any amount beyond that investment.

If the general partner makes a decision which is harmful for the firm, and in particular for the limited partner, the limited partner cannot challenge that decision unless it is in specific violation of the partnership agreement. The limited partner will have to bear the consequences of that decision to the extent of his investment.

[129] ibid.

But, if the general partner exceeds his mandate under the partnership agreement, the limited partner can sue for breach of contract.

In short, it can be said that in partnerships, whether limited or general, as regard to liability among partners, the partners have to draft some sort of substitute for BJR and this substitute can vary from agreement to agreement. The basic difference between the BJR and these substitutes cannot be neglected; i.e., individual partner's liability to third parties and indemnification as between parties. Under the BJR, a director making any wrong decision cannot be held liable in the exercise of poor judgment. But if a partner observes all the conditions of the partnership agreement and commits an honest mistake in judgment, he will still be liable personally for any loss suffered if that decision gives rise to a default in payment of debts etc. The same is true for the general partner in a limited partnership.

II. Strategic Alliances: Interplay Of Corporate Structures

The general discussion of the BJR in partnerships allows us to pursue an analysis of it within strategic alliances. However, before we get into that analysis, it will be useful to understand the general concept and structure of strategic alliances.

1. Definition:

There is no precise definition of term strategic alliance. According to Black's Law Dictionary, in a strategic alliance "[a] coalition is formed by two or more persons in the same or complementary businesses to gain long-term financial, operational and marketing advantages without jeopardizing competitive independence"[130]

Under this definition the necessary ingredients of a strategic alliance are:

1.Two or more entities

2.same or complementary businesses

3.long-term gains

4.competitive independence

[130] B. A. Garner, ed., *Black's Law Dictionary*, seventh ed., (U.S.A.: West Group, 1999) [hereinafter Black's Law Dictionary].

The only aspect of this definition that can be questioned is that of "long-term" gains. Even if an alliance is created for a short term specific purpose, it will still remain an alliance. The only difference that the length of term makes is to the sophistication of an alliance, since a long-term alliance is likely to be rigorous in its governance structure than is a short-term alliance.

I would summarize major features of a strategic alliance as follows:

1. In an alliance all the parties contribute something to the venture. It can be R&D, resources, production facilities or any other feature of strategic value to others.
2. All the members of an alliance, to obtain the goals of the alliance, adopt a common strategy.
3. Alliances are generally premised on equal benefits for all the parties involved.[131]
4. All members bear the risks attached to the venture.[132]

1(a) Alliances and Joint Ventures

Alliances are related to and can be confused with joint ventures and this terminology is used inconsistently. For the purposes of this thesis

[131] See J. R. Harbison & P. Pekar, Jr., "A Practical Guide to Alliances: Leapfrogging the learning Curve a Perspective for U.S. Companies" (1998) 1063 PLI/Corp 9.

the joint venture will be treated as a subset of alliances. Black's Law Dictionary defines a joint venture as "[a] business undertaking by two or more persons engaged in a single defined project."[133] Black's Law Dictionary states four elements necessary to constitute a joint venture:

(a) An agreement,

(b) Common purpose

(c) Shared profits and losses and

(d) Equal control[134]

This definition is virtually indistinguishable from that of the strategic alliance except that it clearly involves profit and control discussion. This means that the term joint venture always indicates presence of an alliance but an alliance does not necessarily indicate existence of a joint venture. In other words, joint ventures are a subset of strategic alliances and strategic alliances are not a form of joint venture.[135] However some authors do not agree with this point of view.[136]

Generally, a joint venture is a venture where two or more parties form a jointly owned and controlled entity, while keeping their individual

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[132] ibid
[133] Black's Law Dictionary supra note 130.
[134] Ibid.
[135] S. Khemani & L. Waverman, eds., *Global Competition Policy: Modalities of Cooperation,* (New York: Routledge, 1996).
[136] M. Yoshino & U.S. Rangan, Strategic Alliances infra note 142.

identity and independence intact. This said, the entity can be a corporation, a general or limited partnership or a limited liability company. Unisource and Global One are examples of this joint ventures in the telecommunication industry.[137] Joint ventures are usually formed when companies want to engage in a specific business that is related to but is not their primary business.[138]

2. Kinds Of Alliances

There is no formal legal framework distinguishing among alliances, and their classification is based on function and practice rather than any text for validity. Often, alliances are categorized on the basis of their territorial scope, form of equity participation and their duration. This produces the following classification:

a. Domestic and Cross-border Alliances
b. Equity participating and non-equity participating alliances
c. Short-term and long-term alliances

a. Domestic and Cross-border Alliances

[137] See K. Zourray, " Global Markets, Limited Options" (1998) 32:7 Telecommunications 36.
[138] J. M. Geringer, "Selection of Partners for International Joint Ventures" (1988) Bus. Q. 31.

Domestic alliances are those in which all the parties involved are from a single country. Cross-border alliances are those in which one or more members are from another country or countries.

Domestic alliances among corporations present the problem of aligning domestic partnership law with domestic corporate law as concerns the treatment of the BJR. Cross-border alliance presents the additional potential complexity of allaying a variety of corporate law regimes with a variety of possible partnership regimes. The cross-border alliance is of great intent in this thesis for this reason. The Star Alliance among fifteen airlines from different countries will serve as our example.[139]

b. Equity Participating and Non-equity Participating Alliances

In some alliances, the members have cross equity ownership with each other.[140] In smaller alliances, one member may hold equity ownership in the other member's assets.

The non-equity participating alliances are those in which members do not have cross-holdings and maintain total independence.

[139] See discussion infra.
[140] For example, Fuji-Xerox Alliance.

c. Short-term and Long-term Alliances

Short-term alliances are generally contractual arrangements with emphasis on a particular goal.[141] However, not every alliance with a particular goal is short-term since ever very specific goal can ... long-term involvement.

The long-term alliances are more sophisticated and complex. They generally focus on enduring benefits and long-term planning.

3. Structural Forms Of Alliances

An alliance can take many structural forms. The limit of its structural forms depends upon the imagination of its creators. An alliance form can range from an arm's-length contract to a joint venture.[142] The most common forms, however, are the following:

a. Contractual Arrangements

[141] For example, an agreement between Siemens and Philips to develop new semiconductors.

[142] M. Yoshino & U.S. Rangan, *Strategic Alliances: An Entrepreneurial Approach to Globalization,* (Boston: Harvard Business School Press, 1995) [hereinafter M. Yoshino & U.S. Rangan, Strategic Alliances]

In contractual alliances, members of an alliance share their resources to obtain a common goal and share the profits and risks of that cooperation, but do not create a separate entity. These contractual arrangements can be regarding any one or more aspects of business. The most common contractual arrangements are:

(i) Product Development Arrangements

(ii) Distribution Arrangements

(iii) Licensing Arrangements[143]

b. Minority Equity Participation

This type of alliance can be seen frequently between a smaller company with good R&D, ideas or technology and a bigger company ready to invest in it. The smaller company gets access to resources of the bigger company and in return offers certain pricing or other preferences from the developing company. As the equity participation is non-controlling, the smaller company can keep its own identity protected.

The difference between obtaining a loan from some financial institution and minority equity participation is that minority investment alliances

[143] C. Wei, "Cross-Border Strategic Alliances in the Transition of Regulated Telecommunications" (2000) unpublished, McGill University.

give the returns on equity investment, secondary importance and focus on strategic goals of the alliance.

c. Joint Ventures

Joint Ventures are the most common, popular and sophisticated form of an alliance. As stated above, a joint venture is a venture where two or more parties form a jointly owned and controlled entity while keeping their individual identity and independence intact. International joint ventures come in a multitude of sizes and shapes. In certain cases, a joint venture is a partnership, in others it is a corporation.[144] Typically, smaller or domestic alliances form a corporation whereas bigger or international alliances prefer partnerships. The reasons can vary from tax considerations to different corporate structures and corporate governance models in different jurisdictions.[145]

4. Reasons For Emergence Of Alliances

[144] M. E. Hooton, "Structuring And Negotiating International Joint Ventures" (1994) 27 Creighton L. Rev. 1013.
[145] See A. S. Gutterman, *The law of Domestic and International Strategic Alliances: A Survey for Corporate Management* (Wesport: Quorum Books, 1995) at 285-318.

a. Integrated Product Lines

In a highly competitive market consisting of specialized corporations, it is difficult for any single corporation to maintain high standards of excellence in each and every dimension of their products and services. Therefore, corporations will engage in strategic alliances with other corporations that meet their standards are in complementary issues of business with a view to being able to provide better end products.[146]

b. Competitive Advantage

By introducing a better end product or process that results from cooperation of partner corporations, all the alliance members can gain a competitive advantage[147] for a reasonable span of time and also gain goodwill that will give them enduring benefits.[148]

c. Risk and Cost Sharing

By forming an alliance, corporations may share profits with other members of the alliance, but at the same time the costs and risk

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[146] See V. S. Killingsworth, "Strategic Licensing: Leveraging Technology Through Alliances" 1998 Cyberspace Law 13.
[147] See J. Bleeke & D. Ernst, "The Way to Win in Cross Border Alliances" (1991) Harv. Bus. Rev., 127.

attached to a venture can also shared by all the members. A company may not be able or willing to start a venture because of the risk factors, whereas a distribution of risk can encourage it to do so.[149]

d. Entry into International Markets

Cross-border Strategic Alliances may be the best way to enter into international markets[150] for the following reasons:

i. Expenses

To enter into a foreign market on its own may be more expensive for a corporation than allying with a company that is already doing business in or situated in a foreign country.[151]

ii. Marketing Advantages of Local involvement

Involvement of a local company is not only useful for reducing expenses, but it also offers certain marketing advantages as well. Consumers or customers are sometimes hostile to foreign competition

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[148] See Y. L. Doz, *The Alliance Advantage: the Art of Creating Value through Partnering* (Boston, Harvard Business School press, 1998) [Hereinafter Doz]
[149] D. E. Brown, Jr., K. M. Cole &, J. A. Smith, Jr., "Strategic Alliances: Why, How, And What To Watch For" (1999), 3 N.C. Banking Inst. 57.
[150] ibid.
[151] Doz supra note 148.

and furthermore may have preferences that do not align perfectly with the marketing strategy of the foreign force. Local participation can help to overcome these problems.[152]

iii. Independent Identity

As opposed to mergers and acquisitions, in alliances, the identity of the local corporation remains intact. This fact can prove very favourable for the foreign corporations as sometimes, for example in case of flag carrying airlines, the insistence on keeping the identity of the local corporation intact may extend even to government fiat.

e. Less Hostile Legal Regulations

Due to above-stated reasons, alliances will often face a less hostile regulatory environment than would mergers or acquisitions.[153] In the case of an alliance, the independent identity of all the members is protected and every member can earn profits resulting in prosperity of its country. It is especially important to note that alliances can overcome overt regulation of foreign investment limits, which remain

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[152] See C. L. Hill, *International Business: Competing in the Global Marketplace*, 2d ed. (Chicago: Irwin/McGraw-Hill, 1997).
[153] F. Matte, Q.C., "International joint Ventures and Strategic Alliances: The Canadian Antiturst Experience" (2000) 18 Wisconsin International Law Journal 563.

in place for many sectors in developed and developing countries alike.[154]

5. DISADVANTAGES OF ALLIANCES

a. Lack of Total Control

The first drawback to strategic alliances is the lack of coordinating central control.[155] In any alliance, a company must take some of its resources and put them, at least to some degree, in the hands of an outside party. The corporation is also not able to make quick decisions alone and often has to share the profits, which, depending on the number of alliance members and their actual contribution to alliance value can significantly dilute earnings.

b. More Managerial Time and Resources

Strategic Alliances may also require proportionately more managerial time and resources than a single corporation. They may be harder to manage since they involve dealing with outside parties and sharing

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[154] For example, see the Canadian Transportation Act part on airlines or the Telecommunication Act part on foreign ownership.

control, resources and decision-making. Due to absence of total control, which is available in cases of mergers and acquisitions, implementation of policies can be difficult to coordinate and decision-making can be more time-consuming.[156]

c. Limited Scope and Flexibility

Once a corporation joins a Strategic Alliance, its options to participate and engage in other ventures either in partnership or alone become considerably limited. Generally, an alliance member cannot engage in other alliances or transactions that are directly related to an existing alliance. These limitations can sometimes result in significant less opportunity for an alliance member.[157]

It is evident from the above list of advantages and disadvantages that the benefits of an alliance can often outweigh its disadvantages. That is why alliances are emerging with such a rapid pace. The main concern in forming an alliance is coordination among its members. If an alliance is well-coordinated and the members are willing to

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[155] C. Wei, "Cross-Border Strategic Alliances in the Transition of Regulated Telecommunications" (2000) unpublished, McGill University.
[156] See S. M. Besen, "An Overview of Strategic Alliances" (1994) 8:7 Insights 22.
[157] See R. D. Harroch, " Strategic Alliances" (1997) 1002 PLI/Corp 121.

cooperate with each other, the alliance can be extremely beneficial to all its members.

II. Analysis Of Shareholder's Rights And Control Over An Alliance Partnership

Today many cross-border and domestic alliances exist that work in the form of a partnership. This specific structural form can give rise to many legal complications such as duties owed by each venturer to the other, liability to third parties etc. [158] We, however, intend here only to highlight some of those complications which relate to the BJR. The relevant issues relate to the shareholder protection aspect of the rule and concern control, decision-making and liability.

1. Shareholders' Rights In General

[158] A. B. Weissburg, "Reviewing The Law On Joint Ventures With An Eye Toward The Future" (1990) 63 S. Cal. L. Rev. 487.

Typically in a North American corporation, the shareholders have the right to vote, the right to sell shares, the right to receive dividends, the right to be informed of major changes in the corporation.

Shareholders' approval or vote is required in cases of amalgamation[159], amendment of articles of incorporation[160] or by-laws[161], sale of property[162], disposal or creation of new shares[163] and election of directors.[164] Shareholders exercise their control over the corporation primarily through their voting rights. Changes to the board of directors are the ultimate manifestation of control.

2. Forming An Alliance Partnership

The decision to form an alliance with other corporations typically is undertaken with shareholders' approval and support. Before joining an alliance, the corporation needs support from shareholders. Once the approval is obtained to enter into an alliance and the corporation enters into a partnership agreement with other corporations, and it is there that complexities may arise. The most problematic case is when the strategic alliance enters into a partnership agreement. If an

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[159] See for example, Canada Business Corporation Act R.S.C. 1985, c. C-44, (CBCA) section 183.
[160] CBCA sections173-176.
[161] CBCA section 103.
[162] CBCA section 189.
[163] CBCA section 190.
[164] CBCA section 106.

alliance joint venture gives rise to a new corporation through which the entity is governed, ordinary principles of corporate law would apply to that corporation with choice of law becoming the way of resolving any potential clashes regarding the BJR.

3. Legal Issues

The following legal issues may arise out of an alliance partnership:

a. Articles of Incorporation

A corporation is governed by its articles of incorporation and is legally obliged to follow them. On the other hand, when a corporation enters into a partnership agreement, that agreement is also legally binding and the corporation is under obligation to follow that agreement. The question here should be: can a corporation enter into an agreement that is contrary to its articles of incorporation? Or can a corporation enter into an agreement and surrender its articles of incorporation? For example, if the partnership agreement states," if any clause of this partnership agreement is contrary to a clause of article of incorporation of any individual corporation, the clause of this partnership agreement will prevail", what will be the legal position of that clause?

b. Decision-making

In an alliance partnership the decision-making powers can be assigned to a board or body that may or may not include all the members of the alliance. As a matter of principle, all the major decisions made by a corporation should be subject to approval of shareholders, whereas in an alliance that involves a large number of corporations, getting approval from each individual corporation's shareholders may be overly cumbersome.

So, can the corporations take decisions for alliance purposes without getting approval from their shareholders, or is the approval of the shareholders necessary before each and every decision.

c. Delegation of Powers

In large alliances usually a board or body is formed for specific purposes although all the members are not usually represented in each and every board. The question here can be whether a corporation can delegate its decision-making authorities by transferring power to someone else.

d. Liability

The next question concerns liability. The general rule of partnership law is that partners are jointly and severally liable in case of default or other liabilities. The question here becomes, if a decision taken by a representative body of the alliance gives rise to liability of the partner, what will be the liability of the directors of the underlying corporations.

Obviously, these questions are not easy to tackle, and a comprehensive answer to them is beyond the scope of the thesis.

However, we can study an existing alliance and examine its response to these questions. In this regard, as stated above, we have chosen the Star Alliance. Although Star Alliance cannot truly be considered as a representative of all existing alliances, yet, it is one of the most sophisticated alliance in the world and involve airline companies which are themselves governed by various approaches to the BJR. It is therefore a good test case for the consideration of how different approach to the BJR can be reconciled within the network of global business relations.

III. Theoretical Questions, Practical Answers: Study Of Star Alliance[165]

The Star Alliance came into existence in May 1997. Initially, it was a partnership of limited scope among Lufthansa, United Airlines, SAS, Air Canada, and Thai Airlines. In the subsequent years, this partnership expanded not only in scope but also in membership.[166] Currently, Star Alliance has fifteen members.[167] The Star Alliance is the largest airline network in the world[168] and provides access to 894 airports in 129 countries and to over 500 lounges.[169]

1. Nature of Star Alliance

The Star Alliance is a non-equity participating, cross-border, long-term alliance. It is believed to be an equity participating alliance by most, however cross-shareholding and equity ownership is not a policy of

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[165] The information regarding the Star Alliance is confidential. We contacted Mr. Ross McCormack of Air Canada, who is chairman of Alliance Management Board, for information. He was kind enough to assign Ms. Roula Zaarour, Director for Alliance Development in Air Canada, to answer our queries. Most of the information given below has been obtained from personal interview with Ms. Zarrour. The author is extremely thankful for this favour. [hereinafter The Interview]

[166] See M. A. Taverna, "Star Alliance Approaches Next Phase of Collaboration" Aug. 23, 1999 Aviation Week & Space Technology at 58.

[167] http://www.star-alliance.com/ Visited November 2001. According to website, the information given in facts and figures is pre-September 11, 2001 data. The member airlines are continually adjusting to the current downturn in traffic, so at this point in time it is not possible to give exact figures.

[168] Ibid.

[169] ibid.

Star Alliance, and the existing instances are the independent decisions of parties and are result of separate bilateral agreements.[170]

2. Working of the Star Alliance

Whenever the Star Alliance wants to extend its services to any region, it surveys the major player acting in that region. The key players in that area are tested on an elaborate list of criteria, the most important of them are: existing affiliations and inclinations. If the selected player is a member of any competitive alliance or has an inclination to join a competitor alliance, such player is immediately excluded from the list of potential partners.

If the selected player clears first phase of inquiry then its safety record, quality of product etc. are examined. If a player satisfies these conditions, then negotiations take place. After negotiations, a memorandum of intent is signed and eventually the selected player is accepted into the Star Alliance.

Once a player joins the Star Alliance, it is provided a list of requirements that include the sharing of frequent flier programs,

[170] The Interview supra note 165.

codes, lounge access, etc. The selected player has to pay a certain fee at the time of joining the alliance. After getting member status, the airline gets the benefits of the marketing and information technology sector of the Alliance, joint advertising, joint sale and purchase, joint management training and so on. According to the alliance's founding members, the forming of the alliance has increased profits up to 10% for all of the airlines concerned.[171] A new member can tap into a combined market share of 20.6% of world traffic enjoyed by the Star Alliance.[172]

3. Governance of the Star Alliance

Star Alliance is governed by the "Alliance Governance Document"[173], which is a sort of constitution of the Alliance. Under that document, there exists an "Alliance Management Board". This Alliance Management Board is the supreme body of the Alliance. All the members have one representative on that board. All members of the Board have equal powers. The Chairman of the Board is selected on yearly basis and the chairmanship rotates among the members.[174]

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171 G. Thomas, "Star alliance Founders Say Membership Means Profits" May 17, 1999, Aviation Week & space Technology at 64.
172 See Alliance Survey, Airline Business, July 1999, at 37.
173 The Interview supra note 165.

The process of decision-making in the Alliance Management Board varies. Some decisions need simple majority; some two-third majority and some major decisions need complete unanimity of all the members. The examples of major decisions are, admitting or expelling a carrier, deciding the business plan budget and long-term planning regarding image of the Star Alliance.

In most cases the dissenting members are not bound to participate or follow the decision taken by the majority. Individuality of the alliance members is very much respected. Under the Alliance Management Board, there are many specialized bodies for purchases, advertising, studies and planning etc. These specialized bodies are further sub-divided into special task forces.

4. Star's Answers to The Above Questions

a. Articles of Incorporation

The first question regarding shareholder rights was: could a corporation enter into an agreement that is contrary to its articles of incorporation? Or can a corporation enter into an agreement and

[174] Currently Mr. MacCormack of Air Canada is the Chairman of the Board.

surrender its articles of incorporation. For example if the partnership agreement states," if any clause of this partnership agreement is contrary to a clause of article of incorporation of any individual corporation, the clause of this partnership agreement will prevail" what will be the legal position of that clause?

The Star Alliance agreement has been carefully drafted to avoid any sort of clash with articles of incorporation of any partner or corporate law of any country. According to Star Alliance's governance system, the member airlines do not have to modify their articles of incorporations. The only mandatory element of the alliance is the fulfillment of certain basic conditions like participation in code sharing, frequent flyer program, access to lounges and other alliance sources. The rest of the requirements are optional and no company is forced to accept anything which it does not want to do. This non-obligation strategy averts any clash between the agreement and the articles of incorporation. Hence, this question may never arise for the alliance.

b. Decision-making

The next question was can the member corporations take decisions for alliance purposes, without getting approval from their shareholders, or is approval of shareholders necessary before each and every decision?

Again, the Star Alliance gives complete liberty to its members in decision-making. As explained above, major alliance decisions which are mandatory, require complete unanimity among alliance members. The less important decisions, which do not require unanimity, are not binding on the dissenting members. For example, if a majority of the members decide to upgrade their airplanes or to buy airplanes from a certain vendor, the dissenting member does not have to participate. So, the individual identity and will of all the partners is protected. Usually, the representatives of the member airlines are the key officials of their respective companies, which makes it easier for the representatives to decide because they are already aware of the policy of their respective companies.

c. Delegation of Powers

In large alliances usually a board or body is formed for specific purposes and usually all the members are not represented in each and every board. The question here can be whether a corporation can delegate its decision making power to someone else?

The scenario suggested above applies to the Star Alliance, however the arrangement of the alliance deals with it quite adequately. As explained above, the supreme body of the alliance is the Alliance Management Board, where all the members have equal representation. Smaller bodies for specific purposes are created but these bodies are ultimately accountable to the management board and the members of the board are accountable to their respective companies or in other words, the shareholders. So, the delegation of powers does exist in the alliance but it is the same as it is within the corporations themselves. In individual corporations, powers are also delegated to different bodies but the ultimate control lies with the board. This is also the case in the Star Alliance.

d. Liability

The next question is that of liability. The general rule of partnership law is that partners are jointly and severally liable in case of default or other liabilities. The question is when a decision taken by a representative body of the alliance gives rise to liability for the alliance, what will be the liability of members directly involved in decision-making and the members not directly involved in it?

This further can be addressed in a series of three steps:

(i) Liability to third parties;

(ii) Liability among the members; and

(iii) Liability to individual member's shareholders.

i. <u>Liability to Third Parties</u>

The Star Alliance does not enter into any agreements with third parties as Star Alliance. Even in cases of complete unanimity, this option is avoided. All the members deal with third parties in their individual capacity. Star Alliance may negotiate a deal as an alliance, but it will not enter into a deal as an alliance. For example, Star Alliance may negotiate lower rates with an airplane manufacturer on the basis of joint purchasing power, but the deals to buy from that manufacturer will be entered into by all the members separately. This strategy helps the alliance members to avoid any liability arising on account of membership to the alliance and restricts their liability for the actions taken by them only.

ii. <u>Liability Among the Members</u>

So far as liability among the members is concerned, we should keep in mind the nature of the alliance and its fundamental deviation from basic partnership structure. In the Alliance, the important decision-making is done by the Alliance Management Board. The Board consists of one representative from each member. Major decisions need complete unanimity; other decisions require consent of willing or affected members. This means that, every member is involved in a decision which could affect its interest and no decision is taken on behalf of other members. This is different from routine partnerships in which a partner, under certain circumstances, can decide on behalf of the firm. The involvement of all the interested partners in every decision concerning them makes the alliance different from the ordinary partnership and displaces the liability problem to each decision-maker. Even where partners are not in agreement with decisions, they can choose individually not to implement them.

iii. Liability to Shareholders

Liability to shareholders can be a difficult question depending on the circumstances. Liability to shareholders can be of the member corporations or of the Star Alliance. It is difficult to hold the Alliance directly liable to shareholders of member corporations, yet in some circumstances liability may be extended to the Star Alliance. For example, if any action taken by the alliance members ultimately causes depreciation in stock value of shareholders of a member corporation or in any other way reduced the earnings of the shareholders, the shareholders may either sue the representative of their company in the alliance or they may sue both the representative and the alliance. But the chances of success of that suit may not be that good. The suit against the representative director may fail because the director is protected by the BJR.

According to case law, the shareholders in all likelihood cannot successfully sue the alliance as well. In *Faour* v. *Faour*[175] it was held that a corporate shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation. The cause of action for injury to the property of a corporation or for impairment or destruction of its business is vested in the corporation, as distinguished from its shareholders, even though the harm may result indirectly in the loss of earnings to the shareholders. The individual shareholders have no separate and independent right of

[175] *Faour* v. *Faour*, 1990 Tex. App. Lexis 385.

action for wrongs to the corporation which merely result in depreciation in the value of their stock. To recover for damages to the corporation, the shareholder must bring the suit derivatively in the name of the corporation.[176]

In another case the Court observed that a derivative action can be brought only when a corporation has failed to enforce a right which may properly be asserted by it.[177] In other words, if a corporation does not have proper reasons to assert a right, the derivative claim cannot be filed. In the case of the Star Alliance, all the alliance members may find themselves without any proper reasons to file a suit against the alliance as every member is involved in a decision which could affect its interest and no decision is taken on behalf of other members.[178]

Although, the solution here seems flawless for the alliance, no solution can be perfect or answer all the possible contingencies. In the above setting, we are assuming that everything is perfect and every one is working diligently, in good faith and there is complete harmony in the alliance. However, it is hard to imagine any system working this way for a long time. There can be numerous situations which can put the strategy of the alliance to test. For example, what if one or more

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[176] ibid.
[177] *Coles* V. *Taliaferro*, 1990 Kan. App. Lexis 43.

directors working in the Alliance Management Board as representatives of their respective companies are not working in good faith. For instance, in *HMG/Courtland Properties, Inc.* v. *Gray*[179] a corporation brought an action against directors to recover for breach of fiduciary duty and fraud arising from the concealment of one director's interest as buyer of corporate property. The corporation also sued the partner of one director whose partnership was an investor in the property. The Court held that the directors failed to demonstrate the entire fairness of the transactions and fraudulently concealed the director's interest. Though the partner did not aid and abet the director's breach of fiduciary duty, the partner was nonetheless liable to pay restitution. This is just one example; there can be numerous parallel instances. Therefore, it is fair to say that although the alliance has tried to minimize its liability to members' shareholders, yet it is not possible to eliminate the liability issue altogether.

As stated above, in the alliance, ultimate business decisions are to be made by the member corporations and these decisions are made by each member through the mechanism used for internal decisions. Similarly, member corporations have the same liability to shareholders

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[178] For details see part, liability among the members, supra.
[179] *HMG/Courtland Properties, Inc.* v. *Gray* 749 A.2d 94, Del.Ch.,1999.

as they have for their internal decisions. Thus, the alliance has attempted to displace the business judgment issue back to the individual partners. However, it is not possible to eliminate the liability issue altogether and it may arise at any time depending on the facts and circumstances. All possible eventualities cannot be covered in a single document.

In the light of above analysis, it is clear that a proper structuring and governance plan can be used to avoid most legal complexities and technicalities. The governing structure of the alliance has contained the liability issues to the members, and thus the issue of BJR in the alliance, for the time being, remains the same as it is for each member, the application of the BJR varies from member to member as it varies from jurisdiction to jurisdiction. However, different alliances have different governing structures. So, the issues of the liability and the BJR may also vary from alliance to alliance. In the Star Alliance model, however, the interests of the members' shareholders are as protected or vulnerable as in their respective corporations.

PART IV

CONCLUSION: THE FUTURE OF THE BJR

In their now classic text, Berle and Means[180] described the most striking feature of modern widely held corporations is the separation of ownership and control. Shareholders collectively own the corporation but do not, as a general rule, control it. Despite some remarkable differences, especially as to the degree of shareholder dispersion, this is the case in most the jurisdictions today. The separation of ownership from control creates a fundamental tension between shareholders and management. In order to overcome this tension, every system of corporate governance demands mechanisms that ensure accountability. Although managers hold their power in trust for the shareholders, there is always an apprehension that they may not carry out the business fully in accord with their fiduciary obligations owing to their inherent self-interest. Corporate laws in different jurisdictions, although they may significantly differ from each other, provide inter alia two devices which enforce the fiduciary duties imposed upon the managing group[181]: First, shareholders can protect their interests by participating in decision-making on fundamental corporate matters.

[180] A. A. Berle & G. C. Means, The Modern Corporation and Private Property, 1-4 (1967) Harcourt, Brace & World, Inc., New Y`ork, 293.
[181] Shareholder Participation under German Law supra note 113.

This idea suggests that monitoring should be relegated to those who provide equity capital to the corporation. However, since normally there is just one shareholder meeting per year, shareholders do not have adequate opportunity to use the monitoring function effectively.[182] Second, there is almost always some kind of legal device by which shareholders or corporate organs representing shareholders may commence legal proceedings to hold management liable if it breaches its fiduciary obligations or makes any disastrous decisions on behalf of the corporation.[183]

On the other hand, directors are not necessarily corrupt and can be victims too. Excessive monitoring, and unnecessary intervention and control can impede their functioning. The constant threat of liability can significantly affect their performance as well. Therefore, there is a need for a mechanism which can ensure proper safeguard for shareholder interests and provide a conducive environment to management to effectively manage the business of corporation. The legal system responds to these needs in the form of the business judgment rule. The BJR provides directors of a corporation enough breathing space to allow for proper functioning and protects them from unwanted litigation and scrutiny. Although at first glance, the BJR

[182] ibid.
[183] ibid.

appears to be a rule favourable to the directors alone, yet, it protects the rights of the shareholders by imposing certain conditions on the directors' functioning.[184]

As we have seen, although the fundamental structure of corporations all over the world is quite similar, it is not identical. There are different variations to the degree of separation of ownership and control and there are different prevailing ways to monitor and control the functioning of the directors.[185] In most of the corporations in America, shareholders are widely dispersed. It is difficult for them to monitor the working of the directors. Most shareholders probably cannot identify the directors of their company by name. Therefore, under these circumstances, shareholders of American corporations rely on the court's intervention. This reliance was extended to a painful level, and the directors rather than shareholders became victims, so the courts invented the BJR. The BJR is now a balancing force and the courts use it in favour of the director or the shareholder as the circumstances may warrant.

In Japan the degree of monitoring by shareholders is very high and there is also a high potential of actual intervention by the

[184] See Part 1 above Scope of BJR.

[185] For example, monitoring through Keiretsu in Japanese firms and supervisory boards in Germany.

shareholders.[186] Effective monitoring by shareholders in Japan is said to have struck a balance in the Japanese corporate world. Historically, there was a nominal amount of litigation between the shareholders and the directors. Therefore, Japan never felt a need to construct a rule like the BJR, and indeed there is no such rule in the Japanese Commercial Code. However, the situation has considerably changed in last two or three decades and there is now a significant rise in shareholder litigation.[187] The Japanese courts are now looking for a concept similar to the BJR. However, since Japan is a civil law jurisdiction, the courts are reluctant to develop any such rule on their own. If the litigation trend continues it is quite likely that Japan may embrace the concept of the BJR in the near future although, the reasons for doing so may differ from those that prompted the American courts to adopt it.

In Germany, another civil law jurisdiction, there is no provision regarding the BJR. Shareholders are protected by their ability to monitor the activities of the board of directors through the supervisory board and the directors are protected from litigation through the deployment of an immensely difficult mechanism for filing suit against directors. The mechanism is so difficult that a genuinely aggrieved

[186] See Keiretsu above.
[187] Shareholder Derivative Litigation in Japan supra note 82.

shareholder may find himself helpless on certain occasions. Shareholders' protection would appear to be lacking in the German model of corporate governance. Although the supervisory board is supposed to adequately protect the interests of shareholders, the effectiveness of the board is under considerable criticism.[188]

Other than the corporation, there are two basic corporate structures i.e., sole proprietorship and partnership. Sole proprietorship in principle contains no separation of ownership and control. The partnership, on the other hand, could involve a relatively higher degree of separation of ownership and control. That separation in ownership and control can be seen in the case of limited partnerships. The limited partner, although she shares in ownership, cannot exercise any significant control. The BJR, however, does not apply to partnerships because of a different jurisprudential approach regarding personality and liability in partnerships. However, the interplay of partnerships and corporations, which is quite common in the form of alliances, can give rise to various legal issues regarding liability and accountability.

The interplay of the BJR in the corporate and partnership setting led us

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[188] See T.J. Andre, German Supervisory Boards supra note 101.

to the study of alliances in particular, we studied the case of the Star Alliance as it offered a situation in which there is an interplay of different corporate structures and different models of corporate governance, in a highly prominent and successful alliance. The study revealed that the Star Alliance has adopted a non-obligation approach and handles the issues hidden in the interplay of different business structures very carefully.

As regards the interplay of different business structures, the BJR issue may arise when the alliance as a whole takes an erroneous decision or a member corporation takes an erroneous decision on behalf of other member corporations. The Star Alliance has tried to make sure that these situations could never arise in the alliance. Every decision which could affect any member needs the approval of that member. By giving approval, the affected member takes the responsibility for all the risks involved in that venture and cannot blame others afterwards. That member also becomes completely accountable to its shareholders. In this way, the shareholders' protection aspect of the BJR cannot be attracted beyond the individual corporations nor any member can hold other members liable for any negligent decisions. Thus, the Star Alliance has attempted to displace the BJR issue back to the individual member corporations.

So far as the interplay of different corporate cultures is concerned, policy of the alliance regarding the BJR remains the same i.e., displacement of the BJR to individual members. The Star Alliance has neither adopted the BJR as a standard mechanism of check and balance, nor has it rejected it. The alliance has simply left the matter up to the individual members. The corporations that make decisions are accountable for those decisions in the same way as they are accountable for their internal decisions. For example, the German partner may have to obtain approval of the supervisory board or the Japanese partner might worry about its Keiretsu members while the American partner is dealing with shareholders meeting. The approach of every jurisdiction is respected and stays intact in the alliance. In this way, the alliance has averted an issue which had potential for great complications and conflicts.

The study of the Star Alliance instructs us that the clash in corporate cultures may be avoided by an appropriate governing mechanism. In light of the inquiry undertaken by this thesis the future of the BJR may evolve in two respects. First,it may evolve within the context of corporate cultures. Would the BJR emerge as a universal rule for all corporate models? As we have seen, different corporate models, due to their peculiar settings, adopt different ways to ensure a proper check and balance between the shareholders and the directors. In both Japanese and German models, there are only two parties i.e., directors and shareholders, who maintain the balance between themselves. On application of the BJR, a third impartial party i.e., the courts gets involved in the matter. The involvement of a court provides a more effective and specific dispute resolution mechanism acceptable both to the shareholders and the directors. In Japan, as mentioned, the corporate community is now looking for a rule similar to the BJR. This indicates growing acceptance of the BJR. However, due to a powerful monitoring system, the BJR may not be invoked as often in Japan as in America but it is obvious that there is a role for the BJR to play. In Germany, directors of a corporation seem to be in command. In practical terms, they have rendered the monitoring by shareholders, almost harmless. In Germany, the second prong of the BJR, which checks the authority of directors, is in lacking. So, based on the study of these two corporate models, we can conclude that some form of the BJR, though it may not be as developed as in America, is required in every corporate culture.

The second discussion for the evolution of the BJR is in the context of the interplay of different corporate structures in alliances. The study of the Star Alliance shows that alliances are very careful about the intricacies of this interplay and are avoiding liability issues as much as possible. These issues to an extent can be avoided with careful drafting of agreements and structuring of alliances. However, it is not possible to eliminate these issues altogether and complex questions may arise in the future. The alliance agreements provide practical solutions for existing problems and try to foresee and avoid future problems. The Star Alliance has adopted a non-obligation policy. It does not want any clash with other corporate cultures and it does not want to assume to any liability to third parties or to shareholders. Respect for other corporate cultures is a good strategy but the policy regarding liability to shareholders can be troublesome. In my opinion,[189] the Star Alliance has focused so much on avoiding liability that it has not addressed its options when the liability cannot be avoided. As stated above[190] there can be situations giving rise to alliance-level liability without necessarily resulting from a failure on the part of the strategy of the alliance. The policy of the alliance is good when everything works as anticipated or as planned, but a director acting in bad faith would not only be personally liable, but might implicate some alliance members, if not the whole alliance, as well.

We can foresee a large number of alliances following the same or similar strategies for the foreseeable future. Because, for the time

[189] Based on the limited information.
[190] See liability to shareholders part supra.

being not much work has been done in this regard by the courts or by the scholars, eventually alliances will have to face the liability issues in the courts. How these issues would be settled can only now be a matter of speculation.

So, to conclude, it is hoped that that the BJR adapted to context, will emerge as a universal standard in the near future. By BJR, I mean the principles and logics underlying the BJR i.e., checks and balances, not the BJR in precise terms as it exists today. Secondly, as the BJR continues to evolve we may see great conceptual debates regarding its application to the multi-corporate strategic alliances context.

It may be, however, that the BJR will have to be modified to deal with the alliance setting. It is far from obvious that alliance directors, who do not fact direct monitoring by shareholders should benefit from the full deference accorded by the BJR. Nor is it obvious that when a corporation relies on alliance policies as a basis for its decisions that shareholders should simply rely on the business judgment of alliance partners.

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