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Evolution of German corporate governance (1995-2014): An empirical analysis

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Evolution of German corporate governance (1995-2014): An empirical analysis

Abstract

The research paper addresses the evolution of corporate governance in Germany with a particular regard to whether there can be observed a gradual convergence to a shareholder primacy corporate governance system. In order to investigate a potential shift of the German corporate governance system to an Anglo-American tiled corporate governance system we have empirically assessed on a polynomial base fifty-two separate company and corporate governance variables for twenty years (1995-2014). Our research suggests that a gradual convergence has taken place prior to the global financial crisis. However, our results suggest that the convergence process experienced a slowdown in the aftermath of the global financial crisis, which may be linked to the stability of the German corporate governance system during the global financial crisis and the political environment during this time. Our paper does not only contribute to the research by analysing the development of the German corporate governance system but also by identifying new reasons for this development and by explaining why a new convergence process may be observed in the future again.

Corporate Governance

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Introduction to the corporate governance debate in Germany

The international corporate governance debate reached Germany rather comparatively late, in the second half of the 1990s.[1] This was partly a reaction to a period of economic difficulty that Germany experienced in the years after the reunification in 1990. Till then the model of the so-called 'Rhenish capitalism' of West Germany was characterised by features such as a strong welfare state, bank loans being the primary source of finance, cross-ownership concentrated in few shareholders, little institutional investor pressure and, most significantly, compulsory board membership of employee representatives.[2] This system came under pressure in an era of increasing globalisation. International competition, liberalised capital markets and the weaker performance of the German economy in the 1990s questioned the viability of the German economic model.[3] The discussions about necessary reforms of German company law eventually led to the introduction of corporate governance in Germany. As this article will show, Germany has witnessed several changes to its company law and corporate governance system since the late 1990s. These reforms raise the question to what extent the German system of company law and corporate governance has converged or is gradually converging with the Anglo-American system of shareholder value.[4]

We sought to empirically track the development and transmutation of German corporate governance into an Anglo-American tiled corporate governance system. In the empirical phase of the research we collected data on fifty-two separate company and corporate governance variables based on the OECD Principles of Corporate Governance and previous indices for twenty years (1995-2014). The variables were scaled polynomially, i.e., the value could be zero, or one, or two which meant the survey went beyond a simple yes/no response in order to take into account systems which use optional rules or 'soft law'.

We argue that Germany has experienced a period of gradual convergence towards shareholder value corporate governance system from the Mid 1990s till the beginning of the global financial and economic crisis. However, we find that whilst this convergence has not stopped it has, at least, significantly slowed down since 2008-2009. It appears as if the unique features of the German corporate governance systems such as the pluralist purpose of the company and the

[1] J J du Plessis and I Saenger, 'An Overview of the Corporate Governance Debate in Germany' in J du Plessis et al., *German Corporate Governance in International and European Context* (2nd edn, Springer 2012) 16.
[2] See, for example, J Edwards and M Nibler, 'Corporate governance in Germany: the role of banks and ownership concentration' (2000) 15 *Economic Policy* 240; S Vitols, 'Negotiated Shareholder Value: the German Variant of an Anglo-American Practice' (2004) 8 *Competition & Change* 357.
[3] See G Volk, 'Deutsche Corporate Governance-Konzepte' (2001) *DStR* 412.
[4] See A Gamble and J Kelly, 'Shareholder Value and the Stakeholder Debate in the UK' (2001) 9 *Corporate Governance: An International Review* 110.

Corporate Governance

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employee representation at board level have enjoyed renewed support since the onset of the crisis. In our view, this development is linked to the relatively strong performance of the German economy post 2008 which has led to more content with the present German system of corporate governance. We argue that in addition to the economic parameters the political environment has further contributed to the stabilisation of the German corporate governance system. Between 2005-2009 and again since 2013 Germany has been governed by a grand coalition of the two main centre-right and centre-left parties. This focus on the political centre has also led to a consensus between labour and the employer side which has reduced the appetite for reforms. However, the process of globalisation and the increasingly international investment structures will continue to put pressure on the German pluralist model of corporate governance. It is to be expected that those pressures will lead to a gradual, albeit slow convergence with some features of shareholder value corporate governance. However, at present, we do not anticipate a full convergence, but rather expect the German system to retain features such as employee participation at board level at least in the short to mid-term future.

Gelöscht: employee

Empirical Methodology

This paper will thematically follow the shareholder primacy corporate governance principle as outlined by Henry Hansmann and Reiner Kraakman:

1. ultimate control over the corporation should rest with the shareholder class;
2. the managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders;
3. other corporate constituencies, such as creditors, employees, suppliers, and customers, should have their interests protected by contractual and regulatory means rather than through participation in corporate governance;
4. non-controlling shareholders should receive strong protection from exploitation at the hands of controlling shareholders; and
5. the market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests

Based on this classification, the researcher will broadly look into increased shareholder rights, increased market for corporate control, reduced managerial and stakeholder rights as outlined in the OECD principles of corporate governance.

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The dilemma in choosing between hard law and soft law, between statute books, private contractual regulations (like listing rules) and non-binding governance codes impacts on the aim of the research. It can be methodologically dealt with to a large extent by following an ordered response model offering choice from multiple options instead of a binary option. Financial development depends to a large extent on the availability of funds to primary and secondary markets. These markets are governed by listing rules and companies who want to raise money from these markets would have to adhere to these rules. Listing rules have become quite expansive over the years and in many ways set a higher disclosure and shareholder rights benchmark for companies. However, the soft laws; the corporate governance codes, the general practice etc. though usually non-binding and do not have the force of a statutory law or judicial precedent are an equally important indicator of the overall trend of a country towards achieving greater corporate governance. Thus, for each variable the researcher will first direct the legal survey towards the listing agreements of the share market with the highest market capitalisation in a country. If the variable is not addressed by the listing agreement then the survey will take into account the company and securities law focussing on statutes enacted at a federal level. For every variable which is addressed by hard law and enforceable, generally by the market regulator, and justiciable, usually by courts will be coded as 2. If the variable is not adequately dealt with by hard law the survey will move to soft law such as non-binding corporate governance codes, codes of ethics for company executives and self-governing codes like City codes etc. These variables would be coded as 1. If the variable is not dealt with by either hard law or soft law it will be coded as 0. Therefore, unlike the early research by La Porta et al., this research will not compile the compulsory minimum standard of corporate governance, neither will this research arbitrarily source some variables from hard law and others from soft law. For each variable which can be dealt with by regulation there will be a three-stage ordered response – no law 0, soft law 1 and hard law 2. This will not only capture a wider picture of the implementation of corporate governance policies in different jurisdictions, but will also be useful in intra-code comparison and finding out which portions of corporate governance tend to be implemented differently via soft law etc.

The article also uses a financial development analysis for a simple comparison/contrast with the change in corporate governance. The financial market development index is a Bayesian factor analysis of five individual variables - Foreign Direct Investment (FDI), market capitalisation of listed companies, number of listed domestic companies, S&P global equity index and volume of stocks traded.

Corporate Governance

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The variables used are provided in Appendix A and a sample questionnaire used to collect data is provided in Appendix B.

Distinguishing features of German corporate governance

German companies can be differentiated into public limited companies (*Aktiengesellschaft)*, abbreviated as 'AG' and private limited companies (*Gesellschaft mit beschränkter Haftung)*, abbreviated as 'GmbH'. These two types of companies are regulated by separate Acts of Parliament: The *Aktiengesetz* ('AktG') deals with public limited companies and the *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* ('GmbHG') deals with private limited companies. Although the word *Aktiengesellschaft* is often translated into English as 'joint stock corporation',[5] the more widely used reference to it in English is 'public limited company'.[6] For ease of understanding, this article will also refer to public limited companies. The position of German AGs has, in recent years, been challenged by the European company (SE). However, the AG has so far defended its leading position among German companies.[7]

From an international and comparative perspective, German company law is an interesting area of study as it exhibits some characteristic features that differ significantly from the Anglo-American organisation of company law and corporate governance.[8] Germany is generally called a stakeholder value or pluralistic system which puts it into strong difference to Anglo-American approaches to company law.[9] The probably most widely discussed distinguishing feature of German company law is the compulsory boardroom representation of employees, known as co-determination.[10] A public limited company must have a dual board, consisting of a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*).[11] Whilst the members of the

[5] For example, the law firm Norton Rose published an English translation of the *Aktiengesetz* in 2013 in which it called the Act 'German Stock Corporation Act'. The translation can be accessed at http://www.nortonrosefulbright.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf (accessed 11 September 2016).
[6] See the discussion of terminology in J J du Plessis et al, 'An Overview of German Business or Enterprise Law and the One-Tier and Two-Tier Board Systems Contrasted' in J J du Plessis et al, *German Corporate Governance in International and European Context* (Springer, 2nd edn, 2012) 5.
[7] See G Deipenbrock, 'Sustainable development, the interest(s) of the company and the role of the board from the perspective of a German Aktiengesellschaft', University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2010-02, 9-10.
[8] M Goergen et al., 'Recent developments in German corporate governance' (2008) 28 *International Review of Law and Economics* 1.
[9] S Wen, 'The magnitude of shareholder value as the overriding objective in the UK: the post-crisis perspective' (2011) 26 *Journal of International Banking Law and Regulation* 326.
[10] See M Roth, 'Employee participation, corporate governance and the firm: A transatlantic view focussed on occupational pensions and co-determination' (2010) 11 *European Business Organization Law Review* 53; see J J du Plessis and O Sandrock, 'The rise and fall of supervisory codetermination in Germany?' (2005) 16 *International Company and Commercial Law Review* 67-79.
[11] See for a detailed assessment of the system of co-determination: O Sandrock and J J du Plessis, 'The German System of Supervisory Codetermination by Employees' in J J du Plessis et al., *German Corporate Governance in International and European Context* (Springer, 2nd edn, 2012) chapter 5.

Corporate Governance

management board are all executive directors who run the business on a day-to-day basis[12], the members of the supervisory board are tasked with supervising the conduct of the members of the management board and advising them on future business decisions.[13] The functional separation between the management board and the supervisory board guarantees a sophisticated level of decision making within the company. The composition of the supervisory board is subject to statutory rules regarding the inclusion of employee representation. A public limited company that has more than 500 employees and less than 2000 employees has to have 30% employee representation on the board.[14] In the case of a company with 2000 or more employees, the employee representatives have got to make up 50% of the members of the supervisory board.[15] The other half are elected by the shareholders. If there is a decision where both sides cannot agree, the chairman of the company has got the final say.[16] The casting vote of the chairman inhibits equal co-determination as the chairman is a shareholder representative.[17] However, the purpose of the employee representation is to lead to more consensual decision-making which integrates the perspectives of the employees into the running of the business. The dual board structure with mandatory employee representation in supervisory boards is an entrenched feature of German company law that has survived the pressures of globalisation and the legislative changes since the 1990s that are discussed in this paper. Debates about the functioning of the supervisory boards were one of the key issues in the corporate governance

Gelöscht: we

[12] Section 76 (1) AktG; A Ross, K Crossan, 'A review of the influence of corporate governance on the banking crises in the United Kingdom and Germany' (2012) *Corporate Governance: The International Journal of Business in Society* 215, 219; M Rahman and C Carpano, 'National corporate social policy, corporate governance systems, and organizational capabilities' (2017) *Corpor*ate Governance: The International Journal of Business in Society 13, 20.

[13] Section 111 AktG; M Habersack in *Münchener Kommentar zum* Aktiengesetz (4th edn, Verlag C.H.Beck 2018) § 111, para 12; H Merkt, 'Germany- Internal and external corporate governance' in A Fleckner and K Hopt (ed), *Comparative Corporate Governance- A Functional and International Analysis* (Cambridge University Press 2013) 533; A Ross, K Crossan, 'A review of the influence of corporate governance on the banking crises in the United Kingdom and Germany' (2012) *Corporate Governance: The International Journal of Business in Society* 215, 220; M Rahman and C Carpano, 'National corporate social policy, corporate governance systems, and organizational capabilities' (2017) *Corpor*ate Governance: The International Journal of Business in Society 13, 20.

[14] Section 4 DrittelbG (*Gesetz über die Drittelbeteiligung der Arbeitnehmer im Aufsichtsrat*). This Act can be translated into English as 'One-Third Participation Act'.

[15] Section 7 MitbestG (*Mitbestimmungsgesetz*). This Act can be translated into English as 'Codetermination Act'.

[16] Section 29 (2) MitbestG.

[17] H Merkt, 'Germany- Internal and external corporate governance' in A Fleckner and K Hopt (ed), *Comparative Corporate Governance- A Functional and International Analysis* (Cambridge University Press 2013) 533; S Renaud, 'Dynamic Efficiency of Supervisory Board Codetermination in Germany' (2007) *Labour – Review of Labour Economics and Industrial Relations* 689, 690; M Poole, R Lansbury, and N Wiles, 'A Comparative Analysis of Developments in Industrial Democracy' (2001) *Industrial Relations* 490, 505; M Rahman and C Carpano, 'National corporate social policy, corporate governance systems, and organizational capabilities' (2017) *Corpor*ate Governance: The International Journal of Business in Society 13, 20.

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discussions since the late 1990s and this issue has thus been a major topic in the German corporate governance debate.[18]

Apart from co-determination another important feature of the stakeholder orientation of German companies is the question of the purpose of the company (*Unternehmensinteresse*). The AktG stipulates that the management board has direct responsibility for the management of the company.[19] Whilst the 1965 AktG did not repeat the public welfare clause of the German *Aktiengesetz* of 1937, it is generally considered that this provision is still valid.[20] The commentary notes that, when the 1965 Act was drafted, the general view was that it would go without saying that the directors have to take into account equally the interests of shareholders, employees and the public.[21] It would therefore not need to be expressly written down in the Act. At present, this pluralistic view of directors' duties is still considered to be the generally accepted, yet not undisputed, view.[22] However, since the 1990s, there has been an increasing influence of the idea of shareholder value in Germany due to the opening of the German capital markets to a more international audience.[23] Contrary to this trend, a particularly important development was an amendment of the German Corporate Governance Code in 2009, i.e. after the onset of the global economic and financial crisis. The Code now defines the tasks of the management board in the following way:

> The Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.[24]

This stakeholder-oriented definition of the interest of the enterprise is significant as it reinforces the traditional view that, in their decision-making process, directors have to take into account

[18] See also J J du Plessis and I Saenger, 'An Overview of the Corporate Governance Debate in Germany' in J J du Plessis et al., *German Corporate Governance in International and European Context* (2nd edn, Springer 2012) pp 22-30.
[19] Section 76 (1) AktG.
[20] H Fleischer in H Fleischer (ed), *Handbuch des Vorstandsrechts* (Verlag C.H. Beck 2006) section 1; H Merkt, 'Germany: Internal and external corporate governance' in A Fleckner, K Hopt (eds), *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge University Press 2013) 537 .
[21] See G Spindler in *Münchener Kommentar zum Aktiengesetz* (3rd edn, Verlag C.H. Beck 2008) section 76, para 65; H Fleischer in Spindler/Stilz (eds) *Aktiengesetz* (3rd edn, Verlag C.H.Beck 2015) section 76, para 23; Hüffer/ Koch in *Aktiengesetz* (12th edn.; Verlag C.H.Beck 2016) § 76, para 30.
[22] See H Merkt, 'Germany: Internal and external corporate governance' in A Fleckner, K Hopt (eds), *Comparative Corporate Governance: A Functional and International Analysis* (Cambridge University Press 2013) 536; G Volk, 'Deutsche Corporate Governance-Konzepte' (2001) *Das deutsche Steuerrecht* 412; P Ulmer, Aktienrecht im Wandel – Entwicklungslinien und Diskussionsschwerpunkte (2002) *Archiv für die civilistische Praxis* 143, 158.
[23] See for an analysis of shareholder value and section 76 of the AktG: H Fleischer in Spindler/Stilz (eds) *Aktiengesetz* (3rd edn, Verlag C.H.Beck 2015) section 76, paras 29-42; K Bottenberg *et al.*, Corporate Governance between Shareholder and Stakeholder Orientation: Lessons from Germany (2017) *Journal of Management Inquiry* 165, 169.
[24] German Corporate Governance Code, 4.1.1.

Corporate Governance

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the views of different stakeholders and that shareholders do not take priority in that process. Although the Code is not a law, this provision strengthens the pluralistic understanding of the corporation. However, although this amendment to the Code demonstrates that the triumph of shareholder value is, at least in Germany, not certain, the management board nevertheless continues to be subject to the pressures of financial markets and shareholders interest in dividends.[25]

Historic development: From company law to corporate governance?

The 1965 Act on public limited companies was the most significant reform of the German law on public limited companies after World War II. It replaced the 1937 Act.[26] Although the 1937 Act was not regarded to be a typical Nazi regime Act, soon after World War II there has been a call for the amendment and modernisation of the 1937 Act. The declared objectives of this reform were achieving more transparency, strengthening shareholder rights, and an improving the protection of minority shareholders.[27] The 1965 Act has remarkably shaped the present German law on public limited companies. However, not only the law makers but also the jurisprudence played a key role in shaping the present German law on public limited companies in the aftermath of the enactment of the 1965 Act. Cases such as *Kali & Salz*[28], *Holzmann*[29], and *Holzmüller*[30] which were mainly concerned with the protection of shareholder rights were of outstanding importance for subsequent reforms. Reforms of the law on public limited companies in the decades after the 1965 Act primarily concerned issues such as, inter alia, capital markets law, technical developments, implementations of EU Directives or, indeed, corporate governance.[31] Some of the reforms were amendments to the AktG whilst others were reforms outside this Act. A particularly important reform was the Co-determination Act of 1976 which introduced the equal representation of employees in supervisory boards of large corporations. Several legislative amendments were made in the year 1998 (six in total). In that year, no-par-value shares were introduced, shareholder rights were strengthened, and the commercial law was reformed, too. The 1998 reforms are, to some extent, considered to be a

Gelöscht: Once the process of reforming the 1937 Act had started, the proposals elaborated by the Ministry of Justice led to an ongoing debate amongst politicians and scholars.

[25] D Hexel, '10 Jahre Corporate Governance in Deutschland: Eine Bestandsaufnahme aus gewerkschaftlicher Sicht' (2012) *AuR* 334, 336.
[26] See for an overview of the historic development: C Windbichler, *Hueck/Windbichler Gesellschaftsrecht* (21st edn, Verlag C.H. Beck 2008) pp 278-287.
[27] M Habersack in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H. Beck 2016) Einführung para, 25.
[28] BGH NJW 1978, 1316.
[29] BGH NJW 1982, 2444.
[30] BGH NJW 1982, 1703.
[31] P Ulmer, Aktienrecht im Wandel – Entwicklungslinien und Diskussionsschwerpunkte (2002) *Archiv für die civilistische Praxis* 143, 147.

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consequence of corporate failures in the 1990s which led to calls for an improved corporate governance, e.g. more efficient supervisory boards.[32] Equally, the need for more capital led to companies to sell their shares at foreign stock markets. This, in turn, necessitated an adaption to foreign principles of corporate governance.[33]

The 2000s saw further important changes to German company law and corporate governance, both prior to and post the economic and financial crisis.[34] The primary goal was to improve the corporate governance of German listed companies.[35] The introduction of the German Corporate Governance Code in 2002 will be addressed in a separate section below. The Transparency and Disclosure Law of 2002 complements the rules about the cooperation between the managing board and the supervisory board as well as linking the AktG to the newly introduced German Corporate Governance Code.[37] A further important milestone was the 2005 Act on the Disclosure of the Compensation of Members of the Managing Board.[38] This Act requires the individual disclosure of the remuneration of members of the managing board which was previously only a recommendation of the German Corporate Governance Code. Executive pay was further addressed in the 2009 Act regarding the Appropriateness of Management Board Compensation which requires the compensation structure to be directed towards the sustainable growth of the company.[39] Although, as the name suggests, the Act to Modernise the Law on Private Limited Companies and to Combat Abuses of 2008, primarily focussed on private limited companies, it also contained changes for public limited companies such as amendments to the rules regarding the disqualification of directors.[40] To date, the German law on public limited companies remains a topic for legislative interventions. In 2015, a requirement for co-determined supervisory boards of 30 percent female members was established by law.[41]

Gelöscht: . It has been pointed out that the increasing frequency of reforms since 1998 would be notable.[36]

[32] G Volk, 'Deutsche Corporate Governance-Konzepte' (2001) *Das deutsche Steuerrecht* 412; P Ulmer, Aktienrecht im Wandel – Entwicklungslinien und Diskussionsschwerpunkte (2002) *Archiv für die civilistische Praxis* 143, 146.
[33] M Habersack in *Münchener Kommentar zum* Aktiengesetz (4th edn, Verlag C.H.Beck 2016) Einführung, para 38.
[34] For an overview of the reforms prior to the financial crisis see: P Klages, 'The contractual turn: how legal experts shaped corporate governance reforms in Germany' (2013) *Socio Economic Review,* 159.
[35] ibid, para 52.
[37] M Habersack in *Münchener Kommentar zum* Aktiengesetz (4th edn, Verlag C.H.Beck 2016) Einführung, paras 56-58.
[38] R von Rosen, Corporate governance in Germany (2007) *Journal of Financial Regulation and Compliance* 30, 35.
[39] M Habersack in *Münchener Kommentar zum* Aktiengesetz (4th edn, Verlag C.H.Beck 2016) Einführung, para 70.
[40] ibid, para 66.
[41] Art 3 Gesetz für die gleichberechtigte Teilhabe von Frauen und Männern an Führungspositionen in der Privatwirtschaft und im öffentlichen Dienst vom 24.04.2015.

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Also, the increasing internationalisation of company law led to the reception of some Anglo-American legal transplants into German company law since the 1990s.[42] This further fuelled the debate about whether or not there would be a gradual convergence of company law systems around the world and, in particular, if German company law was converging with the Anglo-American model of shareholder value.[43] This debate has been part of Fleischer's analysis of some foreign legal transplants that were received in the German law on public limited companies such as the business judgment rule or the corporate compliance responsibility of executive directors.[44] The business judgment rule was adopted by the German Federal Court of Justice in 1997 and codified in the AktG in 2005.[45] Fleischer also looked at the increasing influence of the Anglo-American idea of shareholder value and how there was room for it in the duty of the management board to manage the company.[46] However, his article was written in 2004 and therefore five years before the clarification in the Code that directors of German public limited companies have to take into account the interests of the shareholders, its employees and other stakeholders.

Gelöscht: a

Gelöscht: e

The German Corporate Governance Code

One particular legal transplant was the introduction of a corporate governance code into the German legal system.[47] As mentioned, the idea of a corporate governance code was taken up comparatively late in Germany.[48] The idea of introducing a corporate governance code roots back to the introduction of the KonTraG[49] in 1996 and was taken forward by two private initiatives in the year 2000.[50] The first initiative were corporate governance principles for listed companies ('Code of best Practice'), developed by the Policy Commission Corporate

[42] G Cromme, Corporate Governance in Germany and the German Corporate Governance Code' (2005) *Corporate Governance- An International Review,* 362.

[43] For an overview of this debate see: M Goergen, M Manjon, and L Renneboog, 'Is the German system of corporate governance converging towards the Anglo-American model?' (2008) *Journal of Management and Governance,* 37; D Denis and J McConell, 'International Corporate Governance'(2003) *Journal of Financial and Quantitative Analysis,* 1.

[44] H Fleischer, 'Legal Transplants im deutschen Aktienrecht' (2004) *Neue Zeitschrift für Gesellschaftsrecht* 1129.

[45] BGH, Urteil vom 21. April 1997, BGHZ 135, 244 (*ARAG/Garmenbeck*). The business judgment rule was codified in section 93 (1) 2 of the AktG.

[46] H Fleischer, 'Legal Transplants im deutschen Aktienrecht' (2004) *Neue Zeitschrift für Gesellschaftsrecht* 1129, 1131.

[47] Theisen calls the Code an 'import', see M Theisen, 'Aufstieg und Fall der Idee vom Deutschen Corporate Governance Kodex - Analyse eines deutschen Sonderwegs –' (2014) 37 *Der Betrieb* 2057, 2064.

[48] von Werder in Kremer/Bachmann/Lutter/v.Werder (eds), *Deutscher Corporate Governance Kodex Kommentar* (8th edn, Verlag C.H. Beck 2018) 2. Teil Vorbemerkung, para 6.

[49] Gesetz zur Kontrolle und Transparenz im Unternehmensbereich. This Act can be translated into English as 'Law on control and transparency in business'.

[50] G Cromme, Corporate Governance in Germany and the German Corporate Governance Code' (2005) *Corporate Governance- An International Review,* 362, 364.

Corporate Governance

Governance. These principles were known as the Frankfurter principles.[51] The second initiative was a draft code, developed by the Berliner Initiative German Code of Corporate Governance (GCCG).[52] The two proposals are based on an international model, yet are different in their design, content and the level of detail. However, it was seen critically that two codes could exist in parallel.

The Ministry of Justice, therefore, appointed initially 12 (then 13) prominent figures from business, academia and public life as the so-called codex commission under the lead of the head of the supervisory board of ThyssenKrupp, Dr Gerhard Cromme.[55] The commission was tasked with the development of a German Corporate Governance Code. The initial composition of the codex commission demonstrated an attempt to include all stakeholders that were affected by the code. Therefore, the members came from listed companies, banks, financial services as well as shareholder representatives and academia.[56] The law only indicates the role of the commission by presupposing its existence and by mentioning that the commission gives recommendations. At its inception, the mandate of the commission was specified by the then Ministry of Justice Däubler-Gmelin who said that the commission should develop a German Corporate Governance Code on the basis of the law and should scrutinise it periodically. The German Corporate Governance Code (hereafter: 'the Code') was adopted on 26 February 2002.

The overall objective of the Code is to promote the confidence of investors, customers, employees and the general public in German corporate governance in order to improve the standing of Germany as a location for international and national investors.[58] Thus, the Code is available on a website both in German and in English so that a foreign audience can easily access it.[59] The Code's foreword describes its dual objectives:

> The German Corporate Governance Code (the "Code") presents essential statutory regulations for the management and supervision (governance) of German listed companies and contains internationally and nationally recognized standards for good and responsible governance. The Code aims to make the German Corporate Governance system transparent and understandable. Its purpose is to promote the trust of

Gelöscht: The idea of a German Corporate Governance Code, based on an international model that both initiatives took forward was positively received.[53]

Gelöscht: Therefore, the government commission Corporate Governance, which, too, was appointed in the year 2000 recommended the implementation of a further commission for the development of a uniform German Corporate Governance Code.[54]

Gelöscht: followed the recommendation of the government commission and …

Gelöscht: The Ministry of Justice has got the competence to increase or reduce the membership of the commission, to remove members or even to dissolve the commission.[57]

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[51] M Lutter, 'Deutscher Corporate Governance Kodex' in P Hommelhoff, K Hopt and A Werder (ed) *Handbuch Corporate Governance- Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis* (2nd edn, Schäffer-Poeschel Verlag und Verlag Dr. Otto Schmidt KG 2009) 123, 124.
[52] N Pfitzer and P Oser, M Schiller, '*Deutscher Corporate Governance Kodex- Ein Handbuch für Entscheidungsträger*' (Schäffer-Poeschel Verlag 2003) 15.
[55] ibid, para 9.
[56] W Goette in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H.Beck 2018) § 161, para 22.
[58] von Werder in Kremer/Bachmann/Lutter/v.Werder (eds), *Deutscher Corporate Governance Kodex Kommentar* (8th edn, Verlag C.H. Beck 2018) 2. Teil Vorbemerkung, para 33; M Schiller, *'Der Deutsche Corporate Governance Kodex- Ziele, Wirkungen, Anwendungs- und Haftungsfragen'* (VDM Verlag Dr. Müller 2005) 20.
[59] See http://www.dcgk.de/en/home.html (accessed 11 September 2016).

Corporate Governance

international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations.[60]

The Code therefore serves the dual function of both presenting the main statutory regulations for public limited companies, as found in the AktG, and formulating standards of good corporate governance which may go beyond the rules, prescribed by statute.[61] The first objective, the presentation of the main principles of the German law on public limited companies makes the rules more accessible to an international audience as the German AktG is written in German and, to date, only a non-official translation by an international law firm is available online.[62] This has been called the 'communicative function of the Code'.[63]

Gelöscht: ¶

The code applies only to listed companies and compliance with it is not mandatory. Including the foreword, it is divided into seven sections, for instance, one on the management board and one on the supervisory board. As described in the foreword, the Code consists of three types of provisions: First, there are recommendations which are marked by the word 'shall'.[64] Companies are allowed to deviate from these recommendations, but they are then required to disclose this annually and to give an explanation for this ('comply or explain'). The basic idea behind this approach is that companies then have flexibility. Second, the Code contains suggestions (marked by the term 'should'). Companies do not have to disclose deviations from these provisions. Third, the remaining components of the code are not marked by the terms 'shall' or 'should' and are merely descriptions of legal regulations or explanations.[65]

Gelöscht: example

Gelöscht: ly

An interesting feature of the German approach is that section 161 of the AktG imposes a statutory duty on the supervisory boards and management boards of all listed companies to annually issue on their website a declaration of compliance with the recommendations of the Code which are provisions phrased with the word 'shall'.[66] This declaration must state whether the company has complied with the recommendations in the Code and they must provide an

Corporate Governance

[60] German Corporate Governance Code, Foreword, available at: http://www.dcgk.de/en/code//foreword.html (accessed 11 September 2016).
[61] M Schiller, *'Der Deutsche Corporate Governance Kodex- Ziele, Wirkungen, Anwendungs- und Haftungsfragen'* (VDM Verlag Dr. Müller 2005) 20.
[62] Norton Rose, *German Stock Corporation Act (Aktiengesetz English translation as at September 18, 2013*, available at http://www.nortonrosefulbright.com/files/german-stock-corporation-act-109100.pdf (accessed 11 September 2016).
[63] von Werder in Kremer/Bachmann/Lutter/v.Werder (eds), *Deutscher Corporate Governance Kodex Kommentar* (6th edn, Verlag C.H. Beck 2016) 3. Teil Kommentierung Präambel, para 102.
[64] M Lutter, 'Deutscher Corporate Governance Kodex' in P Hommelhoff, K Hopt and A Werder (ed) *Handbuch Corporate Governance- Leitung und Überwachung börsennotierter Unternehmen in der Rechts- und Wirtschaftspraxis* (2nd edn, Schäffer-Poeschel Verlag und Verlag Dr. Otto Schmidt KG 2009) 123, 124.
[65] See also W Goette in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H.Beck 2016) § 161, para 23.
[66] Section 161 AktG; R von Rosen, Corporate governance in Germany (2007) *Journal of Financial Regulation and Compliance* 30, 33.

explanation if they have not complied or will not comply with the recommendations. Section 161 requires companies to make that declaration both with regards to their actions in the past as well as in the future (whether the company will comply with the Code's provisions).[67] Whilst this section does not require companies to comply with the recommendations of the Code (following the 'comply or explain' principle), the management board and supervisory board can be liable if the company does not correspond with its duty of declaration.[68] Also, the German Federal Court of Justice ruled that the validity of a resolution to release management board members and supervisory board members from liability could be challenged if the declaration of compliance was false.[69] The Baums Commission was of the opinion that the compliance with the 'comply or explain' principle should not be left to the individual companies, but that rather a middle way between non-binding rules and complete bindingness would be preferable.[70]

Gelöscht: held

Gelöscht: The declaration has to be published on the company's website.[71]

The Corporate Governance Code does not fit easily into the German civil law system. The concept of such a code originates in English law as a common law system and a much more widespread use of codes. The code has therefore given rise to a debate about is legal quality. The commentary of the Code hence makes clear that 'it is no law'.[72] A classification within the usual hierarchy of legislation seems to be rather difficult since it is a form of self-regulation (soft law) which does not establish any binding rules that go beyond the pertinent statutory provisions.[73] This however, still does not allow any inference to its actual legal quality.[74] It has been discussed whether it could also be classified as a codified form of trade practices. However, the declared purpose of the code as a code of 'best practice' is not to refelect the current trade practices but rather to improve these practices.[75] Another argument against the classification as a form of trade practices is that the code explicitly offers the possibility to opt

Gelöscht: therefore

[67] See also W Goette in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H.Beck 2018) § 161, paras 40- 44; Hüffer/ Koch in *Aktiengesetz* (12th edn.; Verlag C.H.Beck 2016) § 161, paras 14-22.
[68] K Kiethe, 'Falsche Erklärung nach § 161 AktG - Haftungsverschärfung für Vorstand und Aufsichtsrat?' (2003) 12 *Neue Zeitschrift für Gesellschaftsrecht* 559; W Goette in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H.Beck 2018) § 161, paras 97- 102; Hüffer/ Koch in *Aktiengesetz* (12th edn.; Verlag C.H.Beck 2016) § 161, paras 25-30.
[69] Bundesgerichtshof, Urteil vom 16.02.2009 - II ZR 185/07. See also: S Goslar and K von der Linden, '§ 161 AktG und die Anfechtbarkeit von Entlastungsbeschlüssen' (2009) 34 *Neue Zeitschrift für Gesellschaftsrecht* 1321.
[70] See W Goette in *Münchener Kommentar zum* Aktiengesetz (4th edn, Verlag C.H.Beck 2016) § 161, para 11.
[72] von Werder in Kremer/Bachmann/Lutter/v.Werder (eds), *Deutscher Corporate Governance Kodex Kommentar* (6th edn, Verlag C.H. Beck 2016) 2. Teil Vorbemerkung, para 80.
[73] T Heldt/R Fischer zu Cramburg in T Heidel (ed) *Aktienrecht und Kapitalmarktrecht* (4th edn, Nomos 2014) 2036.
[74] P Ulmer, 'Der Deutsche Corporate Governance Kodex- ein neues Regulierungsinstrument für börsennotierte Aktiengesellschaften' (2002) *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 150, 159.
[75] S Berg and M Stöcker, 'Anwendungs- und Haftungsfragen zum deutschen Corporate Governance Kodex (2002) *Wertpapiermitteilungen* 1569, 1571.

Corporate Governance

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out of the rules of the Corporate Governance Code without any legal consequences.[76] Therefore, it is not binding which in contrast is a key characteristic of trade practices. Although there have been different attempts of a legal classification amongst scholars, the legal quality of the Corporate Governance Code remains open.[77] Furthermore, there is an ongoing debate about the question of whether or not the statutory declaration of compliance pursuant to section 161 of the AktG is constitutional or not.[78] Yet, it is agreed that the Code can only fill in the margins that the statutory provisions leave.[79]

The German Corporate Governance Code has been regularly amended since it was introduced. The foreword of the Code states, that 'as a rule the Code will be reviewed annually against the background of national and international developments and be adjusted, if necessary'.[80] The amendments that have been made, inter alia, aligned the Code with statutory developments such as the Management Compensation Disclosure Law. In particular, the changes to the Code focussed on improving the work of the supervisory board.[81] However, this transplant remains subject to discussion.[82] It has been argued that the German approach to the corporate governance code with the statutory declaration of compliance and the level of detail has led to a more positive reception in academia than in its addressee, the business community.[83] It remains to be seen how the code will further develop in the years to come.

Gelöscht: ing

Analysis of changepoint in corporate governance development in Germany

Gelöscht: ¶

[76] M Kort, 'Corporate Governance Grundsätze als haftungsrechtlich relevante Standards' in G Bitter et al. (ed) *Festschrift für Karsten Schmidt zum 70. Geburtstag* (Verlag Dr. Otto Schmidt 2009) 945, 958.
[77] For an overview of the different explanations see P Ulmer, 'Der Deutsche Corporate Governance Kodex- ein neues Regulierungsinstrument für börsennotierte Aktiengesellschaften' (2002) *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 150.
[78] W Goette in *Münchener Kommentar zum Aktiengesetz* (4th edn, Verlag C.H.Beck 2016) § 161, paras 26 – 31.
[79] W Bayer, 'Grundsatzfragen der Regulierung der aktienrechtlichen Corporate Governance' (2013) *Neue Zeitschrift für Gesellschaftsrecht* 1, 3.
[80] German Corporate Governance Code, Foreword.
[81] J J du Plessis and I Saenger, 'An Overview of the Corporate Governance Debate in Germany' in J du Plessis et al., *German Corporate Governance in International and European Context* (2nd edn, Springer 2012) 39.
[82] See, for example, G Spindler, 'Zur Zukunft der Corporate Governance Kommission und des § 161 AktG' (2011) *Neue Zeitschrift für Gesellschaftsrecht* 1007.
[83] M Theisen, 'Aufstieg und Fall der Idee vom Deutschen Corporate Governance Kodex - Analyse eines deutschen Sonderwegs –' (2014) 37 *Der Betrieb* 2057, 2064; for an empirical overview of the compliance rates in Germany see: M Stiglbauer and P Velte, 'Impact of soft law regulation by corporate governance codes on firm valuation: the case of Germany' (2014) *Corporate Governance: The International Journal of Business in Society* 395, 397.

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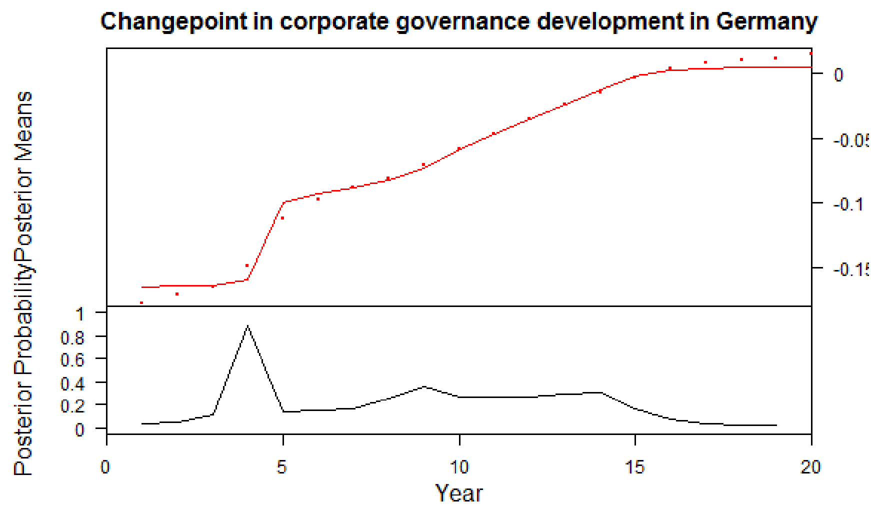

28 This chart shows that the German system of corporate governance experienced a period of convergence with the OECD Principles of Corporate Governance between 1998 and the beginning of the global financial and economic crisis in 2008. In particular, the 1998 reforms of German company law and several amendments in the first half of the 2000s, including the introduction of the German Corporate Governance Code, show the convergence with shareholder value corporate governance. However, it is noticeable that there has been a stabilisation of the German system since 2009, i.e. since the beginning of the crisis.

In our view, this slowdown in legal reform can be linked to economic and political factors. First, with regards to economic factors, it is important to note that Germany has experienced a period of economic strength since the economic crisis began. The German export-based economy has been strong in recent years and unemployment levels in Germany have gone down significantly.[84] We argue that this economic environment has reduced the appetite for change. Quite in the contrary, this has led to a feeling that the German economic model, including its pluralist system of company law is rather successful. Consequently, traditional features such as employee representation at board level that might have appeared as being out of date in the early 2000s have again appeared to be part of a successful model. The leading shareholder value systems, the United States and the United Kingdom, on the other hand, were hit harder by the crisis and its consequences. This situation had contributed to the feeling that there is not much

[84] A Moravicsik, 'Europe after the crisis: How to sustain a common currency' (2012) 91 *Foreign Affairs* 54, 59; L Funk, 'The German Economy during the Financial and Economic Crisis 2008/2009' (Konrad Adenauer Stiftung 2012) 27.

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need for reform, rather that part of the strength of the German economy can be found in its corporate governance model. In this context it is interesting to consider that the periods of relative strong convergence towards Anglo-American shareholder value corporate governance between the Mid 1990s and 2008 occurred during a period where Germany suffered a difficult economic period with high unemployment.[85] It was even considered to be 'the sick man of Europe'.[86] In that situation, questions were asked about the viability of the traditional features of German corporate governance and how future-oriented it was. As a consequence of the high unemployment, the centre-left government consisting of the Social Democratic Party (SPD) and the Green Party (1998-2005) reformed the German labour market and introduced cuts to the social welfare system. These reforms have become known as 'Agenda 2010' which were intended to modernise Germany and make its economy more competitive in a globalised world.[87] These reforms coincide with the reforms of German company law and corporate governance towards the Anglo-American model such as the adoption of legal transplants such as the Corporate Governance Code.

Since the German economy has regained strength in the aftermath of the financial crisis there seems to be a re-discovery and renewed appreciation of its consensus-based approach that tries to combine the interests of labour and employers at board level both at home and abroad. Consequently, changes to the traditional feature of employee boardroom representation as part of the system of co-determination are unlikely to happen in the short to medium term, at least as long as the economic performance remains strong.[88] Rather than appearing outdated as in the 1990s, these characteristics now seem to prevent the pursuit of short-term gains to the detriment of the long-term financial viability of companies and also to prevent excesses.

In our view, the political situation has further contributed to the slowing down of reform and convergence with shareholder value. Since 2005 Germany has been governed by the centre-right Christian Democratic Union (CDU) which has formed a grand coalition with the main centre-left party SPD between 2005-2009 and again since 2013 and 2017. Whilst, in theory, the strong majorities that these governments have in Parliament could lead to periods of frequent reforms, in practice they rather seem to lead to a consensus-based style of government between

[85] L Funk, 'The German Economy during the Financial and Economic Crisis 2008/2009' (Konrad Adenauer Stiftung 2012) 12.
[86] See 'The sick man of the euro' (2009) *The Economist*, available under: http://www.dcgk.de/en/home.html (accessed 20 October 2018).
[87] For an overview see: W Eichhorst and P Marx, 'Reforming German labour market institutions: A dual path of flexibility' (2011) 21 *Journal of European Social Policy* 73.
[88] K Bottenberg *et al.*, 'Corporate Governance between Shareholder and Stakeholder Orientation: Lessons from Germany' (2017) *Journal of Management Inquiry* 165, 169.

Corporate Governance

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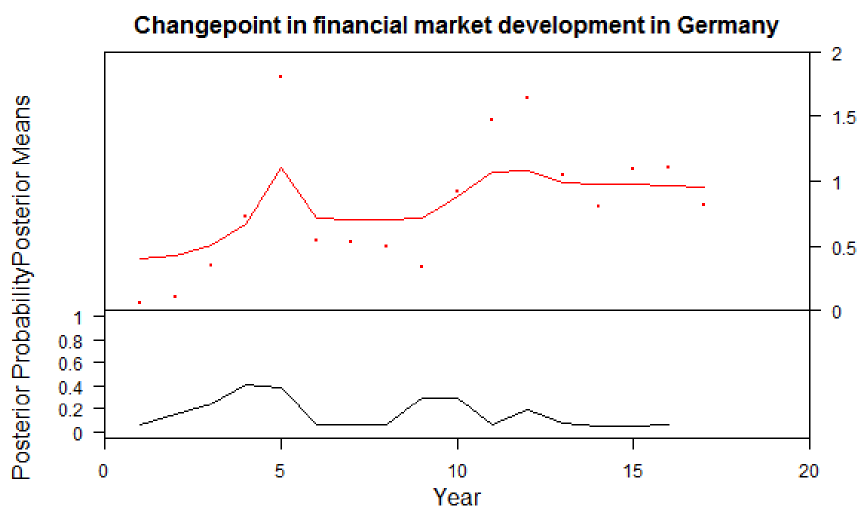
the employee and labour side with limited reform. Moreover, at least since the crisis was overcome in Germany, the government did not feel the need the need for much reform in light of the strong economic performance and the good figures from the labour market. The current economic and political environment therefore suggests that the German corporate governance model is likely to be strengthened rather than weakened in the short to medium term future.

Analysis in financial market development in Germany



The development of the financial market development points at a further ground for stabilisation of German corporate governance as it is slower and steadier than in the United Kingdom or the USA. An important feature of the German financial market is the limited shareholding by the general public. Investment into shares has traditionally been low in Germany as saving accounts used to be very popular. Equity cross-holdings and firm interlocks, therefore a less dispersed ownership structure, in contrast, are a very common feature in the German corporate landscape.[89]

However, there has been increasing foreign investment in Germany in recent years. This will inevitably increase the pressure on German boards to increase dividends and pay greater attention to shareholder interests. Also, it is to be expected that foreign investors will push in

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[89] MP Basha, 'Global corporate governance: debates and challenges' (2004) *Corporate Governance: The International Journal of Business in Society* 5, 10; K Bottenberg *et al.*, 'Corporate Governance between Shareholder and Stakeholder Orientation: Lessons from Germany' (2017) *Journal of Management Inquiry* 165, 173.

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the general direction of companies working in a similar fashion to Anglo-American companies. This situation can lead to a 'clash of culture' with uncertain outcome. For instance, the hedge fund Hermes has been particularly active in this regard in 2016 by pushing for a 'shareholder revolt' at the Annual General Meetings of Deutsche Bank and Volkswagen, two German companies that were in the news due to scandals.[90] Whilst in the traditional German system of corporate governance, the powers of shareholders are limited and, instead, the supervisory board plays a key role in the control of the board, foreign investment funds are less likely to accept this approach, as evidenced by the activism of Hermes.

Conclusion

In conclusion, we find that whilst the German system of corporate governance has experienced a strong period of convergence with Anglo-American shareholder value between the Mid 1990s and the global economic and financial crisis, that this has slowed down significantly since then. We argue that this development needs to be understood in the context of the economic and political development of Germany. Whereas there was a weak economic performance of the German economy during the 1990s and right into the Mid 2000s, things have changed in recent years, especially after the crisis. Whilst the United Kingdom and the United States experienced a difficult economic period, Germany's export-oriented economy regained strength and, consequently, the unemployment rates went down significantly. In light of this development the German corporate governance model did not seem as 'outdated' and 'old-fashioned' as it might have appeared during the 1990s and early 2000s. Consequently, there was a re-appreciation of the advantages of this model and its inclusion of labour at board level. The interest in the pluralist model was renewed. Politically, this situation coincided with periods of grand coalitions between the major centre-right party CDU and the major centre-left party SPD which further added to the consensus-based approach between labour and employers.

However, whilst this points at a stabilisation of the German pluralist model of corporate governance, it might well be that the next crisis will call this model into question again and thus lead to a stronger convergence again. Moreover, Germany continues to be subject to the pressures of globalisation and increasing foreign investment into its companies. This will lead to a stronger push for Anglo-American shareholder value and more rights for shareholders. The example of Hermes hedge fund in 2016 demonstrate such pressures which are likely to increase once the performance of companies is not as strong as it is at the moment.

[90] For details see: Financial Times https://www.ft.com/content/0dde3bac-fee2-11e4-84b2-00144feabdc0 (accessed 21 October 2018).

Corporate Governance

We therefore argue that whilst there has been a growing recognition that the German pluralist model of corporate governance has its particular advantages and strengths it will remain under pressure and will be subject to a gradual convergence. However, the pace of that convergence will be much slower than expected in the Mid 2000s. However, it also needs to be taken into account that a large number of leading German companies are part of the Mittelstand and they are often family-owned companies which are not subject to the rules that apply to listed companies.[91]

Gelöscht: Also

Appendix A

Corporate governance variables

Shareholder rights index

- *Secure methods of ownership registration* - 2 if a central depository is available and shares are mandatorily held in an electronic dematerialised format in the central depositories, 1 if there is a central depository but it is optional to have shares in dematerialised format, 0 if there is no central depository.

  The first step for a shareholder to claim these rights would be to prove himself a shareholder, with increasing cross-border holdings, registration often becomes the first hurdle. Thus, a pro-shareholder corporate governance regime would insist on an easy process with dematerialised shares which allow for electronic transfer especially through a central clearing house to reduce frauds, transaction time etc.

Gelöscht: Thus

- *Transfer of shares* – 2 if shares of listed/public companies which can be traded in the open market are fully transferable, 1 if there are restrictions at the discretion of companies and if a non-binding regulations call for full transferability of shares, 0

[91] U Noack.and D Zetsche, 'Corporate Governance Reform in Germany: The Second Decade' (2005) *European Business Law Review* 1033, 1034.

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otherwise; 2 if foreign nationals are allowed to own and transfer shares and are treated on a par with the citizens of the host country, 1 if foreign nationals are allowed to own and transfer shares but with certain restrictions not placed on the citizens of the host country 0 if foreign nationals are not allowed to own or transfer shares.

The founding pillar of pro-shareholder corporate governance allows the shareholders a free choice to exit a company. Hence there is a need for an equity market, the shares need to be fully transferable and there should not be an onerous burden on the shareholder to transfer the shares. Some jurisdictions may have some restrictions on transfer such as a lock in period for promoters, restriction on preference shares, partially paid up equity shares etc. In the majority of such cases these non-transferable shares are not allowed to be traded on the open market (though sometimes trade is allowed in private markets). Therefore, to allow uniformity, only those shares which can be traded on the open market (like common equity shares) need to be fully transferable. Some jurisdictions place extra burden on foreign nationals and thus increase the cost of access to capital, a pro-shareholder policy would allow foreign funds entry to the financial market as it would give shareholders more choice and would lead to a more vibrant equity market.

- *Regular and timely information* – 2 if half yearly and annual reports are mandatorily sent to shareholders and a central registry, 1 if annual reports are sent to the central registry only and not to shareholders, 0 if no reports are sent or otherwise; 2 if it is statutorily mandated that an annual report includes at least five of the following: a. balance sheet, b. profit and loss statement, c. cash flow statement, d. statement of changes in ownership equity, e. notes on the financial statements and f. an audit report, 1 if it is recommended under a non-binding code 0 if otherwise; 2 if financial reporting mandatorily is based on International Financial Reporting Standards (IFRS) and

Corporate Governance

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International Standards on Auditing (ISA) 1 if it is recommended under a non-binding code 0 if otherwise.

Timely and regular information is key in order to make an informed choice. Shareholders always suffer from an information gap, thus pro-shareholder corporate governance policies would always insist on higher burdens on companies to share the maximum possible financial reports on more than an annual basis. IFRS and ISA or comparable standards ensure that companies' financial records comply with the globally accepted standards. This would allow easy comparisons across companies and help in shareholder choice.

- *Participate in shareholders meetings* – 2 if the law explicitly mandates that any class of shareholders are allowed to attend the meeting and take part in discussion, 1 if it is a common practice backed by a non-binding code 0 otherwise; 2 if a law mandates that a proxy form to vote on the items on the agenda accompanies notice of the meeting or if shareholders may vote by mail on the items on the agenda, 1 if it is recommended by a non-binding code or is a general practice, 0 if under law/non-binding regulation/practice absent shareholders vote (or shareholders who have not returned the proxy form/postal ballot) is given to mangers by default; 2 if cross-border proxy voting is allowed without any restriction, 1 if it is allowed with some restriction or a non-binding governance code recommends cross-border proxy voting without restriction, 0 otherwise.

Although some classes of shareholders like those holding preference shares are barred from voting, a policy which allows them to participate in the meeting (without voting) is more shareholder-friendly than regulations which completely bar the participation of nonvoting shareholders from general meetings. Further, in many highly dispersed companies it is not possible for the shareholder to attend the meetings and personally cast votes and proxies are generally used. A system which recognises shareholders as owners of the company would try to make it easier for more shareholder participation

Corporate Governance

rather than using regulatory loopholes. A further mark of a liberalised regime would be to allow foreign nationals to use proxies to cast their votes as it otherwise might be financially onerous on the foreign shareholder.

- *Dividend* – 2 if shareholders can approve the amount of dividend to be paid with a simple majority, 1 if it is recommended under a non-binding regulation or code, 0 otherwise; Shareholder primacy corporate governance ensures shareholder wealth maximisation, timely and appropriate dividends is one way. In many common law jurisdictions the board of directors decides the amount of dividend to be paid. Thus, shareholder approval by simple majority on the amount of dividend paid would ensure that shareholders have an indirect say on the amount of dividend rather than a situation where the board can itself decide and approve the dividend amount.
- *Supermajority for extraordinary transaction* – 2 each if it is mandated by rule or statute that 75% or more shareholders need to agree for the following authorizing a) capital increases; b) waiving pre-emptive rights; c) buying back shares; d) amending articles of association; e) delisting; f) acquisitions, disposals, mergers and takeovers; g) changes to company business or objectives; h) making loans and investments beyond limits prescribed under prospectus; i) authorizing the board to: (i) sell or lease major assets; (ii) borrow money in excess of paid-up capital and free reserves, and (iii) appoint sole selling agents and apply to the court for the winding up of the company, 1 each if it is under a non-binding regulation with a comply or explain architecture or if it is a common practice, 0 otherwise.

Shareholders should retain control over the board in the case of an extraordinary transaction which may affect the long term and short-term viability and profitability of the company. Buy back of shares, issuance of new shares and corporate restructuring generally lead to changes in the total paid up share capital and directly impacts on share prices. Capital restructuring can also lead to the consolidation of incumbent

Gelöscht: short term

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management in a widely held company. This provision can be misused by majority shareholders who can issue new shares to themselves, waiving the pre-emptive rights of first refusal of the minority, this leads to further dilution of minority held shares. Moreover, with an increased number of shares the price of shares would generally fall thereby expropriating the share value of the minority. Similarly, significant changes to the asset base of the company would also impact on the prices of shares. Rights issues can also be used as a takeover defence. Some jurisdictions allow for some of these powers to be exercised directly by the board, some require a simple majority while others demand a supermajority. If a supermajority is required for these transactions, shareholders are able to get full ex-ante information about aspects limiting their rights that would normally be factored into the price of the security. This limitation on absolute board power would also enable minority shareholders to protect themselves from self-dealing corporate insider expropriation by dilution, to an extent.

Anti-Managerial rights index

- *Performance related pay* - 2 if under law a minimum fixed portion of executive remuneration is performance linked, 1 if it is a common practice or recommended under a non-binding corporate governance code, 0 otherwise; 2 if executive remuneration requires shareholder approval, 1 if shareholder approval is only advisory, 0 otherwise; 2 if there are statutory rules relating to stock option plans and stock linked pension funds exist, 1 if there is a non-binding code or regulation, 0 otherwise.

One of the cornerstones of agency-based shareholder value maximisation of corporate governance is to align the interests of the managers and the employees to the interest of the shareholders i.e. to increase the price of shares on equity markets. This can be achieved if emphasis is placed on encouraging executives to take a major portion of their remuneration in stock options. Like the OECD principles of corporate governance

Corporate Governance

which states that performance related pay should be allowed to develop, most jurisdictions do not put in a fixed line as to how much executive compensation should be linked to the performance of share prices. However, a jurisdiction which wants to implement a performance-linked pay for executives will fix a minimum amount of compensation which must be linked to share performance. Similarly, for employees there can be stock-linked pension funds or employees stock ownership plans (ESOPs). In many jurisdictions these exist as general practice, however as it becomes more prevalent legislators tend to regulate it by bringing rules. Thus, the presence of guiding rules relating to ESOPs etc. acts as a proxy for the fact that performance related pay for employees has been generally accepted. Executive compensation is usually fixed by the remuneration committee, however, if shareholders need to approve the quantum of compensation, it adds another layer of shareholder control over the directors.

Gelöscht: Similarly

Gelöscht: Thus

- *Proportionality of ownership of share and control* – 2 if ordinary equity shares that do not carry a preference of any kind, neither for dividends nor for liquidation carry one vote per share,[92] 1 when a non-binding code discourages the existence of methods of disproportional control like multiple-voting and nonvoting ordinary shares, pyramid schemes or does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares owned, 0 otherwise

Each shareholder should be given proportional equity control to the amount invested. However, over the years, due to financial requirements, various forms of shares have evolved – preference shares which have higher or fixed cash flow rights but sacrifice voting rights, golden shares which may contribute little to equity but have disproportionate voting rights etc.[93] which are separate from ordinary equity shares. The

Gelöscht: However

[92] Even with a strict imposition of one share one vote rule, which should in theory nullify golden shares, there would be other ways like stock pyramids, cross-ownership structures and dual class equity structures which gives disproportional control delinked from cash flow rights by careful manipulation of common equity shares.
[93] See generally Milton Harris and Artur Raviv, 'Corporate governance: Voting rights and majority rules' (1988) 20 Journal of Financial Economics 203-235

survey will limit itself to one vote per one ordinary share to ensure proportionality of control across the ordinary equity class. Thus, for example, a jurisdiction which does not have any regulation on disproportionate voting rights like golden shares, pyramid schemes etc. would be scored 0.

- *Markets for corporate control* - 2 if pre-offer takeover defences are statutorily banned, 1 if there is a non-binding code which specifically discourages directors from using pre-offer defences, 0 if there is no regulation; 2 if post-offer takeover defences are statutorily banned, 1 if there is a non-binding code which discourages directors from using post-offer defences, 0 if there is no regulation; 2 if at least 25% or more shares are to be with the public for listed companies, 1 if there is a non-binding code for the same, 0 otherwise; 2 if a declaration to the market by a shareholder holding 5% of share capital is necessary whenever their shareholding changes by more than 1-5% of the total subscribed share capital within a given period of time, 1 if the disclosure is recommended by a non-binding code, 0 otherwise;

To ensure that the market for corporate control can function effectively, any pro-shareholder corporate governance would try to restrict the powers of the incumbent managers to scupper takeover attempts. Takeover defences can be divided into two categories based on the time when they can be effected. Defences like the poison pill, automatic rights issue, golden parachute for executives, staggered board etc. are arranged before a bid is made for the control of the company. On the other hand, defences like targeted repurchase bids (coupled with white knight etc.), asset restructuring (crown jewel defence, scorched earth policy etc.), capital restructuring (issue of new shares to existing shareholders), greenmailing are usually set in motion once the takeover bid has already been made. 'Poison pills provide their holders with special rights in the case of a triggering event such as a hostile takeover bid. If a deal is approved by the board of directors, the poison pill can be revoked, but if the deal is not

Corporate Governance

approved and the bidder proceeds, the pill is triggered. Similarly, golden parachutes are severance agreements that provide cash and non-cash compensation to senior executives upon an event such as termination, demotion, or resignation following a change in control.'[94] Rights issue (either contingent on takeover bid or post bid effected by incumbent management) allows for the issue of new shares to existing shareholders, this would lead to an increase in the number of shares and make it expensive for the raider to get majority control. As detailed in several pieces of research, takeover defences affect share prices and earnings.[95] Thus, an ideal shareholder primacy corporate governance system would discourage takeover defences. It is also necessary to differentiate between pre-bid and post-bid defences as many jurisdictions allow some form of defence such as counter offers etc. which usually raises the share prices and thus offers a better exit to shareholders. Therefore, if a jurisdiction bans the incumbent management from executing pre-offer defences such as staggered board, poison pill, golden parachute, supermajority (over 80%) to approve merger, dual class recapitalisation then the jurisdiction would be coded 2, if some of them are banned and others are specifically discouraged by a non-binding code then the country is coded 1, if there is no code or rule then it is coded 0. Similarly, for post-bid defences the survey will look for laws and rules banning or discouraging asset restructuring, liability

[94] Paul Gompers, Joy Ishii and Andrew Metrick, 'Corporate governance and equity price' (2003) 118 (1) Quarterly Journal of Economics 107 working paper available at < http://www.boardoptions.com/governancearticle.pdf>. In their seminal paper they studied 24 firm level corporate governance factors for 1500 large corporations for the period 1990-1999. The corporate governance provisions were divided into five thematic groups: tactics for delaying hostile bidders, director/officer protection, voting rights, other takeover defences, and State/laws. Paul A. Gompers et al. focussed on anti-shareholder provisions in the company's prospectus and other documents creating a 'G index' where higher scores meant lower shareholder rights. They then concentrated on two extreme ends of the index creating a 'Dictatorship Portfolio' of the firms with the weakest shareholder rights (G≥14), and a 'Democracy Portfolio' of the firms with the strongest shareholder rights (G ≤ 5).'

[95] See Richard S. Ruback, 'An Overview of Takeover Defenses' in Alan J. Auerbach, (ed.) *Mergers and Acquisitions* (University of Chicago Press 1987) table 3.1 and 3.2; Pornsit Jiraporn, 'An empirical analysis of corporate takeover defences and earnings management: evidence from the US' (2005) 15 (5) Applied Financial Economics 293-303.

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restructuring, capital restructuring and targeted repurchase (not open competitive bidding).

In developing countries the share markets are generally illiquid and there is a high prevalence of block-holder directors. This situation can be remedied by having a minimum amount of shares with the public which may lead to more dispersed holding.[96] In India, which as per S&P is a leading emerging market, only recently was it made mandatory that for listing at least 25% of the shares should be with public. Therefore, to ensure that markets in developing countries move towards a more open market it is imperative that shares become more dispersed, the first step towards this would be a minimum of 25% free float.

The disclosure rule for shareholders with 5% shareholding would nullify any attempts to effect a creeping acquisition and allow for proper share valuation due to an expected increase in demand.

- *Impediments to cross border voting* – 2 if American Depositary Receipt (ADR) and Global depository receipt (GDR) with voting rights at par equity is allowed, 1 if ADR and GDR have voting rights with some restriction, 0 otherwise.

An investment bank can buy shares of companies listed at a share market in a developing country and later issue a negotiable security linked to these issues at a stock exchange in a developed country. These negotiable securities are referred to as depository receipts and their value varies according to the price of the underlying share in the original host country. If depository receipts for foreign companies are issued in the US market they are referred as ADR and if these depository receipts are issued in the non US market[97] it is commonly referred to as GDR. ADR and GDR allow foreign capital to flow into

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[96] Though Cheffins et al. 'Ownership Dispersion and the London Stock Exchange's 'Two-Thirds Rule': An Empirical Test' (2012). University of Cambridge Faculty of Law Research Paper No. 17/2012. Available at <http://ssrn.com/abstract=2094538> concludes that two-thirds rule of London stock exchange was not the catalyst for dispersion of ownership and control that might have been expected.
[97] For example in European stock exchanges like Frankfurt Stock Exchange, London Stock Exchange etc.

Corporate Governance

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the host country and at the same time ensures that the companies adhere to the deposit agreements. Deposit agreements follow a strict set of disclosures, thus jurisdictions which allow ADR and GDR automatically ensures that companies which choose to issue ADR or GDR has to comply with strict standards. Whether the ADR/GDR purchaser would be able to vote depends on the depository agreements, however from a pro-shareholder view any equity investment should be able to exert proportionate control. Thus, shareholder primacy corporate governance would allow default voting rights for depository receipts to be on a par with domestic equity shares.

- 2 if by law external auditors need to be changed after 1-5 years and some cooling off period, 1 if it is recommended under a non-binding code, 0 otherwise.

  A regular change in the external auditor would ensure that management always remains at arms-length from the auditors. A quick glance at major corporate fraud like the Enron scandal, Satyam scandal[98] would suggest that in many cases it was the willing oversight of the auditors which led to the delayed discovery of fraud. Thus, a pro-shareholder corporate governance policy would favour a change of auditors at regular intervals so that the integrity of the financial information/disclosure is maintained.

- 2 each if it is mandatory for presence of audit committee, remuneration committee, nomination committee with a majority of independent directors, 1 if it recommended by a code, 0 otherwise.

  NEDs are supposed to act as an internal control mechanism looking at a long-term view. Through these committees they are supposed to keep watch on executive directors and managers, appoint auditors, fix remuneration of the executives and maintain continuity with nominating executives for the top positions. The majority rule has to be enforced by statutory binding regulation. Independent directors are those directors who do not

Gelöscht: Thus

Gelöscht: long term

[98] Criminal prosecution of auditors is still on-going

Corporate Governance

have any financial interest in the company and whose remuneration is not linked with performance.

- 2 if the country has legal protection for whistle-blowers, 1 if it is recommended in a non-binding corporate governance code etc., 0 otherwise.

Minority shareholders rights index

- *Ability to influence an electing member of board* – 2 if cumulative voting is allowed, 1 if it is recommended but discretionary, 0 otherwise.

  Shareholders should be allowed to have effective control over the board by electing its members. Most jurisdictions offer shareholders the opportunity to elect members but in a shareholder primacy system cumulative voting would be allowed as minority shareholders would then be able to pool their votes for certain board candidates.

- *Prohibit abusive self-dealing* - A score of 0 if the board of directors, the supervisory board or shareholders must vote and the self-dealing majority shareholder is permitted to vote, 1 if it is recommended under a non-binding code that the board of directors or the supervisory board must vote and the self-dealing majority shareholder is not permitted to vote, 2 if it is mandatory that the self-dealing majority shareholder is not permitted to vote; 2 if shareholders must vote and the self-dealing majority shareholder is not permitted to vote, 1 if it is recommended, 0 otherwise. A score of 0 is assigned if no disclosure is required 1 if disclosure on the terms of the transaction is recommended, 2 if it is required; 2 if an external auditor is required to review the transaction before it takes place, 1 if it is recommended, 0 otherwise.

  A majority shareholder who is also a member of the board is at a distinct advantage over minority shareholders in terms of insider information and control. This may also lead to the diversion of company's assets for personal gain and eventual expropriation. Therefore, a shareholder wealth maximisation of corporate governance would call for

Gelöscht: Therefore

Corporate Governance

strict regulations to limit any self-dealing, putting in place checks and balances like NEDs, external auditors and even approval in shareholder meetings.

- *Ability to take judicial recourse* - 2 if direct or derivative suits are available for 100 shareholders or shareholders holding a minimum of 5-10% of the share capital, 1 if more than 10% or more than 100 shareholders are required for a suit, 0 in other cases. Business judgment rule prevents courts from interfering in the internal decision-making process of a company, unless a sizeable number of shareholders approach the court. A pro-shareholder corporate governance policy would try to keep this threshold low so that even minority shareholders can approach the court to seek redressal in cases of oppression and mismanagement. Yet at the same time it should not be so low that the company has to always defend frivolous law suits.

Gelöscht: decision making

Anti-Stakeholder rights index

- 0 if under a regulation stakeholder representation is found/encouraged in board, 1 if it is discouraged by a non-binding code or if there is no mention, 2 if it is prohibited by a binding regulation; 0 if under a regulation stakeholders or their representatives can be present/are encouraged to be present in shareholders meeting, 1 if it is discouraged by a non-binding code 2 if it is prohibited by a binding regulation and only shareholders can be present; 2 in the case of a unitary managing board where a majority of its members are directly elected by shareholders or are selected with the concurrence of the elected members of the board, 1 where under a non-binding code it is encouraged, 0 otherwise; 0 if stakeholders find remedy inside company law, 1 where there is a non-binding code under which stakeholders other than shareholders are offered remedy outside of company law, 2 if the company code or the listing agreements do not have any provision for stakeholder remedies except for shareholders; 0 if the country has a code of ethics for directors which explicitly states that stakeholder rights come before any other shareholder rights, 1 if it is recommended that directors give due consideration to the rights of different stakeholders but does not state if one group has a higher claim than another, 2 if there is a mandatory code which mentions that shareholders have precedence over other stakeholders. Shareholder primacy corporate governance demands that stakeholders like creditors, employees, suppliers and customers are not

Corporate Governance

represented at any stage of the decision-making process. They should find remedies outside the corporate law and corporate governance mechanism. Therefore, a jurisdiction which mandates dual board structure with stakeholder representation would score lower in the overall assessment.

Gelöscht: decision making

Gelöscht: Therefore

Corporate Governance