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TAKING SHAREHOLDER PROTECTION SERIOUSLY?
CORPORATE GOVERNANCE IN THE UNITED STATES AND GERMANY

INSTITUTE FOR LAW AND FINANCE
Johann Wolfgang Goethe-Universität Frankfurt

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Taking Shareholder Protection Seriously?

Corporate Governance in the United States and Germany

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CORPORATE GOVERNANCE IN THE UNITED STATES AND GERMANY
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“Aktionaere sind dumm und frech. Dumm, weil sie Aktien kaufen, und frech, weil sie dann auch noch Dividende haben wollen.“ (Shareholders are stupid and impertinent: stupid, because they buy shares, and impertinent, because they demand a return.)

–Carl Fuerstenberg (1850-1933)

Introduction

The attitude expressed by Carl Fuerstenberg, a leading German banker of his time, succinctly embodies one of the principal issues facing the large enterprise – the divergence of interest between the management of the firm and outside equity shareholders. Why do, or should, investors put some of their savings in the hands of others, to expend as they see fit, with no commitment to repayment or a return? The answers are far from simple, and involve a complex interaction among a number of legal rules, economic institutions and market forces. Yet crafting a viable response is essential to the functioning of a modern economy based upon technology with scale economies whose attainment is dependent on the creation of large firms.

In the US, contemporary corporate law is supposed to have as a central objective the protection of shareholder interests in the management-controlled firm, and judges have often affirmed the importance of maximizing shareholder value. An early and famous statement of the principle can be found in Dodge v. Ford Motor Co. (1919): “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.” One leading contemporary commentator on corporate governance is of the view that “Shareholder wealth maximization is usually accepted as the appropriate goal in American business circles.”

Others go even further: “There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”

One of the ways of advancing that objective

1 Lutz Graf Schwerin von Krosigk, Die grosse Zeit des Feuers 646-7 (1957).
in the US is to impose fiduciary duties, and in particular a duty of loyalty, on corporate officers and directors: “Managers must prefer investors’ interests to their own in the event of conflict. That is the core of the duty of loyalty.”

But the legal reality even in the US is not so straightforward. Stockholders are owners of the corporation but not of its assets, and they do not possess direct decision-making authority over the use of those assets. That lies formally in the hands of the board of directors, and neither the courts nor the legislatures have been at all rigorous about demanding director fidelity to shareholder interest or facilitating efforts of shareholders to assert control over directors. The Supreme Court of Delaware, by far the most important corporate law jurisdiction in the US, has been assiduous in constructing an elaborate theology of deference to board decisions, with but casual regard to maximizing shareholder welfare. And more than half the states have adopted “stakeholder” statutes allowing boards in making decisions to take into consideration a variety of non-stockholder interests, thus enabling them to justify and defend—primarily in resisting takeovers—almost any action they wish to take. That is also the position taken by most continental European legislation—in particular, by German corporate law. It is not the exclusive or even primary purpose of the board to protect the interests of the shareholders, but rather to promote the “interests of the firm” (“Unternehmensinteresse”), an obviously broader (if ambiguous) concept.

Is that a good or a bad thing? On that question there is substantial controversy. Some applaud the concept that the board should have regard for, and be empowered to balance, the competing interests of all who are affected by its activities—shareholders, creditors, debtors, management, employees, customers, suppliers, the local community, the environment, the nation, the public interest, the global community, etc. The larger the firm,
the longer the list. In this way, it is contended, the interests of society as a whole would be better served.

Others advocate treating shareholders quite differently from other “constituencies” and giving their interests primacy so far as corporate law is concerned. The case rests on two broad premises. The first is negative: a board of directors has no legitimacy as an institution for making the kind of trade-offs among the many competing interests and demands required by the constituency model, nor any guide for doing so other than its personal preferences. Such decisions lie in the domain of the political process. The second is positive: equity shareholders play a role in the functioning of the firm that is unique, crucial and highly vulnerable. That requires further explanation, which we will provide in Part I next.

But the purpose of this paper is not especially to join in, or add to, the normative debate among the various and overlapping models of corporate governance: the shareholder-primacy model, the director-primacy model, the manager-oriented model, the labor-oriented model, the stakeholder model, and so on. Our intent instead is to clarify what a shareholder-primacy model would really require, and to measure how far from it we actually are, in both the US and Germany. Advocates of particular positions can interpret this to their own ends, but we believe that on careful reflection many would agree that the current mixture of legal rules is incoherent and inefficient. Since this article is written primarily for an audience of both lawyers and economists in our two countries, we will try to make the legal system of each comprehensible to readers not already familiar with it, to highlight some of the similarities and differences, and to express our judgments as to how those systems function in practice as well as in theory.

I. The Role of Corporate Governance

“Corporate Governance” can be, and sometimes is, defined so broadly as to encompass every force that bears on the decision-making of the firm. That would include not

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only the control rights of stockholders, but also the contractual covenants and insolvency powers of debt holders, the commitments entered into with employees and customers and suppliers, the regulations issued by governmental agencies, and the statutes enacted by parliamentary bodies. And in a still more comprehensive sense, the firm’s decisions are powerfully affected by competitive conditions in the various markets in which it transacts, and indeed by the social and cultural norms of the society in which it operates.

We wish to be more selective, and focus on the position of outside minority stockholders and how it differs crucially from the position of other stakeholders or constituencies. First, we review the distinctive features of stockholders’ claims on the firm, and why their protection is socially important. Second, we look at the special problems of minority shareholders, from the standpoint of agency cost theory. And third, we consider the various mechanisms for addressing those problems.

A. The Nature of Equity Claims

What distinguishes outside equity stockholders from most other stakeholders is that their claim is residual in priority and poorly defined—hence, it does not lend itself to enforcement by contract law. Their claim is only to whatever is left after all prior claims are paid—lenders’ principal or interest, employees’ salaries, suppliers’ bills, government taxes. The fact that they are the residual risk-bearers is critical; their investment provides a degree of assurance that those with fixed or prior claims will be paid in accordance with their terms, and enables the firm to contract on more favorable terms with other inputs to production. But their claim not only comes last, but necessarily in no fixed amount; their ‘contract’ with the firm is highly incomplete, specifying neither a date for repayment of their investment nor a rate of dividend return. This would seem to leave them highly vulnerable to exploitation by those in control of the firm.

Yet it is important in a market economy that institutions exist to reduce the areas of vulnerability of outside equity investors, for several reasons. It enlarges the pool of capital available for productive investment, and can be essential for the large-scale enterprises needed to obtain economies of scope and scale. In emerging economies with weak property rights and poor corporate governance institutions, firms are typically dependent on inside equity

capital, coming from the founding family, their affiliated firms and their personal associates; outside capital is limited and expensive, for good reason.

Furthermore, only diversified outside shareholders, with no other claim on the firm, have maximizing firm value as their sole objective. Social welfare in a competitive environment is served by maximizing firm value (within whatever social rules the state adopts), thereby in general advancing economic efficiency and increasing social wealth. But other stakeholders (managers, employees, customers, suppliers, lenders) have a primary concern with their individual transactions with the firm, which are usually well-defined and enforced through contract law; normally they are not and need not be dependent on the institutions of corporate governance.

B. Minority Shareholders and Agency Costs

Let us now be more specific about the vulnerability of outside minority shareholders. Berle and Means (1932) famously framed the issue in terms of the “separation of ownership and control” in large public corporations,\(^\text{11}\) while Jensen and Meckling (1976) put it more generally as the conflict of interest between principal and agent.\(^\text{12}\) The basic problem is that agents and managers are entrusted by principals and investors with authority over their property and capital, to be used to advance the interests of the owners rather than for personal gain.

In the context of the business firm, more specifically, equity investors may be taken advantage of in a number of ways. Those in control of the firm—who may be its managers or its largest shareholders—may find ways to appropriate corporate assets and income for themselves, in transactions with the firm, as in the recent Adelphia and Tyco cases. Some of the more common ways will be discussed below. These traditional conflict of interest situations are sometimes referred to as “control rents” or as the “private benefits of control.” Or those in control may waste corporate resources without direct pecuniary transfers to themselves, by poor managerial investment and operating decisions, or by shirking on how hard they work, or by blocking their replacement by better managers. Such misuse of their

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position results in poor performance by the firm as a whole, which may be much more significant than excessive or undisclosed compensation for its control group.\(^{13}\)

The question for minority shareholders, as owners of a portion of the firm, is what they can do to protect their residual and incompletely-specified interests. As Jensen and Meckling point out, agency costs are familiar and ubiquitous, but can be reduced and bounded by a variety of devices. For our purposes, attention will be concentrated on (1) the legal rules that to a limited extent define and protect certain shareholder rights, (2) the powers and duties of the board of directors, as elected stockholder representatives, (3) the restraints on the purchase of control by an acquiring firm, displacing incumbent management, and (4) efforts to align management and stockholder interest by designing appropriate incentive compensation plans. There are broader economic forces that also constrain the management of the firm, such as the pressure for efficiency to survive in competitive product and factor markets, but they lie outside the scope of our discussion.

This perspective provides a framework for analysis of corporate governance in the US, Germany or any country. The role and importance of equity finance, and presence of agency costs, are universal phenomena, faced in every market economy (and in state-controlled economies as well, though in different guises). The institutions for handling them are diverse, reflecting different political forces, cultural values and histories. In our view, all necessarily have their shortcomings or limitations. But our main point is that any efforts at improvement need to be based on an accurate understanding of how they work—both in theory and in practice. That is what we endeavor to examine in Part II, for the US and Germany.

II. Institutions for Bounding Agency Costs

A. Legal Rules

As we indicated above, the central concerns of outside stockholders have to do with self-enrichment by those in control and with poor performance by the firm. To what extent do legal rules address those concerns, and could they do it more effectively? And are there efficient mechanisms to enforce the legal rules, whatever their content?

\(^{13}\) This distinction among kinds of agency costs is not definitionally precise, but useful nonetheless in subsequent analysis. See M. Eisenberg, “The Structure of Corporate Law”, 89 Colum. L. Rev. 1461 (1989).
1. Conflicts of interest

a. US

The primary legal doctrine directed toward conflict issues is the concept of officers and directors as fiduciaries, owing certain general duties to the company and its shareholders. The fiduciary duty concept is derived from the common law of trusts, but has been modified in its application to the business context. Part of that duty is the duty of loyalty, which requires the directors to seek to protect the best interests of the corporation and not pursue their own interests over those of the corporation and its shareholders.\textsuperscript{14}

The duty of loyalty is a principle, not a precise proscription. It has found some specification over time in state corporation codes and court decisions, but is intended to cover a very wide range of possible applications. To draw from a prior summary:

“One can postulate a continuum of situations involving conflicts of interest between controlling managers and owners, with the conflicts becoming less sharp (and perhaps the legal rules less useful). At one extreme would be outright theft, embezzlement, and misappropriation; without effective legal (usually criminal) sanctions in these cases, only the gullible would part with their money. A somewhat less transparent form of achieving the same end is the self-dealing transaction between the manager and his firm. By buying too low or selling too high, the controlling party transfers wealth from the firm to himself, but the picture can be confused by intricate transactions in non-standard assets or subject to varying degrees of price unfairness. Enforcement becomes more difficult, but still seems essential if agency costs are to have any bound. The appropriation of corporate opportunities, excessive managerial compensation and consumption of managerial perks can be still more judgmental, and probably the legal rules less effective, but the order of magnitude is also often less. And when one reaches conflicts highly intertwined with the regular operation of the business, such

\textsuperscript{14} See Remillard Brick Co. v. Remillard-Dandini, 241 P.2d 66, 74 (Cal. 1952): “directors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit. The concept that a corporation is an entity cannot operate so as to lessen the duties owed to all of the stockholders.”
as excessive diversification, or self-retention by less competent managers, the fiduciary duty of loyalty probably offers little protection.”¹⁵

The core conflict of interest situation is the self-dealing transaction, and here state corporation laws have been rather specific. Most define the problem in terms of a “transaction between a corporation and one or more of its directors or officers...or an organization in which one or more of its directors or officers are directors or officers, or have a financial interest”¹⁶, and then require that it be approved after full disclosure by a majority of the disinterested directors or shareholders, or be fair to the corporation. The defects in this rule are many, and most flow from reliance on formalism coupled with a failure to distinguish between abuse of control and abuse of trust. The problem in a self-dealing transaction is that the party benefiting from it is in a position to control its approval by the corporation, so that the usual presumption, in a transaction between independent parties, that both sides can look out for their own interest does not apply. The problem in an abuse of trust transaction is that the agent has a personal interest in the transaction which is not (as agency law requires) disclosed to and taken into account by the ultimate decision-maker, where the agent does not control the ultimate decision but is relied on by the principal. In consequence:

1. The rule as stated is too broad—it covers transactions between the corporation and one in the formal status of a (subordinate) officer or an (outside) director who in no way controls the decision of the board or management. The problem, when there is one, lies in the extent of reliance being placed on a person with an interest not fully disclosed to the CEO and board when they make their decision.
2. The rule is too narrow—it does not by its terms cover transactions with a controlling party who is not a member of the board, such as a parent company or majority stockholder. Courts have often stepped in to fill the legislative hole, by treating a controlling shareholder also as a fiduciary.
3. Directors are regarded as “disinterested” if they have no direct financial benefit from the transaction, regardless of the degree of control over their selection and continued presence on the board exercised by the party benefiting from it. “Disinterested” is not the same as “independent” in attitude and action. Thus the approval required by law offers no assurance of negotiation of an arm’s length bargain.

(4) No attention is paid to whether shareholder approval comes from shareholders with a large enough stake in the company to do more than approve semi-automatically what management recommends to them. Again, the real issue is whether the transaction is with someone in a control position, either as a dominant CEO or a major stockholder; if so, a formal approval process can offer at best only weak protection.

(5) The fairness of the transaction is regarded in some jurisdictions as an issue which need not be reached if formal approval has been obtained from disinterested directors or shareholders. But if it is a true self-dealing transaction, with a controlling party, then review of the terms of the deal by an outside and independent (judicial) monitor is the only possible safeguard for the interests of the minority shareholders.

The more blatant forms of self-dealing can fall into the categories of theft and misappropriation, and be dealt with by the criminal law, but the imposition of criminal penalties requires much higher standards of proof and culpable intent. Much of such conduct remains in the domain of private law actions to recover the improper gains, and there—as we have outlined above—the defects of the legal rule leave considerable room for control persons to manipulate processes of formal approval to their own benefit. The extent to which dominant CEOs have been willing to take advantage of corporate assets has drawn wide publicity in the recent cases of John Rigas in Adelphia Communications (accused by prosecutors of using the company as a “personal piggy bank”) and L. Dennis Kozslowski in Tyco International Ltd. (described as using a public company as “his personal cash machine”). This is an area in which SEC mandatory disclosure requirements could be more precisely designed to reveal transactions with potential for self-dealing abuse.

It would not be difficult to draft a clearer self-dealing statute, focusing on persons possessing actual control power rather than occupying a management position, and providing a defense based on the substance (fairness) of the transaction rather than on a process (disclosure and approval) that addresses the different problem of agents with a undisclosed adverse interest. The current statutory provisions offer a degree of protection for shareholders that is certainly important but falls far short of full coverage, and have pointed the courts toward an undue emphasis on procedure over substance.

b. Germany

Traditionally, German stock corporations (*Aktiengesellschaften*) have had shareholding structures that differ from those of their U.S. counterparts. Most German corporations are controlled by a family, a controlling majority shareholder, or at least a number of large shareholders. For this reason, German corporate law has focused less on the regulation of conflicts between shareholders and managers and more on those between controlling and minority shareholders. A specialized area of German corporation law (*Konzernrecht*) addresses, *inter alia*, the conflicts of interest that may arise in connection with transactions between a corporation and its controlling shareholders. *Konzernrecht* specifies some of the duties of loyalty that controlling shareholders owe to minority shareholders. For example, transactions among affiliated companies must be described in an annual report on control relationships that must be prepared by independent auditors. This report is designed to ensure that transactions among affiliates take place at arm’s length prices. It should be noted, however, that the report is disclosed to the supervisory board only, not to the shareholders, which presents an enforcement issue.

Rules and principles regulating conflicts of interest between managers and the corporation, in particular with regard to self-dealing, are less developed in German than in U.S. law. In this regard, it is necessary to distinguish between the specific rules that focus on particular situations and general principles that supplement such specific rules.

The point of departure for this analysis is the separation between the management board (*Vorstand*) and the oversight body, the supervisory board (*Aufsichtsrat*). This roughly corresponds to a distinction between inside and outside directors; however, pursuant to German law, these two sets of directors have significantly different duties and work in different management bodies. The members of the management board manage the corporation's business and are subject to a wide-ranging obligation not to compete with the company (§ 88 Stock Corporation Act). They may not take advantage of corporate opportunities. They may not receive anything of value from third parties in exchange for undertaking activities in connection with their duties in the corporation. Transactions between a member of the management board and the corporation may not be approved by the

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19 See §§ 311 et seq. Stock Corporation Act (*Aktiengesetz*).
interested manager or even by the entire management board, but only by the supervisory board, to which law assigns this specific duty (§ 112 Stock Corporation Act). German law contains strict provisions that specifically regulate a corporation's loans to the members of its management board.\(^{20}\)

German law seeks to guarantee the independence of the supervisory board members from the management board. First, the members of the management board are appointed by the supervisory board (§ 84 Stock Corporation Act), and second, the management board’s influence on the selection of the members of the supervisory board is limited because in companies with more than 2,000 employees, only half of the supervisory board is appointed by the shareholders and the other half is elected by the employees (in corporations with between 500 and 2,000 employees, the employees appoint one-third of the supervisory board). The management board's ability to influence the selection of the shareholders' representatives seated on the supervisory board will depend on whether the company is a publicly held company with a widely dispersed free float or a corporation with one or more dominant shareholders. In a company with a majority shareholder both organs will be dominated by this shareholder, whereas in companies with widely dispersed ownership the management board and in particular its chairman will often have a decisive say in who will become a management board or a supervisory board member, insofar as the latter are elected by the shareholders. Reciprocal “back scratching” between members of the management board and the supervisory board is rendered significantly more complicated by the fact that the management board alone may not represent the company in dealings between a supervisory board member and the company, but must act together with the entire supervisory board in such cases (§ 114 Stock Corporation Act).

By assigning such transactions to the competence of the supervisory board, German law thus uses primarily procedural rules to handle such cases of potential self-dealing. The only express provision for a judicial examination of the fairness of the benefits conferred upon managers regards the compensation managers receive from the company; the compensation has to be “appropriate” (§ 87 Stock Corporation Act). However, if it is possible to bring a derivative suit, a court may examine whether a transaction between management and the corporation is appropriate and made on an arm's length basis.\(^{21}\)

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\(^{20}\) § 89 Stock Corporation Act, and § 15 Banking Act (Gesetz über das Kreditwesen).

\(^{21}\) For a description of the obstacles to derivative suits under the Stock Corporation Act, see Section II.A. 3. b., below.
These procedural rules addressing transactions between directors and the corporation technically apply only to members of the management board and the supervisory board. They do not extend to other related party transactions, such as those involving relatives of the directors or firms in which directors have a substantial holding. Firms that prepare their financial statements on the basis of internationally accepted accounting standards (such as IAS or U.S. GAAP) are required to disclose material related party transactions (see IAS 24 and SFAS 57). Beyond this, the German Corporate Governance Code (the "GCGC") states that material related party transactions should be approved by the supervisory board (para. 4.3.4 GCGC). There is no direct sanction for a violation of the GCGC. However, if the supervisory board fails to impose appropriate rules on the management board for related party transactions, and the corporation is damaged as a result of such failure, the supervisory board will become liable for such damages (3116 Stock Corporation Act). Moreover, if a member of the management board were to unjustly deplete the corporation’s assets by transferring assets from the corporation to himself or to a firm he controls, he would violate his duty of loyalty and be subject to strict civil liability (§ 93 Stock Corporation Act), as well as -- if the act were done willfully -- criminal sanctions. As in the Anglo-American legal systems, German legal doctrine contains a duty of loyalty (Treuepflicht) that members of a management body owe to their corporation, and the violation of which creates liability to the corporation for damages. The violation of the duty of loyalty will create strict personal liability. However, as will be explained in more detail below, the procedural requirements determining the success of an action for damages based on civil liability are set higher under current German law, making the case quite difficult to prosecute.

Thus German law on managerial self-dealing, like that in the U.S. does not define the problem in a clear and precise way.

2. Management performance

The continuance in office of poorly performing top management is not dealt with solely or even primarily by legal rules, but they do have some bearing on the subject, which we will now consider.

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22 English translation at http://www.corporate-governance-code.de/eng/kodex/4.html The GCGC is not a set of mandates, but a set of desirable practices; if a corporation does not observe them, it must explain its non-adherence.

23 Ibid.
A second aspect of the fiduciary duty of officers and directors comes under the heading of the duty of care, which requires them to act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."24 The standard as thus expressed is one of reasonable or ordinary diligence, knowledge and skill, and would seem to create possible civil liability for ordinary negligence. Only rarely would negligence ever fall into the domain of the criminal law for poor administration of the affairs of the corporation.

However, the ordinary negligence standard is actually a standard of desired conduct rather than a standard of potential liability. All jurisdictions apply the “business judgment rule,”25 which in effect transforms the liability standard into a gross negligence test.26 And the American Law Institute, in its Principles of Corporate Governance (1994), went still further and in Section 4.01(c) recommended a standard of protection requiring only “rational belief” that the action was in the company’s best interests.

Under such standards, there is small likelihood of considered board decisions resulting in personal director liability for a violation of the duty of care, though it is not impossible.27 And if a director were found liable for a violation of the duty of care, without any element of improper personal gain from self-dealing, the judgment would usually be covered by ‘D & O’ insurance, paid for by the company. Is all this contrary to the best interests of shareholders? It seems unlikely. The rule recognizes that business necessarily involves the taking of investment risks, that shareholders can reduce those risks more efficiently through portfolio diversification than managers can diversify their human capital, and that lawsuits brought in the wake of some loss are strongly biased against the decision-maker by the bad outcome. The best interest of the shareholders is served by managers who make risk-neutral decisions, not by managers made more personally risk-averse by the specter of personal liability for bad outcomes. Indeed, shareholders might be better off if duty of care liability were simply

24 Cal. General Corporation Law Section 309(a); for a similar formulation, see Model Business Corporation Act Section 8.30(b).
25 As defined by the Delaware Supreme Court, the rule “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 interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.” Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
27 In dramatic failures, such as Enron and its successors, it is automatic for plaintiffs’ attorneys to charge as wide a variety of defendants under as many causes of action as possible. It remains to be seen how many result in out-of-pocket losses to directors.
abolished, and in the late 1980s state corporation statutes were amended to allow shareholders to make that choice through charter amendment, or to limit monetary liability to a modest amount. Notably, that option was not extended to duty of loyalty liabilities. Nor do loyalty violations find any shelter under the business judgment rule.

But if shareholders have no remedy for poor management performance in legal liability rules, do others? Not really. Shareholders may derive some indirect protection from the covenants that bondholders or banks have negotiated into their loan agreements, designed to maintain a certain minimum level of equity cushion or cash flow, or a maximum leverage ratio or amount of total debt. If these well-specified requirements are not met, the debtholders can invoke their contractual remedies, to accelerate maturity in whole or in part, or enforce a security lien on pledged assets—steps that management would certainly wish to avoid, though not for reason of any exposure to personal liability. But the terms of debt covenants, where they exist, are set to enhance the probability of debt repayment, not to provide incentives to maximize the total value of the firm, let alone the value of the equity. The interests of shareholders and debtholders do not coincide. And while incumbent management may be ousted in bankruptcy proceedings, that is not assured and comes far too late to do shareholders much good.

In short, legal liability rules are basically irrelevant to addressing the concerns of minority shareholders in US companies over poor, or even miserable, managerial performance. And probably that is as it should be, in the shareholders’ own interest, as discussed above. That makes it all the more important that there be other effective mechanisms to deal with the problem.

b. Germany

At first sight, the general principle of German corporate law that the director of a stock corporation must act with the diligence of a prudent businessman (§ 93 Stock Corporation Act) appears to be quite rigorous, especially considering that this is a principle of mandatory

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29 See, e.g., Del. General Corporation Law § 102(b)(7) and Cal. General Corporation Law § 204(a)(10). Most public corporations have proceeded to opt-out of all care liability, without significant shareholder opposition.
law (§ 23(5) Stock Corporation Act). Culpable action, i.e., negligent or willful action, that breaches this duty of prudent business management, triggers liability to the corporation. Actions based on a breach of the duty of care are, however, significantly restricted in two ways, producing a result similar to that in the U.S.\(^{31}\) First, German courts have admitted a "business judgment" defense that allows a director to argue that the action alleged to breach the duty of care was undertaken on the basis of business judgment (unternehmerisches Ermessen).\(^{32}\) Second, as explained in more detail below, current German law makes it difficult for a corporation to bring a liability action against one of its directors. In practice, the most important sanction for business errors and commercial failures is that of not being re-elected to office or, in serious cases, being prematurely removed from office. A German manager in practice would almost never be faced with liability for a breach of the duty of care (except in a case where the breach also involved a violation of law, such as a social security or tax law).

3. Disclosure obligations

Another type of legal duty imposed on management is mandatory disclosure requirements, in the interest of investor protection. There has long been a debate over the extent to which information disclosure by the firm needs to be mandated, since sellers have reason to provide reliable information to buyers who may otherwise assume the worst. That argument loses much of its force, in our view, when it comes to disclosure of conflict of interest transactions. However, we will not rehearse that debate here, but simply review the content and enforcement effectiveness of the disclosure regimes currently in place.

a. US

In connection with public offerings of securities in the US, the Securities Act of 1933 requires the filing of a registration statement with the SEC and dissemination of a prospectus containing extensive information about the business and financial history of the issuer. Upon becoming a public company, an issuer also incurs comparable disclosure requirements in mandatory periodic reports, filed with the SEC and sent to shareholders. The contents of these documents is spelled out at length in SEC rules, and the financial statements must be

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32 See the decision of the German Federal Civil Court (Bundesgerichtshof) in ARAG/Garmenbeck, 135 BGHZ 244 (April 21, 1997).
presented in accordance with generally accepted accounting principles ("US GAAP") and audited by an independent public accountant in accordance with generally accepted auditing standards ("GAAS"). The establishment of GAAP rules has been the responsibility of the Financial Accounting Standards Board ("FASB") and the setting of audit standards is now, under the Sarbanes-Oxley Act of 2002, the responsibility of the Public Company Accounting Oversight Board ("PCAOB"), in both cases subject to review and (in effect) final determination authority in the SEC.

Disclosures in connection with private purchases and sales in the secondary market do not follow such a rigid and detailed format. Instead, the SEC has adopted Rule 10b-5, which basically proscribes any material misstatement or omission made with 'scienter' (roughly, knowledge) by a party to the transaction. ("It shall be unlawful for any person...to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made...not misleading...in connection with the purchase or sale of any security.") This very general language has given rise to an enormous amount of interpretive gloss. Strictly speaking, it is not a mandatory disclosure rule but a trading rule: unless there has been disclosure, insiders (including the company) may not trade.

Section 11 of the 1933 Act expressly creates private rights of action, claiming a material misstatement or omission in a registration statement or prospectus, for purchasers against issuers (on a basis of strict liability) and against top management and directors (on a negligence basis). Rule 10b-5 has been held by the courts to have created an implied private right of action against those making such statements, on a scienter basis. Both are enforced by class action lawsuits, not derivative suits, as noted above. The result has been the development of a specialized plaintiffs’ bar which vigorously pursues securities violations, to an extent far beyond what the SEC could have done by itself.

How much protection does all this afford minority shareholders? In the context of a person’s decision to invest in a company, it provides very effective remedies for fraud by the issuer/seller. That does not mean it lacks for critics or limitations. The ‘material omission’ branch of the standard can give rise to hindsight lawsuits, brought more for their settlement value than for culpable conduct. A large recovery against the company often means what is in essence a large transfer payment from one group of shareholders to another, both innocent of wrongdoing, rather than a sanction against management for knowing transgressions.
On the other hand, the prospectuses and annual (or quarterly) reports generate a very large flow of information to the securities markets, to assist in accurate pricing and in productive capital allocation decisions. This too has its critics: Enron, WorldCom (now MCI) and other corporate disasters of the last several years have called into question the clarity and adequacy of accounting rules and audit standards. Still, whatever the flaws (and the room for improvement), the disclosure regime has sustained remarkably deep capital markets and reasonably accurate pricing mechanisms, to the undeniable benefit of the economy as a whole.

b. Germany

At present, German law does not provide a suitable action against management and supervisory board members to hold them directly liable to shareholders and the investing public for false or misleading information that they release to the market and for the omission of material information. This gap is a result of the traditionally unimportant role that the organized capital markets have played for corporate finance and private investment in Germany. In theory, liability could result from the release of false or misleading information (or material omissions) provided to investors in securities prospectuses, interim reports, financial statements, shareholder newsletters or current reports, and information released in annual shareholders' meetings or analyst meetings. However, only the liability that attaches to securities prospectuses meets international standards. Under current German law, a director incurs liability for other releases of false information only if it is demonstrated that he willfully sought to deceive. In addition, some trial courts also require that the plaintiff prove actual knowledge of the false information (i.e., actual familiarity with the annual report containing a false statement or material omissions) and reliance thereon. The prosecution of such actions is further aggravated because German law does not provide a class action or representative action mechanism in such cases. In 2001, the German government established a Reform Commission, which made recommendations for correcting the defects of the existing framework. The government included these recommendations in a plan for legislative action that was released in February 2003. The following are the key points of the plan:

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33 §§ 44 seq. Stock Exchange Act (Boersengesetz); § 13 Securities Prospectus Act (Verkaufsprospektegesetz).
• In the future, not only the issuer, but also the competent members of management and supervisory bodies, will be personally liable for materially false or misleading information that the issuer releases to the secondary market.

• Consideration will be given to whether such liability should be extended to all written and oral information regarding the capital market.

• The liability of management and supervisory board members will be capped for acts of gross negligence. The level of the cap is still being debated; there will be however no cap in cases of willful actions.

• A number of procedural improvements are to be undertaken to allow larger numbers of plaintiffs to prosecute actions together, but this will not be a true class action as used in the U.S.

In addition to the above, measures are being considered to effect significant improvements in the auditing of corporate financial statements--increased auditor independence, improved and more independent supervision of the auditing profession, and an enforcement system for auditing financial statements for compliance with the law and accounting standards.

4. Enforcement of legal liability rules

a. US

If legal rules are not effectively enforced, their existence and scope does not much matter, except for whatever moral influence they may have. The predicate for any form of enforcement is that the plaintiff must have knowledge of the putative violation. The disclosure rules discussed above are one source of the needed information, though they have been designed primarily to provide the capital markets with financial information about firm performance to and pay only passing attention to conflict of interest transactions by those in control.

There are other channels whereby evidence about conflict transactions and accounting fraud may be brought to light and outside board members or public authorities informed – accountants, outside counsel, employee whistleblowers, the financial press. The Sarbanes –
Oxley Act of 2002 contains a number of provisions intended to deepen those channels and increase the likelihood that possible violations will be reported. But assuming awareness, if the problem is not corrected within the firm, what next?

Conflict of interest rules–duty of loyalty violations–may in relatively extreme cases find enforcement through criminal sanctions. If top managers are helping themselves in sufficient magnitude to corporate assets as “loans” (subsequently forgiven) or “perks” (for personal expenses) without even going through the formal mechanisms of board approval, or taking undisclosed self-dealing profits, they may attract the attention of prosecuting authorities. In the current climate in the US, there is a growing list of examples, as noted above. But, short of outright fraud and theft, history suggests this cannot be counted on, for prosecutors have many demands on their limited resources and non-violent crime (let alone disputable self-dealing) does not usually come at the top of their priorities.

Shareholders, who are the injured parties, confront a number of obstacles, some legal (and unnecessary) and some practical, to defending their interests for themselves. The legal obstacles begin with the fact that under US law the shareholders can not sue directly to recover losses from conflict of interest transactions by insiders but must bring a “derivative suit.”35 The chain of reasoning verges on the theological: such transactions involve possible breaches of the fiduciary duty of loyalty, fiduciary duties of officers and directors are owed to the corporation as an entity and not to its owners, the corporation is thus the party which has the cause of action against its insiders, the shareholder is therefore bringing a suit against the corporation to force it to bring suit against some members of its management or board, and any recovery will go to the corporation. But the affairs of the corporation are managed under the auspices of its board, not by its shareholders. Therefore the shareholder must first make a demand on the board to bring the suit for the corporation, unless a demand is “excused” because there is reasonable doubt that the board is disinterested or independent or made a valid business judgment in the first instance.36 If demand is required and the board refuses to bring the action, then the shareholder is blocked from pursuing the case, unless the board’s refusal was wrongful or outside the protection of the business judgment rule, which in effect treats the decision to sue an insider for a loyalty violation as the same as any other business decision. If demand is excused, as for example when the board members shared in the

35 Since recovery for failure to meet care standards is unlikely at best, as noted, this discussion will be confined to loyalty violations.
36 This is the Delaware rule: **Aronson v. Lewis**, 473 A.2d 805 (Del. 1984).
conflict of interest transaction, then the shareholder can proceed to file suit, but the board can appoint a special litigation committee of new or disinterested members who then conduct their own investigation of the merits of the suit and decide whether to permit it. That decision is subject to judicial review under different standards in different jurisdictions, which address the committee’s composition and procedures and may (Delaware)\textsuperscript{37} or may not (New York)\textsuperscript{38} pay any attention to the merits of the shareholder’s case.

Though simplified, this summary of the demand requirement imposed on derivative suits gives a sense of the gauntlet that the shareholder must run merely to get the case before a court, where the merits can be fully adjudicated at a trial. At each stage, there is ample opportunity for defensive maneuvers, appeals and delay. And there are yet more special burdens placed on this category of suit: contemporaneous standing requirements for the plaintiff, furnishing a bond for defendants’ attorney fees, perhaps even a demand on the other shareholders to authorize the plaintiff to act on their behalf. All of this is purportedly justified by the need to protect the corporation from ‘strike suits’ without merit, brought to induce settlement payments.

The result is that derivative suits are, if not an extinct species, certainly an endangered one. The decisions again fail to make critical distinctions: between care suits (of little value anyway) and loyalty suits (essential to shareholder protection), and between derivative actions against outside third parties (part of management’s discretion in running the company) and against insiders (where their chosen associates can not be completely relied on to monitor their conduct). But in the current state of the law, shareholders have compelling reasons to make every effort to bring their complaints in the form of direct actions (free from all the special burdens) to vindicate their own rights, as opposed to derivative actions that are supposed to be vindicating corporate rights. Since fiduciary duties are usually characterized as being owed to the corporation, loyalty violations must be brought as derivative suits if stated in a straightforward manner, which has led to finding ways to base them on securities laws that create private rights of action not for shareholders but for those who purchased or sold securities, who will receive any recovery. In the process, the gravamen of the case becomes, not the self-dealing transaction itself, but the failure to fully disclose it in

\begin{footnotes}
38 Auerbach v. Bennett, 393 NE.2d 994 (NY 1979).
\end{footnotes}
connection with some securities transaction by the insider or the company. That will not
reach all breaches of fiduciary duty,\textsuperscript{39} but it does provide coverage for some.

But there are practical, as well as legal, obstacles to effective enforcement of
shareholder rights, that apply as much to direct actions as derivative ones. In the context of
the public corporation with numerous small shareholders, and even with many institutional
shareholders, there is the familiar collective action problem. It is not rational, or at least it is
not optimal, for a small number of shareholders owning a modest fraction of the shares to bear
the full risk and initial cost of a lawsuit whose benefits, if successful, will be shared by all the
other shareholders, who can simply free-ride on their efforts. Without a way to surmount this
problem, conflict of interest violations will be pursued only to a limited extent, in situations
where there are major blockholders outside the management or control group.

A partial solution in the US to this collective action problem has consisted in awarding
substantial attorney’s fees to successful plaintiffs’ counsel, both in derivative suits (which are
collective in nature, since the damages recovered go to the corporation) and in direct suits
under the securities laws which are conducted as class actions on behalf of all affected
shareholders. The amount of the fees approved by the court, and thus the incentive for the
attorney, usually has been in the range of 20\% to 30\% out of the damage award, which
produces under-investment in the litigation in relation to the amount at stake for the class.
And having the litigation opportunity found and managed by the attorney, with the titular
plaintiff only a nominal party, creates other misalignments of interest between the attorney
and the shareholder clients; principal-agent costs show up here also.\textsuperscript{40} Despite its defects,
however, without the attorney-driven lawsuit there would be in a great many cases no
enforcement at all of laws attempting to bound conflict of interest extractions by those in the
control of the firm. Leaving it all to action by criminal prosecutors or a government agency
would hardly be an improvement.

\textsuperscript{39} Santa Fe Industries v. Green, 430 US 462 (1977).
\textsuperscript{40} Efforts to ameliorate them led to § 27 of the Private Securities Litigation Reform Act of 1995, prescribing the
choice of a lead plaintiff appointed by the court, and to efforts by some judges to set the level of fees
through a species of auction bidding by law firms.
b. Germany

German law places significantly higher hurdles in the way of a shareholder's successful prosecution of an enforcement action against management board and supervisory board members than are found in U.S. corporation law statutes.

Like U.S. law, German law makes a distinction between liability to the corporation and liability to the shareholders. Liability arising from a breach of the duty of care or duty of loyalty runs primarily to the corporation. There are a number of reasons for this: The director's employment contract is entered into between the director and the corporation, not between the director and the shareholders. (The majority position in Germany asserts the doctrine that management boards and supervisory boards are “organs” of the legal person, which leads to a similar position. This "organ" theory of German law, which was developed in the nineteenth century, concedes considerable room for independent action to directors.) In addition, it is generally believed, although there is no explicit statutory provision or judicial holding, that the management board and supervisory board members are not obliged to exercise care and loyalty exclusively in the interest of the shareholders, but also in the interests of other stakeholders in the firm (employees, creditors, the public at large). Although there are no court rulings on this, this doctrine tends to broaden the spectre of managements' actions which don’t lie in the interest of the shareholders. Lastly, any compensation for damages to the corporation's assets flows back to the corporation, and so will redress the common damage suffered by the shareholders, but provides no particular incentive for action by an individual shareholder.

In actions seeking to enforce liability initiated by the corporation against a member of the management board, the corporation is in principle represented by its supervisory board (§ 112 Stock Corporation Act). The problem with this rule is that when the supervisory board alleges that a management board member has breached its duty, such allegation may also imply that the supervisory board itself has failed to fulfill its oversight duties. For this reason, supervisory boards undertake this type of liability action only rarely ("one crow doesn’t gouge out the other crow’s eye"\(^{41}\)). In response, courts have not allowed supervisory boards to raise the defense of the business judgment rule in cases addressing whether they should have

\(^{41}\) “Eine Kraehe hackt der anderen kein Auge aus”.

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initiated a liability action against a management board member. Still, actions of this type arise almost exclusively when a corporation enters insolvency proceedings and the bankruptcy trustee files the action, or on occasion when the entire top management (supervisory board and management board) has been replaced by a new owner.

The German legislature has also observed this problem of cautious supervisory boards, and attempted to address it through the following provisions: First, the shareholders' meeting may by majority vote resolve that the corporation must take action against a management board or supervisory board member (§ 147(1) Stock Corporation Act). The litigation will then be run by the management board (against members of the supervisory board) and the supervisory board, respectively (against members of the management board), but the shareholders meeting or the court on demand of a minority of shareholders can institute a special independent representative to bring the suit (§ 147(2) Stock Corporation Act). Second, shareholders with collective holdings constituting either 5.0% of the share capital or a market value of €500,000 may petition a court to appoint a special representative if evidence demonstrates a compelling suspicion of illegal activities or serious violations of the law or the articles of association (§ 147(3) Stock Corporation Act). Thus, German stock corporation law, in contrast to partnership law, does not recognize a derivative suit by a single shareholder.

The entire legal framework discussed above seems flawed and is sharply criticized by German legal scholars. In particular, the thresholds for the action are too high and the manner in which costs are allocated is prohibitive. Differently than in U.S. law, German lawyers may not work on a contingency fee basis, and in contrast to the so-called “American Rule”, an unsuccessful shareholder must bear not only her own costs and those of her lawyer, but also the costs of the opposing party (§ 147(4) Stock Corporation Act). Beyond this, a court-appointed special representative is under no obligation to follow instructions received from the shareholders. Also in this area, the German government’s Reform Commission recommends making changes to bring German law up to international standards. The planned legislative measures seek to strengthen the right of shareholders to prosecute the company’s claims against directors by, inter alia:

42 See ARAG/Garmenbeck, 135 BGHZ 244.
• Lowering the threshold for actions to the significantly smaller shareholding of 1% of the share capital or a quotation or market value of € 100,000.
• There will be a demand requirement. At this stage, the board has no free discretion whether or not to sue. It may decline to bring a suit only where prevailing interests of the company not to sue can be shown to the court, so these reasons will be subject to judicial review.
• In order to avoid "strike suits“, the trial court will hold a preliminary hearing to assess the merits of the case. If the court admits the case to a full trial, the company will bear the costs of the proceeding even if plaintiff loses on the final judgment. If the preliminary hearing goes against the plaintiff, the latter may still proceed at his own risk.

These measures will still not eliminate the basic problems dampening any plaintiff’s motivation to undertake such actions. The plaintiff will bear all the costs and risks of initiating the action; there is no remuneration for a successful suit; in the case of success, free riding shareholders will benefit equally from the judgment.

B. The Board of Directors

Another mechanism for constraining the behavior of management in the public corporation is the board of directors, elected by the shareholders and potentially a protector of their interest in both good performance of the firm and limitations on the extraction of control rents. The structure, powers and duties of the board are not the same in US and Germany, as we will next review.

1. Formal role: powers and duties

a. U.S.

In the US, state corporation laws almost uniformly provide a simple default rule: that the business and affairs of the firm shall be managed by or under the direction of a board of
directors elected by the shareholders,\textsuperscript{44} which has the power to select and remove the officers. It is clear that the board has ample authority to act as an overseer of management, if it chooses.

But beyond the fiduciary duties already described, the law does not provide unequivocal guidance on the exact role of the board, and in practice there are at least three competing and, inevitably, overlapping concepts of its primary function. One is to act as counselors to the CEO, providing advice and perspectives from their own experience for management to consider in reaching decisions but otherwise deferring to management’s ultimate judgment. Only in a crisis or unusual circumstances would the board try to override, or even replace, the CEO. A second is to act as representatives of the shareholders’ interests and seek to maximize the equity value of the firm. This perspective would require the board to view itself as on occasion bargaining with management, over issues such as compensation or related party transactions, and to monitor management performance in a more demanding way. A third concept, reflected in the stakeholder statutes, is that the board should see itself as “balancing” the interests of everyone significantly affected by the firm’s actions. How much weight should be accorded shareholder value is generally left unclear, but the Pennsylvania statute goes so far as to require that it shall not be controlling.\textsuperscript{45}

The consequence in the US is that, although the board has sweeping formal powers, if it adheres to proper procedures it is largely free to choose how active or passive a role it will play. The factors that bear on its choice in practice will be considered below.

\textbf{b. Germany}

Germany has had an obligatory two-tier system since 1870; before that, a single-tier and a two-tier board were both in use. In theory, the tasks and duties of the management board and the supervisory board are strictly separated. The management board conducts the business affairs of the corporation (§ 76 Stock Corporation Act). The supervisory board appoints the members of the management board, who are company officers, and can remove

\textsuperscript{44} Del. §141(a); Cal. §300(a).
\textsuperscript{45} Pa. C.S.A. § 511(d).
them from office, but must have good reason (wichtiger Grund\textsuperscript{46}) if it does so before the end of their term of office, which can last as long as five years (§ 84 Stock Corporation Act).

Furthermore, the supervisory board oversees the management of the corporation (§ 111(1) Stock Corporation Act); the supervisory board has the right to co-approve transactions that are particularly important, as specified in the articles of association or designated by the supervisory board itself (§ 111 (4)(2) Stock Corporation Act). Returning to the distinction (between private benefits of control and unsatisfactory performance) that underlies our analysis, "oversight" (Überwachung) of the management board means first of all that the supervisory board should monitor to prevent self-dealing and similar unjustified private benefits of control. Second, the supervisory board should monitor the success of management's performance and create the conditions for such success, in particular through the appointment of capable managers, the removal of incompetent management board members (if sufficient legal grounds exist) and through vigilant, continuing supervision through expression of its views. However, as will be discussed below, this second task in particular presents both theoretical and practical problems.

The supervisory board has broad information-gathering and intervention powers available to it for the enforcement of its oversight duties (see §§ 90, 111(2) Stock Corporation Act). The duties provided for by law flow from the duty of loyalty that each supervisory board member owes to the corporation. The purpose of these duties, however, is by no means exclusively to protect the interests of the shareholders. The majority position is that the supervisory board must primarily protect the interests of the firm (Unternehmensinteresse).\textsuperscript{47} This position is emphasized and strengthened by the representation of employees on the supervisory board. As mentioned above, in firms with more than 500 employees, one-third of the seats on the supervisory board are reserved for employee representatives, and in firms with more than 2,000 employees, one-half of the seats are so reserved.\textsuperscript{48} Subcommittees of the board reflect the same split.

\textsuperscript{46} Such good reasons are constituted by material breaches of duty, incapacity to manage, or a vote of no confidence by the shareholders’ meeting.

\textsuperscript{47} Cf. German Federal Civil Court, 64 BGHZ 325, 329 (June 5, 1975).

\textsuperscript{48} To break ties, the shareholder-selected chairman has a second vote. For a detailed description, see T.Baums/B.Frick, "The Market Value of the Codetermined Firm", in M. Blair/M. Roe (eds.). Employees and Corporate Governance, 206, 208 et seq. (1999).
This ambiguity and absence of a single focus for the exercise of duties is exacerbated by another problem that, in practice, hinders the efficient oversight of management in the German system. In connection with the mandatory co-determination rules, German law also sets obligatory sizes for supervisory boards; for larger corporations, a 20 member supervisory board is required. If one includes the members of the management board, the company is saddled with a cumbersome body of about 30 members or more, and this in itself points at an inefficiency of the German system in comparison to the smaller boards that are common in international practice. As a consequence, the supervisory board meets less frequently than would a smaller body; and much depends on the work of the chairperson of the supervisory board and individual committees rather than on the activities of the board as a whole. Legal policy makers have made repeated recommendations to reduce the size of the supervisory board; however, these attempts have in the past been unsuccessful, primarily because of opposition from labor unions. Labor unions have a concrete interest in large supervisory boards because they can appoint three officers to such boards, and because the representatives of the labor unions and of the employees direct most of their compensation for work on the board back to the unions. As a result, the role of plenary supervisory board meetings has been reduced to a few sessions to hear reports from the management board, adopt formal resolutions and air issues that particularly affect employee interests. Strategic questions and criticism of the management board are often addressed in separate informal meetings between shareholders' representatives on the supervisory board and the management board. In emergency situations, however, the supervisory board is forced to become active. Also, if a corporation has a major shareholder that is represented on the supervisory board, a picture of the board could develop that would be quite different from that found in a widely held company. As noted above, the civil liability of supervisory board members – and with it their personal motivation to undertake meaningful oversight of and collaboration in the management of the corporation – is in most cases merely a theoretical possibility.

2. Director selection

a. Concentrated ownership

1. U.S.

The party possessing the actual capability of selecting the directors, which depends on the distribution of stock ownership and voting power in the individual case, will largely

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determine the role of the board. If there is a controlling shareholder—an outside individual or parent company that owns a majority or near-majority block of the voting stock—the board in the U.S. can be expected to represent the interest of that owner. Normally such interests will lie in the direction of maximizing profit (and the equity value) of the firm, which greatly reduces minority stockholders’ concern over monitoring firm performance, but it may also lie in the direction of maximizing the control rents obtained by the majority owner to the exclusion of the minority. The conflict of interest or related-party transaction problem thus remains important. As Jensen and Meckling pointed out, minority shareholders on buying into such a firm will attempt to estimate and price the private benefits of control, but that does not satisfactorily cover the situation where an outsider subsequently acquires control of a previously widely-held company. All parties could be better off ex ante if the legal system more effectively bounded control rents.

If there is not a single controlling stockholder but a number of blockholders who in the aggregate approach operating control, both the benefits and the costs described above exist, but in diminished degree. There has been considerable debate about the capability and effectiveness of institutional investors as monitors of public corporations. Even though institutional investors as a category own about half the equity of NYSE companies, their individual holdings usually amount to a small percentage of a given company’s capital, so coordination among a substantial number of such investors would be required. This would not be easy both in practice and as a matter of law, and tends to reduce the actual leverage that institutional investors exercise over incumbent management to a level much lower than one might at first think present. Furthermore, there would still be a free-rider problem, though diminished, and institutional investors might find it preferable to simply sell. On the other hand, their ability to extract private control rents would also diminish, since the dispersion of control leads to a more transparent environment. Institutional investor activism has been growing, led by public pension funds such as CalPERS, but -- partly for legal reasons -- it has

49 See n.12 supra.
51 The legal issues for a "group" acting together include reporting requirements under '34 Act §§ 13(g) and 13(d), short-swing profit liability under § 16(b), short sale prohibitions under § 16(c), "affiliate" status under the '33 Act, and a triggering of company-adopted "shareholder rights plans" (poison pills). See B. Black, “Shareholder Passivity Reexamined,” 89 Mich. L. Rev. 520 (1990), for an early account of such difficulties, and SEC Staff Report, Review of the Proxy Process Regarding the Nomination and Election of Directors 10-11 (July 15, 2003).
yet to take the form of exercising direct pressure on boards by trying to nominate and elect members.

Activism does exhibit a certain potential for monitoring, and perhaps it is causing some boards to pay closer attention to shareholder interests, but institutional investors have not been up until now a powerful determinant of board behavior in the US. The SEC would like to increase institutional investor voice a little bit, but not too much. It has recently issued a proposed rule that would allow "eligible" (holding at least 5% for at least two years) shareholders, in a restricted process consuming at least two years, to have from one to three nominees included in a company's proxy solicitation materials.

Quite a lot of discussion has been devoted to the composition of the board, as apart from the matter of their incentives and who selected them. Does the percentage of outside (non-executive) v. inside (management) directors make a difference in firm performance? Many shareholder activists claim it does, and the listing requirements adopted recently by the NYSE and NASDAQ would require a majority of "independent" directors on the boards of public companies. But the empirical studies so far do not find consistent evidence to support the claim that a larger number or majority of outside or independent board members results in better firm performance. Likewise, there has been considerable advocacy, as valuable corporate governance reform, of the proposition that the board chairman should be an outside director, not the CEO, but again the empirical evidence is inconclusive.

2. Germany

Shareholding structures in Germany are gradually coming to resemble those found in Anglo-American corporations. However, even today most corporations, including those which are publicly listed, continue to have majority shareholders or shareholders that exercise de facto control (these include families, foundations, other companies – which raises questions as to the control structure of those companies – and the State). Institutional shareholders (such as insurance companies, banks, mutual funds and pension funds), and in

52 For a historical exploration of the reasons, see M. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (1994).
particular foreign institutional investors, have been increasing their presence in Germany. Even if only because of their relatively high costs of information, contact and action, however, foreign institutional investors have less incentive to press for good corporate governance, file shareholder suits or demand supervisory board seats in Germany than they do in their own markets. German banks have historically played a significant role in the oversight of company management, which has led to misunderstandings regarding the nature of the underlying institutional arrangements and their effects, in the literature on this subject produced outside of Germany.\textsuperscript{57} For a number of reasons, the historically characteristic influence of German banks has in recent years significantly diminished. Equity holdings have, after the introduction of a favourable tax exemption, been sold to a large extent; bank managers have given up their positions at the helm of supervisory boards of their industrial clients; and the depositary voting system has been supplemented by a proxy voting system run by the management of the company rather than by the depositary institutions acting as proxies. Interlocking share ownership among large corporations, though it still exists, has also been diminishing.

b. The widely-held company

1. U.S.

In cases where stockholdings are diffuse and institutional investors do not exercise significant control, shareholder voting power is latent and of little immediate consequence. That presents two polar possibilities. The first, and most common, is that the CEO will dominate the board, whether or not he is also the chairman, and can usually control the filling of vacancies. That puts the CEO, at least until he decides to step down, in a position analogous to that of a controlling shareholder, and he might well turn to maximizing his managerial control rents. The other end of the spectrum is a genuinely independent board, with a majority of outside directors who control the nominating process and fill vacancies on their own. This has not been the typical board in the public corporation, but it is one that can sometimes develop over time and seems currently to be the goal of corporate governance

activists, as witnessed by the listing requirements recently adopted by the New York Stock Exchange and Nasdaq\textsuperscript{58} and approved by the SEC\textsuperscript{59}.

Although “independence” in the legal sense of absence of financial ties to the company beyond director fees does not guarantee that a director’s decision-making will be independent (which is more a reflection of who in reality can select and fire a director than it is of the level of directors’ fees), it does mitigate somewhat against bias. If the co-opting or self-perpetuating board were to become a common pattern in US public companies, whose interests would it represent? That requires an analysis of director incentives, which is our next heading. It would not necessarily be the small public shareholders, unless there were some practical way for them to overcome the collective action problem and oust an incumbent board, or otherwise align the board’s self-interest closely with their own. The recent SEC rules on shareholder participation in the director nomination process are not a solution.\textsuperscript{60}

2. Germany

In Germany, things look somewhat different due to different institutional arrangements and shareholding structures. As mentioned above, the members of the management board are appointed and removed (for cause) by the supervisory board rather than directly by the shareholders; in a company with more than 2,000 employees, one-half of the members of the supervisory board are elected by the shareholders and the other one-half are elected by the employees. Therefore, the influence of the management board on the persons who can appoint or remove them is limited. Collaboration with outside directors in "managerial rent-seeking" may thus be less pronounced in the German system, but a German management board may well have more latitude to act without supervision (because of the less intensive interaction between the management board and the supervisory board), especially in large corporations that do not have a controlling shareholder.

3. Director incentives

The public interest theory of the board is that its members will meet their legal and moral obligations out of a sense of selfless duty and internalized norms. It would help of course if those legal and moral obligations were better defined and generally agreed on,

instead of being clouded in ambiguity and uncertainty about whose interests are to be served. But in any case, directors will possess substantial discretion, so attention must be given to their personal incentives.

A number of incentives come to mind. Directors may wish to retain their positions because of the status, contacts and compensation that go with them, or to avoid the reputational loss of being dropped. If so, they will obviously be attentive to the wishes of those who put them on -- and can remove them from -- the board. If directors are also stockholders, as is generally the case, they have an incentive to increase the value of their shares. In most cases, this is not a very strong incentive, since director stockholdings are likely to be relatively small in absolute terms and infinitesimal as a percentage of the company’s outstanding capital. Directors no doubt also have an incentive to preserve their reputations, to perform their legal and moral obligations, and to avoid legal liability. None of these incentives necessarily creates a strong pressure for directors to assert independence from management and work hard to thoroughly understand the company's business and maximize shareholder value. Moreover, such maximization is not even a formal goal for board members in Germany’s stakeholder regime.

C. Purchase of Control by an Acquiring Firm

1. Reasons for acquisitions

There are many possible motivations for one firm to set out to acquire another, not all of which are socially beneficial. Some are driven by the prospect of an increase in the market value of the combined firms, which may come from different sources. The combined firm may possess greater market share, even to the point of obtaining monopoly or oligopoly rents (at which point it becomes a concern for the antitrust laws). The combination may create “synergies” based on economies of scale or scope, or enable advantage to be taken of tax loss carry-forwards. Or, more to the point of this article, it may be a way to replace self-serving or poorly performing management.

On the other hand, there are examples of the combined firm having a lower value than the sum of its constituent parts. That may come about because of errors of judgment by the management of the acquiring firm, or because they are serving their own interest in building a
bigger empire despite its cost, to reap correspondingly greater compensation, power and celebrity. Either way, they too may become a corporate governance problem.

2. Friendly takeovers

By definition, friendly takeovers are those negotiated with, and approved by, target management. They therefore are not an effective source of discipline over control rents, since the incumbent management has to be bought out at no less than the control rents’ discounted net present value (or be subject to the credible threat of a successful hostile takeover) to gain its acquiescence—a part of the purchase price in which the stockholders do not share. Transmitting that payment to the target management can raise fiduciary duty issues, but of a sort with which courts find it difficult to cope. Regarding it as a self-dealing transaction is confused by the fact that the payment is in form often coming from the acquirer, and relevant “fairness” standards are hard to define. Target management can be awarded salary increases, option grants, and consulting contracts, and may have already awarded itself ‘golden parachutes’ in the form of generous severance packages as part of employment contracts approved by the board. If friendly takeovers impose any constraint on control rents, it is a lax one; indeed, they may provide a final opportunity for management to enrich itself.

As for poor performance, however, the picture is somewhat different. By hypothesis, there is a gain to be achieved by replacement of the incumbent management, one which it can not obtain by itself. The target management has an incentive, therefore, to allow the transaction for a price paid to it; the acquirer has to see profit in the acquisition; and some of the gain will go to the shareholders to induce them to vote in favor of the sale. The result is a division of the potential gain among the three parties, in some indeterminate fashion. That is what seems to occur in these transactions, although shareholders might wish for a bargaining mechanism that better represented their ownership interests.

3. Hostile takeovers

In hostile takeovers, the acquirer purchases ownership and control directly from shareholders in the trading market, usually in the form of a tender offer, rather than going through management to get its approval of a merger. This potentially provides an answer to how to overcome both control rent and poor performance problems, by ousting the incumbent
management if they are responsible. Now the expected gain will be in theory divided just between two parties—the buyer and the target shareholders—although the target management may still extract a share, through golden parachutes or compensation for belated acquiescence. The buyer’s share has to be large enough at least to cover the expected costs and risks of making the bid, or none will be forthcoming. Beyond that minimum, the split is again indeterminate, and will be affected by whether there are other alternative acquirers (creating a seller’s market) or targets (creating a buyer’s market).

a. US

The tide in the contest between acquirers and target managements in the US has ebbed and flowed in recent years. At one time, the proxy fight for the election of directors seemed about the only way to wage such a contest, but the challenger was generally at a substantial disadvantage in winning—not only because incumbent management had a set of major procedural advantages (controlling the agenda and shareholder lists for the annual meeting, charging expenses to the company) but also because the shareholders were merely being given a choice between known incumbents and outside “raiders.” With the development of the tender offer in the 1960s, they didn’t have to make a comparison between alternative management teams but merely a comparison between the price being offered by the acquirer and the market price under current management, and acquirers did much better. Management struck back in a number of ways: procedural requirements in the Williams Act of 1968 that gave the target earlier warning and more time to resist, charter amendments (to delay consummation of control transfer) such as staggered boards, abolition of the right of shareholders to remove directors without cause or to hold special meetings or act by written consents without them, supermajority shareholder vote requirements to approve clean-up mergers of which the members of the prior board had not approved. But these proved less effectual than desired, especially as the development of junk bond financing facilitated the making of all-cash offers. Once an acquirer had obtained at least a majority of the stock, the incumbents usually saw the handwriting on the wall and gave in.  

61 This issue is raised in the current criminal prosecution of the Mannesmann supervisory board’s compensation committee for the bonus paid to its CEO at the time of Vodafone’s takeover. See Wall St. J., Nov. 6, 2003, p. A1: “After Huge Merger, German CEO Faces Trial Over Payment”.

Delaware provided incumbent management the upper hand again in two 1985 decisions. In Unocal, the Supreme Court agreed with management that tender offers were “threats” and authorized the target company to use any defensive tactics that were “reasonable in relation to the threat posed.” The force of that holding soon became clear in Moran, upholding the use of the new device of a ‘poison pill’, so long as it was reasonable under Unocal in the mind of the judge. The corporate bar has invented a number of variants of the poison pill, but essentially they are rights given by the board to stockholders (other than the would-be acquirer) to buy shares at a deep discount from the market price if anyone obtains more than a set percentage (such as 10% or 20%) of the outstanding stock. The resulting dilution of the acquirer’s investment is so costly that no one has ever triggered such a pill. The rights can be redeemed (at no or nominal cost) by the target board, to permit friendly acquisitions of which it approves, but not (once issued and triggered) by a shareholder vote.

The requirement that use of the pill must pass muster with the Delaware Supreme Court as “reasonable” turned out to be of little substance. If the target justified a refusal to redeem on the basis that management had a strategic plan that it claimed would lead in the future to greater value than the acquirer was bidding in an all-cash, 100% offer, that seemed in the Time case sufficient for the Court to keep the offer from being decided by the shareholders, who might after all be unable to properly evaluate management’s plan and reach the right conclusion. Subsequent Delaware decisions have gone down the same line and refused to order a pill’s redemption.

Since the “enhanced scrutiny” promised in Unocal has proved hollow, attention returned to the proxy fight as an accompaniment to a tender offer. If the acquirer could win the proxy fight and get control of the board, then it could redeem the pill and proceed with the offer; shareholders would really be voting in the proxy contest not on an alternative management slate but on the price being offered for their stock. The response to that was renewed attention to the earlier device of the staggered board; winning one proxy fight would not be sufficient, since only a third or a fourth of the board would be up for election. The pill could remain in effect, and a year or more would have to elapse before the acquirer could try a

66 Except presumably in the situation where a company is deemed to have put itself up for a sale that results in a change in control. See Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).
67 Paramount Communications v. Time, 571 A.2d 1140 (Del. 1989).
second time to pursue its offer— if it still made sense to do so. That prospect would eliminate
many potential tender offers from ever being made. As a recent theoretical and empirical
study\textsuperscript{68} concluded: “Effective staggered boards are the most powerful antitakeover device in
the current arsenal of takeover defense weapons.”

Not every state authorizes staggered boards, and not every company has one, though a
majority of large public corporations do. Nor does every company have a poison pill,
although they can be quickly adopted And perhaps, even where a company has both, a
Delaware court may rule that refusal to redeem the pill in certain special circumstances is a
violation of the board’s fiduciary duties, or an acquirer may be willing to engage in a two year
struggle. Even without judicial compulsion, a board might override management’s desire to
remain in office. So some hostile takeovers may succeed despite target management’s
unyielding opposition. But at present it seems clear that hostile takeovers play a very limited
role in the protection of shareholder interests where management is determined to stay in
power. In substance, Delaware jurisprudence seems to be willing to give management
something approaching an absolute veto over hostile tender offers, despite overwhelming
evidence that they confer large benefits on target shareholders.\textsuperscript{69}

b. Germany

Proxy fights are extremely rare in Germany. Likewise, hostile takeovers executed
through public tender offers— and the threat they pose to executives of possible removal from
office if the corporation’s share price drops because of unsuccessful management— do not
significantly affect corporate governance in Germany, but they do occur. Vodafone’s hostile
takeover of Mannesmann rocked corporate Germany, and there have been several smaller
hostile takeovers since that time. However, hostile takeovers through public bids are only one
among a number of ways of achieving control. Since German companies often have a
dominant shareholder or a number of significant minority shareholders, a hostile change of
control (that is, a change of control that management opposes) can take place through the

\textsuperscript{68} L. Bebchuk, J. Coates, and G. Subramanian, “The Powerful Antitakeover Force of Staggered Boards: Theory,

\textsuperscript{69} For a review, see G. Jarrell, J. Brickley and J. Netter, “The Market for Corporate Control: The Empirical
Evidence Since 1980,” 2 \textit{J.Econ. Persp.} 49 (1988). The size of the average premium— around 50%— is
an indicator of how costly and inefficient a bound on agency costs the hostile tender offer has become.
See also A. Schleifer and R. Vishny, “Large Shareholders and Corporate Control,” 94 \textit{J. Pol. Econ.} 461
(1986).
privately negotiated placement of a large block of shares. Until recently, such transactions were also less capital intensive because German law – unlike that, for example, in England – contained no requirement that all shareholders be offered the right to sell their shares at an appraised price in case of a change of control.

Until recently there was also general agreement that the management board and the supervisory board had no right to influence the makeup of the shareholding ownership (this is occasionally referred to with the confusing name of the "neutrality principle"). This meant that in the case of a tender offer or a change in control through other means, the management was not authorized to use any defensive tactics. However, when the European Community attempted to adopt a directive that would have prevented the managements of all EU companies from using defensive tactics, Germany led a coalition to defeat the directive. This was stated to be because a number of other EU member states had defensive tactics that were not available in Germany and would have slipped under the directive's prohibitions. For example, Electricité de France could have taken over a German electric utility against the will of German management, but was itself immune to takeover because the French government held preferred shares with special voting rights ("golden shares"). While Germany was working to defeat this European directive, it adopted its own takeover legislation that rejected the so-called "duty of neutrality". The management board of a German corporation may now pursuant to § 33(2) of the Securities Acquisitions and Takeovers Act (Wertpapiererwerbs- und Übernahmegesetz) be authorized by the shareholders' meeting for a period of 18 months to undertake defensive measures such as the sale of an essential asset which would require the consent of the shareholders' meeting or the issuance of new shares to a third party. The management board and supervisory board acting together may also use (very limited) defensive tactics, such as the sale or purchase of assets or the use of authorized capital, if they are compatible with prudent and diligent management (§ 33(1) Securities Acquisitions and Takeovers Act). U.S.-style poison pills, which would dilute the value of the acquirer’s stock, are, however, illegal, as is any measure that would damage the company (as distinct from shareholders.)

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The European Community does not intend to abandon its legislative project on takeovers. In this regard, the European Court of Justice recently published several rulings in which it voided various types of defensive tactics used against other European bidders.72 The European Commission has recently attempted to push through legislation imposing a "duty of neutrality," together with a prohibition on defensive tactics such as voting caps, multiple voting rights and other voting devices in the various member states, but was unable to convince either the European Council or the Parliament. A proposal is currently being discussed that would place certain defensive tactics at the disposal of the member states on a discretionary basis. It would also allow member states to classify their corporations as those open or closed to takeover, and allow a company to use defensive tactics against a bidder that was not itself open to a takeover. At present, in any case, it is safe to say that the market for corporate control through hostile takeovers in Germany operates on only a very limited basis.

D. Incentive Compensation

Another approach is to try to align management’s interests with those of shareholders by using rewards (performance-based compensation) rather than sanctions (liability), contract rather than legal rules. Incentive compensation has little impact on conflict of interest transactions; it is instead addressed to enhancing motivation and overcoming the agent’s inclination to shirk. In particular, agency theory postulates agents (officers) who are risk averse and principals (diversified shareholders) who are risk neutral, and seeks to reward the agents for taking more risk in the interest of the owners of the firm. The theory leads to compensation packages that include a fixed-salary component and a variable incentive component. Leaving aside the firm-specific questions of what the total amount of compensation should be and how that is actually determined, problems arise with how the performance of top management is measured and the choice of incentive plans.

Performance measures generally fall into two types: accounting-based and stock-price-based. Neither is free from serious defects. Accounting numbers are subject to substantial manipulation by top management, within GAAP rules as well as in violation of them, as recent cases have exemplified. Stock prices reflect general trends in the economy, up or down, for which management is not responsible and deserves neither credit nor blame.

72 See ECJ Commission vs. Belgium, C-503/99 (June 4, 2002); ECJ Commission vs. France, C-483/99 (June 4, 2002); ECJ Commission vs. Portugal, C-367/98 (June 4, 2002); ECJ Commission vs. Spain, C-463/00 (May 13, 2003); ECJ Commission vs. United Kingdom, C-98/01 (May 13, 2003).
In terms of the type of plan, again there are two broad categories: payment in cash and payment in stock or stock options. They differ in tax treatment and in accounting treatment, and the rules can become intricate and beyond our level of detail. But there is a problem that cuts across all types, and that is the time period required for the executive to reap full benefit. If there is immediate full ownership (so that the bonus cash can be spent, or when the option is exercised the stock can be immediately sold), and the amounts are large, the agent may be induced to move from risk averse beyond risk neutral into becoming risk insensitive, or in the extreme to becoming a manipulator of the financial reports, if the short-term payoff is great enough. This seems to be part of the explanation for recent cases like Enron, WorldCom and Tyco.73

Incentive compensation is clearly useful; it does address one agency problem. It is also readily abused to obtain rents, in the presence of a pliable board.74 And it does not really align management and shareholder interests, since management does not share in the shareholders' downside risk under most plans.

III. Recommendations

What conclusions do we draw from this survey? To return to the propositions with which we began, it cannot be said that either US or German law is designed to give primacy to shareholder interests. In a well-known article,75 La Porta, Lopez-de-Silanes, Shleifer and Vishny on a scale of 0 to 6 rated legal protection of shareholder rights at 5 for the US and 1 for Germany. In our view, the rating for the US at least is overly generous, or simplistically-conceived. We will summarize our findings, and suggest some relatively straightforward steps that would have to be taken if either legal system were to take shareholder protection seriously.

A. Legal Rules

1. US

a. Conflicts of interest

For corporate governance purposes, the focus should be on abuses of control, so the statutes would have to be drafted in those terms. Sometimes the locus of control in a corporation is fairly obvious, from share ownership percentages or the role the CEO has played in director selection, but it may also be a question of fact that would have to be resolved by examining evidence—which is the function for which courts exist. All transactions between the company and a controlling person—manager or shareholder—should be susceptible to review for fairness. If the control status seems ambiguous, then internal process (approval by “disinterested” directors or shareholders) could transfer the burden of proof as to lack of fairness to the plaintiff.

b. Management performance

Assessing management decisions in large firms is not a function for which judges and courts are well suited, so the insulation provided by the business judgment rule in our view serves shareholder interests. Ought it to be carried further, to the point of full abolition under ‘opt-out’ provisions? Management has generally thought so, and the necessary charter amendments to eliminate care liability have been widely adopted. But there is an intermediate position, specifically authorized by the Delaware and California statutes, of permitting a limited amount of liability; the ALI suggests at least the amount of the person’s annual compensation from the company. It is hard to assess what the optimal incentive balance in this context might be, but even a minimum amount might assist the functioning of the reputation market.

Beyond that, assessment of (and sanctions for) inadequacies in management’s performance are best left to the board of directors (if it can muster the will to act) and, more importantly, to the market. For market discipline to be effective, management should not be permitted to entrench itself from replacement through hostile tender offers.

76 See n. 29 supra.
77 ALI, Principles of Corporate Governance § 7.19.
c. Enforcement

The derivative suit, with its many obstacles, should apply only to corporate causes of action against unrelated third parties, free from any insider conflict of interest taint. The decision to bring such lawsuits is a matter appropriately within management’s business judgment, and derivative suits to require them to do so would predictably be rare.

But shareholder suits against insiders to enforce their fiduciary duty of loyalty, or to recover damage to the company from knowing transgressions of clear legal rules, are a distinctly different matter, and should not be hindered by treating them the same as suits against outsiders. They should be viewed procedurally the same as direct (class) actions, a result achieved by characterizing insiders’ fiduciary duties as running to the shareholders as well as to the firm. Indeed, there are decisions already saying exactly that and their procedural implication could be readily drawn by courts taking shareholder protection seriously.

2. Germany

a. Conflicts of interest

To date, German law inadequately regulates transactions between controlling shareholders, directors, their related parties, and the corporation. The main problem is a lack of sufficient information regarding such transactions. As a first step, the reports for insolvent companies on transactions among affiliated companies and persons should be publicly disclosed for the five year period immediately proceeding commencement of the insolvency proceedings. Furthermore, the right of shareholders to bring actions against directors on behalf of the corporation seeking compensation for damages should be improved. The current hurdles to such actions are too high.

78 See n. 14 supra.
79 Cf. the proposals at n. 43 and accompanying text.
b. Management performance

The most important sanction for bad performance is not being re-elected to office or, in serious cases, being prematurely removed from office. Furthermore, the supervisory board could theoretically (and, according to judgments of the courts, should) sue a director in case of culpable (intentional or negligent) behavior. It is doubtful whether the Reform Commission proposal that it should be made possible not only for the supervisory board, but also for shareholders constituting a small percentage of the share capital, to initiate an action against directors for their intentional or grossly negligent breach of their duty of care (the diligence of a prudent business man) should be followed. As a practical matter this would mean that directors would (and should) be personally liable without limit for intentional breaches of duty because D&O insurance does not cover intentional acts. For gross negligence, directors would only be liable for their individual portion (retention) on the policy. However, the risk of such personal liability would, economically, as part of the compensation package, be paid by the company. Nevertheless, a judicial action for damages against a director would do enough damage to a director’s reputation that directors would have reason to avoid behavior that could provoke such actions.

c. Enforcement

German law needs to be reformed to facilitate actions to enforce the statutory and fiduciary duties that directors owe both to their corporation and to investors.

German law does not currently allow an individual small shareholder to file a derivative suit to enforce directors' liability for breach of these duties to their corporation. It is possible for a block (5% or €500,000) of shareholders to act together, but the threshold of shareholdings necessary for such an action is set too high. The manner in which costs are apportioned (through the "loser-pay" rule) also works to impede the filing of such actions. Moreover, the compulsory appointment of a "special representative" whose costs the shareholders must bear, yet to whom they cannot issue instructions, presents an unworkable and even bizarre legislative construction.

As said, the German law governing the liability that directors owe to investors (which, in practice, is usually based on the disclosure of false or misleading information and for
material omissions) also needs to be reformed. Under German law, not only is the standard for liability set too high (for the disclosure of false information to the market, liability attaches only where willful conduct and investor reliance can be proved), but the procedure used to enforce liability is also defective. German law does not provide in this area any form of collective representation like a U.S. class action. Such a mechanism is necessary to overcome the well-known collective action problems that exist in publicly held corporations – although it should be noted that not every aspect of the class action rules (in particular, application of the “American Rule” for apportionment of the costs of proceedings appears questionable) should be adopted in Germany.

B. The Board of Directors

1. US

Boards might prove more effective as monitors of management if it were made unmistakably clear that their primary responsibility is to the shareholders. Stakeholder or constituency statues impair or destroy that responsibility, without replacing it with any defined and enforceable obligation to anyone else. The result has been to enlarge the Board’s unfettered discretion, making it truly accountable to no one. Taking shareholder protection seriously would mean ending the current muddled and competing concepts of the role of the Board.

The impact of the Sarbanes-Oxley Act of 2002 and the changes to NYSE listing requirements, requiring a board with a majority of independent directors and a nominating committee of all independent directors, may well be to establish a legal foundation for autonomous boards – a self-perpetuating group that controls its own election and selects its own successors. Such a board could become, at least over time, largely beyond the sway of the CEO and able to set its own course, determined by its members’ own preferences and incentives.

Director incentives are strongly determined by whoever selects or can remove them. It would be useful to enhance the ability of institutional investors to act together, and even seek representation on the Board, for to a considerable degree their interests coincide with those of the outside minority shareholders—who on their own are unable to exert much influence over
the directors. Pure proxy fights are quite expensive and not much of a solution to the shareholders’ collective action problem; unless the party launching the fight is also taking a very large equity position in the firm, his motives are suspect (or at least subject to being impugned) as primarily seeking control rents for himself.

But under a proposal currently being considered by the SEC, holders of at least 5% of outstanding shares would, under special and narrow circumstances, be able to put some competing candidates on the company’s annual proxy statement for the election of directors, avoiding the costs of separate solicitation.80 Though much will depend on the specifics of any adopted rule, the concept offers the possibility of subjecting even an otherwise autonomous board to some shareholder (presumably institutional investor) discipline.

2. Germany

German companies should be permitted to choose between using a two-tier (supervisory and management board) and a one-tier (board of directors) management structure, which is the model set forth in the EC Regulation for a European Corporation (Societas Europaea).81 The market would then be able to decide on the respective strengths and weaknesses of the two management structures. Regardless of this, German supervisory boards are too large to effectively carry out their duties, and should thus be reduced in size. Furthermore, although it is unlikely that employee co-determination will be changed in the medium-term, it appears to be a mistake that only employees residing in Germany are represented in co-determination. The entire co-determination system should be examined and adjusted where necessary. In the long-term, international investors will not accept nationally appointed supervisory boards because they will (correctly) fear that decisions are made not to further business efficiency, but rather to serve parochial interests and in particular local labor interests. Overall, both the management and the supervisory boards of German corporations must adapt their operations to international business practices. This means improved information flows to the outside directors on the supervisory board, closer collaboration of both organs, supervisory board members with greater independence and international stature, and better pay for them (in particular, the practice of employee representatives diverting their

80 See n.53 supra.
salaries into the treasuries of the labor unions is questionable) -- which should be accompanied by stricter enforcement of duty of loyalty obligations once the statutory regulation of director liability is improved.

C. Purchase of Control

1. Friendly takeovers

Friendly acquisitions generally reflect a drive towards better use of resources, and are generally blocked only to address social concerns, such as the impact on competition. A problem that remains, however, is the setting of limits on the share of the purchase price management can obtain for itself. We have no answer as to how to define standards that are appropriate and readily enforceable and are left with the vague constraints of a fiduciary duty.

German law contains a provision - § 87 Stock Corporation Act - that requires compensation for managers to be “adequate”. This holds also in friendly or hostile takeover situations. The Corporate Governance Code requires that the supervisory board fix a cap on the gain which a manager could reap from a stock option program or comparable remuneration instruments in such a situation.\(^{82}\) Furthermore, German law contains clear rules restricting the types (but not amounts) of payments or other benefits a bidding company may grant the management of a target company in a public takeover: all such moneys and benefits promised or rendered to the members of the management or supervisory board of the target company must be published in the offer document (§ 11 (2) 3. Securities Acquisitions and Takeovers Act). Finally, neither the bidder nor any person affiliated with the bidder may promise or render any "undue" compensation or other benefit to the members of the management or supervisory board of the target company in connection with the bid (§ 33 (3) Securities Acquisitions and Takeover Act).

2. Hostile takeovers

The market for corporate control is potentially the most powerful mechanism for achieving effective corporate governance, in terms of both firm performance and managerial control rents. By the same token, it is potentially the most threatening to underperforming or

\(^{82}\text{German Corporate Governance Code (cf. fn. 22) sec. 4.2.3.}\)
self-enriching corporate management. Management has often had the upper hand politically, but its record in state legislatures has not been unmixed; it has actually done much better in the Delaware Supreme Court than in the Delaware legislature.

Taking shareholder protection seriously would mean limiting the defensive efforts of incumbent management to endeavoring to persuade shareholders not to sell, or to soliciting competing offers. It would require depriving them of the ability to exert a veto (de jure or de facto) over control change and thereby to prevent the shareholders from making their own choices on whether to accept an offer.\textsuperscript{83} A partial step toward that end would be to make it possible for institutional investors to take larger ownership positions, and cooperate more easily, than is now permitted.

The German government’s decision to give the management board the power to use defensive measures with the approval of the supervisory board has entrusted the wrong people with the decision on whether the market for corporate control should operate, and is therefore highly questionable. It may still be hoped that the correct rule will be implemented at the European level. Furthermore, German law should ease the communication between shareholders in order to allow for proxy contests.

D. Incentive compensation

Some of the shortcomings in current incentive compensation plans could be ameliorated if the executive held a large fraction of the compensation, whether in cash or in stock, for a period of several years after receipt, in a banking scheme where the balance would be affected by subsequent performance. This would help induce management to take a longer-term perspective on its decisions, and introduce more risk sensitivity while lessening the incentives to manipulate current results.\textsuperscript{84} That would not necessarily have to be cast in terms of a mandatory legal requirement; it could be induced by differential treatment under GAAP and the tax code, or in Germany through the Corporate Governance Code. Restricted stock plans are the form that comes closest at present to meeting these criteria.

\textsuperscript{84} Interestingly this objective may be partially achieved by the forfeiture provisions of §304 of the recent Sarbanes-Oxley Act, which require the CEO and CFO to repay the company all incentive or equity-based compensation and stock sale profits they receive within a year after any accounting “misconduct” resulting in a restatement.
It would also be possible to remove general market or industry effects from performance measures by adopting index-adjustments, but ‘abnormal returns’ in stock price event studies reflect deviations from established expectations, and thus are thereafter not a measure of continued outstanding or poor performance.

E. Concluding remarks

Though the authors have contrasting views on certain aspects, we have tried to provide an overview of a large and complicated subject, which necessarily meant omitting a number of both important ramifications and technical details. And we recognize that there are policy implications and considerations that we have not discussed fully, or at all. The scope of this paper is more limited, though essential to those broader debates – to define what taking shareholder protection seriously could entail, and how far two of the world’s most important economies are from doing so at present.
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<td>Bob Wessels</td>
<td>Germany and Spain lead Changes towards International Insolvencies in Europe</td>
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