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Corporate Governance in the United States and Germany**

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Taking Shareholder Protection Seriously? Corporate Governance in the U.S. and Germany

by Theodor Baums, University of Frankfurt, and Kenneth E. Scott, Stanford Law School and Hoover Institution*

Aktionaere sind dumm und frech. Dumm, weil sie Aktien kaufen, und frech, weil sie dann auch noch Dividende haben wollen. (Shareholders are stupid and impertinent: stupid, because they buy shares, and impertinent, because they demand a return.)

—Carl Fuerstenberg (1850-1933)¹

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

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

American business circles.”² Others go even further: “There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”³ One of the ways of advancing that objective in the U.S. is to impose fiduciary duties, and in particular a duty of loyalty, on corporate officers and directors: “Managers must prefer investors’ interests to their own in the event of conflict. That is the core of the duty of loyalty.”⁴

But the legal reality even in the U.S. is not so straightforward. Stockholders are owners of the corporation but not of its assets, and they do not possess direct decision-making authority over the use of those assets.⁵ That lies formally in the hands of the board of directors, and neither the courts nor the legislatures have been at all rigorous or consistent in demanding director fidelity to shareholder interest or facilitating efforts of shareholders to assert control over directors. The Supreme Court of Delaware, by far the most important corporate law jurisdiction in the U.S., has constructed an elaborate theology of deference to board decisions, with but casual regard to maximizing shareholder welfare.⁶ And more than half the states have adopted “stakeholder” statutes that allow boards to take into consideration a variety of non-stockholder interests, thus enabling them to justify and defend almost any action—notably resistance to takeovers.⁷

* This article is a slightly shorter version of an article originally appearing in the *American Journal of Comparative Law*, Vol. 53 (Winter 2005), which has granted permission to publish this version. Many of the references to specific legal provisions and cases have been omitted; those interested in such references are urged to consult the original. We wish to express our appreciation for the comments of Herbert Hax, Christian Kirchner, and the other participants at the Corporate Governance Workshop of the Center for the Study of New Institutional Economics, University of Saarland, Saarbrücken, Germany, October 25, 2002, and of Ron Gilson and Richard Phillips.

1. Lutz Graf Schwerin von Krosigk, *Die grosse Zeit des Feuers* (1957), pp. 646-47.
2. M. Roe, “The Shareholder Wealth Maximization Norm and Industrial Organization,” *University of Pennsylvania Law Review*, Vol. 149 (2001), p. 2063.

3. H. Hansmann and R. Kraakman, “The End of History for Corporate Law,” *George-*

town Law Journal, Vol. 89 (2001), p. 439.

4. F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law* (Cambridge, MA: Harvard University Press, 1991), p. 104; see also S. Bainbridge, *Corporation Law and Economics* (Foundation Press, 2002), pp. 419-29.

5. We focus on the publicly held corporation as the dominant form of large enterprise, but most of the issues to be discussed find application to other forms of legal entity, including limited liability companies and limited partnerships, cooperatives, mutuals, and non-profits.

6. Only in the narrow context of a company putting itself up for a sale of control in a takeover auction does Delaware appear unequivocally committed to strict adherence to shareholder interests.

7. See L. Bebchuk and A. Ferrell, “Federalism and Corporate Law: The Race to Protect Managers from Takeovers,” *Columbia Law Review*, Vol. 99 (1999).

That is also the position taken by most continental European legislation, particularly German corporate law. Under German law, it is not the exclusive, or even the primary, purpose of the board to protect the interests of the shareholders, but rather to promote the “interests of the firm” (“*Unternehmensinteresse*”), an obviously broader, if ambiguous, concept.

Is that a good or a bad thing? On that question there is substantial controversy. Some applaud the concept that the board should have regard for, and be empowered to balance, the competing interests of all who are affected by its activities—shareholders, creditors, debtors, management, employees, customers, suppliers, the local community, the environment, the nation, the public interest, and, indeed, the global community. The larger the firm, the longer the list.⁸ By directing companies to serve multiple interests, it is contended, corporate boards will better serve the interests of society as a whole.

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

But the purpose of this paper is not especially to join in, or add to, the normative debate among the various and overlapping models of corporate governance: the shareholder-primacy model, the director-primacy model, the stakeholder model, and so on.⁹ Our intent instead is to clarify what a shareholder-primacy model would really require, and to measure how far from it we actually are, in both the U.S. and Germany. Advocates of particular positions can interpret this to their own ends, but we believe that on careful reflection most would agree that the current mixture of legal rules is incoherent and inefficient. Since this article is written primarily for an audience of both lawyers and economists in our two countries, we will try to make the legal system of each comprehensible to readers not

already familiar with it, to highlight some of the similarities and differences, and to express our judgments as to how those systems function in practice as well as in theory.

The Role of Corporate Governance

“Corporate governance” can be, and sometimes is, defined so broadly as to encompass every force that bears on corporate decision-making. That would include not only the control rights of stockholders, but also the contractual covenants and insolvency powers of debt holders, the commitments entered into with employees and customers and suppliers, the regulations issued by governmental agencies, and the statutes enacted by parliamentary bodies. And in a still more comprehensive sense, a company’s decisions are powerfully affected by competitive conditions in the various markets in which it transacts, and indeed by the social and cultural norms of the society in which it operates.

We wish to be more selective and focus on the position of outside minority stockholders and how it differs crucially from the position of other stakeholders or constituencies.¹⁰ First, we review the distinctive features of stockholders’ claims on the firm, and why their protection is socially important. Second, we look at the special problems of minority shareholders from the standpoint of agency cost theory. Third and last, we consider the various mechanisms for addressing those problems.

The Nature of Equity Claims

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

Thus, it is important for market economies to develop institutions that reduce the areas of vulnerability of outside

8. See M. Blair and L. Stout, “A Team Production Theory of Corporate Law,” *Virginia Law Review*, Vol. 85 (1999); R. Green, “Shareholders as Stakeholders,” *Washington & Lee Law Review*, Vol. 50 (1993); and L. Mitchell, “A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes,” *Texas Law Review*, Vol. 70 (1992).

9. For a sampling from the current literature, in addition to the articles cited above, see S. Bainbridge, “Director v. Shareholder Primacy in the Convergence Debate,” *Trans-*

national Lawyer, Vol. 16 (2002); M. Dooley, “Two Models of Corporate Governance,” *Business Law*, Vol. 47 (1992); P. Davies, *Introduction to Company Law* (Oxford University Press, 2002); and F. Kuebler, *Gesellschaftsrecht* (5th ed., 1998).

10. This discussion follows that of K. Scott, “Corporate Governance and East Asia,” in A. Harwood, R. Litan, and M. Pomerleano, Eds., *Financial Markets & Development* (Washington DC: Brookings Institution Press, 1999).

equity investors. Such institutions enlarge the pool of capital available for productive investment, and can be essential for the large-scale enterprises needed to realize economies of scope and scale. In emerging economies with weak property rights and poor corporate governance institutions, business enterprises typically depend on inside equity capital, coming from the founding family, their affiliated firms, and their personal associates. Outside capital is limited and expensive, for reasons we have already suggested.¹¹

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

Minority Shareholders and Agency Costs

Let's now be more specific about the vulnerability of outside minority shareholders. In their 1932 classic, Adolf Berle and Gardner Means famously framed the issue in terms of the "separation of ownership and control" in large public corporations.¹² In a much-cited paper published over 40 years later, Michael Jensen and William Meckling described the problem more generally as the conflict of interest between "principals" (stockholders) and their "agents" (managers).¹³ The basic problem is that agents and managers are entrusted by principals and investors with authority over their property and capital, which is to be used to advance the interests of the owners rather than for the personal gain of the agents.

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

replacement by better managers. Such managerial misuse of their position results in poor performance by the firm, which may cause much greater harm to shareholders than excessive or undisclosed compensation for the managers or their control group.¹⁴

The question for minority shareholders, as owners of a portion of the firm, is what they can do to protect their residual and incompletely specified interests. As Jensen and Meckling pointed out, agency costs are familiar and ubiquitous, but they can be limited by a variety of means and devices. In the rest of this paper, we focus on four such means:

- 1) The *legal rules* that to a limited extent define and protect certain shareholder rights;
- 2) the powers and duties of the *board of directors*, as elected stockholder representatives;
- 3) the *market for corporate control*, which offers outsiders the opportunity to purchase control and, if necessary, change the management of inefficient companies; and
- 4) effective *incentive compensation* plans.

This perspective provides a framework for analyzing corporate governance in the U.S., Germany, or any country. The challenges associated with developing equity finance, including the presence of agency costs, are universal concerns that are faced by every market economy (and by state-controlled economies as well, though in different guises). The institutions for handling them are diverse, reflecting different political forces, cultural values, and histories. In our view, all necessarily have their shortcomings or limitations. But our main point is that any efforts at improvement need to be based on an accurate understanding of how they work, both in theory and in practice. That is what we attempt to provide, both for the U.S. and Germany, in the next four sections of this paper.

Legal Rules

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

U.S. Legal Responses to Conflicts of Interest

The primary legal doctrine directed toward conflict issues is the concept of officers and directors as fiduciaries who owe certain general duties to the company and its shareholders. The fiduciary duty concept is derived from the common

11. See R. La Porta, F. Lopez-de-Silanes, A. Shleifer, and R. Vishny, "Legal Determinants of External Finance," *Journal of Finance*, Vol. 54 (1997).

12. A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: Harcourt, Brace & World, Inc., 1932).

13. M. Jensen and W. Meckling, "Theory of the Firm: Managerial Behavior, Agency

Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3 (1976).

14. This distinction among kinds of agency costs is not definitionally precise, but useful nonetheless in subsequent analysis; see M. Eisenberg, "The Structure of Corporate Law," *Columbia Law Review*, Vol. 89 (1989).

law of trusts, but has been modified in its application to the business context. Part of that duty is the duty of loyalty, which requires directors to seek to protect the best interests of the corporation and not pursue their own interests over those of the corporation and its shareholders.

The duty of loyalty is a principle, not a precise proscription. It has found some specification over time in state corporation codes and court decisions, but is intended to cover a very wide range of possible applications. As one of us wrote in this journal in 1998:

One can postulate a continuum of situations involving conflicts of interest between controlling managers and owners, with the conflicts becoming less sharp (and perhaps the legal rules less useful). At one extreme would be outright theft, embezzlement, and misappropriation; without effective legal (usually criminal) sanctions in these cases, only the gullible would part with their money. A somewhat less transparent form of achieving the same end is the self-dealing transaction between the manager and his firm. By buying too low or selling too high, the controlling party transfers wealth from the firm to himself, but the picture can be confused by intricate transactions in non-standard assets or subject to varying degrees of price unfairness. Enforcement becomes more difficult, but still seems essential if agency costs are to have any bound. The appropriation of corporate opportunities, excessive managerial compensation, and consumption of managerial perks can be still more judgmental, and probably the legal rules less effective, but the order of magnitude is also often less. And when one reaches conflicts highly intertwined with the regular operation of the business, such as excessive diversification, or self-retention by less competent managers, the fiduciary duty of loyalty probably offers little protection.¹⁵

The core conflict-of-interest situation is the self-dealing transaction, and here state corporation laws have been rather specific. Most define the problem in terms of a “transaction between a corporation and one or more of its directors or officers...or an organization in which one or more of its directors or officers are directors or officers, or have a financial interest,”¹⁶ and then require that such transactions either be approved only after full disclosure by a majority of the disinterested directors or shareholders, or be “fair to the corporation.” The defects in this rule are many, and most flow from reliance on formalism coupled with a failure to distinguish between abuse of control and abuse of trust. The problem in a self-dealing transaction is that the party benefiting from it is in a position to control its approval by the corporation, so that the usual presumption

in a transaction between independent parties—that both sides can look out for their own interest—does not apply. The problem in an abuse-of-trust transaction is that the agent has a personal interest in the transaction that is not (as agency law requires) disclosed to and taken into account by the ultimate decision-maker, and where the agent does not control the ultimate decision but is relied on by the principal. As a result:

1) The rule as stated is too broad in the sense that it covers transactions between the corporation and an individual with the formal status of an (subordinate) officer or a (outside) director who in no way controls the decision of the board or management. The problem, when there is one, lies in the extent of the reliance placed on persons with an interest that is not fully disclosed to the CEO and board when they make their decision.

2) The rule is also too narrow in that it does not by its terms cover transactions with a controlling party who is not a member of the board, such as a parent company or majority stockholder. Courts have often stepped in to fill this legislative hole by treating a controlling shareholder as a fiduciary.

3) Directors are regarded as “disinterested” provided they have no direct financial benefit from the transaction, regardless of the degree of control over their selection and continued presence on the board exercised by the party benefiting from it. But “disinterested” is not the same as “independent” in attitude and action. Thus the approval required by law offers is no assurance of negotiation of an arm’s-length bargain.

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

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

The more blatant forms of self-dealing can fall into the categories of theft and misappropriation, and be dealt with by the criminal law, but the imposition of criminal penalties

15. K. Scott, “The Role of Corporate Governance in South Korean Economic Reform,” *Journal of Applied Corporate Finance*, Vol. 10 (1998).

16. Del. Code Ann. tit. 8, § 144 (2005).

requires much higher standards of proof and culpable intent. Much of such conduct remains in the domain of private law actions to recover the improper gains, and there—as we have outlined above—the defects of the legal rule leave considerable room for control persons to manipulate processes of formal approval to their own benefit. The extent to which dominant CEOs have been willing to take advantage of corporate assets to pay personal expenses has drawn wide publicity in the recent cases of John Rigas in Adelphia Communications (accused by prosecutors of using the company as a “personal piggy bank”) and Dennis Kozlowski in Tyco International (described as using the company as “his personal cash machine”). Although both of these cases ended with convictions of the CEO, this is an area in which SEC mandatory disclosure requirements could be more precisely designed to reveal transactions with potential for self-dealing abuse.

It would not be difficult to draft a clearer self-dealing statute, one that focuses on persons who possess actual control power rather than occupy a management position, and that provides a defense based on the substance (fairness) of the transaction rather than on a process (disclosure and approval) that addresses the different problem of agents with an undisclosed conflict of interest. The current statutory provisions, besides leading the courts toward an undue emphasis on procedure over substance, offer a degree of protection for shareholders that, while important, still falls far short of full coverage.

German Legal Responses to Conflicts of Interest

Unlike their U.S. counterparts, most exchange-listed German corporations are controlled by a family, a controlling majority shareholder, or at least a number of large shareholders.¹⁷ For this reason, German corporate law has focused less on the regulation of conflicts between shareholders and managers and more on those between controlling and minority shareholders. A specialized area of German corporation law (known as *Konzernrecht*) addresses, among other things, the conflicts of interest that may arise in transactions between a corporation and its controlling shareholders.¹⁸ *Konzernrecht* specifies some of the duties of loyalty that controlling shareholders owe to minority shareholders. For example, transactions among affiliated companies must be described in an annual report of control relationships that must be prepared by independent auditors. This report is intended to ensure that transactions among affiliates take place at arm’s-length prices. It should be noted, however, that the report is disclosed to the supervisory board only, not to the shareholders, which presents an enforcement issue.

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

The point of departure for this analysis is the separation between the management board (*Vorstand*) and the oversight body, the supervisory board (*Aufsichtsrat*). This roughly corresponds to the U.S. distinction between “inside” and “outside” directors. But, as prescribed in German law, these two sets of directors have significantly different duties and work in different management bodies. The members of the management board manage the corporation’s business and are subject to a wide-ranging obligation not to compete with the company or take personal advantage of opportunities that arise in connection with their duties in the corporation. Transactions between a member of the management board and the corporation may not be approved by the interested manager or even by the entire management board, but only by the supervisory board, which is assigned this specific duty by law.

German law seeks to guarantee the independence of the supervisory board members from the management board. First, the members of the management board are appointed by the supervisory board. Second, the management board’s influence on the selection of the members of the supervisory board is limited by the fact that, in companies with more than 2,000 employees, only half of the supervisory board is appointed by the shareholders and the other half is elected by the employees (in corporations with between 500 and 2,000 employees, the employees appoint one-third of the supervisory board).

In practice, however, the management board’s ability to influence the selection of the shareholders’ representatives on the supervisory board depends on whether the company is a publicly held company with a widely dispersed free float or a corporation with one or more dominant shareholders. In a company with a majority shareholder, both boards will be dominated by this shareholder. But in companies with widely dispersed ownership, the management board—particularly its chairman—will often have a decisive say in who will become a management board or a supervisory board member. The resulting potential for reciprocal “back scratching” between members of the management and supervisory boards is enlarged by the fact that, in any dealings between a supervisory board member and the company, the management board alone may not represent the company but must act together with the entire supervisory board. By

17. See M. Becht and E. Boehmer, “Ownership and Voting Power in Germany,” in F. Barca and M. Becht, Eds., *The Control of Corporate Europe* (Oxford University Press, 2001).

18. See §§ 311 et seq. Stock Corporation Act (Aktiengesetz).

assigning such transactions to the competence of the supervisory board, German law uses primarily procedural rules to handle such cases of potential self-dealing.¹⁹

These procedural rules addressing transactions between directors and the corporation technically apply only to members of the management board and the supervisory board. They do not extend to other related-party transactions, such as those involving relatives of the directors or firms in which directors have a substantial holding. Companies that prepare their financial statements on the basis of internationally accepted accounting standards (such as IAS or U.S. GAAP) are required to disclose material related-party transactions. Beyond this, the German Corporate Governance Code (the "GCGC") states that *material* related-party transactions should be approved by the supervisory board. But because the GCGC is a set of "best practices" rather than mandates, there are no direct sanctions for violations of its provisions (though companies are required to explain their decisions not to comply). Nevertheless, if the supervisory board fails to impose appropriate rules on the management board for related-party transactions, and the corporation is damaged as a result of such failure, the supervisory board will become liable for such damages. Moreover, if a member of the management board were to deplete the corporation's net worth by transferring assets from the corporation to himself or a firm he controls, he would violate his duty of loyalty and be subject to strict civil liability, as well as criminal sanctions (if the act were done "willfully").

As in the Anglo-American legal systems, German legal doctrine contains a duty of loyalty (*Treuepflicht*) that members of a management body owe to their corporation, and the culpable violation of which creates liability to the corporation for damages. The violation of the duty of loyalty will create strict personal liability. But, as explained in more detail below, the procedural requirements determining the success of an action for damages based on civil liability are set higher under German than under U.S. law, making the case difficult to prosecute.

In sum, German law on managerial self-dealing, like that in the U.S., fails to define the problem in a clear and precise way, and both attach too much weight to approval

by directors who are likely to be only nominally independent in control transactions.

U.S. Law and Inefficient Boards and Managers

In both the U.S. and Germany, the continuance in office of poorly performing top management is not dealt with solely or even primarily by legal rules, but they do have some bearing on the subject.

A second aspect of the U.S. concept of the fiduciary duty of officers and directors comes under the heading of the duty of care, which requires them to act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."²⁰ The standard as thus expressed is one of reasonable or ordinary diligence, knowledge, and skill, and would seem to create possible civil liability for ordinary negligence. Only rarely would negligence ever fall into the domain of the criminal law for poor administration of the affairs of the corporation.

Moreover, even as applied in civil courts, the ordinary negligence standard is actually a standard of desired conduct rather than a standard of potential liability. All jurisdictions apply the "business judgment rule,"²¹ which in effect transforms the liability standard into a gross negligence test.²² And the American Law Institute, in its *Principles of Corporate Governance* (1994), went still further and recommended a standard of protection that requires only "rational belief" that the action was in the company's best interests.

Under such standards, there is small likelihood of considered board decisions resulting in personal director liability for a violation of the duty of care (though it is not impossible, as made clear by the *Van Gorkom* decision in the mid-'80s).²³ And if a director were found liable for a violation of the duty of care, without any element of improper personal gain from self-dealing, the judgment would usually be covered by "D&O" insurance, paid for by the company.

Is all this contrary to the best interests of shareholders? It seems unlikely. The rule recognizes that business necessarily involves the taking of investment risks, that shareholders can reduce those risks more efficiently through portfolio diversification than can managers by trying to diversify their human capital, and that lawsuits brought in the wake of some loss are strongly biased against the decision-maker

19. The only express provision for a judicial examination of the fairness of the benefits conferred upon managers concerns whether the compensation managers receive from the company is "appropriate." However, if it is possible to bring a derivative suit, a court may examine whether a transaction between management and the corporation is appropriate and made on an arm's-length basis.

20. Cal. Corp. Code § 309(a) (West 2005). For a similar formulation, see Model Bus. Corp. Act § 8.30(b) (2002).

21. As defined by the Delaware Supreme Court, the rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

22. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

23. In dramatic failures, such as Enron and its successors, it is automatic for plaintiffs' attorneys to charge as wide a variety of defendants under as many causes of action as possible. It remains to be seen how many result in verdicts against directors. More recently, eleven outside directors of WorldCom agreed in a settlement to pay personally \$20 million, through a formula based on 20% of their net assets; see "Ex-WorldCom Directors Reach Pact," *Wall Street Journal* (Mar. 21, 2005), p. A6. And earlier in 2005, ten former directors of Enron had agreed to a class-action settlement in which they will personally pay \$13 million, based on 10% of their pretax proceeds from stock trading during the period in which false information was allegedly being given to the public; see "Ex-Directors of Enron to Chip in on Settlement," *New York Times* (Jan. 8, 2005), p. C1.

by the bad outcome. The best interest of the shareholders is served by managers who make risk-neutral decisions, not by managers made more personally risk-averse by the specter of personal liability for bad outcomes. Indeed, as one of us argued over 20 years ago, shareholders might be better off if duty of care liability were simply abolished.²⁴ And in the late 1980s, after the *Van Gorkom* decision, state corporation statutes were amended to allow shareholders to make that choice through charter amendment, or to limit monetary liability to a modest amount.²⁵ Notably, that option was not extended to duty-of-loyalty liabilities. Nor do loyalty violations find any shelter under the business judgment rule.

But if shareholders have no remedy for poor management performance in legal liability rules, do others? Not really. Shareholders may derive some indirect protection from the covenants that bondholders or banks have negotiated into their loan agreements, designed to maintain a certain minimum level of equity cushion or cash flow, or a maximum leverage ratio or amount of total debt.²⁶ If these well-specified requirements are not met, the debtholders can invoke their contractual remedies, to accelerate maturity in whole or in part, or enforce a security lien on pledged assets—steps that management would certainly wish to avoid, though not for reason of exposure to personal liability. But the terms of debt covenants, where they exist, are set to enhance the probability of debt repayment, not to provide incentives to maximize the total value of the firm, let alone the value of the equity. The interests of shareholders and debtholders do not coincide. And while incumbent management may be ousted in bankruptcy proceedings, that is not assured and comes far too late to do shareholders much good.

In short, legal liability rules are basically irrelevant to addressing the concerns of minority shareholders in U.S. companies over poor, or even miserable, managerial performance. And, as discussed above, that is probably in the shareholders' interests and as it should be. But that also makes it all the more important that there be other effective mechanisms to deal with the problem.

German Law and Inefficient Boards and Managers

It is a general principle of German corporate law that a director of a stock corporation must act with the diligence of a prudent businessman. Negligent or willful action that breaches this duty of prudent business management triggers liability to the corporation. But, as in the U.S., the practical reality is that actions based on a breach of the duty of care

are significantly restricted in two ways.²⁷ First, there is a “business judgment” defense that allows a director to argue that an action alleged to breach the duty of care was undertaken on the basis of business judgment (*unternehmerisches Ermessen*).²⁸ Second, as explained in more detail below, current German law makes it difficult for a corporation to bring a liability action against one of its directors. In practice, the most important sanction for business errors and commercial failures is that of not being re-elected to office. A German manager in practice would almost never be faced with liability for a breach of the duty of care (except in a case where the breach also involved a violation of law, such as a social security or tax law).

U.S. Law and Disclosure Requirements

Another type of legal duty imposed on management is mandatory disclosure requirements with the aim of protecting investors. There has long been a debate over the extent to which corporate disclosure should be mandated, since companies already have incentives to provide reliable information to potential buyers of their securities who may otherwise assume the worst. This argument loses much of its force when it comes to disclosure of conflict-of-interest transactions. However, we will not rehash that debate here, but simply review the content and enforcement effectiveness of the disclosure regimes currently in place.

For public offerings of securities in the U.S., the Securities Act of 1933 requires the filing of a registration statement with the SEC and dissemination of a prospectus containing extensive information about the business and financial history of the issuer. Upon becoming a public company, an issuer also incurs comparable disclosure requirements in mandatory periodic reports that are filed with the SEC and sent to shareholders. The contents of these documents are spelled out at length in SEC rules, and the financial statements must be presented in accordance with U.S. GAAP and audited by an independent public accountant in accordance with generally accepted auditing standards (“GAAS”). The establishment of GAAP rules has been the responsibility of the Financial Accounting Standards Board (“FASB”) and the setting of audit standards is now, under the Sarbanes-Oxley Act of 2002 (“SOX”), the responsibility of the Public Company Accounting Oversight Board (“PCAOB”), in both cases subject to review and (in effect) final determination authority in the SEC.

Disclosures in connection with private purchases, and purchases and sales in the secondary market, do not follow

24. See K. Scott, “Corporation Law and the American Law Institute Corporate Governance Project,” *Stanford Law Review*, Vol. 35 (1983).

25. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (2005); Cal. Corp. Code § 204(a)(10) (2005). Most public corporations have proceeded to opt out of all care liability, without significant shareholder opposition.

26. See the seminal article by C. Smith and J. Warner, “On Financial Contracting: An

Analysis of Bond Covenants,” *Journal of Financial Economics*, Vol. 7 (1979).

27. For a detailed analysis in English, see T. Baums, “Personal Liabilities of Directors in German Law,” *International Company and Commercial Law Review*, Vol. 7 (1996).

28. See § 93 (1) (2) Stock Corporation Act as of Nov. 1, 2005. This rule has been developed by the courts; contrast from the decision of the German Federal Civil Court (Bundesgerichtshof) in ARAG/Garmenbeck, BGHZ 135, 244 (1997).

such a rigid and detailed format. Instead, the SEC has adopted Rule 10b-5, which basically proscribes any material misstatement or omission made with “scienter” (roughly, knowledge) by a party involved in the purchase or sale of a corporate security. Strictly speaking, it is not a mandatory disclosure rule but a trading rule—one that says that, unless there has been proper disclosure, insiders (including the company) may not trade.

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

How much protection does all this afford minority shareholders? In the context of a person’s decision to invest in a company, it provides very effective remedies for fraud by the issuer or seller. But such protection and remedies are by no means perfect, and clearly come at a cost. The “material omission” branch of the standard can give rise to “hindsight” lawsuits, brought more for their settlement value than for culpable conduct. And a large recovery against the company generally amounts to a large transfer payment from one group of shareholders to another, both innocent of wrongdoing, rather than a sanction against management for intentional transgressions.

On the other hand, the prospectuses and annual (or quarterly) reports generate a very large flow of information to the securities markets, which help ensure accurate pricing and productive capital allocation decisions. This too has its critics: Enron, WorldCom (now MCI), and other corporate disasters of the last several years have called into question the clarity and adequacy of existing accounting rules and audit standards. In 2002 Sarbanes-Oxley required a company’s CEO and CFO to certify that its financial statements fairly present its operations and financial condition, with criminal penalties for knowingly false certifications; and numerous civil lawsuits have been successfully brought against Arthur Andersen and other major accounting firms for flawed financial statements. Still, whatever the flaws (and the room for improvement), the U.S. disclosure regime has sustained remarkably deep capital markets and reasonably accurate pricing mechanisms, to the undeniable benefit of the economy as a whole.

German Law and Disclosure Requirements

At present, German law provides shareholders and the investing public with at best limited means for holding management

and supervisory board members liable for false or misleading disclosure. This legal “gap” reflects the traditionally limited role that the organized capital markets have played for corporate finance and private investment in Germany. In theory, liability could result from the release of false or misleading information (or material omissions) provided to investors in securities prospectuses, interim reports, financial statements, shareholder newsletters or current reports, and information released in annual shareholders’ meetings or analyst meetings. In practice, only the liability associated with securities prospectuses meets international standards. In the case of other releases of false information, under current German law a director incurs liability only if it can be demonstrated that he willfully sought to deceive. In addition, the courts also require that the plaintiff prove causality between the false information and the transaction in question. Although there is a government plan to amend the existing laws in these respects, it has been delayed until the next parliamentary session. The prosecution of such actions has been further impaired by German law’s failure, until recently, to provide a class action or representative action mechanism in such cases (a subject we return to).

In addition, the German finance and governance system has adopted measures that aim to bring about significant improvements in the auditing of corporate financial statements—namely, increased auditor independence, improved and more independent supervision of the auditing profession, and an enforcement system for auditing financial statements for compliance with the law and accounting standards.

U.S. Enforcement of Legal Liability Rules

Up to this point, we have reviewed the deterrents to and protections against corporate conflicts of interest and poor performance that are provided investors by U.S. and German law. But the law by itself is hardly the whole story. If legal rules are not effectively enforced, their existence and scope does not much matter, except for whatever influence they may have as moral standards.

One requirement for effective enforcement is, of course, that the plaintiff have knowledge of the putative violation. The disclosure rules discussed above are one source of the necessary information, though they have been designed primarily to provide the capital markets with financial information about firm performance and pay only passing attention to conflict-of-interest transactions by those in control. But there are other channels whereby evidence about conflict transactions and accounting fraud may be revealed to outside board members or public authorities, including accountants, outside counsel, employee whistleblowers, and the financial press. Sarbanes-Oxley contains a number of provisions intended to deepen those channels and increase the likelihood that possible violations will be reported to

the board. But assuming awareness, if the problem is not corrected within the firm, what next?

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

Shareholders with grievances confront a number of obstacles, some legal (and unnecessary) and some practical, in defending their own interests. The legal obstacles begin with the fact that, under U.S. law, shareholders cannot sue directly to recover losses from conflict-of-interest transactions by insiders, but must instead bring a “derivative suit.”²⁹ The chain of reasoning verges on the theological: such transactions involve possible breaches of the fiduciary duty of loyalty; fiduciary duties of officers and directors are owed to the corporation as an entity and not to its owners; and the corporation is thus the party with the cause of action against its insiders. This in turn means that the shareholder must bring a suit against “the corporation” to force it to bring suit against some members of its management or board, and any recovery will go to the corporation. But because the affairs of the corporation are managed under the auspices of its board, not by its shareholders, the shareholder must first make a demand on the board to bring the suit for the corporation. To be sure, such a demand could be “excused” in cases where there is reasonable doubt that the board is disinterested or independent or made a valid business judgment in the first instance (per Delaware law).³⁰ But if demand is required and the board refuses to bring the action, then the shareholder is blocked from pursuing the case, unless the board’s refusal was wrongful or outside the protection of the business judgment rule, which in effect treats the decision to sue an insider for a loyalty violation as the same as any other business decision. If a demand is excused, as when for example board members shared in the conflict-of-interest transaction, then the shareholder can proceed to file suit. But, in such cases, the board can appoint a special litiga-

tion committee of new or disinterested members who then conduct their own investigation of the merits of the suit and decide whether to permit it. That decision is subject to judicial review under different standards in different jurisdictions, which address the committee’s composition and procedures and may (Delaware)³¹ or may not (New York)³² pay any attention to the merits of the shareholder’s case.

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

The result is that derivative suits are, if not an extinct species, certainly an endangered one. The decisions again fail to make critical distinctions: between care suits (of little value anyway) and loyalty suits (essential to shareholder protection), and between derivative actions against outside third parties (part of management’s discretion in running the company) and against insiders (where their chosen associates cannot be completely relied on to monitor their conduct). But, in the current state of the law, shareholders have compelling reasons to make every effort to bring their complaints in the form of direct actions (free from all the special burdens) to vindicate their own rights, as opposed to derivative actions that are supposed to be vindicating corporate rights.

Since fiduciary duties are usually characterized as being owed to the corporation, loyalty violations must be brought as derivative suits if stated in a straightforward manner. This has led to finding ways to base such actions on securities laws that create private rights of action, not for shareholders per se, but for those who purchased or sold securities, who will receive any recovery. In the process, the gravamen of the case becomes not the self-dealing transaction itself, but the failure to fully disclose it in connection with some securities transaction by the insider or the company. That approach will not reach all breaches of fiduciary duty,³³ but it does provide coverage for some.

But there are practical, as well as legal, obstacles to effective enforcement of shareholder rights that apply as much to direct actions as derivative ones. In the context of the public

29. Since recovery for failure to meet care standards is unlikely at best, as noted, this discussion will be confined to loyalty violations.

30. This is the Delaware rule. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

31. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

32. *Auerbach v. Bennett*, 393 NE.2d 994 (N.Y. 1979).

33. *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

corporation with numerous small shareholders, and even with many institutional shareholders, there is the familiar collective action problem. It is not rational for a small number of shareholders owning a modest fraction of the shares to bear the full risk and initial cost of a lawsuit whose benefits, if successful, will be shared by all the other shareholders, who can simply free-ride on their efforts. Without a way to surmount this problem, conflict-of-interest violations will be pursued only to a limited extent—mostly in situations where there are major blockholders outside the management or control group.

A partial solution in the U.S. to this collective action problem has consisted in awarding substantial attorney's fees to successful plaintiffs' counsel, both in derivative suits (which are collective in nature, since the damages recovered go to the corporation) and in direct suits under the securities laws, which are conducted as class actions on behalf of all affected shareholders. The amount of the fees approved by the court, and thus the incentive for the attorney, although typically in the range of 20-30% of the damage award, has been a smaller percentage in the largest cases, which can produce "underinvestment" in the litigation in relation to the amount at stake for the class. And the common practice in which the attorney discovers and then manages the litigation opportunity, with the titular plaintiff only a nominal party, creates other misalignments of interest between the attorney and the shareholder clients.³⁴ But, for all the defects of the attorney-driven lawsuit, without it there would be in a great many cases no enforcement at all of laws attempting to limit conflict-of-interest extractions by those in the control of the firm. Leaving it entirely to action by criminal prosecutors or a government agency would hardly be an improvement.

German Enforcement of Legal Liability Rules

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

Like U.S. law, German law makes a distinction between liability to the corporation and liability to the shareholders. Liability arising from a breach of the duty of care or duty of loyalty runs primarily to the corporation. There are a number of reasons for this: The director's employment contract is formally entered into between the director and the corporation, not between the director and the shareholders. In addition, it is generally believed that the management board and supervisory board members are not obliged to exercise care and loyalty exclusively in the interest of the shareholders, but

must also take account of the interests of other stakeholders in the firm (employees, creditors, the public at large). Although there is neither an explicit statutory provision requiring it or court rulings bearing on it, this doctrine tends to broaden the likelihood of upholding management actions that are contrary to the interest of the shareholders. Finally, any compensation for damages to the corporation's assets flows back to the corporation, and so provides no particular incentive for action by an individual shareholder.

Another obstacle arises from the fact that if the corporation wishes to initiate an action against a member of the management board, the corporation is in principle represented by its supervisory board. The problem with this rule is that when the supervisory board alleges that a management board member has breached its duty, such allegation may also imply that the supervisory board itself has failed to fulfill its oversight duties. For this reason, supervisory boards rarely undertake this type of liability action. In response to this conflict of interest, courts have not allowed supervisory boards to raise the defense of the business judgment rule in cases addressing whether they should have initiated a liability action against a management board member.³⁵ But even so, actions of this type are limited to the rare cases when a corporation enters insolvency proceedings and the bankruptcy trustee files the action, or when the entire top management (supervisory board and management board) has been replaced by a new owner.

The German legislature has also attempted to address this problem of reluctant supervisory boards through the following provisions: First, the corporation can be forced to take action against a management board or supervisory board member by a majority vote at the shareholders' meeting. In that event, although the litigation will be run by the management board (against members of the supervisory board) or the supervisory board (against members of the management board), either the shareholders (through a majority vote at the shareholders' meeting) or the court (at the request of a minority of shareholders) can institute a special independent representative to bring the suit. Second, according to a recent amendment of the Stock Corporation Act,³⁶ shareholders with collective holdings constituting 1% of the share capital (or a nominal or proportional value of €100,000) may bring a suit in cases with sufficient evidence of illegal activities or serious violations of the law or the articles of association. Before a suit can be filed, there is a demand requirement. At this stage, the board does not have complete discretion whether or not to sue. It may decline to bring a suit only where the overriding interests of the company in not suing can be demonstrated to

34. Efforts to reduce such conflicts led to § 27 of the Private Securities Litigation Reform Act of 1995, which prescribes the choice of a large shareholder as lead plaintiff appointed by the court, usually one of the largest institutional investors, and to efforts by some judges to set the level of fees through a species of auction bidding by law firms.

35. See ARAG/Garmenbeck, BGHZ 135, 244.

36. See Integrity of Corporations Improvement and Modernization of Annulment Suits Reform Act (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts), v. 6.17.2005, Bundesrat Drucksache 454/05.

the court—and the reasons adduced by the board will be subject to judicial review. In order to avoid “strike suits,” the trial court will hold a preliminary hearing to assess the merits of the case. If the court admits the case to a full trial, the company will bear the costs of the proceeding even if the plaintiff loses on the final judgment. If the preliminary hearing goes against the plaintiff, the latter may still proceed at his own risk.

But if such measures represent steps in the right direction, they do not eliminate the basic problems dampening any plaintiff’s incentives to undertake such actions. The plaintiff will bear all the costs and risks of initiating the action, although these may be lower than previously because of the preliminary hearings mentioned above. And there is no special payoff to a shareholder for bringing a successful suit; in the event of success, *all* shareholders will benefit equally from the judgment. And, unlike their U.S. counterparts, German lawyers may not work on a contingency fee basis.

In sum, the ability of shareholders to enforce what legal rights they have is limited at best in the U.S., and even more so in Germany.

The Board of Directors

Another mechanism for motivating and constraining the managements of public companies is the board of directors, who are elected by the shareholders and potentially a protector of their interest in maintaining good corporate performance and in limiting self-dealing and other private benefits. But, as we now discuss, there are some important differences between the U.S. and Germany in the structure, powers, and duties of the board.

Powers and Duties of U.S. Directors

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

But beyond the fiduciary duties already described, the law does not clearly specify the exact role of the board, and in practice there are at least three competing, and inevitably overlapping, concepts of its primary function. One is to act as counselors to the CEO, providing advice and perspectives from their own experience for management to consider in reaching decisions but otherwise deferring to management’s ultimate judgment. Only in a crisis or unusual circumstances would the board try to override, or even replace, the CEO. A second is to act as representatives of the shareholders’ interests and seek to maximize the equity value of the

firm. This perspective would require the board to view itself not only as an advisor, but also as bargaining with management over issues such as compensation or related-party transactions, and as a demanding monitor of management performance. A third concept, reflected in the stakeholder statutes, is that the board should see itself as “balancing” the interests of everyone significantly affected by the firm’s actions. How much weight should be accorded shareholder value is generally left unclear, but the Pennsylvania statute goes so far as to require that it shall not be controlling.³⁷

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

Powers and Duties of German Directors

Germany has had an obligatory two-tier system since 1870; before that, a single-tier and a two-tier board were both in use. In theory, the tasks and duties of the management board and the supervisory board are strictly separated. The management board conducts the business affairs of the corporation. The supervisory board appoints the members of the management board, who are company officers, and can remove them from office, but must have good reason to do so (such as material breach of duty, incapacity to manage, or a vote of no confidence at the shareholders’ meeting) before the end of their term of office, which can last as long as five years.

Further, the supervisory board oversees the management of the corporation and must co-approve all important transactions, as specified in the articles of association or designated by the supervisory board itself. Oversight of the management board means, first of all, that the supervisory board is supposed to prevent self-dealing and limit private benefits of control. Second, the supervisory board is supposed to monitor management’s performance and create the conditions for corporate success, in particular through the appointment of capable managers, continuous evaluation of their performance and, if necessary, the removal of incompetent management board members. But, as will be discussed below, the last of these tasks in particular—the removal of inefficient managers—presents both theoretical and practical challenges.

The supervisory board has broad information-gathering and intervention powers for carrying out its oversight duties. The duties provided for by law flow from the duty of loyalty that each supervisory board member owes to the corporation. The purpose of these duties, however, is by no means exclusively to protect the interests of the shareholders. The majority position, as noted earlier, is that the

37. 15 PA. CONS. STAT. ANN. § 511(d) (West 2005).

supervisory board must primarily protect the interests of the firm.³⁸ This position is emphasized and strengthened by the representation of employees on the supervisory board. As mentioned earlier, in companies with more than 2,000 employees, one-half of the seats are reserved for employee representatives.³⁹ Subcommittees of the board reflect the same split.

The ambiguity created by this absence of a single focus for the exercise of duties is exacerbated by another problem that, in practice, hinders the efficient oversight of management in the German system. In connection with the mandatory co-determination rules, German law also sets obligatory sizes for supervisory boards. For larger corporations, a 20-member supervisory board is required. If one includes the members of the management board, the company is saddled with a cumbersome directorate of about 30 members or more, and this in itself points to an inefficiency of the German system in comparison to the smaller boards common in international practice. As a consequence, the supervisory board meets less frequently than would a smaller body, and much depends on the work of the chairperson of the supervisory board and individual committees rather than on the activities of the board as a whole. Legal policymakers have made repeated recommendations to reduce the size of the supervisory board; however, these attempts have been unsuccessful, primarily because of opposition from labor unions.⁴⁰ Labor unions have a concrete interest in large supervisory boards because they can appoint three officers to such boards, and because the representatives of the labor unions and employees direct most of their compensation for work on the board back to the unions. As a result, the role of plenary supervisory board meetings has been reduced to a few sessions to hear reports from the management board, adopt formal resolutions, and air issues that particularly affect employee interests. Strategic questions and criticism of the management board are often addressed in separate informal meetings between shareholders' representatives on the supervisory board and the management board. In emergency situations, however, the supervisory board is forced to become active. And, as a general rule, supervisory boards that include representatives of major or controlling shareholders may become far more vigorous in pursuing shareholder interests than boards of widely held companies.

Director Selection in the U.S.: The Case of Concentrated Ownership

The party who possesses the actual capability of selecting the directors, which depends on the distribution of stock ownership and voting power in the individual case, will largely determine the role of the board. In the case of U.S. companies with a controlling shareholder—an outside individual or parent company that owns a majority or near-majority block of the voting stock—the board can be expected to represent the interests of that owner. Normally such interests will lie in the direction of maximizing the firm's profit (and the equity value), which greatly reduces minority stockholders' concern about monitoring firm performance. But, in some cases, controlling shareholders may instead aim to increase their private control benefits at the expense of the minority. Thus, the conflict-of-interest or related-party transaction problem we discussed earlier remains important. As Jensen and Meckling pointed out, minority shareholders on buying into such a firm will attempt to estimate and price the private benefits of control, but that does not satisfactorily cover the situation where an outsider subsequently acquires control of a previously widely held company. All parties could be better off *ex ante* if the legal system more effectively limited control rents.

In cases where there is not a single controlling stockholder but a number of blockholders who together have operating control, both the benefits and the costs described above are present, though to a lesser degree. Public pension funds like CalPERS have been increasingly active in corporate governance, which has prompted considerable debate about the capability and effectiveness of institutional investors as monitors of public corporations.⁴¹ Even though institutional investors as a category own about half the equity of NYSE companies, their individual holdings usually amount to a small percentage of a given company's capital, so coordination among a substantial number of such investors would be required. Such coordination would not be simple, either in practice or as a matter of law,⁴² which tends to reduce the leverage that investors might otherwise exercise over incumbent management. Furthermore, there would still be a "free-rider" problem, though diminished. On the other hand, the ability to extract private control benefits would also be lower, since the dispersion of control leads to a more transparent environment. But if institu-

38. See, e.g., German Federal Civil Court, BGHZ 64, 325 (329) (1975).

39. To break ties, the shareholder-selected chairman has a second vote. For a detailed description, see T. Baums and B. Frick, "The Market Value of the Codetermined Firm," in M. Blair and M. Roe, Eds., *Employees and Corporate Governance* (Washington, DC: Brookings Institution Press, 1999).

40. The Federal Government recently convened a commission of experts with the aim of developing proposals to adapt the German codetermination system to the changing conditions and requirements of the markets. But the composition of this commission and the formulation of its task do not lead one to expect that the system will be changed materially.

41. Compare B. Black, "Agents Watching Agents: The Promise of Institutional Investor Voice," *UCLA Law Review*, Vol. 39 (1992), with J. Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor," *Columbia Law Review*, Vol. 91 (1991).

42. The legal issues for a "group" acting together include reporting requirements under '34 Act §§ 13(g) and 13(d), short-swing profit liability under § 16(b), short sale prohibitions under § 16(c), "affiliate" status under the '33 Act, and a triggering of company-adopted "shareholder rights plans" (poison pills); see B. Black, "Shareholder Passivity Reexamined," *Michigan Law Review*, Vol. 89 (1990), for an early account of such difficulties, and SEC Staff Report, "Review of the Proxy Process Regarding the Nomination and Election of Directors" (July 15, 2003).

tional investor activism has been growing, it has yet to reach the stage of an accepted policy of exercising direct pressure on boards by making a coordinated effort to nominate and elect board members.

In sum, although investor activism is causing some boards to pay closer attention to shareholder interests, and may well have significant unrealized potential for more effective monitoring, institutional investors have yet to become a powerful determinant of board behavior in the U.S.⁴³ The recent expansion of the influence of hedge funds and private equity funds may portend a greater role in the future. The SEC at one point indicated that it would like to increase the institutional investor voice a little bit, but not too much. In 2003, it issued a proposed rule that would allow “eligible” shareholders (those holding at least 5% of the firm’s stock for at least two years), in a restricted process consuming at least (another) two years, to have from one to three nominees included in a company’s proxy solicitation materials. Although the proposal was supported by many institutional investors and did not pose much of a threat to management control, business lobbying organizations and their counsel denounced it roundly, and the SEC has apparently decided not to take further action.

Quite a lot of discussion has been devoted to the composition of the board, as apart from the matter of their incentives and who selected them. Does the percentage of outside (non-executive) versus inside (management) directors make a difference in firm performance? Many shareholder activists claim it does, and the listing requirements adopted recently by the NYSE and NASDAQ would require a majority of “independent” directors on the boards of public companies. But the empirical studies so far do not find consistent evidence to support the claim that a larger number or majority of outside or independent board members results in better firm performance.⁴⁴ Likewise, there has been considerable advocacy of the proposition that the board chairman should not be the CEO but should instead be an outside director, although again the empirical evidence is inconclusive,⁴⁵ and the SEC has not tried to require it except for mutual funds.

Director Selection in German Companies: The Case of Concentrated Ownership

Although ownership structures in Germany are gradually coming to resemble those in Anglo-American compa-

nies, most German corporations, including those that are publicly listed, continue to have majority shareholders or shareholders that exercise *de facto* control (these include families, foundations, other companies, and the state). Institutional shareholders such as insurance companies, banks, mutual funds, and pension funds—and in particular foreign institutional investors such as private equity and hedge funds—have been increasing their presence in Germany. And while such foreign institutions have taken big stakes in a handful of German companies, the higher costs of information and taking action in Germany have made such investors more cautious in pressing for better corporate governance, filing shareholder suits, or demanding (supervisory) board seats in Germany than they would be in their own markets. But this reluctance is likely to dissipate in the future, especially in cases where a number of institutional investors hold blocks of shares and are able to act jointly.

One reason for expecting greater activism is a recent shift in the governance role of German banks. Despite the banks’ historically significant role in the oversight of German companies (a role that, in our view, has been widely misunderstood by scholars outside Germany),⁴⁶ the influence of German banks has in recent years been sharply diminished. Since the introduction in 2002 of a favorable tax exemption, the banks have sold much of their holdings of corporate equities, and bank executives have given up their traditional positions at the helm of the supervisory boards of their industrial clients. Moreover, the affiliated depositary voting system has been supplemented by a proxy voting system run by the management of the company rather than, as in the past, by depositary institutions acting as proxies. Interlocking share ownership among large corporations, though it still exists, has also been decreasing.

But even so, institutional investor monitoring will likely continue to be less effective in Germany than in the U.S. or the U.K. because of the lack of large German pension funds, the dependence of German investment funds on their holding banks and regulations requiring diversification of their investments, and the relative absence of large German private equity and hedge funds.

Director Selection in Widely Held U.S. Companies

In cases where stockholdings are diffuse and institutional investors do not exercise significant control, shareholder

43. For a historical exploration of the reasons, see M. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton University Press, 1994).

44. For a review of the extensive literature, see S. Bhagat and B. Black, “The Uncertain Relationship between Board Composition and Firm Performance,” *Business Law*, Vol. 54 (1999).

45. J. Brickley, J. Coles, and G. Jarrell, “Leadership Structure: Separating the CEO and Chairman of the Board,” *Journal of Corporate Finance*, Vol. 3 (1997).

46. During the late 1980s and much of the 1990s, corporate finance and governance scholars viewed bank control of corporations as an effective, “relationship-based” corpo-

rate governance mechanism, one that was said to be not only the equal of, but in some respects superior to, the market-based capitalism of the U.K. and U.S. But, starting in the mid-’90s, this view has been largely revised. On this subject, see J. Edwards and K. Fischer, *Banks, Finance and Investment in Germany* (Cambridge University Press, 1994); T. Baums, “The German Banking System and its Impact on Corporate Finance and Governance,” in M. Aoki and H. Patrick, Eds., *The Japanese Main Bank System* (Oxford University Press, 1994); and Geoffrey Miller and Jonathan Macey, “Large Banks Are Not the Answer to America’s Corporate Governance ‘Problem’: A Look at Japan, Germany, and the U.S.,” *Journal of Applied Corporate Finance*, Vol. 9 (Winter 1997).

voting tends to be ineffective and of little consequence. That presents two polar possibilities. The first, and most common, is that the CEO will dominate the board, often serving as the chairman, and typically control the filling of vacancies. That puts the CEO in a position comparable to that of a controlling shareholder, one who may well turn to maximizing private control benefits rather than firm value. The other end of the spectrum is a genuinely independent board, with a majority of outside directors who control the nominating process and fill vacancies on their own. This has not been the typical board in the public corporation, but it is one that can sometimes develop over time and seems currently to be the goal of corporate governance activists, as reflected in the listing requirements recently adopted by the NYSE and NASDAQ and approved by the SEC.

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

Director Selection in Widely Held German Companies

In Germany, as we have already seen, the members of the management board are appointed and removed (but only for “cause”) by the supervisory board rather than directly by the shareholders. And because fully half of the members of the supervisory board in large companies are elected by the employees rather than the shareholders, the influence of the management board on the persons who can appoint or remove them is limited, as is the influence of shareholders on the supervisory board. Collaboration with outside directors in “managerial rent-seeking” may thus be less pronounced in the German system, but a German management board may well have more freedom to act without supervision (because of the less intensive interaction between the management board and the supervisory board), especially in large corporations without a controlling shareholder. Furthermore, because the election as well

as the reappointment of a management director requires a two-thirds majority vote by the supervisory board, there is an incentive for managers to “cultivate” the employees’ representatives on the supervisory board. This helps explain why German managers seem more hesitant to tackle necessary restructurings that include layoffs or wage cuts, since such measures could lead to serious confrontations with the trade unions and the works council.⁴⁷

In sum, small shareholders in widely held companies in both the U.S. and Germany have votes but very little prospect of using them directly for effective monitoring of those with management control. That leads us to a closer focus on directors’ incentives in both systems.

Director Incentives

The public interest theory of the board is that its members will meet their legal and moral obligations out of a sense of duty and internalized norms. It would help of course if those legal and moral obligations were better defined and generally agreed on, instead of being clouded in ambiguity and uncertainty about whose interests are to be served. But, in any case, directors will possess substantial discretion, so attention must be given to their personal incentives.

Though there are undoubtedly many directors in both the U.S. and Germany who are motivated in large part by moral and legal imperatives, there are clearly other incentives at work as well. Directors may wish to retain their positions because of the status, contacts, and compensation that go with them. If so, they will obviously be attentive to the wishes of those who put them on—and can remove them from—the board. To the extent directors are also stockholders, as is generally the case, they have an incentive to increase the value of their shares. In most cases, however, this is not a very strong incentive, since director stockholdings are likely to be relatively small in absolute terms and infinitesimal as a percentage of the company’s outstanding capital. Directors no doubt also have an incentive to preserve their reputations and to avoid legal liability. But none of these incentives necessarily creates a strong pressure for directors to assert independence from management and work hard to thoroughly understand the company’s business and maximize shareholder value. Moreover, such maximization, as we have already seen, is not even a formal goal for board members in Germany’s stakeholder regime. But directors do have incentives to become more assertive when their firm is hit by scandal.

Opportunities for Purchase of Control

There are many possible motives for one firm to set out to acquire another, not all of which are socially beneficial. Some

47. See, e.g., the findings of G. Gorton and F. A. Schmid, “Capital, Labor, and the Firm: A Study of German Codetermination,” *Journal of the European Economic Association*, Vol. 2 (2004).

are driven by the prospect of an increase in the market value of the combined firms, which may come from different sources. The combined firm may possess greater market share, even to the point of obtaining monopoly or oligopoly rents (at which point it becomes a concern for the antitrust laws). The combination may create “synergies” based on economies of scale or scope, or allow for the use of tax loss carry-forwards. Or, more to the point of this article, it may be a way to replace self-serving or poorly performing management.

On the other hand, there are examples of the combined firm having a lower value than the sum of its constituent parts. That may come about because of errors of judgment by the management of the acquiring firm, or because they are serving their own interest in building a bigger empire despite its cost, to reap correspondingly greater compensation, power, and celebrity.⁴⁸ Either way, they too may become a corporate governance problem.

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

As for poor performance, however, the picture is somewhat different. Here there are gains to be achieved by replacing the incumbent management, gains that it cannot achieve on its own. The target management thus has an incentive to allow the transaction (provided it receives adequate compensation in some form); the acquirer has to see profit in the acquisition; and enough of the gains must go to the selling shareholders to induce them to vote in favor of

the sale. The result is a division of the potential gain among the three parties, in some indeterminate fashion. That is what seems to occur in these transactions, although shareholders might wish for a bargaining mechanism that better represents their ownership interests.

In hostile takeovers, by contrast, the acquirer purchases ownership and control directly from shareholders in the trading market, usually in the form of a tender offer, rather than going through management to get its approval of a merger. This potentially provides an answer to how to overcome both control rent and poor performance problems—namely, by ousting the incumbent management if they are responsible. In this case, the expected gains will in theory be divided just between two parties—the buyer and the target shareholders—although the target management may still extract a share, through golden parachutes or compensation for belated acquiescence.⁴⁹ The buyer’s expected share has to be large enough at least to cover the expected costs and risks of making the bid, or none will be forthcoming. Beyond that minimum, the split is again indeterminate, and will be affected by whether there are other alternative acquirers (creating a seller’s market) or targets (creating a buyer’s market).

The U.S. Market for Corporate Control

The tide in the contest between acquirers and target managements in the U.S. has ebbed and flowed in recent years. At one time, the proxy fight for the election of directors seemed about the only way to wage such a contest, but the challenger was generally at a substantial disadvantage in winning—not only because incumbent management had a set of major procedural advantages (controlling the agenda and shareholder lists for the annual meeting, charging expenses to the company), but also because the shareholders were merely being given a choice between known incumbents and outside “raiders.” With the development of the tender offer in the 1960s, they didn’t have to make a comparison between alternative management teams but merely a comparison between the price being offered by the acquirer and the market price under current management, and acquirers did much better. Management struck back in a number of ways: procedural requirements in the Williams Act of 1968 that gave the target earlier warning and more time to resist, charter amendments (to delay consummation of control transfer) such as staggered boards, abolition of the right of shareholders to remove directors without cause or to hold special meetings (or act by written consent with-

48. On average, mergers are value-increasing, but sellers get much better returns than buyers (particularly the largest acquirers); see G. Andrade, M. Mitchell, and E. Stafford, “New Evidence and Perspectives on Mergers,” *Journal of Economic Perspectives*, Vol. 15 (2001); and S. Moeller, F. Schlingemann, and R. Stulz, “Firm Size and the Gains from Acquisitions,” *Journal of Financial Economics*, Vol. 73 (2004).

49. This issue was raised in the current criminal prosecution of the Mannesmann super-

visory board’s compensation committee for the bonus paid to its CEO and other managers at the time of Vodafone’s takeover. The members of the compensation committee and the recipients of the payments were acquitted on the charge of abuse of their fiduciary duties by the court of first instance. But the case is now pending before the Federal Supreme (Penal) Court. See “Deutsche Bank Denies Reports That Its Chief Will Quit if Faced With New Fraud Trial,” *New York Times* (May 20, 2005), p. C4.

out them), supermajority shareholder vote requirements to approve clean-up mergers of which the members of the prior board had not approved. But these proved less effectual than desired, especially as the development of junk bond financing facilitated the making of all-cash offers. Once an acquirer had obtained at least a majority of the stock, the incumbents usually saw the handwriting on the wall and gave in.⁵⁰

Delaware provided incumbent management the upper hand again in two 1985 decisions. In *Unocal vs. Mesa Petroleum*, the Delaware Supreme Court agreed with management that tender offers were “threats” and authorized the target company to use any defensive tactics that were “reasonable in relation to the threat posed.” The force of that holding soon became clear in *Moran vs. Household International*, which upheld the use of the new device of a “poison pill,” so long as it was reasonable under *Unocal* in the mind of the judge. The corporate bar has invented a number of variants of the poison pill, but they are all essentially rights given by the board to stockholders (other than the would-be acquirer) to buy shares at a deep discount from the market price if anyone obtains more than a set percentage (such as 10% or 20%) of the outstanding stock.⁵¹ The resulting dilution of the acquirer’s investment is so costly that no one has ever triggered such a pill. The rights can be redeemed (at no or nominal cost) by the target board to permit friendly acquisitions of which it approves, but not by a shareholder vote.

The requirement that use of the pill must pass muster with the Delaware Supreme Court as “reasonable” turned out to be of little substance.⁵² If the target justified a refusal to redeem on the basis that management had a strategic plan that it claimed would lead in the future to greater value than the acquirer was bidding in an all-cash, 100% offer, that seemed sufficient for the Court (in *Paramount Communications v. Time* (1989)) to keep the offer from being decided by the shareholders, who might after all be unable to properly evaluate management’s plan and reach the right conclusion. Subsequent Delaware decisions have gone down the same line and refused to order a pill’s redemption, viewing it as a matter for the board’s judgment as a proportionate response to the “threat” posed by a takeover bid, so long as it fell within a “range of reasonableness.”⁵³

Since the “enhanced scrutiny” promised in *Unocal* proved hollow, attention returned to the proxy fight as an

accompaniment to a tender offer. If the acquirer could win the proxy fight and get control of the board, then it could redeem the pill and proceed with the offer; shareholders would really be voting in the proxy contest not on an alternative management slate but on the price being offered for their stock. The response was renewed attention to the earlier device of the staggered board; winning one proxy fight would not be sufficient, since only a third or a fourth of the board would be up for election. The pill could remain in effect, and a year or more would have to elapse before the acquirer could try a second time to pursue its offer—if it still made sense to do so. That prospect would eliminate many potential tender offers from ever being made. As a recent study concluded, “Effective staggered boards are the most powerful antitakeover device in the current arsenal of takeover defense weapons.”⁵⁴

Not every state authorizes staggered boards, and not every company has one, though a majority of large public corporations do. Nor does every company have a poison pill, although they can be quickly adopted. And perhaps, even when a company has both, a Delaware court may rule that refusal to redeem the pill in certain special circumstances is a violation of the board’s fiduciary duties, or an acquirer may be willing to engage in a two-year struggle. Even without judicial compulsion, a board might override management’s desire to remain in office. So some hostile takeovers may succeed despite target management’s unyielding opposition. But at present it seems clear that hostile takeovers play a very limited role in the protection of shareholder interests when management is determined to stay in power.

In short, Delaware jurisprudence seems to be willing in substance, though not in verbiage, to give management something approaching an absolute veto over hostile tender offers, despite overwhelming evidence that they confer large benefits on target shareholders.⁵⁵

The German Market for Corporate Control

Proxy fights are extremely rare in Germany. Earlier this year several international investment and hedge funds succeeded in ousting the CEO and several board members of the Deutsche Börse without a formal shareholders’ meeting. But this event also triggered an inquiry by the BaFin (the German financial markets supervisory agency) into whether there had been a concerted action by shareholders that together held a controlling block of shares. If that

50. For a description, see R. Gilson, “A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,” *Stanford Law Review*, Vol. 33 (1981).

51. See R. Gilson and B. Black, *The Law and Finance of Corporate Acquisitions* (Foundation Press, 2d Ed. Supp., 1999).

52. Except presumably in the situation where a company is deemed to have put itself up for a cash sale that results in a change in control. See *Revlon v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986). But not if the company is agreeing to a stock-for-stock merger, because then there is no change of control if both parties are widely held in the market. *Paramount Communications v. QVC Network*, 632 A.2d 34 (Del. 1994).

53. See, e.g., *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995.)

54. L. Bebchuk, J. Coates, and G. Subramanian, “The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy,” *Stanford Law Review*, Vol. 54 (2002).

55. For a review, see G. Jarrell, J. Brickley, and J. Netter, “The Market for Corporate Control: The Empirical Evidence Since 1980,” *Journal of Economic Perspectives*, Vol. 2 (1988). The size of the average premium—around 50%—is an indicator of how costly and inefficient a bound on agency costs the hostile tender offer has become. See also A. Schleifer and R. Vishny, “Large Shareholders and Corporate Control,” *Journal of Political Economy*, Vol. 94 (1986).

turns out to be the case—and the inquiry has yet to reach a conclusion—the shareholders will be required to make a bid for *all* the shares.

Likewise, hostile takeovers executed through public tender offers—and the threat they pose to executives of removal from office if the corporation's share price drops because of unsuccessful management—have not played a significant role in German corporate governance. But they do occur. Vodafone's hostile takeover of Mannesmann in 2000 came as a shock to corporate Germany⁵⁶—and there have been several smaller hostile takeovers since that time.

But hostile takeovers through public bids are only one of a number of ways of achieving control of underperforming companies. Since German companies often have a dominant shareholder or a number of significant minority shareholders, a hostile change of control (that is, a change of control that management opposes) can take place through the privately negotiated placement of a large block of outstanding shares.⁵⁷ Until 2002, such transactions required less capital because German law—unlike that, for example, in England—contained no requirement that all shareholders be offered the right to sell their shares at an appraised price in case of a change of control.

Until recently, there was also general agreement that the management board and the supervisory board had no right to influence the make-up of the shareholder base (occasionally referred to with the confusing name of the “neutrality principle”). This meant that in the case of a tender offer or a change in control through other means, the management was not authorized to use any defensive tactics. But when the European Community attempted to adopt a directive that would have prevented the managements of all EU companies from using defensive tactics, Germany led a coalition to defeat the directive. The stated reason for German opposition to the directive was that a number of other EU member states had defensive tactics that were not available in Germany and would have slipped under the directive's prohibitions. For example, Electricité de France could have taken over a German electric utility against the will of German management, but the French firm was itself immune to takeover because the French government held preferred shares with special voting rights (“golden shares”).

While Germany was working to defeat this European directive, it adopted its own takeover legislation that rejected the so-called “duty of neutrality.” The management board of a German corporation may now be given authorization at the shareholders' meeting to undertake (for a period of 18 months) defensive measures, such as the sale

of an essential asset or the issuance of new shares to a third party, that would otherwise require the specific consent of the shareholders. The management board and supervisory board acting together may also use (very limited) defensive tactics, such as the sale or purchase of assets or the use of authorized capital, if they are compatible with prudent and diligent management. But U.S.-style poison pills, which would dilute the value of the acquirer's stock, continue to be illegal, as is any measure that would damage the company (as distinct from shareholders).⁵⁸

The European Community, meanwhile, has pushed forward its legislative project on takeovers. In this regard, the European Court of Justice has published several rulings in which it voided various types of defensive tactics used against other European bidders. The European Council and Parliament last year adopted a directive that allows member states to classify their corporations as either open or closed to takeover, and allows companies to use defensive tactics against bidders that are not themselves open to a takeover. This directive has yet to be transformed into national law in most member states.

In sum, the market for corporate control in Germany rarely takes the form of hostile takeovers, though there have been a few and could be more. Hostile takeovers are more common in the U.S. but face major obstacles that render them far less of a threat to underperforming managers than they were during the 1980s.

Incentive Compensation

Another way of encouraging managers to increase efficiency and value is to try to align their interests with those of shareholders by using rewards (performance-based compensation) rather than sanctions (liability), or contracts rather than legal rules. Compensation packages aim to motivate managers by including a variable incentive component as well as a fixed component. But setting aside the questions of what the total amount of compensation should be and how it is actually determined, problems arise with how the performance of top management is measured and the choice of incentive plans.

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

56. For a description in English, see J. Anderson and J. Conger, “Vodafone's Takeover of Mannesmann: Boardroom Simulation,” London Business School Case Study (March 2003).

57. See, e.g., J. Franks and C. Mayer, “Ownership and Control of German Corpora-

tions,” *Review of Financial Studies*, Vol. 14 (2001).

58. See the detailed analysis in J. Gordon, “An American Perspective on Anti-Takeover Laws in the EU: The German Example,” in G. Ferrarini et al., Eds., *Reforming Company and Takeover Law in Europe* (Oxford University Press, 2004).

In terms of the type of plan, again there are two broad categories: payment in cash and payment in stock or stock options. They differ in tax treatment and in accounting treatment, and the rules can become intricate and beyond our level of detail. But there is a problem that cuts across all types, and that is the time period required for the executive to reap the full benefit. If there is immediate full ownership (so that the bonus cash can be spent or, when the option is exercised, the stock can be immediately sold) and the amounts are large, executives may be tempted to take steps to boost near-term profits at the expense of longer-term value or, in the extreme, to manipulate financial reports. This seems to be an important part of the explanation for recent cases like Enron, WorldCom, and Tyco.⁵⁹

In sum, although carefully designed incentive compensation plans can be effective in motivating managers to increase performance, such plans are subject to abuse, particularly when overseen by pliable boards.⁶⁰ Moreover, there is some question as to whether plans really succeed in aligning management and shareholder interests, since under all but large stock ownership plans, management generally does not share in the shareholders' downside risk.

Recommendations

What conclusions do we draw from this survey? To return to the propositions with which we started, it cannot be said that either U.S. or German law is designed to give primacy to shareholder interests. In one widely cited study of international corporate governance, legal protection of shareholder rights in the U.S. was rated at "5" (on a scale of "0" to "6") while the German legal system was assigned a "1." In our view, the U.S. rating is overly generous, or simplistically conceived. We will summarize our findings, and suggest some relatively straightforward steps that would have to be taken if either legal system were to take shareholder protection seriously.

Improving Legal Rules in the U.S.

The problem of conflicts of interest. For corporate governance purposes, the focus should be on abuses of control, so the statutes would have to be drafted in those terms. Sometimes the locus of control in a corporation is fairly obvious, from share ownership percentages or the role the CEO has played in director selection, but it may also be a question of fact that would have to be resolved by examining evidence—which is the function for which courts exist. All significant transactions between the company and a

controlling person—manager or shareholder—should be susceptible to review for fairness. If the control status seems ambiguous, then internal process (approval by "disinterested" directors or shareholders) could transfer the burden of proof as to lack of fairness to the plaintiff.

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

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

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

But shareholder suits against insiders to enforce their fiduciary duty of loyalty, or to recover damage to the company from knowing transgressions of clear legal rules, are a distinctly different matter, and should not be hindered by treating them the same as suits against outsiders. They should be viewed procedurally the same as direct (class) actions, a result achieved by characterizing insiders' fiduciary duties as running to the shareholders as well as to the firm. Indeed, there are decisions already saying exactly that,⁶¹ and their procedural implication could be readily drawn by courts taking shareholder protection seriously.

59. See, e.g., J. Coffee, Jr., "What Caused Enron? A Capsule Social and Economic History of the 1990s," *Cornell Law Review*, Vol. 89 (2004).

60. See L. Bebchuk, J. Fried, and D. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation," *University of Chicago Law Review*, Vol. 69 (2002); and L. Bebchuk and J. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, MA: Harvard University Press, 2004).

61. See, e.g., *Remillard Brick Co. v. Remillard-Dandini*, 249 P.2d 66, 74 (Cal. 1952): [D]irectors, while not strictly trustees, are fiduciaries, and bear a fiduciary relationship to the corporation, and to all the stockholders. They owe a duty to all stockholders, including the minority stockholders, and must administer their duties for the common benefit. The concept that the corporation is an entity cannot operate so as to lessen the duties owed to all of the stockholders.

Improving Legal Rules in Germany

Conflicts of interest. To date, German law inadequately regulates transactions between controlling shareholders, directors, their related parties, and the corporation. The main problem is a lack of sufficient information about such transactions. As a first step, the reports for insolvent companies on transactions among affiliated companies and persons should be publicly disclosed for the five-year period immediately preceding commencement of the insolvency proceedings.

Poor management performance. The most important sanction for bad performance is not being re-elected to office or, in serious cases, being prematurely removed from office. Furthermore, the supervisory board could theoretically (and, according to judgments of the courts, should) sue a director in case of culpable (intentional or, if the requirements of the business judgment standard are not met, negligent) behavior. The latest reform of the Stock Corporation Act rather clearly provides that derivative actions of shareholders cannot be based on bad performance or breaches of the duty of care.⁶²

Enforcement. German law needs to be reformed to facilitate actions to enforce the informational obligations that directors and corporations owe to investors. The standard for liability is set too high (for the disclosure of false information to the market, liability attaches only where willful conduct and investor reliance on such information can be proved).⁶³ And there seem still to be few incentives for shareholders to ever bring a derivative suit.

Improving U.S. Boards of Directors

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

The impact of the Sarbanes-Oxley Act of 2002, together with the changes to NYSE listing requirements requiring a board with a majority of independent directors and a nominating committee of all independent directors, may well be to establish a legal foundation for autonomous boards—self-perpetuating groups that control their own

elections and select their own successors. Such boards could in theory become, at least over time, largely beyond the sway of the CEO and able to set their own course, determined by their members' own preferences and incentives.⁶⁴

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

Under a proposal that was put forth by the SEC, though now apparently abandoned, holders of at least 5% of outstanding shares would, under special and narrow circumstances, have been able to put some competing candidates on the company's annual proxy statement for the election of directors, avoiding the costs of separate solicitation. The concept offered the possibility of subjecting even an otherwise autonomous board to some shareholder (presumably institutional investor) discipline.

Improving German Boards

German companies should be permitted to choose between using a two-tier (supervisory and management board) and a one-tier (board of directors) management structure, which is the model set forth in the EC Regulation for a European Corporation.⁶⁵ The market would then be able to decide on the respective strengths and weaknesses of the two management structures. Regardless of this, German supervisory boards are too large to effectively carry out their duties, and should thus be reduced in size. Furthermore, although it is unlikely that employee co-determination will be changed in the near term, it appears even on its own premises to be a mistake that only employees residing in Germany are represented in co-determination. The entire co-determination system should be examined and adjusted where necessary.

In the long term, international investors will not accept nationally appointed supervisory boards because they will (correctly) fear that decisions are made not to further business efficiency, but rather to serve parochial interests, in particular those of the local labor union. More specifically,

62. The text of the Act requires that the suing shareholder bring evidence justifying the suspicion of illegal activities or serious violations of the law or the articles of association. Although the standard of care itself is laid down in the law, the Government's official grounds for the draft bill explicitly state that derivative suits cannot be founded on mistakes in the area of managerial or entrepreneurial decisions. Court decisions or commentaries on this point are still lacking.

63. This should be compared with the United States standard of "scienter" for 10-5 cases and negligence for Prospectus documents.

64. See K. Scott, "The Autonomous Board: Corporate Governance Reform?," *Journal of Institutional & Theoretical Economics*, Vol. 159 (2003).

65. See Council Regulation (EC) No. 2157/2001 on the Statute for a European Company, 2001 O.J. (L 294) 1, http://europa.eu.int/cur-lex/en/archive/2001/1_29420011110en.html.

the practice of employee representatives diverting their salaries into the treasuries of the labor unions is questionable. Members of the works council should not, because of the ensuing conflicts of interest, serve as supervisory members at the same time. Trade unions should not, as is now the case under the current regulation, have a statutory right to supervisory seats irrespective of their election by the employees; and the two-thirds vote requirement for the election and reappointment of managing directors should be abandoned.

Apart from these issues, both the management and the supervisory boards of German corporations must adapt their operations to international business practices. This means improved information flows to the outside directors on the supervisory board, closer collaboration of both organs, and the appointment of supervisory board members with greater independence, international stature, and better pay.

Improving the U.S. and German Markets for Corporate Control

The market for corporate control is potentially the most powerful mechanism for achieving effective corporate governance, in terms of both firm performance and managerial control rents. By the same token, it is potentially the most threatening to underperforming or self-enriching corporate management. Taking shareholder protection seriously, in the U.S. as well as Germany, would mean limiting the defensive efforts of incumbent management to endeavor to persuade shareholders not to sell, or to soliciting competing offers. It would require depriving them of the ability to exert a veto (*de jure* or *de facto*) over control changes and thereby prevent the shareholders from making their own choices on whether to accept an offer.⁶⁶ A partial step toward that end would be to make it possible for institutional investors to take larger ownership positions, and cooperate more easily, than is now permitted.

The German government's decision to give the management board the power to use defensive measures with the approval of the supervisory board has entrusted the wrong people with the decision on whether the market for corporate control should operate, and is therefore highly questionable. It may still be hoped that better rules will be developed in the course of the implementation of the EU's Thirteenth Directive. Furthermore, German law should ease the communication between shareholders in order to allow for proxy contests.

Friendly acquisitions generally reflect a drive towards better use of resources and, in the absence of social concerns such as anti-competitive effects, they too should be encouraged by public policy. Nevertheless, there should

be limits on the share of the "side payments" that the target management can obtain for itself, whether through "golden parachute" severance agreements or accelerated stock option vesting or "consulting" contracts. We have no answer as to how to define standards that are appropriate and readily enforceable, and are left with the vague constraints of a fiduciary duty.

German law contains a provision that effectively requires that compensation for target managers in friendly and hostile takeovers not exceed levels deemed "adequate." And the German Corporate Governance Code provides that the supervisory board should put a cap on managers' gains from stock option programs or comparable instruments in such situations. Furthermore, the German Securities Acquisitions and Takeovers Act requires that the bidder publish an offering document that includes information about any cash payments or other monetary benefits that have been granted or promised to members of the management board or the supervisory board of the target company. These takeover transactions deserve continuing and perhaps heightened attention.

Improving Incentive Compensation

Some of the shortcomings of current incentive compensation plans could be remedied by requiring executives to hold a large fraction of their compensation, whether in cash or in stock, for a period of several years after receipt, in a "banking" scheme where the balance would be affected by subsequent performance. This would help encourage management to take a longer-term perspective in its decisions while reducing incentives to manipulate current results.⁶⁷ Such a change would not necessarily have to be cast in terms of a mandatory legal requirement; it could instead be encouraged by differential treatment under GAAP and the tax code, or in Germany through the Corporate Governance Code. Restricted stock plans come closest at present to meeting these criteria. Another suggestion worth considering is the adoption of stock and option plans that are in some way "indexed" for market- and industry-wide performance, which could help eliminate the problem, particularly pronounced in the U.S., of undeserved "windfalls" to corporate management.

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66. See, e.g., L. Bebchuk, "The Case Against Board Veto in Corporate Takeovers," *University of Chicago Law Review*, Vol. 69 (2002).

67. Interestingly, this objective may be partly achieved by the forfeiture provisions of

the recent Sarbanes-Oxley Act, which require the CEO and CFO to repay the company all incentive or equity-based compensation and stock sale profits they receive within a year after any accounting "misconduct" resulting in a restatement.