

BREAKING ON THROUGH TO THE OTHER SIDE: UNDERSTANDING CONTINENTAL EUROPEAN CORPORATE GOVERNANCE

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1. INTRODUCTION

European corporate governance has become a hot topic in the United States.¹ Many U.S. academics have been turning their attention to the relatively large role played by financial intermediaries, such as insurance companies and (especially) banks, and by labor directors in Continental European corporations, particularly in Germany.² They have been criticizing the resulting: (1) inadequate

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The opinions expressed, as well as any errors, are the Author's.

¹ See David Charny, *The German Corporate Governance System*, 1998 COLUM. BUS. L. REV. 145 (1998); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) [hereinafter Coffee, *The Future as History*]; John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L. REV. 2151 (2001) [hereinafter Coffee, *Do Norms Matter?*]; John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001) [hereinafter Coffee, *The Rise of Dispersed Ownership*]; James A. Fanto, *The Role of Corporate Law in the Adaptation of French Enterprises*, 1998 COLUM. BUS. L. REV. 97 (1998); Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 WASH. U. L.Q. 327 (1996) [hereinafter Gilson, *Corporate Governance and Economic Efficiency*]; Jeffrey N. Gordon, *Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism*, 1998 COLUM. BUS. L. REV. 185 (1998) [hereinafter Gordon, *Deutsche Telekom*]; Jeffrey N. Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany* 5 COLUM. J. EUR. L. 219 (1999) [hereinafter Gordon, *Pathways to Corporate Convergence*]; Jonathan R. Macey, *Italian Corporate Governance: One American's Perspective*, 1998 COLUM. BUS. L. REV. 121 (1998); Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167 (1998) [hereinafter Roe, *German Codetermination*].

² See Michael Adams, *Bankenmacht und Deutscher Juristentag*, 37-38 ZIP 1590, 1591 (1996) [hereinafter Adams, *Bankenmacht und Deutscher Juristentag*] ("Ameri-

internal supervision; (2) insufficient market monitoring; (3) over-conservative corporate strategy; and (4) deficient capitalization.³ They have been disagreeing about whether the civil law tradition will be able to resist the pressure to embrace what they tend to see as a superior common law approach to corporate organization.

Focusing on Germany, I will comment and qualify these three critiques. I will argue that addressing them requires transforming, but not abandoning, the existing legal principles regarding corporations. My guiding idea will be that the continental corporate governance regime is worth preserving not only as part of a distinct legal culture,⁴ but also because it has strengths of its own. The analysis of its fortes will, incidentally, call to mind certain shortcomings in its U.S. counterpart. The continental model, in contrast to that of the United States, has the specific capacity to guide corporations in the integration of the interests of their various stakeholders—such as creditors, employees, and the community.

I will not propose transplanting the “civil law” corporate governance norms, duly reconstructed, to the United States. I am only suggesting that the continental picture of the corporation might provide some insight for an internal revision of U.S. corporate law. Comparative enlightenment and enrichment might thus end up being a two-way street. Like the civil law, the common law might be able to reflect upon and re-imagine itself by confronting its “other”.

Beyond this call for more self-reflection, I will take exception to the inclination in U.S. scholarship to assess corporate governance

cans have examined the Japanese and the German bank-dominated system in reviewing their own corporate monitoring structures.”); see also, e.g., Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985, 986-88 (1993); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 88-89, 105 (1995); Mark J. Roe, *Some Differences in Corporate Structures in Germany, Japan and the United States*, 102 YALE L.J. 1927, 1946 (1993) [hereinafter Roe, *Some Differences in Corporate Structures*].

³ See Macey & Miller, *supra* note 2, at 75; see also Coffee, *The Future as History*, *supra* note 1, at 643; Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 328; Gordon, *Pathways to Corporate Convergence*, *supra* note 1, at 220; Gordon, *Deutsche Telekom*, *supra* note 1, at 186-87; Roe, *German Codetermination*, *supra* note 1, at 167.

⁴ Hopt maintains that codetermination and the universal bank system are deeply rooted in national tradition, history and culture. Klaus J. Hopt, *Gemeinsame Grundsätze der Corporate Governance in Europa?*, ZGR 119, 817 (2000) [hereinafter Hopt, *Gemeinsame Grundsätze*].

regimes exclusively in terms of their effect on performance.⁵ I will note that there are other goals, which even U.S. law recognizes, such as encouraging legal compliance generally or cooperation among the various players within the corporation. I will also call into question the predominantly instrumentalist approach to the company law and point to a reflexive alternative. Moving to such a standpoint requires regarding the law not only as a means to realize specific ends, but also as a self-standing reality that one may assess in terms of non-teleological (deontological) principles, such as justice.

Section 2 of this Article begins by examining some U.S. perspectives on German corporate law. Section 3 will discuss certain possible reforms within the existing legal parameters. The last part of this paper, Section 4, will generally assess the critique and contemplate some aspects of the German system that might provide inspiration for changes in the United States.

2. U.S. PERSPECTIVES OF GERMAN CORPORATE LAW

The recent evolution of U.S. interest in German corporate law has been quite peculiar. In the late 1960s and throughout the 1970s, U.S. scholars viewed German law as presenting a distinct and appealing perspective on company law.⁶ They believed that this alternative approach was very much worth studying because it provided valuable insights for reform in the United States on issues such as worker board representation and corporate social responsibility.⁷

From the late 1980s into the mid-1990s, the comparative debate gyrated in a different direction. The central issue became whether German corporate structure, which allows players with a large stake (such as banks) to monitor the enterprise, was superior to

⁵ See Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 238 ("Seen from an economic perspective, the goal of a system of corporate governance is to maximize the economic value of the firm, as measured by the total of economic returns for all possible residual claimants.").

⁶ Gilson cautions that U.S. commentators were interested "in the German two-tier board system," but otherwise largely ignored corporate governance systems of other nations. Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 331 n.12.

⁷ See, e.g., Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23 (1966) (describing devices designed to extend corporate goals and give shareholders, workers, and the public a larger voice in corporate decisions).

that of the United States.⁸ The question that emerged subsequently was to what extent it made sense to follow the German lead in this respect.⁹

Toward the end of the 1990s, there was still another twist in this discussion. Many jurists, and some economists,¹⁰ embraced the premise that the German model of concentrated ownership and compulsory employee participation was inferior.¹¹ They pondered whether German law would (or should) ultimately give way to the U.S. conception of corporate organization.¹²

It is hard to escape the suspicion that relative macroeconomic performances of the United States and Germany have colored this debate. In the first period, when neither economy seemed to outpace or to be in competition with the other, the comparative (almost anthropological) standpoint prevailed. During the second

⁸ Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 332 ("Competition appeared to be not just between products but also between governance systems, and, at least for a period, the American system did not seem to be winning.").

⁹ See GARY GORTON & FRANK A. SCHMID, *UNIVERSAL BANKING AND THE PERFORMANCE OF GERMAN FIRMS* (Nat'l Bureau of Econ. Research, Working Paper No. 5453, 1996); Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, 70 HARV. BUS. REV. 65 (Sept-Oct 1992); Alfred F. Conard, *The Supervision of Corporate Management: A Comparison of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459 (1984); Roe, *Some Differences in Corporate Structures*, *supra* note 2, at 1990. But cf. JEREMY EDWARDS & KLAUS FISCHER, *BANKS, FINANCE AND INVESTMENT IN GERMANY* 22 (1994) (providing the framework of the German system of investment finance); Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021 (1993) (arguing that there is no evidence to support a preference for German organizational form).

¹⁰ Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 327 ("The turmoil of the 1980s brought corporate governance out of the shadow of purely legal analysis. Economists became interested in how corporations make decisions . . .").

¹¹ See Charny, *supra* note 1, at 162 ("Arguably, the German system is faring much less well in the current, set stage of the postwar readjustment."); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Macey & Miller, *supra* note 2, at 100; Jonathan R. Macey, *Measuring the Effectiveness of Different Corporate Governance Systems: Toward a More Scientific Approach*, 10 J. APPLIED CORP. FIN. 16 (1998).

¹² See Coffee, *The Future as History*, *supra* note 1, at 653; Gordon, *Deutsche Telekom*, *supra* note 1, at 197; Gordon, *Pathways to Corporate Convergence*, *supra* note 1, at 238; Roe, *German Codetermination*, *supra* note 1, at 181. Cf. Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 342 ("The central challenge to architects seeking to remodel existing corporate governance institutions, or design new ones, will be how to manage the tradeoff, a balance no existing system has yet achieved.").

phase, the globalization process was just taking off. More significantly, the United States was mostly mired by recession while Germany was booming. At the time, a cautiously emulative spirit carried the day. During the vertiginously globalized third stage, the United States shifted into economic high speed, while Germany stagnated. The general tone of U.S. scholars then became somewhat triumphant. Now that the U.S. economy has come to a halt and its German counterpart is growing at a miserable rate, who knows what direction this discussion will take?

Of course, U.S. commentators have not been mere cheerleaders. Their analysis has frequently been sophisticated and insightful. Yet, they often focus too much on the impact of corporate governance on economic achievement. They would lose interest if they thought that there was no correlation.

Inasmuch as U.S. critics assume a cause-and-effect relationship, their excitement about the organization of U.S. corporations increases when U.S. macroeconomic achievements are stellar. However, they should bear in mind that company law affects economic performance in a complex way and in conjunction with many other factors.¹³ Moreover, they should realize that corporate structure has functions other than increasing output. I will return to these points further into the article.

What aspect of the German approach has mostly caught the eye of U.S. specialists? Most conspicuously, they have observed that U.S. corporations have a single board, whereas the directorship in Germany has two tiers.¹⁴ In the United States, there is a single directorial board, which includes many independent directors, but whose most active members are usually the managers.¹⁵ German law requires corporations to have two separate councils: one denominated supervisory and the other managerial.¹⁶ The latter is responsible for the day-to-day operation of the business. The for-

¹³ See Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 328 ("I want to make clear at the outset that the existence of an important link between corporate governance and corporate performance is not self-evident.").

¹⁴ See Marcus Lutter, *Vergleichende Corporate Governance: Die deutsche Sicht*, ZGR 224, 226 (2001) ("Our large and listed corporations necessarily live in the dual system, in the two-tier system of management and supervisory council.") [hereinafter Lutter, *Vergleichende Corporate Governance*].

¹⁵ See MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS*, 147 (8th ed. 2000).

¹⁶ See Heinz-Dieter Assmann, in 1 *GROßKOMMENTAR ZUM AKTIENGESETZ* 267 (1992) [hereinafter Assmann, *AKTIENGESETZ*].

mer oversees management, like some U.S. independent directors do.

This distinction, nonetheless, is essentially formal. To discover a real contrast, one has to delve deeper. Thus, one discerns the two key points of divergence that have captured the imagination of U.S. corporate law academia. The first difference is in the function of labor in the corporation's administrative structure. The other distinction is in the role played by large financial institutions in corporate governance.

First, in public corporations with over two thousand employees, German law assigns half of the supervisory council seats to the workers under the principle of codetermination.¹⁷ The shareholders appoint the remaining members. In case of impasse, the council's chairman, who is a representative of stock, casts the deciding vote. Incidentally, French law also contemplates employee participation, but only as an optional feature. In contrast, U.S. law is completely silent on this issue. Proposals for the creation of labor directors emerge consistently in the United States,¹⁸ but never become positive law.

Second, in Germany—like in France and other countries on the Western European Continent—many board members respond to financial entities, such as banks.¹⁹ German banks own large blocks

¹⁷ Gesetz über die Mitbestimmung der Arbeitnehmer (Mitbestimmungsgesetz-MitbestG), v. 4.5 1976 (BGB1.I s.1153); see Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 226-227 ("The supervisory councils of our large public corporations are all codetermined. The law thoroughly regulates codetermination and its details."). In smaller corporations, employees get one third of the positions on the council. BetrVG1952. See generally, Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 800 (detailing the codetermination duties of different kinds of corporations).

¹⁸ See, e.g., Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283, 287 (1998) ("I suggest that workers should have some kind of representation on the board of directors . . ."); Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993) (explaining that corporate law should provide for employee representation on boards).

¹⁹ See Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161, 177 (1992) ("[T]he German model is commonly taken to fix control in management, subject to ongoing monitoring by large banks.") [hereinafter Gilson, *Political Ecology*]; Gordon, *Deutsche Telekom*, *supra* note 1, at 192 ("From an American perspective, the distinctive feature of German corporate governance is the role of leading German banks, which have representatives on supervisory boards of most large publicly traded German firms, often as Chair."); Macey & Miller, *supra* note 2, at

of stock and vote deposited shares,²⁰ as well as shares owned by bank-operated mutual funds.²¹ U.S. law has traditionally forbid-

75 (German "banks exert more influence in corporate decisionmaking than in the United States.").

²⁰ See Gilson, *Political Ecology*, *supra* note 19, at 181 (pointing out "the pervasiveness of bearer shares which shift voting power to the depositories in which they are held, and the barriers to a beneficial owner actually voting bearer shares lodged with a depository or directing the depository how to vote" in Germany).

²¹ Marcus Lutter, *Macht der Banken*, 42 NJW 2766, 2766 (1995) (pointing out that German banks own important investment firms); *see also* Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1602 ("The five main private banks dominate . . . large German firms and thousands of other enterprises through the right to vote deposited shares, direct ownership, and bank-controlled capital investment firms."); Theodor Baums & Christian Fraune, *Institutionelle Anleger und Publikumsgesellschaft: Eine empirische Untersuchung*, 40 AG 97 (1995) (demonstrating empirically bank domination in shareholder meetings); Gilson & Kraakman, *supra* note 2, at 988 ("[Bank] concentration of voting control comes from three sources: the banks' direct stock holdings, the holdings of mutual funds operated by the banks, and the proxy votes of bearer shares deposited with banks through the banks' stock brokerage operations."); Gordon, *Deutsche Telekom*, *supra* note 1, at 192 (stating that banks have direct holdings, manage mutual funds, and most significantly exercise "discretionary authority over customers' shares on deposit"); Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 803 ("The German universal bank system characteristically allows banks to be in the business of both credit and investment"); *id.* at 804 (specifying banks' sources of influence); Claus Köhler, *Referat, in EMPFEHLEN SICH GESETZLICHE REGELUNGEN ZUR EINSCHRÄNKUNG DES EINFLUSSES DER KREDITINSTITUTE AUF AKTIENGESELLSCHAFTEN?* N47, N47- N48 (61. Deutschen Juristentag) (1996) (noting that German banks are creditors, investment fund managers, direct owners of shares, and depots for shares belonging to others); Lutter, *Macht der Banken*, *supra* note 21, at 2766 (describing how universal banks exercise influence in the corporation); Macey & Miller, *supra* note 2, at 88-89 (describing sources of bank voting power); Peter O. Mühlert, *Gutachten E, in EMPFEHLEN SICH GESETZLICHE REGELUNGEN ZUR EINSCHRÄNKUNG DES EINFLUSSES DER KREDITINSTITUTE AUF AKTIENGESELLSCHAFTEN?* E4, E14-E66 (61. Deutschen Juristentag) (1996) (detailing banks' three influence mechanisms: direct ownership, voting rights over deposited shares, and supervisory council seats); Thomas Raiser, *Empfehlen sich gesetzliche Regelungen zur Einschränkung des Einflusses der Kreditinstitute auf Aktiengesellschaften?*, 35 NJW 2257, 2257 (1996) (noting that banks exercise influence in the corporation in virtue not only of their credit business, but also of their direct ownership of shares, control of shares as capital investor, and appointment of supervisory council members); Roe, *Some Differences in Corporate Structures*, *supra* note 2, at 1930 ("German national banks enter boardrooms by combining votes from stock they own directly, stock in bank-controlled investment companies, and securities they vote for their brokerage customers."); Uwe H. Schneider & Ulrich Burgard, *Transparenz als Instrument der Steuerung des Einflusses der Kreditinstitute auf Aktiengesellschaften*, 35 DB 1761, 1761 (1996) ("[T]he potential influence of credit institutions . . . rests on three pillars: supervisory council seats, direct ownership, and the right to vote deposited shares."). *See generally* § 135 (I)(1), AktG. The Appeals Court in Düsseldorf thus noted how, in a particular case, the Deutsche Bank "was a creditor, an agent for its depositor shareholders, and a member of the supervisory council. Under these circum-

den this kind of control by credit institutions.²² Banks may not possess more than a relatively small percentage of a particular company's equity and, until very recently, could not act as investment banks, equity mutual funds, or insurers.²³ The ownership pattern is therefore rather diffuse in the United States, whereas in Germany and throughout continental Europe it is more concentrated.²⁴

U.S. scholars maintain that these two structural variances lead to discrepancies or, rather deficiencies, in the way in which German corporations operate. They note that: (1) there is insufficient oversight by the supervisory council; (2) that the market is unable to be an effective disciplining force; (3) that corporate strategy is excessively risk averse; and (4) that the level of venture and other capital is too low. I will explore these three points separately.

With respect to the first criticism, U.S. commentators argue that presence of labor has prevented the supervisory council from performing its role adequately.²⁵ They point out that, without proper supervision, businesses are unable to function optimally. They therefore view codetermination as detrimental to efficiency.

However, the contention is *not* that employee representatives have either disrupted or dominated meetings with their unreasonable demands. Contrary to what the U.S. debate on worker repre-

stances, a bank must take into account not only its own interests as a creditor, but also those of the enterprise as well as those of the represented shareholders." OLG Düsseldorf, ZIP 1996, 1211, 1215.

²² Roe, *Some Differences in Corporate Structures*, *supra* note 2, at 1930 ("In fact, several laws bar U.S. banks from involvement in the governance of American firms.").

²³ *Id.* at 1948 ("American legal restrictions have historically kept American banks small and weak, by banning them from operating nationally, entering commerce, affiliating with investment banks, equity mutual funds, or insurers, or from coordinating stockholdings with these other intermediaries."); *see also* Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 785 (explaining that, despite constant criticism, the separation between credit and investment businesses under the Glass-Steagall Act prevailed until 1999); Köhler, *supra* note 21, at N48 (discussing efforts in the United States to abolish the Glass-Steagall Act).

²⁴ *See* Gilson, *Political Ecology*, *supra* note 19, at 182 ("The relative importance of bank financing thus helps explain both the importance of banks in the German corporate governance environment and the continued concentration of equity holdings."); Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 223 (citing empirical evidence on high German ownership concentration).

²⁵ *See* Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 222 ("Many believe that codetermination has undermined the potential monitoring capacity of the German board.").

sentation might have anticipated, the German labor delegation has neither paralyzed the council nor exacted excessive concessions to the employees from corporations.²⁶ German workers have obtained comparatively superior working conditions through a labor movement that has been extremely effective at collective bargaining and political lobbying, not by dickering within the supervisory council. Labor representatives in the supervisory council tend to perform their duties within that body pretty much like shareholder delegates, perhaps too much so.

What U.S. analysts actually argue is that German managers have taken as much authority as possible away from the supervisory council in order to avoid potential obstructionism by labor.²⁷ Presumably, management has achieved this objective by colluding with credit institutions,²⁸ which are also wary of the employee delegation and which have other ways of holding their ground. For example, in addition to exerting pressure as creditors, financial intermediaries may always reassert their authority through the council if they feel that managers are deviating too far from their interests.

U.S. commentators certainly realize that other factors further weaken the supervisory council. They recognize that, because of conflicting loyalties, the representatives of labor and of debtholders are not in a position to thoroughly scrutinize management from the standpoint of shareholder value.²⁹ They are also aware that the delegates of the employees and, especially, those of the credit institutions often sit on the councils of many different companies at

²⁶ See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 801 ("The German corporate world seems to have adapted to employee codetermination really well."); *see also id.* at 802.

²⁷ See Charny, *supra* note 1, at 158 ("As the workers will tend to have interests directly adverse to those interest of the managers and the shareholders, inside managers naturally will attempt to avoid decision-making through the board as much as possible.").

²⁸ See Roe, *German Codetermination*, *supra* note 1, at 167-68 ("[M]anagers and stockholders sapped the supervisory board of power (or, more accurately, prevented it from evolving into a serious governance institution in the face of the 1980's and 1990's global competition and technological change) to reduce employee influence in the firm."); *see also id.* at 169 (remarking that "managers and shareholders" have weakened "the large firm's supervisory board").

²⁹ Gordon, *Deutsche Telekom*, *supra* note 1, at 194 (stating that banks may self-deal, by using their "influence to increase interest charges and fees at the expense of equity holders").

the same time and therefore cannot sufficiently concentrate on any one of these enterprises.³⁰

The second objection is that monitoring through the market is weak on the European Continent. Unfriendly acquisitions take place less frequently.³¹ Part of the explanation is that it is difficult to succeed with a tender offer. There usually are not enough scattered stockholders from whom to purchase a controlling share of the business enterprise. Typically, raiders must ally themselves with one of the heavyweight owners.³² Insofar as the big players team up with each other and with management, hostile takeovers will practically be out of the question.³³

Friendly transactions will then become the only option. Yet, they are a less effective disciplining mechanism because the purchaser must typically pay a control premium and buy off displaced managers.³⁴ Only when the difference between potential and current output is large enough to compensate for these additional expenses will the acquisition and the corresponding efficiency gain

³⁰ See, e.g., *id.* at 194 (explaining that bank senior officials "serve on or chair too many supervisory boards to do an effective job . . .").

³¹ Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 328 ("And in both Germany and Japan, capital market monitoring through hostile takeovers, characteristic of United States stock market-centered governance [sic], is virtually absent."); Macey & Miller, *supra* note 2, at 75-76 (arguing that "Japanese and German bank-dominated systems of corporate governance actually prevent the development of robust markets for corporate control in those countries"); Roe, *German Codetermination*, *supra* note 1, at 181 (noting that Germany "lacks takeovers").

³² Gilson elucidates the argument, explaining that:

"[i]n Germany, it is difficult for control to be accumulated or transferred through the market because of the combination of: (1) a two-tiered board system that insulates operating management from prompt displacement; (2) bearer shares that serve to give the large banks voting power that far exceeds their not insubstantial direct equity holdings; and (3) limits on the maximum number of shares a single shareholder can vote."

Gilson, *Political Ecology*, *supra* note 19, at 177-78.

³³ Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1601 ("Cross-over intertwining [of the interests of managers and financial intermediaries] shield incumbent management from market monitoring and thus reduce the value of the enterprise.").

³⁴ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 20 ("In market-centered economies, the market for corporate control is the ultimate disciplinary mechanism, and the hostile takeover, its final guillotine.").

take place.³⁵ With codetermination, the bidder may also have to make concessions to labor representatives regarding layoffs and working conditions.

The third criticism is that Continental European managers have to attend too much to the priorities of controlling financial intermediaries. The latter, as debtholders, are supposedly too risk averse from the standpoint of ordinary shareholders,³⁶ as well as from that of economic efficiency. The point is that these all-powerful financial institutions use their influence behind the corridors to push the corporation towards excessively conservative decision making. The employee delegation is probably also too averse to risk, inasmuch as its constituents have invested all their human capital in the company. It will therefore use whatever weight it has to support for corporate conservatism.

The fourth critique is that financial intermediaries take advantage of minority shareholders within the corporation and, at a macro level, thwart the emergence of a shareholder culture.³⁷ They thus make it more expensive to acquire capital, particularly venture capital, from potential investors.³⁸ The full argument is not

³⁵ See Charny, *supra* note 1, at 161 ("Here, Anglo-American style regulation to facilitate takeovers and prevent self-dealing appears necessary if a takeover market is to develop.").

³⁶ See Charny, *supra* note 1, at 151 ("Though highly sophisticated, as creditors [banks] pursue substantially different interests from those of shareholders."); Gordon, *Deutsche Telekom*, *supra* note 1, at 195 ("Creditors and equity holders will have different attitudes toward risk, since the creditors' claim is capped on the upside (at full repayment) and the equity holders claim is capped on the downside (by limited liability)."); Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 222 ("Because in most cases the bank's interest as creditor (or potential creditor) dominates its stockholder interest, its monitoring decisions will be conflicting."); Macey & Miller, *supra* note 2, at 75 (discussing how German banks have used their influence in corporate decision making "to reduce risktaking among borrowers").

³⁷ See Gordon, *Deutsche Telekom*, *supra* note 1, at 189; Gordon, *Pathways to Corporate Convergence*, *supra* note 1, at 220; see also Roe, *German Codetermination*, *supra* note 1, at 168 ("German securities markets do not develop."); *id.* at 169 ("Standard accounts identify the lack of an equity-holding culture . . .").

³⁸ See Coffee, *The Future as History*, *supra* note 1, at 671; La Porta et al., *supra* note 11, at 1131; Gordon, *Deutsche Telekom*, *supra* note 1, at 187; Gordon *Pathways to Corporate Convergence?*, *supra* note 1, at 220 (explaining that "[i]nitial public offerings historically have been rare in Germany—only 10 in all of 1994, and the stock markets are famously illiquid and volatile," which makes high-tech, venture capital development difficult); Roe, *German Codetermination*, *supra* note 1, at 169 ("German businesspeople, the German business press, and business academics at times point to Germany's lack of a vibrant securities markets [sic] that would take innovative firms public and help charge-up the German economy.").

only that bank hegemony curtails the supply of capital funds through the securities market, but also that codetermination reduces the demand by corporations.³⁹ The end result is not only a further reinforcement of the conservative agenda, but also an excessive reliance on debt to finance corporate operations.⁴⁰

None of the U.S. critics seriously proposes abolishing codetermination or legally restricting the power of financial intermediaries as a solution to these four problems. On the one hand, virtually all of these commentators agree that employee representation in the supervisory council is an integral part of German political culture that is not realistically subject to elimination. On the other hand, they warn against exporting the U.S. restrictions on credit institutions and actually applaud the U.S. process of discarding these limitations as arbitrary, inefficient, and contrary to the national interest.⁴¹ The conclusion is, rather, that German corporations operate at a disadvantage because of these two features and will have to find ways to make up for this handicap in order to remain competitive internationally.

3. RECONSTRUCTING GERMAN CORPORATE LAW IMMANENTLY

I would like to examine the four criticisms of German corporate structure just mentioned. This section will begin with the question of monitoring—internal and external, respectively. Thereafter, it will proceed to the allegation of conservatism. Finally, it will entertain the issue of inadequate capitalization.

I will point out in what respects the critique is off the mark. I will also note the extent to which there is truth to the objections. Furthermore, my discussion will keep in mind German proposals and laws that have emerged in response to the existing problems.

³⁹ See Roe, *German Codetermination*, *supra* note 1, at 169 (“[T]he codetermined structure fits poorly . . . with diffuse ownership.”); *id.* at 178 (“The codetermined German supervisory board might keep corporate issuers’ demand for securities markets and their supporting apparatus low . . .”).

⁴⁰ Gordon, *Deutsche Telekom*, *supra* note 1, at 188 (“Thus, the development of a shareholding culture carries with it some idea of . . . shifting the focus of finance and governance away from creditor claims to equity claims.”).

⁴¹ Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1591 (“Parts of the Glass-Steagall Act have been recognized as too rigid and there are plans, which have been partially carried out, to loosen the system separating bank functions, as long as there are no conflicts of interests among the participants.”); Macey & Miller, *supra* note 2, at 112 (expressing “support proposals to liberalize the Glass-Steagall Act and the Bank Holding Company Act”).

Finally, I will suggest additional reforms that would not entail sacrificing the distinct character of German and Continental European corporate governance.

3.1. *Bolstering Internal Supervision*

Bluntly stated, the first contention is that labor representation in the supervisory council is unfortunate because it leads managers and controlling shareholders to conspire to undermine that body. The argument is that if there were no employee delegation, stockholders would insist on a strong supervisory council and managers would have to run the corporation more responsibly and efficiently. Of course, the concentration of power in the hands of credit institutions facilitates the conspiracy.

There indeed seems to be wide consensus—in Germany as well as in the United States—that the supervisory council does not scrutinize managers' actions closely enough.⁴² This inadequacy responds to the way in which the body operates. As Mark Roe points out, the board is often too large, meets too infrequently, and does not receive enough information to perform its monitoring role appropriately.⁴³

The supervisory council could, on its own initiative, overcome all of these operational deficiencies. First, it could carry out signifi-

⁴² See MANUEL R. THEISEN, *DIE ÜBERWACHUNG DER UNTERNEHMENSFÜHRUNG: BETRIEBSWIRTSCHAFTLICHE ANSÄTZE ZUR ENTWICKLUNG ERSTER GRUNDSÄTZE ORDNUNGSMÄßIGER ÜBERWACHUNG*, at 250 (1987) [hereinafter THEISEN, *UNTERNEHMENSFÜHRUNG*]; see Stefan Grundmann & Peter O. Mülbert, *Corporate Governance—Europäische Perspektiven*, ZGR 215, 222 (2000) (noting the German perception that “the board performs its monitoring function partially inadequately.”).

⁴³ See Roe, *German Codetermination*, *supra* note 1, at 168 (“Board meetings are infrequent, information flow to the board is poor, and the board is often too big and unwieldy to be effective.”); see also EDWARDS & FISCHER, *supra* note 9, at 129–30, 213–14 (suggesting that the supervisory council receives only limited information); Charny, *supra* note 1, at 152 (“[S]upervisory boards on which bank representatives sit meet infrequently [and] are poorly informed”); Gordon *Pathways to Corporate Convergence?*, *supra* note 1 at 222 (“Supervisory boards are unwieldy—commonly twenty seats Also, supervisory boards meet infrequently, normally four times a year or less.”); Friedrich Kübler, *Referat*, in *EMPFEHLEN SICH GESETZLICHE REGELUNGEN ZUR EINSCHRÄNKUNG DES EINFLUSSES DER KREDITINSTITUTE AUF AKTIENGESellschaften?* N10, N17 (61. Deutschen Juristentag) (1996) (stating that a supervisory council with twenty members “is too large to carry out its supervisory duties in an appropriate manner”); Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 229 (“There can be no personal accountability in a body of 20 members.”).

cant deliberation in relatively small committees.⁴⁴ Second, it could gather on a more regular basis.⁴⁵ Third, it could demand as much data as it deemed necessary.

The 1998 Corporate Control and Transparency Act, in fact, compels the supervisory council to move in this direction.⁴⁶ The body must now report on the committees it has set up.⁴⁷ It must meet at least four times a year.⁴⁸ "Finally, the flow of information from the managerial to the supervisory board has been once again improved."⁴⁹ Coincidentally, the supervisory council is presently in a better position to obtain information from the financial and the business auditors.⁵⁰

Marcus Lutter mentions other deficiencies in the supervisory council's operation that the law on corporate control and transparency has fully or partially removed. Some examples are: (1) insufficient participation in the decision making; (2) lack of a compensation system based on performance; (3) unclear standards on liability and sanctions; (4) inadequate working conditions.⁵¹ "The

⁴⁴ See Lutter, *Vergleichende Corporate Governance*, supra note 14, at 226-227 (explaining that, in order to improve accountability, "individuals must come together in committees and responsibly undertake their controversial tasks"); see also *id.*, at 230, 232; Peter Hommelhoff, *Die OECD – Principles on Corporate Governance – ihre Chancen und Risiken aus dem Blickwinkel der Deutschen corporate governance-Bewegung*, ZGR 238, 256-57 (2001) ("Organizationally, the interaction between management and supervisory council regarding information and decision making may be improved considerably with the formation of committees within the supervisory council.").

⁴⁵ See Roe, *German Codetermination*, supra note 1, at 170 ("[T]he board is free to meet more frequently . . .").

⁴⁶ Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG) [Law on Corporate Control and Transparency], v. 30.04.1998 (BGBl. I S. 786-794).

⁴⁷ § 171 II(2), AktG (listed corporations).

⁴⁸ § 110 III, AktG.

⁴⁹ Lutter, *Vergleichende Corporate Governance*, supra note 14, at 228 (citing § 90 II(2), AktG).

⁵⁰ The financial auditor negotiates his or her contract to monitor the corporation with the supervisory council and must participate in the council's final evaluation session. §§ 111 II(3), 171 I(2), AktG. See, generally, Hopt, *Gemeinsame Grundsätze*, supra note 4, at 795-96 (specifying the duties of the financial auditor). See also Grundmann & Mühlert, supra note 42, at 222 ("The Corporate Control and Transparency Act has expanded the monitoring duties of financial auditors, "particularly in listed corporations."); Hommelhoff, supra note 44, at 258 ("With the Corporate Control and Transparency Act, the financial auditor's activities, particularly in support of the supervisory council, have become a characteristic part of German corporate.").

⁵¹ Lutter, *Vergleichende Corporate Governance*, supra note 14, at 227-28.

reforms of the very recent Corporate Control and Transparency Act," according to Lutter, "have clearly raised the standards of corporate governance in Germany."⁵²

However, this significant amendment to German corporate law does not affect the basic critique. Managers and major shareholders will presumably continue to have an interest in undermining the supervisory council. They will have to comply with the letter of the law, but they might just stop at that. In fact, Lutter concedes that the noticeable movement in supervisory councils to "comply with the new legal provisions in a timely and exact manner," "often enough" is just "a ritual."⁵³ U.S. commentators might speculate that management will find ways to subvert the spirit of the new law.

It is indeed quite possible that managers, with shareholder acquiescence, seek to weaken the supervisory council. Predominant investors might be willing to play along insofar as they have other ways of exercising their influence and obtaining information.⁵⁴ Yet, this account seems to be accurate only to some extent. There are many gaps. A more complete analysis actually leads to a more tentative conclusion.

Capital would undoubtedly prefer to have the supervisory council all to itself. Yet, it will most certainly support the body in its current form because a radical transformation is not a real option. In the end, even major investors will probably favor monitoring by a codetermined board to no formal supervision at all.

One should bear in mind that, in principle, shareholder representatives may always outvote the labor contingent. Whenever there is a tie, the chairman, appointed by capital, casts a second vote.⁵⁵ Consequently, investors as a group have ultimate control

⁵² *Id.* at 228.

⁵³ *Id.* at 228-29.

⁵⁴ "[B]ank members [of the supervisory council receive] information critical to bargaining through other facets of the bank's multi-dimensional relation with the firm" Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 344 n.55.

⁵⁵ See § 29 II MitbestG; see also DIETRICH HOFFMANN, DER AUFSICHTSRAT, 107 1994 [hereinafter HOFFMANN, AUFSICHTSRAT] (noting that the chairman has a second vote to settle a tie); Charny, *supra* note 1, at 159 n.33 ("The chairman, a shareholder representative, casts a decisive vote in case of a tie."); Gordon *Pathways to Corporate Convergence?*, *supra* note 1, at 222 ("[I]n a direct conflict the chair can be counted upon to break a tie in favor of the shareholders.").

over the board.⁵⁶ They need not fear employee delegates. They are in a position, ultimately, to use a powerful supervisory council for their own purposes.⁵⁷

A response to my present contention may start off by pointing out that the shareholders' edge is extremely slim. Therefore, dominant investors will not be able to have their way, inasmuch as they do not control all of the stock. Moreover, they may face coordination problems. As a result, they may not always be able to act as cohorts even with respect to the shares they do command.

This reply compels tempering my original argument, but not abandoning it altogether. Labor faces collective action difficulties of its own. More significantly, it will never be in a position to win a vote in the board on its own. It will ineluctably have to recruit at least one shareholder representative in order to prevail. Hence, the dominant investors will presumably be able to block any attempt to hijack the supervisory council for the exclusive benefit of the employees.

It is possible to try to counter my claim from another angle. This retort could even include a concession that stockholders do not fear confrontation with labor on the board. It would exclusively draw on the assertion that investors are reluctant to share information with the workforce's delegates.⁵⁸ The latter may not only leak the data thus obtained to harm the corporation,⁵⁹ but also may use it to gain the upper hand in collective bargaining.

⁵⁶ "Board membership, whether supervisory or unitary, gives labor no formal power when capital retains ultimate voting control (as is the case in Germany, where tie-breaking power resides with the supervisory board chairman, who is chosen by the shareholders)" Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 344.

⁵⁷ See PETER BADURA, *PARITÄTISCHE MITBESTIMMUNG UND VERFASSUNG ZGR* 524 (1974); BVerfGE 50, 290; ELMAR GERUM ET AL., *DER MITBESTIMMENDE AUFSICHTSRAT: EINE EMPIRISCHE UNTERSUCHUNG* 54 (1988).

⁵⁸ See Charny, *supra* note 1, at 158-59 (noting that "codetermination forces some information sharing with workers" and underscoring the importance "of board representation in providing information for the functioning of unions and works [sic] councils"); Gordon *Pathways to Corporate Convergence?*, *supra* note 1, at 222 ("The desire to avoid revealing information to employee representatives means that supervisory board members typically receive much less information than American public company directors.").

⁵⁹ Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 801 (explaining that under codetermination, "keeping secrets becomes more difficult, which may lead management to hesitate to brief regular members of the supervisory council at an early stage on sensitive issues").

This point is crucially relevant; however, one should not overdraw it. Supervisory council members who filter corporate secrets expose themselves to liability for violating their duty of loyalty to the company.⁶⁰ Furthermore, employee delegates would be hurting their own constituency if they gratuitously inflicted damage on the corporation.

All the same, capital may well be wary of giving workers a negotiation advantage by opening up corporate files to their delegates. Yet, in Germany, labor already possesses a considerable amount of information about enterprises. Employees are able to learn a great deal about their companies through a high level of organization and through their legally guaranteed role in the productive decision-making. Moreover and as already noted, the law now requires management to provide the supervisory council with considerable key data. Consequently, the main investors are not likely to believe that they can keep labor in the dark by undermining the overseeing board.

As already noted, key stockholders in Germany have mechanisms of control other than the supervisory council. Moreover, they act principally as creditors who are keen on avoiding risky strategies. Therefore, they do not have to micromanage the corporation into profit maximizing. They only need general oversight and veto power in order to preclude excessive risk taking. Thus, they might be content with general oversight through their informal channels and have no particular need for rigorous board monitoring.⁶¹

However, the supervisory council is actually an ideal body for broad supervision—much better suited than more casual mechanisms. It is actually not appropriate for second-guessing management. Investors will not be prone to do without the general monitoring body just because of the diffuse benefits they might get from denying employees access to some corporate data.

⁶⁰ §§ 93, 116, AktG; see HOFFMANN, AUFSICHTSRAT, *supra* note 55, at 135; UWE HÜFFER, AKTIENGESETZ, at 22, § 93 (1997) [hereinafter HÜFFER, AKTIENGESETZ]; Klaus J. Hopt, in 11 GROßKOMMENTAR ZUM AKTIENGESETZ, at 11, § 93 (1999).

⁶¹ See Roe, *German Codetermination*, *supra* note 1, at 163 ("Instead of boardroom governance, out-of-the-boardroom shareholder caucuses and meetings between managers and large shareholders substitute for effective boardroom action."); *id.* at 174 (specifying informal mechanisms through which capital may obtain information); *id.* at 181 ("Large blockholders' representatives meet informally with managers, outside of the formal meetings, and this seems to be Germany's significant monitoring mechanism . . .").

The upshot is the following. Major shareholders would probably prefer not to share power with labor. Yet, they will most certainly not try to incapacitate the supervisory council. If they did make such an attempt and succeeded, they would end up hurting themselves.⁶² They would not be able to keep an eye on management, whose interests may diverge significantly from their own.

On the one hand, I have granted that the supervisory council is not effective enough. On the other hand, I have maintained that it would be inaccurate to attribute the body's inefficacy entirely to the intrigues of managers and bankers. What other factors contribute to the deficiency? The rationale is rather complex, but certainly worth reflecting upon.

One might be tempted to argue that, inasmuch as they come from different cultures, capital and labor representatives inevitably have trouble working together. From this standpoint, even if all council members were keen on checking on management, they would still not be able to cooperate effectively. There is some merit to this argument, though its form is too extreme. In all corporate governance regimes, even those in which stockholders appoint the entire board, overseers have divergent backgrounds. Codetermination simply adds another layer of diversity.

More to the point, all delegates in the German supervisory council—including those representing labor—tend to develop a common perspective just by virtue of being on the board together. The challenge these individuals face—like board members anywhere in the world—is to preserve their different viewpoints and bring them to bear on their shared purpose.⁶³ The presence of labor representatives—or that of bank appointees, for that matter—does not ultimately change the nature of this venture.⁶⁴

In part, the supervisory council evinces the natural propensity to passivity of corporate overseers everywhere. Inasmuch as they do not run the business day in and day out, these individuals will typically be too ill-informed to contest managerial decision-

⁶² See Roe, *German Codetermination*, *supra* note 1, at 168 ("[D]iffuse stockholders will at key points in a firm's future need a plausible board (due to a succession crisis, a production downfall, or a technological challenge) . . .").

⁶³ See ULRICH EISENHARDT, *GESELLSCHAFTSRECHT* 307 (1994) [hereinafter EISENHARDT, *GESELLSCHAFTSRECHT*].

⁶⁴ See, e.g., HOFFMANN, *AUFSICHTSRAT*, *supra* note 55, at 5 (arguing that all council members should represent the interests of the enterprise as a whole rather than those of their own group).

making.⁶⁵ Further, unlike management, they are not with the corporation on a full-time basis. Hence, they will often not have sufficient time or enough at stake to perform their monitoring role thoroughly.

Though the problem of corporate overseer's lack of information, time, and motivation to perform their duties appropriately is universal, it takes a specific form in Germany. Accordingly, the solution will have to be sensitive to the German context. I will briefly discuss each of these three deficiencies separately.

I have already mentioned that the 1998 Corporate Control and Transparency Act improves the flow of information from management to the supervisory council. German lawmakers could go further in the same direction. They could require that management provide more detailed information to the supervisory council on a more timely basis.⁶⁶ They could also impose a duty on council members to obtain "independent professional advice."⁶⁷ The entire board would thus benefit from an additional, untainted point of view. More specifically, the employee delegation would be able to hire business consultants in order to keep up when the council is considering complex commercial issues.

Clearly, overseers require not only the relevant data. They must also have the means to process all the facts. The financial and the business auditors—as well as the expert advisors just proposed—could certainly help on this front. Yet, it is key to an adequate deliberation environment. For example, a reduction in the size of the council,⁶⁸ or explicit legal encouragement for the formation of committees, would make a significant difference in this regard.

However, downsizing the board is extremely difficult, inasmuch as it would require tampering with the codetermination law.

⁶⁵ See THEISEN, *UNTERNEHMENSFÜHRUNG*, *supra* note 42, at 251.

⁶⁶ See Hommelhoff, *supra* note 44, at 256 ("[T]he German supervisory council is not integrated rapidly or intensively enough to the management's flow of information or decision-making process."); Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 232 (calling for laws forcing managers to provide the supervisory council with more specific information).

⁶⁷ Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 799.

⁶⁸ See Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1599 (stating that corporate governance reform should focus on the supervisory council's size, "which is too large and hinders a reasonable performance"); Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 229 (urging a reduction in the number of supervisory council members).

The statute that, among other things, grants workers a presence within the corporate structure is the product of an intense political struggle among extremely powerful groups in German society, most conspicuously labor unions and employers' associations.⁶⁹ It embodies a painstakingly bargained-for balance of a multiplicity of competing interests. Consequently, its amendment is extraordinarily difficult. Its most recent minor modifications, for instance, were controversial within and outside of the government.⁷⁰

As already noted, since its enactment in 1952, the Codetermination Act has been significantly revised only once, in 1976. In fact, the conflict to which that single revision gave rise continued after the legislative vote and ended up in the Constitutional Court.⁷¹ The tribunal finally upheld the amendments in a controversial split decision.

Klaus J. Hopt reports that, during the debate that led to the enactment of the 1998 Corporate Control and Transparency Act, the acting Minister of Justice, businessmen, and legal experts unanimously supported reducing the size of the supervisory council.⁷² Nonetheless, unions and the Minister of Labor opposed this position. They eventually carried the day and blocked the reform.⁷³

Therefore, the prospects of reducing the total number of supervisory council seats are not promising. Yet, this kind of change is not indispensable. The aim is to allow an informal and open discussion of key issues affecting the corporation among a relatively small group of persons. It is possible to attain this kind of focused and honest deliberation through committees, which ultimately report to the board as a whole.

⁶⁹ See GUNTHER SCHWERDTFEGER, *MITBESTIMMUNG IM PRIVATEN UNTERNEHMEN* 117 (1973); Hartmut Oetker, in 12 *GROßKOMMENTAR ZUM AKTIENGESETZ*, at 16 (1999) (Vorbemerkung zum Mitbestimmungsgesetz).

⁷⁰ *Streit um Mitbestimmung spitzt sich zu*, SÜDDEUTSCHEZEITUNG ONLINE (sueddeutsche.de) (Feb. 10, 2001). The changes concerned only workers' councils, not the supervisory council. See *Hintergrund: Eckpunkte zur Reform der Betriebsverfassung*, SÜDDEUTSCHEZEITUNG ONLINE (sueddeutsche.de) (Feb. 10, 2001).

⁷¹ BverfGE 50, 290, 323; see also PETER HANAU AND PETER ULMER, *KURZKOMMENTAR ZUM MITBESTIMMUNGSGESETZ*, at 24 (Einleitung) (1981) [hereinafter HANAU-ULMER, *MITBESTIMMUNGSGESETZ*]; HANS-JUERGEN PAPIER, *DIE AKTIENGESELLSCHAFT*, at 242 (1978); REINHARD RICHARDI, *DIE AKTIENGESELLSCHAFT*, at 29 (1979); THOMAS RAISER, *KOMMENTAR ZUM MITBESTIMMUNGSGESETZ*, at 40 (Einleitung) (1987) [hereinafter RAISER, *MITBESTIMMUNGSGESETZ*].

⁷² Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 785.

⁷³ *Id.*

The German legislature could thus concentrate on promoting the formation of committees. The full supervisory council would have to approve them, and there should be no violation of the representative parity between capital and labor. The law could, specifically, establish that all large public corporations must have certain committees at all times—such as those in charge of auditing or executive compensation—and others only under certain circumstances—such as those reviewing litigation or mergers.⁷⁴

The 1998 Corporate Control and Transparency Act also contributes to expanding the amount of time that the board devotes to the corporation with the already noted increase in the number of meetings. Pursuant to my previous recommendation, council members would have to spend additional hours attending committee meetings. The law could even specify a minimum number of hours that it expects individuals to dedicate to their supervisory functions. The point would be not to police their use of time, but rather to communicate the message that they must take their job seriously. Of course, the corporation would have to increase their remuneration accordingly.⁷⁵

One way to provide the supervisory council with incentives—at least of a monetary kind—to monitor corporate decision making with care would be to offer stock options. German corporations have traditionally relied on this type of remuneration less than their U.S. counterparts.⁷⁶ Yet, they have been catching up lately. Significantly, the 1998 Corporate Control and Transparency Act eliminates prior legal restrictions on executive stock options and allows option plans as long as shareholders approve.⁷⁷

However, the statute covers only managers on this issue. It does not do away with the German prohibition on stock options for supervisory council members. The final elimination of this ban

⁷⁴ See Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 229 (“At any rate, stock exchanges should require each listed corporation to set up at least 3 committees . . . , including at least an audit committee.”); *see also id.* at 230; Hommelhoff, *supra* note 44, at 258 (“[A]n audit committee should be set up in all corporations listed in the German stock exchange.”).

⁷⁵ See Kübler, *supra* note 43, at N19 (calling for remuneration of supervisory council members sufficient to enable them to carry out their duties responsibly).

⁷⁶ HÜFFER, *AKTIENGESETZ*, *supra* note 60, § 87. Manager compensation is lower in Germany across the board and not just with respect to stock options. *See Gordon Pathways to Corporate Convergence?*, *supra* note 1, at 235 (“Top managers in Germany are paid considerably less than their U.S. counterparts.”).

⁷⁷ § 192(1)(3), AktG.

would constitute a step forward.⁷⁸ Favorable tax treatment, similar to that available in the United States, would further encourage the use of stock options.

German board members may lack not only the time, but also the motivation to supervise appropriately because of their frequent participation in the supervisory councils of various corporations at the same time. The law allows them to occupy up to ten seats simultaneously.⁷⁹ These multiple commitments may give rise to conflicts of interest.

Board members may sit on the supervisory council of another company along with an individual who happens to be a manager whom they should be supervising. Actually, that very individual may be on the board of overseers of still another corporation for which they primarily work as managers. This kind of incestuous networking makes reliable supervision highly improbable.

The German Corporation Act forbids only "direct crossover intertwining"⁸⁰ between companies and financial entities. In other words, "the legal representative of a credit institution" may not sit on the supervisory council of a corporation that has appointed one of its managers to that credit institution's supervisory council.⁸¹ Thus, the arrangement depicted in Figure 1 is illegal. However, if exactly the same overlap takes place between two companies that are not in the credit business, there is no illegality. Moreover, a bank may appoint its representatives to as many corporations as it

⁷⁸ Lutter calls for "the establishment of such options program also for supervisory council members." Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 231. In contrast, Theisen argues against stock options for council members with the following argument. "The supervisory council must carry out its functions independently of corporate performance and therefore must be compensated basically independently, though appropriately." Theisen, *Corporate Governance*, *infra* note 87, at 162. Yet, so long as a third party approves and monitors the option plan, there should be no impairment of the council's independence.

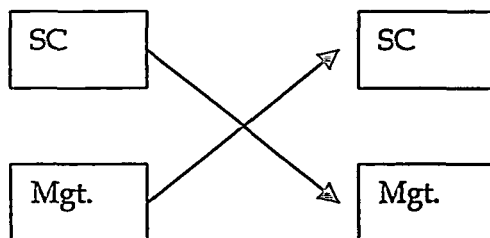
⁷⁹ §100 II, No. 1, AktG; see EISENHARDT, *GESELLSCHAFTSRECHT*, *supra* note 63, at 283; KLAUS J. HOPT, *FESTSCHRIFT FÜR ULRICH EVERLING*, 475, 480 (1995); FRIEDRICH KÜBLER, *GESELLSCHAFTSRECHT*, 183 (5th ed. 1998) [hereinafter KÜBLER, *GESELLSCHAFTSRECHT*]; Köhler, *supra* note 21, at N50; Raiser *supra* note 21, at 2259.

⁸⁰ See Peter O. Mülbert, *Aktiengesellschaft, Unternehmensgruppe und Kapitalmarkt*, at 16 (1995) [hereinafter Mülbert, *Aktiengesellschaft*]; see also, ERNST GEBLER, *AKTIENGESETZ KOMMENTAR*, at 26, § 100 (1974); HÜFFER, *AKTIENGESETZ*, *supra* note 60, at 3, §100.

⁸¹ AktG §100(II)(3); see also ANDREAS MEYER-LANDRUT, *GROßKOMMENTAR ZUM AKTIENGESETZ*, at 6, § 100 (1979); THOMAS RAISER, *RECHT DER KAPITALGESELLSCHAFTEN*, at 31, § 15 (1992).

wants, so long as none of those companies names any of its managers to the bank's supervisory council.

Figure 1. Bank Corp.



German law could adapt to deal with these concrete difficulties. It could, for instance, reduce the number of supervisory council seats that a particular individual may occupy at the same time—from the current ten to, perhaps, five.⁸² It could also forbid all kinds of direct, crossover intertwining.

The problem, however, is more institutional, than personal. In other words, the danger is not just that a particular individual might run into this kind of conflict of interest, but that an institution—such as a financial intermediary—might. For example, a bank could have one set of its employees sit on a particular company's supervisory council and completely different group serve on its own council. The bank might thus end up basically sitting on both ends of the transaction when it comes to negotiating the terms of a loan to that corporation.

It might be relatively easy to deal with such conspicuous cases,⁸³ but considerably more difficult to preclude subtler conflicts of interest. A categorical ban or limitation on the employees of fi-

⁸² See Lutter, *Macht der Banken*, *supra* note 21, at 2767 ("Thus the recommendation I have been making for a long time: No more than 5 council seats per person!"); Mühlert, *supra* note 21, at E119 ("The limit on seats established in 100 II (1) AktG should be lowered to five in order to guarantee a responsible exercise of the mandate."). But cf. Kübler, *supra* note 43, at N16 (rejecting a reduction in the maximum number of seats that a person may hold).

⁸³ These kinds of actions are arguably already illegal. See Mühlert, *supra* note 21, at E106 (suggesting that bank appointees may not allow the information they acquire as members of the supervisory council affect their bank decisions with respect to the corporation); Johannes Semler, *Referat*, in EMPFEHLEN SICH GESETZLICHE REGELUNGEN ZUR EINSCHRÄNKUNG DES EINFLUSSES DER KREDITINSTITUTE AUF AKTIENGESELLSCHAFTEN? N29, N31 (61. Deutschen Juristentag) (1996) (contending that German corporate law already bans "concrete conflicts of interests").

nancial institutions would be too extreme and unfair.⁸⁴ A better approach would be to rely on transparency. If supervisory council members had to disclose all their connections,⁸⁵ they might be less tempted to double-deal and, in any case, it would be easier to keep an eye on them.

Naturally, all of these legislative amendments would not in themselves solve the general problem of overseers' proclivity to passiveness, nor the specific loyalty issues that a codetermined and bank-dominated system ineluctably gives rise to. They would have to be part of a larger effort to continue specifying the standards not only through statutes,⁸⁶ but also through case law, as well as codes of practice.⁸⁷ Of course, the government and the courts would have to intensify their (already significant) efforts to enforce and apply the new criteria.⁸⁸ The challenge is to change the

⁸⁴ Kübler, *supra* note 43, at N12 ("[A]bsolute prohibitions on intermingling and participation are dubious because they hinder economically reasonable cooperation and integration even when there are no competition problems."); Mühlbert, *supra* note 21, at E119 ("Rules disqualifying bank representatives from becoming supervisory council members are not advisable.").

⁸⁵ Various commentators have suggested this approach. See, e.g., Mühlbert, *supra* note 21, at E119 (proposing amending German corporate law to compel council members to disclose directorial positions they hold in other companies); *id.*, at E118 (advocating amendments to require council members to disclose whether they occupy leading positions in banks that hold deposited shares of the corporation); Schneider & Burgard, *supra* note 21, at 1762 (recommending disclosure of banks' appointments to the council, of their direct shareholdings, and of their deposited shares).

⁸⁶ Raiser *supra* note 21, at 2261 (pleading for a statutory specification of the duties of care and loyalty).

⁸⁷ See Tobias O. Wiese, *Verantwortlichkeit des Aufsichtsrats—Aktuelle Entwicklungen im Bereich der Corporate Governance*, 53 DB1901, 1905 (2000) (calling for new laws, court decisions, and corporate governance codes to define directors' duties). Theisen documents the recent German revolution in corporate governance codes. He refers to the year 2000, in which four commissions set out to draft such codes, as the "Year of Corporate Governance." Manuel René Theisen, *Corporate Governance: Eine neue Leitkultur für die Unternehmensführung?*, RWZ 157, 159 (2001). He censures these efforts for their lack of cohesion with each other, as well as for their blind assimilation of U.S. norms, which are at times incompatible with the German legal and economic reality. *Id.* at 163-64.

⁸⁸ See Wiese, *supra* note 87, at 1902-03 (recommending court liability as a way to improve corporate monitoring). Of course, it is crucial that judges not go overboard in their scrutiny. They should generally defer to the expertise of council members and not try to engage in *ex post facto* second-guessing. Ideally, they should take a procedural approach when reviewing the actions of council members. That is to say, they should determine whether the board conducted a reasonable investigation—e.g., obtained relevant documents, consulted the appropriate specialist, asked the right questions—prior to adopting its decision.

motivational structure of board members,⁸⁹ as well as to create new corporate governance culture.⁹⁰

Some scholars have submitted that the U.S. corporations have more efficient internal supervision mechanisms than their German counterparts.⁹¹ The argument is that independent directors in the United States have the expertise and the right incentives to probe into management's decision making. The irony is that, in the previous dialectical cycle, the main argument was that inner monitoring in U.S. corporations was inadequate and that, in contrast, German corporate overseers, such as financial institutions and employees, had enough at stake and sufficient resources to watch carefully how managers were doing their job.⁹² The assumption then seemed to be that U.S. management completely dominated the board and that independent directors had a hopelessly limited impact.

Though now the debate has taken a 180-degree turn, the fact remains that U.S. independent directors generally do not have the right incentives or informational resources to make a difference in the administration of the corporation. They have too much of a

⁸⁹ See Lutter, *Vergleichende Corporate Governance*, *supra* note 14, at 229 ("All the necessary tools are already there; the challenge is to put them to use. In fact, what is at stake is the direction of human behavior as well as the motivation of individuals.")

⁹⁰ See Theisen, *Corporate Governance*, *supra* note 87, at 165 (stating that individuals involved, as well as those concerned, must come to accept the new standards as "a corporate governance and supervision culture" that is superior to the status quo).

⁹¹ See Gordon, *Deutsche Telekom*, *supra* note 1, at 201 ("One possible evolutionary path is for the supervisory board, under pressure from foreign capital investment, to move more in the direction of an American-style board, especially in the attitude of directors."); Roe, *German Codetermination*, *supra* note 1, at 168 (outlining four characteristics that make German boardrooms weaker than their U.S. counterparts).

⁹² See Roe, *Some Differences in Corporate Structures*, *supra* note 2, at 1931-32:

[T]he competitive advantage of the foreign structure may lie not just in reducing what we think of as agency costs, but in (1) changing the environment of decisionmaking—bringing more individuals and organizations to the table when technologies and markets are changing too rapidly for a single CEO or a single firm to stay current; (2) improving the information flow to large stockholders in ways that a fragmented securities market cannot achieve; or (3) improving organizational performance by facilitating relation-specific investments without using a stultifying, large vertical organization and by providing a matrix for decisionmaking across related organizations.

Id.

tendency to defer to management, both because they usually owe it their appointment and because they are not familiar with the day-to-day operation of the company. Management typically sets the agenda and runs U.S. board meetings. To be sure, lately U.S. courts have not only encouraged the designation of independent directors, but also have called on them to be more active. Yet, the adduced structural impediments make this kind of engagement difficult.

By contrast, all German council members are, in principle, independent directors inasmuch as, pursuant to the law, they may not sit on the managerial board.⁹³ Moreover, they—or rather their constituents—normally have a vested interest in the firm and therefore a good reason to take their job seriously. Nonetheless, they work in a body that remains, to some extent, institutionally weak. They also face the motivational impediments previously cited. The supervisory council will be able to realize its full monitoring potential only through a reconfiguration of its underlying conditions and an invigoration of its membership. I have already provided some ideas to this effect.

A worthwhile comparison of the two systems of corporate governance requires much more empirical work. Only this kind of evidence could confirm or falsify my belief that, overall, both approaches to corporate monitoring are at present more or less equally deficient. Furthermore, my assertion that a bolstered supervisory council could be an effective control device rests on an analysis of the body's constitution and inner dynamics, but will find ultimate proof only after the implementation and a careful examination of the contemplated changes.

It is helpful to keep sight of how corporate monitoring should ideally function. One has to choose a middle point between extremes. Just as it would be catastrophic if supervision never took place, it would be highly undesirable if control were ever-present, to the point of suffocating effective management.⁹⁴

A monitoring mechanism that focused on, and dealt adequately with, crises would be useful. It would be more valuable,

⁹³ See Theisen, *Corporate Governance*, *supra* note 87, at 157 ("The German (and Austrian) separation model, in contrast with the American or Swiss models, allows absolutely no direct overlap in personnel between the direction and the supervision bodies.").

⁹⁴ See Kübler, *supra* note 43, at N15 (stating that the supervisory council should respect "management's discretion in running the enterprise").

however, if it went beyond this. It might, for instance, reinforce long-term planning, while providing a balanced assessment of the multiplicity of interests at play in corporate activity.

3.2 Reinforcing External Monitoring

This third matter is crucial because the market theoretically plays a key role in monitoring corporations. On the one hand, sub par managers face the punishment of a lower share price. Insofar as their compensation and reputation hinges on that price, they will take a hit right away. On the other hand, and more significantly, they risk a hostile takeover and eventual replacement. The logic is that predators buy a sub-optimally run company at a discount and obtain a return on their investment insofar as they are able to improve management.⁹⁵

Inasmuch as takeovers are indeed more difficult and less frequent in Germany than in the United States, they play a less prominent role in disciplining corporations. "The development of a market for hostile corporate acquisitions," as Peter O. Mülbert concedes, "has been considerably hindered by the long-term ownership [and control] of shares by banks."⁹⁶ As already noted, financial intermediaries often join an unholy alliance with management, which makes unfriendly takeovers more difficult. Moreover, even if banks were open to hostile acquisitions, they would presumably demand a control premium, which would have a dissuasive impact on potential bidders.

It is key to bear in mind that hostile acquisitions became common place in the U.S. market only relatively recently. Moreover, hostile acquisitions are now a more frequent occurrence in Germany than they were a decade ago. Within the next few years, the German—or, more accurately, European—market may end up significantly closing the gap with its U.S. counterpart on this front.

The 1995 and 1997 "Takeover Codes" render the bidding process in Germany more open and fair.⁹⁷ They generally require,

⁹⁵ Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1601 (expressing that the threat of hostile takeovers compels managers to "focus on increasing shareholder value when running the corporation"); Kübler, *supra* note 43, at N13 (underscoring the contribution of proxy contests to the disciplining of managers).

⁹⁶ Mülbert, *supra* note 21, at E117; *see also* Semler, *supra* note 83, at N36 (noting that German capital markets' monitoring potential is not fully developed).

⁹⁷ *See* Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 788.

among other things, that the target's management remain neutral when confronted with competing bids.⁹⁸ They also impose on the successful bidder the obligation to make a full-price offer to all shareholders.⁹⁹ Nonetheless, corporations are not fully complying with these voluntary codes.¹⁰⁰ "Therefore, now a takeover law is generally considered unavoidable."¹⁰¹ Such an enactment will further facilitate market monitoring through hostile acquisitions.

In order to continue in this direction, German corporate law could, through the previously proposed measures, make it more difficult to leave the supervisory council out of the loop. On the one hand, an effective council—or, even better, a specialized committee—could prevent managers from selfishly resisting a reasonable acquisition effort. On the other hand, the body could support them if it deemed that the transaction would furnish a short-term gain for the raider, but no long run benefits for the enterprise. In this way, the German system might keep shortsighted, bust-up operations, which abound in the United States, in check. The judiciary could back up the council in its monitoring of managerial responses to hostile takeover attempts.

Realistically, however, even a revitalized supervisory council will not be terribly enthusiastic about these unfriendly acquisitions. Members appointed by financial intermediaries will view these transactions as involving an unsavory, albeit efficient, kind of risk, as discussed in the next section. The representatives of employees will fear layoffs and a deterioration of working conditions.

Nevertheless, the process of globalization will generally have the effect of introducing more bidders and methods of improving production. In other words, the margin between current and potential performance will increase, as will the number of entities ready to capitalize on this differential. At the same time and as pointed out in the next section, international competition will force financiers, as well as workers, to be more open about efficient risk.

Furthermore, the gradual development of a shareholder culture adduced *infra* will, as a consequence, enhance the prospects of foreign or domestic companies seeking to acquire a German corpora-

⁹⁸ See *id.* at 790.

⁹⁹ See *id.*

¹⁰⁰ Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1599 (providing that the 1995 Code "was signed by only 250 of the 677 listed corporations").

¹⁰¹ Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 788.

tion. Even if they are not able to acquire a controlling block, suitors will have a much stronger hand if they are able to buy a significant number of shares. Under these circumstances, they will probably end up paying a lower premium to execute the takeover.

In the United States, corporations also tend to resist outside bids with vehemence. Controlling insiders are equally unwilling to yield their power. The law has only gradually come to limit managers' prerogatives in this area.¹⁰² Yet, it has done so almost exclusively from the standpoint of shareholder value.¹⁰³ In contrast, German law might be able to incorporate the perspective of other constituencies—such as workers and creditors—as it compels management to be more open about external offers.

3.3. Encouraging Efficient Risk Taking

I would now like to move on to the third feature of German corporate governance that has run into criticism in the United States. Financial intermediaries exercise whatever pressure they can through the council and, especially, through other informal channels, to minimize even efficient risk. They probably can count on the support of employee representatives, whose constituents have a lot at stake in the corporation, on this matter.

It is helpful to approach this issue through a simple example, very loosely based on the famous footnote of *Crédit Lyonnais Bank of Nederland, N.V. v. Pathe Communications Corp.*, decided by the Delaware Court of Chancery.¹⁰⁴ Suppose a corporation with \$50

¹⁰² This process culminates in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (1985). The Delaware Supreme Court held not only that the board's actions vis-à-vis a takeover attempt are subject to careful judicial scrutiny, but also that defensive mechanisms are illegal when "dissolution of the company becomes inevitable." *Id.* at 184. "Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity." *Id.*

¹⁰³ See, e.g., *id.* at 182 ("A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders."); *id.* ("[C]oncern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.").

¹⁰⁴ *Crédit Lyonnais Bank of Nederland, N.V. v. Pathe Communications Corp.*, 17 DEL. J. CORP. L. 1099, 1155 n.55 (Del. Ch. 1991); John C. Coffee, Jr., *Court Has a New Idea on Directors' Duty*, NAT'L L.J., Mar. 2, 1992, at 18; C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (1993).

million in assets and \$20 million in debt has to choose between two plans. The first option (A) involves purchasing \$50 million worth of innovative technology, which has the potential of increasing assets fourfold (from \$50 to \$200 million), but which is equally likely to bring total assets down to zero.

The second alternative (B) is to invest the \$50 million in conventional machinery. Under this scenario the value could increase or decrease by \$10 million. From the enterprise's standpoint Plan A makes more sense, as illustrated by the expected values in Figure 2. Plan A has an expected value of a \$100 million, twice as much as that of Plan B. In fact, Plan B represents no improvement over the status quo.

Figure 2. Expected Values for the Corporation

	Plan A	Plan B
Prob.(Value)	50% (200)	50% (60)
Prob.(Value)	50% (0)	50% (40)
Expected Value	100	50

This analysis focuses exclusively on the company's perspective. Debtholders will view the matter differently. For instance, a bank that has made a \$20 million loan to the corporation will regard Plan B as having a higher expected value: \$20 million versus \$10 million. It will not find Plan A's potential of quadrupling assets particularly exciting, since it would only have a \$20 million claim on the full amount. It will be more concerned about the 50% chance of the company going broke and not being able to return a single penny of the \$20 million owed. Therefore, it will prefer the alternative plan, which guarantees, under both possible outcomes, that the corporation will pay back the credit. Of course, it will be just as happy to maintain the status quo, in which its \$20 million remain safe. Figure 3 depicts the creditor's perspective.

Figure 3. Expected Values for Holder of Debt

	Plan A	Plan B
Prob.(Value)	50% (20)	50% (20)
Prob.(Value)	50% (0)	50% (20)
Expected Value	10	20

German banks may, by the same token, favor a cautious and sub-optimal strategy under similar circumstances. Insofar as they

are also partly shareholders, however, they would tend to look upon an efficiently risky plan more favorably than their counterpart in the previous example. In fact, from the stockholders' standpoint, this kind of business opportunity appears even more attractive than it does from the corporation's perspective.

Figure 4 depicts the perspective of shareholders. They have to discount the corporate value by the amount of debt. Of course, the total amount of assets sets a limit on this deduction. At any rate, shareholders will view Plan A not as twice as good, but actually as three times more appealing than Plan B.

Figure 4. *Expected Values for Stockholders*

	Plan A	Plan B
Prob.(Value)	50% (180)	50% (40)
Prob.(Value)	50% (0)	50% (20)
Expected Value	90	30

Nonetheless, German financial intermediaries would ultimately discard this kind of investment opportunity if their creditor interest clearly predominated and the total expected value for them were lower than that associated with the conservative path. Most certainly, they would not hesitate to use all the shares they vote—and not simply those they own—in order to force their preferences on the company.¹⁰⁵

To be sure, this divergence between the interests of creditors and those of the corporation emerges principally when insolvency is looming on the horizon. In other words, debtholders will oppose a strategy that makes sense from the corporate standpoint only if there is a risk of bankruptcy. They then will favor any other strategy that guarantees that the company will remain solvent. Conversely, they will be basically indifferent in cases in which corporate creditworthiness is not at stake. Therefore, they will not contravene even extremely risky but profitable ventures, so long as the debt they hold is not in jeopardy.¹⁰⁶

¹⁰⁵ See RAISER, *KAPITALGESELLSCHAFTEN*, *supra* note 81, at 80, § 16; KÜBLER, *GESELLSCHAFTSRECHT*, *supra* note 79, at 165; Carsten Peter Claussen, *Doppelloyalität, DIE AKTG 59* (1981).

¹⁰⁶ See Köhler, *supra* note 21, at N49 ("Destructive behavior by banks vis-à-vis other enterprises is improbable if only because the interests of banks and those of the corporation and its shareholders generally go hand in hand."); Kübler, *supra* note 43, at N20 ("[A]s a rule, all shareholders—banks as well as share deposi-

This analysis is somewhat misleading. It focuses exclusively on discrete, one-shot business decisions. A more dynamic, long-term approach would suggest that creditors might object to efficient risk even if there were no immediate threat of insolvency. They might look unfavorably upon any investment with the potential to considerably reduce corporate value. They might view any such plan as the possible beginning of a pattern that could ultimately drive the company to bankruptcy. In any case, they would probably disfavor any measure that might bring the corporation too close to insolvency for their comfort.

German financial intermediaries, who hold significant amounts of long-term debt, may often be in this situation. They may look down upon an investment that could bring the company to a point at which its next decision will expose it to bankruptcy. They may be very aware that they might not be able to dissuade management from taking the efficient insolvency risk in the ensuing round.

Insofar as these institutions exercise their influence through the supervisory council, they will be able to recruit labor representatives. The constituency of employees is presumably as bankruptcy-averse as that of creditors. After all, the company inevitably lays off all of its workers when it goes under. However, employees have a somewhat larger interest in corporate value upswings than creditors do, insofar as their wages often climb as a consequence. Their delegates will therefore be generally risk-averse, but presumably less so than the financiers' representatives.

The presence of labor on the board has two additional effects. On the one hand, financial intermediaries are in a position to more decisively stave off a strategy that might break the enterprise. On the other hand, they have less fear of investments that might bring the company to a point at which its next decision could bring about insolvency; for they will be better able to avert such a risky choice in the subsequent stage.

To the extent that German credit institutions exercise pressure mostly outside the supervisory council, labor will not have as much of an impact on their attitude towards bankruptcy risk. Therefore, they will probably use all of their indirect influence against business plans that might in any way take the corporation

tors—are equally interested in the success of the corporation.”); Raiser, *supra* note 21, at 2258 (“[C]redit institutions have an interest of their own in [the corporation’s] health and success.”).

in the direction of insolvency. In all likelihood, they will end up opposing some investments that are sensible from the perspective of the enterprise.

Nevertheless, restrictions on bank direct holdings or on a bank's ability to set up mutual and other funds are unwarranted.¹⁰⁷ They would involve burdensome government regulation and would ultimately disadvantage German financial institutions with respect to foreign competitors. As I have already pointed out, scholars both in the United States and in Germany are virtually unanimous on this issue. The U.S. experimentation with limitations of this kind was not particularly beneficial and is gradually coming to an end.

In contrast, it would make sense to limit the extent to which financial intermediaries exert control beyond their ownership rights through deposited stock and the shares they hold as fund managers. The law could require them to give at least the depositor more say in how to vote. It could forbid them to act without the explicit consent of the shareholder.

At present, these institutions must obtain a proxy,¹⁰⁸ which is valid for a maximum of fifteen months. They must additionally tell the real owner how they intend to cast the ballot,¹⁰⁹ in case they receive no specific instructions.¹¹⁰ However, if the individual concerned does not direct them to vote one way or another, they may go ahead and cast the ballot as they declared they would.¹¹¹

The legislature could simply do away with this vote by default.¹¹² It could establish that if the depositor does not express a

¹⁰⁷ See Mülbert, *supra* note 21, at E117-E119 (rejecting drastic changes in German bank's influence mechanisms in corporations); Raiser *supra* note 21, at 2261 (repudiating a legal separation of the credit and the investment businesses of banks.). But cf. Lutter, *Macht der Banken*, *supra* note 21, at 2767 (recommending limiting bank direct shareholding to 10%); Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1599 ("In the United States, banks may not participate in the capital investment business. This regulation should also be introduced in Germany, if only to strengthen German capital markets.").

¹⁰⁸ §135 I 1, AktG

¹⁰⁹ §128 II 1, 2, AktG; see Winfried Werner, in 4 GROSSE KOMMENTAR ZUM AKTIENGESETZ, at 29, § 128 (1993) [hereinafter Werner, AKTIENGESETZ].

¹¹⁰ §128 II 3, 4, AktG; see Werner, AKTIENGESETZ, *supra* note 109, at 41, § 128.

¹¹¹ §135 V, AktG. See generally, Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 804 (explaining how banks vote deposited shares under the law).

¹¹² See Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1602 (proposing a ban on voting deposited shares in the absence of instructions); Hopt,

preference, there may be no further action. Such a measure would significantly limit the discretion of those who are simply custodians of the shares. The law could also require banks to justify their vote.¹¹³

Another interesting proposal,¹¹⁴ which the German Social Democratic Party submitted while in the opposition, would require banks to appoint an independent third party to decide how to vote deposited shares.¹¹⁵ Such a requirement would discourage casting the votes in question against efficient risk and would increase the monitoring of the corporation.¹¹⁶ However, now that the Party is in power, it seems to have moved this recommendation to the back burner.

All the same, such restrictions on the ability of financial intermediaries to vote stock under their command would not significantly diminish the weight they carry in the corporation. Presumably, they would be able to obtain a proxy from many a depositor if they needed to do so. In addition, much of their voting power is due to direct ownership and would therefore not be affected by either of the discussed measures. Finally, their predominance stems not only from the ballot box, but also from their extensive debt holding.

Gemeinsame Grundsätze, *supra* note 4, at 787 (stating that a "simple ban" is one of the controversial reform proposals).

¹¹³ Several authors have expressed support for this option. See Lutter, *Macht der Banken*, *supra* note 21, at 2767; Mühlert, *supra* note 21, at E100, E118; Schneider & Burgard, *supra* note 21, at 1765.

¹¹⁴ See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 805 (discussing various failed reform proposals made in the context of the 1998 Corporate Control and Transparency Act).

¹¹⁵ SPD-Draft on § 135 Akt-E, BT-Drucks 13/367 (January 30, 1995), printed in ZIP 332, 334 (1995); see also Lutter, *Macht der Banken*, *supra* note 21, at 2767 (suggesting that shareholder associations cast the vote for deposited shares). But cf. Raiser *supra* note 21, at 2261 (criticizing voting representative as too expensive); Semler, *supra* note 83, at N38 (rejecting proposals to have a third party cast the vote for deposited shares as unfeasible).

¹¹⁶ Nonetheless, Michael Adams criticizes this proposal "to abolish the right to vote deposited shares in the absence of instructions and to introduce an voting agent." Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1594. He underscores "the danger that this representative, for whose integrity there are fewer guarantees than for that of credit institutions, might become the all-powerful dominator in stockholder meetings." *Id.* Yet, the underlying problem is not that banks are dishonest, but rather that they have a conflict of interest. This difficulty would not apply to an independent agent.

A resolute supervisory council, as previously contemplated, might pressure the corporation away from inefficient conservatism. The employee representatives would only need a minimum of shareholder support to stand up against management and financial intermediaries. The difficulty, however, is that the labor delegation will often also favor a conservative strategy, particularly one that preserves jobs or does not require considerable retraining of workers. Only in exceptional circumstances is an efficiently risky approach in the employee's best interests.

In an ideal world, employee representatives would generally look out for workers while keeping in mind the enterprise's needs. If they deviated too much from this norm, the judiciary would call them to order. As a rule, they would push for an optimal plan that harmed the employees the least. They would not be extremely risk averse. Financial shareholders' delegates would, in turn, also try to balance in this way the interests of the corporations and those of creditors.

There is good reason to be somewhat skeptical with respect to this idealism. A revitalized supervisory council would probably continue to protect banks excessively—perhaps workers too. The corporation would nonetheless be able to survive, so long as its competitors operated within a similar organizational framework.

Nonetheless, as soon as the German enterprise has to match up against companies that do not face the same constraints, its situation changes dramatically. International competition ineluctably transforms the choices that financial intermediaries, as well as workers, face. If these groups are rational, they are going to alter the way in which they throw their weight around. An inefficiently conservative strategy, which once might have seemed attractive to them, would probably appear considerably less so now. In the past, they might have been able to ward off efficient risk in an environment in which their counterparts acted accordingly. At present, they face severe penalties for this kind of behavior. The corporation's very existence is at stake in a way in which it had not been in the past. At this juncture, the more uncertain but optimal plan looks more and more appealing. The perspectives of creditors and shareholders move closer to convergence.

It is possible to illustrate this phenomenon through my previous, simplistic example. International competition shifts the expected outcomes under the conservative strategy. Before, the company was able to maintain its profit level without much altera-

tion of its standard operating procedure. Today, if the corporation simply stays on automatic pilot, it will flounder in the face of foreign competitors, which have already introduced the contemplated innovations. The company might, under these circumstances, be able to eke out marginal gains, but only in the best of cases.

Thus, the expected profits are \$10 million in the better scenario and \$0 in the worse one. The expected value of Plan B ends up being lower than that of Plan A. Even a creditor would favor taking that risk. Coincidentally, a similar shift in preferences may take place on the part of workers too. Notice that if the company makes absolutely no changes in this new scenario, it will probably not be able to keep its assets at their current level of \$50 million. It may very well come up completely empty-handed at the end of the term.

Figure 5. Shifted Expected Values for Debtholders.

	Plan A	Plan B
Prob.(Value)	50% (20)	50% (10)
Prob.(Value)	50% (0)	50% (0)
Expected Value	10	5

In any case, the corporate influence of German and continental European banks has already started to wane.¹¹⁷ Furthermore, as a shareholder culture develops along the lines traced below, it will become increasingly difficult for financial intermediaries to control the corporate agenda. There will be more and more unaffiliated shareholders, who will object to sub-optimally conservative strategies. These individuals will exert additional pressure on the company to undertake economically sound risks.

3.4. Improving Capitalization

This fourth criticism is somewhat more complicated than its antecedents. The starting premise is that controlling stockholders, particularly financial intermediaries, exploit minority shareholders. I will first examine this assumption.

¹¹⁷ Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 15 ("Considerable evidence exists that the traditional system of concentrated ownership is at least marginally weakening across Europe. Data compiled by the Conference Board shows a measurable decline in the stakes held in the twenty-five largest corporations by banks and nonfinancial corporations in Germany, France, and Japan.").

Insofar as a shareholder or group thereof holds a controlling block of shares, the minority will tend to be at a disadvantage. To be sure, minority stockholders will have a right to their proportional share of dividends and value growth. Yet, when broader decisions are at stake, the corporation will tend to favor the interests of the majority over those of the minority. In this sense, minority stockholders will generally be worse off in the concentrated ownership arrangement existing in Germany than they are in the diffuse system that prevails in the United States.

All the same, it is simply not true that minority shareholders have fewer substantive rights in Germany than they do in the United States.¹¹⁸ Both jurisdictions afford these stockholders the same basic protections. With respect to more specific prerogatives, sometimes the U.S. legal system is indeed more generous, but at other times it is less so.

The duty of care and loyalty applies to managers and board members in both countries.¹¹⁹ In Germany, it covers controlling shareholders too, including financial intermediaries. Thus, with respect to this most fundamental principle, German minority investors have a slight edge over their U.S. counterparts.

On more specific issues, it is difficult to conclude that either of these legal systems offers better guarantees. First, unlike a small number of their U.S. counterparts, German stockholders may not

¹¹⁸ Cf. Coffee, *Do Norms Matter?*, *supra* note 1, at 2161 (stating that “researchers have regularly criticized German civil law for its lack of minority protections”).

¹¹⁹ See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 785.

Directors’ duties of conduct are similar, to a great extent. In particular, German law—like its American and English counterparts—has interpreted the duty of care through an evolving business judgment rule. With respect to the duty of loyalty, which is usually less developed in Germany, courts and scholars are aware of the problem and are attempting to raise the requirements to meet international standards.

Id. Compare §§ 93, 116, AktG (providing that supervisory council members and managers have a duty to conduct themselves as prudent and conscientious businessmen), with *Cede & Co. v. Technicolor*, 634 A.2d 345, 367 (1993) (“Duty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.”). But cf. Coffee, *Do Norms Matter?*, at 2170 (suggesting that fiduciary duties are stronger in the United States than on the European Continent); Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 221–22 (“Germany is classified as a country without a robust tradition of fiduciary duty protection of the interests of minority stockholders.”).

vote cumulatively.¹²⁰ Second, both German and U.S. law ban insider trading,¹²¹ which represents one way of exploiting minorities. Third, both systems allow all shareholders, including those who are in the minority, to enter voting trusts or agreements.¹²² Fourth, minorities have a right to participate in the profits of a sale of control in Germany, but usually not in the United States. Fifth, the right to inspect corporate documents and to make proposals is somewhat stronger in the United States than in Germany.¹²³ Sixth, German shareholders, in contrast to their U.S. counterparts, may call an extraordinary stockholder meeting without the board's acquiescence, so long as they hold at least five percent of the shares.¹²⁴

Sixth, the 1998 Corporate Control and Transparency Act outlawed "capped voting, which limits the number of votes that may be cast by a single shareholder regardless of the number of shares held."¹²⁵ U.S. scholars had criticized this device because it served "to assure voting control in the large banks. Because the cap does not apply to shares held by the bank as custodian, and because the bulk of the bank's voting power comes from custodial shares, the

¹²⁰ In the United States, cumulative voting is mostly optional. "By 1992, only six states maintained mandatory cumulative voting; forty-four jurisdictions (including the District of Columbia) chose the permissive form; one state (Massachusetts) did not permit cumulative voting. No important corporate law jurisdiction maintained mandatory cumulative voting." Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 145-146 (1994); see Oliver C. Brändel, in 2 GROßKOMMENTAR ZUM AKTIENGESETZ, at 1, § 12 (1992).

¹²¹ Compare *In the Matter of Cady, Roberts and Co.*, 40 S.E.C. 907 (1961) (making SEC Rule 10b-5 applicable to insider trading); 1934 Securities Exchange Act § 16(b), 15 U.S.C. § 78p (banning short-swing profits), with Zweites Finanzmarktförderungsgesetz [Second Financial Market Promotion Act], 1994 Bundesgesetzblatt, Teil I [BGBl. I] 1749; Gesetz über den Wertpapierhandel [Securities Trading Act], (July 26, 1994) (banning insider trading in German markets).

¹²² Compare, e.g., DEL. CODE ANN. tit. 8, § 218 (1994), with ALFONS KRAFT, GESELLSCHAFTSRECHT 344 (2000) ("Agreements in which a shareholder commits himself to vote in a particular way (voting agreements) are legally valid.').

¹²³ In Germany, the right to obtain information is limited to shareholder meetings, while in the United States there usually is no such restriction. Compare § 121, AktG, with DEL. CODE ANN. tit. 8, § 220 (1994) (providing right of inspection upon proper demand and purpose). Moreover, whereas SEC Rule 14a-8 requires shareholders to have 1% of the shares or a total of \$1000 invested to submit proposals, § 122(2), AktG demands 5% ownership in order to submit matters for a vote at the annual meeting.

¹²⁴ § 122(1), AktG.

¹²⁵ Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 343.

bank's voting control is locked in."¹²⁶ At present, however, there is no longer a difference between U.S. and German law on this matter.

Even though the comparative picture is blurry with respect to substantive entitlements, it is less so when it comes to procedural rights. German minority shareholders are at a clear disadvantage vis-à-vis their U.S. counterparts when it comes to enforcing their rights.¹²⁷ First of all, there are no derivative suits in Germany.¹²⁸ Stockholders may demand a corporate suit for violation of fiduciary duties only if they own a 10% of the shares.¹²⁹ To be sure, the bulk of the minority claims will be of a direct nature, inasmuch as the plaintiffs usually contend that the majority is infringing upon their individual prerogatives, not upon those of the corporation. Nonetheless, when the majority is also harming the corporation as a whole, the minority stockholders would benefit from the derivative action.

For instance, a financial institution with a majority interest in a corporation may fail to assert with vigor a corporate claim against another company of which it is a 100% owner. Essentially, it would be transferring value from the minority shareholders to itself. Yet, in Germany these investors would be unable to file a claim on behalf of the corporation. If anything, they would have to

¹²⁶ *Id.* at 343 n.51; see also Charny, *supra* note 1, at 161 ("Capped voting . . . can impede acquisitions by outsiders or increase the rents that insiders garner for a change in control."); Gilson, *Political Ecology*, *supra* note 19, at 183 ("[A] capped voting scheme functions to assure that no owner/decisionmaker can exist. Control cannot be centralized in anyone. The result, and presumably the goal, is to assure that control rests with management while shareholders bear the impact of economic change.").

¹²⁷ See Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1596 ("In Germany, as opposed to the United States, the litigation option is closed off by the imposition of unrealizable prerequisites; thus minority shareholders have in fact no legal protection against deposit banks and the enterprise's management.").

¹²⁸ See Raiser *supra* note 21, at 2260 ("There is no derivative suit under German law."); Gordon, *Deutsche Telekom*, *supra* note 1, at 201 (stating that German corporate law does not permit a shareholder derivative suit).

¹²⁹ § 147, AktG; see Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1596 ("The provisions of § 147, which establish the prerequisites for the enforcement of these claims, have de facto precluded the liability of members of the enterprise's administration."); Gordon, *Deutsche Telekom*, *supra* note 1, at 201 ("Ten percent is a very high threshold, especially in a large public firm, that could be lowered."); Raiser, *supra* note 21, at 2261 ("This high threshold operates in practice prohibitively."). The Social Democratic Party, in fact, proposed reducing the threshold to 5%. ZIP 1995, 331 (339).

sue directly. In such a case, the defendants would probably move for dismissal on the grounds that there had been no discrimination against the plaintiffs, i.e., that the latter had received treatment equal to that afforded all other stockholders.¹³⁰ It would take quite a creative judge to reject such a motion.

The nonexistence of class actions also handicaps minority shareholders.¹³¹ Each one of these investors may have a legitimate discrimination claim, but its value may be too low to make individual litigation worthwhile. Therefore, a lawsuit makes economic sense only if the plaintiffs sue collectively and share trial expenses. The class action helps them solve the coordination problem. It empowers them not only to litigate as a group, but also to negotiate with the defendant, inasmuch as it enables them to speak for, and to bind, all minority stockholders. Because this option does not exist in Germany, minority stockholders tend not to institute any actions under these circumstances.

It is additionally significant that German law does not authorize contingency fees. Attorneys may not take an economic interest in the cases they litigate. Specifically, they may not enter a contract with their client providing that there will be no charge unless they prevail in court, in which case they will receive a percentage of the damages awarded. Therefore, minority shareholders are unable to hire a lawyer who will assume part of the litigation risk. They must pay their advocate up front. Undoubtedly, given these conditions, they will often refuse to bring even legitimate lawsuits.

To make matters worse, if they lose their case, minority stockholders have to pay the attorneys' fees of their adversaries.¹³² Germany follows what is known in the United States as "the English rule," which establishes that the defeated party in a civil action must assume the litigation expenses of the prevailing party.¹³³ This norm will tend to discourage minority investors unless they have an airtight case or a deep pocket to finance potentially unsuccessful

¹³⁰ See § 53a, AktG (requiring equal treatment of all shareholders).

¹³¹ See Adams, *Bankenmacht und Deutscher Juristentag*, *supra* note 2, at 1596 ("The absence of a class action system to enforce shareholder rights is painfully noticeable.").

¹³² § 91 I 1 ZPO; see also KURT HERGET, *ZIVILPROZESSORDNUNG*, at 2, § 91 (1994).

¹³³ See John H. Langbein, *The German Advantage in Civil Procedure*, 52 U. CHI. L. REV. 823 (1985); JOHN HENRY MERRYMAN, *THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA* 119 (2nd ed. 1985) ("In civil law countries . . . the loser usually pays the winner's counsel fees.").

litigation. To be sure, minority investors with a solid case will, *ce-teris paribus*, be more likely to sue under the German system than under that of the United States. Yet, to the extent that minority shareholders are usually underdogs against a better financed and more experienced corporation, the German scheme is a disincentive to them.

I will address each of these four procedural issues in turn. First, Germany should consider introducing derivative litigation,¹³⁴ not only to protect minority investors, but also to improve corporate monitoring generally. German hesitation on this topic is due to the fear that U.S.-style strike suits might become prevalent.¹³⁵ Inasmuch as the German system imposes attorneys' fees on the losing party and bans contingency fees, frivolous shareholder actions on behalf of the corporation will be less likely than in the United States. The experience with derivative suits in Germany would probably be more like that of France than that of the United States.

Even if German procedure were to abandon the loser-pays-all approach to attorneys' fees, as well as the prohibition against contingency advocacy, there is good reason to suppose that the experience with derivative litigation in Germany would not mirror that of the United States. German judges have wide powers to guide and supervise the ongoing process.¹³⁶ Accordingly, inasmuch as

¹³⁴ See Kübler, *supra* note 43, at N23 (calling for the introduction of derivative suits in Germany); Raiser *supra* note 21, at 2261 (recommending following the U.S. example in Germany and allowing derivative suits).

¹³⁵ *Id.* at N23 (noting that derivative suits are expensive and may serve as a blackmail mechanism).

¹³⁶ See §§ 136, 139 ZPO. Rosenberg, Schwab, and Gottwald specify that judges have not only the authority, but also the duty to direct the process.

The court has a duty to carry forward the procedure lawfully and purposively, to process the legal dispute exhaustively and expeditiously, and to bring the dispute to an end in the most efficient way. This engagement by the court is called process direction. This is one of the court's most important tasks, inasmuch as the final judgment on the goods and the adequacy of the procedure depend on it The process's direction is the court's responsibility by virtue of its office and does not require the parties' motion or a request. Nor can the parties relieve the court of this duty. The court must dutifully deliberate upon those decisions placed within its discretion.

VON LEO ROSENBERG ET AL., *ZIVILPROZESSRECHT* 435, § 79 (15th ed. 1993); see Langbein, *supra* note 133, at 823.

they tend to be more "managerial" than their U.S. colleagues,¹³⁷ they will be in a better position to watch and punish the abuses of the derivative lawsuit.

The three other procedural items require more cautious treatment. They each touch upon a broader procedural principle, which has an effect far beyond corporate law. The treatment of these questions should, hence, be more circumspect than that of the unavailability of derivative suits, which impinges exclusively upon the law of business organizations. It may be that there are reasons of weight for the German approach from the perspective of civil procedure and of the numerous other legal areas affected. If that were the case, it would not make sense to alter the Civil Process Code simply with an eye on obtaining some benefits in the regulation of corporations.

Nonetheless, there are solid procedural grounds for making a change, at least with respect to the second and fourth issues. Regarding the second matter, it is crucial to note that class actions generally enable plaintiffs to assert public values. Accordingly, German minority shareholders suing as a class would be fighting for more than their individual prerogatives. They would be pleading their rights collectively. The class action would also assist them in pooling their efforts.

The countervailing concern in the United States is usually that collective suits facilitate frivolous litigation and undermine the rights of individuals who are not in court. Yet, inasmuch as they have special powers with respect to class actions, U.S. courts are able to forestall these potential difficulties. According to U.S. law, they must: (1) certify that the class meets all the requirements; (2) watch over the litigation process; and (3) give their consent before the plaintiff may withdraw or settle the case.¹³⁸ They are thus in a

¹³⁷ Judith Resnik has noted a recent shift in U.S. federal adjudication on this respect.

Many federal judges have departed from their earlier attitudes; they have dropped the relatively disinterested pose to adopt a more active, 'managerial' stance. In growing numbers, judges are not only adjudicating the merits of issues presented to them by litigants, but also are meeting with parties in chambers to encourage settlement of disputes and to supervise case preparation. Both before and after the trial, judges are playing a critical role in shaping litigation and influencing results.

Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 376-77 (1982) (citations omitted).

¹³⁸ See generally FED. R. CIV. P. 23.

privileged position to catch and throw out baseless lawsuits, as well as to ensure that there is no violation of the absent class members' rights. Germany could adopt similar safeguards. Furthermore, inasmuch as they regularly have the managerial powers already mentioned, German judges would be better able than their U.S. counterparts to prevent abuses of the class action suit.

Similarly, Germany could move away from the principle that the losing party must bear all lawyers' expenses.¹³⁹ This notion seems to rest on the premise that whoever suffers a defeat in court is somehow at fault. Such an assumption is problematic. A person might lose a case due to: (1) an error of the decision maker; (2) the ultimate rejection of a colorable legal claim; or (3) ineffective assistance of counsel. Under any of these scenarios, it is unfair to impose an additional penalty beyond an adverse determination on the merits. Moreover, insofar as litigants bring legitimate issues for adjudication, they are doing a service to the legal system and society as a whole. For this reason, they deserve encouragement, not punishment.

Of course, the underlying preoccupation is frivolous suits. Yet, the German response, in this respect, is clearly overdrawn. The penalty applies to the kind of cases just alluded to, even though they obviously fall outside the area of concern. A narrowly tailored measure that imposed attorneys' fees only on hopelessly baseless claims would be sufficient to attain the stated goal. Once again, actively engaged German judges would be in an ideal position to keep gratuitous litigants in line.

If achieving these across-the-board modifications to German civil procedure were not feasible, an alternative would be to limit changes to the area of corporate law or, even further, to claims of minority shareholders. On the one hand, the procedural code could allow class actions only when filed by such individuals. On the other hand, it could ban shifting attorneys' fees in the cases mentioned earlier. These measures would significantly improve the prospects of minority investors trying to vindicate their rights.

However, Germany should pause before adopting contingency fees, which at times are immensely arbitrary. For instance, it seems unfair to allow an attorney who has not spent much time on a case to pocket millions of dollars in compensation. Of course, the cli-

¹³⁹ See Gordon, *Deutsche Telekom*, *supra* note 1, at 201 ("[T]he 'loser pays' rule could be eliminated altogether.").

ents must agree to the arrangement in advance. Yet, they usually sign these contracts with minimal information and with few other options. In addition, contingency fees lead lawyers to regard a case too narrowly in terms of its money value and focus too much on the damage award. This attitude inevitably corrupts some attorney-client relationships and deteriorates the services rendered. The courts may certainly intervene, but normally do so only when the misbehavior is most blatant.

A lawyer and client could, instead, enter an agreement establishing that the latter will pay fees that are on the high end, but nonetheless reasonable, only if there is a money judgment. Naturally, fewer lawyers would be interested in this kind of arrangement than would accept contingency fees. Potential plaintiffs, in the aggregate, would therefore suffer a loss if this were the only option available.

To make up for this disadvantage, German law could require corporations to pay the attorneys' fees of shareholders that raise legitimate claims in court. The judge could make a determination at the end of the case on the appropriateness of fee shifting. There probably should be a presumption in favor of plaintiffs on this issue. Naturally, this idea is applicable not only in Germany, but also in the United States.

These procedural changes would improve minority shareholders' lot in Germany. They would build on the improvements in "procedural law (minority rights)" and "sanctions" that have already taken place.¹⁴⁰ As a long-term consequence, more individuals would invest in the stock market and generally require less compensation for the problem of minority exploitation. However, the amendments would contribute to the development of a shareholder culture only in conjunction with other factors.

One such contributory element would be a conscious government effort to distribute widely the stock of privatized companies. Jeffrey Gordon has critically studied this development in the context of the privatization of the German public telephone company.¹⁴¹ Curiously, Gordon concludes that cross-border mergers,

¹⁴⁰ Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 785-86 (explaining that the strengthening of "procedural law (minority rights)" and "sanctions" has increased the directors' exposure to liability).

¹⁴¹ See Gordon, *Deutsche Telekom*, *supra* note 1, at 186 ("[A] major objective of the [Telekom] offering was to promote a 'shareholding' culture among German citizens."); *id.* at 188 ("This paper argues that the Telekom offering does not take

such as that between Daimler Benz and Chrysler, may unintentionally contribute even more to the creation of a shareholder culture, than governmental privatization operations.¹⁴²

Another key component would be the popularization of the stock market as people become more aware of securities trading, gain easier access through mutual funds and the Internet, and dispose of more funds for retirement and other investments. This phenomenon is already taking place in Germany, somewhat as it did years earlier in the United States.¹⁴³ The German securities market is growing exponentially,¹⁴⁴ while ever more companies are going public.¹⁴⁵

Another crucial part of this process is the ever-increasing listing of large German corporations in the U.S. securities market. These companies are thus seeking access to the U.S. capital market.¹⁴⁶ John Coffee observes that they thus become subject to much of the Securities Exchange Commission's regulation. He advocates subjecting them to virtually all the rules.¹⁴⁷ In any case, German

the idea of a shareholding culture very far."); Gordon *Pathways to Corporate Convergence?*, *supra* note 1 at 238 ("The Deutsche Telekom transaction was literally about creating a 'shareholder culture' . . .").

¹⁴² Gordon, *Pathways to Corporate Convergence?*, *supra* note 1, at 228.

¹⁴³ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 20 ("[T]he current ownership levels in nations such as Germany probably exceed those in the United States in the early twentieth century when dispersed ownership first arrived.").

¹⁴⁴ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 7 ("[S]ecurities markets are growing across Europe at an extraordinary rate . . ."); Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 806 ("German stock exchange markets are growing rapidly . . ."); Mühlert, *supra* note 21, at E116 ("[T]he German system is evolving . . . towards a stronger reliance capital markets."); see also Gordon *Pathways to Corporate Convergence?*, *supra* note 1, at 240 ("In a system previously established on an 'insider governance' model, it may seem a natural evolutionary step to give institutional investors a place at the bargaining table to argue for shareholder value."); Grundmann & Mühlert, *supra* note 42, at 223 (noting the "increased significance of institutional investors").

¹⁴⁵ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 7 ("[E]ntrepreneurs in civil-law countries are making use of IPOs at a rate equivalent to that in the common-law world . . .").

¹⁴⁶ Gilson, *Political Ecology*, *supra* note 19, at 183 (informing that the development of international capital markets has provided an alternative source of funds with a resulting decrease in the percentage of the capital of large German corporations provided by bank credits and loans—from 16.9% in 1974 to 6.6% in 1984); Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 793 (noting "the attractiveness of the U.S. capital markets and the increased access to them [by German companies] through the New York Stock Exchange").

¹⁴⁷ See Coffee, *The Future as History*, *supra* note 1, at 683.

corporations trading in the United States would have to operate more transparently, following strict U.S. disclosure and accounting requirements.¹⁴⁸ Individual investors—not only in the United States, but also in Germany—would be in a better position to trade in German securities. Their information gap vis-à-vis the imposing financial intermediaries, as well as their susceptibility to exploitation would diminish considerably. Of course, this development would be basically an extension of the process already set in motion by the 1998 Corporate Control and Transparency Act.

In the end, the German securities market will come under pressure to adopt rules to increase the transparency of listed corporations. In addition to introducing measures to this effect on their own, the stock exchanges could lobby the government to tighten securities laws. The German authorities could become more vigilant in this area.

The increasing dispersion in ownership patterns in Germany will ineluctably reduce the influence of financial intermediaries.¹⁴⁹ These institutions will be less able to conspire with management in undercutting the supervisory council, to thwart any hostile takeover attempt, to force an inefficient conservative agenda on the corporation, or to take advantage of minority investors. German companies will generally have wider access to capital at a lower rate and, hence, position themselves to engage in venture capitalism.¹⁵⁰ It will become even easier for new companies to start up a novel idea and then go public.¹⁵¹ New investors will no longer have to charge extra for their capital to make up for the anticipated

¹⁴⁸ The 1998 Act to Facilitate Capitalization allows German corporations to follow International Accounting Standards instead of traditional German criteria. Gesetz zur Verbesserung der Wettbewerbsfähigkeit deutscher Konzerne an internationalen Kapitalmärkten und zur Erleichterung der Aufnahme von Gesellschafterdarlehen (Kapitalaufnahmeerleichterungsgesetz) [KapAEG], v. 20.4.1998 (BGBl. I S.707).

¹⁴⁹ See Grundmann & Mühlert, *supra* note 42, at 222-23 ("The increased role of the stock market in financing enterprises and the related decreasing influence of large controlling shareholders in listed enterprises have rendered the market a prominent corporate governance factor in countries such as Germany.").

¹⁵⁰ See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 807 ("The shift towards capitalization through stock exchanges is well under way and undermines the dichotomy between jurisdictions or systems that rely on banks and those that rely on capital markets.").

¹⁵¹ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 18 ("In 1999, Germany saw 168 IPOs, and France saw 75. For the decade, France led with 581 IPOs, Germany followed with 380, and Spain was a close third with 355.").

exploitation of the minority by the majority. Moreover, business families will more readily sell much of their interest broadly in the market. The reason is that, generally, the premium charged by those who sell their control of the company will no longer include an implicit fee for the benefit of being able to take advantage of the minority.

4. CONCLUDING THOUGHTS

The adjustments mentioned in the previous section are preferable to drastic changes that would bring German corporate law very close to that of the United States. First, moving from a double- to a single-tier structure and eliminating the employee delegations would not be advisable. Having a body that is separate from and independent of management is key to preventing managers from overreaching. The U.S. system has recognized this point and has been increasingly encouraging the use of disinterested directors. In many large U.S. corporations, independent board members now outnumber their interested colleagues. What Germany must actually do—or, rather, continue to do—is make the supervisory council stronger and even more autonomous.

Codetermination is a fundamental part of the German social contract.¹⁵² It probably will, and certainly should, remain in place. It facilitates consideration of workers' concerns, which may be at odds with those of managers and shareholders.¹⁵³ In particular, it enables the employees to have a say in, though not a veto right over,¹⁵⁴ decisions that might be profitable in the short term, but extremely burdensome on the workforce. Workers may bargain collectively for protection. Yet, if they have representation on a robust supervisory council, they will obtain crucial information to defend their contractual interests, and they will be able to react when unexpected circumstances emerge.

Closing the informational gap between labor and management along these lines is not only fair and advantageous to employees. It may also facilitate reaching a collective bargaining agreement

¹⁵² See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 817 (demonstrating that codetermination rests on "special and fundamental political decisions").

¹⁵³ See *id.* at 801 (providing that codetermination makes possible "a better integration and motivation of employees, as well as a better and faster execution of decisions").

¹⁵⁴ See Charny, *supra* note 1, at 159 (explaining that "workers are not in a position to block any decisions").

when there is a need for a mode-of-production alteration that requires huge sacrifices by workers. "Game theory literature demonstrates," according to Ronald Gilson, "that the players in bargaining games with asymmetric information often fail to reach a resolution even though gains from trade are available. However, when information concerning the subject of the bargain is symmetric, the likelihood of success increases dramatically."¹⁵⁵

Similarly, it would be unsound for Germany to try to imitate the United States in restricting, by law, the influence of financial intermediaries within the corporation. As noted earlier, the United States is now in the process of discarding the legal limitations saddled on banks and other financial institutions. Germany should simply adopt measures to limit overreaching. It should also continue updating its securities norms in order to enable ordinary shareholders to be an effective counterweight. Furthermore, once the supervisory council returns to the center of decision making, labor will be in a position to play a similar role. The ultimate objective should be to create an environment in which credit entities do not cause or contribute to the previously analyzed problems, but rather provide crucial supervision and counseling to the corporation.¹⁵⁶

Consequently, the preservation of codetermination and the universal bank system should not be an act of resignation. These institutions are not simply inalienable cultural legacies. They may also contribute enormously to a flourishing corporate governance regime. The aim of the proposed reforms is not damage control, but rather the realization of a somewhat neglected potential.

It is a mistake to regard German corporate governance as hindering economic growth. Naturally it is tempting to go from the assertion that structure affects performance, to the observation the European corporations are doing worse than their U.S. rivals, and finally to the conclusion that European corporate organization is worse than that of the United States. Yet, unlike Oscar Wilde, one should be capable of resisting temptation.

Structure undoubtedly bears upon performance, but in a complex way. Obviously, other factors—such as technology, human capital, or the government's macroeconomic policies—also play a

¹⁵⁵ Gilson, *Corporate Governance and Economic Efficiency*, *supra* note 1, at 344.

¹⁵⁶ See Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 797 (stating that financial intermediaries may improve the information available, provide advice, and protect the different stakeholders from each other).

critical role. A set of similarly structured companies may do worse than a different group due to these factors. The existing research has simply failed to establish that it is the corporate governance regime that is hindering continental European companies economically.

More importantly, though economies on the European continent have been relatively sluggish lately, many local corporations have been competing quite effectively at the international level, even against U.S. adversaries. In any case, comparative law should not seek to determine whether a particular system is better than others. This kind of determination is especially wrongheaded when the criterion of comparison is an extremely narrow one, such as corporate output.

First of all, corporate law has numerous underlying objectives.¹⁵⁷ It seeks to facilitate business activity, but also to prevent violations of other legal principles—sometimes even at the expense of efficiency. For example, the directors typically have no corporate authority or violate their corporate duty when they approve bribing state officials, no matter how profitable such an action may be.¹⁵⁸

Furthermore, there is a reflexive as well as an instrumental dimension in corporate law. In other words, corporate rules do not merely advance pre-established objectives, but actually create an independent reality, which one should also examine internally and in terms of ends that it generates on its own. For instance, the norms configure a space within which various actors, such as managers, shareholders, employees, creditors, and suppliers interact. One should evaluate this configuration on the basis of not just extrinsic goals, such as economic performance, but also the fairness of the engendered interrelationships. Fairness or justice is not simply one purpose among many that legal arrangements serve, but rather a principle that purports to structure these institutions immanently. In other words, one does not assess them from the outside and independently of their internal constitution to determine whether they have yielded an end product called justice. Instead, one has to view them from the perspective of an insider, fo-

¹⁵⁷ See Charny, *supra* note 1, at 146 (“[C]orporate governance systems serve diverse and potentially conflicting functions . . .”).

¹⁵⁸ See generally *Miller v. American Telephone & Telegraph Co.*, 507 F. 2d 759 (1974) (“[E]ven though committed to the benefit of the corporation, illegal acts may amount to a breach of fiduciary duty . . .”).

cusing on their inner workings, in order to ascertain whether they are just.

When addressing the instrumental and reflexive deficiencies of a corporate governance system, it may be helpful to seek ideas for reform in other jurisdictions. Yet, it is key to consider how that system hangs together and how it fits in with the rest of the legal order. The point of this kind of reflection is, first, to understand the full implication of proposed changes and, second, to try to preserve as much as possible the integrity of the broader legal culture.

For instance, labor law and corporate law are intrinsically intertwined in Germany. Hence, it would be a disaster to alter aspects of corporate governance, such as employee representation, without considering the effect on labor law. One would risk neglecting unforeseen consequences as well as rendering the entire legal system seriously incoherent. By the same token, it would have been irresponsible to suggest altering shareholders' procedural rights without taking into account the way in which German procedure operates generally.

Another illustration of my point may draw on Olivier Pastré's ascertainment that in France, "the law is virtually non-existent", whereas "in the United States, the law is omnipresent."¹⁵⁹ I believe he means that the French system does not seek to establish statutory and judicial rules to regulate thoroughly the way in which individuals and entities interact. Other civil law jurisdictions fall into this generalization. They establish general principles and expect the parties to work out with each other the details as well as to solve any problems that might emerge. Thus, when reforming the relationships within the corporate administrative structure, one should be cautious about requiring too much statutory regulation and judicial interpretation.

This caveat regarding externally inspired alterations of legal institutions is particularly relevant in the context of European integration. As part of the economic integration process, there has been an attempt to harmonize corporate governance regimes.¹⁶⁰ In

¹⁵⁹ Olivier Pastré, *Corporate Governance: The End of "L'Exception Française?"*, 1998 COLUM. BUS. L. REV. 79, 81 (1998).

¹⁶⁰ See Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 14 ("Rather than individual states modifying their own individual statutes, law reform within the European Community has proceeded largely on the basis of efforts at harmonization"); Grundmann & Mülbert, *supra* note 42, at 217 (stating that the European Community Commission on Implementing a Framework for a Financial Market considers "national differences in the area of corporate structure a possible legal

light of the radical differences within the European Union,¹⁶¹ this undertaking is extremely complicated.¹⁶² Of course, the main challenge is the dichotomy between the civil law and the common law monitoring regimes, "i.e., the supervisory council of the two-tier German corporate structure and the board of directors with outside directors of the single tier Anglo-Saxon system."¹⁶³

In any case, when imposing European legal institutions on a particular country, it is crucial to consider the inner logic and the spirit of domestic law. In fact, European legal integration would work most appealingly with an approach that went from the bottom up, not with a top-down model. In other words, one would start from within the national legal order and ponder what kind of European norms might best contribute to the development of that order.

I will close with a final example of how continental European legal culture differs from that of the United States. Didier J. Cherpitel makes the following statement:

[T]he French consider that a director does not act in the name of the interests he represents but in the name of the company on whose Board he sits, the word company being

or factual impediment to the development of a unitary financial market in the European Union"); Hommelhoff, *supra* note 44, at 262 ("[A] unified set of organizational principles for all listed corporations in the European Union looms in the horizon as an attainable goal.").

¹⁶¹ See Grundmann & Mülbert, *supra* note 42, at 218 (asserting that differences in corporate governance within the European Union are far greater than within the United States).

¹⁶² See Grundmann & Mülbert, *supra* note 42, at 218 ("Even the framework for an European discussion on corporate governance is difficult because of the diversity of fundamental positions."); see also Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 810 ("In the harmonization of corporate law, the European Commission has long run into political and other difficulties.").

¹⁶³ See Grundmann & Mülbert, *supra* note 42, at 221; see also *id.* at 222 (discussing that harmonization attempts have failed due to the "fundamentally different positions among the European states with respect to the 'best' structure for the board and, similarly, with respect to employee codetermination within the enterprise"); Coffee, *The Rise of Dispersed Ownership*, *supra* note 1, at 14 (providing that, in the European harmonization movement, "the old battles over codetermination and workers' rights continue"); Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 810 (stating that important harmonization plans "have been delayed, some of them for decades, because the member states have not been able to agree on fundamental points. In particular, Germany has not been willing to make compromises in the area of codetermination.").

used in its widest sense to represent not only the shareholders but also employees, clients, suppliers, etc.¹⁶⁴

Once again, it is possible to extend the assertion to other civil law jurisdictions. With respect to Germany, for instance, Klaus J. Hopt declares the following: "[t]he clearly predominant traditional view assumes that the goals of the corporation encompass the interests of shareholders . . . as well as those of creditors . . . and of employees, as a special group of creditors."¹⁶⁵

Therefore, continental European systems should be careful when adopting U.S. legal devices, which might rest on the premise that the corporation exclusively represents the interests of equity holders.

This point of contrast signals the way to a discussion about improving U.S. corporate law. Of course, it would be an error to blindly import into the United States concepts from civil law jurisdictions. The challenge is, instead, to find inspiration in continental European law in order to transform U.S. corporate governance on its own terms.

For instance, U.S. law already contains—albeit in a fragmentary state—the notion that the corporation has responsibilities beyond maximizing shareholder value. The judicial precedents have endorsed the idea of corporate social accountability;¹⁶⁶ the so-called "constituency statutes" recognize director duties to stakeholders such as employees, creditors, and the community;¹⁶⁷ and securities

¹⁶⁴ *Id.* at 80 (quoting Didier J. Cherpitel, *Les défis du rapport Viénot*, BANQUE STRATÉGIE, Oct. 1995, at 2).

¹⁶⁵ Hopt, *Gemeinsame Grundsätze*, *supra* note 4, at 799; see also Gordon *Pathways to Corporate Convergence?*, *supra* note 1, at 224 ("The German corporate governance system is famed for its concern for stakeholder interests, particularly employees."). But cf. Grundmann & Mülbert, *supra* note 42, at 220-21 ("[The] legal mandated consideration of stakeholder interests has been neglected in fact.").

¹⁶⁶ See, e.g., *A.P. Smith Mfg. Co. v. Barlow*, 13 N.J. 145 (1953) (holding that a business corporation's contribution of funds for general maintenance of a privately supported educational institution was not an ultra vires act). See generally, PHILLIP I. BLUMBERG, *CORPORATE RESPONSIBILITY IN A CHANGING SOCIETY* 1-53 (1972); PRINCIPLES OF CORPORATE GOVERNANCE § 2.01, A.L.I. (1994) ("Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business: (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes.").

¹⁶⁷ See, e.g., N.Y. JURISPRUDENCE 2D § 684 (1996) ("Duty to Creditors: The position of a director is one of trust in which he also owes an active duty of faithful conduct to the corporate creditors."); CONN. GEN. STAT. ANN. § 33-756(d) (1997) ("[A] director of corporation . . . shall consider . . . (3) the interest of the corpora-

regulations empower individual shareholders to raise issues of social concern related to the corporation's business.¹⁶³ The United States may derive insights from the civil law experience on how to integrate the interests of all these stakeholders as well as how to square the corporation's commercial mission with its communal obligations. Ultimately the continental European principle that rights carry obligations with them—which informs not only corporate but also constitutional law and other fields—may be a source of enlightenment in the United States.

I have delved into the U.S. debate about German and continental European corporate law in order to expose some frequent misconceptions and to propose a certain reexamination. In this age of internationalization, comparative law is crucial. Legal systems constantly come in contact. They must learn about and from each other. They must cooperate and grow together, while they preserve their distinctness and coherence.

Europeans are right to underscore that globalization should not translate into "U.S.-Americanization." This kind of reduction is equally inappropriate in comparative law. By the same token, when the international outlook changes, and European economies start outpacing their U.S. counterpart, legal theorists should avoid the opposite mistake. U.S. scholars should not, at that point, desperately seek ways to copy European models. In the end, the law must be able, through the efforts of its practitioners and theoreticians, to make its own the words of Don Quixote de la Mancha: "I know who I am and I know what I can be."¹⁶⁹

tion's employees, customers, creditors and suppliers."'). Cf. COMMITTEE ON CORPORATE LAWS, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990) (discussing whether state provisions allowing directors to take into account the interests of other constituencies should be included in the Revised Model Business Corporation Act).

¹⁶³ SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (1998); see *Med. Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970).

¹⁶⁹ MIGUEL DE CERVANTES, *EL INGENIOSO HIDALGO DON QUIXOTE DE LA MANCHA* 35 (1ra Parte, Cap. 5) (1940).

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