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GERMANY'S CORPORATE AND FINANCIAL LAW 2007:

(GETTING) READY FOR COMPETITION

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Abstract: The paper provides an overview of the status of corporate and financial law making in Germany in 2007 and examines the driving forces behind current reforms. It also considers amendments to tax and accounting law that are related to corporate and financial law. The authors provide brief comments on pending legislative steps and measure the impact of the reforms on the overall structure of German business law.

This paper serves three purposes. Firstly, it provides an insight into the dynamic development of German corporate and financial law under the influence of European, national, and international reform agendas.

Secondly, it reveals that the German legislature responds to competitive pressure in the market for incorporations through service-oriented law making and innovative reforms. Generally speaking, these reforms follow three lines: 1) Simplifying the current law; 2) Increasing flexibility for issuers, investors and market participants; and 3) Opening German law as an option for foreign corporations.

Finally, it develops the working hypothesis requiring further testing in the future that the German legal system has regained strength as a role model for other states. This emancipation comes after almost 20 years of 'permanent corporate law reform' in which primarily provisions stemming from foreign (Anglo-American) jurisdictions were adopted and the German corporate and financial law was turned from upside down.

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All websites were visited in spring 2007. The paper discusses the legal situation as of 8 June 2007. © Ulrich Noack und Dirk Zetzsche, Düsseldorf / Germany 2007. Comments are welcome at ulrich.noack@uni-duesseldorf.de or zetzsche@uni-duesseldorf.de.

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I. INTRODUCTION

Competition in the market for regulators has become a frequently used catchword in European corporate academia.[1] In particular, it has been asserted that, since the ECJ issued its decision regarding CENTROS, ÜBERSEERING, INSPIRE ART,,and SEVIC,[2] the legal preconditions for competition amongst regulators in Europe are set, as well as whether and how certain Member States will maintain their position in the European legal systems. Given that Germany is often thought to be exemplary of "old Europe", i.e. slow in reforming and struggling to keep up with the pace of international developments, it is particularly interesting to observe how this representative of traditional Europe responds to the new competitive environment.

In light of this stereotype, we revealed the remarkable result that the German legislature has responded dynamically to competitive pressures in the market for incorporations. Since significant reforms at a European level still had to be implemented, legislative activity alone did not provide evidence for reform forces at work in Germany. However, where discretion was vested in the German legislature, we found a service-oriented approach to law making and innovative reforms. We also see first signs that German law has become more influential at a European level when compared to the previous two decades. While

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1 J Armour, *Who Should Make Corporate Law? EU Legislation versus Regulatory Competition*, 58 Current Legal Problems 369 (2005); L Enriques, *EC Company Law and the Fears of a European Delaware,* 15 EBLR 1259 (2004); M Gelter, The Structure of Regulatory Competition in European Corporate Law 5:2 JCLS 247 (2005); Kieninger, *The Legal Framework of Regulatory Competition Based on Company Mobility: EU and US Compared* 6 German LJ 740 (2005); T Tröger, *Choice of Jurisdiction in European Corporate Law: Perspectives of European Corporate Governance* 6 EBOR 3 (2005).

2 ECJ, 9 March 1999, Case C-212/97, [1999] ECR I-01459, - Centros -; ECJ, 5 November 2002, Case C 208/00, [2002] ECR I-9919 - Überseering -; ECJ, 30 September 2003, Case C 167/01, [2003] ECR I-10155 - Inspire Art -; ECJ, 13 December 2005, Case C-411/03, [2005] ECR I-10805 – Sevic –.

this observation requires further careful testing, these first signs indicate that Germany is regaining strength as a country that exports its legal system after almost 20 years of primarily adopting provisions stemming from foreign examples.

Presenting the current steps of corporate and financial law reform requires, first, a look back at recent history which comprises the first decade of the 'permanent corporate law reform' (sub II.). We go on to describe the reforms of 2005 and those being adopted, or prepared, by the Grand Coalition (sub III.) before drawing some careful conclusions from past, present and planned reform activities in Germany (sub IV.).

II. THE FIRST DECADE: ALLOWING MARKET FORCES TO WORK

A. The traditional explicit system of corporate control

Traditionally, Germany, together with the Scandinavian countries, has provided corporate governance scholars with a riddle; although capital markets with their monitoring and pricing effects were institutionally less attractive in Germany when compared to Anglo-American countries, managers and controlling shareholders did not seem to exploit minority shareholders to the extent that was observed in other countries with an industrial structure based on concentrated ownership.[3] From the perspective of a national observer, this characteristic was

[3] J C Coffee, *Do Norms Matter? A Cross-Country Evaluation* 149 U. Pa. L. Rev. 2151, at 2158 (2001); R Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy* 119 Harvard Law Review 1641 (2006); T Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-country Analysis* (2003) Working Paper, online < http://ssrn.com/abstract=237809 >; M J Roe, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (OUP, NY: 2003), at 168, 189 [Roe, POLITICAL DETERMINANTS].

not surprising since German corporate law contains substitutes for indirect investor monitoring through capital markets. In addition to the two-tier board structure, these substitutes include strong shareholder rights in shareholder meetings;[4] a specific legal regime for majority–minority conflict, known as *Konzernrecht*[5]*;* and creditor representation in supervisory boards that augments minority shareholder monitoring.[6] Since these measures require direct investor influence, we will refer to them as explicit devices of corporate control. Furthermore, some commentators hold that social and ethical restraints,[7] or restraints provided by worker representatives in supervisory boards,[8] limited German managers' and majority holders' propensity to exploit minority shareholders as well. These aspects have been the subject of some superficial academic study, and do not constitute our topic.

B. The permanent corporate law reform

In the early 1990s, Germany had neither a sufficient number of corporations, investors, financial institutions, nor rules[9] for the existence of viable capital markets. This paper focuses on the last of these factors, which are held to be par-

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[4] E.g. D A Zetzsche, *Shareholder Interaction Preceding Shareholder Meetings of Public Corporations – A Six Country Comparison* 2 ECFR (2005) 107, early version at < http://ssrn.com/abstract=624241 > [Zetzsche, *Shareholder Interaction*], and *Explicit and Implicit System of Corporate Control*, CBC Research Paper, at < http://ssrn.com/abstract=600722 > [Zetzsche, *Explicit and Implicit System*], at B.III.2.

[5] E.g. Zetzsche, *Explicit and Implicit System*, *supra* note 4, at B.II.2.

[6] E.g. Roe, POLITICAL DETERMINANTS, *supra* note 3, at 187.

[7] Zetzsche, *An Ethical Theory of Corporate Governance History* (2007), CBC Research Paper, at < http://ssrn.com/abstract=970909 >.

[8] Roe, POLITICAL DETERMINANTS, *supra* note 3, at 187.

[9] Some market-rules dating back to the19th century existed in Germany. These rules, however, focused almost entirely on the primary market, rather than the secondary market. In addition, the securities industry relied on codes of conduct, but many loopholes existed.

ticularly important for the rise of strong securities market.[10] These rules for viable capital markets, and thus, the preconditions for a market-oriented corporate governance regime, have been developed within a decade[11] confronting German corporate lawyers with more than 10 major legislative measures[12] together with an uncountable number of quasi-legislative steps through enforcement agencies, corporate governance code committees, private regulators (such as stock exchanges), as well as national and European accounting standard setters. The length and intensity of such reform prompted commentators to define the situation the 'permanent corporate law reform'.[13] The most important legislative steps of the first decade of the 'permanent corporate law reform' include:[14]

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[10] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets* 48 UCLA L. Rev. 781 (2000-2001).

[11] A foreign observer might ask what it was that catalyzed this flurry of legislative activity, and in particular, the development of market-based corporate governance devices. Scholars begin to examine the remarkable turnaround from an explicit to an implicit corporate governance system, see W Zöllner, *Aktionär und Eigentum (Shareholder and Property)*, DER GESELLSCHAFTER 2004, 5; J N Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany* 5 Columb. J. Eur. L. 219 (1999), and *The international relations wedge in the corporate convergence debate* in Gordon/Roe (eds) CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (CUP 2004) 161 and C J Milhaupt (ed.) GLOBAL MARKETS, DOMESTIC INSTITUTIONS (Columbia UP, 2004) 214.

[12] Securities Regulation: *Gesetz zur Stärkung des Finanzplatzes Deutschland* (1. FMFG) of 11.7.1989, BGBl. I (1989) 1412; *Zweites Finanzmarktförderungsgesetz* (2. FMFG), of 26.7.1999, BGBl. I (1994) 1749; *Drittes Finanzmarktförderungsgesetz* (3. FMFG), of 29.3.1998, BGBl. I (1998) 529; *Wertpapiererwerbs- und Übernahmegesetz* (*WpÜG*) of 20.12.2001, BGBl. I (2001) 3822; *Viertes Finanzmarktförderungsgesetz* (4. FMFG) of 21.6.2002, BGBl. I (2002) 2010. Company and Accounting Law: *Umwandlungsrechtsbereinigungsgesetz* of 28.10.1994, BGBl. I (1994) 3210; *Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts* of 2.8.1994, BGBl. I (1994) 1961; *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)* of 27.4.1998, BGBl. I (1998) 786; *Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung - NamensAktiengesetz (NaStraG)* of 18.1.2001, BGBl. I (2001) 125; *Transparenz- und Publizitätsgesetz* (TransPuG) of 19.7.2002, BGBl. I. (2002) 2681. In addition, the legislature adopted a plethora of minor legislative steps.

[13] W Zoellner, *Aktienrecht in Permanenz – Was wird aus den Rechten des Aktionärs (The Permanent Corporate Law Reform – What happens to the rights of shareholders?)* DIE AKTIENGESELLSCHAFT (1994) 336; U Seibert, *Aktienrechtsreform in "Permanenz"? (Permanent Corporate Law Reform?)* DIE AKTIENGESELLSCHAFT (2002) 417.

[14] For a topical overview of past reforms see E Nowak, *Investor Protection and Capital Market Regulation in Germany* in: Krahnen/Schmidt (eds), THE GERMAN FINANCIAL SYSTEM

- The establishment of a Federal Financial Services Agency [FSA];[15]
- A significant number of measures that improved Germany's securities laws on the basis of a disclosure approach,[16] and
- The German takeover law introduced in 2001.

At the same time, **corporate law was modernized in a market friendly way**, by:

- Strengthening auditor independence and the powers of the supervisory board in 1998;
- Reforming the law on shareholder meetings in four legislative steps between 1994 and 2002,[17] which comprised the weakening of bank influence in the proxy voting process and the implementation of rules that permit the use of the internet in shareholder meetings for example;[18]
- Creating a squeeze-out provision in 2001 and

(OUP 2004); U Seibert, *Corporate Governance and the Role of Investment Funds*, 3 German LJ 11 (2002); Zetzsche, *Explicit and Implicit System*, *supra* note 4, at C.III.2.

[15] First established as "Bundesaufsichtsamt für das Wertpapierwesen" in 1994/1995, it merged with the „Bundesaufsichtsämtern für das Versicherungswesen und das Kreditwesen" and renamed into "Bundesaufsichtsamt für Finanzdienstleistungen" (Federal Agency for Financial Services) in 2001.

[16] See D A Zetzsche, AKTIONÄRSINFORMATION IN DER BÖRSENNOTIERTEN AKTIENGESELLSCHAFT (SHAREHOLDER INFORMATION IN PUBLIC COMPANIES), (Carl-Heymanns-Verlag: 2006) § 12.

[17] 1994: *Gesetz für kleine Aktiengesellschaften*; 1998: *KonTraG*; 2001: *NaStraG*; 2002: *TransPuG*, see *supra* note 12.

[18] See U Noack, *Modern communications methods and company law* EBLR 100 (1998); U Noack & M Beurskens, *Internet-Influence on Corporate Governance*, 3 EBOR 129 (2002); D Zetzsche (ed.), DIE VIRTUELLE HAUPTVERSAMMLUNG (THE VIRTUAL SHAREHOLDER MEETING) (Erich-Schmidt-Verlag: 2002), and *Corporate Governance in Cyberspace – A Blueprint for Virtual Shareholder Meetings*, CBC Research Paper, at < http://ssrn.com/abstract=747347 >.

- Resolving the German Corporate Governance Code [GCGC] by the semi-official German Corporate Governance Code Commission [Codex Commission] in 2002.[19]

The GCGC fulfils three functions. Firstly, it summarizes German law governing corporations listed at regulated markets - the legal framework - for domestic and foreign investors and the lay public. Secondly, with respect to some issues, the Code requires corporations to *comply or explain*. Companies can deviate from these *recommendations*, but if they do so, they must disclose the deviation in the corporate governance statement and explain the reason for the deviation to investors. Thus, the Code exerts some indirect pressure on corporations listed at regulated markets to adopt generally accepted corporate governance practices[20] and is apparently quite successful in doing so.[21] Finally, it suggests the implementation of certain practices in fields of corporate governance where there is still debate among experts as to what the "best practice" actually is. Firms can deviate from these *suggestions* without disclosure.[22]

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[19] For an English translation and background information, see www.corporate-governance-code.com . S. 161 of the *Aktiengesetz* (German Stock Corporation Act) requires listed companies to issue a declaration of conformity as to the provisions of the Code on an annual basis. The code is administered by the Codex Commission. The Federal Secretary of Justice appoints its 13 members who are managers, academics and representatives of stakeholders. The Codex Commission will observe the development of corporate governance in legislation and practice and will review the Code at least once a year for possible adaptation. The government established a website as a contact for interested parties' comments and suggestions.

[20] For example, Nr.2.3.3: "The company shall … assist the shareholders in the use of proxies. The Management Board shall arrange for the appointment of a representative to exercise shareholders' voting rights in accordance with instructions."

[21] According to a study cited by Jaap Winter, almost all German corporations fulfil almost all recommendations of the code. While one could assume that this is due to lax drafting of the Code, the GCGC provisions are, in fact, relatively detailed as compared to, e.g., the United Kingdom and the Swiss Corporate Governance Codes.

[22] For example, the Code suggests that the representative (see *supra* note 20) should also be accessible during the General Meeting.

C. The hybrid approach

Although the German government initiated the *development* of strong capital markets in Germany during the last decade, it is important to note that the recent reforms did not strive for a *dominant* role in a market-based system of corporate control. Instead, the legislature pursued a *dual purpose strategy*. In addition to improving corporate governance by strengthening the impact of market forces, the German government modernized the traditional explicit system of corporate control and, in particular, the law of shareholder meetings. Thus, market forces and direct investor influence together create a “hybrid system” in Germany that relies on both implicit and explicit corporate governance devices.

III. THE SECOND DECADE: IMPORT AND EXPORT OF CORPORATE LAW

While the reforms of the First Decade of corporate law reform were primarily imposed by Germany’s need for stronger securities markets, four factors drove the corporate law reform of the Second Decade.

Firstly, as a measure to improve the European Single Market for financial services and products,[23] the *European legislature* intruded into the (traditionally) national domain of corporate governance. In doing so, it was underpinned by the occurrence of some widely-discussed scandals.[24] In addition, the European

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[23] *Financial Services Action Plan*, COM(1999)232 (11.05.1999).

[24] European investors associate corporate misbehavior with firms such as Ahold, Vivendi, Parmalat, and Royal Dutch/Shell. These scandals that became publicly known after the European Commission suggested its Financial Markets Action Plan kickstarted the European Commission’s Corporate Law Action Plan.

Corporate Law Action Plan[25] led to first results which required legislative activity in implementing these measures.

Secondly, *international developments*, especially in the United States, required adjustments of the national rules.

Thirdly, regulators implemented the proposals of the influential German *Government Commission on Corporate Governance* from 2001.[26] The German federal government translated these proposals into a "Ten-Step Program for Corporate Integrity and Investor Protection," [Ten-Step Program][27] from which most of the reforms of the Second Decade follow. This Ten-Step Program was rooted in the belief that investor confidence and thus German capital markets could be made stronger through increased transparency, denser control of corporations and stricter criminal and civil liability for issuers and individuals who engage in misconduct. Some of these reforms became latter the subject of European harmonization efforts.

Finally, the clearer the ECJ expressed its position on the freedom of incorporation in Europe, the more obvious it became that the German position on incorporation frequently known as 'Seat Theory' could not be maintained. In seeking to get Germany's company law ready for competition in the market for regula-

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[25] *Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM(2003) 284 ('*Corporate Law Action Plan')* (21.05.2003). See K Lannoo & A Khachaturyan, *Reform of Corporate Governance in the EU* 5 EBOR (2004), 37, 38.

[26] See T Baums (ed) BERICHT DER REGIERUNGSKOMMISSION CORPORATE GOVERNANCE (REPORT OF THE GOVERNMENT'S COMMISSION ON CORPORATE GOVERNANCE), 2001. An English translation is available in T Baums, *Company Law Reform in Germany* 3 JCLS 181 (2003).

[27] Federal Secretaries of Justice and Finance, *10-Punkte-Programm der Bundesregierung zur Verbesserung der Unternehmensintegrität und des Anlegerschutzes*, 25.02.2003, avalaible at <www.bmj.bund.de/enid/fa8a71ef4a25638be7ee184cc9d06cdd,0/ai.html>.

tors, the attractiveness of German companies for foreign corporations and investors became an increasingly important aspect in reforming German corporate law.

These macro factors prompted ongoing legislative activity. We distinguish between two periods. The first period ended with the early federal elections of 2005 (sub A.). The second period which peaked in early 2007 describes the law making of the Grand Coalition which came to power at the end of 2005 (sub B.).

A. EARLY FEDERAL ELECTIONS: DISCLOSURE & SHAREHOLDER RIGHTS

In 2005, on the verge of early Federal elections, Germany observed legislative action in corporate law, securities law and accounting law.

1. Corporate law

In the field of corporate law, three legislative measures were particularly important.

(a) European Companies

Firstly, the legislature adopted the rules for the European Company [Societas Europea - SE]; a supra-national corporate form that is based on European law.[28] There is some evidence that the *Law on the European Company*[29] has impacted on corporate Germany quite severely. After the tax law governing the

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[28] The European Company framework will allow companies incorporated in different Member States to merge or form a holding company or joint subsidiary, while avoiding the legal and practical constraints arising from the existence of 25 different legal systems. The European Company framework comprises the Council Regulation on the Statute for a European Company 2157/2001/EC (08.10.2001) OJ 2001 L 294, and the Council Directive complementing the Statute for a European Company with regard to the involvement of employees in the European company 2001/86/EC (08.10.2001) OJ 2001 L 294.

[29] *Gesetz zur Einführung der Europäischen Gesellschaft (SEEG)* of 28.12.2004, BGBl. I (2004) 3675.

transformation of a corporation into a SE was finalized in December 2006,[30] four of the largest German companies have re-incorporated as SE,[31] as of spring 2007 with more likely to follow. Officially, these companies cited aspects relating to the corporate identity and the self-identification of employees in non-German subsidiaries as reasons for their decisions.

However, a legal aspect may add to the understanding of the current trend towards the SE: Under the European Directive, an SE may be incorporated as a firm with either a two-tier or a one-tier board structure. More precisely, the SE scheme establishes a one-tier board system, but provides for a clear division of functions across the board members to the extent that it eventually enables a two-tier board system. In this respect, the law governing the European Company is more flexible than the German *Aktiengesetz* under which a two-tier board structure is mandatory.[32] This aspect is particularly important for companies in which the controlling shareholder (the entrepreneur, or family patriarch), is interested in simultaneously exercising control, running the day-to-day business.

(b) Manager Liability and Shareholder Rights ('UMAG')

Moreover, in early 2005, the German legislature adopted the *UMAG.*[33] This bill strives to improve the governance system of *corporations*, but since the law

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[30] *Gesetz über steuerliche Begleitmaßnahmen zur Einführung der Europäischen Gesellschaft und zur Änderung weiterer steuerlicher Vorschriften - SEStEG (Bill on tax measures related to the introduction of European Companies and amending other provisions of tax law)* (07.12.06), BGBl I (2006), 2782.

[31] Allianz, BASF, Fresenius, Porsche.

[32] This is one of the aspects which prompted a discussion as to whether the German law on worker codetermination in corporations can still be maintained in its traditional form. While the polity is stalemated, firms weigh their options. We will address this issue more in detail below. See *infra*, sub III.B.3.d).

[33] UMAG (22.09.2005), BGBl. I (2005), 2802

governing European Companies relies on the Aktiengesetz, the UMAG-reform is also meaningful for SEs. *UMAG* stands for the long title 'Bill on the Improvement of Corporate Integrity and on the Modernization of the Regime governing the Contest of Decisions made at Shareholder Meetings.'" It amended the German *Aktiengesetz* with respect to three crucial areas of corporate governance. These are (1) Liability of corporate managers; (2) Shareholder meetings; and (3) Shareholders' right to contest decisions of shareholder meetings.

(1) The first area regards the *liability of corporate managers*. Though the duties of loyalty and care imposed on managers are essentially comparable to those of officers in other European and North-American countries,[34] German corporations rarely hold managers liable for breach of their duties. Presently, the *Aktiengesetz* generally assigns the right to sue managers for damages to the corporation to the supervisory board.[35] The supervisory board rarely exercises this right since the negative impact on the corporate reputation often outweighs the financial benefit of a lengthy law suit against a (former) manager of the corporation. However, the shareholder meeting, or a minority holding 10 percent of the nominal capital, may demand that a suit be filed against the managers.[36] Furthermore, these entities may apply to court for the appointment of an "independent representative" who files the suit against the managers on behalf of the company.[37] Pursuant to s. 147 (4) of the *Aktiengesetz*, if the company loses in

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[34] See, in particular, the Federal Court's decision in *ARAG/Garmenbeck*, judgement of 21.04.1997 – II ZR 175/95, BGHZ 135, 244 = NJW 1997, 1926, acknowledging inter alia the business judgment rule, which was codified in 2005 in s. 93 (1) sentence 2 of the *Aktiengesetz (UMAG)*.

[35] S. 112 of the *Aktiengesetz*.

[36] S. 147 (1) of the *Aktiengesetz*.

[37] S. 147 (2) of the *Aktiengesetz*.

court it may recover its expenses from the shareholders who induced the suit in the first place. Shareholders who have either a majority in the meeting or 10 percent of the nominal capital tend to be represented in the supervisory board. In order to avoid the cost risk to themselves and the reputational damage to the company (and, consequently, their stake in the firm), influential shareholders usually push for a quiet settlement between the manager and the supervisory board. Consequently, bad managers had good chances to leave German management boards unharmed and with retirement benefits

Comparative studies held that the safeguard for German managers with respect to shareholder suits was rare among countries with advanced corporate laws and strong capital markets.[38] However, in seeking to fill this gap, the Federal Government also aimed to avoid a lawyer-driven stream of corporate litigation with doubtful benefits for shareholders, as, for example, studies show exists in the United States.[39] Thus, the *UMAG* gave a minority holding 1 percent of the overall shares or 100,000 € in nominal capital the right to induce a pre-procedure for shareholder suits. In this pre-procedure, the court will allow for direct shareholder litigation on behalf of the company, similar to Anglo-American derivative suits, if the shareholders fulfil certain conditions that should function as an obstacle to strike suits.[40] Moreover, the *UMAG* abolished the cost provision that put minority shareholders at a disadvantage.

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[38] T Baums & K E Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany* 53 Am. J. Comp. L. 31 (2005).

[39] R Romano, *The Shareholder Suit: Litigation without Foundation?* 7 J.L. Econ. & Org. (1991) 55, 84; R B Thompson & R S Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions* 57 Vand. L.R. 133 (2004).

[40] S. 148 of the *Aktiengesetz* (*UMAG*) requires that (1) the shareholders who intend to sue bought the shares at some point in time before they received knowledge about the inappropriate managerial conduct in question; (2) the shareholders tried to induce the su-

In order to further facilitate shareholder activism, the *UMAG* implemented a shareholders' forum ('Aktionärsforum'). This is a special website administered by the electronic Federal Bulletin[41] which should reduce shareholders' collective action problems.[42] On this website shareholders may give notice of their intent to induce the above pre-procedure for a particular shareholder suit; initiate a special investigation of certain managerial conduct; propose a vote on a specific issue in shareholder meetings, or call a shareholder meeting on behalf of the corporation. As far as we know, this institution is unique.

We think that, in fact, the use of the internet is likely to constitute the best approach in addressing the perennial issue of rational apathy - particularly in an international context. Two years after its implementation, however, few shareholders have used the shareholders' forum. Some investors challenging management have sufficient shares to meet thresholds without support from other shareholders; others are not willing to cooperate with other shareholders, and a third group is not aware of the shareholders' forum and its function in corporate law. Furthermore, securities law claims, where collective action problems are probably at their most severe, are not yet in the catalogue of rights which may be exercised over the shareholders' forum. Thus, we would propose extending

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pervisory board to sue the officers before they apply to court; (3) facts indicate a serious breach of managerial duties which caused damage to the corporation; (4) from the perspective of the corporation, there are no better reasons for abstaining from suing the officers. These strict measures substitute for higher thresholds that were demanded by the Federal Council.

[41] S. 127a of the *Aktiengesetz* (*UMAG*). The shareholders' forum is available at < https://www.ebundesanzeiger.de/ebanzwww/wexsservlet?state.partid=6&state.category=67&page.navid=topartstart >.

[42] On collective action problems with respect to shareholder suits, see E M Iacobucci & K E Davis, *Reconciling Derivative Claims and the Oppression Remedy* 12 S.C.L.R. (2000) 87, at 114 et seq.; on the theory of collective action problems, see K Holzinger, *The Problems of Collective Action: A New Approach* MPI Collective Goods Preprint No. 2003/2, online <http://ssrn.com/abstract=399140>.

the scope of the shareholders' forum to all shareholder minority rights and include claims based on securities law, for example, for those stemming from wrongful disclosure. In addition, we would propose requiring companies to connect their investor relations website to the shareholders' forum, if shareholders of the respective company call for support in action against management over the shareholders' forum.

(2) The shareholders' forum is also related to the second core issue of the *UMAG*, which is the *procedure of shareholder meetings*. This is due to the fact that shareholders may use this section to table resolutions and attempting to garner support from other shareholders.[43] Another issue related to the procedure of shareholder meetings was the reform of the identification and authorization of shareholders for their meetings.[44] This aspect of the *UMAG* affects companies which issue bearer shares, hence, approximately 90% of all German corporations listed at regulated markets. The *UMAG* amended the traditional wording from s. 123 of the *Aktiengesetz* which had previously described a process that the European Expert Group on Cross-Border Voting termed "reconciliation"[45] as a method of identifying shareholders by reconciling all share transac-

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[43] For details on this function of the shareholder forum see Zetzsche, *Shareholder Interaction*, *supra* note 4, at C.III.1.

[44] S. 123 (2) – (4) of the *Aktiengesetz*. On the implications of the recent reforms, see S Simon & D A Zetzsche, *Aktionärslegitimation und Satzungsgestaltung - Überlegungen zu § 123 AktG i.d.F. des UMAG (Designing the Articles of Association for shareholder identification – considerations with regard to § 123 of the Stock Corporation Act after the UMAG*) NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2005) 369.

[45] Expert Group on Cross-Border Voting in Europe, "CROSS-BORDER VOTING IN EUROPE - Final report of the Expert Group on Cross-Border Voting in Europe" (Aug 2002), available at < http://www.jura.uni-duesseldorf.de/dozenten/noack/texte/normen/amsterdam/final.htm >, at 5.3.

tions right up to the date of, or a cut-off date shortly (a few hours) prior to the shareholder meeting.

The *UMAG* replaced the reconciliation-system by a record date system that entirely relies on the shareholders' bank account ('book-entry system'). Only those bank clients who hold shares in their bank account under their own name at the relevant record date are entitled to exercise their shareholder rights at the meeting. The mandatory record date is set at the beginning of the 21st day prior to the meeting. Since the procedure for identifying and authorizing shareholders may rely entirely on electronic means, the *UMAG* facilitated electronic proxy voting and other forms of electronic voting *in absentia*, as required by the OECD principles of Corporate Governance.[46] As first figures demonstrate, the implementation of the record date system was a great success, raising average turnouts at shareholder meetings in the 30 largest corporations by app. 4 percent.[47]

The third element regarding shareholder meetings was a push for a *cut back* of the overly formalised understanding of the exercise of information rights an individual shareholder in Germany had traditionally held. Previous to the reform, an individual shareholder could ask any question related to the topics that the meeting was called to vote on,[48] and management was required to answer these questions. Failure to fully answer such questions could lead to the contesting of the shareholder meeting's decision. Enforcing the information right

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[46] OECD, Principles of Corporate Governance 2004, at II.C.4., available at www.oecd.org/dataoecd/32/18/31557724.pdf .

[47] Deutsche Schutzvereinigung für Wertpapierbesitz e.V., *Hauptversammlungspräsenzen (Turnouts at Shareholder Meetings)*, available at http://www.dsw-info.de/Hauptversammlungspraesenzen.70.0.html .

[48] Pursuant to s. 131 of the *Aktiengesetz*. Though section (3) of that provision accounts for certain exceptions to this wide claim, esp. if the answer may harm the corporation, courts tend to construe s. 131 *Aktiengesetz* very strictly.

with the related right to contest decisions made at shareholder meetings gave individual shareholders very broad powers in exercising their information rights. These powers were abused in recent years by strike suitors.[49] Thus, the *UMAG* introduced a provision pursuant to which any information that is published on the corporate website is considered to be given in the shareholder meeting. In light of this provision, corporations can significantly reduce their efforts in answering questions in shareholder meetings by making available a diligent, year-long disclosure on their corporate websites.

(3) Tightening the right to contest shareholders' decisions in order to prevent unnecessary abuses constituted the third focus of the *UMAG*-reform. From the traditional point of view - the *Aktiengesetz* generously assigned rights to challenge the meeting's decision to shareholders as part of the traditional watchdog-function of the shareholders.[50] However, the effectiveness of the watchdog function became doubtful due to strike suits launched by professional plaintiffs who forced management into costly settlements. The risk was greatly increased as the *filing* of a contest may prevent the implementation of a shareholder meeting's decision. Previous to the reform, corporate Germany saw many large-scale mergers and acquisitions being blocked until the German Federal Supreme Court ruled on the case up to three or four years after the day of the shareholder meeting. Thus, managers often preferred to share the gains of the proposed measures (contained in the meeting decision) with strike suit claim-

[49] German corporate law traditionally allows for challenging the meeting's decision on the ground that the decision violated either a statutory provision or a provision of the Articles of Association. This does not only pertain to the substance of the decision, but also to the procedure through which the decision was established. This is part of the traditional German concept which perceives the individual shareholder to be the watchdog of management, the supervisory board, and majority shareholders.

ants rather than delay the implementation of the measure itself through a costly, long-term court procedure.

The UMAG addressed this problem from a substantial and a procedural point of view. From a substantial point of view, the *UMAG* clarified[51] that the failure to provide information which a reasonable shareholder would not consider to be relevant for his voting decision, does not justify the contest of a shareholder meeting's decision.[52] Moreover, shareholders are generally deterred from challenging the meeting's decision for the lack of disclosing information on the value of the corporation or some of its subsidiaries, if these matters can be settled in a specific evaluation procedure (*Spruchverfahren*). The *Spruchverfahren* is permissible in situations where the company's value is a typical concern (mergers, acquisitions, amalgamations etc.). The last exclusionary reason is particularly relevant in the context of freeze-outs and fundamental changes, the validity of which were frequently threatened by strike suitors until the adoption of the *UMAG*.

From a procedural point of view, the *UMAG* introduced a preliminary procedure[53] by which Regional Courts (Landgerichte) must decide within 4 months after the meeting whether management may pursue the measure, regardless of the contest being filed.[54] If a Regional Court allows the implementation of the

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[50] *Supra* II.1.

[51] The Federal Court adopted this test in its decisions of 29.11.1982 – II ZR 88/81, BGHZ 86, 1, 22 and 19.6.1995 – II ZR 58/94-2, DIE AKTIENGESELLSCHAFT (1995) 462.

[52] S. 243 (4) of the *Aktiengesetz (UMAG)*.

[53] The rules of this preliminary procedure were tested for almost ten years with respect to the transformation of a stock corporation into another corporate form (e.g. into a limited liability corporation) with overall positive results. See ss. 207 et seq. of the *Umwandlungsgesetz* ("Restructuring Law").

[54] 1 month (term for filing the suit) according to s. 246 (1) of the *Aktiengesetz* (*UMAG*) and 3 months (for court procedures) according to s. 246a (3) of the *Aktiengesetz* (*UMAG*). Further delay may result from appeals (6 months according to commentators: compare H Dieckmann & D Leuering, *Der Referentenentwurf eines Gesetzes zur Unternehmens-*

measure, the final court decision will only be relevant for damage claims.[55] Moreover, any settlement must be published.[56] Thus, the *UMAG* mitigated incentives for both suit claimants and managers to strive towards shady settlements to the detriment of the shareholder constituency. The first experiences with this policy instrument show positive results. Since the implementation of the *UMAG*, even fiercely contested transactions can be cleared and go ahead in 6 to 10 months (including a review of the regional courts' decision by the provincial court ('Oberlandesgericht')).

(c) Disclosure of Executive Remuneration ('VorstOG')

German accounting law traditionally only required the disclosure of the remuneration of the board as such. However, in early 2005, the European Commission recommended disclosing the managers' individual, rather than their collective, salary, for all Europe.[57] Following this recommendation, the *Bill on the Disclosure of Members of the Board of Management* [*VorstOG*][58] required companies to disclose the remuneration that each member of the board of management receives individually. However, the shareholders' majority of 75% of the shares represented in the meeting may renounce the obligation to individually

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integrität und Modernisierung der Anfechtungsklage (The Federal Secretary of Justice's UMAG Draft) NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2004) 253-254.

[55] If the court of first instance (in the preliminary proceeding) holds that the measure may take place and the main court eventually finds the measure to be illegal, the claimants may be reimbursed for their damages. The measure itself, however, will nevertheless be deemed to be legal by the force of the preliminary judgment, s. 246a (4) of the *Aktiengesetz* (*UMAG*).

[56] Ss. 248a, 149 of the *Aktiengesetz (UMAG).*

[57] The European Commission, *Commission Recommendation on fostering an appropriate regime for the remuneration of directors of listed companies* (14.12.2004), 2004/913/EC, OJ L 2004 385/55.

[58] *Vorstandsvergütungs-Offenlegungsgesetz* - VorstOG (03.08.2005), BGBl. I (2005), 2267; the *VorstOG* amends ss. 285, 286, 289, 314, 315, 334 of the *Handelsgesetzbuch*

disclose managers' emoluments**.** The Federal Government decided to intervene, because most public German companies refrained from disclosure – in similarly uniform fashion that most companies complied with regard to the other recommendations – despite the fact that the GCGC had recommended an individual disclosure of the remuneration of each manager since 2003. In light of the widely discussed examples provided by *Mannesmann AG* and *Metallgesellschaft AG,* the *VorstOG* is particularly detailed with regard to severence payments.

2. Securities law

While the corporate law reforms of 2005 merely sought to adjust procedural provisions, the securities law agenda comprised changes of substantive provisions as well. It consisted of three measures dealing with the relationship between investors and corporations[59] and at least three measures reforming the institutional framework of the capital markets.[60] We focus on the former steps.

(*Commercial Code*), which regulates parts of German accounting law applicable to public corporations.

[59] *Anlegerschutzverbesserungsgesetz* (*Bill on the Improvement of Investor Protection – AnSVG*) (29 October 2004) BGBl. I (2004) 2630; *Kapitalanleger-Musterverfahrensgesetz – KapMuG* (*Bill introducing an Example Procedure for Investor Suits*) (16 August 2005), BGBl I (2005), 2437, as amended; *Prospektrichtlinie-Umsetzungsgesetz* (22 June 2005) BGBl. I (2005) 1698. The fourth measure, the *Kapitalmarktinformationshaftungsgesetz – KapInhaG (Bill pertaining to the Liability for Capital Market Information)*, was re-shelved after criticism from public companies. See on the background of the KapInhaG Baums, "Report", *supra* note 26; H Fleischer, Opinion for the 64th session of the Verein Deutscher Juristentag e.V. (German lawyers' society - DJV), in DJV (ed), 64th session of the DJV (Beck, Munich: 2002) F99.

[60] *Investmentmodernisierungsgesetz (Bill on the Modernization of Provisions Related to Investment Companies)* of 15.12.2003, BGBl. I (2003) 2676; *Gesetz zur Umsetzung der Richtlinie 2002/87/EG des Europäischen Parlaments und des Rates vom 16. Dezember 2002 - Finanzkonglomerate-RL-Umsetzungsgesetz (Bill Implementing the European Rules on Financial Conglomerates)* (21.12.2004), BGBl. I (2004) 3610; *Gesetz zur Änderung der Vorschriften über Fernabsatzverträge bei Finanzdienstleistungen* (*Fernabsatz-Finanzdienstleistungsgesetz)* (*Bill regulating the Distant Selling of Financial Services*) of 02.12.2004, BGBl. I (2004) 3102. Article 3 of the *Bill on the Improvement of Investor Protection* also contains institutional reforms.

(a) Market Abuse

The Bill on the Improvement of Investor Protection ('AnsVbG'), which was adopted at the end of October 2004,[61] strived for increased transparency and imposed civil and criminal liability for misconduct on securities market actors. Article 1 of this bill primarily implemented the European *Market Abuse Directive*,[62] and the provisions defining details thereof,[63] which have been enacted according to the European Lamfalussy-procedure.[64] We deem four aspects to be particularly relevant.

(1) The first aspect regards current change reports. German law has traditionally distinguished inside information from facts that triggered current change reports. Pursuant to Article 6 (1) of the *Market Abuse Directive*, an issuer has to file current change reports regarding any inside information which directly concerns such issuer. That is, unless, the issuer delays disclosure under its own responsibility pursuant to Article 6 (2) of the *Market Abuse Directive*,[65] it must

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[61] *Supra* note 59.

[62] *Directive 2003/6/EC of the European Parliament and of the Council on insider dealing and market manipulation* (28.01.2003) OJ 2003 L 096/16.

[63] Commission Directive 2004/72/EC of 29.04.2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions; Commission Directive 2003/124/EC of 22.12.2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation; Commission Directive 2003/125/EC of 22.12.2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest; Commission Regulation (EC)2273/2003 of 22.12.2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

[64] New procedure for deciding and applying securities legislation agreed by the European Council in March 2001 and endorsed by the European Parliament in February 2002 (see IP/02/195).

[65] "An issuer may under his own responsibility delay the public disclosure of inside information, as referred to in paragraph 1, such as not to prejudice his legitimate interests provided

make the aforementioned disclosure. The German *Securities Trading Law* was amended accordingly.[66] Furthermore, secondary insiders[67] who *forward* inside information or recommendations to buy or sell financial instruments were integrated into the range of regulatory offences as well. Previously to the *AnsVbG*, only those secondary insiders who were personally engaged in trading activities were subject to prosecution.[68]

(2) The second aspect of the AnsVbG is the implementation of the European *whistle blower provision* (Article 6 (9) of the *Market Abuse Directive*). The German *Securities Trading Law* now requires that financial intermediaries and stock exchanges notify the FSA ('BAFin') about any fact that gives rise to the assumption that a transaction might constitute insider dealing or market manipulation.[69] The duty to blow the whistle merely extends to the level of market institutions, but not to the level of the company: managers, employees, lawyers and public accountants do not have to notify securities agencies upon receiving knowledge of suspicious facts.

(3) Thirdly, European law defines in detail illegal practices of market manipulation. Its adoption through the AnsVbG required some changes to the German provisions on market manipulation which were enacted with the *Fourth Bill on*

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that such omission would not be likely to mislead the public and provided that the issuer is able to ensure the confidentiality of that information."

[66] In ss. 12 et seq., esp. 15 of the *WpHG* (*Securities Trading Law*), (hereinafter WpHG), but also ss. 37b, 37c of the *WpHG* pertaining to civil liability.

[67] I.e. those who received inside information from persons who have access to the source of company information (primary insiders).

[68] S. 39 of the *WpHG* will be changed accordingly.

[69] S. 10 of the *WpHG*.

the Improvement of Financial Markets in 2002.[70] The fact that the discovery of market manipulation does not require the malefactor to act in bad faith probably constitutes the most significant change. Rather, it suffices that his or her actions are *able* to manipulate the capital markets.[71] Furthermore, the specific actions considered to constitute market manipulation have been defined in an order issued by the Federal Secretary of Finance.[72] In addition, the German legislature adopted the European safe-harbour-regime,[73] which is likely to increase the level of certainty for market participants.

(4) Finally, Article 12 of the *Market Abuse Directive* mandated changes in the law governing the German FSA ('BAFin'). The BAFin was empowered to interpret and define details of European and German Securities Law provisions on a plethora of issues.[74] Thereby, the legislature intended to create the preconditions necessary for future adaptations of technical provisions, as well as cooperation between European securities regulators.[75] Though the vesting of extensive powers in a federal agency is a well known phenomenon (for example in the United States), the German constitution requires that all material provisions

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[70] *Supra* note 12.

[71] S. 20a (1) of the *WpHG*.

[72] See Federal Secretary of Finance, *Verordnung zur Konkretisierung des Verbotes der Marktmanipulation – MaKonV (Order with respect to the appropriation of market manipulation)*, 01.03.2005, BGBl. I (2005) 515.

[73] Pursuant to Article 1 (2) *Market Abuse Directive* and Art. 4 and 5 of Commission Directive 2003/124/EC (22.12.2003), *supra* note 63. The Regulation of the German Federal Secretary of Finance on the Specification of the Prohibition of Market Manipulation of 11.11.2003, BGBl. I (2003) 2300, augments European law.

[74] E.g., see ss. 15 (7), 29, 35 (4), 36 (5), 37i (1) S.3, 37m S.3 of the *WpHG*.

[75] See Article 16 of the *Market Abuse Directive*, implemented through Article 36c of the *WpHG*.

are enacted by Parliament.[76] The extended powers of the BAFin, even though they may be justified under European law, may conflict with this requirement.

(b) Prospectuses

The *Bill implementing the Prospectus Directive*[77] also emanated from European reform activity which was triggered by the Financial Services Action Plan.[78] The reform abolished the legislative distinction between a public offering of securities (previously regulated in the *Verkaufsprospektgesetz*) and the offering of securities that are allowed to be traded at a stock exchange (previously regulated in the *Börsengesetz*). As both kinds of securities are dealt with in the new *Wertpapierprospektgesetz* (Law on Securities Prospectuses),[79] the relevant sections of the aforementioned laws and orders thereon are repealed. Furthermore, before the *Bill implementing the Prospectus Directive* was adopted, stock exchanges had jurisdiction with respect to the formal review of prospectuses with respect to securities admitted to stock exchanges, while prospectuses for public offerings were reviewed by the Federal Financial Services Agency

[76] See the Federal Constitutional Court's decision in *Kalkar*, BVerfGE 49, 89, 126; *Hochschulorganisationsrecht*, BVerfGE 61, 260, 275; *Familiennachzug*, BVerfGE 76, 1, 74; *C-Waffen*, BVerfGE 77, 170, 230 (Wesentlichkeitstheorie).

[77] *Supra* note 59. Further relevant determinations are: (1) German issuers can choose whether they want to issue German and English or merely English prospectuses; (2) a simplified authorization procedure exists with respect to bonds; (3) the law defines the date up to which an issuer must update a prospectus.

[78] The Prospectuses Directive (*Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC* (04.11.2003) OJ 2003 L 345/64 and the *Commission Regulation implementing the Prospectus Directive* (29.04.2004) OJ L 2004 215/3 [Prospectuses Regulation] strive for easier access to capital in Europe, as well as increased transparency and market integrity. By harmonising the necessary disclosure requirements, the new legal framework as a whole creates an effective "single passport" for both EU and non-EU issuers. The Regulation will come into force 01.07.2005, the day on which the deadline for Member States to implement the Framework Directive expires.

[79] Pursuant to Article 1 of the *Prospektrichtlinie-Umsetzungsgesetz*, *supra* note 59; see J Ekkenga, *Änderungs- und Ergänzungsvorschläge zum Regierungsentwurf eines neuen Wertpapierprospektgesetzes (Suggestions for altering and supplementing the draft for a Wertpapierprospektgesetz)* BETRIEBSBERATER (2005) 561.

("BAFin"). Now the BAFin reviews all types of prospectuses. The BAFin was thereby turned into a fully-integrated securities regulator. This improved the agency's standing in Europe and beyond. Moreover, the measure reduced the stock exchanges conflicts of interests when reviewing draft prospectuses. However, with respect to provisions imposing liability for wrongful disclosure, the legislature retained the traditional distinction between the *Verkaufsprospektgesetz* and the *Wertpapierprospektgesetz*.

(c) Collective Investor Suits

The third securities bill was rooted in the Federal Government's Ten-Step Program and concerns procedural issues relating to class actions. Traditionally, German corporate law did not allow for class action suits; with two consequences: Firstly, courts could barely handle large-scale securities actions in an orderly and timely fashion. Secondly, substantive claims for misleading disclosure and market manipulation were unlikely to be realized due to the high costs and risk of corporate and securities litigation that the first claimant had to bear.[80] The German legislature addressed these problems with the *Law on Example Procedures for Investor Suits*.[81] The new legislation enabled shareholders to take advantage of collective suits without importing the flaws of American type securities class actions that are, as mentioned above,[82] considered to be particularly lawyer-, rather than investor-driven.

Therefore, the law requires that a disclosure-related law suit must be registered with the electronic Federal Bulletin by the regional court at which the law suit is

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[80] With respect to "collective action problems" regarding shareholder suits see *supra* note 42.

[81] *Supra* note 59. For details, see F Reuschle, *Das Kapitalanleger-Musterverfahrensgesetz (The Law on Example Procedures for Investor Suits*) NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2004) 590.

[82] *Supra* note 39.

filed. As soon as 10 law suits are registered, the provincial court ('Oberlandesgericht') will decide upon the factual basis of the claims and certain legal questions that were previously prepared by the regional court.[83] During this procedure, the claimant with the first registered claim becomes the "sample claimant". Other claimants may support the sample claimant's evidence and procedure.[84] Once the provincial court has decided upon the sample claimant's claim, the respective regional courts will deal with the peculiarities of the other claims. If the court dismisses the claim, all claimants will share in the costs of the sample procedure.[85]

3. Accounting law

(a) Independence of Auditors

Finally, the German government reformed accounting law to a significant extent. In addition to a general tendency towards enhancing the scope of application of the International Financial Reporting Standards (IFRS), the *Accounting Reform Law*[86] strengthened auditor independence. The significance of these alterations was demonstrated by the international scandals surrounding *Enron* and *Worldcom*, as well as *Ahold* and *Parmalat*. The *Accounting Reform Law* imposed strict rules through a variety of measures which emphasize the principle "Keep your distance!" - Accountants should keep their distance from companies by avoiding any relationship with a company beyond that of accountant-client.[87]

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[83] S. 1 of the KapMuG.

[84] Ss. 4 (1), 8(1), 12 of the KapMuG.

[85] Ss. 17 of the KapMuG.

[86] *Gesetz zur Einführung internationaler Rechnungslegungsstandards und zur Sicherung der Qualität der Abschlussprüfung* (Bilanzrechtsreformgesetz – BilReG) of 4.12.2004, BGBl. I (2004) 3166.

[87] Otherwise, as J C Coffee, Jr., *What caused Enron? A capsule social and economic history of the 1990s* 89 Cornell L.R. (2004) 269 states, the market will understand payments

Before the adoption of the *Accounting Reform Law*, auditors were prohibited from certifying financial statements when they had participated in keeping the books, prepared the company's financial statements, or when they had received more than 30 percent of their turnover from a single client. The *Accounting Reform Law* lowered the threshold to 15 percent of the turnover. In addition, auditors are prohibited from certifying statements when they supply material management or financial services and insurance, or evaluation services to the company. Accountants for corporations listed at regulated markets and companies that offer financial and insurance services must not supply tax or law consultancy with regard to the same financial statement that they certify; they must not appear in court for the company and must not implement computer systems for book-keeping purposes.

(b) Unveiling Accounting Deficiencies

Moreover, in seeking to encourage accountants' diligence, the *Accounting Control Law*[88] introduced a two-step enforcement procedure for corporations listed at regulated markets. The first step is executed by a privately organized body, termed the 'checkpoint for accounting statements'. This institution reviews statements of companies where there is some evidence of inaccurate accounting. Furthermore, it undertakes random checks and reviews on behalf of the German FSA. If it finds that there are indeed accounting failures, it cooperates with the firm in order to correct the statements. As a second step, if the "check-

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from the firm to the accountant as "bribes", and the reduction of these payments as "punishment".

[88] "G*esetz zur Kontrolle von Unternehmensabschluessen* (Bilanzrechtskontrollgesetz – BilKoG)" of 15.12.2004, BGBl. I (2004) 3408.

point" and the company do not agree on an accounting issue, the FSA may examine the statements by itself and impose enforcement measures.

Three aspects of the *Accounting Control Law* appear to be at odds. Firstly: the "checkpoint for accounting statements" is a control institution in which the body of publicly certified accountants watches its peers. Rather than establishing another semi-independent institution, the legislature should have focused on providing the accounting professionals with the proper incentives for remaining independent. Secondly, the control institution has no jurisdiction of any kind about the issue on which it is deciding. Consequently, without *res judicata* of the checkpoint's decision, from a legal point of view, there is no benefit to the company, other than that it receives an additional opinion on an accounting issue.[89] Thirdly, accounting law is made on an international and European level. The control institution, however, is to be established and financed by parties within the "German economy". We wonder whether this is appropriate for companies with an international focus.

(c) Enforcement

Eventually, the *Law on the Supervision of Accountants*[90] increased the pressure on accountants by means of a further method. It implemented an independent body - the *Abschlussprüferaufsichtskommission* (Accounting Supervisory Committee - APAK) under the supervision of the German Federal Secretary of

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[89] B Grossfeld, *Bilanzkontrollgesetz – Offene Fragen und etwas Optimismus (The Accounting Control Law – Open questions and some optimism)* NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2004) 105, suggests giving the *Accounting Control Law* the benefit of the doubt: Given the seismic changes that currently shake the accounting law and the accounting profession, a privately organized control institution would be a capable forum for a get-together of professionals who are on the lookout for the appropriate solution. We are convinced, however, that public corporations will not be willing to pay tutorial lessons for highly-paid accounting professionals for a long time.

[90] Abschlussprüferaufsichtsgesetz (APAG) of 27.12.2004, BGBl. I (2004), 3846.

Business and Labor – in order to supervise the self-administration and self-supervision system currently exercised by the *Wirtschaftsprüferkammer* (Association of Publicly Certified Accountants).

Given that the German tech bubble was not characterized by large scale accounting fraud (with regard to retrospective information), but by the abuse of forward-looking information which is not subject to an auditor's review, we doubt that all these steps together were necessary, and that it was, in fact, a wise step to implement all these measures in a very short period of time. It is likely that with respect to accounting law, waiting would have reduced the need for extensive legislation – to the benefit of society.[91] Furthermore, if one had sought to increase the pressure on accountants, the lifting of the liability-privilege that accountants enjoy under German law[92] would have been a less expensive, but at the very least an equally efficient measure in increasing accounting diligence.

4. Catching up with international developments

Though the sheer volume of changes hinders discrete systemization, the reforms that were adopted in the first half of the second decade exhibit four tendencies.

(1) Almost all of the legislative steps sought to provide investors with **better information**. This is particularly true with respect to the abundance of enforcement measures, which should guarantee that managers and accountants do

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[91] See F Paris, V Fon & N Ghei, *The Value of Waiting in Lawmaking*, 18:2 EurJ L & Econ. 131 (2004.

[92] Subject to s. 323 of the *Handelsgesetzbuch*, accountants are merely liable vis-à-vis the corporation. Further, liability is capped at € 4 Mio. for each financial review of a public corporation.

their job correctly. This information may be used for exercising both explicit influence – the traditional German way; as well as implicit influence – the new market-oriented way.

(2) Apart from the adjustments to the decision-directed suit, the reforms generally strengthened **shareholder rights to sue to a significant degree**. From a German point of view, the additional shareholder rights to sue constitute the most spectacular step. This pertains to suits which an Anglo-American observer would consider to be derivative suits, as well as to those which are filed for "regular" securities fraud. A consequence of this change is that certain powers will be shifted from the supervisory board to shareholders and investors.

It is unclear, however, whether investor and shareholder suits will, in fact, strengthen the overall supervision of managers in a two-tier board system,[93] or whether it will deter day-to-day supervision with a "race to court." Traditionally, the German supervisory board did not only fulfil responsibilities inherent to the board in one-tier board systems, but its existence also mitigated shareholder rights to sue officers for damages to the corporation.This is because the legislature traditionally assumed that the supervisory board, with the best information, would have the best preconditions for assessing whether a suit against officers is worth the efforts, or whether other efforts are deemed more effective.

(3) The German legislature strived for **additional improvements to the law on shareholder meetings**. A foreign spectator might wonder whether the share-

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[93] As Baums/Scott, *supra* note 38, expect.

holder meeting may be characterized as a corporate governance device. Remarkably, the argument that rational shareholders would not invest time and money in the participation at shareholder meetings - the well-known "rational apathy" argument[94] - does not seem to hold water with respect to German shareholders. In fact, more than 4,000 shareholders (as individuals), on average, attend the meetings of the thirty largest German publicly listed corporations.[95] We hold that, despite some conceptual weaknesses, this surprisingly high turnout catalyzes at least some positive effects, which cannot be considered in detail here.[96] However, European (non-German) and international shareholders do not participate in German shareholder meetings to the same extent. Consequently, the government's measures primarily seek to achieve higher *international* turnouts (since German turnout is already high), by facilitating cross-border authorization and the use of the internet in all procedural steps of the meeting.

Other than with respect to shareholder meetings, we did not see any changes to substantive corporate law. Instead, the German government focused on the better enforcement of duties that already existed. We account for the relatively

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[94] The Berle & Means concept (in: The Modern Corporation and Private Property (1933) 64-65, and 244 et seq.) has been repeated over and over again, see R C Clark, CORPORATE LAW (1986) 390; E Latham, *The Commonwealth of the Corporation* 55 Nw. U.L.R. (1960) 25; H G Manne, *Some Theoretical Aspects of Share Voting – An Essay in Honor of Adolf A. Berle*, 64 Colum. L.R. (1964) 1427, 1437-8; F H Easterbrook & D Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW (HUP: 1991) 77; M M Siems, DIE KONVERGENZ IM RECHTSSYSTEM DER AKTIONÄRE (THE CONVERGENCE OF LEGAL SYSTEMS IN THE LAW ON SHAREHOLDERS – A STUDY ON COMPARATIVE CORPORATE GOVERNANCE IN THE ERA OF GLOBALISATION), (2005) at 72 et seq.

[95] Zetzsche, *Explicit and Implicit System*, at B.III.3.b).

[96] On the benefits, see *idem*, at B.III.3.c). On the conceptual weaknesses, see U Noack, *Hauptversammlung und Internet: Information – Kommunikation – Entscheidung (Shareholder Meetings and the Internet: Information, Communication, Decision)*, CBC Research Paper, online < http://ssrn.com/abstract=646723 >.

modest type of adjustments by the fact that the current law has proven to be quite effective for big companies that typically abide by the rules. Thus, substantial changes do not seem appropriate whilst enforcement, a matter that is particularly relevant for smaller companies, does.

(4) Finally, we have shown that the state increasingly interfered with the corporate conduct of publicly listed companies. It did so by means of quasi-mandatory provisions, such as the Corporate Governance Code, or through public regulation, with the extensive powers given to securities regulators. All of these reforms, however, have pushed German legal resources to the limits. Many of the aforementioned laws were hastily written and/or hastily adopted by the legislature – a procedure which experience shows is likely to result in inaccuracies and methodical flaws. Time pressure also often resulted in an Anglo-American detail-oriented style of drafting, as time for developing self-evident principles (rather than rules) were scarce. Since practice tends to construe detail-oriented rules narrowly, we expect either the costs of enforcement to rise or the necessity of subsequent rectification of legislative deficiencies to come up in the near future. Moreover, the reforms of the year 2005 also required an immense effort in corporations, the government, law firms and German academics.

Many of these provisions are prompted by European regulators. Hence, it would be misleading to attribute the whole increase in regulatory measures to the German authorities. Furthermore, regulatory density is an international trend which is apparently rooted in the U.S. We are, however, critical as to whether dense regulation is likely to mitigate the criminal intent of those who want to abuse securities markets. Rather, criminals tend to deem themselves cleverer

than the system which they abuse. It certainly does, however, raise the costs of the companies that are subject to these rules.

German corporations provided some evidence of this assessment when they deemed the reforms to securities law adopted from 2004 through 2005 (based on European law, but created under significant U.S. influence) entirely useless.[97] In fact, the adoption of these rules deterred German companies and biased them against American-style rule-based law making. It is therefore hardly surprising that the American capital markets have lost some of their appeal to European issuers.[98]

Putting the macro-perspective aside; as an intermediate result, we hold that the reforms in Germany in 2005 have followed the same pattern as all reforms that took place during the first decade of Germany's 'permanent corporate law reform': The German government endeavoured to invigorate *the capital markets*, thereby securing their pricing and monitoring functions by implementing rules that enable both public and private enforcement. In this way the reforms of 2005 brought the German securities law in line with traditionally (more) market-oriented jurisdictions, such as England and the United States. At the same time, the traditional, explicit measures retained their place in the German system of corporate control.

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[97] Deutsches Aktieninstitut e.V., *Kosten und Nutzen der Regulierung börsennotierter Unternehmen (Costs and benefits of regulating public companies)*, März 2007, available at www.dai.de.

[98] See, for example, T Tröger, *Corporate Governance in a Viable Market for Secondary Listings*, CBC Research Paper (2007), available at < http://ssrn.com/abstract=965488 >.

B. THE GRAND COALITION: PREPARING FOR COMPETITION

The pace of corporate law reform did not slow down under the Grand Coalition.

1. Adopted Legislation

Most legislative activity was prompted by European Law: As a first step, the German legislature implemented the *Disclosure Directive* of 2003,[99] the *Transparency Directive*,[100] the *Takeover Directive*,[101] the Directive on *Cross-border mergers,*[102] the *Markets in Financial Instruments Directive* ('MiFiD')[103] and the rules on the European Cooperatives.

(a) Takeovers

The European Takeover Directive[104] establishes minimum guidelines for the conduct of takeover bids involving the securities of publicly listed companies governed by the laws of Member States. When the German legislature enacted its takeover legislation in 2001, it had anticipated the adoption of the Takeover Directive. Consequently, the finalisation of the Takeover Directive rendered only minor amendments to the German Securities Trading- and Takeover Law

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[99] *Directive 2003/58/EC of the European Parliament and of the Council amending Council Directive 68/151/EEC, as regards disclosure requirements in respect of certain types of companies* (15.07.2003) OJ 2003 L 221/13.

[100] *Transparency Directive on the requirements for information provided about issuers whose securities are admitted for trading on a regulated market* (17.12.2004) OJ 2004 L 390/38.

[101] The *Directive 2004/25/EC of the European Parliament and of the Council on takeover bids* (21.04.2004) OJ 2004 L 142/12.

[102] *Directive 2005/56/EC of the European Parliament and of the Council on cross-border mergers of limited liability companies* (26.10.2005) OJ 2005 L 310/1.

[103] *Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC ('MiFiD')* (21.04.2004) OJ 2004 L 145/1.

[104] *Supra* note 101.

(‘*WpÜG*’) necessary. These changes were made with the *Bill implementing the Takeover Directive*[105] which essentially focuses on four measures:

Firstly, it implements the **European passport for cross-border takeover activity**. As a general principle, the authority competent to supervise a bid is that of the Member State in which the target has its registered office, if that company's securities are admitted to trading on a regulated market in that Member State.[106] Extending this principle, s. 11 a *WpÜG* requests the German BAFin to allow the execution of a bid within Germany based on the offering memorandum that is approved by the securities regulator of the Member State in which the target is incorporated. Thus, if an English bidder targets a Dutch company that is listed in Amsterdam and Frankfurt, the bidder is merely required to receive approval for its offering memorandum by the Dutch Autoriteit Financiele Markten (AFM). The European passport for takeover bids (hence, the purchase of securities) is the reverse of the European passport for the *issuance* of securities (hence, the sale) as required by the Prospectus Directive.[107] We welcome this development, as it complements the Single Financial Market in Europe.

The second key aspect of the *Bill implementing the Takeover Directive* is **takeover defences**, hence implementing the complicated European law on management neutrality, anti-frustration break-through rules and reciprocity. As a principle, European and German law prohibits any defensive measures and re-

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[105] Übernahmerichtlinie-Umsetzungsgesetz (08 July 2006), BGBl I (2006), 1426. In addition to the amendments discussed herein, all disclosures must be made through the electronic version of the Federal Bulletin at www.e-bundesanzeiger.de . We discuss the new disclosure system *infra* at note 131.

[106] Article 4 (1) of the Takeover Directive.

quires a board's neutrality in relation to the bid.[108] This means that the board of the offeree company may not take any defensive action, other than seeking alternative bids, which may result in the frustration of the bid. This is particularly true with respect to the issuance of shares to investors other than the bidder ('poison pill').

This anti-frustration rule is subject to three exemptions. In addition to an *ordinary-business exemption*, the target's *shareholders* may lift the ban on frustrative measures by authorizing management to defend the company's independence with certain, precisely defined defences.[109] This authorization may materialize in the form of prior authorisation, approval or confirmation. German takeover law limits the validity of these authorisations for a period of up to 18 months after the shareholders' decision. Furthermore, *measures* upon which the target's management *decided before the offerer's bid* was published may be executed according to plan.

Moreover, under German law the supervisory board may authorize defensive measures.[110] Despite theoretical agitation, this exemption has been subject to little concern in practice, given that when authorizing defensive measures, the supervisory board must make its decision in the company's best interest.[111] Thus, the sale of the crown jewels cannot be justified by relying on this clause. This does not change the fact that the supervisory board exemption is inconsistent with the anti-frustration rule of Article 9 of the Takeover Directive. Member

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[107] Article 17 and Recitals (1), (4), (14), (17), (45) of the Prospectus Directive, *supra* note 78.

[108] Article 9 of the Takeover Directive; s. 33 *WpÜG*.

[109] Article 9 (2) and (3) of the Takeover Directive; s. 33 (2) *WpÜG*;

[110] S. 33 (1) sent. 2 *WpÜG*.

States are, however, entitled to opt out of the anti-frustration rule.[112] If a Member State does so, it must grant the general meeting of shareholders the right to opt into the anti-frustration regime - a measure which signals openness for market control as well as potential bidders to investors. The German legislature decided to grant German companies the supervisory board-exemption as long as other Member States in which voting caps, multiple voting rights and restrictions on the transfer of shares are common, remain on their protective path. Shareholders may opt into the anti-frustration rule by adding a clause to the Articles of Association which states accordingly.[113]

The Takeover Directive tried to challenge the anti-takeover sentiment that is common in many Member States, and the spiral of reciprocity that it triggers, with complicated Rules on breakthrough and reciprocity which the *Bill implementing the Takeover Directive* transformed into the *WpÜG*.[114] In many Member States, Articles of Association and contractual agreements provide restrictions on the transfer of securities, voting caps and multiple voting rights. With regard to takeover situations, the **Break-Through-Rule** of the Takeover Directive nullifies such entitlement in principle.[115] Furthermore, where, following a bid, the offeror holds at least 75 % of the capital carrying voting rights, no restrictions on the transfer of securities, on voting rights, nor any extraordinary rights of shareholders concerning the appointment or removal of board mem-

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[111] Noack in Schwark, Kapitalmarktrechtskommentar, § 33 *WpÜG* Rn. 18.

[112] Article 12 of the Takeover Directive.

[113] Article 12 (2) of the Takeover Directive; s. 33a (1) *WpÜG*.

[114] Article 11 and 12 of the Takeover Directive, ss. 33a – d *WpÜG*.

[115] Article 11 (2) and (3) of the Takeover Directive.

bers provided for in the Articles of Association of the target apply.[116] However, *Member States* may opt out of the Break-Through Rule,[117] and many Member States have decided accordingly. While German legislature entitled the shareholders to decide upon whether they wanted to apply the Breakthrough rule to their company,[118] the Break-Through Rule is of little meaning for German companies. This is due to the fact that defensive measures under German law are reduced to extraordinary rights concerning the appointment of board members, and very few German companies rely on these additional rights.[119]

Thus, the **Reciprocity Rule** is particularly important for German target companies. Under the Reciprocity Rule, Member States may, under the conditions determined by national law, exempt companies from applying the anti-frustration rule (Article 9 and 11 of the Takeover Directive) if they become the subject of an offer launched by a company which does not apply the anti-frustration rule itself.[120] It is the rationale of the Reciprocity Rule that only bidders who may be successfully targeted themselves are allowed to take advantage of a liberal approach towards takeovers. If the bidder's corporate law allows for defensive measures, the target may defend itself with equivalent measures, if its shareholders decide accordingly. Accordingly, s. 33c of the *WpÜG* entitles shareholders to opt into Reciprocity.

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[116] Article 11 (4) of the Takeover Directive.

[117] The German takeover law meets the requirements of the Takeover Directive through implementing the break-through rule in ss. 33a – d *WpÜG*.

[118] S. 33b of the *WpÜG*.

[119] Multiple voting rights and voting caps have been abolished in 1998 with a transition period of five years having expired in 2003 (S. 12 (2) of the AktG; s. 5 EG AktG (1998). Further, while restrictions on the transferability of shares are legal, management of public companies must consider the principle of equality as well as the best interests of the corporation when deciding upon whether it enforces the restriction on transferability. As a result, management of corporations listed at regulated markets may rarely used restricted shares as a takeover defence.

[120] Article 12 (3) of the Directive.

We note that many questions surrounding the Breakthrough and Reciprocity Rules have yet to be answered. In particular, can a company which is privately held be subject to the rules of Articles 9 and 11 of the Directive that, by definition, merely apply to companies listed at a regulated market within the EU Member States? In other words, may a bid by Hedge Funds and private equity funds which are typically privately held investment vehicles allow for reciprocity? Furthermore, which law do we apply to bids by European companies that are controlled by companies outside of the Common Market? For example, do the anti-takeover rules of companies incorporated in U.S. federal states allow for reciprocity? The Reciprocity principle essentially means a quid-pro-quo of corporate laws: Only companies that may be subject to a takeover bid themselves can request the target company to release their defences. Consequently, companies may use any defensive measure against bids by privately held companies and by parent-companies sheltered by the walls of American state anti-takeover laws.

The third significant amendment to the *WpÜG* is the introduction of a right to **freeze out** minority shareholders, or request the **sell out** of their shares that entirely depends on the success of the previous bid.[121] Since 2001, Germany's Aktiengesetz entitles a majority shareholder holding 95 percent of the shares to freeze out the remaining shareholders. Consideration for the outstanding shares must be set in recognition of the fair value of the stocks, which has to be set in recognition of stock prices. In addition, a book-based pricing mechanism tests

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[121] Ss. 39 a – d *WpÜG*, implementing Articles 15 and 16 of the Takeover Directive.

whether the fair value of the company is, in fact, higher than the market value of its shares. This evaluation is typically contested. Consequently, the final consideration for the outstanding shares is settled in a lengthy review of the evaluation by the courts. The *WpÜG* adds a freeze out regime to German law that entirely relies on a market-based pricing mechanism. If, following the offer, 90 percent of the shares to which it refers are tendered, the price of the bid is deemed a fair price of the shares.

Practitioners criticize the ownership threshold of 95 percent, and the required success-rate of 90 percent as too high. From a comparative point of view it is often the case that ownership thresholds of 90 percent, and / or success rates of less than 90 percent, suffice.[122] Since freeze outs expropriate minority shareholders, care is warranted. We deem the court-administered evaluation procedure that German corporate law requires a fair alternative with respect to shares that are sparsely traded, and thus where stock prices are not reliable. By contrast, if the scope of the bid comprises most or all of the equity, a 90 percent ownership threshold for the entitlement to freeze out, and a success rate of 75 percent of the outstanding shares should work fine. The latter should also discourage Hedge Funds with event-driven strategies based on freeze out thresholds.

Furthermore, if a bidder holds 95 percent of the shares following the bid, minority shareholders may request that the bidder purchases their shares according to the terms of the bid. Since 1965, however, German law has granted minority

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[122] A comparative view provide C van der Elst & L van den Steen, *Opportunities in the M&A After Market: Squeezing Out and Selling out*, (2006), available at < http://ssrn.com/abstract=933609 > .

shareholders a sell-out right, if the majority holder entered into a control agreement ('Beherrschungs- und Gewinnabführungsvertrag') with the target company. Majority holders typically enter into such agreements in order to receive the right to deal with the target at their will. In return, they must compensate minority shareholders. Given that entering into control agreements is, in practice, a step that we typically see prior to the freeze out of the majority, and stock prices of sparsely traded stocks are typically higher than the price offered in the bid, we believe that the sell out right has little meaning for transactions involving German companies.

The fourth focus of the Bill is **disclosure**. Any means that might impede a bid in the future must be disclosed in the company's Annual Report.[123] All decisions on the authorization of defensive measures must be included in the Articles of Association, whose current version is kept at the Commercial and Enterprise Registers (*Handelsregister*). Any document relating to the bid or the target's response must be disclosed in the internet, disseminated to market participants, or disclosed in the Federal Bulletin.[124]

(b) Cross-border Mergers

The *Second Bill on the Amendment of the Transformation Law*[125] also follows on from European law. Putting a few minor amendments aside which provide more flexibility and certainty to corporate transactions, the reform primarily seeks to implement the European *Directive on Cross-Border Mergers of Limited*

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[123] Ss. 289 (4) and 315 (4) of the *Handelsgesetzbuch*.

[124] For example, s. 10 (3) *WpÜG*: notice announcing a bid; s. 14 (3) *WpÜG*: offer document; s. 16 (3): convocation of a shareholder meeting deciding upon the acceptance of the bid, or defensive measures, respectively.

Liability Companies.[126] This Directive aims to facilitate cross-border mergers between limited liability companies in the European Union by proposing a simplified legislative framework. The measures envisaged by the EU are designed to reduce the cost of such operations, to guarantee their legal certainty and to offer the option of cross-border mergers to the maximum number of companies, particularly those not wishing to set up a European Company ('SE').

The German legislature seeks to meet this requirements by introducing a new chapter of the *Transformation Law* ('UmwG') dealing with cross-border mergers of privately held limited companies ('GmbH') and stock corporations ('Aktiengesellschaften').[127] In addition it seeks to comply with the European Court of Justice's judgement in re SEVIC Systems AG[128] regarding the cross-border amalgamation of a German *Aktiengesellschaft* with a Société Anonyme incorporated in Luxembourg.

Among the substantive provisions introduced by the reform, the entitlement to apply for a review of the evaluation on which the merger is grounded deserves particular attention.[129] Under this provision, shareholders of a foreign company that amalgamates with a German company may apply to court in order to achieve the re-evaluation of their own company, and thus better compensation, given that their own law would entitle the shareholders to a procedure that is equivalent to the German 'Spruchverfahren' if the amalgamation partner was a domestic company. Thus, Austrian shareholders may apply to German courts to

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[125] *Zweites Gesetz zur Änderung des Umwandlungsgesetzes* (19 April 2007) BGBl. I (2007), 543.

[126] *Supra* note 102.

[127] Ss. 122a – 122l of the *Transformation Law*.

[128] *Supra* note 2.

[129] S. 122h of the Transformation Law; s. 6c of the Spruchverfahrensgesetz.

open a *Spruchverfahren*. If the evaluation procedure is alien to the law of the amalgamated foreign company, the interests of its shareholders may be represented in German courts through a representative.

Obviously, in cross-border mergers corporate cultures are likely to clash. In light of this observation it will be interesting to see how for example British companies will respond to re-evaluation of amalgamation-mergers by German courts years after the closing of the transaction. The broad jurisdiction of German courts in protecting minority shareholders in merging companies negatively affects certainty, and will thus affect the price that bidders are willing to pay for German companies. On the other hand, the speed of corporate transactions may increase if questions of fair evaluation may be separated from questions regarding the procedure of the amalgamation. Moreover, minority shareholders in German companies are likely to purchase, or keep, their stock in controlled companies if they can be expected to be treated better (due to the threat that such a procedure provides) than their peers in foreign corporations. Thus, German companies are likely to get financing at better rates. Time will tell which of the two aspects will prove more important.

(c) Accessibility of Company Data

In two major reform bills commonly referred to as EHUG[130] and TUG,[131] the legislature adopted the amendments of the Disclosure Directive of 2003 and the

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[130] *Gesetz über elektronische Handelsregister, Genossenschaftsregister sowie das Unternehmensregister (Law on the electronic commercial, cooperative and enterprise register*) (10 November 2006), BGBl. I (2006) 2553.

[131] *Transparenzrichtlinie-Umsetzungsgesetz* (Bill adopting the Transparency Directive) (05 January 2007) BGBl I (2007) 10.

Transparency Directive with regard to the accessibility of company data through information storage and retrieval systems.

German and European law require both private and public companies to disclose far-ranging information to shareholders, creditors, other market participants and the public. The information that has to be disclosed under these rules is more extensive in scale and scope than those provided by data storage and retrieval systems that merely focus on corporations listed at regulated markets and the needs of the capital markets (such as the U.S. Edgar, or the Canadian SEDAR). However, prior to the recent reforms, two significant weaknesses of the German disclosure system were widely discussed among corporate scholars: The lack of efficient enforcement vis-à-vis private companies and the fragmentation of the system.[132]

In particular, German companies needed to distribute corporate information through various sources, including newspapers, the website of the corporation and those of stock exchanges, the Federal Bulletin and others. In order to curb this uncontrolled growth in the use of media for company disclosure, the Federal German government took the first step of launching an electronic version of the federal bulletin in 2003,[133] and mandating that *some* corporate information is published in this electronic version. The German legislature fixed these prob-

[132] Company data were subject to registration at systems that are organized and administered by local courts (so called "Handelsregister"), and were primarily published in local newspapers. Other information was accessible at the company's website, the websites of the stock exchanges and private information intermediaries, as well as the authorities involved in the supervision of corporate and securities law. The split jurisdiction of the German federal states and the involvement of manifold public, private, and semi-private actors in providing company information imposed significant costs upon those seeking company information.

lems for good with two major legislative projects that came into force on 1 January 2007: The Law regarding the Electronic Commercial and Company Registrar ('EHUG') and the Law implementing the Transparency Directive ('TUG'). Under these reforms, the newly established Federal Justice Agency enforces the disclosure obligations. In addition, the legislature provided a significant overhaul to the methods utilized, and the channels through which companies need to go in order to fulfil their disclosure obligations.

Through these reform bills, the German legislature established a "one-stop-shop option" for the *retrieval* of all company data that German companies must disclose under both corporate and securities law. It did so by setting up an integrated storage mechanism (www.unternehmensregister.de) and a dissemination mechanism (www.e-bundesanzeiger.de) run by a private entity.[134] This system is destined to become part of the European Business Register that is currently in the making.

By contrast, the *delivery* of company data by the issuers to the company register remains complicated. While the overall situation has improved significantly when compared to the status ex ante, companies still need to simultaneously distribute the relevant information through several channels. The "several-stop-delivery" concept is more complicated, and hence more costly to issuers than a one-stop-delivery system whose entry-gate is an officially administered or supervised website.

[133] Online: < www.ebundesanzeiger.de>.

[134] Theoretically, the dissemination platform is a useless double-feature. However, many provisions, of which most are required by European law, distinguish between the storage and the dissemination of information. Therefore, the legislature decided to implement both, but as technically connected measures. Users enjoy nevertheless a one-stop-shop.

It was the intention of the German Federal Secretary of Justice to implement such a one-stop-delivery system for both corporate and securities law-based information. However, the European rules and implementing of the Transparency Directive require a concept of intermediary-based dissemination for certain securities law-based information. Within this concept, issuers must forward their disclosures to informational intermediaries before they are allowed to disclose them in any other way. Disclosure in any other way includes storage in, and access through, an officially administered information storage and retrieval system. This intermediary-based approach is flawed given that European law neither defines the intermediaries (hence, issuers do not know where they should send their disclosures) nor does it require the intermediaries to publish the information sent to them by the issuers. Thus, transparency is a random effect. Moreover, internet-based technologies (such as RSS-feed etc.) render an intermediary-based concept for the dissemination of information on the whole useless. Unfortunately further reform is, therefore, warranted – on a European level!

(d) Transparency Directive

In addition to the storage, and retrieval, of corporate information, the *Transparency Directive* establishes standards for **shareholder information**, and **shareholder proxy voting**.

With respect to **shareholder information**, the *Transparency Directive* requires, in particular, information about the place, time and agenda of shareholder meetings, and the rights of holders to participate in meetings.[135] Member States

[135] Pursuant to Article 17 (2) of the *Transparency Directive*, *supra* note 100, share issuers are required to ensure that all of the facilities and information necessary to enable holders

must allow the use of electronic means for the purposes of conveying information to shareholders *if the shareholders so decide*.[136] If the shareholder meeting decides accordingly, the issuer must organize an electronic dissemination procedure.[137] Furthermore, the *Transparency Directive* entitles shareholders to exercise voting rights by **proxy**. In particular, the Directive requires that "issuers make available electronic or paper proxy forms to each person entitled to vote." We criticize the *Transparency Directive* to the extent that it interferes with the current transition from electronic proxy voting to electronic direct voting[138] by stipulating "proxy forms" rather than using open expressions.

(e) MiFiD

In spring 2007, the German Federal Assembly adopted the *Bill Implementing the Market in Financial Instruments Directive*, which comes into force in November 2007. Securities law seeks to enable smooth and efficient trading by

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of shares to exercise their rights, are available in the issuer's home Member State. Further, the *Transparency Directive* requires information about the total number of shares and votes that the company has. Pursuant to Article 21 (1) of the *Transparency Directive* the information must be disclosed on a timely and a non-discriminatory basis.

[136] Article 17 (3) of the *Transparency Directive*.

[137] Four conditions apply: 1) the use of electronic means may not depend upon the location of the seat or residence of the shareholder; 2) identification arrangements are to be put in place so that the shareholders are effectively informed; 3) shareholders are to be contacted in writing to request their consent to the use of electronic means, and their consent is deemed to be given if they do not object; and finally 4) the issuer is to determine the apportionment of costs entailed in the conveyance of information by electronic means.

As we discussed more in detail in an earlier work, some aspects of the information requirements problematic: 1) The fact that the shareholder meeting is to decide upon the level of information that *individual* shareholders can have access to provides an opportunity for majority shareholders to abuse the vote; 2) The "apportionment of costs" provision may hamper the establishment of cost-efficient solutions to dissemination problems; 3) Article 17 of the *Transparency Directive* merely requires dissemination of information to *market institutions*, such as information intermediaries. In addition, dissemination of meeting-related information to *shareholders* is required, in order to overcome adverse incentives to vote. See U Noack & D Zetzsche, *Corporate Governance Reform in Germany: The Second Decade*, 16:5 EBLR 1033 (2005).

[138] See references *supra* note 18

informed investors, at low transaction costs. We deem the MiFiD the core of the European Union's Financial Services Action Plan, since it connects the four European Directives that focus on substantive provisions (the Market Abuse Directive, the Prospectus Directive, the Takeover Directive and the Transparency Directive).

For Germany, as for the rest of Europe, the implementation of the MiFiD and its implementing measures[139] required a significant overhaul of the infrastructure of financial markets. In particular, the definition of 'financial services' was widened,[140] which on the one hand extended the BAFin's jurisdiction, and on the other enabled the providers of these services to rely on a European Passport, which means that they may offer their services without requiring further reviews by other financial services agencies. Furthermore, stock exchanges and other trading systems became subject to the same rules. These rules include transparency pertaining to both pre-trading and post-trading information.[141] Prior to the reform, German securities law had not required pre-trading transparency. In addition, the rules governing the organisation of financial services providers became more detailed with special respect to conflicts of interest, best execution,

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[139] Commission Regulation (EC) No 1287/2006 (10.08.2006) implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (Text with EEA relevance), OJ L 241 / 26 - 8; Commission Directive 2006/73/EC (10.08.2006) implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (Text with EEA relevance), OJ L 241/ 1- 25.

[140] S. 2 (3) and (3a) of the *WpHG*.

[141] Ss. 31g, 31h of the *WpHG*; ss. 30, 31 of the *Börsengesetz (Stock Exchange Act)*, hereinafter *BörsG*.

and compliance.[142] Furthermore, the MiFiD seeks to put the clients' needs into the centre of financial services with detailed rules requiring information about,, and considering the needs of, the respective customers in every aspect of service providing.[143] This includes handling retail investors differently to professional customers.[144]

In seeking to stay flexible for further amendments in European law, the German government will rely on regulation where details and interpretative provisions are regulated by order of the Secretary of Finance rather than needing to be codified by Parliament.

In addition to implementing the MiFiD, German financial law was significantly liberalised in order to **reduce the bureaucratic burden** imposed on financial services providers and issuers of securities over the last two decades. In particular, financial service providers are not longer required to specifically advise their customers on the risk of trades involving financial futures. Prior to the reform, brokers and banks were required to repeat their advice every two years. In addition, the German legislature **abolished the admission offices** at stock exchanges. Prior to the reform, the admission offices were responsible for admitting the issuance of securities at German stock exchanges.[145] The reform empowered the management of the stock exchanges in admitting securities issues. Furthermore, **the Official Market was abolished**.[146] Originally, issuers of securities in the Official Market had to inform investors more often than issu-

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[142] See for example ss. 31 (1) No. 2, 31c, 31d, 33, 33a of the *WpHG*.

[143] S. 31 (3) through (9) of the *WpHG*.

[144] S. 31a of the *WpHG*.

[145] S. 30, 31 of the *BörsG*.

ers in Regulated Markets; as defined under the first European financial services directive. At its core, the Official Market was a high quality segment for listing securities whose criteria were regulated by law rather than by the stock exchanges. However, stock exchanges created quality segments for securities listed in the regulated market with listing requirements that were equivalent to the legal framework for the Official Market, where these provisions were deemed useful and less burdensome, and where the rules governing Official Markets were superfluous. Thus, Official Markets simultaneously lost its appeal and purpose. Consequently, the German legislature decided to focus on Regulated Markets, as defined under European Law, and abolish Official Markets. This does not prevent stock exchanges from developing their own quality trading segments,[147] as the Deutsche Börse AG did with its Prime and General Standard. Finally, the legal rules on **traders, brokers and dealers were simplified.**[148]

Overall, with the exception of additional disclosure rules, the legislature decided in favour of self-regulation, and vested stock exchanges with more discretion. This enables stock exchanges to optimize, and modernize their trading systems, and is meant to assist them in entering into competition with alternative and internalized trading systems for providing the best, and most inexpensive, trading services to investors.

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[146] S. 2 (5) of the *WpHG*; ss. 32 et sequi of the *BörsG*.

[147] S. 42 of the *BörsG*.

[148] Ss. 27 through 29 of the *BörsG*.

(f) **Cooperatives**

In 2003, with two acts of legislation, the European Union facilitated cooperatives wishing to engage in cross-border business.[149] The respective Regulation refers, in many respects, to domestic laws and the respective Directive required transformation by 18 August 2006. Responding to this demand the legislature enacted the *Bill Introducing the European Cooperative Society and Amending the Law on Cooperatives.*[150]

In doing so, the German legislature sought to enact an attractive environment for SCEs which should encourage incorporation in Germany. In many respects, the law governing SCEs has been borrowed from the law governing the European Company. This particularly pertains to the law on mergers, on the transfer of seats, on the board(s) and also the rules on the monistic board structure and on creditor protection. Borrowing heavily from the SE scheme is a wise decision, given that practice provided the German SE with a warm welcome.[151]

At the same time, the legislature reformed the Law Governing Cooperatives (‘*Genossenschaftsgesetz*’), focusing on three legislative aims. Firstly, provisions preventing small associations from incorporating as cooperative, such as formal requirements and costly obligations (such as the mandatory review of annual reports), were abolished. Secondly, the reform facilitated financing the cooperative’s business, by enabling the provision of assets other than cash. In particular, the legislature facilitated arrangements that assist cooperative banks in

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[149] Council Regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society (SCE) (22.07.2003), OJ L 207/1-24, and Council Directive 2003/72/EC supplementing the Statute for a European Cooperative Society with regard to the involvement of employees (of 22.07. 2003), OJ L 207/25-36.

[150] Gesetz zur Einführung der Europäischen Genossenschaft und zur Änderung des Genossenschaftsrechts (EuroGenEinfG) (14.08.2006), OJ I (2006), 1911.

strengthening the equity in their balance sheet when applying International Accounting Standard No. 32.[152] Finally, the legislature decided to adopt provisions which have been tested in the law governing corporations since the early 2000s. These include strengthening the rights of the supervisory board as well as the members of the cooperative (to the detriment of management), enabling electronic voting in the members' general meetings and securing independence of the mandatory annual review of the cooperatives' business.

2. In the making

Four major legislative projects are currently in the making: These pertain to (1) private limited companies, (2) the incorporation of foreign companies, in general, (3) investment companies, and (4) the auditors' professional laws.

(a) Modernising the private limited company

The Law Governing the GmbH ('GmbHG') is probably the most successful legal export of corporate Germany: Many developed corporate laws distinguish between private and public limited companies, a distinction which was initiated by the enactment of Germany's GmbHG in 1892. With few changes, the rules from 1892 have remained influential to date. Today, approximately 1 million companies are incorporated as German GmbHs.[153] This practice accounts for special expertise on the lawyers' side and a deep and substantial case law on almost all aspects of the GmbH.

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[151] *Supra*, text at notes 28.

[152] Cooperative banks constitute one of the three pillars of the German financial system, and are particularly meaningful in providing financing services to small and medium enterprises, as well as consumers.

[153] U Kornblum, *Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrech (German Statistics on Corporate Law)*, GmbH-Rundschau 2005, 39.

However, over the last five years, the former role model for the British ‘limited liability company’ became the centre of an intense debate resulting from the ECJ decisions in *Inspire Art* and *Überseering*. In particular, it was questioned whether, from a comparative perspective, financial and administrative barriers to achieving limited liability were too high. In 2005, the Federal secretary of Justice issued a proposal under which the minimum capital required for incorporating a GmbH was to be lowered from 25,000 € to 10,000 €. Because of the early federal elections, the proposal was removed, supplemented and re-tabled by the Grand Coalition as the Government’s draft-*Bill Modernising the Law Governing the GmbH and Hindering Abuses of the Corporate Form* (‘MoMiG’).[154] The MoMiG which is currently under deliberation has four emphases: Firstly, it introduces a plethora of alterations which seek to fasten, facilitate, and reduce the costs for, incorporating a GmbH; second, it introduces a way through which entrepreneurs achieve limited liability at essentially zero costs; third, it seeks to streamline the law surrounding corporate insolvencies; and fourth, it aims at preventing abuses of the corporate form in, or in the vicinity of, bankruptcy.

1) As to alterations which raise the appeal of the GmbH, probably the most influential amendment is the lessening of the minimum capital from currently 25,000 € to 10,000 €. The new threshold is a compromise between those experts requesting the abolishment of any significant minimum capital requirement, and those vouching for a high minimum capital as signal for quality and integrity, and a substitute for personal liability. Other amendments seek to ac-

[154] Regierungsentwurf eines Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG) (23 May 2007).

celerate the administrative process for the registration of a GmbH, and are of little relevance in this context.

2) The German legislature seeks to spur business activity through providing entrepreneurs with limited liability in the stressful first years of running their business. Therefore it is going to introduce a new label for low-capitalized GmbH which is “Unternehmergesellschaft - UG” (‘Entrepreneurial Company’). Entrepreneurs may instantaneously achieve limited liability through incorporation, in the limits provided by the Law governing the GmbH, without submitting a meaningful minimum capital to the UG. While the entrepreneur may payout an adequate managerial salary, s/he must leave a quarter of the profits in the firm until the company’s profits make up for the minimum capital of 10,000 Euro that is required for incorporating as a GmbH. When the equity of the UG comprises 10,000 Euro or more the UG becomes a GmbH. .

The UG is a well-received support for small business that relies on signalling effects to the market participants. While contractual creditors may be deemed to be able to watch out for themselves, tort creditors are prevented from doing so. However, given that a legal minimum capital may, if at all, provide for equity rather than liquidity, there is no guarantee that tort debtors are financial capable, regardless of any many minimum capital required. Consequently, the UG does not unreasonably extend the risks which tort creditors face. We welcome the UG as a well-done compromise between low-barrier schemes such as the British limited liability corporation, and high-barrier schemes for which the German GmbH was formerly exemplary.

3) With respect to insolvent GmbHs, the legislature focused upon the provisions of capital maintenance and the liability of managers. For years, the German

rules on **capital maintenance** were subject to discussion. This was due to the fact that uncertainty stemmed from several decisions requiring shareholders to re-pay capital and reimburse for services which they had received from the company prior to and in the vicinity of insolvency. In addition, recent judgements on upstream loans by the corporation to its shareholders and cash-pools in corporate groups[155] had complicated the financing of subsidiaries and the efficient allocation of assets in large organizations. After an intense discussion, the legislature decided against wrongful trading rules, or other rules requiring a probe into whether management, or shareholders were aware of the company's crisis when distributing capital, or re-paying credit, to shareholders. This was due to the uncertainty which is inherent to such approaches, and the pro-litigation tendency which results from the former. Instead, the legislature prefers a clear-cut solution: Shareholders must re-channel those assets to the company (or its administrator/trustee in bankruptcy, respectively) that they received within one year prior to the company's petition into bankruptcy. This will render litigation useless, and increase assets of the insolvent firm. We hold that this legislative step is preferable to other, more complicated solutions for agency problems that are typically experienced in insolvent companies. The substantial German case law provides sufficient evidence that justice and certainty may conflict in the wake of insolvency. It is time to cut through the Gordian knot which German rules on capital maintenance have become over a century of case law.

4) Regarding **manager liability**, Germany had experienced abuses. Under the current rules, managers are obliged to petition the GmbH into bankruptcy if the

[155] See the Judgement by the Bundesgerichtshof (Federal Supreme Court) in II ZR 171/01 (24.11.2003).

firm is insolvent,[156] while shareholders are not. Delaying the petition will make managers personally liable to creditors. However, shareholders of GmbHs often instruct managers not to file the petition, or threaten to hold them liable for breach of fiduciary duties vis-à-vis the corporation if they nevertheless file the petition. Consequently, managers of insolvent companies often leave the sinking ship, or even flee the country, in order to avoid personal liability. In this case, the GmbH increases its indebtedness vis-à-vis long-term creditors, telecommunication providers, employees and, in particular, landlords without prospect for regaining solvency.

The draft-Bill imposes the obligation to petition the company into bankruptcy upon shareholders if they know that the firm is insolvent, or if the last manager leaves the firm. This obligation will be subject to the same civil and criminal sanctions which managers face who neglect their duty to file for bankruptcy.

All of the new provisions surrounding insolvent GmbHs govern the relationship between creditors, or the administrator / trustee in bankruptcy on the one hand and the company on the other, rather than the internal affairs of the company. Furthermore, their scope exceeds private limited liability companies, and essentially affects all corporate forms which shelter shareholders from personal liability (corporations, cooperatives etc.). Thus, it was a logical step to codify these provisions to be part of insolvency law rather than corporate law. Consequently, these provisions are part of the German Law Governing Insolvencies (‘*Insolvenzordnung*’). By regulating manager and shareholder liability vis-à-vis creditors in the *Insolvenzordnung,* and thus irrespective of the corporate law regime,

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[156] Insolvency is defined as a state in which the firm is unable to meet its financial obligations when they are reasonably due (‘illiquidity’), or when the company’s debt exceeds the assets of the corporation (‘over-indebtedness’).

companies incorporated under foreign laws acting entirely, or at the very least having branches in Germany (which is frequently associated with some British limited liability companies), will become subject to this liability regime as well.[157] This will fill a loophole created by the developing market for incorporations.

(b) Cross-border Incorporations

Formally a part of the *MoMiG*-draft-Bill, but with substantial relevance to all corporate forms is one important amendment with respect to the choice of law that governs corporations. Currently, the corporation should be registered at the place where management presides, or where the company's operation is located.[158] With the MoMiG-draft-Bill, the government proposes to abolish this restriction. Thus, the internal affairs of corporations which entirely function beyond German borders (for example in Romania or England) may become subject to German corporate law. This is a significant step for corporate groups. Under the current law, internationally operating corporate groups with headquarters in Germany need to tap the market for corporate law services around the world. This imposes not only significant costs, but also excessive risks on corporate groups resulting from misunderstandings with regard to legal details, enforcement issues and cultural influences which may affect decision-making by local courts.

Under the likely new regime, all corporate subsidiaries, together with their subsidiaries, and so on, may opt into German corporate law, by shareholder resolution. All EC Member States must treat these companies incorporated under German law as if they were incorporated under their domestic laws. This

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[157] T Wilms, DIE ENGLISCHE LTD. IN DEUTSCHER INSOLVENZ (THE ENGLISCH LTD. COMPANY UNDER GERMAN INSOLVENCY LAW), (Nomos: 2006), at 189 et seq.

[158] S. 4a of the *GmbHG*, s. 5 of the *Aktiengesetz*.

scheme enables corporate groups headquartered in Germany to organize all issues relating to their subsidiaries under German law. It facilitates contracting with the managers of subsidiaries to a significant extent (e.g. giving them a share into stock option plans of the parent company). Furthermore, it will extend the scope of the codified and thus certain (in relative terms) German law on corporate groups ('*Konzernrecht*') and other issues relating to minority share-holders, such as freeze-outs, mergers etc. More importantly, given that suits against corporations have to be filed at the registered seat,[159] all legal issues of a corporate group may be centred at the corporate headquarter if all subsidiar-ies are incorporated at this place, with two effects: (1) Corporate groups may streamline their demand for local counsels of subsidiaries, and (2) Corporate groups may shelter themselves from frivolous litigation on corporate law grounds, such as for the (apparent) breach of fiduciary duties which may be common in other jurisdictions, but not in Germany.

We visualize that this expected amendment significantly lowers the risk result-ing from legal uncertainty in less-well developed corporate law environments. Furthermore, it enables corporate groups to choose the corporate law structure that best fits the group, and thus enables German corporate groups to operate more efficiently, in general. We deem this proposal not only a necessary step in the competition of corporate laws (if any), but also an important signal of change in Germany's approach towards competition: Enabling foreign-based corporations to incorporate in Germany removes a barrier which still prevents market forces (if any) from working *in favour* of Germany. Removing this barrier

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[159] Ss. 14, 147 (2), 148 (2), 246 (2), 249 of the *Aktiengesetz*.

signals that, after the reforms of the last two decades, Germany's legal environment is fit to compete and ready *to export* its law. After two decades in which Anglo-American rules have swept the German legal market and the costs and disadvantages related to detailed Anglo-American rule-making have become known to corporate Germany, this reform step is evidence for a newly gained confidence into home-made legal products.

(c) Collective Investments

Over the last decade, German financial law became more and more complicated. Thus, the Grand Coalition of Christian-Conservatives and Social Democrats agreed on deregulating and reducing bureaucracy, the financial sector in order to spur innovation and competitiveness of the German financial industry. In addition to the *Bill Implementing the MiFiD*, which we discussed above, the draft-*Bill amending the Investment Law*[160] has been identified by the Grand Coalition as a key-project for its deregulation and liberalisation project. This is due to the fact that legislative activity and financial dynamism in Luxembourg imposes significant competitive pressure[161] on the German financial industry with respect to collective investment schemes. Far more funds are registered in Luxembourg that in Germany,[162] however, in contrast, their customer base is typically among German investors.

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[160] Gesetz zur Änderung des Investmentgesetzes und zur Anpassung anderer Vorschriften (Investmentänderungsgesetz), Government Draft (27.04. 2007), BT-Drucks. 274/07.

[161] Official Reasons, BR-Drs. 247/07, at 108.

[162] Luxembourg is the second largest mutual fund market in the world, after the United States (A Kohrana, H Servaes & P Tufano, *Mutual Fund Fees Around the World*, Working Paper (2006). Pursuant to data provided by the Portuguese securities regulator, Investment funds incorporated in Luxembourg currently hold a market share comprising 32.7% of all UCITS investments in Europe (UK: 14.0%; Ireland: 12.5%; Germany: 10.1%), available at http://www.cmvm.pt/NR/exeres/1F3F72BC-CFDD-4CC5-8999-B97F58F304D8.htm .

In order to reverse this trend, the German government cut back the rules on collective investment schemes to the minimum level that the *European Investment Directive ('UCITS')*[163] mandates (for example, a fund's minimum capital was reduced from 730,000 € to 300,000 €). Oversight which was previously split between the BAFin and the Deutsche Bundesbank (Germany's Central Bank) is concentrated in the hands of the BAFin. Furthermore, procedural rules have been introduced enabling fast-track permissions for new funds and the issuances of fund units to investors. Moreover, following the example provided by Luxembourg's *Société d'Investissement à Capital Variable*, under the future German law Investment Corporations ("Investmentaktiengesellschaften') will be structured pursuant to the requirements of the UCITS-Directive. Cross-border activities of Investment Corporations will thus be governed by the pan-European UCITS provisions on licensing and sales.[164] The German government simultaneously pushed for developing a European framework for open-ended real estate funds. Open-ended real estate funds are an investment pattern through which many German consumers gain access to professionally managed investments in commercial and other types of property. The European Commission established an expert group that will investigate whether EU-level action in this area would deliver benefits for industry and investors.[165] Furthermore, the government seeks to improve fund governance by requiring that some of the funds' board members are independent directors. Finally, while the German

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[163] Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (85/611/EEC), OJ L 1985, 375/3 ('UCITS').

[164] Articles 6 through 6c, and 44 through 48 of UCITS, *supra* note 163.

[165] European Commission, Press Release (02.04.2007), IP/07/458. The establishment of the Expert Group was first suggested by the European Commission in its *White paper on enhancing the single market framework for investment funds* (15.11.2006), COM(2006) 686, at 14.

government continues to apply a paternalistic approach vis-à-vis retail investors, it strives for entire liberalisation with respect to funds in which merely professionals invest.

Generally speaking, we deem the government's measures sound. Asymmetric paternalism of securities regulation is expected to spur innovation in the institutional market while limiting the risks (and the profits!) for inexperienced investors. While asymmetric paternalism reduces the investment opportunities for retail investors and thus increases the dependency of this investor group on professional investment services,[166] in a capital market constituency that is as immature as German retail investors, this approach may be the best alternative for protecting the public confidence in, and featuring openness for, capital markets, in general. We note, however that the reform of the Investment Law does not address some of the issues that are widely discussed in a national and international level. These include: (1) the regulation of Hedge Funds and (2) cost transparency of investment funds' transactions.

(1) Hedge Funds and activist investors spurred a heated debate in the public sphere and academia. Furthermore, the German Federal Government announced that it sees the improvement of transparency regarding Hedge Funds as important goal of their EU presidency as well as their chair of the G7/G8 which take place simultaneously during the first half of 2007.[167] However, it did not include amendments to the German law on Hedge Funds in the draft-*Bill amending the Investment Law*. This is primarily due to the fact that systematic

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[166] D Zetzsche, *Zugang und Ausschluss im Unternehmenskapitalmarktrecht (Access and foreclosure in corporate financial law)*, in: Gesellschaft Junger Zivilrechtswissenschaftler (ed.), Volume 2006.

risks can only be addressed at the international level (G7/G8-Group), while improving investor protection is ineffective when Hedge Funds can re-incorporate under laxer laws of other Member States.[168] Another aspect may be that with 25 Single Hedge Funds with value under management of app. 1.2 billion € and 15 Funds of Hedge Funds with value under management of 480 m € as of November 2006,[169] the German financial industry is not among the ten biggest players in the Hedge Fund universe.[170] Consequently, the German government prefers to wait until the UCITS-reform at a European level or until the council of Secretaries of Finance of the G7-Group agree on steps with which they address systemic risk. The Report by the Counterparty Risk Management Policy Group II[171] may provide the factual basis for further legislation.

(2) Investment funds must disclose the Total Expense Ratio (TER) of the fund. Pursuant to the standards provided by IOSCO which was adopted by the German legislature, the TER does not include transaction costs for trading. However, the overall amount of transaction costs is to be disclosed in the fund's annual report. Frequently flipping investments may fill the pockets of traders that are affiliated with the fund, at the cost of, but without benefit to, investors. In order to discourage this type of behaviour (termed 'churning'), some experts hold that disclosure of the transaction costs for individual transactions as well as

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[167] BT-Drucks. 16/3415.

[168] Request by the German Free-Democrative Party (F.D.P.) to the Bundestag, *Transparenz by Hedge-Fonds (Transparency of Hedge Funds)* (17.01.2007), BT-Drucks. 16/4085, and the Federal Government's response (05.02. 2007), BT-Drucks. 16/4301, at 7.

[169] Federal Government, idem.

[170] See the TASS-database which the German government cites in BT-Drucks. 16/4301, at 3 and 4.

the Portfolio Turnover Rate ('PTR') would improve investor protection.[172] The European Commission also recommended disclosure of transaction costs,[173] but currently reconsiders its recommendation in light of the general review of the UCITS-Directive.[174] In order to avoid costly revisions of the Investment Law, the German legislature decided to wait until decisions are made at a European level.

(d) Accounting Profession

In 2006, the Eight European Directive on Company Law was repealed and the fourth and seventh Directive became subject to significant amendments.[175] The reform of European accounting law was aimed at reinforcing the reliability of financial statements by establishing minimum requirements for the statutory audit of annual accounts and consolidated accounts. The directive specifies the duties of auditors, their independence and ethics, and introduces requirements for external quality assurance. In particular, it seeks to improve public oversight over the audit profession and co-operation between oversight bodies in the EU. The new measures are intended to strengthen confidence regarding the func-

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[171] Toward Greater Financial Stability: A Private Sector Perspective - The Report of the Counterparty Risk Management Policy Group II (25.07.2005), available at http://www.crmpolicygroup.org/ (23.04.2007).

[172] Request by the German Free-Democrative Party (F.D.P.) to the Bundestag, *Anlegerschutz durch Transparenz bei Investmentfonds (Investor Protection Through Transparency of Investment Funds*) as of 27.11.2006, BT-Drucks. 16/3523, and the Federal Government's response (0712.2006), BT-Drucks. 16/3772.

[173] Commission Recommendation 2004/384/EC (27.04.2004) on some contents of the simplified prospectus as provided for in Schedule C of Annex I to Council Directive 85/611/EEC, OJ L 144/42, Recital (9) and No. 2.2.1, 2.2.2.1 and 4.

[174] European Commission, *White paper on enhancing the single market framework for investment funds* as of 15.11.2006, COM(2006) 686 .

[175] Directive 2006/43/EC of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (17.05.2006) OJ 2006, L 157/87.

tioning of EU capital markets. They are also thought to provide a basis for co-operation with oversight bodies of third countries to take account of globally interconnected capital markets.

The German Parliament ('Bundestag') is currently consulting on the government's draft-*Bill strengthening the oversight on, and reforming the duties of, auditors* (Berufsaufsichtsreformgesetz – BARefG) through which parts of the aforementioned Directive are going to be implemented.[176] In particular, the German legislature seeks to strengthen the self-government of auditors through empowering the Wirtschaftsprüferkammer ('Chamber for Accounting Matters'). The Wirtschaftsprüferkammer is a semi-official, independent body in which membership of accountants is mandatory responsible for administering accountants' professional matters. Under the proposed Bill, the *Wirtschaftsprüferkammer* will be entitled to undertake investigations and impose enforcement measures. The *Wirtschaftsprüferkammer* is also sought as the partner for investigations in accountants' conduct on an international level which the Directive seeks to facilitate.

3. Outlook

Despite almost 20 years of reform activity in Germany, corporate and financial law will remain a restless field.

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[176] Entwurf eines Gesetzes zur Stärkung der Berufsaufsicht und zur Reform berufsrechtlicher Regelungen in der Wirtschaftsprüferordnung (Berufsaufsichtsreformgesetz - BARefG), Gesetzentwurf Bundesregierung 04.10.2006 Drucksache 16/2858, zZ beraten im Ausschuss für Bildung, Forschung und Technikfolgenabschätzung

(a) Financing stock corporations

In its Company Law Action Plan of 2003[177] the European Commission draws the conclusion that simplifying the Second ('Capital') Directive on Company Law (Directive 77/91/EC) would significantly promote business efficiency and competitiveness. In August 2006, the reform of the Second Company Law Directive,[178] which needs to be transformed into national law by 15 April 2008, was finalized. The reform of the Second Directive pertained to three aspects of financing stock corporations: (1) giving markets a greater meaning in business evaluations; (2) facilitating the acquisition of a company's own shares and (3) financial assistance.

(1) However, the laws of the Member States still require evaluation by independent experts when a stock corporation seeks to allot shares for consideration other than in cash.[179] This particularly relates to considerations in securities such as shares of other companies under a business combination agreement. Notwithstanding limitations resulting from the implementation of the Market Abuse Directive, Member States may facilitate contributions to the company other than in cash by enabling companies to substitute for the pricing mechanism of an expert evaluation by using the weighted average price of the respective security at regulated markets.[180] Furthermore, Member States may enable the use of fair value opinions by independent experts if the fair value is determined for a date of not more than six month before the effective date of the asset contribution; unless circumstances account for significant changes in the fair

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[177] *Supra* note 25.

[178] Directive 2006/68/EC of the European Parliament and of the Council amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital (06.09.2006), OJ L 264/32-3.

[179] For example, ss. 27, 283 of the *Aktiengesetz*.

value of the assets.[181] Before the reform, accuracy as to the date of the asset contribution was required which was, in practice, difficult to verify in large-scale mergers. A second evaluation at the time of the contribution was often necessary in order to meet legal requirements. Difficulties occurred when these two evaluations differed. Under the reformed Directive, within one month of the effective date of the contribution, companies have to report on the consideration, its value and the evaluation technique on which it relies.

(2) Under European law, the acquisition of a company's own shares is generally subject to the authorisation of shareholders. Prior to the reform, the duration of the period for which the acquisition was given was not to exceed 18 months. Even if the shareholders consented to the buy-back of shares, the overall amount of shares being able to be re-purchased under the authorization was limited.[182] The reform extended the period for which authorization may be given to 5 years,[183] for two reasons: First, since authorization of share buy-backs has become a common topic on every shareholder meeting's agenda, there is little effect to be gained in requiring shareholder consent; and second, share buy-backs have become a common method to reduce the equity which a company uses without declaring a dividend (which typically implies signals to the market, and prompts tax consequences to investors). Furthermore, the reform lifted the ceiling provided by the 10 percent threshold on the repurchasing of shares entirely. Under the reformed Second Directive, companies may acquire their own

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[180] Article 10a (1) of Directive 2006/68/EC.

[181] Article 10a (2) of Directive 2006/68/EC.

[182] Under German law, for each authorization the overall amount was limited to 10 percent of the company's share capital, s. 71a of the *Aktiengesetz*.

[183] Article 19 (1) (a) of Directive 2006/68/EC.

shares up to the limit of their own Distributable Reserves.[184] Moreover, Member States may impose ceilings at their own discretion.

(3) Under the reformed Directive, companies may assist third parties in purchasing their own shares by the provision of credit, security or funds, directly or indirectly, if the transaction takes place under fair market conditions.[185] Prior to the adoption of the reform, European law hindered companies assisting an outside buyer, since financial assistance was deemed a circumvention of the prohibition on repurchasing a company's own stock. Now, subject to Member States' discretion, white knights in contested mergers may theoretically purchase a target's shares with the target's own cash. This provides the ground for potential abuse. Thus, the reformed Second Directive requires prior approval by the company's shareholders following a detailed report by the management. Even with the authorization of shareholders, the overall amount of financial assistance granted to an outside buyer may not result in the reduction of the firm's Distributable Reserves.

Given the demands of Germany's businesses and the Government's pro-competitive attitude, we expect that the German legislature will follow a liberal approach and enable companies to take advantage of the liberalisation of the Second Directive.

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[184] Article 19 (1) (b) of Directive 2006/68/EC. The term Distributable Reserves is defined in Article 15 (1) of the Second Directive.

[185] Article 23 (1) (a) of Directive 2006/68/EC.

(b) Shareholder Rights

The (forthcoming) European *Directive on the exercise of certain rights of shareholders in listed companies* (hereinafter *Shareholder Rights Directive*)[186] sets minimum requirements for the procedure of general meetings of shareholders. Key issues of the Directive include shareholders' (1) access to information, in particular by internet in advance of General Meetings, (2) right to ask questions, (3) right to table resolutions, (4) right to vote in absentia, and (5) participation in general meetings via electronic means. The Directive establishes electronic proxy voting as a minimum standard for corporations that are listed on regulated markets. It also requires Member States to entitle corporations to go one step further and implement electronic direct voting if the shareholders decide accordingly. The Shareholder Rights Directive emphasizes the idea of a cross-border constituency, and seeks to remove obstacles "which hinder the access of non-resident shareholders to the information relevant to the general meeting and the exercise of voting rights without physically attending the general meeting".[187] However, it unfortunately does not keep to its own promises since the Directive's scope does not extend to banks, custodians and other intermediaries which are indispensable for truly enabling the cross-border exercise of shareholder rights.[188]

The adoption of the Shareholder Rights Directive will mandate some minor alterations to German corporate law: Electronic proxy voting is a frequently used

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[186] The text of the Directive as adopted by Parliament on 15 February 2007 is available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2007-0042+0+DOC+XML+V0//EN (21.03.2007).

[187] Recital (5) of the Shareholder Rights Directive, *supra* note 186.

option, but not yet obligatory. In addition, the German legislature must enable electronic direct voting for companies who wish to offer these services to its shareholders. By doing so, it may rely on a similar proposal prepared by the Federal Corporate Governance Commission of 2001.[189] In other respects, German law is up to date. In particular, the record date requirement, which the Directive imposes, has already been implemented by the UMAG.[190] Thus, the legislative changes in the last ten years have prepared German law well regarding the cross-border exercise of shareholder rights in Europe.

In addition, we may see the legislature acting with respect to two topics that are currently widely discussed. Since German investment funds are strongly encouraged to vote, many funds have asked proxy voting providers for support. In particular, Institutional Shareholder Services (ISS) have gained a large market share. Since ISS also advises many foreign funds investing in Germany (and globally), ISS de facto holds control over the outcome of shareholder votes in corporations listed at regulated markets. It is currently being discussed whether the involvement of ISS is a wise decision.

Furthermore, the example provided by ABN-Amro demonstrated that even the largest financial institutions are subject to significant pressures from activist investors. Commentators request increasing transparency standard with regard to

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[188] For details, see Zetzsche, *Virtual Shareholder Meetings and the Shareholder Rights Directive – Challenges and Opportunities* (2007), from SSRN.

[189] See Report (*supra* note 26). The recommendation was based on proposals made by the Association of Notary Publics, see Jens Fleischhauer, *Hauptversammlung und neue Medien (Shareholder meetings and new technologies)*, ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2001, 1133.

[190] *Supra*, text at note 44 et sequi.

Hedge Fund's activities and shareholdings (German law currently requires disclosure of holdings comprising 3 percent or more of an issuer's voting rights).

(c) Transfer of Seats

In addition, the forthcoming 14th Directive on the cross-border exercise of Shareholder Rights and the Directive on the *Cross-border transfer of registered offices*,[191] will keep the legislature busy. Because of the ECJ's judgement in re SEVIC,[192] it is clear that Articles 43 and 48 of the EC Treaty preclude discrimination of mergers involving a domestic and a company incorporated in an EC Member State, as compared to mergers involving entirely domestic corporations. Mergers involving a shelf-company in the host Member State have become a frequently used substitute for the transfer of seats. Thus, European law de facto enables the cross-border transfer of seats. However, the European Commission wants to add the direct way to the set of options for companies in Europe. Under the Commission's proposal, "a company transferring its registered office would be registered in the host Member State and would acquire a legal identity there, while at the same time being removed from the register in its home Member State and giving up its legal identity there. If necessary, companies would have to adapt their structures and assets in order to meet the substantive and formal conditions required for registration in the host Member State. However, they would not be obliged to go through liquidation proceedings

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[191] In February 2004, the European Commission launched a public consultation that relates to the outline of the planned proposal for a 14th Company Law *Directive on the cross-border transfer of the registered office of limited companies*. For details, see online: < http://europa.eu.int/comm/internal_market/company/seat-transfer/index_en.htm >. Whether this proposal will result in a directive is yet unclear. The more European case law on transfer of seats evolves, the lesser the need for a proposal.

[192] *Supra* note 2, at 5.

in their home Member State or to create a new company in the host Member State."[193]

For many years, the question of employee participation blocked European law-making with respect to the transfer of seats. In this respect, the Commission's proposal wisely follows the same lines as the compromise reached for the Directives governing the SE and cross-border mergers: Employee participation in companies transferring their registered office would be governed by the national law of the host Member State. However, more extensive regimes being used in the home country would have to be maintained, unless new arrangements could be negotiated and agreed upon between the company and its employees.

Another issue blocking the outbound transfer of seats were taxes. Traditional German doctrine had required the liquidation of the company when re-incorporating cross-border. Book profits unveiled in the dissolution of the company became subject to taxation. This effectively hindered the transfer of seats. Under the influence of the European judicature, and in light of the liberal approach of German company law towards cross-border mergers, the tax law governing the transfer of seats has been subject to a ground-breaking reform. Since 2007, outbound transfers of seats no longer trigger any tax consequences.[194]

The European Commission has not finalized its proposal. However, given that the key issues of co-determination and taxes have been solved, from a corporate law perspective, we do not expect difficulties emanating from the forthcoming 14th Directive.

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[193] European Commission, Press Release, IP/04/270 (26.02.2004).

(d) Stalemate: Board Structure & Co-Determination

In adopting the reforms on European accounting law, the German legislature will be urged to require that each quoted firm must have an audit committee which monitors the financial reporting process and the effectiveness of the company's internal control. At least one member of the audit committee must be independent.[195] This is the third piece of the large-scale puzzle with which European law seeks to improve board governance.

The first and second pieces comprised two recommendations that the European Commission issued in 2004. The recommendation on directors' remuneration[196] seeks to ensure that shareholders are able to fully appreciate the relationship between the performance of the company and the level of remuneration of directors, both ex ante and ex post, and to make decisions on the remuneration items linked to the share price. German shareholders traditionally have the power to decide upon the remuneration of supervisory board members. Since the legislature adopted the aforementioned *VorstOG*,[197] the need for legislative action following on from this recommendation merely pertains to the powers of shareholders to decide upon the remuneration of the German board of management.

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[194] S. 12 (3) of the *Körperschaftssteuergesetz (Tax law governing corporations*), as amended.

[195] Article 41 (1) of the Directive on statutory audits of annual accounts and consolidated accounts, *supra* note 175.

[196] *Supra* note 57.

[197] See *supra* III.B.1., notes 61 et seq.

Furthermore, the recommendation on directors' independence[198] is vested in the belief that the presence of independent representatives on the board who are capable of challenging management's decisions may serve as an effective device in protecting the interests of shareholders and, where appropriate, of other stakeholders. However, the European Commission (probably under the pressure of the 13 Member States, in which employees' codetermination regimes are implemented[199]) reduced its independence requirement with respect to directors. Under the current recommendation, worker representatives in the boards are deemed independent. Presently, in German corporations with more than 2000 employees, employee representatives account for half of the seats on the supervisory board (but employee representatives do not have equivalent voting power).[200] Under the definition adopted by the Commission, these representatives are deemed independent. The German legislature refrained from discussing the question of whether directors' independence is a sound approach for all or some corporations in Germany and / or Europe. In particular, it is uncertain whether the independence requirement is useful for corporations with concentrated ownership, whether these requisitions need to be adjusted or

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[198] European Commission, *Commission Recommendation on the role of non-executive or supervisory directors and on the committees of the (supervisory) board* (15.02.2005) 2005/162/EC, OJ L 2005 52/51.

[199] See T Baums & P Ulmer (eds), EMPLOYEES' CO-DETERMINATION IN THE MEMBER STATES OF THE EUROPEAN UNION (2004).

[200] Under the *Mitbestimmungsgesetz* of 1976 that is applied to corporate groups with more than 2000 workers, workers elect the half of 12, 16, or 20 supervisory board members. However, the shareholders elect the chairman of the board whose voting power is doubled in contentious votes. Under the *Drittelmitbestimmungsgesetz* of 2004 that is applied to corporate groups with more than 500 and up to 2000 workers, a third of the supervisory members will be elected by workers. The oldest and most extensive regime under the *Montan-Mitbestimmungsgesetz* of 1951, which essentially assigns 50% of the seats and the votes to worker employees, merely regards to corporations in mining industries and steal production (with approximately 20 firms remaining, including ThyssenKrupp AG).

whether other measures[201] are more appropriate for these types of companies, respectively. At this point in time, we personally believe that the latter is the case: In companies with concentrated ownership, controlling shareholders typically exercise control over management. Weakening controlling shareholders' influence over management through independence requirements implies weakening control over management. Thus, measures need to be adopted for companies with concentrated ownership that merely limit controlling shareholders' opportunities to exploit minority shareholders without preventing controlling shareholders from effectively monitoring management.

In its amendments of 2005, the German Codex Commission responded to the independent director debate with a gentle recommendation that vested significant discretion into supervisory boards: "It shall not be the rule for the former Management Board chairman or a Management Board member to become Supervisory Board chairman or the chairman of a Supervisory Board committee. If this is intended, special reasons shall be presented to the annual general meeting."[202] Furthermore, "the Supervisory Board shall include what it considers an adequate number of independent members. A Supervisory Board member is considered independent if he/she has no business or personal relations with the company or its Management Board which cause a conflict of interests. Not more than two former members of the Management Board shall be members of the Supervisory Board …"[203] In light of this soft law approach, it came as no surprise that some of the largest corporations decided against the Codex-

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[201] See the measures presented *supra* II.1., for example *Konzernrecht*, transparency requirements, guaranteed dividends, sell-out rights, etc

[202] No. 5.4.4 GCGC (as amended).

recommendation, and appointed ex-Chairmen of the Management Board to serve as Chairmen of the Supervisory Board.[204]

In this context, it is noteworthy that three large-scale forces drive the discussion about worker codetermination in Germany: (1) The *flexibility* which the framework for the European Company (SE)[205] provides; (2) The *competitive pressure* that the Directive on Cross-border mergers[206] and the forthcoming 14th Directive on the Cross-border transfer of registered offices exerted on German corporate law;[207] and (3) The *conflict of interests* that employee representatives who sit in supervisory boards frequently face.

The latter aspect has come to the attention of the German public through no less than three widely publicized scandals within the last five years in some of Germany's largest corporations:

- In 2003, the Vice-Chairman of the Board of *Lufthansa AG*, Mr. Bsirske who was simultaneously the representative of one of the most influential German unions, organized a strike of Lufthansa-employees against the company. This spurred discussion whether union representatives on su-

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[203] No. 5.4.2 GCGC (as amended).

[204] Examples include Volkswagen AG (Mr. Piech) and the former chairman of Siemens AG (Mr. von Pierer).

[205] *Supra* note 28.

[206] See the Press Release by the European Commission: "Employee participation was a key issue in the negotiations, given the widely diverging systems in force in the Member States. This raises the question of how to deal with cross-border mergers implying a loss or a reduction of employee participation. The Parliament agreed that employee participation schemes should apply to cross-border mergers where at least one of the merging companies is operating under an employee participation system. Employee participation in the newly created company will be subject to negotiations based on the model of the European Company Statute."

[207] In 2006, Air Berlin plc was incorporated in Berlin, but under English law in order to avoid worker co-determination in the supervisory board.

pervisory boards are permitted to function as union representatives if these conflicts with corporate fiduciary duties. In 2004 shareholders refrained from discharging Mr. Bsirske. However, under the law on co-determination shareholders have no say in dispelling worker-representatives from the board, regardless of whether they are breaching the duties which corporate law imposes on them with the result that Mr. Bsirske still sits on the board of Lufthansa AG today. The same situation is currently evolving with regard to Deutsche Telekom AG.

- In 2005, it was revealed that a Member of the board of *Volkswagen AG* had paid significant amounts and abundant other services out of the corporate pockets to the head of the workers' council Mr. Volkert who had been a union representative and also a member of Volkswagen's supervisory board since 1992. In return, it is asserted that Mr. Volkert has contributed to a comfortable relationship between Volkswagen's Board of Management and the employees of Volkswagen AG. This is particularly delicate given that Mr. Volkert, in his function as member of the Supervisory Board, was supposed to control management.
- In 2007, one labour union accused the Board of Management of Siemens AG of having bribed a competing labour union. Because of these payments, the competing labour union is asserted to having cooperated with Siemens more generously than was beneficial for the workers that they represented.

While the above display of corruption resulted in criminal proceedings and some tough sentences are indeed expected, these scandals spurred not only the underlying rejection of worker determination in entrepreneurial circles, but also created distrust in the integrity of worker representatives, in general.

In light of these conflicts of interest and the potential for abuse, we hold that reducing mandatory worker codetermination in large corporations to 1/3 of the supervisory board members might be the best step, for four reasons. Firstly, given that split decisions on the shareholders' bench render control to the workers, a 50 percent worker representation prevents open discussions within the Supervisory Board and among its members. Secondly, a 50 percent worker representation enables bargaining between management and workers (jobs/money against lack of control) at the cost of good governance and profitability. This reduces the competitiveness of German companies and exposes them to takeover bids. Thirdly, reducing worker codetermination in large corporations without abolishing it altogether, would signal to shareholders and employees that Germany's commitment to a soft-form shareholder value approach. This is a deeply embedded aspect of German corporate culture,[208] which is said to accrue in the light of German workers – together with their Japanese counterparts – incurring by far the lowest losses to their employers resulting from labour disputes,[209] and simultaneously providing their employers with one of the highest labour-efficiencies in the world.[210] Moreover, labour representation of a third of

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[208] *Supra* note 7.

[209] Pursuant to data presented for the period of 1981 through 2003 by Hagen Lesch, *Arbeitskämpfe und Strukturwandel im internationalen Vergleich (Labour disputes and structural change – an international comparison)*, Vierteljahresschrift zur empirischen Wirtschaftsforschung aus dem Institut der deutschen Wirtschaft Köln, Vol. 32:2, German employers' loss of productivity due to labour disputes is less than 25% of the losses incurred by labour disputes to American firms, and less than 15% of that incurred to British firms.

[210] If measured in unit labor costs, in 2005 (hence, prior to the recent economic recovery) Germany ranked fourth in labor unit costs, behind Norway, Belgium and Sweden. See Christoph Schröder, *Produktivität und Lohnstückkosten im internationalen Vergleich (Productivity and labor unit costs – an international comparison)*, Vierteljahresschrift zur empirischen Wirtschaftsforschung aus dem Institut der deutschen Wirtschaft Köln, Vol. 33:3.

the board members is also common in small German companies and other European states. Finally, a 1/3 ratio would enable venture capitalists (which must typically cede one seat on the board to the entrepreneur) to stay in control of the firm when it exceeds the 2000 employee-mark. Thus, in addition to other effects, a reduction of workers' seats may support private venture capital activity in Germany.[211]

However, as worker co-determination is the holy cow of the German Social-Democrats, the Grand Coalition is stalemated. As long as the Grand Coalition holds onto office we do not expect further action.

4. Race to the best

During the first half of the Second Decade, Germany's legislature caught up with international developments with respect to securities law, in addition to strengthening shareholder rights, while during the current, second half the legislature adopted a more entrepreneurial approach. Much of its activity was triggered by European initiatives. However, where European law provided for leeway, and notwithstanding the ideologized matter of co-determination, we see three patterns outstanding in the Grand Coalition's lawmaking.

First, simplification of the law has become a frequently cited objective. Second, the legislature has ceded control to firms, shareholder and market participants in so much as it refrains from setting mandatory regimes even if this is provided for under European law. Finally, the German legislature has decided to take on competition and sell German corporate law as an attractive option for foreign-based corporations.

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[211] Thanks to *Ron Gilson* for this comment.

Drawing on the official reasons provided by the legislature for the respective measures, the following table shows which measure is deemed to comprise which in respect of the three aforementioned motives:

Table 1: Objectives of recent corporate and financial law reforms in Germany

Simplification	Flexibility	Competitiveness
MiFiD, Collective Investments, ‚Accessibility of Company Data, Financing stock corporations, Transfer of Seats	Takeovers, Cross-border Mergers, Shareholder Rights, Private limited companies (GmbH), MiFiD, Collective Investments, Incorporation, Financing stock corporations, Transfer of Seats	Private limited companies (GmbH), Incorporation, Collective Investments, MiFiD, Accessibility of Company Data, Cooperatives, Financing stock corporations, Transfer of Seats

With some generalization conceded, we conclude that the German legislature strived for competitiveness by simplifying its law and providing more flexibility to decision-makers. However, we did not detect a ‘management-only’ pattern, but rather an often perfectionist approach in weighing different interests. Thus, in getting itself ready for competition, the German legislature has neither pursued a race-to-the-bottom nor a race-to-the-top approach. Instead, the final round of the ‘permanent corporate law reform’ may be most accurately describedas a “race-to-the-best.”

IV. CONCLUSION

We have seen that the German legislature has been active, is active and is likely to be active in the future. Despite the pending of some measures resulting

from European law, Germany will not require major changes since it has undertaken the most significant steps already. Moreover, German *substantive* securities law has generally reached the standard of the British and North-American market rules. Thus, there is an overall clear tendency in favour of reform with which the legislature modernized, simplified and opened its law for competition in the market for regulators. Through twenty years of 'permanent corporate law reform' German corporate and financial law turned from bad boy to role model with respect to dynamism and openness for change.

This brought about significant changes to the business law environment in which German firms operate. In particular, the 'permanent corporate law reform' created a hybrid in three major respects: Firstly, Germany's system in 2007 is a hybrid between explicit and implicit investor influence. Its traditional explicit system of direct shareholder influence has been supplemented by elements adopted from market-based systems, turning it into a system that partly relies on direct, and partly on intermediated (market) control. Secondly, we observe that Germany's legislature is more careful in exercising entitlements vested in it by European law. In the past, the German legislature often wanted to create one-size-fits-all-frameworks of corporate law, stretching European choices to the limits. In the last two decades, a liberal approach has gained significant ground. This observation is closely related to the third hybrid dimension, which is a hybrid between mandatory and enabling approach. Mandatory law was typically associated with German corporate law while the enabling approach is frequently deemed the conceptual basis of Anglo-American corporate law. It must be clarified, however, that the enabling approach is typical for German GmbHs (private limited corporations). At its core, mandatory law, pertained to

public corporations / *Aktiengesellschaften*. Under s. 23 (5) of the *Aktiengesetz*, any provision of the Articles of Association deviating from the law is prohibited unless the law expressly permits deviations. It is here that we see the third hybrid developing: Over the last two decades, the legislature has added more and more of these permissions to the *Aktiengesetz*, thereby extending the discretion vested into shareholders and management as to how they would like to run the company. While this does not include an official parting from the mandatory approach, it constitutes the Golden Mean between mandatory and enabling corporate law.

From a comparative perspective, what does this mean for the standing of German corporate and financial law? Being aware of the premature timing and the difficulties in making such a general statement, we may have seen the tide turn in the big picture of German corporate law. For the last twenty years or so, Germany imported foreign (Anglo-American) law to its corporate and financial law system. The developments of the last five years indicate that the German legal system has regained some strength in influencing other lawmakers in Europe and beyond: For example, European initiatives pertaining to shareholder rights and the accounting profession reflect previous alterations made to German corporate and financial law. Thus, the German legal community has gained some ground in its endeavour to create and shape corporate law standards, instead of importing legal transplants which fit into the domestic legal environment to only a minor extent.

This remarkable development is likely due to the fact that currently an entirely different legal establishment is in charge than that at the beginning of the

1990s, when Germany's 'permanent corporate law reform' commenced. Simultaneously to the extent to which German company and financial law was altered, the sedate, maybe in some respects arrogant and self-assured legal elite of the *Deutschland AG,* whose thinking is rooted in the era of the *Wirtschaftswunder,* has rendered its influence to a globally thinking, dynamic, pro-competitive group of 'law managers' in the ministries, law firms, corporations and universities with international exposure, language skills and networks reaching around the globe. Apart from the ideologized co-determination issue, wherever discretion was vested in the German legislature over the last two decades, it committed itself to provide an attractive framework to corporations, shareholders and institutions, with a particular focus on the headquarters of corporate groups.

In 2007, Germany's legislature is a pro-active player in the worldwide corporate law community. It has decided to take on competition provided by the Anglo-American corporate frameworks. It is thus our working hypothesis that the outlook for succeeding in a competitive environment is not dire. This is, because in pursuing this strategy, the German legal market may rely on five assets:

1) Germany constitutes the largest uniform home-market for a business law system in the Western hemisphere,[212] with thousands of private and public businesses, and a large, skilled, and excessively trained legal workforce. This market size not only provides for a sufficient quantity of case law in order to achieve legal certainty, but also for sufficient admin-

[212] The U.S.-American market is fragmented due to jurisdiction vested into the federal states. All other Western states are smaller than Germany.

istrative resources necessary in developing, maintaining, and reforming, a high quality legal system.

2) The ongoing costs for legal services that go along with incorporation in Germany are likely to be lower than for companies incorporating in Delaware or the U.K. Due to fierce competition in the market for legal services and an unwillingness of German corporate clients to pay excessive fees, the hourly rate for legal services, as well as the profit per partner of business law firms in Germany is low, in relative terms.[213] This goes along with a less work-intensive legal environment, as compared to common law countries, due to a higher degree of codification.
3) Germany is (still) the largest export nation. While further conclusions are immature,[214] the success of German companies abroad is evidence that incorporation in Germany does not *hinder* the firms' ability to compete, despite any criticism which we hear from a theorist, or statistical standpoint.
4) The German legal, societal and corporate culture is closely related to that of the successful economies in Austria, Switzerland, the Netherlands, the Scandinavian states and many other countries in Europe and beyond. These states request an equivalent mid-level of social responsibility from corporations and their managers. This may evolve as a practicable compromise in the perennial debate regarding shareholder value, corporate social responsibility and international investing. Germany provides a

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[213] With legal expertise being centred around five major commercial centers (Düsseldorf, Frankfurt, Munich, Hamburg, Stuttgart), restrictions on competition which follow from a collegial relationship vis-à-vis one's competitors are less likely than among the London City firms which are all clustered together.

[214] For example, we would not state that Germany's current framework constitutes "The End of History for Corporate Law."

modern, codified regime for this Golden Mean which the legislature of other states can easily adopt.

5) Germany exhibits a long-standing reputation as systemic law-maker, with a tradition for well-functioning law export dating back to the 19th century. Parts of German civil and corporate law were exported to China, Turkey, Japan and other countries which currently experience high growth. Thus, we may conclude that adopting German law has *not hindered* growth.

Whether our working hypothesis holds true, requires careful observation in the future. For now, we limit ourselves to just one conclusion: Following twenty years of ‘permanent corporate law reform’, Germany’s corporate and financial law *is* ready for competition. Let competition begin!