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One-Tier vs. Two-Tier Board Structure: A Comparison Between the United States and Germany

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One-Tier vs. Two-Tier Board Structure: A Comparison Between the United States and Germany

Spring Semester 2016

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**Global Research Seminar
Comparative Corporate Governance and
Financial Regulation**

Abstract

The United States and Germany are widely seen as the developed worlds' two preeminent economic superpowers, yet the two countries modes of corporate governance are drastically different. These differences are reflected in corporate board structure, which we analyze below. The "Anglo-American" model of a one-tier board structure is largely a reflection of the neo-liberal norms of shareholder primacy and free market capitalism. The German two-tier model is in many ways a reflection of stakeholder primacy, codetermination and managerialism. Despite substantial differences in size, structure, composition, norms and duties, there has been an increasing convergence in certain board functions, which we analyze in this paper. Our Paper is broken into four parts: (1) an analysis of the American Corporate Board, (2) an analysis of the German Corporate Boards, (3) a comparison of the differences in the two systems and (4) an analysis of the convergence of international corporate governance norms reflected in both systems.

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Table of Content

| | |
|---|------|
| Abstract | - 2 |
| Table of Contents | - 4 |
| Bibliography | - 50 |
| List of Abbreviations and Translations | - 62 |

Table of Contents

| | |
|---|-----------|
| Abstract | 2 |
| I. The American Corporate Board | 6 |
| 1.1 Composition | 6 |
| 1.2 Size | 7 |
| 1.3 Board Demographics | 7 |
| 1.4 Selection & Appointment | 9 |
| 1.5 Compensation | 10 |
| 1.6 General Responsibilities | 10 |
| 1.7 Legal Duties | 11 |
| 1.7.1 State Law and the Preeminence of Delaware Corporate Law | 11 |
| 1.7.2 Duty of Care and the Business Judgment Rule: | 12 |
| 1.7.3 The Duty of Loyalty..... | 14 |
| 1.7.4 The Duty of Good Faith..... | 14 |
| 1.7.5 Federal Duties & The Audit Committee..... | 14 |
| 1.7.6 NYSE Standards..... | 15 |
| 1.8 History of the American Board | 16 |
| 1.8.1 Historical Development of the American Board | 16 |
| 1.8.2 Shareholder Primacy..... | 17 |
| 1.9 Advantages of the Single-Tier Board | 19 |
| 1.10 Disadvantages of a Single-Tier Board | 20 |
| II. The German Corporate Board | 21 |
| 2 Legal Framework in Germany | 22 |
| 3 Germany’s mandatory Two-Tier Board System | 23 |
| 3.1 The Management Board | 23 |
| 3.2 The Supervisory Board | 24 |
| 3.2.1 Appointment, Size & Composition | 24 |
| 3.2.2 Tasks | 25 |
| 3.3 The General Meeting | 26 |
| 4 Historic Development | 27 |
| 4.1 Path Dependency | 27 |
| 4.2 Efficiency | 29 |
| 5 Consequences of a mandatory Two-Tier System | 30 |
| 5.1 Efficient Monitoring through Separation | 30 |
| 5.1.1 Independence | 31 |
| 5.1.2 Information Asymmetry | 32 |
| 5.1.3 Operational Challenges..... | 34 |
| 5.2 Implications specific to Germanys Corporate Law System | 34 |
| 5.2.1 Codetermination | 34 |
| 5.2.2 Ownership Structure | 36 |
| 5.2.3 Influence of the Banking Sector | 37 |
| 5.2.4 Stakeholder Orientation..... | 38 |

| | |
|--|-----------|
| III. The American and German Board Compared and Contrasted..... | 39 |
| 5.1 Board Size..... | 39 |
| 5.2 Board Meetings..... | 42 |
| 5.3 Stakeholder v. Shareholder..... | 42 |
| 5.4 Independence v. Representation | 44 |
| 5.5 Compensation | 46 |
| IV. International Convergence of Board Standards | 49 |
| 5.1 International Convergence in Germany | 49 |
| 5.2 The “1.5” Tier Board in America | 50 |
| V. Conclusion | 51 |

I. The American Corporate Board

1.1 Composition

Corporate boards in the United States are “one-tier” boards³. This one-tier board invests both managerial and supervisory responsibilities in one unified board of directors. This single board is traditionally divided between the (1) Chief Executive Officer (“CEO”) and executives directors, (2) a Chairman or Lead Director (often times the CEO) and (3) Independent Directors.⁴ The CEO or chief executive is now commonly the only executive on the board as a result of the movement towards independent boards and independent board committees. The other executives, such as the CFO, COO or CLO may report directly to the board, but normally are not members of the board. The norm on American boards is for the CEO to serve as the sole representation of the company’s executives. Roughly 50% of boards also have a separate chairman of the board, while the remaining 50% have designated their CEO as both CEO and chairman.⁵ Within the 50% that have two separate offices, the U.S. chairman generally has a wide variety of roles including leading the board meetings and ensuring orderly succession for the CEO. Finally, the remaining board members have largely become independent directors⁶. Willem Calkoen describes independent directors as maintaining two roles: (1) to actively challenge strategy proposed and executed by the officers of the company and (2) to monitor the execution of the business.⁷ In order for a director to be independent, under New York Stock Exchange (herein the “NYSE”) rules they must have “no material relationship with the listed company.”⁸ Case law such as *Oracle Corp* in the Delaware

³ “One-tier” boards will also be referred to interchangeably throughout this paper as “unitary” boards or “single-tier” boards

⁴ Willem J.L Calkoen, *The One-Tier Board in the Changing and Converging World of Corporate Governance* at 187-200 (Kluwer et. al. 2012)

⁵ 2015 Spencer Stuart Board Index, Spencer Stuart (November 2015) at 13

⁶ The rise of the independent director has been meteoric; in 1950 only 20% of directors could be deemed independent, but by 2005 that number was 75% and by 2015 that number was 84% of the Fortune 500. Only roughly 50% of publicly traded companies, however, have a separate CEO and Chairman of the board, but that trend will likely continue to expand as long as shareholders continue to demand separation of the two roles. See Calkoen at 200; *Spencer Stuart* at 12; See Generally Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 *Stan. L. R.* 1467 (2007) (chronicling the rise of independent directors in Corporate America) (We discuss the rise of independent directors more in depth in *Part III* of this paper)

⁷ See *Calkoen* at 200

⁸ NYSE 303A.02

Court of Chancery has furthered heightened the standard of who is independent.⁹ The independent director must also have time for the job, a wide array of knowledge and experience, and should not have too many other board positions. Most executives are limited to no more than three other directorships.¹⁰

1.2 Size

The boards of most listed companies have between eight and twelve board members, with the average board size on the S&P 500 being 10.8¹¹ members. The general consensus amongst both academics and practitioners is that “[b]oards need to be large enough to accommodate the necessary skill sets and competences, but still be small enough to promote cohesion, flexibility and effective participation.”¹² The venerable corporate lawyer Martin Lipton has argued that “a smaller board will be most likely to allow directors to get to know each other well, to have more effective discussions with all directors contributing, and to reach a true consensus from their deliberations.”¹³ Lipton & Lorsch have argued that this ideal size should be no more than ten directors (while favoring eight or nine).¹⁴ American shareholders and management seem to generally agree with Lipton, as American boards are much smaller than their German counterparts.¹⁵ The expanding importance of specialized knowledge on committees, however, may require increasingly larger American boards, which we discuss in *Part IV*.

1.3 Board Demographics

Spencer Stuarts’ 2015 Board index highlights the current demographics of Corporate America. First, within the S&P 500 listed companies, almost half of boards

⁹ *In re Oracle Corp. Derivative Litig.*, 2003 WL 21396449 (Del. Ch. June 17, 2003) (finding that a directors’ independence can be compromised by personal relationships such as school ties)

¹⁰ See Generally ISS, *Director Overboarding (US)* available at:

<https://www.issgovernance.com/file/policy/us-overboarding.pdf>; General Motors Corporation, *Governance and Corporate Responsibility Committee Charter* (December 2015) available at:

https://www.gm.com/content/dam/gm/en_us/english/Group4/InvestorsPDFDocuments/GCRC.pdf; 2015 Spencer Stuart Board Index, Spencer Stuart (November 2015) at 13

¹¹ 2015 Spencer Stuart Board Index, Spencer Stuart (November 2015)

¹² See *Spencer Stuart* at 10

¹³ Lipton, Martin, and J. W. Lorsch *A Modest Proposal for Improved Corporate Governance*, *Business Lawyer* 48, no. 1 at 2 (November 1992)

¹⁴ *id.*

¹⁵ We discuss this point in detail in *Part III* of the paper

have split the role between CEO and chairman.¹⁶ Over half (53%) of new independent directors are senior executives and professionals.¹⁷ 38% of directors are either current or former CEO's, chairmen, presidents or COO's, 34% are other corporate executives, 23% come from the financial sector, 9% come from academia, 4% are consultants, 2% are lawyers, and 9% come from other fields. Gender diversity on boards is increasing, as 31% of new directors on boards are female.¹⁸ Boards are also increasingly demanding greater female representation, as being a female was the second most wanted attribute in a new director after being an active CEO/COO.¹⁹ The boards are also overwhelmingly older, with the average age of independent directors being 63.1 years and only 15% of boards having an average age of 59 years or younger.²⁰ Minorities are increasingly prominent on boards, as 18% of new independent directors hired in 2015 were minorities (up from 12% in 2014).²¹

Independent director representation has skyrocketed, with 84% of all S&P 500 boards being comprised of independent directors.²² The average board is comprised of 9.1 independent directors and 1.7 non-independent directors.²³ The increasing prominence of major institutional and activist investors is also reflected in board elections, as 92% of directors stand for election on an annual basis, rising from 51% in 2005.²⁴ Shareholder input is also increasingly reflected in the rise of mandatory retirement ages for directors (73%).²⁵ 29% of boards also now have truly independent chairs, compared with 9% in 2005.²⁶

Board composition also reflects the rising prominence of committees. In the S&P 500, every Board had the three NYSE Committees: (1) compensation/HR, (2) audit and (3) nominating/governance. 71% of boards have more than just the three NYSE

¹⁶ See *Spencer Stuart* at 12

¹⁷ *Id.* at 15-17

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*; See Also PWC, *PWC's 2015 Annual Corporate Directors Survey* available at:

<http://www.pwc.com/us/en/corporate-governance/annual-corporate-directors-survey/downloads.html>

²² *Id.* at 8-23

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

mandated boards, and 35% have five or more.²⁷ The most prominent non-NYSE mandated committees in descending order are: the executive committee (34%), the finance committee (31%), the risk committee (12%) and the public policy/ social & corporate responsibility committee (10%).²⁸ Cyber-security has also risen in prominence, with 69% of survey respondents assigning cyber-security to an existing committee.²⁹

1.4 Selection & Appointment

Under Delaware law, which we use as a proxy for state corporate law for reasons discussed below, the shareholders elect directors.³⁰ The “most important shareholder power is the right to elect directors, generally at annual meetings.”³¹ Currently, only individuals nominated by the company for the board of directors are included in the company’s proxy statement and card. Shareholders may nominate their own members of the board, but generally do not do so because of the substantial expense involved in soliciting proxies.³² The “vast majority of director elections are uncontested”, and many have argued that “incumbents do not currently face any meaningful risks of being replaced via the ballot box.”³³ Currently, the majority of public firms in the United States have plurality voting rules that favor management nominees and incumbents.³⁴

David Larcker has described the six-step process that management undergoes to select new directors as entailing: (1) identifying the needs of the company, (2) identifying gaps in director capabilities, (3) identifying potential candidates either through director networks or with a professional recruiter, (4) ranking candidates in order of preference, (5) meeting with candidates and offering the job and (6) putting each candidate up for a

²⁷ *Id.*

²⁸ *Id.* at 25

²⁹ *Id.* at 25-29 (many interviewed directors discussed the possibility of a new cyber-security committee being created in the future).

³⁰ See §211 of the DGCL (outlining the shareholders right to elect Directors under Delaware General Corporate Law)

³¹ See John W. White & Marc S. Rosenberg, *The International Comparative Legal Guide to: Corporate Governance 2010*, Chapter 25 (2010)

³² Activist investors are an important caveat to this rule, but we will not address the role of activist investors in this paper because it is of limited importance to this topic.

³³ See White & Rosenberg

³⁴ Cai, Jie, Jacqueline L. Garner, and Ralph A. Walkling, *Electing directors*, *J. Fin.*, 64.5 2389, 2390 (2009) (describing the nomination and election process of directors).

shareholder vote.³⁵ Directors are screened, ranked, and then placed in order before they are put before a shareholder vote.³⁶

Increasingly, major shareholders have begun to play larger roles in helping to select boards of directors, as well as shape the rules of director elections. Activist shareholders, along with ISS, have focused particularly on adopting majority voting for director elections. As institutional shareholders increase their power and input relative to management, they will likely begin to have an even greater say in director elections.

1.5 Compensation

Director compensation on American boards is largely determined by firm size. Director compensation in large-cap corporate America has continued to grow, with average compensation for an S&P 500 director rising to \$277,235 in 2015, which has more than doubled in the past 10 years.³⁷ Cash payments represent only 38% of total compensation, which has consistently declined as a percentage of overall compensation over the last 10 years.³⁸ Stock awards, options and other compensation linked to company performance has risen to 59% of total compensation for directors, while 90% of boards have share ownership guidelines for directors that are meant to align director compensation with shareholder interest.³⁹ Compensation for directors in companies with market capitalization of less than \$1 billion averages \$125,260 while Mid-Cap director compensation (those companies with market capitalization of \$1 billion to \$5 billion) was \$182,500.⁴⁰

1.6 General Responsibilities

The board is often described as having two broad mandates: the mandate to advise and the mandate to oversee.⁴¹ These mandates are also shaped by certain legal duties, outlined below in the discussion of legal duties. The structure and internal division of responsibilities of a board will vary by company and industry, but the board still has a

³⁵ David F. Larcker, *Board of Directors: Duties & Liabilities*, Corporate Governance Research Program Stanford Graduate School of Business at 3 (2011)

³⁶ *Id.*

³⁷ See Spencer Stuart at 30-32

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ PWC at 4

⁴¹ See Larcker

series of basic responsibilities shaped by these two broad mandates. Mike Boland has outlined six general responsibilities falling under these two broad mandates: (1) recruit, supervise, retain, evaluate and compensate the managers, (2) provide direction for the organization, (3) establish a policy based governance system, (4) govern the organization and the relationship with the CEO, (5) uphold the fiduciary duty to protect the organization's assets and member's investment, and (6) the monitor and control function.⁴² Mace has more simply stated that "directors serve as a source of advice and counsel, serve as some sort of discipline, and act in crisis situations."⁴³ This disciplinary function has evolved over the past 30 years to the point that boards have become "less passive" and have moved from being a "managerial rubber stamps to active and independent monitors."⁴⁴ Three of these responsibilities are now mandated to have their own committee under the NYSE rules, which require a compensation/HR committee, an audit committee and a nominating/governance committee.⁴⁵

1.7 Legal Duties

1.7.1 State Law and the Preeminence of Delaware Corporate Law

In the United States, corporate law is state law. I will be analyzing the legal duties of directors using Delaware state corporate law, which serves as an effective proxy of American state corporate law.⁴⁶

In Delaware, the rules governing the directors of a corporation are a combination of common law and statutory law. The Delaware General Corporation Law (Herein referred to as the "DCGL") is the statutory law that governs the directors of a corporation. The Delaware state courts, and in particular the Court of Chancery, have created the common law that governs Delaware directors.

⁴² Mike Boland, *The Role of the Board of Directors*, AG Decision Maker Iowa St. (September 2009)

⁴³ Myles L. Mace, *The President and the Board of Directors*, Harvard Business Review (March 1972)

⁴⁴ See Adams, Renee, Benjamin E. Hermalin and Michael S. Weisbach, *The Role of the Board of Directors in Corporate Governance: A Conceptual Framework and Survey* at 7 (November 2008) (National Bureau of Economic Research working paper 14486); See also Gordon at fn. 5.

⁴⁵ NYSE 303A.04; NYSE 303A.05; NYSE 303A.06; NYSE 303A.07 (NYSE provisions on required committee's for listed companies)

⁴⁶ See Lewis S. Black, Jr. *Why Corporations Choose Delaware*, Delaware Department of State Division of Corporations(2007) (highlighting the pre-eminence of Delaware General Corporation Law in American corporate law).

In Delaware, the director of a corporation has a fiduciary duty to the shareholders. Delaware law has outlined three major roles of a director created by their fiduciary duties to shareholders: (1) “Big Picture” Decision Making, (2) Delegation and (3) Oversight. These three roles are the direct result of the “Triad” of Fiduciary Duties created by Delaware statutory and common law. The “Triad” of Fiduciary Duties owed by directors are: the duties of due care, good faith and loyalty, each of which I will address separately.⁴⁷

1.7.2 Duty of Care and the Business Judgment Rule:

The first fiduciary duty of a director is the duty of care. The duty of care requires that, when managing a corporation’s affairs, the director (1) act in good faith, (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and (3) in a manner the director reasonably believes to be in the best interests of the corporation.⁴⁸ In order to satisfy this duty of care, a director must meet certain basic criteria, namely: they must have reasonable knowledge of the company’s business, act on an informed, good-faith basis, obtain credible information on each issue, adequately deliberate the relevant issues, and understand the consequences that will flow from each decision before making the decision.⁴⁹ It is crucial for a director to exercise “substantive due care”, because they are then eligible for the strong shield of the business judgment rule to protect the board members from liability.⁵⁰

The business judgment rule is a presumption that if business decisions made by the board are made by: (1) disinterested, independent directors; (2) with informed due care; and (3) with a good faith belief that the decision will serve the corporations best interest, the courts will not second guess a decision made by the board.⁵¹ In Delaware, and crucial to the directors “Big Picture” decision making and oversight:

⁴⁷ See Generally Ira M. Millstein, Jolly J. Gregory & Ashley R. Altschuler, *Fiduciary Duties Under U.S. Law* (unpublished working paper with the American Bar Associations International Developments Sub-Committee on Corporate Governance) (2014)

⁴⁸ See Dennis J. Block, Nancy E. Barton & Stephen A. Radin, *The Business Judgment Rule: fiduciary duties of corporate directors*, Aspen Law & Business 2002

⁴⁹ *Id.*

⁵⁰ See Generally Block et. al.

⁵¹ See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (describing the business judgment rule)

“ [The courts] do not measure, weigh or quantify directors’ judgments. [They] do not even decide if they are reasonable in this context. Due care in the decisionmaking context is process due care only.”⁵²

Directors in Delaware are protected from liability for unwise or poor business decisions. Directors may, however, be held liable for a breach of duty of care when they fail to perform their duties responsibly, in good faith, and in a reasonably prudent manner.⁵³ Delaware statute has authorized shareholders to adopt a provision in the certificate of incorporation that eliminates or limits the “personal liability of a director to the corporation or its stockholders for breach of fiduciary duty as a director,” but not for a breach of other duties.⁵⁴ This duty of care has created a requirement that directors approve a company’s significant business plans and extraordinary actions.⁵⁵ Some examples of extraordinary actions include: business combinations, the retirement or creation of debt or equity, entry into new lines of business and significant acquisitions of stock.

While fulfilling their duty of care, directors are empowered to delegate board functions to committees, corporate offices and independent advisors. Under the DGCL, the board may rely in good faith on officers, employees, committees of the board of directors or competent outside advisors, as long as due care is exercised during selection.⁵⁶ A director may not, however, delegate a task that would strip them of their capabilities to use their judgment on management matters, or on matters that must be performed by the Board in a statute, the by-laws or the articles of incorporation.⁵⁷

⁵² *Brehm v. Eisner*, 746 A.2d at 259 (Del. 2000)

⁵³ *Smith v. Van Gorkom*, 488 A.2d 858, 880 (Del. 1985) (outlining the standard for a directors duty of care) (note that in response to the decision, the legislature enacted §102(b)(7) of the DGCL that allows a corporation to enact provision “eliminating or limiting the personal liability of a director” for a breach of their Duty of Care).

⁵⁴ §102(b)(7)

⁵⁵ *Millstein* at 9-13

⁵⁶ §141(e)

⁵⁷ *Millstein* at 9-13; see also *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003).

1.7.3 The Duty of Loyalty

The duty of loyalty for a director mandates that “the best interest of the corporation and its shareholders take precedence over any other interest possessed by a director.”⁵⁸ A director may not engage in self-dealing, misappropriate corporate opportunities or assets, have conflicts of interest, or otherwise profit in an action that is not substantively or “entirely” fair. Unlike for a breach of duty of care, a director’s personal liability for breaches of duty of loyalty may not be limited by a corporate charter or by-law provision.⁵⁹

1.7.4 The Duty of Good Faith

A director has a duty to act in good faith. According to Chief Justice Veasey of the Delaware Supreme Court, good faith “requires an honesty of purpose and eschews a disingenuous mindset of seeming to act for the corporation good, but not caring for the well being of the constituents the fiduciary.”⁶⁰ Traditionally, this duty of “good faith” has been linked to the duty of loyalty, but according to some scholars it may be “considered to be an additional duty” to the duty of loyalty.⁶¹

1.7.5 Federal Duties & The Audit Committee

Following the Enron scandal and the passage of Sarbanes-Oxley (herein called “SOX”) by Congress, some scholars such as Lisa Fairfax have argued that directors’ fiduciary duties are becoming increasingly “federalized”, as Congress has begun to encroach on the traditional role played by the state legislatures in outlining the fiduciary duties of corporate directors. In particular, SOX enhances the monitoring role of directors by “making directors who serve on the audit committee of a corporation responsible for

⁵⁸ See *Stone v. Ritter*, No. CIV.A. 1570-N, 2006 WL 302558 (Del. Ch. Jan. 26, 2006) (outlining the Duty of Loyalty)

⁵⁹ §102(b)(7) (explicitly not allowing a corporation to shield a director “for any breach of the director's duty of loyalty”)

⁶⁰ See E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 Wash. U. J.L. & Pol'y at 9-19 (2003).

⁶¹ *Id.*

closely overseeing auditors' work as well as any disagreements related to that work.”⁶² Key provisions of SOX which federalize director duties include Section 301 requiring an independent audit committee, Section 302 which “implicate[s] the directors' duty to keep abreast of corporate financial affairs” by creating an obligation for the CEO & CFO to oversee the audit committee, Section 305 expanding the SEC's power to bar and penalize directors, Section 306 limiting the ability of directors to trade in company securities, and Section 404 which expands board liability for the annual report. SOX “not only federalizes [some] corporate fiduciary duties, but also adds substance to them.”⁶³

This encroachment by the federal government into a territory that is normally the sole purview of the states could potentially shift power away from directors and to shareholders.⁶⁴ Payne described the original heightening of director standards in the 1960's as a “movement toward an ever increasing moral delicacy and sophistication in the recondite area of the legal regulation of the American corporation” leading to a scenario where “the deliberate forces of justice and morality seem to be tightening the screws on corporate law” and burdening directors with new obligations. This shift, seen over the past twenty years in the usurpment of power from both boards and state governments by the federal government is arguably just a new development in this continuing trend.⁶⁵

1.7.6 NYSE Standards

The NYSE worked in tandem with the SEC to further heighten the duties placed upon the directors of listing members with rule changes in 2002 that required a majority of independent directors, narrowed the definition of independent directors, and created independent corporate governance & compensation committees.⁶⁶ The NASDAQ also

⁶² See Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 Hous. L. Rev. 393,500 (2005)

⁶³ See Fairfax at 401-406

⁶⁴ See Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 Conn. L. Rev. 1125, 1144 (2003) (arguing that SOX could lead to a power shift from directors to shareholders)

⁶⁵ See Bayne, David C. *A Philosophy of Corporate Control*, U. PA. L. Rev. 112.1 at 5 (1963)

⁶⁶ See Morrison & Foerster, *Client Alert: NYSE Adopts Changes to its Corporate Governance and Listing Standards* (August 2002) available at: <http://www.mofo.com/resources/publications/2002/08/nyse-adopts-changes-to-its-corporate-governance> (describing the rules changes implemented by the SEC, NASDAQ &

passed similar rules that heightened board standards and created two new required committees.⁶⁷ The exchanges should be considered a fourth key actor, along with the shareholders, the state government and the federal government in creating and enforcing governance standards on directors.

1.8 History of the American Board

1.8.1 Historical Development of the American Board

The board of directors in the United States has risen as a response to what Berle & Means described in their seminal study as “the separation of ownership and control” in the American corporation.⁶⁸ Because of the historically dispersed ownership of capital in America, there have been collective action problems for shareholders to monitor corporate management.⁶⁹ The board in the American context can be thought of representing the widely dispersed shareholder by solving the “practical difficulty of shareholders monitoring” management on their behalf. This board in its modern existence is best viewed as “an independent, rather than a representative, body”⁷⁰ of shareholders, but this independence should work towards the aid of shareholders. Although there is significant conflict in the literature regarding the purpose for the existence of the unitary board, one conclusion that can be drawn is that the American board exists in its current structure largely out of cultural inheritance and path dependency.

“The norm that the ultimate power over corporate management resides in an elected board has always existed in the American corporate statutes.”⁷¹ Although New York State was the first American state to codify the election of directors to control the management of a corporation, this legislation was merely a reflection of accepted corporate practice dating back to English colonization of North America.⁷² This Anglo-American historical precedent has played an enormous role in shaping the American

NYSE); *See Also Calkoen* for a narrative history of the SEC, NYSE & NASDAQ’s efforts to implement these rule changes.

⁶⁷ *Id.*

⁶⁸ *See* Adolph A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (1932)

⁶⁹ *id.* (dispersed ownership stands in contrast with other nations whose capital markets are dominated by large, controlling blockholders more able to effectively monitor corporate management)

⁷⁰ Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 Hofstra L. Rev. at 16 (2004-2005)

⁷¹ *Id.* at 10

⁷² *Id.*

board structure. For example, the Charter of the Bank of the United States was directly modeled on the Bank of England's provision calling for an elected board of directors to manage the corporation.⁷³ The first Bank of the United States' charter, however, was unique in having the board of directors elect the equivalent of the CEO.⁷⁴ This charter would serve as a model charter for future corporate charters, with its single-tier structure and re-enforcement of emerging norms favoring shareholder primacy.

1.8.2 Shareholder Primacy

Unlike in Germany and other continental European countries that seek to give major roles on the board to stakeholders, the model of shareholder primacy is uniquely Anglo-American in tradition and has only been further entrenched in the late 20th and early 21st century by the Anglo-American norms of free market capitalism.

American notions of shareholder primacy are unique and play an important role in American board structure. Virginia Harper Ho outlines the ideology of shareholder primacy, stating "it is most often equated simply with the view that the purpose of the corporation is to maximize shareholder wealth."⁷⁵ The corporate norm of shareholder primacy has been subject to long and contentious debate. According to D. Gordon Smith, during the early history of the republic "corporate charters and incorporation statutes often identified a public interest associated with incorporation...suggest[ing] that the corporations were operated on some basis other than shareholder primacy."⁷⁶ Case law did not begin to reflect notions of shareholder primacy until the 1830's, when cases such as *Gray v. Portland Bank* began to hold that "the corporation could not act except for the benefit of existing shareholders."⁷⁷ The notion of shareholder primacy became fully engrained in the American corporate lexicon by early 20th century, although there were important caveats to the norm. In particular, during the 1950's and 1960's at the height of corporate managerialism, Jeffrey Gordon argues that boards would functionally value

⁷³ *Id.* at 16-18

⁷⁴ *Id.*

⁷⁵ Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance beyond the Shareholder-Stakeholder Divide*, 36 J. Corp. L. at 73 (2010-2011).

⁷⁶ D. Gordon Smith, *Shareholder Primacy Norm, The*, 23 J. Corp. L. at 296 (1997-1998).

⁷⁷ *Id.* at 74

stakeholder interests in management practices.⁷⁸ Despite these caveats, the state legislatures never took action like in Germany to require direct representation of important stakeholder interests such as employees, or allow the involvement of the government, creditors and others. Instead, stakeholder interests were and remain governed by legislation and contract law, not board representation. Since at least the 1980's, the American norm has been that the corporation should "have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."⁷⁹

Adolfe Berle and Merrick Dodd's classic normative debate in the Harvard Law Review over the role of shareholders versus stakeholders in the 1930's was illustrative of the challenges to the ultimately triumphant consensus of shareholder primacy in American corporate law.⁸⁰ Berle understood corporate power conceded to management as "intended to be used only on behalf of all" shareholders and that actions by corporate management "intended to be greatedened for the purpose of benefiting one set of participants as against another.... [w]ould be to violate every intendment of the whole corporate situation."⁸¹ Berle's conception of corporate law as a "variant of trust law" conceptualized corporate managers owing fiduciaries duties to the shareholder beneficiaries,⁸² and is in many ways reflective of the modern DGCL.

Dodd instead argued from a normative perspective, viewing the duties of corporate managers as wider than that to shareholders.⁸³ Berle may have described the corporate entity as how it existed, but in Dodd's mind "it [was] undesirable, even with the laudable purpose of giving stockholders much-needed protection against self-seeking managers, to give increased emphasis at the present time to the view that the business corporations exist for the sole purpose of making profits for their stockholders."⁸⁴ Dodd instead expressed the need to focus on worker protection and representation, as well as

⁷⁸ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 Stan. L. R. 1467 (2007).

⁷⁹ ALI Principles Of Corporate Governance: Analysis And Recommendations § 2.01 (1994)

⁸⁰ See Generally Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. Corp. L. 637, 674 (2005-2006) (describing the "classic debate" between Merrick Dodd and Adolfe Berle)

⁸¹ A. A. Jr. Berle, *Corporate Powers As Powers in Trust*, 44 Harv. L. Rev. at 1063 (1930-1931)

⁸² *Id.*

⁸³ E. Merrick Jr. Dodd, *For Whom are Corporate Managers Trustees*, 45 Harv. L. Rev. at 1164 (1932)

⁸⁴ *Id.*

public policy and the public good. There has been intensive debate over which side is correct, but it is clear that in the United States Berle's notion of shareholder primacy over stakeholders has reigned supreme, and this principle is reflected in American board structure. As will be discussed later in this paper, Germany has been more sympathetic to Dodd's view, favoring stakeholder interest and representation on the two-tiered board. During the late 19th century when Germany implemented a two-tiered board, it "was the legislators intention to protect both shareholders and the public interest", and this view still maintains prominence in the German board structure.⁸⁵

1.9 Advantages of the Single-Tier Board

The advantages of the single-tier board versus the two-tiered board can be categorized as: (1) having a superior flow of information, (2) faster decision making and (3) better understanding and involvement in the business by the board.⁸⁶

A single-tier boards' superior flow of information comes from its' structure and size. Unlike a two-tiered board, a single-tier board has a greater number of meetings where every member of the board is present. The board, which also houses the various committees, imports a wide array of knowledge on both the manager and the monitor (because all board members must be both in the US)⁸⁷. By housing both the CEO and the independent monitors, the board also has constant contact with the executives of the company, which can promote individual relationships, better understanding of the business and a greater prominence of the supervisory function of the board in management decision making. As Jungmann has argued, because "the non-executive directors are involved in the decision-making process, they have more incentives to supply themselves with all relevant information, since they cannot argue afterwards that they were limited to an ex post control of decisions made by other persons."⁸⁸

The single-tier board is also structured to make faster decisions. Because the management and supervisory board are combined, there is no need for separate approval

⁸⁵ Carsten E. Jungmann, *The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems – Evidence from the UK and Germany*, Eur. Company Fin. L. R., Vol. 3. at 64 (2006); *Smith* at 16.

⁸⁶ *Jungman* 60-64

⁸⁷ *Id.*

⁸⁸ *Id.*

of decisions. Perhaps most importantly, formal board meetings take place more regularly allowing more responsive decisionmaking.

Finally, the combination of more frequent meetings and the unity of the management and supervisory board allows more integration into the business strategy and decision making between the directors and management. When the CEO is on the board and there is a diverse array of business backgrounds on the board (as previously discussed the vast majority of all board members are corporate executives, financial executives, lawyers, accountants and consultants), there is a higher likelihood of understanding the intricacies of each business decision.⁸⁹ This skill set also allows independent directors to be better placed to challenge any potential problems in strategy proposed by management. Better familiarity with the business may help the board make better decisions.

1.10 Disadvantages of a Single-Tier Board

The primary disadvantage of the Single-Tier board is that it has to simultaneously make and monitor the same decision. Mere independence may not be enough to make a board member neutral, in particular when the board is small, there are substantial personal relationships with the board members, and compensation of the board member is directly tied to company performance⁹⁰.

There is another concern that the effectiveness of corporate control depends on the personality “of both the non-executive directors....and the chairman.” The personality of the chairman can be particularly dangerous in the American context if there is a joint CEO/chairman of the imperial variety. Increasing resistance to the imperial CEO by ISS and institutional investors has made this less of a problem. Nonetheless, non-executive directors must have both the knowledge base and self-confidence to directly stand up to the CEO/chairman to prevent domination of the board by the CEO.

There is also concern of the existence of a “serial director.” If the independent director is an executive director on another board, they may be less likely to engage in

⁸⁹ An important caveat to this point is what Martin Lipton described as the increasing “balkanization” of the board into autonomous committees. *See Calkoen* at 160. As board-monitoring standards have been heightened, there are greater barriers to understanding such complex and specialized responsibilities such as those performed by the audit committee. The rise of the “multi-tiered” board, as discussed in *Part IV*, is perhaps undermining one of the greatest strengths of the single-tier board.

⁹⁰ *Part III* will discuss the conflicting literature on compensation of directors in-depth

effective monitoring if they wish for there to be more relaxed monitoring on their own board.⁹¹ This “boys club” effect may not be prevented by mere independence.

Finally, personal relationship can play a major role in both appointment and effective monitoring. In a world where over half of independent directors are outside executives, it is unclear if boards are truly “independent” or if they are just boys clubs of executives, bankers & advisors. Even independent directors may be reluctant to expose the failings of a peer or friend in the boardroom. Delaware case law has heightened the independence test, but personal relationships that develop in the boardroom likely cannot be prevented without an unrealistic independence standard.⁹² The personal relationships that can encourage the flow of information between the board and the company’s management can potentially serve as a double-edged sword. Monitoring may be more difficult when there are feelings of gratitude or norms of social deference to colleagues.⁹³ Independent directors, even though acting in good faith, are also likely to be impacted by their preferences due to “uncontrollable cognitive processes.”⁹⁴ These personal biases may exist in two-tier boards, but they are particularly problematic in one-tier boards when independent directors are attempting to supervise management whom they consistently work and socialize with on the same board.

II. The German Corporate Board

This part of the paper will first describe the legal framework (A.) and two-tier structure in Germany (B.), before highlighting its historic development (C.), the consequential systemic effects (D.) and finally analyzing the state of convergence between the systems (E.).

⁹¹ Grit Tungler, *Anglo-American Board of Directors and the German Supervisory Board - Marionettes in a Puppet Theatre of Corporate Governance or Efficient Controlling Devices*, 12 *Bond L. Rev.* at 264 (2000).

⁹² See fn.8 on *In re Oracle Corp.*

⁹³ See *Tungler* at 264.

⁹⁴ Antony Page, *Unconscious Bias and the Limits of Directors Independence*, 2009 *U. ILL. L. REV.* 237 (2009) (arguing that independent directors are likely to be influenced by uncontrollable preferences and that heightened judicial scrutiny of independent director decisions are necessary)

2 Legal Framework in Germany

In the tradition of civil law countries, corporate law in Germany is based on a wide variety of statutory regulations and the non-statutory German Corporate Governance Code (*Deutscher Corporate Governance Kodex*, “GCGC”)⁹⁵.

Some statutes with wide discretion allow certain company forms to adopt a voluntary two-tier structure.⁹⁶ If implemented, the company’s articles of incorporation govern it. A European limited-liability company (*Societas Europaea*, “SE”) may also choose its own board system, then governed by the Council Regulation on the SE⁹⁷ as well as the German Implementation Act⁹⁸. The GCGC may be applicable for public companies, but deviation is possible.⁹⁹

Other statutes such as the German Stock Corporation Act (*Aktiengesetz*, “AktG”)¹⁰⁰ make a two-tier system for limited companies (*Kapitalgesellschaften*) mandatory.¹⁰¹ There is almost no digression allowed in the articles from the statutory composition and tasks.¹⁰² Difference from the self-regulatory GCGC in public companies must always be explained. Also, codetermination laws¹⁰³ as well as state supervision of certain industries

⁹⁵ German Corporate Governance Code (*Deutscher Corporate Governance Kodex*, “GCGC”), last amended on 5. May 2015, published on 12. June 2015 (Federal Gazette (*Bundesanzeiger*, “BAnz”), AT B1).

⁹⁶ Partnerships (*Personengesellschaften*), foundations (*Stiftungen*), and associations (*Vereine*).

⁹⁷ Art. 38 lit. b Council Regulation (EC) No. 2157/2001 of 8. October 2001 on the Statute for a European company (“SE-VO”), as published on 11. November 2001 (Official Journal of the European Communities (“OJEC”) 2001, L 294/1).

⁹⁸ German SE Implementation Act (*SE-Ausführungsgesetz*, “SEAG”) as published on 22. December 2004 (Federal Law Gazette (*Bundesgesetzblatt*, “BGBl.”) 2004, I, 3675), last amended by Art. 14 of the Law of 24. April 2015 (BGBl. 2015, I, 642).

⁹⁹ No. 1 subpara. 7, 8, 10 & 12, No. 3.10 GCGC; v. Werder, Axel, in: Ringleb, Henrik-Michael; Kremer, Thomas; Lutter, Marcus; v. Werder, Axel (Editors), *Kommentar zum Deutschen Corporate Governance Kodex*, 5th edition, München, No. 1, recital 89 (2014).

¹⁰⁰ German Stock Corporation Act (*Aktiengesetz*, “AktG”), as published on 6. September 1965 (BGBl. 1965, I, 1089), last amended by Art. 1 of the Law of 22. December 2015 (BGBl. 2015, I, 2565).

¹⁰¹ Companies limited by shares (*Aktiengesellschaft*, “AG”) and partnerships limited by shares (*Kommanditgesellschaft auf Aktien*, “KGaA”); partial applicability of the AktG besides other statutes in companies with limited liability (*Gesellschaft mit beschränkter Haftung*, “GmbH”), mutual insurance organizations (*Versicherungsverein auf Gegenseitigkeit*, “VVaG”), and registered cooperative societies (*eingetragene Genossenschaft*, “eG”).

¹⁰² So called *Satzungsstrenge*, section 23 para. 5 AktG.

¹⁰³ German One-Third Participation Act (*Drittelbeteiligungsgesetz*, “DrittelbG”) as published on 18. May 2004 (BGBl. 2004, I, 974), last amended by Art. 8 of the Law of 24. April 2015 (BGBl. 2015, I, 642); German Codetermination Act (*Mitbestimmungsgesetz*, “MitbestG”) as published on 4. May 1976 (BGBl. 1976, I, 1153), last amended by Art. 7 of the Law of 24. April 2015 (BGBl. 2015, I, 642); German Act on Codetermination in the Coal, Iron and Steel Industry (*Montan-Mitbestimmungsgesetz*, “Montan-MitbestG”) as published in a revised version (BGBl. III, 801-2), last amended by Art. 5 of the Law of 24. April 2015 (BGBl. 2015, I, 642).

(i.e. banking or insurance¹⁰⁴) can affect the composition and tasks of the boards in a two-tier structure.

3 Germany's mandatory Two-Tier Board System

Within Germany's mandatory two-tier structure, the executive directors in the management board (*Vorstand*) decide about the company's objectives and implement the necessary measures.¹⁰⁵ Meanwhile, the non-executive directors in the supervisory board (*Aufsichtsrat*) monitor these decisions on behalf of other parties.¹⁰⁶

3.1 The Management Board

The members of the management board are appointed¹⁰⁷ and dismissed for cause¹⁰⁸ by the supervisory board.¹⁰⁹ The number of board members varies according to the company's size, the applicability of codetermination rules and statutes in the articles between one or more persons, averaging in 2012 on 5.6 members.¹¹⁰

While the management board also represents the company in and out of court¹¹¹, it is their main responsibility to jointly run the business.¹¹² Thus, the management board provides the strategic direction for the company through careful planning of

¹⁰⁴ For banks: mainly German Banking Act (*Gesetz über das Kreditwesen*, „KWG“) as published on 9. September 1998 (BGBl. 1998, I, 2776), last amended by Art. 16 of the Law of 20. November 2015 (BGBl. 2015, I, 2029); for insurances: mainly German Insurance Supervision Act (*Versicherungsaufsichtsgesetz*, „VAG“) as published on 1. April 2015 (BGBl. 2015, I, 434), last amended by Art. 3 No.1 of the Law of 21. December 2015 (BGBl. 2015, I, 2553); both industries controlled by federal financial supervisory authority (*Bundesanstalt für Finanzaufsicht*, „BaFin“).

¹⁰⁵ Jungmann, Carsten, *The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems - Evidence from the UK and Germany*, *European Company and Financial Law Review*, Vol. 3, No. 4, 426 - 474, 437 (2006); Roth, Marcus, *Corporate Boards in Germany*; in: Davies, Paul; Hopt, Klaus; Nowak, Richard; van Solingen, Gerard (Editors), *Corporate Boards in Law and Practice: A Comparative Analysis in Europe*, Oxford, 253 - 364, 303 (2013).

¹⁰⁶ No. 1 subpara. 4 f. GCGC.

¹⁰⁷ Section 84 para. 1 AktG.

¹⁰⁸ Section 84 para. 3 sent. 1 AktG.

¹⁰⁹ 1. Exception GmbH under DrittelbG: mandated to shareholders, section 46 No. 5 German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaft mit beschränkter Haftung*, „GmbHG“) as published in a revised version (BGBl. III, 4123-1), last amended by Art. 5 of the Law of 22. December 2015 (BGBl. 2015, I, 2565); 2. Exception KGaA: the general partners form the management board, sections 278 para. 1, 283 AktG.

¹¹⁰ Section 76 para. 2 AktG; Monopolies Commission, *Eine Wettbewerbsordnung für die Finanzmärkte - Zwanzigstes Hauptgutachten der Monopolkommission gemäß § 44 Abs. 1 Satz 1 GWB*, Deutscher Bundestag, Drucksache 18/2150, 17. July 2014, 226 (2014).

¹¹¹ Section 78 para. 1 sent. 1 AktG; i.e. standing for contesting action section 245 No. 4 & 5 AktG.

¹¹² Sections 76 para. 1, 77 para. 1 AktG.

operations.¹¹³ It also manages the workforce, coordinates tasks and controls the strategic focus of the company.¹¹⁴ Its tasks involve i.e. maintaining the books of account¹¹⁵ and keeping themselves¹¹⁶, the supervisory board¹¹⁷, the shareholders¹¹⁸ and federal authorities¹¹⁹ informed about the state of the company.

3.2 The Supervisory Board

3.2.1 Appointment, Size & Composition

The shareholders usually appoint the members of the supervisory board during their annual meeting (*Hauptversammlung*, “general meeting”).¹²⁰ If codetermination laws must be applied, depending on the size of the workforce one third¹²¹ or one half¹²² of the board members are elected by the employees.¹²³ In addition, certain shareholders may be granted the right in the articles to directly dispatch up to one third of the shareholding representing members of the board.¹²⁴ Whoever appoints the board member may also remove them by decision.¹²⁵

The total number of board members can range from 3 to 21 members depending on the amount of share capital, the influence of codetermination and the articles of the company.¹²⁶ In codetermined, listed companies, at least 30% of the supervisory board

¹¹³ No. 4.1.2 GCGC.

¹¹⁴ Witt, Peter, *Vorstand, Aufsichtsrat und ihr Zusammenwirken aus betriebswirtschaftlicher Sicht*; in: Hommelhoff, Peter; Jopt, Klaus, v. Werder, Axel (Editors), *Handbuch Corporate Governance - Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis*, 2nd edition, Köln, 303 - 319, 304 f. (2009).

¹¹⁵ Section 91 para. 1 AktG.

¹¹⁶ I.e. setting up suitable surveillance measures within the company, section 91 para. 2 AktG, No. 4.1.4 GCGC.

¹¹⁷ Section 90 AktG, No. 3.2 GCGC.

¹¹⁸ I.e. set annual meeting, sections 92 para. 1, 121 para. 2 sent. 1 AktG, No. 2.3.1 GCGC; submit financial statements, sections 179 para. 1 sent 1, 175 para. 1 sent. 1 AktG, No. 2.2.1 GCGC; inform about the state of the company, section 131 AktG; profit distribution proposal, sections 121 para. 3 sent. 1, 179 para. 1 sent. 1 AktG.

¹¹⁹ I.e. change in board membership, 181 para. 1 sent. 1 AktG; the increase of share capital, section 184 para. 1 sent. 1 AktG; or the compliance with the GCGC, section 161 para. 1 sent. 1 AktG.

¹²⁰ Sections 100 para. 1 sent. 1, 119 para. 1 No. 1 AktG.

¹²¹ 500 - 2000 employees, section 4 para. 1 DrittelbG

¹²² Above 2000 employees, section 7 para. 1 MitbestG.

¹²³ Section 5 para. 2 DrittelbG, sections 9, 15 - 18 MitbestG; section 6 Montan-MitbestG.

¹²⁴ Section 101 para. 1 sent. 1 & 4 AktG; not possible in a eG, Lutter, Marcus, Krieger, Gerd, *Rechte und Pflichten des Aufsichtsrats*, 5th edition, Köln, recital 15 (2008).

¹²⁵ Section 103 para. 1 sent. 1 AktG.

¹²⁶ Section 95 AktG, section 7 MitbestG, sections 4 para. 1, 9 Montan-MitbestG.

members need to be female and respectively male.¹²⁷ Besides codetermination and diversification, the composition of the board is determined by additional factors: the expertise of the members¹²⁸, a limit on the amount of parallel supervisory board mandates of each member¹²⁹ and, most importantly, the prohibition of a simultaneous seat on the management board¹³⁰. Other personal requirements can only be requested in the articles for members appointed by the general meeting.¹³¹

Thus, the supervisory board members can represent (1) shareholders, (2) employees, (3) labor unions¹³², (4) the company's group holdings¹³³, (5) business partners, (6) creditors or (7) state representatives¹³⁴.

3.2.2 Tasks

On the one hand, the supervisory board controls the decision of the management ex post.¹³⁵ The supervisory board reviews the management by inspecting the books¹³⁶, reviewing the annual report¹³⁷, issuing and overseeing the work of an external auditor¹³⁸, analyzing the information provided by the management board¹³⁹ and reporting to the general meeting¹⁴⁰. In addition, the supervisory board also has standing for court actions against the management.¹⁴¹

¹²⁷ Section 96 para. 2 sent. 1, para. 3 AktG, section 7 para. 3 MitbestG, section 5a Montan-MitbestG; Exception DrittelbG: regardless of listing same representation as segmentation in workforce, section 4 para. 4 DrittelbG.

¹²⁸ No. 5.4.1 subpara. 1 GCGC; If capital market oriented: accounting or auditing skills, section 100 para 5 AktG.

¹²⁹ Section 100 para. 2 sent. 1 No. 1 AktG, not more than 10 parallel mandates.

¹³⁰ Section 100 para. 1 AktG.

¹³¹ Section 100 para. 4 AktG.

¹³² Elected in codetermined companies as part of the employee representation, section 7 para. 2 MitbestG, section 6 para. 3 Montan-MitbestG.

¹³³ Compare section 100 para. 2 sent. 2 AktG.

¹³⁴ Compare sections 394, 395 AktG; 2012: 11.4% supervisory seats, Monopolies Commission, 226 (2014).

¹³⁵ Section 111 para. 1 AktG; Berrar, Carsten, *Die zustimmungspflichtigen Geschäfte nach § 111 Abs. 4 AktG im Lichte der Corporate Governance-Diskussion*, Der Betrieb, 2181 - 2186, 2181 (2001).

¹³⁶ Section 111 para. 2 sent. 1 & 2 AktG.

¹³⁷ Section 171 para. 1 sent. 1 AktG.

¹³⁸ Sections 111 para. 2 sent. 3, 170 para. 1 & 2, 171 para. 1 AktG, No. 7.2.2 GCGC.

¹³⁹ Section 90 para. 1 AktG.

¹⁴⁰ Sections 118 para. 3 sent. 1, 124 para. 3 sent. 1, 171 para. 2 AktG.

¹⁴¹ Section 112 AktG.

On the other hand, the supervisory board can influence the management board to exert ex ante control.¹⁴² While it cannot directly interfere in the management of the company¹⁴³, the articles or the supervisory board must name certain important actions that can only be performed with the consent of the supervisory board.¹⁴⁴ These are, for example, the extension of credits from the company to members of one of the boards¹⁴⁵ or measures that fundamentally change the assets or projected earnings of the company¹⁴⁶. Furthermore, other ways to influence management exist for the supervisory board, for example, by setting incentives through the remuneration¹⁴⁷ and regular advise on strategic decisions.¹⁴⁸

Another function of the supervisory board is the balancing of all interests present in the company by networking with business partners, shareholders, employees and creditors.¹⁴⁹

3.3 The General Meeting

The general meeting of shareholders is the third organ in a limited company.¹⁵⁰ Yet, only the supervisory board can preemptively monitor the management board as the general meeting can only act after misconduct occurred.¹⁵¹ Possible actions include resolutions about important company decisions and the appointment of the supervisory

¹⁴² Malik, Fredmund, *Die Neue Corporate Governance - Richtiges Top-Management - Wirksame Unternehmensaufsicht*, 3rd edition, Ulm, 186 f. (2002); Oetker, Hartmut, *Vorstand, Aufsichtsrat und ihre Zusammenarbeit aus rechtlicher Sicht*, in: Hommelhoff, Peter; Jopt, Klaus, v. Werder, Axel (Editors), *Handbuch Corporate Governance - Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis*, 2nd edition, Köln, 277 - 301, 281 (2009).

¹⁴³ Section 111 para. 4 sent. 1 AktG.

¹⁴⁴ Section 111 para. 4 sent. 2 AktG; if no consent is given the management board can ask for the consent (3/4 approval of given votes) of the general meeting, section 111 para. 4 sent. 3 - 5 AktG.

¹⁴⁵ Sections 89, 115 AktG, No. 3.9 GCGC.

¹⁴⁶ No. 3.3 sent. 2, 5.1.1 sent. 2 GCGC.

¹⁴⁷ Set by the supervisory board, section 87 para. 1 AktG, No. 4.2.3 GCGC.

¹⁴⁸ No. 5.1.1 sent.1 GCGC; Berrar, Der Betrieb, 2181, 2181 (2001); Jungmann, 3 ECFR, 426, 433 (2006).

¹⁴⁹ Hopt, Klaus; Leyens, Patrick, *Board Models in Europe - Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy*, European Company and Financial Law Review, Vol. 1, No. 2, 135 - 168, 141 (2004); Jungmann, 3 ECFR, 426, 432 (2006).

¹⁵⁰ Hoffmann, in: Spindler, Gerald; Stilz, Eberhard (Editors), *Kommentar zum Aktiengesetz*, 3rd edition, München, section 118 AktG, recital 6 (2015).

¹⁵¹ Zattoni, Alessandro; Cuomo, Francesca, *How Independent, Competent and Incentivized Should Non-executive Directors be? An Empirical Investigation of Good Governance Codes*, British Journal of Management, Vol. 21, 63 - 79, 74 (2010).

board or auditor.¹⁵² Statutory liability¹⁵³ of the boards is limited by a business judgment rule and the exculpation of the boards for the last fiscal year by the general meeting.¹⁵⁴ Disclosure¹⁵⁵, the market for corporate control¹⁵⁶ and incentives in contracts are further control devices of the shareholders.

4 Historic Development

4.1 Path Dependency

One explanation for the historic development of Germany's corporate law system can be found in a "mixture of economic, political and cultural factors"¹⁵⁷. These inherited norms and values continuously shape a systems development like a path.¹⁵⁸

The legal situation in Germany, in which the first modern companies emerged, was one in which neither a one nor a two-tier system was obligatory.¹⁵⁹ Instead, the management board was seen as an officer of the shareholders, while (if implemented) the supervisory body was nothing more than a shareholder committee. But as the social view changed, the managers started to consider all stakeholder interests.¹⁶⁰ Subsequently, it was in the interest of the shareholders to have a separate supervisory body to control a management that considers other interests besides theirs. Moreover, it was also in the interest of all other stakeholders to have a separate control unit for the management. An independent board could check if the management actually considered their interests, as

¹⁵² Section 119 para. 1 AktG.

¹⁵³ Sections 48, 93, 116, 117, 399 - 405 AktG, No. 3.8. subpara. 1 sent. 2 GCGC.

¹⁵⁴ Sections 93 para. 1 sent. 2, 119 para. 1 AktG.

¹⁵⁵ Diamond, Douglas; Verrecchia, Robert, *Disclosure, Liquidity, and the Cost of Capital*, The Journal of Finance, Vol. 46, No. 4, 1325 - 1359, 1348 (1991); Bauwhede, Heidi; Willekens, Marleen, *Disclosure on Corporate Governance in the European Union*, Corporate Governance: An International Review, Vol. 16, No. 2, , 101 - 115, 103 (2008); Cormier, Denis; Ledoux, Marie; Magnan, Michel; Walter, Aerts, *Corporate governance and information asymmetry between managers and investors*, Corporate Governance: The international journal of business in society, Vol. 10, No. 5, 574 - 589, 575 (2010).

¹⁵⁶ Baums, Theodor, *Der Aufsichtsrat - nützlich, schädlich, überflüssig?* Working Paper No. 7, Institut für Handels- und Wirtschaftsrecht, Osnabrück, 5 (1994).

¹⁵⁷ Baums, Theodor, *Corporate Governance Systems in Europe - Differences and Tendencies of Convergence - Crafoord Lecture*, Working Paper No. 37, Institut für Handels- und Wirtschaftsrecht, Osnabrück, 9 (1996).

¹⁵⁸ Roe, Mark, *Chaos and Evolution in Law and Economics*, Harvard Law Review, Vol. 109, 1996, 641 - 668, 646 f. (1996).

¹⁵⁹ Baums, Theodor; Scott, Kenneth, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*, Working Paper No. 119, Institut für Bankenrecht, Frankfurt, 28 (2003).

¹⁶⁰ Baums, Working Paper 7, 6 (1994).

shareholders still employ it.¹⁶¹ With a law revision in 1897, the new cultural understanding was transformed into legal practice. Instead of a state permit system that before had served to protect all stakeholders¹⁶², a mandatory two-tier structure for limited companies was introduced.¹⁶³

Like many other legal ideas in the 19th century, the idea of strictly separating management and control stems from the academic study of the Roman legal system.¹⁶⁴ Even though the Romans did not know limited companies in the modern understanding¹⁶⁵, they promoted the separation of “*gestio*” (execution) and “*election, instruction et custodia*” (election, instruction and supervision).¹⁶⁶ Therefore, an example of how the desire to follow an historic ideal shaped the modern German corporate law system.

Similarly the laws on codetermination have been influenced by cultural changes. Workers demanded “industrial democracy”¹⁶⁷ and more influence, threatening wide reaching strikes in the then largest German industry of coal and steel production. Thus, the Acts on Codetermination were first in the form of the Montan-MitbestG introduced in this industry in 1952 and slowly extended to other branches of industry in the following decades.¹⁶⁸

¹⁶¹ Hopt, Klaus, *The German Two-Tier Board: Experience, Theories, Reforms*, in: Hopt, Klaus; Kanda, Hideki; Roe, Mark; Wymeersch, Eddy; Prigge, Stefan (Editors), *Comparative Corporate Governance - The State of the Art and Emerging Research*, Oxford, 227 - 258, 230 (1998).

¹⁶² *Konzessionssystem*, Körber, Torsten in: Bürger, Tobias; Körber, Torsten (Editors), *Aktiengesetz - Kommentar*
2nd edition, München, Introduction, recital 2 (2011).

¹⁶³ Horn, Norbert, *Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860 - 1920) - Deutschland, England, Frankreich und die USA im Vergleich*, in: Horn, Norbert; Kocka, Jürgen (Editors), *Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries - Studies in the History of Industrialization in Germany, France, Great Britain and the United States*, Göttingen, 123 - 181, 145 (1979); Jungmann, 3 ECFR, 426, 449 (2006)..

¹⁶⁴ Böckli, Peter, *Konvergenz: Annäherung des monisitischen und des dualisitschen Führungs- und Aufsichtssystemen*, in: Hommelhoff, Peter; Jopt, Klaus, v. Werder, Axel (Editors), *Handbuch Corporate Governance - Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis*, 2nd editon, Köln, 255 - 276, 256 (2009).

¹⁶⁵ Körber, in: Brügers, Körber, introduction, recital 1 (2011).

¹⁶⁶ Böckli, in: Hommelhoff et al, 255, 256 (2009).

¹⁶⁷ Hopt, Leyens, 1 ECFR, 135, 144 (2004).

¹⁶⁸ Hansmann, Henry; Kraakman, Reinier, *The End of History for Corporate Law*, Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series, No. 280, 5 (2005).

Nowadays, the new corporate law regulations from the European Union (“EU”) promote the political goal of a level playing field for all companies and stakeholders.¹⁶⁹ Thus, the SE was introduced to allow companies to undertake business on an EU wide scale.¹⁷⁰ Hereby, the option to choose a board system was implemented as a compromise between EU members.¹⁷¹ This development was thus also shaped by social and political factors.

4.2 Efficiency

Another approach to explain the development of a specific system is to focus on the economic strive for efficiency.¹⁷² Shareholders will try to maximize their profits.¹⁷³ Thus, they will avoid a sub-optimal corporate governance system. Shareholder pressure then entices improvement of a company’s governance and in consequence creates liquidity for it from capital markets.¹⁷⁴

An explanation why incorporating supervision is efficient is derived from Agency Theory. As executive control of the company is given to managers instead of shareholders, exploitation possibilities emerge for the management, which runs the risk of lowering shareholder’s return. Thus, the separation of interests produces agency costs, which can be lowered through control.¹⁷⁵ It is also more cost efficient to focus supervision in the hands of someone specialized, than for each shareholders to employ it themselves.¹⁷⁶ Additionally in Germany, a traditional lack of minority shareholder

¹⁶⁹ Baums, Working Paper 37, 4 (1996).

¹⁷⁰ Recital 1 sent. 2 SE-VO.

¹⁷¹ Lutter, Krieger, recital 4 (2008); Eberspächer, in: Spindler, Stilz, art. 38 SE-VO, recital 6 (2015).

¹⁷² Clark, Robert, *The Interdisciplinary Study of Legal Evolution*, The Yale Law Journal, Vol. 90, No. 5, 1238 - 1274, 1241 f. (1981).

¹⁷³ Demsetz, Harold, *The Structure of Ownership and the Theory of the Firm*, Journal of Law and Economics, Vol. 26, No. 2, 375 - 390, 390 (1983).

¹⁷⁴ Pfeffer, Jeffrey, *Size and composition of corporate boards of directors: The Organization and its Environment*, Administrative Science Quarterly, Vol. 17, No. 2, 218 - 228, 219 (1972); Coffee, John, *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, Columbia Law School Center for Law and Economic Studies Working Paper No. 144, 12 (1999).

¹⁷⁵ Principal agent problem: Berle, Adolf; Means, Gardiner, *The Modern Corporation and Private Property*, New York, 121 (1944); Jensen, Michael; Meckling, William, *Theory of the Firm. Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, Vol. 3, No. 4, 305 - 360, 308 (1976); Fama, Eugene; Jensen, Michael, *Separation of Ownership and Control*, Journal of Law and Economics, Vol. 26, 301 - 325, 304 (1983); Easterbrook, Frank; Fischel, Daniel, *The Economic Structure of Corporate Law*, 4th printing, Cambridge, 9 f. (1991).

¹⁷⁶ Collective action problem: Fama, Jensen, 26 J.L. & Econ., 301, 309 (1983).

protection has led to large block-holdings as the more efficient investment choice.¹⁷⁷ As a consequence, less liquid capital markets evolved that made it harder to quickly change unsatisfying investments. Therefore, direct corporate control is needed to counterbalance immobility and a specialized, separate board, untainted by conflicts of interest related to the management, seems a rational choice.¹⁷⁸

Resource Dependence Theory offers another explanation based on efficiency considerations. It states that external resources available to the company affect its behavior.¹⁷⁹ As a company depends on employees, the most effective compromise in Germany to permanently secure this external resource was codetermination. Another necessary resource is outside capital. Because debt financing by banks was more prominent in Germany than equity financing¹⁸⁰, bank representatives on the supervisory board were seen as beneficial. The company could continuously inform them about the state of the company and positively effect refinancing decisions. Thus, stakeholder instead of shareholder orientation of both boards allows for the most efficient procurement of resources in Germany.

But these solutions are only efficient in the historic circumstances set by society and law. Therefore one more explanation is delivered by Contingency Theory, which states, that a system develops within the boundaries of its path, always searching for the most efficient solution in light of the path's circumstances.¹⁸¹

5 Consequences of a mandatory Two-Tier System

5.1 Efficient Monitoring through Separation

A separate board with the power to influence management through consent, advise and incentives is an effective, preemptive form of monitoring.¹⁸² Another important

¹⁷⁷ Coffee, Working Paper 144, 8 & 14 (1999).

¹⁷⁸ Coffee, Working Paper 144, 16 (1999).

¹⁷⁹ Pfeffer, Jeffrey; Salancik, Gerald, *The External Control of Organizations - A Resource Dependence Perspective*, New York, 44 (1978).

¹⁸⁰ Baums, Working Paper 37, 9 (1996).

¹⁸¹ Galbraith, Jay, *Designing complex organizations*, Boston, 2 (1973).

¹⁸² Bezemer, Pieter-Jan; Maasen, Gregory; Vand den Bosch, Frans; Volberda, Henk, *Investigating the Development of the Internal and External Service Tasks of Non-executive Directors: the case of the*

monitoring task is the supervision of executive actions, where effectiveness depends on (1) independence from management, (2) information access and (3) overcoming operational challenges.

5.1.1 Independence

Because of a “natural self justification tendency”¹⁸³ a supervisor can never efficiently monitor his own decisions. Therefore, this conflict of interest should always be avoided by exerting control through someone who is independent of the day-to-day management.¹⁸⁴ This can be a separate supervisory board that does not meet with the same frequency as the management.¹⁸⁵

Another conflict of interest is created if the executive managers have influence on the selection of the supervisor. Monitoring might be limited in fear of dismissal.¹⁸⁶ In the German two-tier system, management cannot exert influence on the employees’ board seats, though employee representatives are due to their workforce connection also not truly independent.¹⁸⁷ If the management also holds shares a management nominated supervisor could be elected.¹⁸⁸ As the required majority may only be lowered in the articles through another majority vote, both votes serve to ensure that the election is in the interest of all shareholders.¹⁸⁹ In order to reduce possible management influence

Netherlands (1997-2005), Corporate Governance: An International Review, Vol. 15, No. 6, 1119 - 1129, 1121 f. (2007).

¹⁸³ *Natürliche Selbstrechtfertigungstendenz*, Federal Court of Germany (*Bundesgerichtshof*, “BGH”) 25. November 2002, BGHZ 153, 32, 42; Böckli, in: Hommelhoff et al, 255, 267 (2009).

¹⁸⁴ Fama, Jensen, 26 J.L. & Econ., 301, 304 & 314 (1983).

¹⁸⁵ Supervisory board: 2 per half year, section 110 para. 3 sent. 1 AktG; Management board: according to rules of procedure set by themselves, section 77 para. 2 AktG, Spindler, in: Goette, Wulf; Habersack, Mathias; Kalss, Susanne (Editors), *Münchener Kommentar zum Aktiengesetz*, 4th edition, München, section 77 AktG, recital 35 (2014).

¹⁸⁶ Westphal, James; Zajac, Edward, *Defections from the Inner Circle: Social Exchange, Reciprocity, and the Diffusion of Board Independence in U.S. Corporations*, Administrative Science Quarterly, Vol. 42, No. 1, 1997, 161 - 183, 161 (1997).

¹⁸⁷ Roth, in: Davies et al, 253, 303 (2013).

¹⁸⁸ Sections 124 para. 3 sent. 1, 127, 133 para. 1 AktG; though in articles reduction to simple majority of votes possible, Habersack, in: MüKo, § 103 AktG, recital 15 (2014); also, some scholars suggest that management influences all elections: Semler, Johannes, *The Practice of the German Aufsichtsrat*, in: Hopt, Klaus; Kanda, Hideki; Roe, Mark; Wymeersch, Eddy; Prigge, Stefan (Editors), *Comparative Corporate Governance - The State of the Art and Emerging Research*, Oxford, 267 - 280, 269 (1998); Leyens, Patrick, *Deutscher Aufsichtsrat und U.S.-Board: ein- oder zweistufiges Verwaltungssystem? Zum Stand der rechtsvergleichenden Corporate Governance-Debatte*, *Rabels Zeitschrift für ausländisches und internationales Privatrecht*, Vol. 67, No. 1, 57 - 105, 81 (2003).

¹⁸⁹ Section 133 para. 2 AktG; Rieckers, in: Spindler, Stilz, section 133 AktG, recital 55 (2015).

further, the supervisory board should also include an adequate number of independent members to compensate the possible dependence of the others.¹⁹⁰ Furthermore, in 2013 on average 97% of all supervisory boards established a joint nomination committee of shareholder representatives to propose qualified candidates to the general meeting in a transparent process.¹⁹¹ A majority of three fourths required for a dismissal of a supervisory board member further reduces a single shareholder's influence.¹⁹²

Thus, the German corporate governance system gives personnel authority to those stakeholders in whose interest control is performed - freeing supervisors from personal dependence to the management. In 2011 the supervisory boards of the 100 biggest German companies averaged 21% independent directors, 49% employee representatives, 8% direct shareholder nominations, 5% former executives and 19% other non-independent mandates.¹⁹³

5.1.2 Information Asymmetry

Although independence from management is important, an uninvolved supervisor might lack the information or knowledge needed to exert efficient supervision on executive actions.

One problem arising from the remoteness of the separate supervisory board is a lack of insider business knowledge. It is harder to comprehend, efficiently evaluate and objectively contribute to management actions if economic considerations and alternatives are not presented and understood by the board.¹⁹⁴ Consequently, the supervisory board should be composed of capable members who receive regular further training.¹⁹⁵ Moreover, they need to get to know the company inside and outside the boardroom.¹⁹⁶

¹⁹⁰ No. 5.4.2 sent. 1 f. GCGC; Kremer, in: Ringleb et al, No. 5, recital 1002 (2014).

¹⁹¹ No. 5.3.3 GCGC Heidrick & Struggles, *Towards Dynamic Governance 2014 - European Corporate Governance Report*, available: <http://www.heidrick.com/~media/Publications%20and%20Reports/European-Corporate-Governance-Report-2014-Towards-Dynamic-Governance.pdf>, 22 (2014); Kremer, in: Ringleb et al, No. 5, recital 964 (2014).

¹⁹² Section 103 para. 1 sent. 2 AktG.

¹⁹³ Roth, in: Davies et al, 253, 304 (2013).

¹⁹⁴ Roberts, John; McNulty, Terry; Stiles, Philip, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, *British Journal of Management*, Vol. 16, S5 - S26, S14 & S16 (2005); Zattoni, Cuomo, 21 *Brit. J. Mgmt.*, 63, 65 f. (2010).

¹⁹⁵ No. 5.4.1 subpara. 1, 5.4.5 subpara. 2 GCGC; Banks: special personal requirements to be checked by BaFin, sections 25d para. 1 f., 36 para. 3 KWG; same for VVaG, section 7a para. 4 VAG.

¹⁹⁶ Roberts et al, *Brit. J. Mgmt.*, S5, S13 (2005).

Another option to ensure knowledge about the business is the appointment of former members of the management.¹⁹⁷ But their number is limited to two¹⁹⁸, as the direct relation to the management might affect their independence and hinder the removal of previous strategic mistakes.¹⁹⁹

The information asymmetry is even more pronounced when the supervisory board is solely dependent on the management as a source of information.²⁰⁰ The management board has an obligation to regularly provide specific information and special reports if requested.²⁰¹ However this means, that management handles all information, tainting it with their personal opinion on what should be emphasized or even reported at all.²⁰² Therefore, the risk of inefficient control due to a lack of information is increased.²⁰³ Yet, the right of the supervisory board to inspect all documentation of the company in person reduces the information asymmetry.²⁰⁴ A reduction is also achieved by implementing specific board practices, such as defining which data to collect or when exactly in which form the management should deliver comprehensive information.²⁰⁵ The members of the management board also regularly join the entirety of the supervisory board meeting and may provide information there as well or can be subjected to further questions.²⁰⁶

¹⁹⁷ Hopt, Leyens, 1 ECFR, 135, 143 (2004).

¹⁹⁸ No. 5.4.2 sent. 3 GCGC; Additionally, they cannot be elected within two years after leaving management, unless nominated by a majority of 25% of shareholders, section 100 para. 2 No. 4 AktG, No. 5.4.4 GCGC

¹⁹⁹ Raiser, Thomas; Veil, Rüdiger, *Recht der Kapitalgesellschaften - Ein Handbuch für Praxis und Wissenschaft*, 5th edition, München, section 15, recital 33 (2010).

²⁰⁰ Hooghiemstra, Reggy; van Manen, Jaap, *The Independence Paradox: (Im)possibilities Facing Non-executive Directors in The Netherlands*, *Corporate Governance: An International Review*, Vol. 12, No. 3, 314 - 324, 317 (2004).

²⁰¹ Section 90 para. 1, para. 3 AktG; Section 90 para. 3 sent. 1 AktG: „demand a report“; cannot ask other employees directly for information, Fleischer, in: Spindler, Stilz, section 90 AktG, recital 43; exception banking sector, where supervisory board can talk to employees, section 25d para. 8 sent. 7, para. 9 sent. 4 & 5 KWG.

²⁰² Böckli, in: Hommelhoff et al, 255, 267 (2009).

²⁰³ Jungmann, 3 ECFR, 426, 454 (2006); Hopt, Leyens, 1 ECFR, 135, 147 (2004).

²⁰⁴ Section 111 para. 2 sent. 1 AktG; Spindler, in: Spindler, Stilz, section 111 AktG, recital 37 f. (2015); not right of a single member, just of the whole board, higher regional court (*Oberlandesgericht*, “OLG”) Stuttgart, 30. May 2007, NZG, 549, 550 (2007).

²⁰⁵ No. 3.4 subpara. 1 sent. 3, subpara. 2 sent. 1, subpara. 3 sent. 2 GCGC; Bezemer, Pieter-Jan; Peij, Stefan; de Kruijs, Laura; Maassen, Gregory, *How two-tier boards can be more effective*, *Corporate Governance: The international journal of business in society*, Vol. 14, No. 1, 15 - 31, 23 (2014).

²⁰⁶ Roth, in: Davies et al, 253, 298 (2013); though sessions alone recommended, No. 3.6 subpara. 2 GCGC.

5.1.3 Operational Challenges

A third aspect of effective supervision lies in the ability of a board to overcome operational challenges that may hinder monitoring. That includes implementing routines that guarantee independence and the flow of information. But it also is the ability to ask critical questions and solve interpersonal conflicts such as defensive management behavior or other group dynamics.²⁰⁷ The chairman of the supervisory board hereby fulfills an important intermediate position, as he coordinates work with the management board through regular meetings.²⁰⁸ Conducting regular evaluations can also help to raise awareness of all members of the boards to the importance of addressing operational challenges and information asymmetries.²⁰⁹

5.2 Implications specific to Germanys Corporate Law System

Additionally, systemic factors such as codetermination, ownership structure, bank influence and stakeholder orientation also have implications on the German governance structure.

5.2.1 Codetermination

Through codetermination shareholder influence on a company is diluted.²¹⁰ But social peace and a reduced strike risk are seen as a worthy gain that cannot be achieved otherwise as cost efficiently by contract.²¹¹ Shareholders also maintain the deciding vote

²⁰⁷ Bezemer et al, 14 Corp. Gov. Int'l. J., 15, 15 & 21 f. & 24 (2014).

²⁰⁸ No. 5.2 subpara. 1 sent. 2, subpara. 3 sent. 1 GCGC; Roberts et al, Brit. J. Mgmt., S5, S12 (2005); Kakabadse, Andrew; Kakabadse, Nada; Barratt, Ruth, *Chairman and chief executive officer (CEO): that sacred and secret relationship*, Journal of Management Development, Vol. 25, No. 2, 134 - 150, 141 f. (2006); in the biggest 100 German companies: in 2012 32 cases were chairman was former member of management board of the same company, Monopolies Commission, 227 (2014).

²⁰⁹ No. 5.6 GCGC; Conger, Jay; Finegold, David; Lawler III, Edward, *Appraising Boardroom Performance*, Harvard Business Review, Vol. 76, No. 1, 136 - 148, 138 (1998); Long, Tracy, *This Year's Model: influences on board and director evaluation*, Corporate Governance: An International Review, Vol. 14, 547 - 557, 554 f. (2006); Bezemer et al, 14 Corp. Gov. Int'l. J., 15, 15 (2014).

²¹⁰ Pistor, Katharina, *Corporate Governance durch Mitbestimmung und Arbeitsmärkte*, in: Hommelhoff, Peter; Jopt, Klaus, v. Werder, Axel (Editors), *Handbuch Corporate Governance - Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis*, 2nd edition, Köln, 231 - 252, 236 (2009).

²¹¹ Hopt, Leyens, 1 ECFR, 135, 145 (2004); Waltermann, Raimund, *Arbeitsrecht*, 17th edition, München recital 898 (2014).

and fundamental decisions can still only be made by the general meeting.²¹² But mistrust could arise, if leaked information is used as a tactical advantage or if the management is reluctant to disclose information that goes against workers' interest.²¹³ Thus, strict confidentiality rules are enforced on all²¹⁴ and others are not allowed to join meetings.²¹⁵ Meetings may also be prepared separately, allowing each party to find common ground in their own ranks.²¹⁶

Though representatives are elected by and out of the workforce or unions, they still must be qualified.²¹⁷ As they often come from a company's middle management they usually possess an in-depth knowledge of the company that allows them to communicate its real needs and problems.²¹⁸ Therefore, the diversification of knowledge may increase business opportunities.²¹⁹ Yet, in a larger board of up to 21 members, averaging in 2013 on 17 members²²⁰, a general consensus between all might be hard to find.²²¹ In addition, a minimum of only four supervisory board meetings a year severely limits the possibility for contributions of each member.²²² Division of tasks in board committees, for example an audit or remuneration committee can solve this dilemma partially.²²³ In 2013 on average 4.6 committees were installed on German supervisory boards.²²⁴

²¹² Section 29 para. 2 MitbestG, section 119 para. 1 AktG; Federal Constitutional Court of Germany (*Bundesverfassungsgericht*, "BVerfG"), 1. March 1979, BVerfGE 50, 290, 331 & 339.

²¹³ Jungmann, 3 ECFR, 426, 455 (2006); Böckli, in: Hommelhoff et al, 255, 261 (2009).

²¹⁴ Sections 93 para. 1 sent. 3, 116 AktG, Section 25 para. 1 sent. 1 MitbestG, No. 3.5 GCGC.

²¹⁵ Section 109 para. 1 sent. 1 AktG; for certain topics advisors are allowed, section 109 para. 1 sent. 2 AktG.

²¹⁶ No. 3.6 subpara. 1 GCGC; Böckli, in: Hommelhoff et al, 255, 261 (2009).

²¹⁷ Same requirements as for other members of supervisory board: No. 5.4.1 subpara. 1, 5.4.5 subpara. 2 GCGC.

²¹⁸ Shi, 4 Mq J. Bus. L., 197, 208 (2007).

²¹⁹ Zattoni, Cuomo, 21 Brit. J. Mgmt., 63, 65 (2010).

²²⁰ Heidrick & Struggles, 18 (2014).

²²¹ Witt, in: Hommelhoff et al, 303, 306 (2009).

²²² Section 110 para. 3 sent. 1 f. AktG; Jungmann, 3 ECFR, 426, 456 (2006).

²²³ Section 107 para. 3 f. AktG; No. 4.2.2 subpara. 1, 5.3.1, 5.3.2 GCGC; Ranzinger, Christoph; Blies, Peter, *Audit Committees im internationalen Kontext*, Die Aktiengesellschaft, 455 - 462, 461 (2001).

²²⁴ Heidrick & Struggles, 21 (2014).

5.2.2 Ownership Structure

Furthermore, ownership structure in Germany used to be block oriented, in comparison to a market oriented system in the U.S. with dispersed ownership.²²⁵

One feature is interlocking, which occurs when board members also serve on other companies' boards.²²⁶ On the one hand, this restricts direct competition and can bring fresh, expert views to the board.²²⁷ By being in demand companies and directors can also prove their worth on the job market.²²⁸ On the other hand, only keeping a small group in power might hinder the up rise of new economic ideas and cement class structures.²²⁹ Conflicts of interest can also occur if members sit on competitors' boards. Therefore, the allocation of seats and allowed activities of board members are limited and restricted by the consent of the supervisory board and disclosure to the shareholders.²³⁰ As board members with too many mandates might also not be able to properly fulfill their tasks, they need to assure they can muster enough time, as tasks cannot be mandated to others.²³¹ Overall in 2013, 11% of all directors in Germany had 3 or more mandates on other boards.²³²

Formerly prominent cross holdings between companies are also slowly diminishing.²³³ In the biggest 100 German companies 35 companies were invested into 18 other companies in 2012.²³⁴ This shows a drop in capital investment from 143 in 1996

²²⁵ Bratton, William; McCahery, Joseph, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, Columbia Journal of Transnational Law, Vol. 38, No. 2, 213 - 274

, 214 (1999).

²²⁶ Mizruchi, Mark, *What do Interlocks do? An Analysis, Critique, and Assessment of Research on Interlocking Directors*, Annual Review of Sociology, Vol. 22, 271 - 298, 271 (1996).

²²⁷ Baums, Working Paper 7, 4 (1994); Mizruchi, 22 Ann. Rev. Soc., 271, 274 (1996).

²²⁸ Fairchild, Lisa; Li, Joanne, *Director Quality and Firm Performance*, The Financial Review, Vol. 40, 257 - 279, 277 (2005).

²²⁹ Mizruchi, 22 Ann. Rev. Soc., 271, 276 - 279 (1996).

²³⁰ Mandate limit for managers, No. 5.4.5 subpara. 1 sent. 2 GCGC; mandate limit for supervisors, section 100 para. 2 sent. 1, No. 1, sent. 2 & 3 AktG; time limit for move from management to supervisory board, section 100 para. 2 sent. 1 No. 4 AktG; limit on activities of managers, section 88 para. 1 AktG, No. 4.3.4 GCGC; limit on activities of supervisors, No. 5.4.2 sent. 4 GCGC; disclosure by all, No. 4.3.3 sent. 1, 5.5.2 GCGC.

²³¹ Section 111 para. 6 AktG; BGH 15. November 1982, BGHZ 85, 293, 295 f..

²³² Heidrick & Struggles, 26 (2014).

²³³ So called *Deutschland AG*: Baums, Scott, Working Paper 119, 33 (2003).

²³⁴ Monopolies Commission, 219 (2014).

to 58 in 2012.²³⁵ Additionally, on average other companies held 5.8% seats on supervisory boards.²³⁶

Another still existing characteristic of Germany's capital markets are large block-holdings, leading to less liquid capital markets. Though financing can be achieved otherwise, the options are more limited than in a strictly market oriented system.²³⁷ However, less liquid markets, lead to shareholder immobility and more enduring investments, thus allowing long-term value creation.²³⁸ Due to a favorable tax exemption on selling company stock in 2000 the large block-holdings were partially diluted.²³⁹ But still, families control 1/3 of the 30 biggest German companies.²⁴⁰ In these companies special approval rights and side-payments play an important role, leading to a less transparent market.²⁴¹ In 2012 out of the 100 biggest companies in Germany 21 had a foreign controlling shareholder, 15 were controlled by the state, 26 by families, 8 had other controlling entities, 50 were in dispersed ownership with over 50% of shares traded and only 7 companies were without a controlling shareholder.²⁴²

5.2.3 Influence of the Banking Sector

As there is no institutional separation between commercial and investment banking in Germany²⁴³, universal banks can take on a simultaneous position of (1) depositary of voting rights, (2) shareholder and (3) creditor.²⁴⁴ Between these positions conflicts of interests can arise. Deposited shares could be voted in favor of an own agenda or always in favor of management proposals.²⁴⁵ On the other hand, the practice of giving banks seats on supervisory boards provides professional financial expertise to the

²³⁵ Roth, in: Davies et al, 253, 260 (2013)

²³⁶ Monopolies Commission, 226 (2014)

²³⁷ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 221 (1999).

²³⁸ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 220 (1999).

²³⁹ Roth, in: Davies et al, 253, 258 f. (2013).

²⁴⁰ Roth, in: Davies et al, 253, 260 (2013)

²⁴¹ Coffee, Working Paper 144, 16 f. (1999); Hopt, Leyens, 1 ECFR, 135, 141 (2004).

²⁴² Monopolies Commission, 216 (2014).

²⁴³ Baums, Working Paper 37, 9 (1996); Hopt, Klaus, *Common Principles of Corporate Governance in Europe?*, in: McCahery, Joseph; Moerland, Piet; Raaijmakers, Theo; Renneboog, Luc (Editors), *Corporate Governance Regimes - Convergence and Diversity*, Oxford, 175 - 204, 186 (2002).

²⁴⁴ Hopt, Leyens, 1 ECFR, 135, 143 (2004).

²⁴⁵ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 247 f. (1999); Hopt, in: McCahery et al, 175, 187 (2002).

board.²⁴⁶ In theory, the insight in the state of the company could be used to accumulate supervisory costs and base a bank's credit decisions on that knowledge.²⁴⁷ But there is little evidence that banks base these decisions on supervision²⁴⁸, instead using the board just as a tool to network.²⁴⁹ As critique of their position arose, they widely withdrew from boards of industrial companies.²⁵⁰ Their involvement fell over 80% in the last 20 years and in 2012 in the 100 biggest German companies only 1.4% of supervisory board seats were filled with bank representatives.²⁵¹ The tax exemption of 2000 also allowed them to sell large shareholdings and new regulation limits the activities of depository voting and supplements it by a management run proxy system.²⁵² From all German listed shares in 2014 only 3.3% were still held by financial institutions.²⁵³

5.2.4 Stakeholder Orientation

One more aspect of the German system is its stakeholder orientation in comparison to the shareholder value approach in America.²⁵⁴ While the management board has wide discretion in the running of the business, it is bound to restrictions set by the supervisory board, the articles and basic²⁵⁵ or solicited²⁵⁶ decisions of the general meeting.²⁵⁷ This restriction follows from the fact that the management board is, on the one hand, an officer of the shareholders. Consequently, the codification of the German business judgment rule only refers to the shareholders best interest, and not the interests of the entire enterprise.²⁵⁸ But on the other hand, both boards due to a cultural understanding take into

²⁴⁶ Hopt, in: Hopt et al, 227, 233 (1998).

²⁴⁷ Rock, Edward, *America's Shifting Fascination with Comparative Corporate Governance*, Washington University Law Review, Vol. 74. No. 2, 367 - 391, 381 (1996).

²⁴⁸ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 249 (1999).

²⁴⁹ Hopt, in: Hopt et al, 227, 234 (1998); Roth, in: Davies et al, 253, 281 (2013).

²⁵⁰ Hopt, in: Hopt et al, 227, 252 (1998).

²⁵¹ Roth, in: Davies et al, 253, 260 (2013); Monopolies Commission, 226 (2014).

²⁵² Section 135 AktG; Baums, Scott, Working Paper 119, 33 (2003).

²⁵³ Others: 1.2% state, 48% foreign investors, 15.8% non-financial companies, 13.5% households, 3, 18.2% institutional investors, Deutsche Bundesbank, *Wertpapierhalterstatistiken zur Analyse des Wertpapierbesitzes in Deutschland und Europa: Methodik und Ergebnisse*, Monatsbericht, March 2015, 101 - 114, 110 (2015).

²⁵⁴ Baums, Scott, Working Paper 119, 4 f. (2003).

²⁵⁵ Section 119 para. 1 AktG.

²⁵⁶ Section 119 para. 2 AktG. Exception GmbH: shareholders decide all, section 37 para. 1, 49 para. 2 GmbHG.

²⁵⁷ Section 82 para. 2 AktG.

²⁵⁸ Section 93 para. 1 sent. 2; Roth, in: Davies et al, 253, 263 (2013).

account the interest of other stakeholders of the company as well.²⁵⁹ Stakeholder orientation can help a company to fulfill its social responsibilities²⁶⁰ and concentrate on long-term value creation, increasing stability.²⁶¹ In addition, it can encourage otherwise mostly passive shareholders to actively engage in the company to increase their share value.²⁶²

III. The American and German Board Compared and Contrasted

“Systems of corporate governance, like a society’s other important institutions, contain its cultural values.”²⁶³ The differences in American and German governance standards portray contrasting corporate norms, and different understandings of capitalism. Below, we discuss how differences in (1) board size, (2) number of board meetings, (3) stakeholder versus shareholder interests, (4) independent versus representative directors and (5) director compensation are illustrations of these different corporate values which make each system of governance uniquely tailored to reflect each societies values.

5.1 Board Size

One of the distinct differences between American and German boards is size. American boards average roughly 10.8 board members, while German boards are somewhere in the range of 23. The literature on board size suggests that American

²⁵⁹ No. 4.1.1 GCGC; Baums, Scott, Working Paper 119, 5 (2003); Hopt, Leyens, 1 ECFR, 135, 145 (2004); Oetker, in: Hommelhoff et al, 277, 279 (2009); though cut from the AktG the orientation on enterprise interest is seen as self-evident, Roth, in: Davies et al, 253, 332 f. (2013).

²⁶⁰ Shi, Elizabeth, *Board Structure and Board Composition in Australia and Germany: A Comparison in the Context of Corporate Governance*, Macquarie Journal of Business Law, Vol. 4, 197 - 211, 209 (2007).

²⁶¹ Coffee, Working Paper 144, 17 (1999).

²⁶² Pistor, in: Hommelhoff et al, 231, 236 (2009).

²⁶³ Jeswald W. Salacuse, *Corporate Governance, Culture and Convergence: Corporations American Style or with a European Touch*, 9 Law & Bus. Rev. Am. 33, 63 (2003)

companies should outperform German, but that is not necessarily the case. In fact, there is little evidence that either board has given a strategic advantage to corporations.²⁶⁴

Eisenberg, echoing Lipton, points to two primary reasons why larger boards could hurt firm performance: (1) increased problems of communication and (2) decreased ability of the board to control management, leading to agency problems from the separation of management and control.²⁶⁵ It is important to note that Eisenberg also hypothesized that larger boards would have more independent directors, and that those directors would be highly risk adverse due to a negligible financial stake in the companies success, but substantial risk of reputational damage from a companies failure.²⁶⁶ German boards have fewer independent directors (on average 21%²⁶⁷), so it could be that the increased independence of the American one-tier board makes the American system less effective. It is also possible, though, that Eisenberg's third critique is no longer relevant in light of the shifting compensation structures of directors that align firm performance with director compensation.²⁶⁸

Eisenberg's research found that "firms with small boards attain higher returns on investment in relation to their industry peers."²⁶⁹ Eisenberg does point to three alternative explanations for his findings: firms might increase board size due to poor profitability, large boards could just be a product of firms maturing in their life cycle or that large boards could be representative of problems endemic in the firm (citing the existence of bank representatives on boards with substantial debt).²⁷⁰

A GMI study published in the Wall Street Journal 2014 found strikingly similar results to Eisenberg regarding board size and profitability.²⁷¹ The study found that amongst major American corporations, the stock of firms with smaller board

²⁶⁴ See Jungman fn. 83 (finding no discernable difference between the performance of corporations with one-tier and two-tier boards in the UK and in Germany) (note however that no study has been done comparing American firms with one-tier boards to German firms with two-tier boards)

²⁶⁵ Theodore Eisenberg, Stefan Sundgren and Martin T. Wells. *Larger board size and decreasing firm value in small firms*, J. Fin. Econ at 37 (1998)

²⁶⁶ *id.* at 38

²⁶⁷ In the 100 biggest German companies, Roth, in: Davies et al, 253, 304 (2013)

²⁶⁸ It may be the case that a directors' compensation is not high enough relative to the directors overall income for these compensation changes to make a difference. In a world where roughly 50% of Independent directors are executives, their director compensation may be a small fraction of their overall income. Further study is needed in this area.

²⁶⁹ *id.* at 45

²⁷⁰ *id.* at 48

²⁷¹ Joann S. Lublin, *Smaller Boards Get Bigger Returns*, W.S.J., Aug. 26, 2014.

outperformed their peers by 8.5%.²⁷² Some of the reasons cited in the article were that there is “more effective oversight of management” by smaller boards, smaller boards are more likely to dismiss their CEOs for poor performance and smaller boards are more likely to be “decisive, cohesive and hands-on.”²⁷³

TheCorporateCounsel.net, run by Dave Lynn, one of the worlds’ leading attorneys on corporate governance, is also highly critical of large boards.²⁷⁴ Some of the advantages listed by smaller boards include: greater flexibility, better interpersonal relationships, meetings tend to be more informal and individual directors are more likely to assume responsibility.²⁷⁵ The international data on board size also seems to suggest that firms with smaller boards tend to outperform similar firms with larger boards in both the United Kingdom and Asia.²⁷⁶

Academics & practitioners both seem to overwhelmingly favor smaller boards, yet there seems to be little evidence that American boards outperform their German counterparts, even though German boards are on average twice as big. There are a few reasons why this perplexing conundrum may exist. First, what may matter is the size of the management board, and not the supervisory board. Although German boards are rather large, their management boards tend to only have around 6 members, which is quite small. It could be that the German two-tier board, by keeping its management board so small, has managed to incorporate the positive aspects of the smaller American one-tier board entirely in its management board. A second explanation could be that large supervisory boards are so effective at monitoring the corporation that the negatives of the larger German board are outweighed by the positives of cleaner, less corrupt German corporations.²⁷⁷ A third potential explanation, such as the one proposed by Eisenberg, is

²⁷² *Id.*

²⁷³ *id.*

²⁷⁴ TheCorporateCounsel.net, *Smaller Boards: Bigger Returns*, (September 8,2014) available at: <http://www.thecorporatecounsel.net/blog/2014/09/smaller-boards-bigger-returns.html>

²⁷⁵ The post, while favoring smaller boards, also recognizes some of the weaknesses of small boards and strengths of larger boards.

²⁷⁶ See Paul M. Guest *The impact of board size on firm performance: evidence from the UK*, 15.4 Eur’pn. J. Fin. (2009)(finding that firms with smaller boards outperform similar firms with larger boards in the United Kingdom); Y.T. Mak and Yuanto Kusnadi, *Size really matters: Further evidence on the negative relationship between board size and firm value*, 13 Pac. Basin Fin. J. (2005) (finding that firms with smaller boards outperform similar firms with larger boards in Singapore and Malaysia)

²⁷⁷ Recent scandals by Volkswagen and Siemens suggest this is likely not the case, although there is not empirical data to support this claim in either direction.

that independent directors are less willing to take risks than executive directors. Finally, one more answer is that there simply has not been enough research on the subject to make a definitive conclusion, and that further research comparing similarly situated German and American counterparts could lead to a conclusion more in line with the existing literature on board size.

5.2 Board Meetings

One advantage of the American one-tier board often cited in the literature is that because there are more frequent board meetings in American versus German corporations, there are both better personal relationships on the board and a better diffusion of information between the directors and management. It is unclear if this conventional wisdom is actually true, however. Although German boards are required to meet at least 4 times per year, there are often more informal meetings or other meetings that go unreported. It may be the case that German boards nearly equally as frequently as their American peers informally, but there is little evidence to support this.²⁷⁸

One thing that is clear, however, is that similar to board size, the conventional wisdom in the literature is that more board meetings are better.²⁷⁹ Board meetings are seen as an important resource in improving board effectiveness, and that one of the most common problems that directors' face is lack of time.

5.3 Stakeholder v. Shareholder

The most obvious difference in German and American boards, other than size, is composition. American boards are overwhelmingly composed of independent directors that are either executives or members of the financial industry. German boards, by legislation and reflective of the German policy of codetermination, are required to reserve up to half of the seats on their supervisory board for employees. This board composition is reflective of the competing paradigms in American and German corporate governance: stakeholder versus shareholder primacy.

278

²⁷⁹ See Ivan E. Brick and N. K. Chidambaran. *Board meetings, committee structure, and firm performance*. Unpublished working paper, available at: <http://ssrn.com/abstract=1108241> (November 2007); See Also Nikos Vafeas, *Board meeting frequency and firm performance*, 53.1 J. Fin. Econ. (1999).

In Germany's two-tier system, the Codetermination Act of 1976 provides for a supervisory board of 12, 16 or 20, depending on the number of employees of the firm.²⁸⁰ The average supervisory board size in Germany is 17.1, with the largest German firms maintaining the 20 person supervisory board.²⁸¹ The number of directors on the management board, however, is not subject to statutory regulation, and averages on 5.6 members. The management board in Germany is comprised entirely of non-independent executives, with one executive being designated chairman or spokesperson.²⁸² The overall composition of the management board is also dependent on firm size and industry: Under the MitbestG there is "quasi-parity" codetermination with the deciding vote going to the chairman, and for the coal, iron and steel industries there is parity with the deciding vote going to an independent board member.²⁸³ The boards representation, composed of non-independent management directors, 1/2 employee supervisory directors, other stakeholder supervisory directors and 1/3 independent and shareholder supervisory directors, is broadly representative of the codetermination model entrenched in the GCGC, which states that "the company is to be managed in the interest of the enterprise"²⁸⁴, including employees and other stakeholder interests.²⁸⁵ This view of corporate governance, echoed by Merrick Dodd and others, is entrenched in German corporate governance.

The American view of shareholder primacy is reflected in the unitary board structure as well as board composition. The board is seen as an independent supervisor, as opposed to a partly representative supervisor of stakeholders such as in Germany. American boards do not maintain seats for stakeholders such as employees like in Germany. Instead, American labor rights and other stakeholder interests are governed by contract and governmental regulation.²⁸⁶ Some, such as Marleen O'Connor, encouraged

²⁸⁰ Section *Roth* at 285; if Montan-MitbestG is applicable: largest size is 21; if DrittelbG is applicable no requirements are made for the size of the supervisory board.

²⁸¹ *Roth* at 287

²⁸² *Roth* at 288

²⁸³ *id.*; if DrittelbG is applicable no requirements are made for the management board.

²⁸⁴ *Roth* at 262

²⁸⁵ This stands in contrast with Delaware law, where directors owe a fiduciary duty to the shareholders alone, and not to their employees or other stakeholder interests, though the statutory fiduciary duty of German directors is also only directed at shareholder interests.

²⁸⁶ Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22:97 *Comp. Labor Law & Pol'y Journal*, at 98 (2001).

the United States to adopt director fiduciary duties to their employees.²⁸⁷ Many scholars favoring an abandonment of shareholder primacy embraced the German and Japanese codetermination models in the 1980's when it appeared that corporate America was being outperformed by its German and Japanese peers. American economic performance in the 1990's and early 2000's muted the influence of these scholars.

The purpose of this paper is not to say whether stakeholder or shareholder primacy is better or worse. The obvious should be noted however, that a corporation run for the benefit of shareholders is more likely to benefit shareholders, while a corporation run for the benefit of stakeholders such as employees is more likely to benefit stakeholders, at least in the short run. It is also important to note that neither governance system is entirely dominated by either norm, and that our narrative is built in part by making a generalization about two incredibly nuanced systems of corporate governance.

5.4 Independence v. Representation

German boards, reflecting stakeholder norms, are representative in nature, while American boards are independent. German boards directly represent stakeholder interests by having stakeholder oversight, while American boards represent shareholder interests by maintaining independent oversight.

American board independence is a recent phenomenon, birthed out of judicial and managerial necessity as a response to “preserve managerial autonomy against the pressure of the market” during the 1980's hostile takeover explosion.²⁸⁸ Prior to this emergence, American corporate norms tended to reflect modern German norms. During the 1950's, called the “high-water mark of managerialism” in U.S. corporate governance, stakeholder capitalism was instituted in practice if not in legislation.²⁸⁹ Corporate management felt a responsibility to act in the interest of employees and consumers, and was largely given free reign in the management of the company.²⁹⁰ The board, often

²⁸⁷ *Id.*

²⁸⁸ Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 *Stan. L. R.* 1467 (2007).

²⁸⁹ *Id.*

²⁹⁰ *Id.* at 1512

management picked executives or close company advisors such as outside counsel, was seen as having an “advisory” as opposed to a “monitoring” role.²⁹¹

The rise of board independence, which was largely a response to the unbridled free-market capitalism of the “deal-decade” of the 1980’s, is now one of the defining characteristics of the more neo-liberal shareholder primacy model of corporate governance in America. The independent board responded to what Gordon described as the “three-way paradox” of norms promoting shareholder maximization, defense measures by corporate boards that prevented this shareholder maximization and the high cost of hostile bids and their associated agency problems.²⁹² The independent board resolved this paradox by evaluating management performance based on stock market prices while simultaneously improving the agency problem by created independent board voices.

Developing in tandem with board independence has been the heightening of board monitoring requirements. The Enron collapse highlighted board-monitoring failures. Heightened independent director relationship and monitoring standards promulgated by the NYSE and the SEC, along with those imposed by the Court of Chancery, have placed an even larger burden on independent directors. This newly emergent dual mandate of enhanced monitoring duties to go with outside, independent advisory duties serves as the watchman overlooking modern American capitalism.

The German corporate norm of favoring stakeholders over independent directors is reflective of a different version of capitalism that favors stakeholder input and managerial expertise over independence. The management boards in Germany, which have the responsibility of setting corporate strategy, are almost entirely composed of executive directors with close ties to the corporation. Supervisory boards, which are responsible for monitoring and may advise on strategy, are overwhelmingly composed of employees (49%) and other non-independent executives (24%), with only 29% of directors being truly independent or shareholder nominated.²⁹³ This model favors management expertise and stakeholder input over independent outsiders. The similarities in both structure and norms between 1950’s American corporate boards and modern

²⁹¹ *Id.* at 1512-1522

²⁹² *Id.* at 1526

²⁹³ Roth, in: Davies et al, 253, 304 (2013).

German boards are striking, and highlight the changing landscape of American governance ideals.

5.5 Compensation

German and American board compensation structures both have potentially troubling incentives, but each in a way unique to their own governance systems. German and American boards also regulate director compensation very differently, further reflecting governance norms.

In the United States, director compensation is set by the board in consultation with compensation experts.²⁹⁴ Board compensation in America is also becoming primarily incentive based.²⁹⁵ There is some scholarship that suggests incentive pay aligns director and shareholder interest, even when considering a long investment time horizon and expenditures such as Research and Development.²⁹⁶ Other advisory agencies such as Moody's argue that incentive pay undermines director independence, creates an excessive focus on share price and creates incentives for boards to be less vigorous in regulating earnings materials.²⁹⁷ In general, governance trends in the United States at both the state and federal level have been heightening board independence, but director compensation trends have been moving in the opposite direction, potentially threatening this independence. If both outside directors and executives face the same compensation incentives to increase a company's stock price, the outside directors' ability to oversee management, and protect the shareholders, is put into jeopardy.

German compensation of the management board is set by the supervisory board, but governed by statute.²⁹⁸ Management board compensation, although set by the supervisory board, must "bear a reasonable relationship to the duties of such members", which has greatly limited compensation freedom of contract and made director

²⁹⁴ Susanne Craig, *At Banks, Board Pay Soars Amid Cutbacks*, N.Y. Times March 31, 2013 at Dealbook.

²⁹⁵ See *Supra* Section 1.5

²⁹⁶ See Yuval Deutsch "The Influence of Outside Directors' Stock Option Compensation on Firms' R&D, *Corporate Governance: An International Review* 15.5, 816,827 (2007)

²⁹⁷ Ken Bertsch, Francis Byrd and Mark Watson, *The Downside of Incentive Pay for Outside Directors*, Moody's Investor Service: Special Comment, Report no. 97174 (April 2006)

²⁹⁸ Section 87 para. 1 Stock Corporation Act

compensation subject to judicial review.²⁹⁹ Supervisory board pay is also broadly governed by statute, but is set at the shareholders meeting.³⁰⁰

Incentive based pay is becoming more prominent amongst German directors, but because board independence is not prioritized incentive pay does not threaten independence in the same way as it would on American boards. The supervisory boards composition of employees and management representatives (who set management board pay), raises other potential conflicts that might threaten both shareholders and the company, however. Many have described the so-called Faustian bargain on German boards between labor and management, where labor gives broad leeway to management (potentially ignoring their supervisory duties) in exchange for the protection of German jobs.³⁰¹ German director compensation structures face the same poor set of incentives: the supervisory board, comprised of half labor representatives, may be willing to grant favorable compensation schemes to management in exchange for protection of German labor interests. Pay incentives on German boards highlight the dark side of stakeholder capitalism in Germany for shareholders; their interests, far from being equal to stakeholders such as labor and management, will be subjugated with little recourse outside of litigation.³⁰²

A recent paper by J. Travis Laster and John Mark Zeberkiewicz describes blockholder directors in American corporate governance, and is a useful vehicle for analyzing certain flaws in German compensation practices.³⁰³ Laster & Zeberkiewicz define a blockholder director as “when one or more directors have been designated by a particular class or series of stockholders or were appointed at the behest of an insurgent group” that is then perceived to be “exercising directorial powers for the benefit of a

²⁹⁹ Stephen Harbath and Florian Kienle, *Director Compensation under German Law and the Mannesman Effect*, 3 Eur. Company L. 90,97 (2006)

³⁰⁰ Section 113 Stock Corporation Act (“such compensation may be set forth in the articles of association or granted by the shareholders’ meeting”).

³⁰¹ See Generally Chris Bryant and Richard Milne, *Boardroom Politics at the Heart of the VW Scandal*, F.T. October 4, 2015 (describing the critique that lax supervisory oversight of management was traded for German job protection)

³⁰² German social norms on director pay and judicial review may be enough to prevent compensation abuse, but the incentives to create the possibility in the future of pay structured solely for management benefit.

³⁰³ J. Travis Laster and John Mark Zeberkiewicz, *The Rights and Duties of Blockholder Directors*, 70 Bus. Law. 33 (2014-2015)

subset of the stockholder base.”³⁰⁴ The authors argue that Delaware law rejects “constituency directors” that only represent a subset of the shareholder base, and highlights how fiduciary obligations of Delaware directors require all directors to “promote the value of the corporation for the benefit of its stockholders.”³⁰⁵

Vice Chancellor Laster’s worst fears for Delaware are engrained common practice in Germany. Blockholder directors need not solely be understood as representing shareholders, but in the German context also stakeholder directors. Instead of a fiduciary obligation to act for all shareholders, however, blockholder directors such as labor allied directors in Germany have the ability to represent labor interests, which stands in stark contrast with the Delaware board-centric model resting on collective decisionmaking. Whenever there is a unity of labor and management interests that allow board alliances between the two, shareholder interests and recourse become subjugated. Without Delaware style fiduciary duties given to blockholders, there is always a threat that nebulous “company interests” will really be labor or management interests. The two-tier board structure as it exists in Germany is a particularly opaque vessel that could allow an alliance by blockholders for self-enrichment and scandal, and management board compensation seems a likely location for this plundering.³⁰⁶³⁰⁷

German compensation practices are best considered yet another reflection of stakeholder primacy on the German board, and Germany’s two tier-structure creates the potential for abuse by vote-trading between the supervisory and management boards on compensation, as well as other board practices. Freedom of contract is limited by statute in Germany, probably out of necessity, because there is no private check on compensation practices like there is under Delaware law for shareholders. Conversely in the United States, director compensation practices reflect shareholder primacy norms, but director independence may be undermined by incentive compensation.

³⁰⁴ *Id.* at 37

³⁰⁵ *Id.* at 49,51

³⁰⁶ See Generally The Economist, *Why the leading citizens of corporate Germany are so scandal prone*, August 6, 2009 (highlighting the role that supervisory boards have played in the high number of German corporate scandals); James B. Stewart, *Problems at Volkswagen Start in the Boardroom*, N.Y. Times September 24, 2015 at common sense (highlighting how investors suffer with little recourse when management and labor enter into a board alliance at Volkswagen)

IV. International Convergence of Board Standards

5.1 International Convergence in Germany

A cross-border diffusion of international governance norms has begun to impact both governance systems. The German two-tier system now allows more supervisory board oversight of management, while the American board is increasingly become multi-tiered in function.³⁰⁸ These changes reflect growing attempts by both systems to incorporate strengths of the other. This diffusion is being facilitated by economic globalization³⁰⁹, the strong external effects of rules set by U.S. equity markets³¹⁰ and both shareholder and regulatory pushback for governance improvements. Some might predict the emergence of an international best practice of governance norms developing as part of this trend. Further convergence, however, is likely to be tepid at best.

Some scholars have argued that instead of international best practices on governance norms developing, shareholder pressure will instead lead to a race to the bottom of minimum standards.³¹¹ Other such as John C. Coffee have worried that piecemeal implementation of certain governance norms across cultures will be largely ineffective.³¹² Finally, due to differing roles for stakeholders, governance norms acceptable in one country may never be acceptable in the other.³¹³ There are strong cultural reasons, such as codetermination, that would likely prevent certain outcomes like the rise of truly independent boards in Germany.

Hansmann and R. Kraakman noted “by their nature... [a firm] is strongly responsive to shareholder interests. [firms] do not, however, necessarily dictate how the interests of other participants in the firm [...] will be accommodated”³¹⁴. Both scholars predicted a decline of the two-tier board but also a simultaneous decline in shareholder primacy and greater stakeholder influence.³¹⁵ Today, in Germany a trend towards more shareholder value protection can be observed, but there is little evidence of a shifting

³⁰⁸ I.e. consent for special actions or advising management; Oetker, in: Hommelhoff et al, 277, 282 (2009).

³⁰⁹ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 227 (1999).

³¹⁰ Coffee, Working Paper 144, 20 (1999).

³¹¹ Jungmann, 3 ECFR, 426, 463 (2006).

³¹² Coffee, Working Paper 144, 40 (1999); Bratton, McCahery, in: McCahery et al, 23, 24 f. (2002).

³¹³ Coffee, Working Paper 144, 27 (1999).

³¹⁴ Hansmann, Kraakman, Discussion Paper 280, 2 (2000).

³¹⁵ Hansmann, Kraakman, Discussion Paper 280, 3 & 19 (2000).

norm in Germany towards shareholder primacy, as evident by the use of a stakeholder encompassing definition in the GCGC.³¹⁶ Corporate governance in Germany continues to structure a company's managing and supervising tasks in a way that best facilitates the relationship between managers, board(s), shareholders and other stakeholders.³¹⁷

Both the German and America board systems have proven similarly efficient in each of their respective cultural systems.³¹⁸ Despite the success of the two-tier board in Germany, many Germany scholars have promoted implementing an optional one-tier board structure for German corporations.³¹⁹ European regulators have already implemented this choice allowing a SE to choose between either structure. Every German company has the possibility to change their system to a less codetermined³²⁰, smaller one-tier board. In the 12 years of its existence only 5 of the 100 biggest German companies chose the form of an SE in 2012.³²¹ All 5 companies that did, however, chose a dualistic SE system with management and supervisory board.³²²

5.2 The “1.5” Tier Board in America

The American board has begun to reflect German two-tier model in function if not in form. The heightening of monitoring standards on boards following the passage of SOX has led to the American board increasing in both size and expertise. These heightened standards have required boards to delegate responsibilities increasingly to committees, which are growing in number, expertise and responsibility.³²³ The audit committee, for example, is only composed of a small number of independent directors with expertise in auditing. The board has effectively delegated the entire auditing

³¹⁶ No. 1 subpara. 2 GCGC, based on the OECD definition.

³¹⁷ OECD, Principles of Corporate Governance, 11, Preamble (2004).

³¹⁸ Bratton, McCahery, 38 Colum. J. Transnat'l L., 213, 237 (1999).

³¹⁹ Hopt, in: Hommelhoff et al, 39, 45 (2009); Raiser, Veil, section 13 recital 15 (2010); Commercial law resolution No. 19, 69. German Jurist Conference 2012, resolutions, 21 (2012).

³²⁰ As German codetermination law is not applicable in a SE, Habersack, ZHR, 613, 618 (2007).

³²¹ Others: 64 AG, 13 partnerships, 7 GmbH, 3 KGaA, 3 VVaG, Monopolies Commission, 191 (2014).

³²² One should have a healthy skepticism about the limited number of German corporations switching to a more independent one-tier board structure as evidence of the superiority of the two-tier structure. Neither the Supervisory nor Management board has an incentive to switch structures because such a move would inevitably lead to fewer employee representatives or non-independent executive directors on the board. Only the shareholders, whose representatives occupy minority seats on the supervisory board, would push for such a switch. Some have described the alliance between employee representatives and management as a “Faustian Bargain”, and these two stakeholders would block any move that would diminish both of their respective power.

³²³ *Supra* I.VI

supervisory responsibility to only two or three board members. The rise of committees along with the heightened monitoring standards may dull some of the primary advantages of the single-tier board by effectively marginalizing all other board members that lack the specialized knowledge of the committee.³²⁴ This specialization hurts the flow of information on the board, and blunts one of the primary advantages of the one-tier board.

The rise of executive sessions, which are separate meetings of the independent directors without the executive directors, is yet another example of the fraying of the one-tier board into two or more tiers. Board meetings that are less inclusive of all board members stymie board cohesion and information flow. In this way, the American board may be better described as a “1.5” tier rather than a one-tier board. Supervisory duties, although not legally separate like in the German model, have been heightened and delegated to the point of constituting something unique, and substantively different than a unified one-tier board.

V. Conclusion

The one-tier and two-tier board models of the United States and Germany reflect differing histories, governance norms and national aspirations. Substantial changes over the past 30 years to the American board has made American boards substantively far different than German boards, as they increasingly favor independence over representation and shareholders over stakeholders. In many ways, however, American boards are procedurally becoming more similar to their German counterparts. The heightened monitoring standards for boards and the rising importance of committees has made the one-tier board in America more akin to a multi-tiered board.

In Germany, corporations now have the choice of adopting the one-tier board model but very few have done so. It is possible that demand from the international financial markets will force the German system to conform more strongly with the American board structure, but it remains to be seen if this will be the case. As long as there is ambiguity over which model performs better, it is unlikely that either nation will

³²⁴ See *Calkoen* at 190

abandon their board structure and the cultural norms that each structure represents for the foreseeable future.

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List of Abbreviations and Translations

| | |
|--|-----------|
| Article. - <i>Artikel.</i> | - Art. |
| Association. - <i>Verein.</i> | |
| Chief Executive Officer. | - CEO |
| Chief Financial Officer. | - CFO |
| Chief Organization Officer. | - COO |
| Chief Legal Officer | - CLO |
| Collection of Rulings of the Federal Constitutional Court of Germany. - <i>Entscheidungssammlung des Bundesverfassungsgerichts.</i> | - BVerfGE |
| Collection of Rulings of the Federal Court of Justice in Corporate Law. - <i>Entscheidungen des Bundesgerichtshofs in Zivilsachen.</i> | - BGHZ |
| Company limited by shares. - <i>Aktiengesellschaft.</i> | - AG |
| Company with limited liability. - <i>Gesellschaft mit beschränkter Haftung.</i> | - GmbH |
| Council Regulation (EC) No. 2157/2001 of 8. October 2001 on the Statute for a European company, as published in the announcement of 11. November 2001 (OJEC 2001, L 294/1). - <i>SE Verordnung.</i> | - SE-VO |
| European Court of Justice. - <i>Europäischer Gerichtshof.</i> | - EuGH |
| European limited liability company. - <i>Societas Europaea.</i> | - SE |
| European Union. - <i>Europäische Union.</i> | - EU |
| Federal Constitutional Court of Germany. | - BVerfG |

| | |
|--|-------------------|
| - <i>Bundesverfassungsgericht.</i> | |
| Federal Court of Justice of Germany. - <i>Bundesgerichtshof.</i> | - BGH |
| Federal Financial Supervisory Authority. - <i>Bundesanstalt für Finanzaufsicht.</i> | - BaFin |
| Federal Gazette. - <i>Bundesanzeiger.</i> | - BAnz |
| Federal Law Gazette. - <i>Bundesgesetzblatt.</i> | - BGBl. |
| For Example. - <i>Zum Beispiel.</i> | - i.e. |
| Foundation. - <i>Stiftung.</i> | |
| Delaware General Corporation Law. | - DGCL |
| General Meeting. - <i>Hauptversammlung.</i> | |
| German Act on Codetermination in the Coal, Iron and Steel Industry, as published in a revised version (BGBl. III, 801-2), last amended by Art. 5 of the Law of 24. April 2015 (BGBl. 2015, I, 642). - <i>Montan Mitbestimmungsgesetz.</i> | - Montan-MitbestG |
| German Banking Act, as published on 9. September 1998 (BGBl. 1998, I, 2776), last amended by Art. 16 of the Law of 20. November 2015 (BGBl. 2015, I, 2029). - <i>Gesetz über das Kreditwesen.</i> | - KWG |
| German Codetermination Act, as published on 4. May 1976 (BGBl. 1976, I, 1153), last amended by Art. 7 of the Law of 24. April 2015 (BGBl. 2015, I, 642). - <i>Mitbestimmungsgesetz.</i> | - MitbestG |
| German Corporate Governance Code, last amended on 5. May 2015, published in the announcement of 12. June 2015 (Banz., AT B1). | - GCGC |

| | |
|---|-------------|
| - <i>Deutscher Corporate Governance Kodex.</i> | |
| German Limited Liability Companies Act, as published in a revised version (BGBl. III, 4123-1), last amended by Art. 5 of the Law of 22. December 2015 (BGBl. 2015, I, 2565). - <i>GmbH Gesetz.</i> | - GmbHG |
| German One-Third Participation Act, as published on 18. May 2004 (BGBl. 2004, I, 974), last amended by Art. 8 of the Law of 25. April 2015 (BGBl. 2015, I, 642). - <i>Drittelbeteiligungsgesetz.</i> | - DrittelbG |
| German SE Implementation Act, as published in the announcement of 22. December 2004 (BGBl. 2004, I, 3675), last amended by Art. 14 of the Law of 24. April 2015 (BGBl. 2015, I, 642). - <i>SE-Ausführungsgesetz.</i> | - SEAG |
| German Stock Corporation Act, as published on 6. September 1965 (BGBl. 1965, I, 1089), last amended by Art. 14 of the Law of 24. April 2015 (BGBl. 2015, I, 642). - <i>Aktiengesetz.</i> | - AktG |
| Higher Regional Court in Berlin. - <i>Kammergericht Berlin.</i> | - KG Berlin |
| Higher Regional Court in Germany. - <i>Oberlandesgericht.</i> | - OLG |
| Human Resources. | - HR |
| Limited company. - <i>Kapitalgesellschaft.</i> | |
| Management board. - <i>Vorstand.</i> | |
| Mutual insurance organization. - <i>Versicherungsverein auf Gegenseitigkeit.</i> | - VVaG |
| National Association of Securities Dealers Automated Quotations. | - NASDAQ |
| New York Stock Exchange. | - NSYE |

| | |
|---|------------|
| Number. - <i>Nummer.</i> | - No. |
| Official Journal of the European Union. - <i>Amtsblatt der Europäischen Union.</i> | - OJEC |
| Organization for Economic Co-operation and Development. - <i>Organisation für wirtschaftliche Zusammenarbeit und Entwicklung.</i> | - OECD |
| Paragraph. - <i>Absatz.</i> | - Para. |
| Partnership limited by shares. - <i>Kommanditgesellschaft auf Aktien.</i> | - KGaA |
| Partnership. - <i>Personengesellschaft.</i> | |
| Recital. - <i>Randnummer.</i> | |
| Registered cooperative society. - <i>Eingetragene Genossenschaft.</i> | - eG |
| Sarbanes-Oxley. | - SOX |
| Securities Exchange Commission. | - SEC |
| Sentence. - <i>Satz.</i> | - Sent. |
| Subparagraph. - <i>Unterabsatz.</i> | - Subpara. |
| Supervisory board. - <i>Aufsichtsrat.</i> | |
| United States. - <i>Vereinigte Staaten von Amerika.</i> | - U.S. |
| German Insurance Supervision Act as published on 1. April 2015 (BGBl. 2015, I, 434), last amended by Art. 3 No.1 of the Law of 21. December 2015 (BGBl. 2015, I, 2553). - <i>Versicherungsaufsichtsgesetz.</i> | - VAG |

