Luiss
Libera Università
Internazionale
degli Studi Sociali
Guido Carli

CERADI
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Corporate Governance in Germany - The recent changes

Sonia Khoudja

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Corporate governance is the totality of the institutional and organisational mechanisms, and the corresponding decision-making, intervention and control rights, which serve to resolve conflicts of interest between the various groups which have a stake in a firm and which, either in isolation or in their interaction, determine how important decisions are taken in a firm, and ultimately also determine which decisions are taken.[1]

Since its introduction in the first half of the 19th Century, German company law has been subject to numerous amendments and reforms. These reforms and amendments were prompted in part by stock exchange fraud but also by a routine adjustment of law in accordance with changing commercial and social conditions and structural developments. Large companies have collapsed in connection with criminal behaviour on the part of their management and because of the failure in the system of corporate governance used by these companies. The reform of the pension system towards a model partly based on private capital investment plans[2] demanded reform, and so did the necessity to make the German system more attractive for foreign investors. Another factor demanding reform was the implementation of EU law into national law. The number of stock companies has increased in ten years from a constant number of 2 to 3 thousand companies to over 10.000 companies in the year 2000,[3] and a challenge in the shareholder composition/ owner structure of stock companies has taken place:[4] Big blockholders, such as banks

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[1] Schmidt, Corporate Governance: The role of other constituencies, University of Frankfurt am Main, Working Paper Series: Finance and Accounting, no. 3, 1997, available at: http://netec.mcc.ac.uk/WoPEc/data/frafranaf.html.

[2] In the existing pension system workers look almost exclusively to the state for their pension payment. This system is undermined by the ageing of the population. Financial solvency would require at least partial replacement of the state plan, funded from tax revenues on a "pay as you go" basis, by a private contributory plan, whose payout would depend upon its investment returns.

[3] 966 German stock companies were publicly quoted in December 2000 see Deutsche Börse AG, DAI Factbook 2001, p. 02-1-b; Ulmer, Aktienrecht im Wandel, AcP 2002, 143.

[4] The owner structure of companies in Germany (concentrated ownership) differs significantly from the American or English one (dispersed ownership). This difference can be explained in part by historical reasons. During the Industrialisation, the German state supported the growth of large banks to satisfy the industry's need of capital. In addition, Bismarck created in the late 19th Century a welfare system (pensions and social aid), that made

and insurance companies, are being replaced by financial intermediaries and private investors with a different investment behaviour[5] and numerous former state-owned companies have been privatised. Considering the significant changes made during the last ten years, a scholar was led to speak about a permanent reform of company law.[6]

As opposed to the Sarbanes-Oxley Act that was enacted in the US in August 2002 as a consequence of Enron and other corporate scandals, the amendments made to the German system are not homogenous. Provisions were changed and laws were created out of specific need. The coherence of the result was not taken into account. Reading between the lines of the provisions, one can trace the influence of changing governments and fundamental political disputes. Where the legislator failed, courts had to fill in gaps and to resolve legal problems that had not been solved by law.

It must be added that the latest corporate scandals in Germany have not reached the dimensions of the Enron or Worldcom collapse in the United States. It is however widely contested that this is due to a better system of control or more efficient rules. One given explanation is that the German stockholder and corporate culture is different from the American one. The difference lies not only in the composition of the shareholders –large shareholders instead of spread ownership,[7] but also in the amount of

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the development of private pension plans redundant. The German shareholder is also considered less eager to take risks than his Anglo-American counterpart.

[5] One reason why banks and insurance companies are getting rid of their blocks is that a punishing capital-gains tax on the difference between a stake's book value and its (usually much higher) market value, which made corporate shareholders reluctant to sell, has been abolished in 2001.

[6] Karsten Schmidt called it an "endless story", Schmidt, Gesellschaftsrecht, p. 764.

[7] The German system is still characterised by the influence of powerful actors, such as the typically German universal banks -with no mandatory separation of credit banks and investment banks-, big insurance companies and large companies. These actors were sheltered from capital market pressures through a dense network of equity cross-holdings. However, recent empirical research has shown that their influence is decreasing. To remain competitive in a global market, they had to adapt and separate the fields. There is no consensus about the question which ownership structure is better. The praise of the widespread ownership structure diminished since the Enron and Worldcom scandals in the US, both companies with a widespread ownership structure, see for the argument Luigi Spaventa, Ownership structures and investor protection: The end of a myth?, Draft 2002; see also the article by Reinhard H. Schmidt and Marco Weiß, Shareholder vs. Stakeholder: Ökonomische Fragestellungen, Working Paper, January 2003, Johann-Wolfgang-Goethe Universität, available at www.finance.uni-frankfurt.de/schmidt/publications/Schmidt&Weiss-Corporate-_Governance.pdf.

investments and in the level of State involvement. While in the 90s the need to withdraw from the market and to privatise formerly state-owned companies was widely accepted (Telekom, Energy sector), a reversal in this trend has been observed lately. Politicians and the Press are seriously reconsidering state involvement where private incentives have failed.[8] The reason for this trend lies partly in the difficult economical situation through which Germany and the rest of the world are passing, and partly in the historical role of the German state as a rescuer of failed companies.[9] Another explanation for the different approaches is that in Germany and generally in Europe it is practically impossible to evaluate how widespread corporate malpractice is. Government watchdogs regulating businesses are considered understaffed – if they exist at all.[10]

It is obvious that discussing all aspects of corporate governance that are summarised in the introductory citation would go beyond the scope of the following pages. What I shall try to do is to give an overview of the changes that have been made to the German system of corporate governance (B). For a better understanding, the functioning of the German corporate system is schematically outlined in the first part (A). I conclude with a review of the future plans of the German government (C). For illustrative reasons, practical cases will be taken into account as far as possible.

A. The German system of Corporate Governance

The German stock company (*Aktiengesellschaft, AG*) is regulated by the Stock Company Act (*Aktiengesetz, i.f. AktG*) of 6 September 1965 with all subsequent amendments. The organs of the AG are the General Meeting of Shareholders (*Hauptversammlung*), the Board of Directors or Management Board (*Vorstand*) and the Supervisory Board (*Aufsichtsrat*). The power allocated by statute to each of these organs cannot be altered by the memorandum and

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[8] Recently, rumours about the creation of a "bad bank" by the State intended to help banks in crisis were spread. The proposal came from an unsuspected side: Joseph Ackermann, the Spokesman of the Management Board of the Deutsche Bank, see: "Deutsche Bank will Kredite absichern", in: FAZ, 24 February 2003.

[9] E.g. The German government in the year 2000 tried to save Holzmann AG, a traditional constructing company from bankruptcy by offering it a huge credit. The saving plan did not succeed: Two years later, the company went definitively bankrupt.

[10] Ledbetter, Cowboy Capitalism, in: TIME of Oct. 28, 2002.

articles of the AG.[11] A further role in the corporate game is played by auditors (*Abschlußprüfer*), who are a kind of out-sourced or external control organ and by banks, who through direct (as shareholders) or indirect shareholding (depository voting or proxy rights) and their membership in Supervisory Boards[12] have traditionally a strong influence on companies and the market in general.[13]

One specific and characterising feature of German corporate law must be pointed out: the strict separation between the Management Board and the Supervisory Board. The law enforces this separation by an incompatibility rule (§ 105 I AktG). Thus a member of the Supervisory Board may not simultaneously be a member of the Management Board or an employee of the AG. The system is called the dualistic concept of administration, or *two-tier board system*, as opposed to the *one-tier board system*, where a distinction is made between "inside" directors and "outside" directors.[14] This separation is obligatory for all stock companies and large limited liability companies and is considered the main strength of the German system.[15] The reason for it is to prevent conflicts of interest, to ensure a proper internal control and to give shareholders a representative body to protect their interests against the Management Board. In practice, this high-minded intentions are not always fulfilled. Often, the interlocking between both organs hinder their efficient functioning. It is still common practice in Germany for retiring Management Board members, in particular the chairmen, to move to the Supervisory

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[11] This principle is called the "*Prinzip der formellen Satzungstreue*".

[12] The role of banks as creditors will not be subject of the following discussion.

[13] Henn, Handbuch des Aktienrechts, Heidelberg 1998, p. 241; Schmidt, Gesellschaftsrecht, München 2002, p. 771.

[14] In practice, both systems are getting more and more similar. In the one-tier system, a tendency to divide the functions of the chairman from those of the chief executive officer is visible. In addition, board subcommittees are being staffed with a majority of outside directors and there is an insistence that outside directors be adequately independent. In contrast, the recent reforms in Germany improved the access to information of the Supervisory Board in order to make his work more efficient. See Baums, Paper on the Company Law Reform in Germany, July 2002, Johann-Wolfgang-Goethe Universität, Institut für Bankrecht, Working Paper No.100, available at: www.uni-frankfurt.de/fb01/baums; MüHdb.-Wiesner, Band 4, §19, comment 2 et seq.

[15] See the BDI and PriceWaterhouseCoopers study on "corporate governance in Germany" available at: www.pwcglobal.com, p.34. The study also points out that in the one-tier model a great amount of effort has to be expended to put a controlling member of the Management Board into the position of the "Supervisory Board".

Board.[16] Only recently, Ferdinand Piech, the former chairman of VW, was appointed as chairman of the Supervisory Board of VW, and Rolf-E. Breuer, chairman of the Deutsche Bank from 1997 to 2002, has been the new chairman of the Supervisory Board of the same bank since May 2002.

But now, as announced above, let's have a look at the different actors of the corporate system.

1. The General Meeting of Shareholders

The General Meeting of shareholders has to be called by the Management Board at least once a year to an ordinary meeting, where it decides about current affairs and the exoneration of the members of the Management and Supervisory Board. Extraordinary meetings can be set by law, the statutes of the company and the Management or the Supervisory Board.[17]

The powers assigned to the Shareholders' Meeting by law are the appointment of members of the Supervisory Board representing the shareholders, the appropriation of profit, the exoneration of the members of the Management and Supervisory Board, the appointment of the certified accountant and of auditors in order to check events during the foundation of the company or during its management, the liquidation of the company and last but not least amendments to the statutes of the company.[18]

For amendments to the statutes,[19] as well as for the company's liquidation,[20] the law requires a qualified majority (3/4 of the votes). In general, decisions are determined with a simple majority (1/2 of the votes). Larger majorities or additional requirements can be required by law or the statutes of the company.[21] The votes are determined by the nominal capital of the represented shares.[22] Multiple voting rights (*"Mehrstimmrechtsaktien"*), which

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[16] See for this argument the article by Hirn/ Student, Willkommen im Klub, Manager-Magazin, 07.06.2002 and Hopt, Comparative Corporate Governance, Oxford 1998, p. 243.

[17] MüHdb-Semler, Band 4, § 34, comment 1 et seq.

[18] § 119 et seq. AktG.

[19] § 179 II AktG.

[20] § 262 I Nr.2 AktG.

[21] § 133 AktG.

[22] § 124 AktG.

allow a minority of shareholders to keep control of the company are prohibited,[23] as well as the possibility of a listed company to set a limit on voting rights (*"Höchstimmrechte"*)[24] a method used to protect companies against hostile takeovers. These instruments conflict with the principle "one share one vote", which has become the rule in Germany in 1998.[25]

In contrast to the United States, shares in Germany are mostly bearer shares (*Inhaberaktien*) and not registered shares (*Namensaktien*). The owner of the latter has to be registered in the share register of the company (name, address, residence), while the owner of the first remains anonymous, at least under a certain threshold: The EC Transparency Directive of 1988 imposed mandatory disclosure of shareholdings from a threshold of 10 per cent upwards.[26] In Germany, as well as in France, the threshold was set at 5 per cent upwards.[27]

As a consequence, shareholders who own less than 5 per cent remain anonymous and a bidder cannot address them directly. Depository banks have to forward tender offers that have been published in *Wertpapier-Mitteilungen* (a special legal gazette) to the shareholders. Under the former rule, disclosure was required only for stakes equal to 25 per cent or higher.

The major reason for offering bearer shares is that they are easier to handle. For selling or buying them, in contrast to registered shares, changing the share register is not necessary. The anonymity is considered by many as an advantage. In the last years, the number of companies offering registered shares in Germany has however increased. Registered shares are thought to promote transparency and to make it easier for the Management to recognise takeover attempts. An additional reason is the effort to make the German

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[23] § 12 II AktG.

[24] § 134 I 2 AktG.

[25] Schmidt, Gesellschaftsrecht, p. 849.

[26] In Germany, the EC Transparency Directive of December 12, 1988 (88/627/EWG) was implemented by the Second Financial Market Promotion Act of 26 July 1994 (Legal Gazette, 1994 BGBl. I 1749); Articles 85 to 97 of the EC Listing Reporting Directive (2001/34/EC) also incorporated requirements to notify acquisitions and disposals of major equity holdings.

[27] § 21 Securities Trading Act provides that any person who through acquisition, disposal, or in another manner reaches, exceeds or falls below one of the thresholds of 5%, 10%, 25%, 50% or 75% of the voting rights of a listed company, must promptly provide written notice of such reaching, exceeding, or falling below the specified thresholds to the company and to the Supervisory Authority. The company must publish the notice.

model conform to the requirements and needs of a globalised market, where registered shares are more common.[28]

In the Shareholder Meetings shares are either voted by the shareholders themselves or –in the case of smaller shareholdings- by institutions, mainly banks which act as custodians for the shares.[29] The delegation of voting rights to the company itself or the Management of the company, as practised in the United States, was only recently allowed by the Law on Registered Shares and on the Simplification of Voting, the so-called NaStraG of January, 18th 2001 (*Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung*). This form of proxy voting is however restricted to cases in which the proxy named by management is given express and specific instructions.[30]

A classical problem arising in the context of shareholdings are the fiduciary duties owed by the shareholders to the company and by the shareholders towards each other. In Germany, such duties have long been denied.[31] This attitude changed with the "Audi/NSU" case in 1976[32] and the "Linotype" case in 1989[33] where the Federal Court recognised that majority shareholders have to act as fiduciaries of the company. As such, they may not use their control for ulterior purposes adverse to the interests of the company. Fiduciary duties towards other shareholders were recognised only later in the so called "Hilgers" case in 1999.[34] Still discussed are the fiduciary duties of minority shareholders towards the company that the Federal Court however admitted in the "Girmes" case in 1995: For a capital decrease for re-organisational purposes (*Kapitalherabsetzung zu Sanierungszwecken*), 75 per cent of

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[28] MüHdB-Wiesner, Band 4, § 13, comment 3.

[29] The voting power of banks will be described more detailed below.

[30] Schmidt, Gesellschaftsrecht, p. 854; MüHdB-Semler, Band 4, § 38, comment 50 et seq.

[31] In the 19th century when graduated voting scales (today, all systems are based on the one-share, one vote rule) were still common, the problem of the relationship between shareholders was already recognised. A German expert on railroad law wrote in 1858 that "…the interest of the proprietor of many shares often collides with that of the proprietor of one or only a few.", see the history of voting rights Dunlavy, Corporate Governance in Late 19th –Century Europe and the U.S, in: Hopt/Kanda/Wymeersch/Prigge eds. Comparative Corporate Governance, Oxford 1998, p.

[32] BGH, WM 1976, 449 ("Audi/NSU").

[33] BGHZ 103, 184 = JZ 1989, 443 ("Linotype").

[34] BGHZ 142, 167 = NJW 1999, 3197 = ZIP 1999, 1444 ("Hilgers").

the votes were needed. A blocking minority hindered its passing and consequentially caused the bankruptcy of the company.[35] In this and in other cases where minorities have specific rights, they can be held to exercise these rights with respect to the interest of the company.

As a means of protecting shareholders, any shareholder, regardless of the number of shares held, may file a lawsuit, called *Anfechtungsklage*,[36] to have a General Meeting's resolution declared void or invalidated by the courts on the grounds that it violates the law or the statute of the company. This safeguard is criticised by some scholars because, in a number of cases it has been used by nuisance shareholders (so-called *räuberische Aktionäre*) to block the implementation of important company decisions (e.g. mergers) and have them reviewed by the courts. However, the number of abuses is so small that it does not undermine its positive effects, which are the protection of minorities and the control of far-reaching decisions.[37]

Interests of shareholders are also protected by granting them a pre-emptive right, the so-called *Bezugsrecht*, that was introduced by the HGB of 1897. In case of a capital increase against contributions,[38] new shares must first be offered to existing shareholders in proportion to the nominal value of their shareholdings.[39] These pre-emptive rights may be wholly or partly excluded by a special resolution of a qualified majority. A shareholder holding that this resolution violates law or the company's statute may contest the resolution in court with an *Anfechtungsklage*, and may obtain a judgement declaring it void (§§ 255 and 243 AktG).

Indirect forms of pre-emptive rights are common in practice: To perform the capital increase, all shares are subscribed and paid in by a bank or

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[35] "*Auch dem Minderheitsaktionär obliegt eine Treuepflicht gegenüber seinen Mitaktionäre. Sie verpflichtet ihn, seine Mitgliedsrechte, insbesondere seine Mitverwaltungs- und Kontrollrechte, unter angemessener Berücksichtigung der gesellschaftsbezogenen Interessen der anderen Aktionäre auszuüben.*" BGHZ 129, 136 = NJW 1995, 1739 ("Girmes"); for a detailed discussion of fiduciary duties of shareholders, see Schmidt, Gesellschaftsrecht, p. 587 et seq., p. 800.

[36] The *Anfechtungsklage* is ruled in § 243 AktG and is a special feature of German law.

[37] Ulmer, AcP 2002, 143.

[38] The other cases of capital increases will not be treated here (conditional capital increase, authorised capital, capital increase from the company's funds).

[39] § 186 AktG.

a consortium of banks with an obligation to offer the shares to the existing shareholders before selling them on the open market.[40]

New instruments dealing with the relation amongst shareholders, i.e. the mandatory offer that a majority shareholder has to make when he reaches a threshold of 30 per cent will be discussed later.

If a company waives or restricts its claims to damages[41] against members of the Management Board[42] or the Supervisory Board[43] for breach of duties, a minority of shareholders representing 10 per cent of the share capital can oppose the resolution. Such a minority may also request that the company enforce its claims to damages pursuant § 147 I AktG. The single shareholder however, does not have the right to file in such an *actio pro societate* or *Aktionärsklage*. The requirements set by law are judged as too high even after the latest reforms by the KonTraG that will be outlined in the following chapters. Actions by the General Meeting or a minority in practice are very rare. For this reason, the legislator is planning to introduce new rules and to ease the existing requirements.

2. The Management Board

The Management Board runs the day-to-day business of the firm under its own responsibility. It generally has several members,[44] who are appointed for a maximum of five years by the Supervisory Board and may be re-appointed. They must be removed from office by the Supervisory Board if there is a serious reason for doing so.[45] § 84 III AktG specifies as serious

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[40] Schmidt, Gesellschaftsrecht, p. 901.

[41] § 50 AktG.

[42] § 93 IV AktG.

[43] § 116 AktG.

[44] The Management Board can be composed of one or more directors, § 76 II 1 AktG. Companies with a capital stock of more than 3 Million Euro, must have a Board composed of at least 2 directors, § 76 II 2 AktG. It is the Supervisory Board that decides about the number of Management Board members. The Management Board of DaimlerChrysler e.g. has 13 members, Thyssen Krupp 8, Deutsche Bank 4, Siemens 13...

[45] So MüHdB-Wiesner, Band 4, § 20, comment 37; another opinion sustains that the Supervisory Board has a far-reaching decisive power of whether to dismiss the Management

reason gross violations of duties, incompetence and a shareholders' vote of no confidence. Courts' decisions recognised as serious reason i.e. the abuse of the company's asset for own purposes,[46] the wilful deceit of the other members of the Management Board,[47] harming the reputation of the company through speculative affairs.[48]

If the Management Board has more than one member, the Supervisory Board can appoint a chairman.[49] Unlike the powerful "chief executive officer" of an American company, the chairman of the German Management Board remains *primus inter pares* and has mainly organisational competences, such as summoning board meetings, settling the order of the day and leading the meetings. In the company statute the vote of the chairman can be set decisive in case of a deadlock.[50]

The compensation of the Management Board members is fixed by the Supervisory Board pursuant § 87 AktG.[51] This provision is, however, worded very vaguely. It says that a Supervisory Board can decide on pay, bonus, allowances, insurance, provisions and perks as well as pensions and payments to family members after a death, for any member of its Management Board. The Supervisory Board members are only required to ensure that the total

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Board member or not, even if a serious reason for removal exists, KölnKommAktG-Mertens, 2. Auflage, Köln 1986 et seq., § 84 AktG, comment 102.

[46] BGH AG 1998, 519.

[47] OLG Düsseldorf, AG 1982, 225.

[48] BGH WM 1956, 865.

[49] § 84 II AktG.

[50] Schmidt, Gesellschaftsrecht, p. 811; KölnKommAktG-Mertens, § 84, comment 90.

[51] Only recently the proportionality of the compensation of Management Board members was subject to public debate: a Düsseldorf court is deciding whether to go ahead with proceedings after prosecutors laid charges against six individuals over severance payments to Mannesmann executives involved in the 2000 takeover by Vodafone of the UK. Mr. Ackerman, chief executive of Deutsche Bank and Mr. Zwickel, chairman of the IG Metall trade union, were members of the Mannesmann Supervisory Board committee that approved a 15 Million Euro "appreciation award" to Mr. Esser and 43 Million Euro in additional compensation payments to other managers after the 175 Million Euro bid. The central charge against the Supervisory Board Members and Klaus Esser is believed to be "breach of trust" or failure to act in the interest of shareholders (*"Untreue"*) and a trial would focus on interpretation of § 87 AktG. FT Deutschland of 18 February 2003; FT International of 19 February 2003, p. 12; The Economist, February 22nd 2003, p. 65.

remuneration stands in appropriate or "commensurate" relation to the Management Board member's work and to the company's situation.[52]

Not only in the US, but also in Germany, equity based management compensation i.e. stock-options, gained ground in the last years.[53] After the crash of the new economy, they are seen, at least in the US, as one cause for the failure of many companies. They create an incentive for management to engage in short-run, rather than long-term, stock price maximisation because executives can exercise their stock-options and sell the underlying shares on the same day.[54] In Germany however, stock-options can be exercised only after holding the shares for at least 2 years.[55] Therefore, the risk for a short-term orientation of the management is lowered considerably.

The Directors have extensive reporting obligations towards the Supervisory Board on intended business strategies, profitability of the company and business transactions with a major impact. They have further to declare openly all actual and potential conflicts of interest.[56] These duties do not only follow out of the special provisions of the Stock Corporation Act, but also out of the nature of the directors' contract and out of their duties as agents of the company. Their work is based in general on a contract to manage someone else's business, the so called *entgeltliche Geschäftsbesorgung* ruled in § 675 BGB. The agent (in this case the director) has to inform the principal (the company represented by the Supervisory Board), about all circumstances that are essential for managing the business (§§ 675, 666 BGB). As there is a plurality of principals, which in general in cases of dispersed ownership will be inexperienced investors, the directors have to behave as fiduciaries. They have to abstain from anything that could harm the interest of the principal. In order to strengthen the control over the management and to contribute to a balance-of-power system, the Management Board has further information duties towards the Supervisory Board, which do not result out of their working

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[52] Schmidt, Gesellschaftsrecht, p. 811; MüHdB-Wiesner, Band 4, § 21, comment 1 et seq.

[53] § 192 II Nr.3 AktG.

[54] Coffee Jr., What Caused Enron, Columbia Law School Working Paper No. 214, January 2003, available at: www.law.columbia.edu/law-economicstudies/abstracts.html.

[55] § 19 II 5 Nr.2 EStG.

[56] KölnKommAktG-Mertens, § 93 AktG, comment 72.

contract.[57] These information duties were stated more precisely by the KonTraG in 1998 and the TransPuG in 2002 (§ 90 I AktG). If a Management Board member does not duly comply with its reporting obligations or the requirements of the Supervisory Board, it is sanctioned by law with a mandatory fine or with imprisonment of up to 3 years. The Supervisory Board can also decide on the revocation of a Management Board member.[58]

In dealing with the outside world, in and out of court, the company is represented by the Management Board.[59] A limitation of the statutory authority of the members of the Management Board to represent the AG is not possible *vis-à-vis* third parties, § 82 I AktG. Internally, however, the articles of the statute or a shareholders' resolution may limit their authority to represent the AG. A violation of such an internal limitation can only be invoked by the AG *vis-à-vis* third parties in order to avoid a commitment made by the directors if the breach was obvious to the third. However, the violation by a director of the limitation imposed, constitutes a breach of his service contract with the AG and gives rise to claim for damages pursuant § 82 II AktG.[60] One limitation to the representative power of the Management Board is recognised by law: in order to avoid conflicts of interest, the company when dealing with a member of the Management Board, is represented by the Supervisory Board (§ 112 AktG). Accordingly, if, for example, the Management Board does not act diligently or breaches his duties and harms the company, the Supervisory Board must claim for damages in the name of the company.[61]

As outlined above, the Management Board acts on his sole responsibility (§§ 76-78 AktG). This means that the task of managing the company's affairs is reserved to the Management Board. Management tasks can neither be left to the Supervisory Board, that has to monitor the Management Board, nor to the General Meeting of Shareholders. For certain types of transactions however, the statute of the company can provide that the decision requires the consent of the Supervisory Board.[62] In practice, for transactions

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[57] KölnKommAktG-Mertens, § 84 AktG, comment 33 and 84.

[58] §§ 407, 400, 84 III AktG.

[59] § 78 I AktG.

[60] MüHdB-Wiesner, Band 4, § 23, comment 1 et seq.

[61] Schmidt, Gesellschaftsrecht, p. 820.

[62] § 111 IV 2 AktG.

involving real estate or the acquisition of significant interests in other companies the consent of the Supervisory Board is regularly needed. In the statute, management decisions cannot be made dependent from the consent of the General Meeting of Shareholders.[63] For decisions to change the structure of the company or risky decisions the Management Board can request the consent of the Shareholders' Meeting.[64] With the consent of the shareholders, the responsibility for decisions falls back to the company and the Management Board is exonerated pursuant § 93 IV 1 AktG. Acquisitions undertaken without the shareholders' consent are legally valid and binding. The shareholders will have the possibility to claim damages from the Management Board if they suffer loss.

It has been hotly disputed whether in some cases the Management has a duty to involve the shareholders in the decision making progress. The BGH[65] in his 1982 "Holzmüller" decision hold that the membership of a shareholder is in itself a right protected by the law of tort. Therefore for fundamental decisions which might affect the membership rights of shareholders and their pecuniary interests, such as major structural changes to the company, managers can have a duty to involve shareholders in the decision making process.[66]

In their decision making, the directors have to respect different, sometimes incompatible, interests. In the 80s and again recently, a discussion emerged on the interests the directors have to take into account when managing the company (shareholder value vs. stakeholder value). One opinion tends to favour shareholder interests as it is the case in the United States. The Directors have the duty to maximise the value of the shares. Respecting other interests would be considered as a breach of their duty.[67] Following the latest company scandals, the critique of this approach has become louder. Taking into account only shareholder interests is seen as the cause for many company failures. To satisfy investors and stock market analysts managers were hold to

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[63] KölnerKomm-Mertens, § 82, Comment 31.

[64] § 119 II AktG.

[65] The BGH is the German Federal Supreme Court, established in 1950 in Karlsruhe. It decides about criminal and civil matters (www.bundesgerichtshof.de).

[66] BGHZ 83, 122 = NJW 1982, 1703 ("Holzmüller").

[67] Schilling, BB 1997, 373.

"window-dressing the figures either within the rules or outside them".[68] In Germany, the majority opinion is that the responsibility of the Directors goes beyond the shareholders' interests and includes the interest of the employees, the creditors and even the public interest.[69] Under this opinion, the Management Board is neither obliged nor entitled to act solely in the interest of the shareholders. It is therefore the responsibility of the Management Board to balance these interests and to bring them to practical concordance.[70]

The directors owe fiduciary duties to the company partly due to their function as organ of the company and partly due to their contractual relation to the company (*Anstellungsverhältnis*).[71] The duties are owed to the company itself. As a consequence, all decisions have to be taken with respect to the interest of the company. The directors have to pursue this interest and to set aside their own economic interest. They have to abstain from any behaviour that could harm the company.[72] In the general rule, § 93 I AktG, directors are expected to maintain a standard of behaviour as betting a diligent and prudent business man. The business judgement rule serves as a guideline for the responsible behaviour of the Directors. To determine whether a particular Management Board member has acted within the required standard, the circumstances of each case must be examined. This objective standard does not depend on the knowledge and the abilities of the specific members.[73]

The courts played an important role in concretising and developing the substance of fiduciary duties owed by directors. Generally, three cases are admitted. The first, set explicitly in § 93 I 2 AktG, is the requirement to maintain the confidentiality of company secrets, in particular operational and trade secrets.[74] The second is to do what is best to promote the purpose of the AG (*Gesellschaftsförderungspflicht*) and the third is the duty of loyalty, the so called *Loyalitätspflicht*, towards the company that requires a director to protect the

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[68] FT 29 January, 2003, Shareholders' glory days may be numbered, by John Plender.

[69] Schmidt, Gesellschaftsrecht, p.768, 805; Ulmer, AcP 2002, 143, 155; Hopt, ECGI Working Papers No.3/2002, October 2002, p.20, available at: www.ecgi.org/wp/law_series.htm.

[70] This theory is called the *Konkordanztheorie*.

[71] Schmidt, Gesellschaftsrecht, p. 815.

[72] Baums, Personal Liability of Company Directors in German Law, 1996; KölnKommAktG-Mertens, § 93, comment 69.

[73] MüHdB-Wiesner, Band 4, p. § 26, comment 1 et seq.

[74] AktG-Mertens, § 93 AktG, comment 84.

interests of the company and to refrain from doing anything that could injure it.[75]

One manifestation of the duty of loyalty is explicitly ruled in § 88 AktG. It is forbidden for Management Board members to compete with the AG. In the case of the director failing to abide by his duty not to compete with the company, the company can claim damages following § 88 II AktG or can ask that the contracts drawn up by the director be drawn up in the company's name. Moreover such a behaviour counts as a serious reason in the sense of § 84 II AktG and allows the Supervisory Board to remove the director from office.[76]

The "corporate opportunity" doctrine, in German called *Geschäftschancenlehre*, is another manifestation of the fiduciary duties owed to the company.[77] This doctrine, created by courts, is applied when a corporation has a legitimate interest or expectancy in, and the financial resources to take advantage of, a particular business opportunity, i.e. a real estate. If an officer or director diverts a corporate opportunity to himself, he breaches his duty of loyalty to the corporation and is liable for all damages caused by his dealing. If the opportunity, is directly offered to him, according to the corporate opportunity doctrine, he has not the right to take any advantage for himself or a third deriving from his knowledge, if in consequence damage would be caused to the company. The BGH went even further declaring that a director cannot take any advantage of a business opportunity as soon as the company could have an interest in it. The specific articulation of the company's interest in the opportunity is not necessary.[78] The core principle of the corporate opportunity doctrine is that a fiduciary will not be permitted to avail of himself of an opportunity which was developed through the use of the corporation's assets. Only if the Supervisory Board agrees, the director is allowed to seize the opportunity (§ 88 I AktG analogously).[79]

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[75] MüHdB-Wiesner, Band 4, § 21, comments 12 and 63, and § 25, comment 8; KölnKommAktG-Mertens, § 93 AktG, comment 27.

[76] Schmidt, Gesellschaftsrecht, p. 816.

[77] KölnKommAktG-Mertens, § 93 AktG, comment 67 et seq.; MüHdb-Wiesner, Band 4, § 25, comment 9.

[78] BGH WM 1976, 76; BGH WM 1985, 1443.

[79] MüHdb-Wiesner, Band 4, § 25, comment 9.

While the company has to prove the damage, each board member has the burden of proof to show that he has complied with this standard as required by § 93 II 2 AktG.[80]

3. The internal controlling organ – The Supervisory Board

The Supervisory Board is an independent organ of the AG installed in 1870 giving up the former state control. Historically, it is the incarnation of the idea of a strictly separate outside board to control the Management Board for the sake of the shareholders, but also to protect the public interest.[81]

The Supervisory Board is the central control organ of the company and, in general, consists of representatives of the shareholders and the labour side. Its members representing the shareholders are elected by the General Meeting for a maximum period of four years and may be re-elected. They can be revoked from office at any time by a simple majority.[82] The Supervisory Board includes a minimum of 3 and a maximum of 21 members.[83] Recent empirical analyses calculated an average size of ca. 11 members.[84]

Many facts are considered to have contributed to the inefficiency of the control system. The size of the Supervisory Board is considered to be too high in academic circles, and the appointment procedure for new Supervisory Board members seems contra-productive to an efficient supervision: new members of the Supervisory Board are often selected by the Management Board before

[80] KölnKommAktG-Mertens, § 93 AktG, comment 100.

[81] For a good historical overview, see Hopt, Der Kapitalanlegerschutz im Recht der Banken, München 1975, p.37.

[82] Schmidt, Gesellschaftsrecht, p.834.

[83] § 95 AktG fixes the number of Supervisory Board members with respect to the company's base capital: 3 Supervisory Board Members is the minimum, while companies with a base capital of more then 10.000.000 Euro must have a 21-person board. The Co-Determination Act, that prevails over the Stock Company Act, fixes the size of the Board with respect to the number of employees. Companies with less than 10.000 employees must have a 12-person board, those between 10.000 and 20.000 get a 16-person board and those with more than 20.000 employees must have a 20-person board, § 7 Co-determination Act. The provisions of the Co-Determination Act prevail over those of the AktG.

[84] See for further information Prigge, A Survey of German Corporate Governance in: Hopt/Kanda/Wymeersch/Prigge eds., Comparative Corporate Governance, Oxford 1998, p. 944.

being appointed by the Shareholders' Meeting.[85] This contributes to create a critical closeness between supervised and supervisor. The frequency of board meetings is also subject to criticism. In publicly noted companies, board meetings are to be held at least four times a year, which is considered by many as being insufficient for adequate information, well monitored management and to ensure control.[86] The efficiency of control is also decreased by the accumulation of seats in Supervisory Boards. Under German law, it is not forbidden to cumulate seats, as long as this does not exceed ten mandates. If the seats are in affiliated companies, the law even allows board members to cumulate more than 10 (§ 100 AktG). Multiple mandates are considered a potential source of conflicts of interest: personal links may serve to entrench groups of persons and companies and to create interdependencies among their members that might reduce the intensity of control.[87] The proposal of a Corporate Governance Commission to reduce the cumulation of seats were not taken up by the recent amendments.

The main function of the Supervisory Board is to supervise and control the management of the company, ensured by the Management Board. The latter has the duty to report regularly on its activities and to inform the chairman of the Supervisory Board of any important developments in the company or its subsidiaries (§ 90 I AktG). These legally required reporting obligations are not sufficient to fully satisfy the information requirements of the Supervisory Board. According to § 90 III AktG a Management Board's report on every single matter concerning the company and its associates can be requested at any time on the initiative of the Supervisory Board. A single member of the Supervisory Board can ask the Supervisory Board to request a report, but the Supervisory Board must conform to this demand only if the request has the support of another Supervisory Board member.[88] In addition, the Supervisory Board has a right of inspection (§ 111 II AktG). When it considers it necessary, it can inspect the books, papers and values of the

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[85] Ulmer, AcP 2002, 143. Lutter, ZHR 1995, 287.

[86] ibid.

[87] KölnKommAktG-Mertens, 2. Auflage, München 1996, § 100 AktG, comment 6.

[88] MüHdB-Wiesner, Band 4, § 25, comment 18.

company or appoint an external expert for this purpose. A single member of the Supervisory Board however, does not have such a right of inspection.[89]

In order to efficiently fulfil the controlling function, the Supervisory Board also has the power to appoint and dismiss the members of the Management Board and, according to the case, the right or the duty to claim damages from the Management Board in the company's name in case they fail to conform to their duties.[90] When dealing with the directors, the AG is not represented by the Management, as it usually is, but by the Supervisory Board (see above).[91]

The relation between the Supervisory Board and the independent balance sheet auditor is of crucial importance for an efficient controlling system. This was recognised by the legislator, who by a new regulation tried to tighten the relation between the controlling organs.

A specific feature of German law is *labour representation* or co-determination on Supervisory Boards.[92] The first attempts to integrate the institutions of worker apprenticeships and codetermination into the system of governance were made during the *Weimar* period, but failed. It was only after the Second World War that co-determination was adopted with the Co-determination Act in 1976.

Co-determination consists of two key elements: employee representation on the Supervisory Boards of enterprises and work councils (*"Betriebsrat"*), which operate at the plant level.[93] If the company is not subject to the Co-determination Act of 1976, (for example stock companies with less

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[89] KölnKommAktG-Mertens, § 111, comment 42; MüHdB-Hoffmann-Becking, Band 4, § 29, comment 33; Schmidt, Gesellschaftsrecht, p.823.

[90] As regards the duty of the Supervisory Board to claim damages in the name of the company from the Management Board, see the case ARAG/Garmenbeck, BGHZ 135, 244 = NJW 1997, 1926. A remarkable increase in the amount of D&O insurances was an immediate consequence of this decision.

[91] Schmidt, Gesellschaftsrecht, p.822.

[92] FAZ, 21.01.2003, p.20, By a recent decision the ECJ may have set a tombstone to the German co-representation. It decided that Germany has to recognise companies, when they change their seat to Germany. The German provisions concerning the co-determination of workers in Supervisory Boards would not apply anymore in these cases.

[93] The work council will not be subject to the discussion. Their power is however limited by the fact that work councils are legally bound to act in a manner that promotes the overall health of the company.

than 500 employees), the Supervisory Board's members are elected by the shareholders. In those companies, which are subject to the Law on Co-determination, between one third and one half of the Supervisory Board is chosen by the employees and the trade unions.[94]

The co-determination of employees is very disputed in Germany. One hypotheses goes so far as saying that the co-determination rules are a major explanatory factor for the weakness of Supervisory Boards. Capital givers and management might prefer the labour side to remain ill informed and therefore withhold information.[95] It is also supposed that co-determination could weaken the control function of the Supervisory Board through fractionalisation, since separate meetings of the shareholder and the labour sides before the board meeting are common practice. Shareholders' representatives are said to take side with the management, and the employees' representatives only to be concerned with the employees' interest, while both should have only the benefit of the company in view.[96]

Despite these critical views, the rights of co-determination of employees and trade unions have met with vast consensus. As the social existence of the employees depends on the employing company, they also have an interest in its running. Although it takes more time to reach certain decisions, this does not seem to have a negative influence on the control function of the Supervisory Board.[97] It obviously has an impact on the contents of decisions: through the co-determination, social aspects of takeovers and investments gained importance. It also contributed to a "patient capital" position[98] rather than to a short-term orientated shareholder value

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[94] MüHdB-Hoffmann-Becking, Band 4, § 28, comment 1 et seq.

[95] Roe, German Co-Determination and German Securities Markets, in: Hopt/Kanda/Wymeersch/Prigge eds., Comparative Corporate Governance, Oxford 1998, p. 361.

[96] Hopt, The German Two-Tier Board: Experience, Theories, Reforms, in: Hopt/Kanda/Wymeersch/Prigge eds., Comparative Corporate Governance, p. 227, 246.

[97] In the Holzmann AG case cited above, KPMG was the responsible auditor since many years. After the discovery of huge unexpected losses in 1997, the members of the Supervisory Board nominated by the employees asked for a change of auditor while the shareholder nominated members, in order to avoid negative attention, didn't approve a change, Student/ Wilhelm, "Rette sich, wer kann", Manager-Magazin 1/2000, p. 54.

[98] Under the "patient capital" approach we understand the long-term commitment of financial resources. In Germany, this approach was based on the close bank-industry relations. It was regarded for a long time as the critical strength of the German post-war system of governance.

position.[99] The control exercised by labour representatives on Supervisory Boards is constrained by the fact that these boards, in general, play only a small role in corporate decision making. In any case, shareholders eventually have the upper hand because the chairman of the Supervisory Board, who is chosen by the shareholders, is able to cast a second, deciding vote if there is a deadlock.[100] But even those in favour of maintaining the German system of co-determination agree on the necessity of reforming some substantial factors, such as the size of Supervisory Boards, the infrequency of meetings and the low information flow from the Management Board to the Supervisory Board.

In the performance of their duties, the members of the Supervisory Board must recognise the diligence of an orderly and conscientious member of a Supervisory Board. If they fail to do so, they become liable to pay for damages (§§ 116, 93 AktG). By the KonTraG of 1998 and the Transparency and Disclosure law of 2002 that will both be the subjects of the following discussion, the rights of the Supervisory Board were significantly extended.

4. The external control through the auditor

The proper functioning of a market economy depends heavily on confidence of the public in audited financial statements. The statutory auditor is expected to protect the interests of shareholders, creditors and the public in general by providing them with reassurances concerning accuracy of financial statements, the solvency of the company, the existence of fraud and the responsible behaviour of the company with regard to environmental and societal matters.[101]

By law, all German companies must, report their financial results.[102] However, according to the company's size, different degrees of disclosure are

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[99] Hopt, Gesellschaftsrecht, Comment 928 f.; O'Sullivan, Corporate Governance in Germany, Levy Institute Public Policy Briefing No.49, 1998, available at: www.ideas.repec.org.

[100] This decisive power of the chairman must be fixed in the statute of the company, MüHdB-Hoffmann-Becking, Band 4, § 31, comment 17 and comment 57.

[101] See also the Green Paper of the EU Commission on the role, the position and the liability of the statutory auditor within the European Union (96/C 321/01).

[102] § 316 I HGB.

required. Whereas small companies do not have to be audited, medium-sized and large companies must obtain an independent auditor's opinion. The classification of companies in small, medium-sized and large is based on the criteria of the total assets and the sales or the number of employees. Independently from these criteria, all companies listed on any German Stock Exchange are subject to the reporting requirements of a large company. Annual reports contain a report by the Management Board on operating activities, a balance sheet, an income statement, and related notes, as well as an independent auditor's report.

The independent auditor has to be German Public Auditor (*Wirtschaftsprüfer*).[103] Most of the German public auditors (87 per cent) are part of the Institute of Public Auditors, Incorporated Association (*Institut der Wirtschaftsprüfer e. V.*) that is the only German professional organisation which represents public auditors.[104] The institute's influence is exercised mainly through the advice it provides in the formulation of legislation, its participation in international committees and through its non-mandatory recommendations regarding accounting standards.

The procedure for the financial statements is the following: It is the Management Board and not the auditor which has the responsibility to adopt financial statements. Directors are in the best position to know the affairs of their company, to maintain its records and to prepare its accounts.[105] The auditor, elected by the General Meeting of Shareholders,[106] has to state whether, in his view, the financial statements have been prepared in accordance with the law and whether they show a true and fair view of the company. In the following, the statements are presented to the Supervisory Board which has to approve them[107] and to report the results of the audit to the General Assembly.[108]

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[103] MüHdB-Hoffmann-Becking, Band 4, § 44, comment 1 et seq.

[104] In 2002, the Institute of Public Auditors, IdW, had 10867 members. For more information and actual numbers, control the site: www.idw.de.

[105] § 170 I AktG, § 242, 264 I HGB.

[106] § 119 I No.4 AktG.

[107] § 172 I AktG.

[108] § 171 II AktG.

The independence of the auditor from the Management Board is of utmost importance, since he must control the management's behaviour. To guarantee his independence and to hinder conflicts of interests, strict rules of personal incompatibility are set in § 319 HGB. The auditor can neither be shareholder nor Supervisory or Management Board member of the company he controls.[109] If an incompatibility rule is not respected, the election of the auditor is void pursuant § 241 No. 3 AktG.[110] The contract between the company and the auditor is concluded by the Supervisory Board.[111] On the Management Board's request (or that of the Supervisory Board or a minority holding 10 per cent of the share capital (*Grundkapital*) or a share of 1 Million Euro in authorised capital (*Nennkapital*)), the court must appoint another auditor, if reasons laying in the person of the auditor make a change necessary (i.e. prejudice).[112]

An auditor's fault or negligence can have consequences which go beyond damages to the audited company. For this reason, civil liability rules are of utmost importance.[113] In Germany, the negligent auditor will be liable to the company both for breach of contract[114] and in tort. Under § 323 HGB, not only the auditor but also all his assistants as well as the representatives of an auditing company participating in the audit are directly liable to the injured party.[115] The limitation of the auditor's contractual liability have been augmented recently by the KonTraG.

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[109] Other incompatibility rules can be found in § 319 II HGB and will not be enumerated here.

[110] Schmidt, Gesellschaftsrecht, p.914; MüHdB-Hoffmann-Becking, Band 4, § 44, comment 3.

[111] §111 II 3 AktG.

[112] § 318 III HGB.

[113] See also the European Commission study on systems of civil liabilities of statutory auditors of 15 January 2001, available at: http://europa.eu.int/comm.

[114] § 323 HGB.

[115] Schmidt, Gesellschaftsrecht, p.915.

5. The banks' role

I must spend a few words about another distinct feature of the German Corporate system. The influence of banks and other powerful actors on German stock companies is a hotly debated subject although, according to some practitioners and scholars[116] and recent empirical research[117] their influence is overestimated and actually decreasing.

The close relationship between banks and industry has historical reasons. It was crucial for the development of the newly industrialised enterprises in the industrialisation process at the end of the 19th century. In Germany, the state strongly supported the growth of large private banks and enacted a punitive tax on securities transactions. Because the German central bank offered very liberal rediscounting terms to the principal private banks, they were able to satisfy the capital needs of German industry without having to resort to the equity market. This development was further encouraged by the creation of a state social and pension system under Bismarck in the 70s of the 19th Century. For this reason, large private pension funds, as they are known in Great Britain and the US, are still not common in Germany.[118] An overwhelming number of stock companies has a highly concentrated ownership structure that makes them similar to "semi-private" companies.

A German specific feature are universal banks (*Universalbanken*). The specificity of universal banking is that, in contrast to separate banking where the various banking groups exist in parallel, credit institutions are able to integrate all the banking transactions defined by § 1 I AktG into a single group and to offer all of the various kinds of financial services under one umbrella.[119]

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[116] Mülbert, Bank Equity Holdings in Non-Financial Firms and Corporate Governance and Breuer, The Role of Financial Intermediaries and Capital Markets, both in: Hopt/Kanda/Wymeersch/Prigge eds., Comparative Corporate Governance, Oxford 1998, p. 445 and p. 537.

[117] Brendel, Zur Macht der Banken in Deutschland: eine empirisch-historische Untersuchung, Münster 2001, p.176.

[118] See for further information report of a conference on the power of banks (Macht der Banken) organised by the Friedrich-Ebert-Stiftung on 4. May 1995 in Francfort, available at: www.fes.de; Coffee Jr., The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control, December 2000, Columbia Law and Economics Working Paper No. 182, available at: www.law.columbia.edu/law-economicstudies/abstracts.html.

[119] For the risks of each of these systems (universal vs. separate banking), read Chapter 3 of Hopt, Der Kapitalanlegerschutz im Recht der Banken, München 1975, p. 190.

This includes classical banking activities such as the credit and deposit business, as well as investment services, placement and brokerage of securities, and even insurance activities, trading in real estate and other things. Such universal banks are entitled to acquire holdings in companies regardless of the legal form. Most of the holdings however, are acquired in companies structured as stock companies.[120] Limitations on holdings are, for the most part, contained in provisions of the German Banking Act, implementing EU directives.[121]

The traditionally important role universal banks play is due to banks' membership in Supervisory Boards, banking operations, bank shareholdings and depository voting rights.

The German practice of having bank delegates on the Supervisory Board has been regularly observed since the early nineteenth century. This situation may give raise to various conflicts of interest. The banks delegate might use secret information of the company for other clients. Or he might pass confidential data to the bank that results in an exclusion of the credit line of the company.[122] It is however contested that through their membership in Supervisory Boards banks have a strategic advantage. The Supervisory Board member has the obligation to safeguard the interests of the supervised company and must maintain secrecy *vis-à-vis* his employer about information obtained in exercising this function.[123] In addition, as a result of the adaptation to international requisites, banks are reducing their Supervisory Board seats in other companies.[124]

The relationship settled by banking operations, notably extending loans and providing payment and settlement services, is considered of great importance. The importance of this relationship for corporate governance has

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[120] Mülbert, p. 445 et seq.

[121] Council Directive 89/646 of December 15, 1989, on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions and Amending Directive OJEC L 386/1, 1989; Council Directive 91/121 of December 21, 1992 on Monitoring and Controlling Large Exposures of Credit Institutions OJEC L 29/1, 1993.

[122] Joachim, The liability of Supervisory Board Directors in Germany, in: The International Lawyer 1991, 41.

[123] Mülbert, p. 452.

[124] So it is the case for the Deutsche Bank, the Commerzbank and other big players.

been lowered by recent developments. With the implementation of the Securities Trading Act,[125] informational insider advantages were decreased. The Act proscribes various forms of insider trading (§§ 12ff., 38 WpHG), the passing on of insider facts and requires universal banks to create internal organisational structures that minimise the potential for conflicts of interests between the bank and its customers and to establish adequate internal control systems that prevent bank employees from violating the prohibition on insider trading (§ 33 WpHG).[126]

Universal banks are allowed to trade stock. According to German banking law, credit institution can acquire and hold stock of non-bank firms for their own account. In their position as shareholders banks have the same information rights as other shareholders. In practice, they may have an advantage out of their informal links with the company. However, vital measures are rarely taken by the Shareholders' Meeting. They are taken by the Management. More important decisions, i.e. the increase of capital and structural changes, require a qualified majority of 75 per cent, a threshold that is rarely reached by a bank.[127]

Depository voting rights (*Depotstimmrechte*) are considered to be another contributing factor in banks' role for the corporate market. Private shareholders, holding a few shares of one company, often have no interest or will to participate in General Meetings and to exercise their voting rights. Therefore, they can delegate the representation of their interests to any designated person (shareholder or not), to a bank, or a shareholders' association.[128] As a matter of practicability, most of the smaller shareholders are represented by their custodian banks, that may gain a great influence over the company since most shareholder-depositors refrain from instructing the depositary on how to exercise the voting rights. Representation by banks is permitted under certain restrictions, that are set in § 135 AktG. The Stock Company Code permits custodian banks to ask their clients for a standing

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[125] The Securities Trading Act (*Wertpapierhandelsgesetz, WpHG*) of 26 July 1994 was promulgated as Art. 1 of the Second Financial Market Promotion Act. Besides implementing various EC Directives (Directives 89/592/EWG, 88/627/EWG and 93/22/EWG) it set up the Federal Office for Securities Supervision, called BaKred.

[126] Mülbert, p. 453.

[127] Mülbert, p. 445.

[128] The delegation of the representation of voting rights was first regulated in the Stock Company Act of 1884.

proxy. If given, the standing proxy is valid for a maximum of 15 months, and the shareholder may revoke it at any time. If the bank is not given specific instructions by its clients, which is often the case, it may vote at its discretion in the best interest of the shareholder.[129] The depository voting rights of banks have been restricted by the Law on Transparency and Control in Business.

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[129] MüHdB-Semler, Band 4, § 38, comment 53; Baums, Shareholder Representation and Proxy Voting in the European Union, in: Hopt/Kanda/Wymeersch/Prigge eds., Comparative Corporate Governance, Oxford 1998, p. 545.

B. The new regulations

In the past years, German lawmakers have recognised the growing significance of a good corporate system for the market's promotion. Several new laws have been enacted and a Financial Supervisory Authority has been installed as a reaction to various crisis in the corporate sector[130] and to a changing investment behaviour.[131] The efficiency of the company control system, transparency and investor's protection are the key issues addressed by the new laws and amendments. In first lieu, I will trace the history of the changes and the legislator's intentions (1.). I will then outline the major changes (2.).

1. Legislative History and Objectives

On 1 May, 1998 the law on control and transparency in business, called **KonTraG** *(Kontroll- und Transparenzgesetz)*, was enacted. The declared goals of the KonTraG were the improvement of the work of the controlling organs, more transparency and the strengthening of the shareholders' position. This was to be achieved by improving the co-operation between Supervisory Board and independent auditors while weakening the influence of the Management Board on the internal (Supervisory Board) and external (auditors) supervisors.[132]

The transparency requirements set by the KonTraG in 1998 did not hinder new frauds and insolvencies though. Price and market manipulation augmented significantly with the boom of the New Economy in the late

130 The break down of Metallgesellschaft AG and the crash of the New Economy in the year 2000.

131 The reasons for the changing investment behaviour were already outlined.

132 BegründungRegE 6.11.1997-BR/Drs. 827/97.

nineties and its consequent crash.[133] The prosecution of such offences often failed because of insufficient regulation[134] and inefficient division of competences. Although a case of similar scope to Enron or Worldcom did not happen in Germany, the call for a better control of entrepreneurial risk arose.

In May 2000, the German government entrusted a group of entrepreneurs, representatives of shareholders associations and institutional investors, trade unionists, politicians and scholars with the task of reviewing the German corporate governance system. The panel of experts, with Professor Theodor Baums as chairman, published its results and proposals in July 2001. The federal government immediately acted on one of the Panel's central proposals by appointing a group of experts to draft and continuously improve a code of behaviour for the management of companies, as well as by creating the legal framework for this new instrument. The Corporate Governance Commission, headed by Dr. Gerhard Cromme[135], set out the **Corporate Governance Code** which was presented to the Federal Ministry of Justice on February 26, 2002.[136] In the same time, the German government prepared a draft for a **Transparency and Disclosure Act** (*Transparenz- und Publizitätsgesetz, TransPuG*) based on suggestions put forward by the Corporate Governance Commission, that was enacted on July 19, 2002.

The Corporate Governance Code is not fixed in law but works according to the principle "comply or explain", which the Panel recommended. The rules of the Code are not binding in substance but have the character of

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[133] To name only the scandals in turn of the Start-Up star ComROAD and the investment behaviour of the Bankgesellschaft Berlin: The publicly traded German technology firm **ComROAD**, which specialised in mobile Internet applications, disclosed in early 2002 that 96 per cent of its reported 2001 sales were "fictitious", billed through a non-existent Hong-Kong company. The former CEO was accused of stock manipulation.

The **Bankgesellschaft Berlin**, a state-owned bank, is accused of having falsified the balance sheets for years. It seams that also the auditing company (BDO) is involved and attested the balance sheets in knowledge of the fraud. As the bank is owned by the Land Berlin, it will fall back to the latter to guarantee for the open amount of ca. 14 Billion Euro.

[134] Until recently, e.g. market manipulation was not prosecuted. Rules preventing certain kind of insider dealings were introduced only in 1994 with the Second Financial Market Promotion Act.

[135] Gerhard Cromme is also the Chairman of the Supervisory Board of ThyssenKrupp.

[136] Cf. German Corporate Governance Code, available at: www.corporate-governance-code.de/index-e.html.

recommendations.[137] They are intended as a kind of "reference catalogue" which can be used by observers of German companies to assess their activities. The Code is based on similar "Codes of Best Practice" that exist in almost all countries with major capital markets and contains 50 rules of corporate governance.[138] Each year the Commission will reassess whether the code is up to date and conforms to everyday practice. The central points of the Code are to ensure transparency and to strengthen the independence of the Supervisory Board from the Management Board, a task already addressed by the KonTraG.[139]

The Transparency and Disclosure Act was intended to give a legal foundation for the application of the Code. The Act made it mandatory for the Management and Supervisory Boards of publicly listed companies to state whether the rules are being observed in their annual reports (§ 161 AktG[140]). An unrestricted positive statement of approval can only be made if all of the Code's recommendations have been complied with in the previous financial year. Deviations from the Code's recommendations have to be declared and should be put specifically enough to show whether individual members have breached the Code or whether it is common company practice not to apply the recommendation ("comply or explain"). No legal sanction is however intended for a derogation to this declaration. It is left to the capital market to decide which company's corporate governance policy is preferable.[141] Other aims of

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[137] **Recommendations** are marked by the use of the word "shall" ("*soll*"). Companies can deviate from them, but are then obliged to disclose this annually. **Suggestions** which can be deviated from without disclosure are marked by the use of terms such as "should" or "can" ("*sollte*" or "*kann*").

[138] The extent of the Code is criticised, see the interview of Horst Höger, member of the Management Board of the Union Asset Management Holding AG, "Gute Führung wünschenswert", in: FAZ 10.09.02, B8.

[139] see Ulmer, Der Deutsche Corporate Governance Kodex – ein neues Regulierungsinstrument für börsennotierte Aktiengesellschaften, ZHR 2002, 151.

[140] § 161 AktG, [Declaration regarding the Corporate Governance Code]: The Management and Supervisory Boards of quoted companies annually declare, which recommendations of the "German Corporate Governance Code Government Commission" with respect to company management and monitoring, as published by the Federal Ministry of Justice in the electronic version of the Federal Gazette (Bundesanzeiger), have been and will be complied with, or which recommendations have not been or will not be applied. This declaration shall be made permanently available to the shareholders.

[141] In January 2002 the Corporate Governance Code was declared as a success by the Ministry of Justice (BMJ, Press release Nr.05/2003), other declarations are a bit less optimistic: see the Article in Financial Times Deutschland, 21.02.2003, were the results of a recent survey

the TransPuG were to enhance transparency and supervision of companies, to improve working efficiency of the companies organs and to reconcile corporate accounting to international standards.[142]

The inefficient prosecution of market manipulation and financial fraud, as well as the often overlapping competences of the existing federal institutes for the supervision of financial services, led the German legislator to create a new authority equipped with more extensive powers following the British[143] and the Scandinavian example. Another reason to establish a single regulator for integrated financial services supervision was that the needs of the market have changed significantly in the last years. An increasing number of clients of banks, financial services institutions and insurance companies are demanding integrated financial products. The providers of those products have adapted to these demands and developed cross-sectoral products and strategies. Banking and financial services on one hand and insurance business on the other can no longer be distinguished from each other. Insurance companies entered the traditional banking business, while banks have developed new lines of products once reserved for insurers. A tendency among banks, financial services institutions and insurance undertakings to form cross-sectoral groups can be observed. In a context where the boundaries separating the various institutions are progressively being erased, it is no longer possible to establish whether a particular subject is a bank, an non-banking intermediary or an insurance company, or whether a group is more involved in one or another of such activities.[144]

(January 2002) by the Financial Times Deutschland and Haarmann, Hemmelrath und Partner, a leading German law firm, on the implementation of the Corporate Governance Code rules by the Dax 30 Companies are outlined. The survey revealed that most of the top stock companies, although having adapted the recommendations of the Corporate Governance Code, decided to opt-out some important recommendations. The results of the survey are available at: www.ftd.de/corporate-governance.

[142] See also the Regierungsentwurf TransPuG, Begründung Allgemeiner Teil and the Beschlussempfehlung und Bericht des Rechtsausschusses (6.Ausschuss), Drucksache 14/9079, www.bmj.de.

[143] The British Financial Services Aurthority-FSA was created in 1998.

[144] Allianz, the biggest insurance company bought Dresdner Bank, Germany's third biggest bank in 2000, Münchner Rück and HypoVereinsbank merged some years ago.

On 1 May 2002, the **Federal Institute for Financial Services Supervision**, called **BAFin** (*Bundesanstalt für Finanzdienstleistungsaufsicht*[145]), began its work.[146] The establishment of this Authority followed the adoption on 22 April 2002 of the Law on Integrated Financial Services Supervision (*Gesetz über die integrierte Finanzdienstleistungsaufsicht*). By this act, the traditional institutional supervisory approach[147] (also known as "sectional" approach) was given up in favour of a new approach: the "single-regulator supervision".[148]

Further amendments to already existing laws were made through the **Fourth Financial Market Promotion Act** (*Viertes Finanzmarktförderungsgesetz*) that came into force on 1 July 2002. With this Act, the German government pursues the intention to promote the Financial Market and to improve investors' protection. It imposes greater transparency requirements, new disclosure rules for directors' dealings and extends the powers of the newly created Federal Supervisory Authority.[149]

Dealing with **takeovers** is another issue addressed by recent legislation.

In contrast with the US and Great Britain where acquisitions and mergers were in the focus of interest since the early 80s, the way of dealing with takeovers was not much discussed in Germany. On one hand, this was traced back to the different corporate structure: while British or US public held companies have a wide spread ownership, the biggest German companies have at least one large shareholder.[150] The first system is more convenient for

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[145] www.bafin.de.

[146] The BaFin is headed by Jochen Sanio, the former President of the Federal Institute for the banking supervision (BaKred).

[147] Supervision is performed over each single category of financial operator (or over each single segment of the financial market) and is assigned to a distinct agency for the entire complex of activities, following the traditional segmentation of the financial system into three markets. This approach is effective in cases of intermediaries of a very similar type that do operate in just one of the three traditional segments of financial intermediation.

[148] The single-regulator supervisory model is based on just one control authority, separated from the central bank, and with responsibility over all markets and intermediaries regardless of whether in the banking, financial or insurance sector. This authority would be concerned with all the objectives of regulation (stability, transparency and investor protection, maybe competition).

[149] 4_FMFG_RegEntwurf_AT-011101.doc (Stand 14. November 2001).

[150] For the reasons see Fn. xx. (5) and (67).

takeovers, because it is easier to convince small shareholders than it is to convince larger ones to sell their shares. On the other hand, the German dualistic concept of administration, the co-determination of workers and some other German typical concepts were thought to prevent hostile takeovers[151] and to make a ruling redundant.[152]

It was only in 1989/1990 that the takeover-discussion reached Germany after rumours were spread about a takeover bid for the Feldmühle AG by the Flick-nephews "Mick and Muck" and another one for the German Continental AG by Italian Pirelli. A group of experts was appointed and in 1995 they presented a Takeover Code on a voluntary basis, providing certain principles for takeovers. This Code was a failure because no efficient mechanisms were provided to enforce its provisions. It was not adopted by a number of large German companies. Takeovers and public offers went to a large degree unregulated.[153] Politicians took interest in the matter only after the first threat of a serious hostile takeover in the Krupp/Thyssen case in March 1997 and the successful bid of British Vodafone for German Mannesmann, which was first a hostile takeover, and later on became a formally friendly one (October 1999 until though February 2000). The need for legal regulation became obvious. As the efforts for a European takeover directive failed in Summer 2001 (on German initiative), the German **Takeover Act** (*Wertpapiererwerbs- und Übernahmegesetz, WpÜG*), which is modelled on the English City Code on Takeovers and Mergers of 1986, was enacted on 1 January 2002.[154]

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[151] Co-determination of workers can be an impediment to takeovers because workers in general are afraid of the consequences of takeovers such as shutting down plants and laying off employees.

[152] Peltzer, ZIP 1989, 69.

[153] Baumann, Takeovers in Germany and EU Regulation, Experience and Practice, in: Comparative Corporate Governance, p. 659.

[154] For further references see Kirchner, Szenarien einer "feindlichen" Unternehmensübernahme: Alternative rechtliche Regelungen im Anwendungstest, BB 2000, 105 and Krause, Das neue Übernahmerecht, NJW 2002, 705; Krause, Übernahmegesetz und EU-Richtlinie, ZGR 2002, 500.

2. The main changes

As I have already outlined, the main aims of the amendments were to enforce the system of management control (a), to promote the transparency of the market (b) and to establish a more efficient system for the supervision of the financial market (c). Last but not least, legal rules dealing with takeovers were established (d).

a) Amendments concerning the management of Stock Companies and its control

The independence of the controlling organ from the controlled one is of crucial importance for a good system of corporate governance. Although the German two-tier board system in theory guarantees some independence, in practice often it is not so due to interlocking directorships.[155]

aa) Duties of the Management Board

With the KonTraG of 1998, the reporting obligations of the **Management Board** to the Supervisory Board over future corporate planning were increased. According to § 90 I Nr.1-3 AktG the Management Board has to present to the Supervisory Board reports on company policy, company plan, company profitability and sales on an annual or quarterly basis.

Moreover the boards of public limited companies were obliged to ensure that adequate risk management and internal revision systems exist in their own companies (§ 91 II AktG).[156]

The board can be held responsible pursuant to § 93 AktG if it fails to install such a system and it has the burden of proving its' dutiful behaviour. In this specific case, this means that it has to prove that it took adequate measures to recognise and combat risks in time. The legislator left the way in which such a system has to be set up open. It should be adapted to the needs of the

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[155] The tradition of nominating the chairman of the Management Board to the chair of the Supervisory Board was already outlined (see above). It is also common in praxis for directors of a company to sit on the boards of the controlled daughter company or other companies.

[156] § 91 II AktG: *The Management Board must take suitable measures - including in particular the establishment of a monitoring system- to ensure early recognition of any developments potentially threatening to the company's existence.*

company, depending on its size, branch, structure, etc. In any case it must help recognising auditing frauds, risky affairs and breaches of laws in time to make counter-measures possible.[157] The importance of the installation of a risk management system is emphasised by the obligation of the auditor to report about it in the annual report (§ 321 I 2 HGB).[158]

Critics argue that this measure has no impact and that it is mearly the expression of political desire for action.[159] It is however widely accepted that setting up a system able to recognise risks in time is essential for a company and can help prevent crisis.[160]

The compensation of German executives is another issue that was recently brought to the public attention when charges were brought against six former members of the Mannesmann Supervisory Board because they granted Klaus Esser, the former chief executive of Mannesmann a 15 Million Euro "appreciation award".[161]

The disclosure requirements for the compensation of Board members in Germany are basic: listed companies don't have to publish the salaries and compensation payments of their board members. Neither do they have to disclose board members' total share holdings.

The Corporate Governance Commission suggested to make the disclosure of the individual directors' pay obligatory.[162] However, this suggestion was not taken up by the legislator.

The Corporate Governance Code contains some recommendations aiming to make the compensation system more transparent for stockholders and potential investors.[163] The Code establishes that the compensation of the

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157 Romeike, "KonTraG – Gesetzlich verordnetes Risk Management?", in: RiskNews, 13.07.2002, www.risknet.de; Freg, Die Haftung des Unternehmensführer nach dem KonTraG, Der Syndicus Juli/August 2000, available at: www.forumrecht.de.

158 Schmidt, Gesellschaftsrecht, p. 915.

159 So argues Hüffer, AktG, § 91 comment 5.

160 Schmidt, Gesellschaftsrecht, p. 818.

161 See Fn. 51.

162 The same recommendation was made in the 2002 Corporate Governance Report written for the EU-Commission by a group headed by Jaap Winter (Winter-report).

163 Points 4.2.3. and 4.2.4. Corporate Governance Code.

members of the Management Board shall be comprised of a fixed salary and variable components and that it shall be disclosed in a suitable form and reported in the Notes of the Consolidated Financial Statements. The variable compensation should include one-time and annually-payable components linked to the business performance as well as long term incentives.

Even though one year after the publication of the Code most big companies have accepted its recommendations,[164] some of them declared that they wouldn't comply with the disclosure of the individual pay of senior executives for reasons of privacy.[165]

bb) Strengthening the Supervisory Board

Although many voices were heard in favour of limiting the number of Supervisory Board memberships to 5 and augmenting their remuneration, the maximum number of memberships in Supervisory Boards that an individual may hold remained 10.[166] After long discussions, the KonTraG of 1998 only provides that the chairmanship of a Supervisory Board counts double because this task is more time-consuming than a normal membership.[167]

To avoid conflicts of interests, in the recommendation to shareholders on the election of new Supervisory Board members details of their other board memberships and their full time work are to be given (§§ 124 III, 125 AktG). Listed companies must enumerate in an appendix to the annual report for each board member all their other Supervisory Board seats and memberships in similar controlling bodies.[168]

The formation of committees as it is legally required in the US for publicly quoted companies, was put at the Supervisory Board's discretion. The KonTraG only included a "suggestion clause" in § 171 II AktG by which the

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[164] Compare the survey available at www.ftd.de/corporate-governance. (Fn. xx)

[165] Only six out of the surveyed Dax-30 companies declared to disclose the individual pay of the board members. Allianz AG, one of the biggest insurance companies world-wide, e.g. did not.

[166] Ulmer, AcP 2002, 143.

[167] § 100 II Nr.3 AktG.

[168] Note by Ministerial Counsellor Dr. Ulrich Seibert, Federal Ministry of Justice, Bonn, about the law of control and transparency in business (KonTraG), available at: www.bmj.de.

Supervisory Board of publicly quoted companies are obliged to inform the Shareholders' meeting about any committees that are formed.

The Corporate Governance Code, issued four years after the KonTraG, emphasised the importance of forming committees, mainly an audit committee, in order to increase the efficiency of the Supervisory Board's work and to improve the handling of complex issues.[169]

To reach a stronger independence of the Supervisory Board from the Management Board was one of the Corporate Governance Code's main objectives. As shown in a recent study, the majority of the members of the Supervisory Board (80 per cent) tend to get their information about the company from the Management neglecting other sources (other employees of the company, external advisors). Also, in many companies the Management Board has a major influence in selecting the members of the Supervisory Board. In only 26 per cent of the companies the Supervisory Board selects its members independently. Supposedly, in all other cases, the Management Board has the final decision.[170]

To ensure the independence of the Supervisory Board, the Corporate Governance Code establishes, that no more than two former members of the Management Board shall be members of the Supervisory Board, and that Supervisory Board members shall not exercise directorships or similar positions or advisory tasks for important competitors of the enterprise.[171]

The members of the Management Board have to inform the Supervisory Board of any conflict of interest which may result from a consultant or directorship function with clients, suppliers, lenders or other business partners. Further on, the Supervisory Board shall inform the General Meeting of (material) conflicts of interest in its annual report. Material conflicts of interest and those which may arise for personal reasons concerning a Supervisory Board member, and are not merely temporary shall result in the

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[169] Point 5.3. Corporate Governance Code.

[170] The Deloitte Consulting study can be consulted on www.dc.com.; see also "Aufsichtsräte wollen stärker mitreden" in: FAZ 16.09.02, S. 23.

[171] Point 5.4.2 Corporate Governance Code.

termination of his mandate.[172] Criticism may arise since it is not clear enough what is meant by "material" and not "merely temporary".[173]

One should bear in mind that the rules of the Corporate Governance Code are not binding and therefore derogation is not punishable. Derogations have to be disclosed and explained.

cc) Enforcing the external control

Big auditing companies were subject to harsh criticism, not only in the US but also in Germany. Due to falsely attested balances and undiscovered losses, trust in auditors has suffered. New rules are intended to improve the auditors' work, by imposing independence from the Management Board and improving their collaboration with the Supervisory Board.

Scandals have shown that auditors are too dependent on the Management Board. Conflicts of interest can emerge when the auditor of a company offers other services that may influence the company's economic position (for example if the auditor is also the management advisor of the same company). The amount of the non-audit revenues received by auditors from their audit client exceeds the audit fees received by the same client.[174] As the individual client becomes material to the auditor, the auditor becomes less independent of its clients. When the advising service provider is also the auditor of a company and the corporate finance advice turns out to be wrong and adversely influences the company's earnings, conflicts of interest are programmed, since it may be the management of the company and the auditor's common interest not to disclose the unfavourable situation.[175]

The KonTraG took measures to enforce the independence of auditors. An auditor contracted to a company over the years and whose income mainly depends on this company can give an impression of dependency. To enforce the independence and diminish conflicts of interest an auditor is excluded from

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[172] Point 5.5.3 Corporate Governance Code.

[173] Vereinigung institutioneller Privatanleger, Info-Newsletter 13.03.02, Flaumweich – der deutsche Corporate Governance Kodex, www.vip-cg.com.

[174] see also, Coffee/Berle/Flom, The Enron debacle and gatekeepers liability: Why would the gatekeepers remain silent?, 2001.

[175] Bormann, Unabhängigkeit des Abschlußprüfers: Aufgabe und Chance für den Berufsstand, BB 2002, 190; Prigge, A Survey of German Corporate Governance, in: Hopt/ Kanda/ Wymeersch/ Prigge eds., Comparative Corporate Governance, Oxford 1998, p. 998.

performing the audit if more than 30 per cent (previously 50 per cent) of his total revenue over the previous five years stems from that company.[176]

Furthermore, the KonTraG changed the appointment procedure for the independent balance sheet auditor. The former procedure at the AG was that the Supervisory Board proposed a balance sheet auditor, the General Meeting elected and the Management Board appointed him and negotiated the contract (also the auditor's compensation). This was generally criticised because it contributed to the critical closeness of the relationship between management and auditors,[177] which can be described by the German saying *"you don't bite the hand that feeds you"*. With the KonTraG, the relation between Supervisory Board and auditor was to become closer. It still is the General Meeting that elects the auditor, § 119 I Nr.4 AktG.[178] What has changed is that it no longer is the Management Board who awards the contract, but the Supervisory Board, § 111 II 3 AktG.[179] Moreover, the KonTraG made the auditor's participation at the balance sheet meeting of the Supervisory Board or the respective committee mandatory (§ 171 I 2 AktG), as well as the direct delivery of his report to each member of the Supervisory Board (§ 321 V Commercial Code). This is considered an important step in the right direction. The *de facto* dependency of the controlling organ from the controlled one was not justified and not fruitful.

The Reform Act of 1998 also provides that auditors should be changed after a certain number of years.[180] It was first discussed to make the change of the auditing company mandatory. The argument was that auditors – knowing that their work is time-limited and will eventually be scrutinised by a successor – would have an incentive to be more thorough and demanding with their clients. The temptation to sacrifice accounting rigor for the sake of a friendly relationship with a client would be diminished. These arguments were however criticised. While helping to reduce conflicts of interest, rotating auditors tend to diminish the control over the management since the auditing firm needs much time and investment in order to familiarise itself anew with the company to be audited. Another problem taken into account is the problem of choice. A

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176 § 319 II Nr. 8 HGB.

177 Prigge, in: Comparative Corporate Governance, p. 996.

178 MüHdB-Hoffmann-Becking, Band 4, § 44, comment 2.

179 MüHdB-Hoffmann-Becking, Band 4, § 44, comment 5.

180 § 319 III Nr.6 Commercial Code.

global company replacing its multinational auditor today has a maximum of three candidates.[181] The final compromise was to leave the auditing company change up to the company, while setting a mandatory change concerning the individual who has signed the audit certificate more than six times in the past ten years.[182]

Moreover, the KonTraG made it obligatory for the auditor to be present at meetings of the Supervisory Board held to approve the annual report and accounts, or at a financial audit committee meeting.[183] This measure was taken to improve the collaboration between internal and external controller.

Furthermore the scope of auditing was expanded: the auditor is obliged to describe in the report the future development of the company and the risks inherent in that development. He has to form his own opinion about the company's position.[184] This duty has to be seen in correspondence with the Directors' obligation to set up a risk detection system discussed above. The auditing obligation of the early risk detection system was further expanded by the Transparency and Disclosure Act of July 2002 from officially quoted companies to all publicly quoted companies, § 317 IV Commercial Code.

Another important point was to increase the liability of auditors. The former limitation of liability for negligence of 250.000 Euro was changed for audits of non-listed companies to 1 Million Euro and for listed companies to 4 Million Euro (§ 323 II HGB).[185]

The Corporate Governance Code also contains some recommendations concerning the relation between auditor and Supervisory Board: Prior to submitting a proposal for election, the Supervisory Board or, respectively, the audit committee shall obtain a statement from the proposed

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[181] Hopt, in: Comparative Corporate Governance, p. 256, see also the article of Jim Peterson " Rotating auditors doesn't add up", International Herald Tribune 31 August, 2002, p. 15.

[182] Note by Ministerial Counsellor Dr. Ulrich Seibert, Federal Ministry of Justice, Bonn, about the law of control and transparency in business (KonTraG), available at: www.bmj.de.

[183] § 314 IV AktG.

[184] § 317 HGB.

[185] Schüppen, Aktuelle Fragen der Wirtschaftsprüferhaftung, DB 1998, 1317.

auditor stating whether, and where applicable, which professional, financial and other relationships exist between the auditor and its executive bodies on the one hand, and the enterprise and the members of its executive bodies on the other hand, that could call its independence into question. The statement shall include the extent to which other services were performed for the enterprise in the past year, especially in the field of consultancy, or which are contracted for the following year.[186]

dd) Actions and claims

One way to ensure that members of Supervisory or Management Boards exercise their duties properly is to increase their personal responsibility, for example by giving shareholders an instrument to enforce the claims of the company (*Actio pro societate* or *Aktionärsklage*).

Before 1998, only the General Meeting (by simple majority) or a 10 per cent minority had the possibility to pursue gross breach of duty by Management or Supervisory Board members in the name of the company and for account of the company, § 147 I 1 AktG.[187] In addition, the General Meeting or a minority holding 10 per cent of the base capital or shares of an amount of 500.000 Euro could request the replacement of the appointed representatives.

With the KonTraG, the enforcement of compensation claims against members of either board was made easier: if the claim against the board members is not filed by the General Meeting or a 10 per cent minority, the new § 147 III AktG provides that shareholders holding 5 per cent of the share capital or a share of 500.000 Euro in authorised capital can ask the court to appoint special representatives to sue board members for damages to be paid to the company.[188] However, the courts appoints the special representative only if facts exist which justify the strong suspicion that damage has been inflicted on the company as a result of dishonesty or gross violations of law or

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[186] Point 7.2. of the Corporate Governance Code.

[187] In American law this action is known as "shareholders' derivative action" in opposition to the "direct action" with which shareholders can sue board members for damage caused directly to them and not to the company.

[188] Baums, Corporate Governance in Germany, 1998, Johann-Wolfgang-Goethe Universität, Institut für Bankrecht, Working Paper Nr. 70, available at: www.uni-frankfurt.de/fb01/baums; Lutter/Krieger, Rechte und Pflichten des Aufsichtsrats, Köln 2002, comment 855.

statutes. The same minority was attributed the right to propose a special audit if boards are suspected of breaches of duties concerning transaction with controlling or associated companies, § 315 II AktG. To prevent hasty litigation, the legislator has provided that the representatives are only appointed if the court has received sufficient evidence of a breach of duty.

This amendment is judged of little practical relevance. The requirements are still considered as being too high because in practice only very few shareholders reach this threshold. Moreover, while lowering the threshold on one side, on the other the legislator added requirements that by many are seen as discouraging possible claimants: An *actio pro societate* can only be done under suspicion of grossly negligent behaviour of the board members[189] and the minority has to bear the risk of the procedural costs in the case the claim of the company is rejected. Moreover, it is left to the special representative whether to fill in the law suit against the board members without giving the shareholders the possibility to contest the representatives' decision.[190] The efficiency and the practical relevance of this amendment are widely contested.[191]

The Transparency and Disclosure Act of July 2002 increased the penalties in the event of betrayal of business secrets by members of the Management or Supervisory Boards of publicly quoted companies.[192]

The demands for a more efficient responsibility system is becoming stronger[193] and in a ten-point-plan, presented by the German Government in

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[189]"…wenn Tatsachen vorliegen, die den dringenden Verdacht rechtfertigen, daß der Gesellschaft durch Unregelmäßigkeiten oder grobe Verletzung des Gesetzes oder der Satzung Schaden zugefügt wurde…".

[190] The concept of appointing a special representative does only exist under German law. In England, France and the United States every single shareholder has the right to sue Board members for damages. Further comparative remarks can be found at Ulmer, ZHR 1999, 291.

[191] Criticising the amendment Ulmer, Aktionärsklage zur Kontrolle von Vorstand und Aufsichtsrat, ZHR 1999, 291; in favour of the amendment Krieger, Aktionärsklage zur Kontrolle von Vorstand und Aufsichtsrat, ZHR 1999, 343.

[192] Imprisonment was augmented from 1 to 2 in § 404 I AktG and from 2 to 3 years for intentional or remunerated betraying as said in § 404 II AktG.

[193] For the critique, see Ulmer, AcP 2002, 143 and ZHR 1999, 329 and Schmidt, Gesellschaftsrecht, p. 875.

August 2002 (preceding the elections by a few weeks[194]) and concretised in February 2003,[195] it was publicly declared a priority. The plan that was concretised in the beginning of March 2003 seeks to create an *actio pro societate* that would allow a minority holding 1 per cent of the company capital or shares reaching the market value of 100.000 Euro to claim damages for the company.

b) Dealing with Market Abuse: New Transparency and Disclosure rules

Transparency and Disclosure are of utmost importance to every financial system. Only if all market participants can equally obtain quick and comprehensive information about market-moving corporate information they are in a position to make a proper investment decision.

Specific persons are addressed by the new rules: Those who (aa) through their position in the company (company insiders), (bb) their relation with the company (analysts) or (cc) through other means (issuing or credit giving banks) have an informational advantage compared to other market participants. In the following, I will trace the major changes in this respect.

aa) Insider dealing and market manipulation

There are two main categories of market abuse: insider dealing and market manipulation. Both issues were addressed by the recent legislation, that implemented some European Directives (such as the Insider Dealing Directive 89/592/EEC).

Insiders are persons who due to their function or by any other way have learned of non-public and price-sensitive information (e.g. forthcoming changes in the capital or the acquisition of major shareholdings). Taking advantage of insider information would undermine investors' confidence in fair and equal securities trading and offend the principle of the equal treatment of

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[194] Honi soit qui mal y pense.

[195] See the articles in: FTD 24.02.2003; Süddeutsche, 26.02.2003; FAZ, 25.02.2003; FT 26.02.2003.

all shareholders.[196] Moreover, to be aware of insider or director's dealings is of major importance for the market, as it can provide pointers to the assessment of business prospects by the company management.

For these reason, § 14 WpHG prohibits insider trading that may take advantage of inside knowledge and/or pass on of inside information without having been authorised to do so.

In accordance with § 9 WpHG, Securities trades have to be reported to the BaFin. Afterwards, they are analysed and then evaluated by the BaFin staff with particular attention to unusual price movements or turnover.

Since 1998, the Supervisory Authority[197] in case of insider investigation has the right to require issuers and individuals who are in possession of inside information to provide all of the documents needed for the investigation. To help the investigation work, credit institutions are required to provide information concerning the trades in insider securities contained in the portfolio of individuals who are suspected of insider dealing that were carried out during a period of six months previous to a possible insider transaction.[198]

If indications of forbidden insider dealings are revealed, the BaFin passes the case on to the respective public prosecutor's office. The latter may conduct further investigations and is responsible for the criminal prosecution. Insider offences are punishable by a fine or imprisonment of up to five years.[199]

The Corporate Governance Code set further recommendations serving to fight insider dealings by increasing transparency.

In the Code, the company's obligation to treat all shareholders equally in respect of information is emphasised: all new facts made known to financial analysts and similar addressees are to be disclosed to the shareholders by the

[196] The principle of the equal treatment of all shareholders was also addressed on the comunitarian level by the proposal for Directive on insider dealing and market manipulation, Brussels, 30.5.2001, COM (2001) 281 final -2001/0118 (COD), p. 34.

[197] The federal authority for securities supervision, BaWe, and from 2002 on the BaFin.

[198] § 16 II and IV WpHG.

[199] § 38 I Nr. 1 WpHG.

company without delay.[200] The Code also establishes that members of the Management and Supervisory Board shall disclose to the company without delay following consummation the purchase and sale of shares in the company and group-related companies, options as well as other derivatives. After which, the company has to publish the information in a suitable electronic information system or in at least one journal for statutory stock market advertisements, in English, in order to facilitate the evaluation of the company by foreign investors. Moreover, the company shall report the information in the notes to the consolidated financial statements.[201]

The Fourth Financial Promotion Act of July 2002 also introduced provisions preventing and punishing insider dealings.

According to the new § 15a WpHG, transactions in securities of their own company carried out by members of the Management or Supervisory Boards of exchange-listed enterprises, and of their spouses, registered partners and relatives in the first degree, must be notified to the issuer and to the BaFin without delay. Exempted are transactions not surpassing 25.000 Euro in a 30 day time period and shares making part of a compensation plan, such as stock-options.[202] Formerly, the disclosure of dealings of the so-called "secondary insiders" (spouses, registered partners...) was not ruled and consequently not punishable. The issuer has to publish the notification. Further clarifications concerning the procedure of disclosure and publication requirements can be made by the BaFin.[203] If there is suspicion that insider dealings have not been disclosed, the BaFin is empowered to investigate and to ask the suspect to give information about his deposit. The necessary experience comes from the Federal Securities Supervisory Office, BaWe, that is part of the BAFin and has already gained experience while prosecuting for insider trading in the last years. A breach of § 15a WpHG is an administrative offence pursuant § 39 II WpHG. A fine of up to 100.000 Euro can be imposed by the BaFin.

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[200] Point 6.3. Corporate Governance Code.

[201] Point 6.6. Corporate Governance Code.

[202] Dietrich, Verpflichtung zur Offenlegung der Geschäfte von Organmitgliedern in Wertpapieren des eigenen Unternehmens, in: Der Syndicus, Nov/Dec 2002 available at: www.forumrecht.com; Großmann, Der Betrieb 2002, 2031.

[203] See for example the Circular 27.06.2002, circular of the BaFin – German Financial Supervisory Authority concerning the disclosure and publication requirements according to Section 15a WpHG.

This solution is considered inefficient by some scholars. The notification process lasts so long that the investors generally receive the information about the insider deal when it is already too late to take measures. It has been suggested to oblige insiders to inform about their intention of buying or selling shares (over-passing certain thresholds), so that private investors have enough time to act.[204]

Next to insider dealings, **price and market manipulation** is another investor harming practice addressed by recent legislation.[205] Its raise is closely linked to the raise of financial markets. In 1884 already, the German legislator introduced with § 88 Stock Exchange Law (*Börsengesetz, BörsG,*) a criminal provision punishing the manipulation of stock exchanges which remained unchanged in its concept until recently. As a penal provision, the public prosecutor and not the Federal Authority for Securities Supervision was responsible for prosecuting violations. Less serious contraventions were not prosecuted as long as the public interest was not touched. Investors had no civil basis for claiming damages in the case of market manipulation because § 88 BörsG was not recognised as a protecting law[206] in the sense of § 823 II BGB.[207]

The Fourth Financial Market Promotion Act replaced § 88 BörsG with §§ 20a and b WpHG prohibiting price and market manipulation.

Under § 20a WpHG it is forbidden to make incorrect statements about facts that are relevant to the evaluation of securities, such as the earnings or sales generated by a company, or to withhold such information, for instance by failing to submit compulsory notifications. It is also forbidden to spread

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[204] Rudolph, BB 2002, 1036, 1040; Großmann, Der Betrieb 2002, 2031.

[205] At European level, there are no common provisions against market manipulation. The Insider Dealing Directive (89/592/EEC) limited itself to preventing the misuse of privileged information. At the national level, the Insider Dealing Directive has been implemented, while no legislation addressed market manipulation.

[206] Anyone who infringes a statutory provision intended for the protection of others will be held liable under § 823 II BGB. The notion of a violated protective norm refers to statutes (of private and public law), government decrees, local by-laws, food and drugs regulations, and police orders, in sum all rules which are substantially designed to protect an individual or a group of individuals rather than the public as a whole.

[207] Lenzen, Das neue Recht der Kursmanipulation, Johann-Wolfgang-Goethe Universität, Institut für Bankrecht, Working Paper Nr. 101, available at: www.uni-frankfurt.de/fb01/baums.

rumours or to carry out transactions with the aim of exerting illegal influence on the market or exchange price.[208]

All market participants, analysts and journalists comprised, have to conform to this prohibition. In view of the vague requisites set by § 20a WpHG, the Ministry of Finance is empowered to set clearer definitions by the way of ordinances.[209] Moreover, the former criminal offence was changed into an administrative offence (§ 39 I WpHG). In consequence, the BaFin, in its function as a public authority, is enabled to take effective action against price and market manipulation and to prosecute contraventions (§ 20b WpHG) and impose fines for less serious contraventions which have not hitherto been prosecuted. Criminal offences however, are still prosecuted by the public prosecutor and not by the Federal Authority.[210]

The disclosure of price-sensitive information (**ad-hoc disclosure**) and insider trading are closely linked: the more quickly information is published the more difficult it is to misuse inside knowledge. Under the rules preceding the Fourth Financial Market Promotion Act, investors were not protected against the omitted, late or incorrect disclosure of price-sensitive information.

By the insertion of **§ 37b and 37c WpHG** a basis for investors to claim compensation for the effects of late, omitted or incorrect disclosure of price-sensitive information in the sense of § 15 WpHG was established. § 37b WpHG deals with the omitted disclosure of price-sensitive information. This provision protects both, shareholders who paid too much for their shares and those who sold their shares for a price too low after the omission. § 37c WpHG treats the publication of misleading or false information. Practical examples are omitted or late win warnings[211] and false information about big chain orders[212] for which formerly no basis of claim existed. The opinion of the courts concerning wrong ad-hoc information was not uniform. For example in one case (*Infomatec*), the directors of a company published an

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[208] BaFin Press Release 12/2002 of 28 June 2002.

[209] Großmann, Praxisrelevante Änderungen des Wertpapierhandelsgesetzes – Die Auswirkungen des Vierten Finanzmarktförderungsgesetzes, in: Der Betrieb 2002, 2031.

[210] 4_FMFG_RegEntwurf_BT, p. 255.

[211] AG München, NJW-RR 2001, 1707 ("EMTV").

[212] LG München NJW-RR 2001, 1701 ("Infomatec").

incorrect information concerning a non-existing order. The claim of an investor was denied by one court and accepted by another.[213]

The respondent is not the person who is responsible for the omitted or incorrect disclosure, but the company. From an economical point of view this is judged negatively because the shareholders as owners of the company will damage themselves by claiming compensation.[214] For a claim to succeed there has to be a causal link between the omitted, incorrect or late information and the security trade of the investor. The onus of proving the causal link is not reversed in favour of the investor/claimant as it is the case in § 45 II No.1 BörsG for claims resulting out of false or misleading prospectus. In many cases it will be impossible for the investor to prove the causality. The courts will have to fill out this gap as they did before with the prospectus liability.[215]

The issuer is only held responsible for wilful intention and gross negligence. The proof for lack of responsibility is left to him. He will have the burden to prove that he is not responsible.

bb) Analysts

The Fourth Financial Market Promotion Act also imposed stricter disclosure rules to securities services companies to help investors identifying conflicts of interest. Before the reform, there were no rules setting standards of behaviour for these companies. § 34b WpHG extends certain rules of conduct contained in the Law governing Securities Trading, such as comprehensibility, due and proper care and disclosure of conflicts of interest to securities services companies to make them observe certain basic rules of analysis.[216]

When recommending securities, securities services companies are now obliged to disclose their own economic interest in the securities they are

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[213] Accepting the claim LG Augsburg, Urteil vom 24.09.01, Az: 3 O 4995/00 (WM 2001, 1944; ZIP 2001, 1881; BB 2001, 2130), denying it LG Augsburg, Urteil vom 09.01.02, Az: 6 = 1640/01 (WM 2002, 592; ZIP 2002, 530).

[214] Baums, Anlegerschutz und Neuer Markt, ZHR Heft 4 2002, ?; Rudolph, Viertes Finanzmarktförderungsgesetz – ist der Name Programm?, BB 2002, 1036; Fleischer, NJW 2002, 2977.

[215] The courts based the prospectus liability on the figure of the "Anlagestimmung", out of which they developed a prima facie proof (Anscheinsbeweis) in favor of the investor: BGH WM 1982, 862; Fleischer, Das Vierte Finanzmarktförderungsgesetz, NJW 2002, 2977.

[216] 4_FMFG_RegEntwurf_BT_011101.doc, page 263; Thomas List, Der europäische Finanzbinnenmarkt kommt, Börsen-Zeitung Online, 2.Juli 2002.

analysing. They have to make public inconveniences and conflicts of interest. § 34b I 2 WpHG sets forth the specific cases in which a conflict of interest is presumed and a disclosure duty exists: securities services companies are obliged to inform the public of facts such as own participations in the company of one per cent or more or their membership in an underwriting syndicate of the company in question during the last 5 years. Such information is important to investors because transactions of this type frequently involve a relationship that may last for many years after the securities are underwritten and, as such, can impair the objectivity of securities analyses relating to those companies. For the same reason securities services companies that acted as financial advisers to the companies that are subjects to securities analyses are held to disclose their conflicts of interest.[217]

The compliance with § 34b WpHG is controlled by the BaFin. A breach of § 34b WpHG is considered as an administrative offence for which the BaFin is allowed to impose fines of up to 200.000 Euro pursuant § 39 WpHG.[218]

α) Banks

The amendments made to the Stock Company Act by the KonTraG in 1998, limited the position of **banks**. The KonTraG set out that banks have to inform their customers when they hold 5 per cent or more of the voting rights if the company is listed or if the bank was a member of the company's most recent underwriting syndicate. Banks have to disclose in their annual accounts all appointments of their employees and managers to the boards of large corporate entities, such as stock companies and companies with limited liability.[219] According to § 135 I 3 AktG, a bank may not exercise the voting rights of its customers in stock companies in which it holds more than 5 per cent of the share capital, unless it has specific instructions from the customer or it does not exercise its own voting rights.[220]

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[217] see 4_FMFG_RegEntwurf_BT_011101.doc, page 263; Zydra, FAZ, 6. Mai 2002, Analysten – ein Berufsstand am Pranger.

[218] Grossmann, DB 2002, 2031.

[219] Claussen, Wie ändert das KonTraG das Aktiengesetz?, Der Betrieb 53, 1993, 183 et seq.

[220] Seibert, Kontrolle und Transparenz im Unternehmensbereich, AG-Sonderheft – Die Aktienrechtsreform, 1997, 68.

c) The new financial market supervisory approach

The BaFin is a federal institution governed by public law that belongs to the portfolio of the Federal Ministry of Finance, and as such has a legal personality. Its official seats are Bonn and Frankfurt. It supervises about 2700 banks, 800 financial services institutions and over 700 insurance undertakings.

The tasks of three federal offices are unified under the roof of the new authority: The Federal Banking Supervisory Office (*Bundesaufsichtsamt für das Kreditwesen, BaKred*[221]), the federal Office for Insurance Supervision (*Bundesaufsichtsamt für Versicherungsaufsicht, BAV*) and the Federal Institute for Securities Supervision (*Bundesaufsichtsamt für den Wertpapierhandel, BAWe*).[222] To take account of the nevertheless existing sectoral differences, separate organisational units were created for banking supervision, insurance supervision and securities supervision/ asset management. The co-ordination of those units is carried out by three cross-sectoral departments.

Through the Fourth Financial Market Promotion Act of July 2002, the BaFin's powers were extended, so that it is now authorised to investigate and sanction the manipulation of exchange and market prices. But it still lacks the ability to independently verify company balance sheets. Its proceedings are secret, meaning that market manipulation may be uncovered but investors, the media and the public may never hear about it.

In 2001, Germany's securities regulator opened 39 investigations into insider trading. Only two cases resulted in sanctions. In contrast, the American SEC, also considered understaffed, in 2001 ordered 62 convictions out of 64 investigations.

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[221] The BaKred was set up in January 1962 as an independent superior federal authority reporting to the Federal Minister of Economics and since 1972 to the Federal Minister of Finance.

[222] The BAWe was established on 1 August 1994 pursuant to Article 1 of the Second Financial Market Promotion Act of 26 July 1994 (Legal Gazette, 1994 BGBl. I 1749).

d) A new law dealing with takeovers

The Takeover Act regulates all aspects of public bids to acquire certain market-traded equity securities of German domestic companies, whether for stock, cash or a combination thereof, and establishes clear rules and procedures. It applies only to takeover bids for target companies having their legal seat in Germany, §§ 1, 2 III WpÜG.[223] The most important points concern the duties of behaviour of directors prior and after the publication of the public offer, the content and procedure of the offer and the squeeze-out of minority shareholders.

Before the entering into force of the Takeover Act, a major point of discussion was if the Management Board of the target company should be allowed to defend the company against hostile takeover attempts (*post-bid defences*) and if so, how wide ranging such measures should be.[224]

The Code now provides that the Management Board should refrain from activities that might prevent the success of the takeover. What sounds like the "board neutrality" position of the 13th European Company Law Directive, which would have forbidden board action that would tend to frustrate a takeover bid, in practice isn't. As a result of the criticism by German industry[225] and some academics[226] far-reaching exceptions to the principle of "board neutrality" were introduced. The German opposition to the solution of the 13th Directive was based on the so called unequal "level playing field": The Directive only addressed the particular barrier to a hostile bid through the board's defensive response. Other, perhaps more significant instruments, used to protect companies against foreign or hostile takeovers, e.g. "golden shares"

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[223] In other European countries and also in the US the takeover laws apply to those companies, whose shares are admitted to the relevant market or whose shareholders are situated in the relevant state.

[224] For the discussion see Drygala, Die neue deutsche Übernahmeskepsis und ihre Auswirkungen auf die Vorstandspflichten nach § 33 WpÜG, ZIP 2001, 1861; Winter/Harbarth, Verhaltenspflichten von Vorstand und Aufsichtsrat bei feindlichen Übernahmeangeboten, ZIP 2002, 1.

[225] Volkswagen and other influent companies used their influence (Schröder-connection: Schröder was once the chairman of the Supervisory Board of VW) to defeat the antifrustration rule of the 13th Directive.

[226] Kirchner i.e. fought agressively against the obligation of strict neutrality of the Management Board of the target company, Kirchner, Neutralitäts- und Stillhaltepflichten des Vorstands der Zielgesellschaft im Übernahmerecht, AG 1999, 481 and ibid. Szenarien einer "feindlichen" Unternehmensübernahme: Alternative rechtliche Regelungen im Anwendungstest, BB 2000, 105.

and differentiated voting rights that Germany abolished in 1998 but a number of Member States like France and the UK continue to have in place, were not addressed.[227]

The exceptions to the "board neutrality" principle, that are likely to become the rule, are set in § 33 WpÜG.[228] The Management Board is allowed to take those measures that every careful director would take in a normal situation (§ 33 I 2 Alt.1 WpÜG).

It also has the right to look for another bidder (§ 33 I 2 Alt.2 WpÜG) and the right to request shareholders to authorise it in advance for a period of up to 18 months to take measures to prevent a possible takeover. For such a resolution to be passed a majority of not less than 75 per cent of the shareholders represented on the meeting must vote in favour of it. The action has to be more or less defined ("*der Art nach bestimmt*"). This criterion is not considered clear enough. It seems improbable that the General Assembly gives such an *ex ante* authorisation to the Management Board to sell the crown jewels of the company without being informed to whom or under which conditions. Measures taken by the directors of the target company to defend the company from the bid on the ground of such a resolution must be approved by the Supervisory Board, that must consider whether the takeover would really harm the interests of the company (§ 33 II 1-4 WpÜG).

The right of the Management Board to take defensive measures merely upon approval of the Supervisory Board, without any mandate of the General Meeting and without informing the shareholders (§ 33 I 2 Alt.3 WpÜG) is considered the most important defensive measure. Because of this provision, leading investors' protection companies, and some academics judge the Takeover Act as a defeat in the fight for the investors' interests and protection.[229] It

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[227] See Gordon, An American Perspective on the New German Anti-takeover Law, ECGI Working Paper N°2/2002, October 2002, available at: www.ecgi.org. and Meier-Ewert, Germany's reversal of position on the Takeover Bids Directive, CEPS Comment ary of 18 May 2001, available at: www.ceps.be.

[228] Krause, Das neue Übernahmerecht, NJW 2002, 705; Drinkuth, Das neue Übernahmerecht, in : Der Syndicus, März/April 2002, www.der-syndicus.de; Gordon, An American Perspective on the New German Anti-takeover Law, ECGI Working Paper N°2/2002, October 2002; Hopt, Takeovers, Secrecy and Conflicts of Interest: Problems for Boards and Banks, ECGI Working Paper N°03/2002, October 2002 (www.ecgi.org/wp); in favour of the exceptions to the "board neutrality" is Schneider, Die Zielgesellschaft nach Abgabe eines Übernahme- oder Pflichtangebots, AG 2002, 125.

[229] Marcus Lutter an independent and widely known expert called it a "Scherbenhaufen", a pile of broken glass; Vereinigung institutioneller Privatanleger, Info-

should be the shareholders' decision, given their role of owners of the company, to accept or refute a take-over bid.

Defensive measures which the Management Board will be permitted to undertake with the consent of the Supervisory Board include the following:

-Issue new shares in order to make the takeover more expensive for the tender offeror.

-The target company may seek to acquire its own shares by making open market purchases. As a consequence the price of the shares may rise and the takeover would be more expensive.

-The target company may sell assets that the bidder wants in order to make itself less attractive to the bidder (Crown Jewel Defense).

-The target company may create problems of antitrust law by acquiring another company whose concentration with the tender offeror would be anticompetitive.

-The target company may also make a counteroffer to take over the tender offeror (Pac Man Defense).

-The going public of one or more subsidiaries in order to oblige the tender offeror to make a mandatory takeover offer also for the subsidiaries which would make the takeover more expensive.

The Takeover Act distinguishes between three different procedures: Public offers, voluntary and mandatory takeover bids. In large parts, the same provisions apply for these procedures.

A **public offer** (*einfaches öffentliches Erwerbsangebot*) is a publicly announced offer to acquire a target company's stock through purchase or exchange by the individual shareholders. After reaching a decision to submit a public offer, the offeror must announce his intention without delay through the officially prescribed methods of publication. Within four weeks of the public announcement of the intention to make an offer, the offeror must present a detailed "Offer Document" to the Financial Services Supervisory Authority that has to control whether it is conform to the requirements of the

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Newsletter 09.01.02, Übernahme(verhinderungs)gesetz und deutsche Corporate Governance, www.vip-cg.com.

Takeover Act (§ 14 II WpÜG). The offeror must publish its offer in the supra-regional officially designated financial gazettes (Börsenpflichtblatt) and on internet immediately after the BAFin has given its approval, or, if the BAFin does not raise any objections, then the offeror must publish its offer within ten working days. Immediately upon receipt of the offer, § 27 WpÜG requires the Management Board of the target company to express its view as to the offer, including a statement as to whether the board members intend, in respect to their own shareholdings, to accept or to reject the offer. It is criticised that Supervisory Board members are exempted from that rule, because their views and intentions are of even higher importance for the decision of the Shareholders.[230]

If the offeror intends to acquire the control of 30 per cent or more of the voting shares through the contemplated offer, it is a **voluntary takeover bid** (*Übernahmeangebot*), thus subjecting the offeror to additional requirements (§§ 30-34 WpÜG). According to these rules, the offeror must make a non-discriminatory offer for all the outstanding shares at a reasonable price. Reasonableness of the consideration offered for the shares will be determined by the BAFin with reference to the weighted average market price over the quarter period immediately preceding the offer announcement, and the price paid by the offeror. If the consideration offered for the target's shares is wholly or partially in stock, such shares must be "liquid", which means that they should be convertible to cash, vested with voting rights and admitted to trading on a regulated market within Europe.[231]

The **mandatory offer** (*Pflichtangebot*) is an instrument with a minority protecting purpose that formerly was not known to German law. In case of a control shift, it gives the minority shareholders an early right of exit with the intention to prevent an unfair "freeze-out" of minority shareholders, or other forms of oppression.[232] The special rules for mandatory offers (§ 35 WpÜG) apply when a shareholder gains direct or indirect control of 30 per cent or

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[230]Schneider, AG 2002, 125, 133; Krause, ZGR 2002, 500, 510; Hopt, ECGI Working Paper N°3/2002, October 2002, p.18.

[231] Krause, ZGR 2002, 500.

[232] Hopt, Takeovers, Secrecy, and Conflicts of Interest: Problems for Boards and Banks, Working Paper N°03/2002, October 2002, available at www.ecgi.com.

more of the voting rights exercisable at a shareholders' meeting, even in the absence of an intention to take over the company.[233]

When a party reaches the threshold of 30 per cent, it is obliged to notify the BAFin and the Stock Exchanges where the shares and the derivatives referring to the shares are listed, and to publish the fact. The notification must take place within seven days after the acquisition of shares leading to a holding of 30 per cent or more. Following to the publication, the Management of the target company must also be informed in writing. Within further four weeks of the control acquisition, the controlling party is required to provide the draft of its offer for the acquisition of all the remaining shares owned by other shareholders in the target company to the BAFin and, if the BAFin does not reject the content of the offer, submit the offer to his fellow shareholders.[234] In specific cases ruled explicitly by law, the BAFin may provide exemptions from the duty of making a mandatory offer.[235]

As to the liability of those making an offer to take over a company, § 12 WpÜG contains a liability provision for the correctness and completeness of the takeover bid documents that is closely knit after the Stock exchange prospectus liability, introduced in 1998. All those shareholders who actually accepted the offer in reliance on the information contained in the statement will have the right to claim damages from the offeror and anyone who actively participated in the preparation of the Offer Document and who have a "genuine interest" in the offer. It is presumed that the takeover bid documents are causal for the acceptance of the bid offer. In consequence, it is the defendant who bears the burden of proving an eventually lack of a causal link. The liability is only for gross negligence. It covers the full money damage and is statute-barred after one year or 3 years (if the seller did not know about the incorrectness of the takeover bid documents). This period results out of the harsh critique of the six-month period of the prospectus liability by the German shareholders' associations, which pointed out that the six month

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[233] To hinder the bypassing of the mandatory bid rule, pursuant to § 30 WpÜG, in specific cases and under certain requisites, the voting rights of third persons are attributed to the bidder; compare Krause, NJW 2002, 705, 713.

[234] Krause, Das neue Übernahmerecht, NJW 2002, 705, 713; Meyding/Voß, Ausgewählte Aspekte im Zusammenhang mit dem Pflichtangebot nach dem neuen Übernahmegesetz, in: Der Syndicus, 26. Ausgabe, Juli/August 2002, 222.

[235] Lenz/ Linke, Das WpÜG in der aufsichtsrechtlichen Praxis, AG 2002, 361.

period is totally unrealistic and not enough to find out the facts for preparing a lawsuit.[236]

Numerous already existing laws have been amended through the Takeover Act. Apart from the changed attitude towards defensive measures of the Management Board, a new way of dealing with a majority shareholder who wants to oblige minority shareholders to leave him their shares has been introduced. Previously, the only possibility for a majority shareholder to **squeeze-out** a minority shareholders was to dissolve the company (which requires support of 75 per cent of the share capital represented at the annual meeting) and to purchase the business in the following liquidation. The Takeover Act introduced § 327a AktG which provides that a squeeze-out will generally be possible as soon as a shareholder owns 95 per cent or more of the shares of an AG. A majority Shareholder holding 95 per cent of the capital of a Stock Company now has the possibility to achieve that the minority shareholders be obliged to leave him their shares against reasonable cash compensation. The purchase demand must be approved by shareholder resolution at the general shareholders' meeting. One reason for permitting a squeeze-out of minority shareholders is that small minorities don't have any possibility of influencing the management of the company. Another reason is that although the influence of minority shareholders on management is marginal they still have the possibility of blocking majority decisions through the demand of judicial review that is open to single shareholders. It is further argued that the squeeze-out provision has to be seen in relation to the mandatory offer rule in § 35 WpÜG: Who is obliged by law to make a mandatory offer to minority sharheholders, in consequence must be enabled by law to reach the position of sole shareholder (*Alleinaktionär*).[237]

Although the squeeze-out provision guarantees that minority shareholders will receive fair value for their holdings, it has been criticised as a fundamental violation of property rights guaranteed by the German constitution (Art. 14 Grundgesetz). Nevertheless, the majority opinion is that

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[236] Assmann, Die Haftung für die Richtigkeit und Vollständigkeit der Angebotsunterlage nach § 12 WpÜG, AG 2002, 153.

[237] Arguments of the Government (Begr. RegE, p. 72), and Krause, Das neue Übernahmerecht, NJW 2002, 705.

property rights are sufficiently protected because the process is subject to judicial scrutiny.[238]

In the event of violations of the Takeover Act, the BAFin may levy fines of up to one million Euro per offender, including individual members of the management board. The BAFin is also authorised to prohibit or invalidate all non-conforming offers and impose a one-year ban on resubmission. It is also empowered to nullify all transactions, including annulment. of share transfers, made pursuant to such invalidated offers. Moreover, if a controlling shareholder has failed to make a timely mandatory offer, he may lose the right to vote those shares previously acquired. Lastly, the offeror may be required to pay interest at a rate of 5 per cent over prime on any consideration that would have been owed, but for his failure to make a timely mandatory offer, calculated in respect of the duration of the lapse.[239]

In November 2002, the European Expert Group presented a further proposal for an EU Takeover Directive. The scope is to reach a "level playing field" at least in all countries of the European Union. Whether this new try will succeed is not yet clear. If so, Germany will have to amend some of the provisions of the Takeover Act, mainly those concerned with the defensive measures of the Management Board.[240] The introduction of the Takeover Act in 2002 can however be seen as a success viewed the former situation.

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[238] Drinkuth, Das neue Übernahmerecht, in: der Syndicus, März 02, www.der-syndicus.de; Krieger, Squeeze-Out nach neuem Recht: Überblick und Zweifelsfragen, BB 2002, 53.

[239] Lenz/ Linke, Die Handhabung des WpÜG in der aufsichtsrechtlichen Praktik, AG 2002, 361.

[240] Seibt/Heiser, ZIP 2002, 2193; Krause, ZGR 2002, 500 and Betriebsberater 2002, 2341.

C. The day after (the election): Plans and conclusion

Preceding the elections of 23 September 2002 by a few weeks, the German government has put forward a **10-point plan** to make companies more attractive to investors. The plan has its origins in the Corporate Governance Commission that reported in 2001.[241] On 25 February 2003, this plan was concretised. The proposals will be introduced in several separate laws to take effect from January 2005.[242]

Under the proposals, company executives will have to bear personal responsibility for misleading shareholders, e.g. by false information they might disseminate concerning the financial health of their company. Interviews and public speeches, by which investors could be misled may also give raise to. Currently in Germany, only the company as a whole, not the managers themselves can be held liable for the publication of misleading information.

Stricter criminal rules for managers and analysts for publishing misleading information about the situation of the company or the balance sheet and for insider trading will be introduced. Currently, only intentional acting, that is difficult to prove, is punished.

Minority shareholders will be enabled to launch joint-action civil cases against individual executives and supervisory board members if they are suspected of spreading misleading information.

The share ownership threshold above which shareholders can file for damages caused to the company by Supervisor or Management Board members is to be lowered from 10 per cent of base capital or shares of an amount of 500.000 Euro to 1 per cent or shares of an amount of 100.000 Euro.

The proposals include the creation of a powerful financial task force that would be able to conduct snap investigations of companies suspected of

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[241] See above.

[242] Ministry of Justice, Press-release 48/02, Berlin 28. August 2002; further articles Germany steps up fraud fight, 04.09.02, www.news.com.au; Tageszeitung of 4.9.2002; BMF, Speech by State Secretary Caio Koch-Weser, September 18, 2002; FT 25.11.2002, Benoit/Williamson, Radical transformation leads Europe; FT 26.02.2003, Williamson, German plan to tighten company law; Ministry of Justice, Press-release 10/03, Berlin 25. February 2003.

malpractice. As part of the changes, the BAFin would be given powers modelled on the US Securities and Exchange Commission and empowered to investigate suspected cases of accounting fraud, not only in the financial sector, but in the non-banking sector as well. The BaFin will also supervise a new independent "enforcement" body to check that company auditing is conducted properly.

Control on auditors would also be sharpened with tighter rules ensuring the independence of auditors: auditing and consultancy activities will be separated more strictly. The BaFin is to maintain a list of registered auditors, and will be empowered to de-list companies that break the rules.

The time period within which listed companies have to publish annual reports would be shortened from one year to three months, and greater adherence to international accounting standards is expected.

Having the recent reforms and the future government plans in view, it is sure that other changes of the corporate governance system will follow soon. What also can be taken for granted is that the upcoming changes will not be revolutionary, as a revolution of the German system is not needed: problem orientated changes may have a bigger impact than drafting completely new laws elaborated by theoreticians and unproved in practice.

Concluding this article it can be said that regulation will never gain over erroneous human behaviour. Scandals and failures, manipulation and fraud will always be part of society. As a scholar[243] outlined in a book dealing with investors' protection, periods of legislative activism have always been a consequence of big collapses or economic crisis and respectively periods of deregulation followed an economic boom. However far reaching legislation is, there will always be possibilities to bypass it. Taking this for granted, the aim of legislation should and cannot be to hinder failures but can only be to minimise their risk and to decrease their impacts on society and on those who do not have the possibility to protect themselves by other means.

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[243] Hopt, Kapitalanlegerschutz im Recht der Banken, München 1975.