Spring 2016

The Structure of Corporate Ownership and Control

Sophia Dai
University of Pennsylvania

Christian Helfrich
Goethe University

Sophia Dai

University of Pennsylvania Law School

Christian Helfrich

Goethe University Frankfurt

The structure of corporate ownership and control

A seminar paper for the Global Research Seminar

Comparative Corporate Governance

Cooperatively organized by University of Pennsylvania Law School and Goethe University

Held by

Professor Fisch (Pennsylvania Law School) and Professor Haar (Goethe Universität)

Fall Semester 2015/Spring 2016

Table of Contents

A. Introduction

This paper will discuss the structure of corporate ownership and control in the United States of America and the Federal Republic of Germany. Although both countries experienced similar historical trends towards greater institutional ownership, their subsequent treatment of the consequences of this evolution is substantially different. Taken as a whole, this comparison can allow more thorough and exhaustive analysis of the corporate governance concerns that plague both systems. We hope to meet the challenge of expounding upon the parallels and variances between the two nations in order to create an ongoing dialogue regarding these tenuous issues facing capital markets and public corporations.

B. U.S. Section

The Evolved Ownership and Control Paradigm

I. Introduction

The separation of ownership and control has long been a source of tension in U.S. corporate governance. The tension naturally arises in publicly traded corporations where the shareholders are unable to directly govern and instead must elect boards to exercise control on their behalf. As with any agency relationship, conflicts and divergence of interest arise and in an effort to diminish the associated agency costs, a number of mechanisms have been tested and implemented: the application of fiduciary duties, management financial incentive structures, and a variety of regulatory schemes. Despite the necessary tensions intrinsic in this relationship, there are substantial benefits to this separation as well, namely creating a more efficient capital market system in which investors are able to use their time to invest rather than govern, but more significantly, allowing corporations to be more than pure profit maximizers and simultaneously prioritize stakeholder interests and corporate social responsibility. As the structure of share ownership has evolved, so too did the original ownership and control paradigm, and now the worry is if the indispensable separation between ownership and control has diminished too greatly. While the original moral hazard problems still exist, there are now additional costs that have arisen as a consequence of these new shifts in the traditional model.

This section of the paper will primarily attempt to answer these central questions regarding U.S. corporate structure: 1) given the current relationship between investors and the governing board, what have been the most fundamental consequences of this change, 2) if this effectively has narrowed the separation of control and ownership, what are then the implications of this transformation, and 3) looking forward, is the current path a sustainable one for the future of corporate governance and corporate value? By acting as the internal governing vehicle on behalf of shareholders, the board's primary responsibility is to monitor management. However, the board's duty is to the corporate entity, not to its shareholders. Thus, when the board's interests becomes either overly divergent from shareholders', or when they simply acquiesce to them, the board's governance becomes grossly insufficient. Policies that actively encourage greater shareholder control may in fact undermine the traditional reasons behind the separation of control from ownership.

Since the end of World War II, the original Berle and Means corporate ownership structure in the United States has evolved from a diffuse, predominantly retail shareholder base to a composition of more concentrated, institutional holders. This gradual shift, while intriguing in itself, has had great implications for governance and the relationship between ownership and control. The consequences of these broad changes in corporate control cannot be fully explained by a move away from dispersed ownership, however. As shareholders have been given greater deference and more governance tools to further their ability to seek and maintain a voice in corporate discussions, these changes have allowed shareholders ever greater access to control and activism.

The original Berle and Means agency problem stemmed from the disconnect that existed between a board effectively controlled by management and the dispersed, individual investors. Shareholders, once powerless, now have an advent of options to affect control, and this expanded influence of institutional holders has both transformed the original agency problem and created new agency tensions: 1) board myopia and the subsequent acquiescence towards shareholders, 2) the dichotomous relationship between the beneficiary owners of shares and their intermediary holders and 3) minority, activist hedge funds acting as controlling shareholders. The limited commitment problem, which depends on the prevailing belief that most institutional holders are rationally short-term, drives each of these agency problems. Due to information asymmetry and inefficiency, strong exit rights, and generally shorter investment holding periods, it is argued that shareholders are less likely to know when a long-term investment will pay off and thus will remain less committed to long-term business strategies proposed by the board, especially if presented with profitable alternatives such as a push for dividend distribution, the sale of shares through hostile takeovers, or the removal and election of directors by proxy.

While the Berle and Means scenario focused on the dangers of misalignment, today's corporate ownership and control concern should be on board acquiescence. Boards, in an effort to appease powerful instituitional investors and keep their positions, may agree to more short-term value creation, so in addition to concerns regarding moral hazard, board myopia now also plagues the relationship between shareholders and directors. Given the incentives structure of these institutions, in which they mainly earn profit through diversification and success of their portfolios, rather than through a focused interest on any particular corporation, institutional shareholders are arguably less likely to value governance rights. Their supposedly more short-term approach to ownership and governance differs from the longer-term concerns of the actual beneficial owners of these shares. This tension from the limited commitment problem is at the root of the more complex agency problem of activist hedge funds acting as controlling shareholders. Hedge funds often do not own a controlling bloc of shares but have been able to act as majority shareholders. This ability to exercise control, of course, is dependent on other institutional investors' cooperation, and when they do "collude" together, whether purposefully or not, they tend to have specific, targeted agendas. The limited commitment problem is truly exacerbated here; academic literature repeatedly articulates that hedge fund activists have strong incentive to convince other investors to abandon their longer-term strategies, even if at the eventual detriment to the corporation, other stakeholders, and even shareholders themselves. Under US corporate law, minority holders like activists would not owe any fiduciary duties to other shareholders. However, it is foreseeable that the interests of shareholders, controlling or not, are likely to be in conflict. That activists have the ability to effectuate control without the corresponding ownership and necessary capital risk is intriguing and it is worth further examination whether the fiduciary duty of loyalty should be levied on them.

The shift to more concentrated institutional ownership has created several new corporate governance questions, but the overall theme of this trend is that dominant shareholders are both more incentivized and now possess the ability to influence their fellow shareholders and consequently, able to discipline management, which might work in direct opposition to the longer-term values and interests of minority holders, beneficiary owners, and the general corporate entity. How did institutional holders come to possess an increased ability to influence boards and management? Are the interests of activist and minority holders necessarily different, and if so, why? Or even those of beneficiary owners and the intermediary institutions? These questions can only be answered by initially understanding the incentive structures that motivate institutional owners. The once problematic implications of separation of ownership and control no longer exist in the same form, only to be replaced by more complex corporate governance issues.

II. The Shift Away from the Berle and Means Corporation

When Berle and Means originally published Modern Corporation and Private Property in 1932, their description of America's dispersed shareholder ownership and the consequent separation of ownership and control was an accurate depiction of the U.S. corporate world.[1] Shareholders were mainly retail investors who had little incentive to become intricately involved in the governance process of any particular corporation. For any investor, diversification is integral and being able to reduce firm specific risk allows otherwise risk-averse shareholders to invest their capital with potentially risk-loving management. While this scheme allows the capital market system to function efficiently, this also necessarily means investors have multiple points of interest and likely conflicted interests. Retail investors of the Berle-Means era could not feasibly monitor corporate boards and insiders,[2] nor would they likely have desired to. And because of how widely spread out these investors were, there was the justified concern that they were weak and passive, essentially powerless before the whims of the board and management.[3] Understandably, the authors emphasized a more paternalistic approach towards corporate actors and believed there was a need for regulatory measures to serve both as a protection mechanism for shareholders and a control mechanism to prevent management from engaging in potentially harmful and risky behavior both to investors and to society.[4] Boards who actively and effectively monitor management would have ideally reduced agency costs that occur as a basic consequence of this separation of ownership and control. The question on how best to diminish the agency costs associated with the separation of ownership and control is one that still very much exists and continues to trouble regulators and corporate governance experts alike.

In the past fifty years, the fundamental nature of ownership has changed. Retail owners are now in the minority of American holders and institutional owners have gained a

---

[1] ADOLF BERLE AND GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, TRANSACTION PUBLISHERS (1932) [hereinafter "Berle"].
[2] *Id*.
[3] *Id*.
[4] Mark S. Mizruchi, *Berle and Means revisited: the governance and power of large U.S. corporations*, UNIVERSITY OF MICHIGAN, 2 (Apr. 2004).

significantly greater stake in the equity holdings of America's corporations.[5] During this same time period, both the SEC and corporate actors themselves have acquiesced in giving shareholders more authority.[6] Proxy voting, "Say on Pay" provisions, the election of outsider directors are all indicators of increased shareholder authority and equally importantly, they are vehicles by which shareholders can gain more power and control. While many institutional holders are reluctant to exercise an active role in the direction and governance of corporations, corporate governance literature suggest many institutional investors tend to agree with other institutional investors on questions of governance and control.[7] Thus, even if one institutional shareholder does not account for a substantial segment of a corporation's investor base, an aggressive shareholder can make a noticeable difference if it has the support of the other institutional holders.

III. Who Owns American Corporations Today?

In today's capital markets, over 70% of the top 500 U.S. corporations are held by institutional investors.[8] Retail ownership has declined substantially but still make up almost a substantial investor base in the U.S. capital markets. Government ownership of public corporations in the U.S. has been significantly less common throughout the 20th century compared to other developed nations and was "virtually non-existent in recent U.S. experience until the 2008 financial crisis."[9] Despite having wholly-government owned corporations in the U.S.[10], "mixed enterprises", with both private and government ownership, are generally viewed skeptically and suspiciously by the American people. The government bailout of banks and corporations post-recession was subject to significant criticism and corporate actors were eager to have the state sell their ownership stakes. Although there is plenty to say in regards to retail and government ownership of public corporations, for

---

[5] THE CONFERENCE BOARD, THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION, Table 10 (2010) [hereinafter "Conference Board"].

[6] Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 J. Corp. L. 681, 686-89 (2007) (discussing the amendments to the SEC proxy regulations in 1992 that greatly expanded the ability of shareholders to influence change in corporations); *see also* Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARVARD BUSINESS REVIEW (Jan.-Feb. 1994).

[7] GILE R. DOWNES ET AL., INSTITUTIONAL INVESTORS AND CORPORATE BEHAVIOR, AEI, 3, 4, 9 (1999) (positing that all institutional investors agree on furthering shareholder rights, voting against bad governance (regardless of performance), poison pills, share repricing) [Hereinafter "Downes"].

[8] Conference Board, *supra* note 5.

[9] Mariana Pargendler, *State Ownership and Corporate Governance*, FORDHAM LAW REV., Vol 80, Iss. 6 2925 (2012) (noting that even if the U.S. government has employed the corporate form, they did it through sole-proprietorships or as guarantors, rather than shareholders of private capital) [hereinafter "Pargendler"].

[10] To name a few: Amtrak, Corporation for Public Broadcasting, Conrail, North Dakota Mill and Elevator.

purposes of this paper, it is more relevant to look at the rise of institutional ownership and its subsequent influence on the control paradigm.

Gilson and Gordon describe three types of institutional shareholders: mutual funds, pension funds, and hedge funds.[11] Mutual funds are investment companies that are subject to strict regulatory oversight by the Securities and Exchange Commission ("the SEC").[12] One of these rules requires that holders of securities in mutual funds must be able to withdraw their funds at any time, which consequently mandates these funds develop a more short-term investment strategy that permits immediate liquidity.[13] Record owners for any mutual fund are only subject to very low minimal investments, and because of these lower minimum requirements, the holders in a mutual fund are typically less sophisticated, less wealthy "laymen" investors who use these investments for longer-term gains. In selecting their portfolio managers, investors follow the relative performance of these funds, by comparing the performance of all funds market wide.[14] This type of selection process has direct consequences on investment strategy. The success of a mutual fund portfolio ultimately depends almost entirely on having an advantage over the market, meaning that fund managers ultimately value private gains over shared market gains.

Pension funds share many of the same features as mutual funds, with the main difference being that the beneficiaries, the employees of the organization, are obliged to join in the fund.[15] It is important to point out that trustees and managers of pension funds have occasionally engaged in politicization of their funds, sometimes ethically, sometimes not.[16] In 2015, the Obama Administration's Labor Department issued Interpretative Bulletin 2015-01 declaring that "[e]nvironmental, social and governance issues may have a direct relationship to the economic value of the plan's investment" and explicitly allows pension fund managers to consider other factors beyond pure profit maximization.[17] Although this rule now gives

[11] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and The Revaluation of Governance Rights,* COL. LAW REV. Vol 113:863 (2013) [hereinafter "Gilson"].
[12] Arthur H. Kohn and Julie L. Yip-Williams, *The Separation of Ownership from Ownership: Concerns Arising from Institutional Investors as Intermediaries*, THE CONFERENCE BOARD (Nov. 2013) [hereinafter "Kohn"].
[13] *Invest Wisely: An Introduction to Mutual Funds*, SEC, *available at*: https://www.sec.gov/investor/pubs/inwsmf.htm (last visited February 22, 2016). It should be noted that despite immediate redepemtion rights, a signifcant portion of the funding is not touched for years at a time and many funds have very low turn-over rates.
[14] Gilson, *supra* note 11, at 894.
[15] Kohn, *supra* note 12.
[16] A less than ethical instance involved the President of CalPers, who also served as the Executive Director of Safeway's Union, who used CalPer's position as a major shareholder of Safeway to try and intervene in the Union's dispute with the company. He was later removed from the board of CalPers.
[17] Department of Labor, *Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments* (Oct. 2015).

more leeway to pension fund managers to substitute in less quantifiable variables for their investment strategies, they generally have had similar investment strategies to mutual funds since these portfolio managers are also selected based on the superior relative returns they can create. No fund manager is incentivized to chase after gains that do not reflect their competitive advantage of the market. Because of their similar investment strategies, Gilson argues that pension and mutual funds alike are less likely to strongly value governing rights.[18] A poorly managed corporation might demand some level of shareholder involvement, but successfully intervening would create value for all shareholders to enjoy, which is directly contrary to these funds' investment strategies. The success of mutual and pension funds' portfolios are dependent on private gains, rather than collective benefits. Furthermore, fund managers will engage in the practice of "underweighting" some of their shares—allowing the fund manager to benefit in relative terms if the price of the stock declines in the market—but ultimately incentivizing them from improving the corporation's performance.[19] Given both the compensation structure of these institutions, the hypothesis is that these institutional investors have little incentive to participate in governance decisions.[20] Consequently, the portfolio managers are arguably less motivated to engage in governance interventions to optimize the management and value of any particular corporation. And while undervaluing governance rights may be in the best interest of the fund managers and funds themselves, this serves to create a new agency problem between the institutional holders and the beneficial owners of the shares, dubbed "agency capitalism" by Gilson and Gordon and explored at length later on in this paper.[21]

Hedge funds are structured in a substantively different way from these other funds. Primarily because they are not required to register with the SEC, hedge funds are not subject to many of the same strict regulations that govern these other institutional holders.[22] Their securities are issued in "private offerings" to highly sophisticated investors who meet a high wealth minimum. Most importantly, their investments are not subject to immediate redemption and liquidity requirements.[23] Shareholders typically cannot demand to redeem their shares at any time, and this gives hedge funds the flexibility to implement longer-term

[18] Edward Rock, *Institutional Investors in Corporate Governance,* Univ. of Penn. Law School, Paper 1458, 13-14 (2015).
[19] Simon C.Y. Wong, *How conflicts of interest thwart institutional investor stewardship*, BUTTERWORTHS JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW (Sept. 2011).
[20] *Id*.; *see also* Gilson, *supra* note 11.
[21] Gilson, *supra* note 11.
[22] Kohn, *supra* note 12.
[23] *Id*.

investment strategies should they choose. Because of the higher wealth and investment requirement and the longer-hold period, the return on these securities are generally significantly higher. Hedge funds are able to hold more concentrated positions in a fewer number of corporations, and analysis of activist hedge fund portfolio turnover rates suggests longer holding periods of around 20 months.[24] Given all of these differentiating factors, hedge funds have significantly different investment strategies and a small segment of them have become activist investors[25]: they acquire a non-controlling but significant stake in a given corporation in an attempt to improve the corporation's governance and business practices, whether through private discussions with the board or more aggressive tactics.[26] In contrast to other institutional holders, activist hedge funds tend to place a higher value on governance rights and choose to monitor boards to extract private gains from successful interventions.[27] The true value creation of activism is debated amongst legal scholars, practitioners, and jurists across the country[28]—whether hedge funds, with the help and acquiescence of other institutional shareholders, actually contribute any genuine value to the corporate entity or to minority shareholders is not easily measured and too substantial a topic to discuss justly here. Putting aside any additional value judgments tied to activism, the corporate control and governance questions that the activist evolution has generated are certainly pertinent to this discussion and should be addressed.

One key requirement for the activist's success is the cooperation of the other institutional shareholders. These are no longer the dispersed and powerless investors of yester-year and even while some institutional investors are purportedly less interested in governance rights, they still value short-term profitability and shareholder rights, which activists tend to emphasize.[29] Having the support of institutional holders during proxy contests or activist interventions is extremely advantageous, and this support is probably the most significant factor in any hedge fund's success. The prevalent use of shareholder advisory

---

[24] Brav et al., *The Return to Hedge Fund Activism*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (Mar 2008).
[25] It should be clarified that not all activists are hedge funds and certainly not all hedge funds are activists, but the most prominent and active activists are hedge funds.
[26] Shane Goodwin, *Corporate Governance and Hedge Fund Activism,* HARVARD BUSINESS SCHOOL (Sept. 2015) (arguing that the compensation structure and the deregulation of hedge funds makes them better monitors of management than other institutional investors).
[27] *Id*.
[28] The infamous disagreement between Lucian Bebchuk and Marty Lipton over activism has been considerably discussed and analyzed by corporate law academics, jurists, and practitioners, but there is no objective standard on who is correct as to the long-term value creation of activism.
[29] Downes, *supra* note 7.

services can also be considered a contributing factor in this institutional "collusion." [30] In Nelson Peltz's recent campaign over DuPont, the proxy advisory firms were clearly biased towards the activist and recommended the company's largest institutional holders to vote for Peltz's recommended board members.[31] While the shareholders ignored the proxy recommendations and sided with the DuPont board, it is significant to note that proxy advisory firms tend to favor activism. The concern would be then that institutional shareholders who use proxy advisory services are passive voters and merely follow the proxy recommendations, even if their voting recommendations are clearly biased. In a recent study on institutional investors, it was reported that the average portfolio manager who manages $100 billion or more in assets, only make approximately 10% of all voting decisions.[32] Outsourcing research and voting decisions arguably can induce boards to make decisions that acquiesce to policies favored by proxy advisory firms, but may in fact decrease shareholder value.[33] However, according to other academic research, while a substantial subset of institutional investors may use proxy advisory firms, they do not substitute the proxy's recommendations for their own voice.[34] The influence of proxy advisory firms is not insignificant,[35] but perhaps its influence on governance questions has been overstated by the media.

IV. U.S. treatment of shareholders and the subsequent effect on the corporation

a) Fiduciary Duties owed to and by shareholders

In the U.S., the courts give significant guidance on the fiduciary duties directors owe to corporations to maximize value.[36] Although traditionally expressed as duties to the corporation, the only group allowed to bring derivative suits against directors and

[30] Nadya Malenko and Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design,* Boston College (2015) (emphasizing the role of proxy advisory firms in influencing voting outcomes is 'substantial and should not be understated) [hereinafter "Malenko"].
[31] David Benoit, *Proxy Adviser Backs Two Trian Board Seats at DuPont*, WALL STREET JOURNAL (Apr. 27, 2015) http://www.wsj.com/articles/iss-backs-activist-trian-getting-two-board-seats-at-dupont-1430145193.
[32] SEC, 2015 INVESTOR SURVEY DECONSTRUCTING PROXY STATEMENTS-WHAT MATTERS TO INVESTORS (2015).
[33] Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms*, Stanford Journal of Law and Economics (Oct. 30, 2014).
[34] Joseph A. McCahery, et al. *Behind the Scenes: the Corporate Governance Preferences of Institutional Investors*, Journal of Finance (June 2015) (arguing that investors who use proxy advisory firms make their own decisions and only use proxy recommendations to gather further guidance on the issues).
[35] Malenko, *supra* note 25.
[36] These include the duty of loyalty, duty of care, and the less explicit but equally important duties of good faith and fair dealing.

management for breaches of their duties are shareholders.[37] The same fiduciary duties that are owed to shareholders by the board are not owed equivocally by the shareholders to each other or to the corporation. What this means is that investors often have the freedom to vote for governance or business decisions that will primarily benefit themselves, even if at the expense of the corporation, other shareholders, and stakeholders. While duties of loyalty and care have traditionally only applied to officers and directors, courts have occasionally applied loyalty duties on majority shareholders on behalf of the minority holders.[38] The duty prohibits controlling shareholders from exercising their controlling influence in such a way to extract private gains for themselves that are in detriment to the minority's interests, but this application of duties on shareholders is rare. The limit is almost only applied in two circumstances: freeze-out mergers and close corporations.[39] In order to be a "controlling" shareholder, the investor generally needs to hold more than 50% of shares[40] and specifically, needs to exercise actual control over the corporation.

Perhaps one reason courts are generally reluctant to import duties onto investors because historically shareholders were believed to have little influence on corporate governance.[41] If shareholders were unable to have real say or effect on the corporation, there was no need to impose limits on their actions. In the United States, the focus of corporate governance has primarily been on the relationship between the board and the shareholders, and rarely on the relationship between shareholders.[42] Another possible reason is that there remains an entrenched belief that minority shareholders who are concerned enough about corporate value to wage an intervention or proxy contest for change, are ultimately attempting to benefit the corporation and all shareholders.[43] While certainly not homogenous, the interests of non-controlling shareholders are assumedly similar and perhaps, minority

---

[37] Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, JOURNAL OF CORPORATION LAW, Vol. 31, 662 (2006) [hereinafter "Fisch"].
[38] *In re* John Q. Hammon Hotels, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009) (clarifying that minority shareholders should have procedural protections especially considering the controlling shareholder and the minority shareholders were competing for the same consideration).
[39] Iman Anabtawi & Lynn A. Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev, 1255, 1271-1272 (2008) [hereinafter "Anabtawi"].
[40] The exception being if the shareholder holds a large enough voting block that they can influence the board without soliciting help from other shareholders. The block is significant enough to create change by itself and independent of additional support.
[41] Anabtawi, *supra* note 39, at 1267-1268.
[42] This is in startling contrast with Germany's corporate governance which recognizes the conflicts that would likely arise between shareholders and imposes fiduciary duties on them.
[43] *Id*.; *see also* J.A.C. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921, 934 (arguing that in US corporate law, the courts have rarely imposed obligations on minority shareholders, except for the vote and when the vote is exercised, it is assumed to be "exercised by a person interested in promoting the corporation's welfare and the value of the investment represented by the stock.").

shareholders willing to engage with the board, primarily do it to increase value that all shareholders can share in. Of course, this belief rests on the assumption that shareholder interests are "similar if not identical"[44] so even if the shareholders are acting in their own self-interest, their actions for the most part would correspond with the interests of the other minority shareholders as well. Holding these assumptions true, there would reasonably be no need for fiduciary duties and limits on most shareholders. Although this may have been true historically, today the rise of activist investors has critically changed the nature of the intra-shareholder relationship and the question whether non-controlling shareholders should have a duty of loyalty to the corporation, their fellow shareholders, and stakeholders will be explored in depth later on.

Despite the corporation being composed of many constituencies with different, perhaps even conflicting, interests, these same fiduciary protections and governance protections are not granted to any other stakeholders[45], who are only protected through contract. While contract law may offer a degree of protection, it is apparent that the interests of stakeholders are of lesser priority than shareholders and they lack access to a similar level of insurance, despite their having considerable stake in the corporation's future. Because stakeholders typically do not have governance rights in the U.S.[46], they are least able to voice their concerns and affect change in the corporation. Stakeholders have the ability to demand changes through contractual modifications and can exit without significant burden[47] but their level of investment in the company is likely to depend on their subjective perspective of the corporation's future trajectory.[48] A company highly motivated by maximizing profits and engages in more risky business strategy to generate high returns at the expense of capital management, which may be appealing to shareholders, would likely be less palatable to customers interested in a steady flow of inputs or for unsecured creditors. Both the board and shareholders are able to make voting decisions that can effectively short-change their stakeholders to no legal detriment to themselves.

---

[44] Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983).
[45] Creditors may be allowed to bring derivative suits when a corporation is clearly insolvent or near the zone of insolvency, but the duties creditors may be able to enforce are not special duties, they are duties the directors owe the corporation. No fiduciary duties are owed to creditors of a solvent company.
[46] There are exceptions to this rule: employees who are given equity stocks or labor unions that own substantial stakes in the company.
[47] Fisch, *supra* note 37, at 666.
[48] K.J. Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value*, 8 (Nov. 19, 2015) available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 [hereinafter "Cremers"].

Given the often divergent interests between stakeholders and shareholders, one interesting case study is that of the stakeholder acting as shareholder: the union shareholder. Employees cannot generally have a significant voice in corporate affairs, but certain unions who have large stakes in their companies are able to demand changes. What is most interesting about this constituency when they exercise control, because they have the influence of shareholders but a rationally different set of objectives, is that they choose to further worker interests rather than pursue profit maximization. One notable example is the United Food and Commercial Workers (UFCW) union protest of Safeway in 2003 and the subsequent refusal of CalPERS, a major Safeway investor, to endorse the reelections of directors and launch of a proxy contest. The President of CalPERS, Sean Harrigan, who was also acting executive director of the UFCW union, was criticized for using his influence as a significant investor to advance union goals. Harrigan led a union rally against Safeway and demanded the CEO's resignation in light of the company's failure to fairly negotiate with their employees. The institutional activism demonstrated here was criticized as being too focused on labor interests rather than the creation of shareholder value. That this criticism is levied is indicative of how strong a hold shareholder primacy has in corporate governance[49]; shareholder value is taken as a good while social utility is deemed secondary. This is not unique to the United States, but it is worth noting that corporate social responsibility is emphasized greatly in other Western industrialized nations as typified by the mandatory representation of stakeholder interests on their boards. Like shareholders, stakeholders have their own objectives, and when given a chance, choose to advocate for their own interests. Thus, when greater control is given to stakeholders, the corporation is more likely to advance goals external to pure profit maximization.

b) Shareholder primacy: Should shareholder value be equated to entity value?

The evolution of shareholder primacy, which has fundamentally changed the face of corporate governance, can be traced to the well-publicized and argued theory of shareholders being the ultimate owners of the corporate entity.[50] This theory that corporations exist to

[49] Although the criticism stemmed from Harrigan's use of his position at CalPERS to influence the labor negotiations, it is foreseeable that if Harrigan's goal was return maximization for the corporation, the criticism would have been less severe.
[50] *See generally* Fisch, *supra* note 37; Lynn Stout, *On the Rise of Shareholder Primacy: Signs of Its Fall, and the Return of Managerialism (in the Closet),* Cornell Law Faculty Publications, Paper 865 (2013).

maximize share or market value[51] has been the driver of the move towards greater shareholder governance rights, which further protects shareholder interests, and this in turn has enabled shareholders to demand and acquire even greater shareholder wealth. Using shareholder value as an approximation for a corporation's health or success essentially sanctions the notion that shareholder value is equivalent to corporate value.[52] Given that shareholder value is so dominantly used as both an assessment tool and the ultimate corporate objective to attain, it becomes necessary to ask if this treatment of shareholder value as equivalent to entity value is a mistake and if it is, which value should boards aim to promote?

The difficulty of defining "value" should not be understated. Corporate law experts continuously attempt to define it, but there's no settled definition that is satisfactory to all sides. The very delineation between shareholder value and entity value is a controversial topic. Perhaps a good starting point is to examine the objectives of the shareholder base and the corporation. Shareholders rationally have one goal in mind, personal or institutional return maximization, whereas the goal of any corporation should be long-term survival, if not success. While these goals are certainly not incompatible, high earnings for shareholders do not require the ultimate survival of a given corporation they're investing in.[53] It is understandable then that shareholders, who value high returns, place heavy emphasis on share price and profitability, but then a corporation, whose survival is dependent on much more complex factors than today's market value, should also use a measurement of value more complex than share price. Entity value should incorporate additional metrics: sustainability, risk, corporate practices, social responsibility, productivity, employee and customer satisfaction, reputation, etc. Share price cannot and does not reflect all of these other variables, which contribute significantly to the long-run health of the corporation.[54] Entity value, as opposed to share value, implies the improvement of the welfare of the company, not inconsistent with the interests of stakeholders or shareholders. But when managers and directors primarily pursue increases in share price, they make the affirmative choice to emphasize shareholder interests above the corporation's as a whole. Fiduciary duties to the corporation is distinct from the duty to the shareholder and by creating this veil between

---

[51] The modern evocation of a shareholder primacy theory has led both academics and corporate agents to use share price as the foremost metric of a corporation. It is important to note that the use of Tobin's Q, share price or net profits all amount to the same thing: they are all measures of shareholder value.
[52] Fisch, *supra* note 46, at 639 (arguing that while "shareholder wealth may be an appropriate proxy for a broader conception of firm value" actual empirical studies do not demonstrate such "reliance on shareholder wealth").
[53] This is not to suggest investors hope for the financial ruin of the firms they invest in, but only that the goals are distinct and at times, can become divergent.
[54] Fisch *supra* note 46, at 673-674.

management and shareholders, it essentially allows the officers to make effective decisions to benefit the corporation without heedlessly succumbing to pressure by investors. At best, share price is an inaccurate and overly simplistic measure of entity value,[55] but at worst using it to measure success can lead boards to make decisions that destroy the long-term value of the corporation.[56]

Shareholders today receive substantial deference in this country: fiduciary duty protections, strong governance rights, and a significant amount of academic literature and judicial opinions that advocate for shareholder primacy and share value maximization above stakeholder or "enlightened" value maximization.[57] Because shareholders are now able to significantly influence corporations, the worry is that the other parties who have a long-term stake in the company may be neglected to the detriment of the corporation's health and social utility. Corporate governance has reached a point in time when shareholder primacy may no longer be a satisfactory answer and this next section will question whether today's emphasis on shareholder value as the foremost metric of corporate value is still compelling.

V. How have the changes in ownership affected corporate governance and performance?

a. Are board interests now too closely aligned with shareholders?

The original Berle-Means agency problem stemmed from the uneven distribution of authority between dispersed shareholders and a board strongly controlled by management. The worry was that the shareholders' best interests would not be represented by their fiduciaries. As the interests of directors were not properly aligned with their investors, they would fail in their monitoring duties and management would be able to exercise substantial, unchecked control. In attempts to resolve this agency concern, Berle and Means advocated corporations adopt more shareholder-friendly policies.[58] The modern influx of a large institutional investor base and the implementation of substantive shareholder rights resulted in a paradigm shift: shareholders are no longer passive or voiceless and now have the ability to impact governance decisions. Institutional shareholders additionally possess institutional influence and although the literature is mixed, there does seem to be a prevalence for

---

[55] *Id.,* at 673.
[56] *Id.*; *see also* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275 (2002).
[57] Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, Business Ethics Quarterly, Vol. 12, No. 2 (Apr. 2002).
[58] Berle, *supra* note 1.

institutional shareholders to vote in alignment with each other. Consequently, institutional investors, especially when acting in concert, have real swaying power over the board. Over the last two decades, institutional holders have pushed management to be more responsive to the more immediate pressures of capital markets and to the electorate's requests.[59] Shareholders now have the power of the proxy vote, and have used their influence to elect independent directors, direct executive compensation, de-stagger boards, and generally implement more shareholder friendly business strategies, such as more frequent distribution of dividends. Shareholders in the earlier part of the century likely also had demands, but the difference is, that when institutional investors make demands today, they are more likely to be met.[60] One of the more significant and tangible consequences of institutional ownership is that corporations are more sensitive than ever to shareholder wishes. While Berle and Means perhaps might see this move towards shareholder compliance as a positive, there are substantial risks to today's evolved agency problem. The rise of unchecked shareholder rights has created novel concerns surrounding board myopia.[61]

This brings the limited commitment problem to focus—due to informational inefficiencies, today's shareholders are rationally inclined to side with business and governance decisions that result in value creation they can foresee occurring during their holding period.[62] Investing in longer-term strategies, while perhaps significantly more beneficial to the corporate entity and other stakeholders, is often out of their purview. These shareholders would thus want to protect their interests by influencing the board to likewise adopt likewise more short-term inclined policies.[63] The limited commitment problem, which accounts for more complexities than the theory of "short-termism" does not deny that there are institutional investors interested in longer-term investments, but emphasizes that it is difficult for most shareholders to credibly value longer-term investment strategies and governance policies. If it is taken as true that institutional shareholders typically focus on quarterly earnings and on share price rather than on longer-term metrics because of their incentives structure, then it is reasonable that they would not generally have objectives aimed at improving long-term corporate performance simply because they will likely no longer be

---

[59] Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless their Powerful Electorates Also Act and Think Long Term?* THE BUSINESS LAWYER Vol. 66, 16 (Nov. 2010) [hereinafter "Strine"].
[60] *Id*.
[61] K.J. Martijn Cremers et al. *Hedge Fund Activism and Long-Term Firm Value,* 8 (Nov. 19, 2015) *available at*: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 [hereinafter "Cremers"].
[62] *Id*. at 22.
[63] *Id*. at 23; Strine, *supra* note 57.

investors of the corporation once those policies take effect. If their own investment strategy is only geared towards the near-future, it would lie outside of their purview to focus corporate strategy on producing sustainable wealth.[64]

Understandably, Delaware corporate law is very clear and adamant on this issue—outside of a Revlon situation[65], the board's fiduciary duties are owed to the corporation and not to its shareholders. The law recognizes that the board should have the power, within limits, to pursue its vision for the future, while taking into account what is best for both the corporation and its shareholders.[66] Contrary perhaps to activists' opinions, the corporation is not made up of only shareholders for the purpose of appeasing shareholders—there are other important constituencies to consider: employees, trading partners, creditors, consumers, and society.[67] However, now that activist investors have begun to launch interventions to "fix" corporations, the boards who are anxious to avoid public interventions or fearful of losing their director positions, are arguably more likely to succumb to the shareholders' demands, regardless of whether enacting the changes will actually be beneficial to the corporation.[68] The contemporary concern is if shareholders now have too much influence over boards, and with executive compensation tied so closely to share value and corporate performance, whether management interests are too closely aligned with shareholders'. The concern is that eventually activists will simply elect fiduciaries who only "parrot the views of institutional shareholders with a short-term focus."[69] Once the board and management are mere puppets of their shareholders, it becomes extremely probable that they will put forward policies that are geared less towards the corporation's long-term survival. If a board is myopically focused on pleasing the stockholders, it really diminishes the advantages created by the traditional separation of ownership and control. The corporation's other stakeholders and long-term interests would tend to be neglected and this myopia would further create a cyclical problem: stakeholders would be disinclined from investing with corporations that are too focused on

[64] This theory does not take it for granted that the shareholders are apathetic to the corporation's long-term survival. While some literature would characterize institutional investors, especially hedge funds, as unconcerned about the continued life of a corporation, it would be unreasonable to apply this investment philosophy to all institutional holders.
[65] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,* 506 A.2d 173 (Del. 1986).
[66] This deference is emphasized by the frequent articulation of the business judgment rule in US corporate law. *See e.g.*, Dodge v. Ford Motor Company, 170 NW 668 (Mich.1919).
[67] *See generally* Shlensky v. Wrigley, 237 NE 2d 776 (Ill. App. 1968).
[68] Yonca Ertimur, *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals*, JOURNAL OF CORPORATE FINANCE, Vol. 16 (June 2009) (showing that the rate at which shareholder majority vote proposals were implemented by boards have increased dramatically—from 16.1% in 1997 to 40% in 2004—and arguing the decision to implement is strongly determined by shareholder pressure).
[69] Strine *supra* note 32, at 12.

pleasing shareholders.[70] This disengagement of stakeholders would be a great disadvantage to any corporation's long-term firm value.

Despite these concerns, the ability of shareholders to have voice and effectuate control should not be understated as a positive. The original fears that shareholder interests were not taken into account by management and firm resources would be used inefficiently and contrary to shareholders' desires, has substantially subsided today. Institutional holders made substantial pushes for shareholder rights and though the causation relationship cannot be fully determined here, their influence on the shareholder rights movement should not be denied. The caution should be on how substantial of an influence institutional investors can have on governance decisions; as with most areas, there is wisdom in moderation—dangerously narrow alignment is likely just as, or more, detrimental than substantial misalignment.[71] In order to preserve the separation of ownership and control, perhaps the growth of shareholder rights and use of shareholder value as a proxy for firm value should not proceed unmitigated.

b. Do institutional holders sufficiently represent the interests of beneficiary owners?

A new agency concern that has emerged along with the prevalence of institutional holders is the tension between these holders and their clients: the beneficial owners of the shares. While there are activist shareholders amongst the institutional holders, i.e. a small percentage of hedge funds, the vast majority of institutional investors are not activist or perhaps, especially proactive in their duties as shareholders. The traditional story articulates that it is more rational for institutional entities to divest their shares of a poorly managed company than to invest their efforts in implementing new value-creation policies for the corporation, even if said changes would be advantageous to the long-term holders.[72] The portfolio manager's desire to generate quick profits for his fund, at the expense of the market, is not similarly aligned to the long-term interests of beneficiary owners. Simply put, the incentive structure that governs these institutions should not encourage the portfolio managers to consider the best interests of the record holders. It is the limited commitment problem and "short-termist" argument again, but it now pits the institutional intermediaries against the beneficial owners as opposed to the board. Intermediary holding institutions have high

[70] Cremers, *supra* note 34.
[71] Commissioner Luis A. Aguilar, Institutional Investors: Power and Responsibility, SEC (Apr. 19, 2013) (acknowledging the great influence and ability to effectuate control institutional holders have and simultaneously recommending that these holders exercise caution in using this power).
[72] Gilson, *supra* note 11.

turnover rates for their equity investments, and in obvious aspects should be considered "traders" rather than "owners" of their investments.[73] As in any agency relationship, institutional holders owe fiduciary duties to vote their shares on behalf of the beneficial owners' interests[74], or at the very least, not in conflict with their interests.[75]

The beneficial owners of these shares are generally ordinary people, who would likely not meet the minimum wealth requirements to invest with hedge funds. These are individuals who are typically using their investments primarily to increase their savings to fund retirement or their children's college education.[76] As these goals are more long-term, they would tend to also need their investments to be sustainable in the long-run. According to Chief Justice Strine and Gilson, this is directly contrary to how the typical mutual fund or pension fund operates. They appear to have short-term investment strategies, and tend to assess quarterly earnings and use stock prices as indications of value.[77] Institutional turnover rates have become increasingly high and different studies posit that mutual funds will not hold the same or similar shares in a portfolio by the next year.[78] When institutional investors participate in corporate governance decisions and vote, they tend to focus on issues such as executive compensation, takeover defenses, and shareholder rights. While these issues may reflect the institutions' interests, they likely do not reflect the interests of the beneficiary owners'.[79] These end-user investors would reasonably care about the ultimate sustainability of their wealth, not quick profits in this year and upheaval in the next. Institutional investors are more concerned with shareholder rights than if their portfolio corporations invest too little in future growth and R&D, if they're too highly leveraged, or if the business strategies are risky. But these issues are of necessary consequence to the end-users—protecting the long-term

[73] Edith Hotchkiss & Deon Strickland, *Does Shareholder Composition Affect Stock Returns?* At 2.
[74] *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1982) (articulating the fiduciary duties owed to ERISA beneficiaries).
[75] Kohn, *supra* note 10.
[76] Strine, *supra* note 57.
[77] Even though share price is volatile and myopic as a measurement of value, it is the dominant instrument used by institutional investors. Maximizing shareholder value through the stock price is criticized as being short-sighted and actually reducing genuine corporate value. See e.g., Steve Denning, *The Seven Deadly Sins of Activist Hedge Funds,* Forbes (Feb. 15, 2015) http://www.forbes.com/sites/stevedenning/2015/02/15/the-seven-deadly-sins-of-activist-hedge-funds/#77b83f074447.
[78] According to Morningstar, the most active mutual funds had portfolio turnover rates that ranged from 215% to 972% and averaged out around 320%. These percentages would equate to holding periods of 24 weeks, 5 weeks, and 16 weeks. DOW PUBLISHING COMPANY, MUTUAL FUND EFFICIENCY AND PERFORMANCE (2007) available at: http://www.dows.com/Publications/Mutual_Fund_Efficiency.pdf; *see also* Simon C. Wong, *Why Stewardship Is Proving Elusive for Institutional Investors,* BUTTERWORTHS JOURNAL OF INTERNATIONAL BANKING AND FINANCIAL LAW, 406 (July/August 2010).
[79] This theory reflects the assumption that beneficial owners would actually engage in governance and have a long-term trajectory, which seem reasonable but are certainly has not been demonstrated irrefutably by empirical evidence.

prospects of firms is the only way to ensure market stability so their investments are still viable in the future.

Because the record holders have a longer-term trajectory in front of them than their investment intermediaries, critics have argued that these intermediary institutions need to consider and genuinely align themselves with protecting those interests for long-term corporate gain.[80] It is especially dangerous given that institutional holders are able to affect control and change at the levels they do. The corporations they influence would thereby also be positioned to advance the institutional views on corporate growth and governance, rather than views held by the beneficiary owners. This separation of ownership from owners here necessarily creates a schism in control and ownership. When the institutional investors and the true owners of corporations have divergent ambitions, it is up to the fiduciary to match their actions to the beneficiary's goals, so there is no stark conflict in interests.

This argument, however thorough, does not seem to present a complete picture—despite having shorter holding periods than in the past, institutional investors do hold onto the same investments for years. Many popular mutual funds have extremely low turnover rates—Vanguard 500 Index Fund (VFINX), which has total net assets of $396.8 billion, has a turnover rate of 3.4%.[81] Although mutual funds and pension funds may be judged on their relative performance and tend towards short-term determinants of value, they, like the beneficiary owners, have equal incentive in the preservation of a strong capital market system. If public corporations begin to fail because of this supposed institutional preference for short-termism, this will necessarily harm the institutions as well as the beneficiary owners. Mutual funds such as Fidelity and Vanguard can only thrive if their investors are satisfied and hopeful in the future. The crux of the conflict seems not to be that institutional holders are all naturally short-termist but that long-term governance interventions are not as advantageous in light of strong exit options.[82] Perhaps it would be of greater value to the beneficiary owners for their intermediaries to partake in more interventions to ensure more optimal, long-term governance approaches.

The recent politicization of pension funds adds an interesting dimension to this intermediary agency problem:[83] should portfolio managers be able to inject their subjective

---

[80] *See e.g.,* Gilson, *supra* note 9; Kohn, *supra* note 10; Strine, *supra* note 32.
[81] *500 Index Fund Investor Shares (VFINX),* Vanguard (Dec. 31, 2015) https://advisors.vanguard.com/VGApp/iip/site/advisor/investments/productoverview?fundId=0040.
[82] Cremers, *supra* note 34.
[83] Daniel Bradley, et al. *The influence of political bias in state pension funds,* JOURNAL OF FINANCIAL ECONOMICS (Jul. 28, 2015) (noting a key difference between mutual funds and pension funds is that in pension

views when selecting investments if 1) the primary goal of fund management is to generate financial returns for the beneficial owners and 2) their views differ from and are thus not representative of the beneficial owners'? Fund managers are expected to maximize profits for their beneficiary owners but when they insert additional concerns about the environment, social utility, or corporate responsibility, and employ these variables in their investment strategies, there is the risk they are diminishing returns for the sake of less quantifiable and more political motivations. The recent 2015 bulletin from the Obama Administration seems to suggest pension funds would not be breaching their fiduciary duties if they were to employ such a selection process,[84] but it can easily be imagined that funds which primarily invest in socially sustainable companies may fail to create satisfactory returns for the beneficial owners—in such an instance, it would be seem that they have failed to adequately represent their clients' interests in this agency relationship. Insiders criticize this practice and contemplate that "pushing politics on retirement funds will destroy returns"[85] and in fact, an empirical study done by Daniel Bradley et al. shows that the political bias fund managers demonstrate has had negative consequences on fund performance.[86] Furthermore, fund managers and beneficial owners are likely to have different opinions on these unsettled, sometimes controversial issues; one can easily imagine blue collar workers having contrary political perspectives on social and environmental issues to an MBA-educated portfolio manager, who may also have different views from the pension's board of trustees. Whose views are the funds supposed to represent? Freely allowing fund managers to integrate their investment strategies with personal political inclinations is challenging and creates a host of new questions that are not easily answered with the current strata of case law.

c. <u>Should activists be treated as controlling shareholders?</u>

Hedge fund activism, whether perceived as value-enhancing or detrimental to the corporate landscape, is a fundamental component of the present ownership and control

---

funds, often the trustees, managers, or officers of pension funds are concurrently politically affiliated in some manner, whereas mutual funds tend to have more financial experts) [hereinafter "Bradley"].

[84] And in fact, pension fund managers may be breaching their duties if they fail to select investments based on these less quantifiable factors. The bulletin explicitly noted that "such issues are not merely collateral considerations or tiebreakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."

[85] Andy Kessler, *Forcing Green Politics on Pension Funds*, WALL ST JOURNAL (Nov. 18, 2015), http://www.wsj.com/articles/forcing-green-politics-on-pension-funds-1447891401.

[86] Bradley, *supra* note 81.

paradigm.[87] Activists publically engage with major Fortune 100 corporations and undoubtedly influence substantially more corporations through private interactions.[88] Even though hedge funds rarely hold a controlling bloc of shares, their power and influence in a given corporation can be equivalent to that of a majority or controlling shareholder.[89] So although they might in quantitative measurements be minority shareholders, in practice and in analysis of their consequence on corporate governance matters, activists are arguably more comparable to controlling shareholders. Their influence and ability to effectuate control did not arise in a vacuum, however, they are only able to exercise control despite lacking the requisite ownership because of their influence on other institutional shareholders.[90]

As discussed above, today's shareholders play a significant role in influencing corporate governance through a wide range of methods: shareholder proposals, private negotiations with the board, campaigns, and proxy contests for board positions. When certain shareholders are able to have this level of dominance in corporate governance affairs, without needing a majority block, this clearly raises implications on the ongoing policy debates surrounding the rights and duties of all shareholders. Their ability to essentially exercise control, without having controlling ownership, has changed the landscape of U.S. corporate law and begs the question if the traditional approach to the fiduciary relationship between shareholders is out of date. If the majority of shareholder interests are homogenous and aligned, then the ability of hedge funds to exercise control is not an issue. But assuming other shareholders, whether institutional or retail, have divergent interests[91] as they most certainly do, then the activists' ability to act as controlling shareholder ought to be reconsidered and potentially limited. By failing to acknowledge the possible fiduciary obligations of minority activists, corporate law is essentially allowing them to act on behalf of their own self-interests and extract private gains at the possible expense of the other shareholders. The heterogeneity of shareholder constituencies should be taken into account—even while institutional holders

---

[87] Lucian Bebchuk, *The Long-Term Effects of Hedge Fund Activism,* Columbia Law Rev., Vol 115.5 (June 2015).
[88] Jason D. Schloetzer, *Activist Hedge Funds, Golden Leash Special Compensation Arrangements, and Advance Notice Bylaws*, THE CONFERENCE BOARD Director Notes DNV7N5 (Dec. 20, 2015) (noting the intense media coverage of activism—22,974 news articles about hedge fund activism were published in 2013 although there were only 200 instances of activist interventions).
[89] In terms of quantitative measure, hedge funds own an extremely insignificant amount of equity shares compared to other institutional investors. Ben W. Heineman, Jr. and Stephen Davis, *Are Institutional Investors Part of the Problem or Part of the Solution?,* The Committee for Economic Development and the Millstein Center at the Yale School of Management, 34 (Oct. 3, 2011).
[90] Serdar Celik and Mats Isaksson, *Institutional investors and ownership engagement*, OECD Journal: Financial Market Trends (2014).
[91] Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REv. 561, 580 (2006).

own approximately 70% of the largest 1000 corporations, retail investors still constitute a substantial subsect of all shareholders and these investors may simply have different investment strategies.[92] If it is taken into consideration that hedge funds often has the power of other institutional holders behind them, then it should be sufficient to say they, as "minority" shareholders, have enough clout to push through their own specific, interested agendas,[93] regardless of the impact it may have on other minority investors.

The fundamental appeal of activists to other shareholders lies in their promise of solving and alleviating the existing corporate deficiencies, whether related to managerial or business strategy. The premise that allows activism to be so successful is rooted in the shareholder belief that boards have somehow failed to maximize shareholder value and intricately tied, is their confidence that activists would be better suited to resolving these issues because they are shareholders themselves. Institutional shareholders similarly value strong shareholder rights and when activists advocate on behalf of better governance or for greater shareholder value maximization, it is reasonable for other shareholders to want to join in. By promoting the further expansion of shareholder rights, activists can really draw in support—but at what cost? Occasionally, by their mere threat of proxy contests and public interventions, the board will acquiesce to their demands.[94] Because of their ability to influence their fellow shareholders and challenge the board, activists introduce a novel problem into the ownership and control relationship. Their share ownership is rarely controlling, but they're able to extract the changes and gains they desire—their capacity to control greatly outweighs their capital risk. Just as the moral hazard issues arose in the Berle and Means generation with directors and management, history repeats itself and the same issues are reborn in a new form. Activists can similarly use mechanisms for control to their advantage, engage in self-dealing and can obtain private gains at the expense of other shareholders or the corporate entity. The courts need to address this and perhaps import fiduciary duties of loyalty onto activist minority shareholders before their influence can

[92] When Carl Icahn initially gained control of a small percentage of Motorola's stock, his hedge fund immediately demanded the company fund a stock buyback by using all of its cash reserves. The activists' devaluation of the future is clearly incompatible with any minority shareholders interested in a more long-term investment horizon.

[93] The caveat being of course, that institutional holders will not always acquiesce to activists. The herd-like behavior is not necessarily a given as demonstrated by the Dupont- Icahn conflict. But the point is not that they are successful a hundred percent of the time, the point is their probability of success is so high that it is a real threat to other independent shareholders.

[94] Last year's instance of activism at General Motors initiated by Harry Wilson and four hedge funds is a prime example—GM settled with the activists and avoided a public debacle. This will be further discussed in the joint section.

become too deleterious towards other shareholders and stakeholders. The current climate of corporate governance is gearing towards a stakeholder revolution,[95] which would not be sustainable under an activist "shareholder primacy at the expense of the corporate entity and stakeholders" heritage.

V. Conclusion

The original reasons why there was a necessary separation of ownership and control still exist today—it clearly enables efficiency, both in terms of business decision making but also investment within capital markets. It assumedly allows the corporation to focus on more than pure profitability and given today's heavy emphasis on social responsibility, this is an imperative advantage. Managerial moral hazard and concerns about board entrenchment, contemporary problems of the Berle-Means era, continue to hound legal scholars today, but to a much lesser extent, mainly due to the evolution of shareholder rights. Even staunch anti-activist advocates can acknowledge this growth as a substantial and necessary addition to U.S. corporate law. But it is significant to also look beyond the rose-colored veneer and see that certain consequences of this structural change, i.e. the rise of activism and board myopia, has had dangerous implications on corporate governance. The effect of shareholders having more influence and voice as a result of the past century's ownership structural changes cannot be said to be only positive. The worry is not so much that shareholders propose ineffective operational or managerial strategies and can lower long-term corporate value, but that everyone buys into the belief that the "indiscriminate expansion of shareholder rights"[96] is the optimal solution to the shareholder-board agency concerns. This in turns facilitates uncurbed activism and creates a host of new problems not easily constrained under this new paradigm. It remains to be seen how the separation of ownership and control can be answered without creating further liabilities for the corporate entity, other stakeholders, and even the board and shareholders themselves. Perhaps if shareholder primacy continues to rise unchecked by their legal experts or corporate insiders, creating substantial costs along the way, regulators and the courts will eventually need to step in. Presently, it seems there is still time for private ordering to resolve this problem without regulatory intervention.

---

[95] The millennial generation of investors strongly advocates for more stakeholder rights and corporate responsibility towards causes beyond profitability.
[96] Cremers, *supra* note 34.

As ownership structure has evolved significantly in the past fifty years, so too must the nation's corporate governance standards. The legal recommendations and solutions that were appropriate decades ago are no longer relevant. This difficult question of control and ownership really comes down to structuring the correct incentives. Despite the evolution of corporate governance in America and the great strides U.S. corporations have made with regards to shareholder rights, there remains no clear answer on how to reconcile this relationship and construct the right incentives so the interests of shareholders, management, and stakeholders can merge. It begs the question: to what extent is this an American problem or a universal story? Perhaps by examining this issue in the context of another corporate law jurisdiction, with different values, history, and players, it will enable the US to see what a sustainable governance solution would look like.

C. German Section

This part of paper is concerned with the structure of the German economy between 1950 and 2016 and its development. For the second half of the 20th century, the German economy was dominated by an enormous nexus of cross-interlocking of investments and a trust-like group of decision-makers. This specific kind of organized capitalism is what scholars called "Deutschland AG (Aktiengesellschaft - Germany Inc.)" to emphasize the close cooperation between different corporations in different economic sectors that let the German economy appear like one giantess corporation.[97] To understand this nexus of close cooperation, this paper will firstly examine the history and the system that resulted in the foundation of "Deutschland AG". Secondly the changes of the economic circumstances and the legal system in Germany during the 1990s will be described before thirdly, the situation today will be presented. The last part will summarize the paper.

I. Development of German corporate ownership

The German economy, after its disastrous breakdown at the end of World War II, grew in the relatively peaceful decades and a period of an ongoing European integration to be today's fourth strongest economy in the world.[98] The German economy herein appears to be characterized by strong continuity, as many companies (or their predecessors) listed in the Deutscher Aktien Index (DAX; German Stock Index) were founded during the 19th century. Among them are well

[97] Ringe, p. 12.
[98] Worldbank GDP.

known, worldwide operating companies like Siemens (1847), Bayer (1863), BASF (1865), Continental (1871), Linde (1879), Daimler (1890), Thyssen/Krupp (1867 Thyssen/1811 Krupp), as well as Commerzbank (1870), Deutsche Bank (1870) and Allianz (1890). With the oldest still existing corporation, Merck which's history can be traced back to the year 1668,[99] that brings the average age of the DAX-listed companies up to 128 years.[100] Throughout those companies' existence, however, the economic circumstances worldwide have changed. A more and more globalized world and the ongoing digital revolution changed the way in which business is done. Besides the changes in corporate ownership, the late 1990s have had a mayor impact. Accompanied by significant changes in the German legislation, German companies experienced a still ongoing internationalization of ownership, while especially German private investors seem to avoid investment in shares. The history and development of what used to be the economic construct of "Deutschland AG", the economic and legislative forces that catalyzed its end as well as the corporate ownership structures in the year 2016 will be the issues dealt with on the following pages.

1. Organized capitalism – principles of "Deutschland AG"

After the end of World War II and the "end" of the Allied control over Germany in 1949, the German economy experienced a time of enormous economic growth today known as the "Wirtschaftswunder" ("economic miracle"). Germany's industry, especially the coal, steel and electricity, was caught in a time of reconstruction and reorganization and in need of financial support. The consequence is what some call a continuity of the economic structure of the German Empire or the Republic of Weimar[101] and the beginning of "Deutschland AG".

a. Banks, companies and politics – founding fathers of "Deutschland AG"?

The foundation of the success of "Deutschland AG" is – in contrast to the Anglo-American liberal capitalism – a form of organized capitalism[102]. Unlike the liberal capitalism, organized capitalism is organized by one or more driving forces. Two examples of this form of capitalism are the French state driven and the German "Rhinish capitalism"[103]. While the French system is based on the regulative power of the central government,[104] the Rhinish capitalism is

[99] ARD/Börse.
[100] Gründerzeit-Unternehmen dominieren, p. 1.
[101] Shonfield, p. 240.
[102] Freye, p. 13.
[103] Höpner/Schäfer, p 5.
[104] Shonfield, p. 71 f.

characterized by a strong cooperation between companies (accompanied by the trade unions), the financial sector and politics.[105]

The general idea behind the concept of "Deutschland AG" has been a system of cooperation and control in opposition to a solely market driven one. Within said system, the financial sector provides financial support for German companies while the capital markets did not play an important role.[106] In a supporting function, legislative and executive powers in Germany provided an assisting legal framework.

The system of close cooperation between those three actors resulted in a common benefit for all three: German financial institutions like Deutsche Bank, but also Commerzbank and – back in the days – Dresdener Bank as well as Allianz grew and joined the ranks of world's biggest financial institutes with a large scale of industrial shares and consequently influence. Additionally, the German tax legislation provided several benefits with regards to institutional investments that will be discussed in the second part of this paper.

Companies benefitted from their "Hausbank", meaning that there are a mere one or two financial institutions providing the financial support for any activity without the need of acquiring money from the financial markets.[107] Additionally, the "Hausbank" has a substantive inside in the company's business which speeds up the process. The trade unions supported the system of "Deutschland AG" as its stakeholder approach supported them in claiming their slice of the pie.

The government provided a legal framework that supported the institutional system of "Deutschland AG". Certain tax reliefs have been implemented as well as rules for corporate governance such as voting caps, multiple-voting shares or proxy voting.[108] By supporting the system, the government benefitted from a certain stabilization of the national economy. As a result, the government prevented dramatic changes in the German ecomony and could be assured of a cooperative work of the leading German corporations which guaranteed a lower unemployment rate and a stable tax income. Although the benefits for the government were less substantive than for companies or banks, a well developing and financed economy is an essential interest for political leaders.

[105] Beyer, p. 118.
[106] Clarke, p. 85:
[107] Frach, p. 60.
[108] Köhler, p. 124.

b. Cross-ownership and the "Festung Deutschland"

One main aspect, which formed the core of the German system, has been cross-participation. In 1996, 60 of the 100 biggest companies in Germany were involved in a system of cross-shareholding.[109] Unlike other systems of cross-participation, the German economy did not consist of several different groups that were isolated from each other, but of one gigantic group. The center of this nexus was formed by financial institutions, mainly Deutsche Bank and Allianz as well as Münchner Rück and Dresdener Bank.[110] At its peak, this nexus of cross-participation contained more than 168 different connections between Germany's 100 biggest companies.[111] But financial institutions did not just base their influence on their own assets, since 1870 they used shares owned by their costumers to exercise their clients' voting rights (proxy voting).[112] These additional voting rights provided the acting financial institutions with a substantive power in the general meeting of shareholders.

Besides the investments from the core (financial institutions) to the edge (industrial companies among others), an outstanding feature of "Deutschland AG" has been the strong connection between the financial institutions in the German financial sector. Over decades, Deutsche Bank and Müchner Rück held shares of Allianz, while Allianz held shares of Deutsche Bank and Münchner Rück.[113]

The term "Festung Deutschland" (Fort Germany) described the way by which German companies, as well as the German market, has been described by foreign investors.[114] The codified regime for corporate groups ("Konzernrecht") and the cooperation as explained above, made it almost impossible for foreign investors to gain control over German companies. A striking example for the way in which "Deutschland AG" defended its members is the attempt of the Italian tire manufacturer Pirelli to acquire the German automotive manufacturing company Continental. In the early 1990s, the fifth biggest tire manufacturer Pirelli attempted a hostile takeover of world's number four, Continental.[115] Although there was a certain appreciation for Pirelli's move in the beginning, in the end a consortium – including several financial and industrial companies – under the leadership of Deutsche Bank and in alliance with the worker's representatives and the State of Lower Saxony's government fought a three year

[109] Hanke, p. 22.
[110] Hanke, p. 22.
[111] Höpner/Krempel 2005, p. 12.
[112] Püttner, p. 15.
[113] Höpner/Krempel 2005, p. 2.
[114] Passarge, p.141.
[115] Baums, p. 2.

battle to protect Continental. Finally, Pirelli had to end its ambitions and sold its shares to the consortium.[116]

Although an institutional investment in Continental was not in the (financial) best interest of the companies aligning to end Pirelli's hostile takeover, but this concept was based on a balance of interests and the protection of the closed German economic system, instead of high dividend. The involved institutions only had a strategic and less of a financial interest.[117]

2. Turning points – the erosion of "Deutschland AG"

While dealing with the reasons for the development of and its end, the question always accrues whether market related or legislative changes have been the major force that drove forward the erosion of "Deutschland AG". The following part of the paper will show, that not one but both aspects came to a cumulative effect that catalyzed the end of "Deutschland AG"

a. Market related changes

The last decade of the 20th century marked the transition to a new era. The end of the cold war, the German reunification and the early beginning of what is called the fourth industrial revolution[118] sped up the ongoing globalization. The breakdown of the Union of Soviet Socialist Republics (USSR) presented capitalism as superior to the form of communism the USSR represented.

The new opportunities of international investments and the growing financial market worldwide led to a dissent about the orientation of German financial institutions. While many established bank managers in the boards of Deutsche Bank or Allianz retired, a new generation of bank managers struggled to move the focus of investments from institutional investments in industrial companies to mergers and acquisitions.[119] To compete in that field and to be acknowledged as a serious service provider, institutional investments in various companies are counter-productive. Being service provider for company A while holding a considerable amount of shares of company B – which company A wants to acquire – easily leads to a conflict of interests. Additionally, a financial institutions customer would bare the risk that information about the takeover plans could be passed on to the corporation it aims for. This reorientation

---

[116] Baums, p. 18.
[117] Streek/Höpner, S. 22.
[118] BmBF.
[119] Streek/Höpner, p. 30.

could be seen shortly after the Pirelli/Continental incident in the case of the attempt of Fried. Krupp AG Hoesch-Krupp to take over Thyssen AG and in the Holzmann crisis.

aa. Thyssen/Krupp

In 1997, Deutsche Bank, among others, supported the Fried. Krupp AG Hoesch-Krupp (five years after Krupp AG succeeded in taking over Hoesch AG in one of the first hostile takeovers in Germany) in their attempt to take over Thyssen AG. While Klaus Breuer from Deutsche Bank explained their efforts as "Inverstmentbanking am Hochreck" ("investmentbanking at the high bar"), the workers representatives fought against the takeover and the state government finally prohibited the takeover.[120] In the end, Thyssen AG and Fried. Krupp AG Hoesch-Krupp negotiated a fusion of both companies that took place November 1997.

bb. The Holzmann crisis

In 1999, Philipp Holzmann AG hoped to restructure its enormous debts. Unlike before, the banks decided that an investment would not be in their best interest. Again politics, led by former chancellor Gerhard Schröder, stepped in accusing the financial sector to favor their own financial benefit instead of the wellbeing of employees and the overall interest of the German economy. Because of the threat to their reputation and the massive public pressure, several financial institutions helped financing the lately futile attempt of reconstruction.

As it can be seen in both cases, the financial institutions more and more dissociated themselves from the principles of "Deutschland AG". While in 1992 the impulse to protect Continental came from the financial institutions, the growing importance of the capital markets and the reorientation of the financial sector led to a point, where a joint action in the interest of the stakeholders and German society could only be forced by a massive threat of the political powers and the syndicates. With one of the three main actors of the system "Deutschland AG" breaking away, the attempt of saving Philipp Holzmann AG can be seen as the last (forced) defense of the "Festung Deutschland".[121]

[120] Hanke, p. 38.
[121] Streek/Höpner, p. 22.

b. Changes in German legislation

The following paragraph will focus on legal regulations that supported the system of "Deutschland AG". Within that analysis, changes in the German legislation made before the end of World War II will not be considered.

aa. German Stock Corporation Act (Aktiengesetz – AktG) [122] and the "Lex Abs"

One of the first attempts of the German legislator has been the limitation of mandates in supervisory boards. The huge voting power of financial institutions (as described above) gave them the opportunity to elect their own representatives into several supervisory boards. Although it is not unusual for institutional investors to be represented in supervisory boards, the network of cross-ownership in the German economic system resulted in a relatively small group having a lot of influence in the leading German companies. A striking example for this concentration of power has been Hermann Josef Abs, former Chief Executive Officer (CEO) of Deutsche Bank. Besides his personal influence on the former German chancellor Konrad Adenauer, Hermann Josef Abs has been elected into 24 different supervisory boards at the same time, serving as president or vice-president in 22 cases.[123] Without judging his capacities, the enormous concentration of power, considering that the companies were among the Germanys biggest, led to a trust like position for Hermann Josef Abs and his colleagues. To limit the influence of the few and to ensure the quality of the work of members of supervisory boards, the German legislator in 1965 codified in § 100 para. 2 sent. 1 n° 1 AtkG[124] that the maximum amount of mandates in supervisory boards is limited to ten. This did not break the influence of the financial sector on the German industry, but it extended the number of involved board members and helped ensure the functionality of supervisory boards.

bb. German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) [125]

The WpHG in §§ 21 ff. regulates the voting right disclosure obligation for shareholders. Since the Transparency Directive Implementation Act[126], this obligation refers to shareholders who own more than 3 per cent of the voting rights in a corporation. They also need to inform the national supervisory authority whenever they reach 5, 10, 15, 20, 25, 30, 50 or 75 per cent of the voting rights. Although shares have always been and should still be an opportunity to invest anonymously (therefore the French stock corporation is still called "société anonyme

[122] In the version of the 22/12/15; BGBl. I 2015, p. 2565.
[123] Zeit, 11/Feb/1994.
[124] BGBl. I 1965 p. 1089.
[125] In the version of the 20/11/15; BGBl. I 2015 p. 2029.
[126] BGBl. I 2007 S. 10.

(SE)"), other investors, as well as the government and the society, have an interest in knowing the block shareholders, as they have a huge influence on corporations that may be essential for the national economy.[127]

cc. German Corporation Tax Act (Körperschaftssteuergesetz – KStG)[128]

The German tax law supported the cross-participation in the German economy for several decades. Investors benefitted from very low standards concerning disclosure obligations of blocks of shares they held and the fact that dividend payouts coming from shareholding blocks higher than 25 per cent were tax free.[129] Once a block over 25 per cent was owned, corporations hesitated to sell them even if there were not very profitable. The main reason for this was the tax of such investments of over 25 per cent.[130] This changed when the German government reorganized the Corporation Tax Act in 2002.[131] The new § 8b para. 2 KStG declared that profits made from sale of shares will not be considered in taxation. This gave financial institutions the opportunity to sell the blocks of shares and reduced the amount of blocks of shares held in German corporations.

dd. Newly implemented institutions

In the progress of reorganizing the German economy, several institutions have been installed to exercise oversight of the German economy: the government commission "German corporate governance codex" and the Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority).

aaa. Government Commission "German Corporate Governance Codex (GCGC)"

The government commission "German Corporate Governance Codex", consisting of government representatives, workers, employers and scientists, was founded in August 2001 to implement the GCGC.[132] Although the character of the GCGC is non-binding, the advice given are very well taken by the German corporations.[133] The legislative projects that were recommended by the commission and have been undertaken by the government will be discussed in the paragraph for the respective law.

[127] Winkler, p. 152.
[128] In the version of the 2/11/15; BGBl. I 2015 p. 1834.
[129] Hanke, p. 29.
[130] Hanke, p. 24.
[131] BGBl. I 2002, p 4144.
[132] Cromme, p. 3 f.
[133] Kommentar DCGK, Vorwort.

bbb. Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin)

The BaFin, founded by the Act Establishing the Federal Financial Supervisory Authority (Finanzdienstleistungsaufsichtsgesetz, FinDAG)[134] in 2002, combines the three former German oversight authorities for insurances, securities trade and credit system under one administration.[135] Today, the BaFin is part of the European System of Financial Supervision ESFS (Europäisches Finanzaufsichtsystem).

ee. Company Control and Transparency Act (Kontroll – und Tranzparenzgesetz KonTraG)

The KonTraG[136] in 1998 is one of the most important changes is the history of German Stock Corporation Law. It has been intended to implement good corporate governance to modernize German stock corporations and to attract new (foreign) investors. The main points for this paper are a new regulation concerning proxy-voting rights, the prohibition of any limitations to voting rights for shareholders and the prohibition of shares with multiple voting rights.

aaa. Proxy voting rights

Proxy voting rights play an important role to guarantee a sufficient amount of voting shares being represented at the annual shareholders' meeting. Especially today, where shareholders are spread throughout the globe, it is often difficult for shareholders to attend the meeting. Furthermore, the proxy voting rights give shareholders the opportunity to stay anonymous if preferred.[137]

The first use of proxy voting rights is dates back into 1870, when banks used the shares in their depos without informing the original shareholder.[138] After the prohibition of such measures in 1884, financial institutions implemented their right to use the voting right in their general terms and conditions.[139] Since 1937, the proxy given to the bank has already been limited to a maximum duration of 15 months.[140] The KonTraG added a prohibition to exercise voting rights in the case where the financial institution owns (directly or indirectly) 5% of the corporation

[134] BGBl. I 2002, p. 1310.
[135] Fischer, p. 110.
[136] BGBl. I 1998, p. 786.
[137] MüKo, Schröer, § 135, Rn. 5 f.
[138] Püttner, p. 15.
[139] Püttner, p. 15.
[140] MüKo, Schröer, § 135, Rn. 7.

and obligation, to inform their customer about alternative ways of representation at the shareholders' meeting.[141]

bbb. The prohibition of limitations to voting rights

Voting rights are codified in § 134 AktG. Before the implementation of KonTraG, corporations had the option to set a certain limit to a shareholders voting rights no matter how many shares he owns. This limitation of voting rights has been one of the core instruments in the system of "Deutschland AG" to ensure the status quo in German corporations and to defend them from "foreign infiltration".[142] Under that regime, a hostile takeover is nearly impossible and (foreign) investors have no chance to expend their influence and control on the corporation. To promote the German economy and to attract new investors, the limitation of voting rights has been prohibited for listed corporations. Because of the strong position of family run businesses, non-listed corporations are excluded from that restriction.[143]

ccc. Shares with multiple voting rights

The rightfulness of shares with multiple voting rights has been discussed since the early 1920s.[144] The shareholder benefits from a higher voting power irrespective of his financial investment.[145]

The emission of new shares with multiple voting rights has been forbidden by law in 1937 except for shares that were emitted with ministerial approval in the case of a "societal interest".[146] The amendment of 1965, although highly discussed, approved this regulation, despite the fact, that the ministerial approval had to be based on a "predominant economical issue".[147] The dispute about shares with multiple voting rights remained, until the German legislator with the KonTraG finally prohibited them.[148] The remaining shares lost their multiple voting rights after a five year transitional period in 2003, if they were not approved by the shareholders' meeting, what never happened.[149]

141 BGBl. I 1998, 786.
142 Müko, Schröer, § 134, Rn.
143 Baums, Die AG 1990, p. 221.
144 MüKo, Heider, § 12, Rn. 40.
145 MüKo, Heider, § 12, Rn. 38.
146 MüKo, Heider, § 12, Rn. 2.
147 MüKo, Heider, § 12, Rn. 2.
148 BGBl. I 1998, p. 786.
149 Kommentar DCGK, Rn. 215.

ff. German Public Transparency and Disclosure Act (Transparenz – und Publizitätsgesetz, TransPubG)[150]

The TransPubG was the second major change in the German legal system with regards to corporate governance. It is mainly based on the work of the government commission "German Corporate Governance Codex.[151] The TransPubG improved the information rights of the supervisory board. The changed § 90 para. 1 AktG states that the management board is obliged to comment on changes to plans presented to the supervisory board in the past. This right to be informed has been implemented to guarantee a certain level of knowledge and understanding for all members of the supervisory board, so that they can effectively supervise the management board's work.[152]

The core provision implemented by TransPubG, however, is the obligation for corporations to state each year which recommendations in the GCGC they follow and in the case where they do not, explain why (§ 161 AktG). As the recommendations of the GCGC are non-binding, the principle of "comply or explain" is used set corporations under a certain pressure. Since these reports need to be published (§ 285 n° 16 and § 325 para. 1 sent. 1 Handelsgesetzbuch (HGB, Comercial Code)[153]) the shareholders (and the general public) are able to read and question the boards decisions.

3. "Deutschland AG" and the 21st century

With the beginning of the 21st century, the structure of German corporate ownership changed. The erosion of "Deutschland AG" and the economic and legal changes discussed above paved the way for a growing influence of foreign investors in Germany. The following part will analyze the growing influence of foreign investors in the DAX (1), the position of family run businesses in Germany's economy (2) and the situation of German private investors (3).

a. Foreign investors and the DAX

Analyzing the ownership structures in Germany, it can be seen that the "Festung Deutschland" has fallen. The DAX[154] has never been more international. At the end of 2014, 59 per cent of the traded shares were hold by investors residing in a foreign country; compared to 45 per cent

[150] BGBl. I 2002, p. 2681.
[151] Kollmann, p. 5.
[152] Hirte, p. 3.
[153] In the version of the 22/12/15; BGBl. I 2015, p. 2565.
[154] In its composition of August 2015; before Vonovia replaced Lanxess.

in 2005[155] and 35.5 per cent in 2001.[156] Within that group, European investors represent the biggest group with 27 per cent, followed by investors from North America with 21 per cent.[157]

When it comes to corporate ownership, the situation concerning foreign investors differs significantly for the different corporations listed in the DAX. In ten corporations (Deutsche Börse, Linde, Infineon, Lanxess, Bayer, Merck, Adidas, Allianz, Daimler and Münchener Rück) foreign investors held more than one third of the tradable shares.[158]. The number of corporations with a German investor's majority has decreased to nine (Fresenius SE, Deutsche Telekom, Deutsche Bank, Fresenius Medical Care, Volkswagen, Continental, Lufthansa, BMW and Henkel).[159]

But not just has the origin of investors in the DAX changed. While the era of "Deutschland AG" was dominated by strategic investments and the principle of controlling, leading and organizing the German economy, the amount of strategic shareholding blocks in DAX corporations has declined. In 2001, the average percentage of the biggest shareholder block was 28.89 per cent (31.10 per cent only considering the 18 corporations that still are DAX-listed).[160] In 13 years, that average has declined to 17.91 per cent (respectively 15.47 per cent).[161] Still, there are three corporations in which the biggest block-shareholder controls more than 50 per cent of the corporation (Merck, Baiersdorf, Volkswagen) and another six with more than 25 per cent (BMW, Continental, Deutsche Telekom, Fresenius Medical Care, Fresenius SE, Henkel). Referring to the important role of financial institution like Deutsche Bank or Allianz, it is interesting to see that among today's block-shareholders there is almost no financial institution. Only in two cases (Deutsche Post and Deutsche Telekom), the major block-shareholder is the Kreditanstalt für Wiederaufbau (KfW), a state-owned bank founded in 1948 to finance the restructuration of Germany (§ 2 Gesetz über die Kreditanstalt für Wiederaufbau, KredAnstWiAG)[162].[163] This shareholding, however, only exists due to the fact that Deutsche Post and Deutsche Telekom have been state owned companies themselves before being privatized.

[155] EY, p. 6.
[156] BpB 25.09.2010.
[157] EY, p. 11.
[158] EY, p. 11.
[159] EY, p. 11.
[160] Ringe, p. 56.
[161] Ringe, p. 56.
[162] BGBl. I 1969, S. 573.
[163] Ringe, p. 55.

b. The strong position of family companies

Family owned companies have always been very important for the world's economy and they still are. According to the Global Family Business Index, published by the University of St. Gallen, the 500 largest family owned businesses generate 6.5 trillion United States Dollar (USD), employ 21 million people and have an average sales volume of 13 billion USD.[164] Germany ranks second as country of origin with 87 registered family owned businesses among the largest 500.[165] According to a definition given by the European Commission (EC), a listed company is a family owned business if the person who established or acquired the firm (share capital) or their families or descendants possess 25 per cent of the decision-making rights mandated by their share capital.[166] Following this definition, Baiersdorf, BMW, Continental, Fresenius Medical Care, Fresenius, Henkel, and Volkswagen are family businesses listed in the DAX. In general, in 12 DAX-listed corporations, the founding families or other family owned corporations represent the biggest block-holder.[167] In the field of strategic long term investments – which equals approximately 20 per cent of the investments in the DAX – families represent 52 per cent of those investments[168].

c. German private investors

With only 8.4 million Germans (13.1%) owning shares, Germans still have a certain aversion concerning investments in the stock exchange market.[169] Although Germans knows about the profit ratio of shares (29 %)[170] and do see shares as long term investment (36 %)[171], they are also of the opinion that investments in shares are risky (44 %)[172] and that they require a profound knowledge 74 %)[173]. The study also differentiates between the answers given by shareholders and non-shareholder and non-surprisingly, the attitude of shareholders towards shares is, but only a bit, more positive than of non-shareholders. The question arises why Germans hesitate to invest in the German stock-listed corporations although their performance worldwide is stable. One reason, surely, is the more conservative way of German investments that is part of the German mentality[174] and their lack of experience concerning investments in the stock

---

[164] Zellweger, p. 1.
[165] Family Business Index.
[166] EC, Family businesses p. 10.
[167] Ringe, p. 56.
[168] DIRK, p. 7.
[169] Aktienanlage ist Kopfsache, p. 7.
[170] Aktienanlage ist Kopfsache, p. 9.
[171] Aktienanlage ist Kopfsache, p.11.
[172] Aktienanlage ist Kopfsache, p. 12.
[173] Aktienanlage ist Kopfsache, p. 14.
[174] DAI Jahresbericht , p. 30.

exchange markets, as mentioned in the study. One significant factor surely still is the experience of German private investors with the shares of "Deutsche Telekom AG". In 1996, one year after its privatization, "Deutsche Telekom AG" shares were traded at the German stock exchange in Frankfurt. The emission has been accompanied by an enormous campaign presenting the shares as "Volksaktie", a share dedicated to the German people instead of institutional shareholders (as happened in previous privatizations like Volkswagen).[175] The success of the campaign triggered a boom in the capital markets and many Germans invested in the former state owned corporation as it has been presented as being sound and solid.[176] In three different emission phases, the price for the "T-Aktie" (T-share; Telekom share) rose and peaked in the year 2000 at 103,50 Euro per share, before it fell enormously.[177] After many investors lost a lot of money and several investigations, the "T-Aktie" and its rise and fall are still in the collective consciousness of many Germans and symbolize their view on how the capital market works.

II. Conclusion

To conclude all the aspects presented so far, one can surely say that, especially in the early days of the reconstruction of the German economy, the idea of "Deutschland AG" and the principles of an organized capitalism helped rebuild and strengthen the Germany economy.

A positive view on "Deutschland AG" would highlight, that the stakeholder approach helped ensure a constant economic growth for a social benefit. The nexus of cross-ownership and the thereby resulting overseen and guided marked competition helped many German corporations to compete internationally and survive, even in times of economic crisis like the 1970s energy crisis. As the financial institutions coordinated the corporations' policies as parts of the supervisory boards, a centralized government-made corporate governance has not been necessary, because the control and supervision has been guaranteed by the "management board of Deutschland AG".

From a more negative point of view, one could argue that the main actors of "Deutschland AG" restored the oligarchic reign of an elite like in the system they grew up with, the monarchial and strictly hierarchic economic system of the German empire. While the allied forces under the lead of the United States tried to break the rule of monopolist corporations like the IG-Farben, the founding fathers of "Deutschland AG" rethought this rule in slightly changed

[175] Munk, p. 8.
[176] Munk, p. 37.
[177] Munk, p. 36.

conditions. Instead of physically recreating corporations like IG-Farben, they created that nexus that provided them with enough control of key corporations to lastly control almost the entire German economy. An ironic aspect of that restoration of hegemonic rule has been the institutional center of that reign. Like the IG-Farben, whose former headquarters are located in Frankfurt and are now part of Goethe University, the new heart of the oligarchic rule used to be the financial district in Frankfurt.

In the end, as often, the truth lies somewhere between both ultimate positions. Surely critics of the “Festung Deutschland” were right, the protective German system hindered the development of free and liberal financial marked. Surely, the German stock market did not play an important role till the end of the 20th century and surely the nexus of cross-participations helped covering the boards’ work and led to a nontransparent system where a few important managers like Hermann Josef Abs, Berthold Beitz or . But one ought not to forget the disastrous situation of the German economy after WWII, when this nexus helped protect the economy and ensured the balance between the interests of corporations, financial institutions and the trade unions. In the end the question how the German economy would have evolved without the protective measures of “Deutschland AG” cannot be answered. Since the German economy was not capital marked focused before the war, a transition from one system to the other would have almost certainly been more problematic than the transition step by step, as happened from 1998 on.

Thinking about what has to come in the upcoming years, the numbers presented concerning the participation of residents in the German stock market is alarming. The survey of the DAI shows that the lack of interest in investments mainly results in a lack of knowledge and experience. Keeping in mind the precarious situation of the social security – especially the pension scheme – the government should take educational measures to raise the activity of citizens. Not only are long-term investments an important aspect in securing a certain wealth for the pensions, the conservative investments in savings, bank books or bonds with their low interest rates, are not adequate to compete with the inflation. Without knowing, monetary assets are wiped out and the Germans miss the opportunity to participate in “their” economy’s success.

To conclude, the changes made have definitely been necessary to materialize the European Single Market. Obviously a closed economy that concentrates on defending the status quo against foreign – including European – investors is incompatible with the idea of a progressing European integration progress. Therefore, the changes of the last two decades do not only guarantee a successful transition into a more capital marked focused economy but have also been important for the European Union. Nevertheless it remains of the utmost importance to keep in mind the core principles of the German social market economy system. Key aspects, such as a certain focus on stakeholder values and the strong position of German trade unions, should be guarded to guarantee social stability. Therefore, the ongoing evolution of the German economy should not be ending in an assimilation with the Anglo-American system, but a newly defined path that combines the best characteristics of both systems.

D. Comparative Part

I. Introduction

In the combined section of the paper, the present state of corporate ownership and control for each country will be shortly summarized and compared. In an attempt to demonstrate the typical structure of share ownership in both countries, two exemplary, model corporations will be compared. The authors selected General Motors and Volkswagen as two analogous automobile manufacturers to analyze and discuss.

II. Current Scope/Status quo

1. US ownership structure

Unlike many other Western and Latin American countries, public companies in the U.S. typically do not have a single controlling shareholder or small group of shareholders with corresponding voting control and equity holdings.[178] Similarly unique to the U.S. is the lack of government ownership of public corporations. While the government has sole-ownership of a number of corporations in the U.S.,[179] it is extremely rare for a corproation to have both private and government ownership of its equity holdings.[180] In the few instances the government did obtain equity ownership of a company, notably after the recession, they were reluctant to do so and promised to sell their stakes as quickly as possible.[181] Americans have a strong aversion to government ownership of private industry and there is criticism levied at both the government and the corporate entity when ownership is in state hands.

Despite the slow growth period following the recession, American citizens and financial funds mostly remain faithful to the capital market system. According to Gallup's annual Economy and Finance survey conducted in April 2015, about 55 percent of Americans are invested in stock market either in the form of individual stocks, stock mutual funds, or a retirement fund. [182] Stock ownership is still at lower levels than it was before the financial crisis with 65 percent of national adults owning stocks in 2007.[183] The largest drop was for those in

---

[178] Ronald J. Gilson, *Controlling shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, Harv. Law Rev. Vol. 119, Issue 6 (Apr. 2006).
[179] Pargendler, *supra* note 9.
[180] Lloyd Musolf, *Uncle Sam's Private, Profitseeking Corporations: Comsat, Fannie Mae, Amtrak, and Conrail* 2(1983).
[181] Simon C. Y. Wong, *Government ownership: why this time is should work*, McKinsey& Company (June 2009) http://www.mckinsey.com/industries/public-sector/our-insights/government-ownership-why-this-time-it-should-work.
[182] *Little Change in Percentage of Americans Who Own Stocks*, GALLUP (Apr. 22, 2015) http://www.gallup.com/poll/182816/little-change-percentage-americans-invested-market.aspx.
[183] *Id*.

the lower middle class, with incomes of $30000-$74,999 from 72 percent in 2007 to 56 percent ownership.[184]

As noted above, the trend from substantial dispersed, retail ownership in the Berle and Means generation has drastically shifted to concentrated institutional ownership today. In 1950, institutional holdings of total outstanding equity was only about 6.1 percent, by 2009 that figure has increased to 50.6 percent, which is actually a slight decrease after a peak of 53.3 percent in 2005.[185] The institutional ownership of the Top 1,000 US corporations—essentially the most efficiently traded stocks—is even more substantial at 73 percent, with institutional ownership peaking at 76.3 percent for the Top 251-500 US companies.[186] Towards the end of 2014, the top fifty largest institutions decreased their equity investments by about $100 billion, only equating to about a 0.9 percent decline overall due to the tremendous size of these investors.[187] Because 80 percent of total institutional ownership is in domestic corporations,[188] most of the sales in 2014 were also likely of US shares. The aggregate concentration of foreign institutional ownership should not be understated—most Western nations, including Japan, have ownership of US equity in at least comparable numbers to their ownership of their own domestic shares, if not more.[189] In fact, the total holdings of Germany's largest institutions constitute a 29.22 percent ownership of German corporations and a 35.54 percent of American corporations.[190]

The U.S. institutions owning the most equity are pension funds (20.7%) and open-end mutual funds (20.4%).[191] Given that these institutions are the primary intermediaries for beneficiaries of 401Ks and other retirement funds, their quantitative dominance and prevalence in the equity markets is understandable. What is interesting about these figures is how numerically insignificant hedge fund ownership; of the 6,000 hedge funds, the ten largest have about $280 billion under management.[192] Compared to the approximate $1.2 trillion controlled separately by the ten largest mutual funds and the ten largest pension funds,[193] the amount of

---

[184] *Id*.
[185] THE CORPORATE BOARD, THE 2010 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION, Table 10 (2010).
[186] *Id.* at Chart 15.
[187] FACTSET, INSTITUTIONAL OWNERSHIP Q2 2014, 4 (Aug. 21, 2014).
[188] *Id*. at 6.
[189] *Id*. at 7-24.
[190] *Id*. at 18.
[191] Arthur H. Kohn and Julie L. Yip-Williams, *The Separation of Ownership from Ownership: Concerns Arising from Institutional Investors as Intermediaries*, THE CONFERENCE BOARD, Table 2 (Nov. 2013).
[192] Ben W. Heineman, Jr. and Stephen Davis, *Are Institutional Investors Part of the Problem or Part of the Solution?,* The Committee for Economic Development and the Millstein Center at the Yale School of Management, 34 (Oct. 3, 2011).
[193] *Id*. at 35-36.

hedge fund ownership seems inconsequential, which makes their often-times successful activism all the more remarkable.

2. German ownership structure

The German economy today is dominated by institutional shareholders. 65 per cent of all shareholders belong to that group. The institutional shareholders are followed by strategic investors (20 per cent) and private individual investors (13 per cent). The remaining 2 per cent remain to brokers or banks.[194]

More than half of all strategic investors (52 per cent) are families or foundations. The German state still holds 18 per cent of those long term investments – mainly in former state owned corporations like Volkswagen, Deutsche Telekom and Deutsche Post – while foreign state funks follow with 9 per cent.

Generally, foreign investors extended their activities in the German economy, especially in the DAX. AS mentioned, at the end of 2014, 59 per cent of the traded DAX-shares were hold by investors residing in a foreign country; compared to 45 per cent in 2005[195] and 35.5 per cent in 2001.[196] The top investor in the DAX is the Norwegian state fund Norges Bank Investment Management, followed by Blackrock. Deutsche Asset & Wealth Management Investment GmbH is the first German investor and ranked seventh.

Although international investors successfully entered the former closed system of the German economy, the characteristic of dominating block shareholder is still existing. From a social but also economical point of view, the number of only 8.4 million Germans (13.1%) owning shares, seems to mark a negative characteristic for the German capital market system. The number even declined in from 2013 to 2014 by 2 per cent. Besides their financial loss because of the inequality of interest rates and the inflation, their potential to contribute to the German financial market remains unused.

With 87 registered family businesses among the largest 500 worldwide, Germany ranks second and continues the successful story of German family businesses that not just play a minor part in Germany's economy but an active and prominent role even in the DAX.[197] This influence is even stronger in the other German indices.

194 DIRK, p. 7.
195 EY, p. 6.
196 BpB 25.09.2010.
197 Family Business Index.

3. Comparative analysis

The global investor profile showed that retail investors globally are generally risk-averse with almost half (45%) of investors preferring low risk/low return assets.[198] This has generally translated to a short-term investing approach. 46% of investors prefer outcomes within 1-2 years and only about 12% preferring longer approaches with payout within 15-20 years.[199] There seems to be some disconnect between all retail investors' expected return and their attitude to risk/investment time horizon. About 42% of North American investors prefer low-risk/low return assets, Europe is even higher at 48.6%.[200] The same post-recessionary risk-aversion seems to apply to institutional investors as well. As their portfolios clearly indicate, institutional holders in the world's largest economies all have placed significant faith in the United States equity markets.[201] Generally considered a safe bet, the US offers to both domestic and global investors, at least in appearance if nothing more, confidence in the market. As indicated by the limited number of retail investors in Germany and the substantial investment in US corporations by German institutions, investor confidence generally is significantly lower than in the US.

Over the past few decades, Germany and the US have both seen the mammoth rise of institutionalism. While certain ownership concerns are unique to Germany—significant ownership by families and the state, general retail aversion to investment—both nations share in a newly developed concentration of ownership that raises questions of control. The same arguments advocating institutional ownership cite better monitoring of management, overall improved corporate performance, and greater shareholder ability to demand value maximization. This theory of institutionalism fails to present a complete picture of the classical problem of corporate governance—a unique set of agency costs presented by a separation of ownership and control necessarily arises here. In Germany, the large share blocks held by a few shareholders, notably family controlled companies, create a worry about minority shareholders that is less obviously relevant in the US picture of ownership.[202] Compared to the US, the regulatory environment creates generally a lower cost of holding larger control blocks. In an effort to protect minority shareholders and other stakeholders, the German system imposes a duty of loyalty on each shareholder towards the corporate entity, stakeholders, and other

---

198 *Global Investor Profile*, SCHRODERS (2015) http://www.schroders.com/globalassets/staticfiles/schroders/sites/americas/us-institutional-2011/pdfs/sgits-full-report-2015.pdf
199 *Id.*
200 *Id.*
201 FACTSET, INSTITUTIONAL OWNERSHIP Q2 2014, 8-24 (Aug. 21, 2014).
202 Daniel Szentkuti, *Minority shareholder protection rules in Germany, France and in the United Kingdom: A comparative overview*, Central European University (Mar. 2007).

shareholders, but is especially applicable to dominant shareholders.[203] One specific application of this general philosophy that the company should serve the interests of all stakeholders is demonstrated by the use of two-tiered boards.[204] Germany has mechanisms in place to protect minority and stakeholder interest that would not be diminished by the presence of a controlling shareholder. This "equal treatment" of all shareholder and stakeholder interests is less observable in the US, but this can primarily be a consequence of the insubstantial number of controlling shareholders in the equity markets. Since various state and federal regulatory burdens make obtaining and holding controlling blocks more costly in comparison[205], there has not really been a tradition of having controlling shareholders in the US nor the consequent equal treatment doctrine to protect against them. In light of concerns about hedge fund activism and the considerable influence they are able to exercise, despite not having controlling blocks, perhaps it is also time for the US to adopt a similar philosophy in which the "controlling" shareholders are pushed to act with equal concern for the corporate entity, other shareholders, and stakeholders.

II. Comparison exemplary corporations

1. Volkswagen AG

Based on the idea to build a car affordable for everyone, the engineer Ferdinand Porsche in 1934 created a prototype. To manufacture this car, the Nazi-government ordered the construction of Europe's biggest car factory. After World War II, the British military command took control over Volkswagen (back then renamed Wolfsburg Motor Works) and in 1949, the military command assigned it to the newly formed state of Lower Saxony under the condition, that they would co-exercise the control with the German federal government and that the trade unions would have a significant role. In 1960, the federal government decided to privatize Volkswagen. The state of Lower Saxony and the federal government each kept 20 per cent of Volkswagen AG while 60 per cent were sold. The government intended to sell the shares as free float to the German people, so that the shares lay with a huge amount of individual investors.[206] In 1988, the federal government sold its last shares and only the state of Lower Saxony remains as governmental representation.

---

[203] Ruster, Bernd, Business Transactions in Germany, Looseleaf, 1983 New York, 23.09 23-123.
[204] Amanda Rinehart et al, *Corporate Governance Practices in Germany and the United States,* Drake Management Review, Vol. 3.1, 7-10 (Oct. 2013).
[205] *See generally* Jeffery Bell, *The Acquisition of Control of a United States Public Company,* Morrison Foerster (2016).
[206] BGBl. I 1960, p. 585.

Today, the ownership of Volkswagen AG is strongly dominated by two families: Porsche and Piëch. The Porsche Holding SE, owned by the successors of Ferdinand Porsche holds 50.73 per cent of the voting rights of Volkswagen AG.[207] The second biggest block investors is the state of Lower Saxony (20 per cent) followed by Qatar Holding LLC with 17 per cent. The remaining 12.27 per cent do not belong to any block holder and remain in free float.

The control mechanisms concerning corporate governance in Volkswagen AG are very unique. As a former public company, the law privatizing Volkswagen (Gesetzes über die Überführung der Anteilsrechte an der Volkswagenwerk Gesellschaft mit beschränkter Haftung in private Hand, VWGmbHÜG)[208] stated several provisions to protect the corporation from hostile takeovers and to maintain the governmental control:

Firstly, § 2 VWGmbHÜG limits the voting rights for all investors to one-fifth. As the German state held and the state of Lower Saxony still holds 20 per cent of the voting rights, no investor can obtain more voting power than the state officials. This limitation is even more important considering the special rules for the shareholders' meeting. Decisions of the shareholders' meeting that would normally need a two-third majority need a four-fifth majority, leading to a blocking minority for the state.

Furthermore, § 4 para. 1 VWGmbHÜG regulates the special right for Germany and Lower Saxony concerning the right to elect representatives to the supervisory board as Germany and Lower Saxony are, as long as they hold any shares, allowed to send two members for the supervisory board, each without approval of the shareholders' meeting.

This provision is even more important in combination with the laws regulating the co-determination in German corporations. According to § 7 para. 1 n° 3 MitbestG (Mitbestimmungsgesetz, Co-Determination Act)[209], the supervisory board in corporations with more than 20000 employees consists of ten representatives of the investors and ten of the workers. Keeping in mind that the government representatives belong to the investors, the shareholders (excluding the government) can only send eight representatives (six if the federal government would hold any shares) of twenty.

[207] Jahresbericht 2014 Volkswagen AG.
[208] In the version of the 04/08/1970, BGBl. I 1970 p. 1149.
[209] In the version of the 24/04/15, BGBl. I 2015 S. 642.

A last protective regulations is stated in § 4 para. 2 VWGmbHÜG. Decisions concerning new facilities or their relocation need to be passed by the supervisory board with a two-third majority. With twenty members, the two-thirds majority is reached if 14 members vote in favor. While this majority is easily reached by the ten workers' representatives and the state officials, the "ordinary" board members need to negotiate.

2. General Motors

The American equivalent of Volkswagen chosen for purposes of comparison is General Motors ("**GM**"), one of America's largest automobile manufacturers. Founded in 1908 by William C. Durant,[210] GM has a long tradition of corporate governance issues, making it an exemplary choice for discussion as it serves to showcase many of the ownership and control concerns discussed throughout this paper.

Today, almost 75% of GM is owned by institutional shareholders.[211] Out of about 1.5 billion shares, approximately 1.15 billion are institutional shares.[212] Vanguard Group and Harris Associates, both institutional holders, together alone own over 10% of all outstanding shares.[213] But its largest shareholder is actually the United Automobile Workers of America ("the UAW"), through a retirement medical trust which owns about 8.7% of GM shares.[214] Given that labor traditionally does not receive any special consideration in the US, the union's large stake in GM certainly add a unique dimension to the auto manufacturer's ownership and control story. But its influence dates back to several decades. In 1936, GM suffered a three-month strike by its workers protesting poor working conditions and was only resolved by negotiation with the UAW.[215] The Union continues to serve as an important bargaining agent for most American autoworkers, and because of its influence, it has steadily advanced the interests of labor in a giant public corporation, which is atypical to many American public corporations where the focus is primarily on shareholder interests. Given the UAW's ownership interest today, this stakeholder has considerable equity leverage and is able to use its influence as a shareholder to benefits its labor interests.

---

[210] *Flint, Michigan*, THE EDITORS OF ENCYCLOPEDIA BRITANNICA, http://www.britannica.com/place/Flint-Michigan?anchor=ref282801 (last visited Feb. 22, 2016).
[211] *General Motors Company Institutional Ownership,* NASDAQ*, available at* http://www.nasdaq.com/symbol/gm/institutional-holdings (last visited Feb. 22, 2016).
[212] *Id.*
[213] *Id.*
[214] *Id.*
[215] *Flint, Michigan*, The Editors of Encyclopedia Britannica, http://www.britannica.com/place/Flint-Michigan?anchor=ref282801 (last visited Feb. 22, 2016).

In recent years, the corporation has undergone significant ownership transition beginning with the federal bailout of General Motors in spring of 2009 after the company faced bankruptcy after suffering a disastrous loss of $69.6 billion in 2007-2008.[216] To salvage both the company and an estimated million jobs, the government loaned GM $5.5 billion and invested another $49.5 billion in the corporation, which equated to a 61% equity stake.[217] From 2009 to 2013, when the government sold its ownership stake, a taskforce appointed by the government oversaw the company's activities. In the aftermath of the investment, the government lost about $11.2 billion of their total investment[218], and GM itself suffered significant reputational damage from having a government overseer.[219] Being labeled "Government Motors," is a stigma the company would not easily recover from.[220] However, proponents of state intervention argue that this picture is incomplete and that the governing task force actually helped to significantly relieve the dire situation at GM.[221] The company turned profits in 2010, and in 2011, its profits were among the highest ever at $7.6 billion.[222] During the Obama Administration's investment period, GM made a series of wise operational decisions—it spun off the less profitable Saab and Saturn brands, consolidated operations and its supply-chain, and began to invest in more energy-efficient cars.[223] But perhaps it was less fiscal concerns and more of the puppeteer strings that were attached to the arrangement that frustrated management; given the typically wide discretion granted boards, public corporations do not have to be concerned with stringent mandates set by their shareholders. However, this deal was conditioned on GM being placed under certain limitations, including a cap on executive compensation.[224] Top management claimed that this control mechanism has severely limited the company from recruiting the best executives and consequently losing talent to better improve the company and generate value. Though considering that their pre-bailout CEO, Rick Wagoner, was extremely well paid and rather aptly helped bring the company to the brink of

---

216 Andrew M. Schocket, *The Federal Government Should Hold On To General Motors*, Ohio State University (Dec. 22, 2012) [hereinafter "Schocket"].

217 This does not include either the government's preferred shares or the loan itself. Eric Beech, *U.S. government says it lost $11.2 billion on GM bailout*, REUTERS (Apr. 30, 2014) http://www.reuters.com/article/us-autos-gm-treasury-idUSBREA3T0MR20140430.

218 *Id*.

219 Bill Vlasic and Annie Lowrey, *U.S. Ends Bailout of G.M., Selling Last Shares of Stock*, NY TIMES (Dec. 9, 2013) http://dealbook.nytimes.com/2013/12/09/u-s-sells-remaining-stake-in-gm/?_r=0 (quoting Mark L. Reuss, the president of GM'S North American division saying "It's been a long, hard road with the label of Government Motors").

220 *Id*.

221 Schocket, *supra* note 27.

222 *Id*.

223 *Id*.

224 *Id*.

bankruptcy, perhaps GM's priorities should not be focused on bringing back higher executive pay.

Shortly after the company completely privatized, GM was plagued by an instance of aggressive shareholder activism in which a group of institutional investors demanded a stock buyback of $8 billion and a seat on the board for Harry Wilson, a former member of the Obama Administration Auto Industry Task Force appointed to oversee GM.[225] The four hedge funds backing Wilson were Appaloosa Management, Taconic Capital Advisors, Hayman Capital Management, and HG Vora Capital management, who together controlled approximately 2.1 percent of GM stock.[226] While it is certainly not unusual for activists to launch proxy contests to elect their own directors, this particular instance of activism was unusual because it was Wilson himself who went to the institutions and offered his ideas in exchange for compensation packages with each fund. Unlike more prominent activist investors, Wilson did not have a substantial stake in the company himself, owning only about 30,000 shares personally, nor was he the head of a major hedge fund. Instead, in a rather entrepreneurial approach to activism, he went out and sought hedge funds to support his ideas—including the $8 billion buyback program and electing himself to a board position.[227] He made a deal with each of the four hedge funds for different levels of compensation if he was successfully elected to serve on the board. For example, his commission with Appaloosa was set at 2% of the upturn on their GM shares, and with Taconic Capital, it was set at 4%. Among other concerns about poor incentives, the golden leashes likely encouraged him to avoid compromise with the company so he could personally profit. The conflict present in any activist shareholder-nominated director is already inherent—the financial compensation plans and side deals certainly only serve to make these relationships more complicated. His contracts, representing four different leashes, with these hedge funds, stipulating different term lengths and demands, would have certainly undermined his ability to act consistently with respect to his fiduciary duties to all shareholders.

In March, GM acquiesced to the buyback and agreed to repurchase $5 billion worth of shares in exchange for Wilson and the institutional funds abandoning their plan to elect Wilson

---

225 Mark Rogers, *GM, Harry Wilson, and the Disturbing Rise of the Golden Leash*, FORBES (Mar. 11, 2015) http://www.forbes.com/sites/forbesleadershipforum/2015/03/11/gm-harry-wilson-and-the-disturbing-rise-of-the-golden-leash/#37158f592083.
226 *General Motors investor seeks board seat, $8 billion stock buyback*, REUTERS (Feb 11, 2015) http://economictimes.indiatimes.com/industry/auto/news/industry/general-motors-investor-seeks-board-seat-8-billion-stock-buyback/articleshow/46197315.cms?curpg=2
227 Ronald Barusch, *Dealpolitik: A New Twist on Shareholder Activism at GM*, WSJ (Feb. 17, 2015) http://blogs.wsj.com/moneybeat/2015/02/17/dealpolitik-a-new-twist-on-shareholder-activism-at-gm/.

to the board.[228] The corporation's desire to avoid a proxy battle was understandable—it would have been extremely costly and ugly for both sides. In the following months, GM purchased back 85 million common shares from its stockholders.[229] At the outset of the GM's announcement, Moody's ratings firm was clear that the buyback would have a negative credit implication on GM.[230] Given the numerous financial and operational difficulties still facing the corporation, its decision to reduce its liquidity position of $25 billion by 20% to fund the repurchase program was a suboptimal decision. That shareholders holding approximately 2% of all shares could affect such drastic change that is potentially detrimental to the corporation epitomizes the influence activists can have, despite not having a comparable ownership stake and risk. This effective separation of economic ownership from control has dangerous implications and these activist arrangements raise serious questions on good corporate governance—perhaps it is time for the either government regulators or the private sector, to reexamine activism and the mechanisms activists would use to exercise control.

<u>3. Comparative analysis</u>

The comparison between General Motors and Volkswagen stands exemplary for the difference in German and US corporations. Although both are not "typical" corporations as they have an outstanding position in the national economy, their similar position in the national but also worldwide economy and the involvement of the national government makes them interesting cases to analyze.

General Motors and Volkswagen both are dominated by institutional shareholders. With 88 per cent, the rate is a bit higher than for General Motors with 75 per cent. The important aspect while comparing both corporations is the number of institutional shareholders. As mentioned Vanguard Group, Harris Associates and the UAW are the biggest block shareholder. Together they own almost 20 per cent of the shares. In comparison with Volkswagen that is somewhere between the Quatar Holding and the state of Lower Saxony. The three biggest (and only) institutional shareholders of Volkswagen together own the 88 per cent while the biggest three of General Motors stay around 20 per cent. This example is also characteristic for

[228] Mark Rogers, GM, Harry Wilson, and the Disturbing Rise of the Golden Leash, FORBES (Mar. 11, 2015) http://www.forbes.com/sites/forbesleadershipforum/2015/03/11/gm-harry-wilson-and-the-disturbing-rise-of-the-golden-leash/#37158f592083.
[229] *Id*.
[230] Matteo Tonello, *Activist Hedge Funds, Golden Leashes, and Advance Notice Bylaws*, The Corporate Board (Jan 7, 2016) https://corpgov.law.harvard.edu/2016/01/07/activist-hedge-funds-golden-leashes-and-advance-notice-bylaws/.

comparing the US and Germany. Although the biggest shareholder blocks in the DAX listed corporations lowered their investments, block-shareholding is still very important in Germany while in the United States blocks over 10 per cent are exceptional.

An interesting and unexpected issue is the ownership of the UAW. Seeing the diversity of shareholders in the United States, their voting block of 8.7 per cent is a serious factor. The German trade unions on the other side do not own shares of Volkswagen, although it was planned from the first years after the war on that the workers of Volkswagen should have a strong position. Generally it is possible for German trade unions to invest in shares but it would not have been appreciated a few years ago. In the DAX and also concerning Volkswagen, the trade unions do not play an important role as investors. This might also be due to the fact that their influence in corporations is guaranteed by the German legal framework.

Another interesting aspect to highlight is the governmental involvement in both corporations. Firstly it is important to state out is the difference in their investments' origin. While the predecessor of the German state was the driving force behind Volkswagen, General Motors has been founded by a private entrepreneur and the US government only got involved because of the crisis at General Motors and the upcoming bankruptcy. Also the maximum influence differs. Only considering Volkswagen after it was handed over by the British military command, the highest amount of shares held by the state of Lower Saxony and the Federal Republic has been 40 per cent. After the US government stepped in during the crisis, the highest amount held have been 61 per cent.

Besides the amount's height, the use of those shares is probably the most interesting aspect in this analysis. The US government shortly after it acquired the shares started to re-privatize the corporation without any intention to guard a certain amount of shares to keep any influence on General Motors. In Germany, only the federal government sold its shares while Lower Saxony guards its shares like its most valuable treasure. In 2007, the German government even risked a confrontation with the EC because it has seen the protective provisions described as violation of the European treaties.

E. Conclusion

The ownership structure of companies is a significant component of any discussion on corporate governance. Despite differences in cultural values, investor confidence in the market, and regulatory schemes, Germany and the US are both presented with the same fundamental problem: how to minimize agency costs necessarily associated with a separation of ownership and control. As ownership structure changes over time, so too does the effect on control and ultimately, corporate performance. The two nations' similar trajectory towards institutionalism may indicate a more enduring and global trend.

In Germany, there is a general concern about the behavior of individual shareholders, and the courts and regulators have implemented instruments to help remedy any potential abuses of power. The protective measures are aimed at correcting the conflicts between individual shareholders and between shareholders and stakeholders. In the US, the primary conflict that has traditionally created anxiety is the relationship between management and shareholders. But the agency concerns have changed in the US as a consequence of the evolution of share ownership. The questions that have been relevant to Germany for years is now demanding notably more attention in the US than ever before. What is the proper function of a company and whose interests should it ultimately serve? How can minority interests be protected in light of an unbalanced control dynamic in the shareholder base, and how should those mechanisms be optimally implemented—by the state or through private ordering? These trends feature in most of the current discussions on corporate governance and despite the noticeable differences found in the comparison between these two nations, the fundamental concerns about ownership and control are universal and not symptomatic of one nation in particular.