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Corporate Governance Reform in Germany: The Second Decade

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Notwithstanding one decade of corporate law reform during which the German legislature augmented the traditional explicit system of corporate control with market-based corporate governance devices, the German corporate governance reform law agenda is still packed. The paper provides an overview of the status of corporate law making on the verge of early federal elections in Germany in fall 2005. It examines the driving forces behind current reforms. It also considers governance-related issues of securities and accounting law. The authors provide brief comments on pending legislative steps and measure the impact of the reforms on the overall structure of the German corporate governance system. The paper serves two purposes. On the one hand, it provides an insight into the dynamic development of German corporate law under the influence of European, national, and international reform agendas. On the other hand, it describes the transition from the traditional German explicit system of corporate control to a system in which the legislature assigns capital markets a greater share in controlling managers.

I. Introduction

Providing an overview of current corporate governance reforms in Germany offers the opportunity to examine two stereotypes. First, Germany is often thought to be exemplary of the “old Europe”, ie slow in reforms, and struggling to keep up with the pace of international developments.

Our second point pertains specifically to corporate governance. Notwithstanding the many differences in the details of its definition,¹ corporate governance deals

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All websites were visited in spring through summer 2005. The paper deals with the legal situation as of 22.07.2005. © Ulrich Noack und Dirk Zetzsche, Düsseldorf and Toronto, 2005. Comments are welcome at ulrich.noack@uni-duesseldorf.de or zetzsche@uni-duesseldorf.de.

¹ For example, A Shleifer & R W Vishny, ‘A Survey of Corporate Governance’, (1997) J. Fin. 52, 737, associate with the expression a relatively narrow meaning, holding that it describes legal issues related to the problem of how equity investors receive a fair return on their investment in public

primarily with the problem of how to ensure that corporate directors conduct themselves appropriately, and refrain from taking advantage of shareholders' lack of control over the assets of public corporations to the detriment of such shareholders.² Based on a strictly literal understanding, one may think that corporate governance is not a German problem for three reasons. First, the *public corporation* does not prevail in German corporate law practice. Approximately 1 million limited liability companies ("GmbHs") are registered in Germany, as compared to only approximately 15,000 stock corporations. Of these 15,000 stock corporations, merely 833 are listed on regulated markets.³ Thus, private companies overwhelmingly constitute the greater proportion of German companies. In private companies, the main concerns from a corporate law perspective do not typically fall under a definition of corporate governance issues.⁴ The second reason is that German corporations do not have directors. Rather, they either have managers, who are responsible for the day-to-day business affairs, or supervisors who sit on the supervisory board.⁵ The third reason is that, in recent years, Germany hardly faced

corporations; F A Gevurtz, *Corporation Law* (St. Paul, Minn.: 2000) 179, § 3.1., defines governance as "the question of how corporate law allocates power."

² J H Farrar et al, *Farrar's Company Law* (Butterworths, London et al – 4th Ed.: 1998) 301; KJ Hopt et al (eds) *Comparative Corporate Governance* (Oxford Univ. Press: 1998) Preface v; J Seligman, *Corporations: Cases and Materials* (Aspen Law & Business, 1995) 133.

³ DAI (ed) *Factbook* (Frankfurt am Main: 2004) 02-6 (per Oct 2004).

⁴ The closed corporation is subject to reforms, as well, due to the competition among state legislators to become the "Delaware of Europe." The competitive environment was developed by the European Court of Justice's decisions in *Inspire Art* (C 167/01 of 30.09.2003), *Überseering* (C 208/00 of 05.11.2002) and *Centros* (C 212/97 of 09.03.1999), see, eg C Kirchner, R W Painter & W A Kaal, 'Regulatory Competition in EU Corporate Law After Inspire Art: Unbundling Delaware's Product for Europe' (11/2004), online: <<http://ssrn.com/abstract=617681>>; T Troeger, 'Choices of Jurisdiction in European Company Law: Perspectives of European Corporate Governance', 6 EBOR (2005) 3; K Schmidt, 'Verlust der Mitte durch "Inspire Art"?' (transl. Do we lose the optimal compromise in the events following *Inspire Art*?), 168 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT – ZHR (2004) 493. Specifically, the German legislature intends to reform the provisions on capital maintenance and lower the minimum legal capital to 10,000 €, in order to facilitate access to limited personal liability, with the *MindestkapG* (transl. Proposal by the Federal Government for a law that lowers the minimum legal capital), BT-Drs. 15/5673 online <<http://dip.bundestag.de/btd/15/056/1505673.pdf>>; see U Seibert, 'Entwurf eines Mindestkapitalgesetzes (MindestkapG) – Substanzielle Absenkung des Mindestkapitals' (transl. MindestkapG – substantial lowering of minimum legal capital) BETRIEBSBERATER (2005) 1069 and B Grunewald & U Noack, 'Zur Zukunft des Kapitalsystems der GmbH – Die Ein-Euro-GmbH in Deutschland' (transl. The future of the legal capital in closed corporations – the 1 € closed corporation in Germany) GMBH-RUNDSCHAU (2005) 189. The *MindestkapitalG* was expected to come into force per 01.01.2006. On 16.06.2005, however, Parliament decided that further consideration of the proposal is necessary. Thus, the law needs to be reconsidered, possibly after the next federal elections in September.

⁵ The two-tier division of function has become increasingly accepted in the Anglo-American world, as well. The rules on independent directors are the first step towards two-tier boards: American stock exchanges required American corporations to elect a majority of independent directors with specific functions: S. 303A of the *Listing Manual of the New York Stock Exchange* determines that independent directors are to sit on the nomination and the compensation committee (as amended per Nov 2003). Even

problems of *corporate* governance with respect to large and established companies. This was the case, regardless of whether one characterizes these firms as exhibiting patterns of concentrated or dispersed ownership. Consequently, with respect to large firms, we have gained some confidence that corporate governance – the German way – does work. When, as we will demonstrate below, Germany nevertheless undertakes a plethora of corporate governance reform steps which impact large firms, we understand these reforms as a marketing instrument for German firms desiring to increase the attractiveness of their shares for international investors, rather than legislative interventions caused by recent scandals.⁶

However, this does not mean that Germany did not experience its share of securities' fraud during the Tech Bubble of the years 1998 to 2000. Germany differs, however, particularly from the United States in that German fraud cases involved almost entirely young and small technology- and internet-firms.⁷ With respect to these firms, corporate governance required adjustments, and these adjustments are currently being undertaken to an extent that demonstrates – positively speaking – the proverbial characteristic of German thoroughness, or – negatively speaking – overly activist and hasty governmental policy.

Presenting the current steps of corporate governance reform requires, first, a look back at the recent history of corporate governance reforms (sub II.). Then, we will describe the current reforms (sub III.) before we assess the impact of European reform activities on the German corporate governance system in the future (sub IV.).

stricter rules will be adopted by most Canadian regulators through the *Proposed Multilateral Policy 58-201 Effective Corporate Governance and 58-101 Disclosure of Corporate Governance Practices* (16.01.2004). The second step is the mandatory separation of the position of the Chief Executive Officer and the position of the Chairman of the Board. Insofar, Nr. 2.2.3 of the Canadian *Proposed Multilateral Policy 58-101* is also a step ahead of the American corporate governance rules. On recent developments with regard to board models see K J Hopt & P C Leyens, 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy' 1 *ECFR* (2004) 135 et seq.

⁶ See the Official Reasoning on s. 161 of the *Aktiengesetz* (transl. German Stock Corporation Law) that implements the German Corporate Governance Codex in the *Aktiengesetz*, see Federal Government, BT-Drs. 14/8769 (11.04.2002) 10 & 21. S. 161 of the *Aktiengesetz* was adopted through the *Law on Transparency and Publicity* in 2002, see *infra* note 17.

⁷ See the list of 45 firms that went either bankrupt or were subject to examinations by the Federal Financial Services Agency, Manager Magazin Online, <www.manager-magazin.de/geld/artikel/0,2828,186368,00.html>. With regard to that, the proceeding re Deutsche Telekom AG, one of the largest German corporations, for overstating the value of real property in its financial statements and prospectuses constitutes the exception. For details, see www.dsw-info.de, under the search-expression "Deutsche Telekom".

II. The First Decade: Allowing Market Forces To Work

A. The Traditional Explicit System of Corporate Control

Traditionally, Germany – and Scandinavian countries as well – provided corporate governance scholars with a riddle, since, although capital markets with their monitoring and pricing effects were institutionally less attractive in Germany as 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.⁸ From the perspective of a national observer, this characteristic was 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,⁹ a specific legal regime for majority–minority conflict, called *Konzernrecht*,¹⁰ and creditor representation in supervisory boards that augments minority shareholder monitoring.¹¹ Since these measures require direct investor influence, we will refer to them as explicit devices of corporate control. Further, some commentators hold that social and ethical restraints,¹² or restraints provided by worker representatives in supervisory boards,¹³ 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

Ten years ago, Germany had neither a sufficient number of corporations, nor investors, nor financial institutions, nor rules¹⁴ for the existence of viable capital mar-

⁸ J C Coffee, 'Do Norms Matter? A Cross-Country Evaluation' 149 U. Pa. L. Rev. (2001) 2151, at 2158; R Gilson, 'Complicating the Controlling Shareholder Taxonomy' (3/2003), online: www.uni-bocconi.it/doc_mime_view.php?doc_id=24692&doc_seg_id=1; 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* (Oxford University Press, New York: 2003), at 168, 189 [Roe, Political Determinants].

⁹ Eg D A Zetzsche, 'Shareholder Interaction Preceding Shareholder Meetings of Public Corporations – A Six Country Comparison' 2 ECFR (2005) 107, early version as CBC Research Paper, online < <http://ssrn.com/abstract=624241> > [Zetzsche, 'Shareholder Interaction'], and 'Explicit and Implicit System of Corporate Control', CBC Research Paper, online <<http://ssrn.com/abstract=600722>> [Zetzsche, 'Explicit and Implicit System'] , at B.III.2.

¹⁰ Eg Zetzsche, 'Explicit and Implicit System', above note 9, at B.II.2.

¹¹ Eg Roe, Political Determinants, above note 8, at 187.

¹² Zetzsche, 'Explicit and Implicit System', above note 9, at B.III.1., and "An Ethical Theory of Corporate Governance History" (from SSRN).

¹³ Roe, Political Determinants, above note 8, at 187.

¹⁴ Some market-rules dating back to the 19th 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.

kets. This paper focuses on the last of these factors, which is held to be particularly important for the rise of strong securities market.¹⁵ These rules for viable capital markets, and thus the preconditions for a market-oriented corporate governance regime, have been developed within a decade¹⁶ that confronted German corporate lawyers with more than 10 major legislative measures¹⁷ and 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”.¹⁸ The most important legislative steps of the first decade of the “permanent corporate law reform” include:

- The establishment of a Federal Financial Services Agency [FSA];¹⁹
- A significant number of measures that improved Germany’s securities laws on the basis of a disclosure approach,²⁰ and
- The German takeover law introduced in 2001.

¹⁵ Bernard S. Black, ‘The Legal and Institutional Preconditions for Strong Securities Markets’ (2000-2001) 48 UCLA L. Rev. 781.

¹⁶ 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 implicit to an explicit corporate governance system, see W Zöllner, ‘Aktionär und Eigentum’ (transl. Shareholder and Property), DER GESELLSCHAFTER 2004, 5; J N Gordon, ‘Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany’ (1999) 5 Columb. J. Eur. L. 219, and ‘The international relations wedge in the corporate convergence debate’ in J N Gordon/ M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press, 2004) 161 et seq., and C J Milhaupt (ed.), *Global Markets, Domestic Institutions* (Columbia University Press, 2004) 214 et seq.

¹⁷ 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 (1999) 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: *Umwandlungsrechtsvereinigungsgesetz* 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.

¹⁸ W Zoellner, ‘Aktienrecht in Permanenz – Was wird aus den Rechten des Aktionärs’ (transl. The Permanent Corporate Law Reform – What happens to the rights of shareholders?) DIE AKTIENGESELLSCHAFT (1994) 336; U Seibert, ‘Aktienrechtsreform in “Permanenz”?’ (Transl. Permanent Corporate Law Reform?) DIE AKTIENGESELLSCHAFT (2002) 417.

¹⁹ First established as “Bundesaufsichtsamt für das Wertpapierwesen” in 1994/1995, it was united with the „Bundesaufsichtsämtern für das Versicherungswesen und das Kreditwesen“ and renamed into “Bundesaufsichtsamt für Finanzdienstleistungen” (Federal Agency for Financial Services) in 2001.

²⁰ See D A Zetzsche, *Aktionärsinformation in der börsennotierten Aktiengesellschaft* (transl.: Shareholder Information in Public Companies), (Carl-Heymanns-Verlag, Köln: 2005) § 12.

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;
- Reform of the law on shareholder meetings in four legislative steps between 1994 and 2002,²¹ which, for example, 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;²²
- Creating a squeeze-out provision in 2001, and
- Resolve of the German Corporate Governance Code [GCGC] by the semi-official German Corporate Governance Code Commission [Codex Commission] in 2002.²³

Since the GCGC and the procedure of its enacting exhibit some idiosyncrasies, the Code deserves particular attention.²⁴ 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 comprises an overview of the mandatory corporate and securities law framework, as well as recommendations, and suggestions. The GCGC 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.

The GCGC fulfils three functions. First, it explains the German law on public corporations – the legal framework – to domestic and foreign investors and the lay public. This is necessary, since the law for public corporations is regulated in various sources with hundreds of sections in the *Aktiengesetz*, the *Handelsgesetzbuch* and many different securities laws and regulations. Second, 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

²¹ 1994: *Gesetz für kleine Aktiengesellschaften*; 1998: *KonTraG*; 2001: *NaStraG*; 2002: *TransPuG*, see above note 17.

²² See U Noack, 'Modern communications methods and company law', EBLR (1998) 100; U Noack & M Beurskens, 'Internet-Influence on Corporate Governance', 3 EBOR (2002) 129; D Zetzsche, (ed.), *Die Virtuelle Hauptversammlung* (Transl.: *The Virtual Shareholder Meeting*) (Erich-Schmidt-Verlag, Berlin: 2002), and 'Corporate Governance in Cyberspace – A Blueprint for Virtual Shareholder Meetings', CBC Research Paper, online < <http://ssrn.com/abstract=747347> >.

²³ For an English translation, recent revisions, and background information, see www.corporate-governance-code.com.

²⁴ This paper focuses on current reforms. For a topical overview of past reforms in English see eg E Nowak, 'Investor Protection and Capital Market Regulation in Germany', in: JP Krahn, RH Schmidt (eds), *The German Financial System* (Oxford University Press, 2004); U Seibert, 'Corporate Governance and the Role of Investment Funds' 3 German Law Journal (2002) 11; Zetzsche, 'Explicit and Implicit System', above note 9, at C.III.2.

deviation in the corporate governance statement which effectively forces the companies to explain the reason for the deviation to investors. Thus, the Code exerts some indirect pressure on public corporations to adopt generally accepted corporate governance practices,²⁵ and is apparently quite successful in doing so.²⁶ Third, it suggests the implementation / use of certain practices in fields of corporate governance where there is still debate among experts as to what the “best” procedure / practice is. Firms can deviate from these *suggestions* without disclosure.²⁷

C. The Hybrid Approach

Although the German government initiated the *development* of strong capital markets in Germany in the last decade, it is important to note that the recent reforms did not strive for a *dominant* role of 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. Current Reforms

A. Macro Factors

While the reforms of the last decade were primarily imposed by Germany’s need for stronger securities markets, three factors drive the current corporate governance reform. First, as a measure to improve the European Single Market for financial services and products,²⁸ the *European legislature* intruded into the (traditionally)

²⁵ 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.”

²⁶ According to a study cited by Jaap Winter, notwithstanding the recommended disclosure of the remuneration of the individual members of the board of management (see below III.B.1.), almost all German corporations fulfil almost all recommendations of the GCGC. 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, eg, the United Kingdom and the Swiss Corporate Governance Codes.

²⁷ For example, the Code suggests that the representative (see above note 25) should also be accessible during the General Meeting.

²⁸ The European Commission defined the scope of its corporate governance activities in its *Financial Services Action Plan* as of 11.05.1999, COM(1999)232, online < http://europa.eu.int/comm/internal_market/en/finances/actionplan/actionen.pdf >, and its *Corporate Law Action Plan* as of 21.05.2003, online < http://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm >. With

national domain of corporate governance. In doing so, it was underpinned by the occurrence of some widely-discussed scandals.²⁹ Second, *international developments*, especially in the United States, required adjustments of the national rules. Finally, regulators implemented the proposals of the influential German *Government Commission on Corporate Governance* from 2001.³⁰ The German federal government translated these proposals into a “Ten-Step Program for Corporate Integrity and Investor Protection,” [Ten-Step Program]³¹ from which most of the current reform steps follow. This Ten-Step Program is rooted in the belief that investor confidence and thus German capital markets can be made stronger through increased transparency, denser control of corporations, and stricter criminal and civil liability for issuers and individuals who engage in misconduct.

B. The Proposals

1. Corporate Law

In corporate law, the legislature adopted the rules for the European Company [Societas Europea – SE], a supra-national corporate form that is based on European law.³² Despite its adoption, the *Law on the European Company*³³ might impact the German corporate landscape more severely than the legislature might have intended: Under the European Directive, a 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 European Company regime provides more flexibility than the

respect to that, see K Lannoo & A Khachaturyan, ‘Reform of Corporate Governance in the EU’ 5 EBOR (2004) 37, 38.

²⁹ 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. For details, see *infra* IV.

³⁰ See T Baums (ed) *Bericht der Regierungskommission Corporate Governance* (transl. Report of the Government’s Commission on Corporate Governance), (Verlag Dr. Otto Schmidt, Köln: 2001), with English translation in T Baums, “Company Law Reform in Germany”, online <<http://ssrn.com/abstract=329962>> [Baums, “Report”].

³¹ Federal Secretaries of Justice and Finance, *10-Punkte-Programm der Bundesregierung zur Verbesserung der Unternehmensintegrität und des Anlegerschutzes*, 25.02.2003, online <www.bmj.bund.de/enid/fa8a71ef4a25638be7ee184cc9d06cdd,0/ai.html>.

³² 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.

³³ *Gesetz zur Einführung der Europäischen Gesellschaft (SEEG)* of 28.12.2004, BGBl. I (2004) 3675.

German *Aktiengesetz* under which a two-tier board structure is mandatory. This is one of the aspects which prompted a discussion³⁴ as to whether the German law on worker codetermination in corporations can still be maintained in its traditional form. We will address this issue more in detail below.³⁵

In contrast, the *UMAG*³⁶ strives to improve the governance system of *corporations*. *UMAG* stands for the long title “Law on the Improvement of Corporate Integrity and on the Modernization of the Regime governing Decision-Directed Suits.” It amends the German *Aktiengesetz* with respect to three crucial areas of corporate governance. These are (1) Liability of corporate managers; (2) Shareholder meetings; and (3) Contest of shareholder meeting decisions.

(1) The first area regards the *liability of corporate managers*. Though the duties of loyalty and care that are imposed on managers are essentially comparable to those of officers in other European and North-American countries,³⁷ German corporations rarely hold managers liable for breach of their duties. Presently, the *Aktiengesetz* assigns the right to sue managers for damages to the corporation generally to the supervisory board.³⁸ The supervisory board rarely exercises this right since the negative impact on the corporate reputation often outweighs the financial benefit of a lengthy 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.³⁹ Further, 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.⁴⁰ Pursuant to s. 147 (4) of the *Aktiengesetz*, if the company loses in 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 firm (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.

³⁴ On 26.05.2004, the German Bundestag (Federal Parliament) in which the Socialdemocrats and the Green Party currently hold the majority, adopted the Law introducing the European Company. The opposition, which held the majority in the Bundesrat (Federal Council), delayed the adoption of the law through a veto of the Bundesrat on 26.11.2004.

³⁵ See *infra*, sub. IV A.

³⁶ BR-Drs. 454/05, online: http://www.parlamentsspiegel.de/portal/WWW/Webmaster/GB_I/I.4/Dokumentenarchiv/dokument.php?k=BBD454/05.

³⁷ 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. (The *UMAG* also seeks to codify the business judgement rule in s. 93 (1) sentence 2 of the *Aktiengesetz*.)

³⁸ S. 112 of the *Aktiengesetz*.

³⁹ S. 147 (1) of the *Aktiengesetz*.

⁴⁰ S. 147 (2) of the *Aktiengesetz*.

Comparative studies hold that the safeguard for German managers with respect to shareholder suits is rare among countries with advanced corporate laws and strong capital markets.⁴¹ 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.⁴² Thus, the *UMAG* gives 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.⁴³ Moreover, the *UMAG* abolishes the cost provision that yet puts minority shareholders at a disadvantage.

In order to further facilitate shareholder activism, the *UMAG* implements a special section in the electronic version of the Federal Bulletin⁴⁴ as a means of reducing shareholders' collective action problems.⁴⁵ In this special section 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, and particularly, in an international context. If the institution proves itself to be successful, we would like to see the scope of this instrument extended to all shareholder minority rights.

(2) At the same time, this special section is also related to the second core issue of the *UMAG*, which is the *procedure of shareholder meetings*. This is due to the

⁴¹ T Baums & K E Scott, 'Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany' (November 2003) European Corporate Governance Institute (ecgi) Law Working Paper No. 17/2003, <http://www.ssrn.com/link/ECGI-Law.html>, at 18-19.

⁴² 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).

⁴³ 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 supervisory 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.

⁴⁴ S. 127a of the *Aktiengesetz (UMAG)*. The website section will be accessible online: < www.e-bundesanzeiger.de >.

⁴⁵ 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>>.

fact that shareholders may use this section to make proposals and attempting to garner support from other shareholders.⁴⁶

Another issue related to the procedure of shareholder meetings is the reform of the identification and authorization of shareholders for their meetings.⁴⁷ This aspect of the *UMAG* affects companies which issue bearer shares, hence approximately 90% of all German *public* corporations. The *UMAG* removes the expression *Hinterlegung* from the current provision pertaining to shareholder identification and authorization. Literally translated, the expression *Hinterlegung* refers to the deposit (of the original share certificate). With the transition from the principle that a share certificate represents one share to so called “global share certificates”, which certify the ownership of more than one up to all shares of an issuer, the meaning of *Hinterlegung* has changed. Today, *Hinterlegung* describes the certification of the ownership of shares by the depository bank that holds the shareholder’s account.⁴⁸ In detail, it describes a process that the European Expert Group on Cross-Border Voting termed “reconciliation”⁴⁹ – a method to identify shareholders by reconciling all share transactions right up to the date of, or a cut-off date shortly (a few hours) in advance of, the shareholder meeting.

However, some foreign investors (and banks) falsely assumed that *Hinterlegung* implies the “blocking of shares”, and, thus, refrained from exercising their voting rights. Thus, the *UMAG* replaces the reconciliation-system by a record date system, meaning that only those who are shareholders at the relevant record date are entitled to exercise their shareholder rights in the meeting. The mandatory record date is at the beginning of the 21st day prior to the meeting.

This system change shifted the weight from the bottom to the top of the procedure of shareholder meetings. Yet, in contrast to the U.S.A., the dates for shareholder *information and shareholder authentication* are not harmonized. Instead, depository banks are obliged to forward any voting-related information to their clients, at a maximum of four and at a minimum of two weeks prior to the shareholder meeting,⁵⁰ while authentication takes places very shortly before the meeting.

⁴⁶ For details on this function of the shareholder forum see Zetzsche, ‘Shareholder Interaction’, above note 9, at C.III.1.

⁴⁷ 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* –’ (transl.: 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* – NZG (2005) 369.

⁴⁸ See U Noack & D A Zetzsche, ‘Die Legitimation des Aktionärs’ (transl: The Identification of Shareholders), *DIE AKTIENGESELLSCHAFT* (2002) 651, and ‘Aktionärslegitimation bei sammelterhaltenen Inhaberaktien’ (transl.: The Identification of Shareholders of Companies Issuing Bearer Shares held in Custody of a Central Depository System), *WERTPAPIERMITTEILUNGEN* (2004) 1.

⁴⁹ 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), online: < <http://www.jura.uni-duesseldorf.de/dozenten/noack/texte/normen/amsterdam/final.htm> >, 5.3.

⁵⁰ See s. 125 (2) No. 3 and s. 128 of the *Aktiengesetz* and AGB Sonderbedingungen für Wertpapiere (transl. Generally applicable contractual terms for financial intermediaries with regard to securities trading and depository business).

This system requires more than one delivery of information from depository banks to their customers, and forces companies to spend significant resources for securing the shareholder authentication. In the future, only one delivery on the 21st day before the meeting will be necessary; this delivery will contain both the shareholder information and the authentication certificate.

Since all information may be transmitted electronically, the current reforms facilitate cross-border electronic voting *in absentia*, as required by the OECD principles of Corporate Governance.⁵¹

The third element regarding shareholder meetings is a push for a *cut back* of the overly formalistic understanding of the exercise of the information rights that shareholders have in Germany. Presently, an individual shareholder may ask any question that is related to the topics that the meeting is called to vote upon,⁵² and management must answer these questions. Failure to fully answer such questions may lead to shareholder suits, the outcome of which may be that decisions of the meeting are declared to be void. This right gives German shareholders very broad powers in exercising their information rights. The individual information right was abused in recent years by shareholders who used it as the basis for bringing strike suits. Thus, the *UMAG* introduces 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 may significantly reduce their efforts in answering questions in shareholder meetings by year-long diligent disclosure on their corporate websites. Further, the *UMAG* clarifies⁵³ that the failure to provide information which a reasonable shareholder would not consider to be relevant for his voting decision, does not justify a shareholder suit against meeting decisions.⁵⁴ Moreover, s. 243 (4) *Aktiengesetz (UMAG)* also prevents shareholders to bring suits for lack of disclosure regarding information on the value of the corporation or some of its subsidiaries if these matters can be settled in a specific opposition procedure (*Spruchverfahren*). The last exclusionary reason is particularly relevant in the context of squeeze outs and fundamental changes the validity of which were yet frequently threatened by strike suitors.

(3) Finally, the *UMAG* addresses the provisions on shareholder meeting decision-directed shareholder suits to avoid strike suits. Decision-directed suits are shareholder suits that aim to declare shareholder meeting decisions void on the ground that the decision violated either a statutory provision or a provision of

⁵¹ OECD, Principles of Corporate Governance 2004, at II.C.4., online www.oecd.org/dataoecd/32/18/31557724.pdf.

⁵² 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.

⁵³ 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.

⁵⁴ S. 243 (4) of the *Aktiengesetz (UMAG)*.

the Articles of Association.⁵⁵ This suit is part of the traditional German concept which perceives the individual shareholder to be the watchdog of management, the supervisory board, and majority shareholders.⁵⁶ The effectiveness of the watchdog function, however, became doubtful due to strike suits by professional plaintiffs, who forced management into costly settlements. The risk is greatly increased, as the filing of a decision-directed suit may prevent the implementation of a shareholder meeting's decision. Court procedures can take up to three to four years until the German Federal Court decides the case. Thus, managers often prefer to share the gains of the proposed measures (contained in the meeting decision) with strike suit claimants rather than delay the implementation of the measure itself through a long-term court procedure.

The *UMAG* seeks to solve the strike suit problem for crucial issues of shareholder consent. It imposes a preliminary procedure⁵⁷ by which Regional Courts (*Landgerichte*) decide whether management may pursue the measure itself within 4 months after the meeting.⁵⁸ If a Regional Court allows the implementation of the measure, the final court decision will only be relevant for damage claim amounts.⁵⁹ Moreover, any settlement must be published.⁶⁰ Thus, there is some hope that the *UMAG* mitigates incentives for both suit claimants and managers to strive for shady settlements to the detriment of the shareholder body.

While specific disclosure of each manager's salary is apparently common in other European countries, German accounting law traditionally requires only the remuneration of the board as such. Thus, the *Law on the Disclosure of Members of the Board of Management [VorstOG]*⁶¹ requires companies to disclose the remuneration that each member of the board of management achieves individually. The

⁵⁵ S. 243 (1) of the *Aktiengesetz*.

⁵⁶ Above II.1.

⁵⁷ 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 (eg into a limited liability corporation) with overall positive results. See ss. 207 et seq. of the *Umwandlungsgesetz* ("Restructuring Law").

⁵⁸ 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 Leuring, "Der Referentenentwurf eines Gesetzes zur Unternehmensintegrität und Modernisierung der Anfechtungsklage" (transl. The Federal Secretary of Justice's *UMAG* Draft) *NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT* (2004) 253-254.

⁵⁹ 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)*.

⁶⁰ Ss. 248a, 149 of the *Aktiengesetz (UMAG)*.

⁶¹ BR-Drs. 451/05 und 398/05, online: http://www.bundesrat.de/coremedia/generator/Inhalt/Drucksachen/2005/0398_2D05.property=Dokument.pdf; the *VorstOG* amends ss. 285, 286, 289, 314, 315, 334 of the *Handelsgesetzbuch* (transl.: Commercial Code), which regulates parts of German accounting law applicable to public corporations.

Federal Government decided to intervene, because most public German firms refrained from disclosure – similarly uniform as most firms comply with regard to the other recommendations – despite the fact that the GCGC had recommended an individual disclosure of the remuneration of each manager. Two side-issues frame the *VorstOG*. First, it is particularly detailed with regard to severance payments – a side-aspect emerging from the spectacular examples provided by *Mannesmann AG* and *Metallgesellschaft AG*. Further, the shareholders' majority of 75% of the shares represented in the meeting may renounce the obligation to individually disclose managers' emoluments.

We are unsure whether the *VorstOG*, in fact, strengthens shareholder rights. Yet, shareholders could easily estimate the salary of each manager from the total remuneration given to the board. This was particularly the case, given that a certain distribution scheme is commonly applied.⁶² This practice is typical for German law which generally mandates collegial responsibility of the members of the board of management for all actions taken by other board members. Consequently, shareholders are essentially as well informed as before the *VorstOG* was adopted. The provisions requiring disclosure by third parties – an issue that is relevant in corporate groups – also bring few improvements, since the controlling shareholder may waive the disclosure obligation if he holds 75% of the votes in the shareholder meeting (which is often the case). While benefits are thus unclear, the *VorstOG*, however, clearly increases the number of provisions applicable to public firms and, hence, the disclosure costs for these firms.⁶³

2. Securities Law

While the corporate law reform steps merely strive for the adjustment of procedural provisions, the securities law agenda comprises changes of substantive provisions, as well. It currently consists of four measures dealing with the relationship between investors and corporations,⁶⁴ and at least three measures reforming the institutional framework of the capital markets.⁶⁵ We will focus on the former steps.

⁶² Generally speaking, in hierarchically organized boards (with a chairman), the chairman of the board of management receives twice the compensation of individual colleagues and the vice-chairman receives 1.5 times the compensation of individual colleagues, while in collegially organized boards all members are paid equally.

⁶³ At first, the German liberal party F.D.P. sought to delay the adoption of the law by procedural tactics in the legislative process preceding the upcoming federal elections in September 2005. However, they reneged, which is probably due to the pressure for conformity exercised by the European Commission's recommendation on director remuneration (see *infra* note 135).

⁶⁴ *Anlegerschutzverbesserungsgesetz* (transl.: Law on the Improvement of Investor Protection – AnSVG) of 29.10.2004, BGBl. I (2004) 2630; *Kapitalmarktinformationshaftungsgesetz* – KapInhaG (transl.: Law pertaining to the Liability for Capital Market Information); *Kapitalanleger-Musterverfahrensgesetz* – KapMuG (transl.: Law introducing an Example Procedure for Investor Suits), BR-Drs. 455/05, online < http://www.parlamentsspiegel.de/portal/WWW/Webmaster/GB_I/I.4/Dokumentenarchiv/dokument.php?k=BBD455/05 >; *Prospektrichtlinie-Umsetzungsgesetz* of 22.06.2005, BGBl. I (2005) 1698.

⁶⁵ *Investmentmodernisierungsgesetz* (transl.: Law on the Modernization of Provisions Related to

The Law on the Improvement of Investor Protection, which was adopted at the end of October 2004,⁶⁶ strives for increased transparency and imposes civil and criminal liability for misconduct on securities market actors. Article 1 of this law primarily implements the European *Market Abuse Directive*,⁶⁷ and the provisions defining details thereof,⁶⁸ which have been enacted according to the European Lamfalussy-procedure.⁶⁹ From a corporate governance perspective, 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 will now have 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*,⁷⁰ it must make the aforementioned disclosure. The German *Securities Trading Law* is to change accordingly.⁷¹ Further, secondary insiders⁷² who *forward* inside information or recommendations to buy or sell financial instruments will be integrated into the range

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* (transl.: Law Implementing the European Rules on Financial Conglomerates), of 21.12.2004, BGBl. I (2004) 3610; *Gesetz zur Änderung der Vorschriften über Fernabsatzverträge bei Finanzdienstleistungen (Fernabsatz-Finanzdienstleistungsgesetz)* (transl.: Law regulating the Distant Selling of Financial Services) of 02.12.2004, BGBl. I (2004) 3102. Article 3 of the *Law on the Improvement of Investor Protection* also contains institutional reforms.

⁶⁶ Above note 64.

⁶⁷ *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.

⁶⁸ 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.

⁶⁹ New procedure for deciding and applying securities legislation agreed by the European Council in March 2001 and endorsed by the European Parliament in Feb 2002 (see IP/02/195).

⁷⁰ "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 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."

⁷¹ In ss. 12 et seq., esp. 15 of the *Wertpapierhandelsgesetz* (transl. Securities Trading Law), but also ss. 37b, 37c of the *Wertpapierhandelsgesetz* pertaining to civil liability.

⁷² I.e. those who received inside information from persons who have access to the source of company information (primary insiders).

of regulatory offences as well. In the past, only those secondary insiders who were personally engaged in trading activities were subject to prosecution.⁷³

(2) The second aspect is the implementation of Article 6 (9) of the *Market Abuse Directive*, which is the European *whistle blower provision*. The German *Securities Trading Law* will require that financial intermediaries and stock exchanges notify the FSA about any fact that gives rise to the assumption that a transaction might constitute insider dealing or market manipulation.⁷⁴ The duty to blow the whistle merely extends to the level of market institutions, but not to the level of the firm: managers, employees, lawyers and public accountants do not have to notify securities agencies upon receiving knowledge of suspicious facts.

(3) Third: The European framework defines, in detail, illegal practices of market manipulation. Its adaptation requires some changes to the German provisions on market manipulation which were enacted with the *Fourth Law on the Improvement of Financial Markets* in 2002.⁷⁵ The fact that the finding of market manipulation will not require the malefactor to act in bad faith probably constitutes the most significant change. Rather, it will suffice that his or her actions are *able* to manipulate the capital markets.⁷⁶ Furthermore, the specific actions that are considered to constitute market manipulation have been defined in an order by the Federal Secretary of Finance.⁷⁷ In addition, the German legislature adopts the European safe-harbour-regime,⁷⁸ which is likely to increase the level of certainty for market participants.

(4) Finally, Article 12 of the *Market Abuse Directive* mandates changes in the law governing the German FSA ("BaFin"). The BaFin will be empowered to interpret and define details of European and German Securities Law provisions on a plethora of issues.⁷⁹ Thereby, the legislature intends to create the preconditions necessary for future adaptations of technical provisions, as well as cooperation between European securities regulators.⁸⁰ 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 are enacted by Parliament.⁸¹ The extended powers of the BaFin, even though they may be justi-

⁷³ S. 39 of the *Wertpapierhandelsgesetz* (Securities Trading Law) will be changed accordingly.

⁷⁴ S. 10 of the *Wertpapierhandelsgesetz* (Securities Trading Law) (*AnSVG*).

⁷⁵ Above note 17.

⁷⁶ S. 20a (1) of the *Wertpapierhandelsgesetz* (Securities Trading Law) (*AnSVG*).

⁷⁷ See Federal Secretary of Finance, *Verordnung zur Konkretisierung des Verbotes der Marktmanipulation – MaKonV* (transl.: Order with respect to the appropriation of market manipulation), 01.03.2005, BGBl. I (2005) 515.

⁷⁸ Pursuant to Article 1 (2) *Market Abuse Directive* and Art. 4 and 5 of Commission Directive 2003/124/EC of 22 December 2003, above note 68. 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.

⁷⁹ Eg, see ss. 15 (7), 29, 35 (4), 36 (5), 37i (1) S.3, 37m S.3 of the *Wertpapierhandelsgesetz* (Securities Trading Law) (*AnSVG*).

⁸⁰ See Article 16 of the *Market Abuse Directive*, implemented through Article 36c of the *Wertpapierhandelsgesetz* (Securities Trading Law) (*AnSVG*).

⁸¹ See the Federal Constitutional Court's decision in *Kalkar*, BVerfGE 49, 89, 126; *Hochschul-*

fied under European law, may conflict with this requirement.

The *Law implementing the Prospectus Directive*⁸² also emanates from European reform activity triggered by the Financial Services Action Plan. The law seeks to abolish the legislative distinction between a public offering of securities (currently regulated in the *Verkaufsprospektgesetz*) and the offering of securities that are admitted to being traded at a stock exchange (currently regulated in the *Börsengesetz*). As both kinds of securities will be dealt with in a new *Wertpapierprospektgesetz* (Law on Securities Prospectuses),⁸³ the relevant sections of the aforementioned laws and orders thereon will be repealed. Further, stock exchanges have currently jurisdiction with respect to the formal review of prospectuses with respect to securities admitted to stock exchanges, while prospectuses for public offerings are reviewed by the BAFin. In the future, the BAFin will review all types of prospectuses. The BAFin will thereby be turned into a fully-integrated securities regulator, which is positive for the agency's standing in Europe and beyond. Moreover, the measure is likely to prevent the stock exchanges from conflicts of interests when reviewing draft prospectuses. However, since both the *Verkaufsprospektgesetz* and the *Wertpapierprospektgesetz* contain liability provisions, the traditional distinction will be retained with respect to provisions on liability for prospectus information. The Government intends to address this methodical inaccuracy in a later reform step.

The two other securities law (proposal)s are rooted in the Federal Government's Ten-Step Program: First, the proposal on a *Law pertaining to the Liability for Capital Market Information*⁸⁴ is an attempt by the German government to close what it and some commentators⁸⁵ perceive to be a loophole in German securities regulation. During the tech bubble, some technology firms (artificially?) pushed up their share prices by issuing inaccurate current change reports and press releases. Dealing with this behaviour was a serious issue in Germany. For a finding of wrongful disclosure, necessary in order to justify imposing civil liability, German law requires that there is evidence of intent.⁸⁶ As a deterrence measure, the cur-

organisationsrecht, BVerfGE 61, 260, 275; *Familiennachzug*, BVerfGE 76, 1, 74; *C-Waffen*, BVerfGE 77, 170, 230 (Wesentlichkeitstheorie).

⁸² Above note 64. 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.

⁸³ Pursuant to Article 1 of the *Prospektrichtlinie-Umsetzungsgesetz*, above note 64; see J Ekkenga, 'Änderungs- und Ergänzungsvorschläge zum Regierungsentwurf eines neuen Wertpapierprospektgesetzes' (transl.: suggestions for altering and supplementing the draft for a *Wertpapierprospektgesetz*) BETRIEBSBERATER (2005) 561.

⁸⁴ Above note 64.

⁸⁵ Baums, "Report", above note 30, No. 186 et seq.; H Fleischer, Statement at 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.

⁸⁶ Pursuant to s. 826 *BGB*, see, for example, *Infomatec*, BGH (Federal Supreme Court) of 19.07 2004

rent proposal seeks to establish civil liability for members of the management and supervisory boards, based on a standard of care equivalent to that for civil liability in negligence. This civil liability will result from the issuance of any misstatement in oral or written communication that is induced by the issuer, eg at shareholder meetings and analyst conferences. However, the threat of civil liability does not pertain to interviews given to the press. According to the proposal, the liability of board members for negligent misstatements will be limited to four years' income. Further, the proposal undertakes to intensify the civil liability for misstatements of certified accountants and other experts.⁸⁷ While there is no question that criminal actors should be held liable which German law allows both with respect to civil and criminal⁸⁸ liability, the business community argues that strict(er) liability may hamper *bona fide* disclosure, and it may harm capital market efficiency through a general lack of information. Thus, the draft-*Law pertaining to the Liability for Capital Market Information* is currently under revision. It may be put on the legislative agenda after the next federal elections.

While the above proposal relates to substantive claims of investors, the other (already adopted) measure concerns procedural issues relating to class actions. German corporate law currently does not allow for class action suits, with two consequences: First, courts can hardly handle large-scale securities actions in an orderly and timely fashion. Second, substantive claims for misleading disclosure and market manipulation may not be realized, due to the high costs and risk of corporate and securities litigation that must be borne by the first claimant.⁸⁹ The German legislature addresses these problems with the *Law on Example Procedures for Investor Suits*.⁹⁰ The law strives to enable shareholders to take advantage of collective suits without importing the flaws of American type securities class actions that are – as mentioned above⁹¹ – considered to be particularly lawyer-, rather than investor-driven. Therefore, the law requires that all disclosure-related claims must be filed at the regional court of the company's registered seat. When 11 suits are filed upon the same disclosure item, the higher regional court will decide upon the factual basis of the claims. In this procedure, the claimant with the highest

– II ZR 217/03, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2004) 811. For misleading disclosure related to a firm's financial situation, civil liability might result from s. 823 (2) of the *BGB* (transl. German Civil Code) in connection with s. 400 of the *Aktiengesetz*.

⁸⁷ This, in particular, pertains to expert statements in prospectuses. For example, if an accountant certifies a financial statement that the issuer includes in a prospectus, the accountant may be held liable for a misleading expert statement.

⁸⁸ BGH (Federal Supreme Court) of 16.12.2004 – 1 StR 420/03, NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2005) 132 re *Haffa/EM.TV*.

⁸⁹ With respect to "collective action problems" regarding shareholder suits see above note 45.

⁹⁰ Above note 64. For details, see F Reuschle, 'Das Kapitalanleger-Musterverfahrensgesetz' (transl. The Law on Example Procedures for Investor Suits) NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (2004) 590.

⁹¹ Above note 42.

single damage claim is to become the “sample claimant”. Other claimants may support the sample claimant’s evidence and procedure as “additional claimants”. Once the higher regional court has decided upon the claim of the sample claimant, the regional court will deal with the peculiarities of the other claims. If the court dismisses the claim, all claimants will have to share in the costs of the sample procedure.

3. *Accounting Law*

Finally, the German government is reforming 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*⁹² strives to strengthen auditor independence. The significance of these alterations was demonstrated by the international scandals of *Enron* and *Worldcom*, as well as *Ahold* and *Parmalat*. The *Accounting Reform Law* imposes strict rules through a variety of measures which emphasize the principle “Keep your distance!” – Accountants should keep their distance from the firms by avoiding any relationship with the firm beyond that of accountant-client.⁹³

Until the present, auditors were prohibited from certifying financial statements when they participated in keeping the books or preparing the firm’s financial statements, or when they received more than 30 percent of their turnover from a single client. The *Accounting Reform Law* will lower the threshold to 15 percent of the turnover. In addition, auditors will be prohibited from certifying statements when they supply material management or financial services, insurance, or evaluation services to the firm. The *Accounting Reform Law* is even stricter with respect to accountants for public corporations and firms that offer financial and insurance services. These accountants must not supply tax or law consultancy with regard to the same financial statement that they certify, must not appear in court for the company, and must not implement computer systems for bookkeeping purposes.

If these measures do not succeed in raising the accountant’s diligence, the *Accounting Control Law*⁹⁴ introduces a two-step enforcement procedure for public corporations. The first step will be executed by a privately organized, independent body, termed the Financial Reporting Enforcement Panel (“the Panel”). This institution reviews statements of firms where there is some evidence of inaccurate accounting. Further, it undertakes random checks and reviews on behalf of the BaFin. If it finds that there are indeed accounting failures, it cooperates with the

⁹² *Gesetz zur Einführung internationaler Rechnungslegungsstandards und zur Sicherung der Qualität der Abschlussprüfung* (Bilanzrechtsreformgesetz – BilReG) of 4.12.2004, BGBl. I (2004) 3166.

⁹³ Otherwise, as JC 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 from the firm to the accountant as “bribes”, and the reduction of these payments as “punishment”.

⁹⁴ “*Gesetz zur Kontrolle von Unternehmensabschlüssen* (Bilanzrechtskontrollgesetz – BilKoG)” of 15.12.2004, BGBl. I (2004) 3408.

firm in order to correct the statements. As a second step, if the Panel and the firm do not agree on an accounting issue, the BaFin may examine the statements by itself and impose enforcement measures.

At this point in time, three aspects of the *Accounting Control Law* appear to be at odds. First: the Panel 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 focus on providing the accounting professionals with the proper incentives for remaining independent, eg through increased liability (see below). Second, the control institution has no jurisdiction of any kind about the issue upon which it is deciding. Consequently, without *res judicata* of the Panel's decision, from a legal point of view, there is no benefit to the firm, other than that it receives an additional opinion on an accounting issue.⁹⁵ Third, accounting law is made on an international and European level. The Panel, however, is to be established and financed by parties of the "German economy". We wonder whether this circle of actors is appropriate for firms with an international focus.

Eventually, the *Law on the Supervision of Accountants*⁹⁶ increases the pressure on accountants by means of a further method. It implements an independent body, the *Abschlussprüferaufsichtskommission* (Accounting Supervisory Committee – APAK) under the supervision of the German Federal Secretary of Business and Labor, that is 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 (which regards retrospective information), but by the abuse of looking-forward information, it is questionable, however, whether all these steps together were necessary, and whether it was advisable 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 voluminous legislation – to the benefit of society.⁹⁷ Furthermore, if one had sought to increase the pressure on accountants, the lifting of the liability-privilege that accountants enjoy under German law⁹⁸ would have been a less expensive, but (at least) equally efficient measure

⁹⁵ B Grossfeld, 'Bilanzkontrollgesetz – Offene Fragen und etwas Optimismus' (transl.: 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.

⁹⁶ Abschlussprüferaufsichtsgesetz (APAG) of 27.12.2004, BGBl. I (2004), 3846.

⁹⁷ See with respect to the timing of law-making, in general, F Paris, V Fon & N Ghei, 'The Value of Waiting in Lawmaking', from SSRN, in EurJ L & Econ. (forthcoming).

⁹⁸ 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.

in increasing accounting diligence. Insofar, we might see the aforementioned *Law pertaining to the Liability for Capital Market Information* filling the gap – but sadly in addition to, and not instead of, other legislation.

C. Assessment

Though the sheer volume of changes hinders a discrete systemization, we see, from a corporate governance perspective, four tendencies.

(1) First, almost all of the legislative steps strive 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 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) Second, besides the adjustments to the decision-directed suit, the reforms generally strengthen **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.⁹⁹

Currently, it is uncertain whether investor and shareholder suits will, in fact, strengthen the overall supervision of managers in a two-tier board system,¹⁰⁰ or whether it will deter day-to-day supervision through a “race to the courts.” At least, before the legislature takes further steps, it is well-advised to test the effect of the current reforms for a significant period of time.¹⁰¹

(3) Third, the German legislature strives for **additional improvements to the law on shareholder meetings**. A foreign spectator might wonder whether the shareholder meeting may be characterized as a corporate governance device.

⁹⁹ Traditionally, the German supervisory board did not only fulfil responsibilities that are 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.

¹⁰⁰ As Baums/Scott, above note 41, expect.

¹⁰¹ The legislature should consider that, as we have experienced with respect to the contest of shareholder meeting decisions, the German corporate world is as vulnerable to strike suits as is, for example, the United States and Japan. Further, as some commentators have pointed out (for example Eugene F. Fama, “Agency Problems and the Theory of the Firm” (1980) J. Pol. Econ. 88, 288, at 293 et seq.), managers are much more vulnerable to losses in reputation as compared to financial losses. We think that a sudden dismissal sends a better signal to the market than any shareholder suit that is costly to the firm can do. The recent German economic history, in which close ties between the large firms have possibly enabled a flow of information between the firms as to why exactly a sudden dismissal occurred – with the information intermediary in this process being the banks – demonstrates this effect.

Remarkably, the argument that rational shareholders would not invest time and money in the participation at shareholder meetings – the famous “rational apathy” argument¹⁰² – 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.¹⁰³ We hold that, despite some conceptual weaknesses, this surprisingly high turnout catalyzes at least some positive effects, which cannot be considered in detail here.¹⁰⁴ 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), through 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 do not see any changes to substantive corporate law. Rather, the German government merely focuses on the better enforcement of duties that already exist. We account for the relatively modest type of adjustments by the fact that the current regime has proven to be quite effective for big firms that typically abide by the rules. Thus, substantial changes do not seem appropriate, but enforcement – a matter that is particularly relevant for smaller firms – does.

(4) Finally, we have shown that the state increasingly interferes with the corporate conduct of publicly listed firms. It does so by means of quasi-mandatory provisions, such as the Corporate Governance Code, or by public regulation, through the extensive powers given to securities regulators. Many of these provisions are prompted by European regulators, hence, it would be misleading to attribute the whole increase in regulatory measures to German authorities. Further, regulatory density is an international trend. 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 to the firms that are subject to these rules.

As an intermediate result, we hold that the current reforms in Germany follow

¹⁰² 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* (Harvard University Press, Cambridge MA: 1991) 77; M M Siems, *Die Konvergenz Im Rechtssystem der Aktionäre* (transl. *The Convergence of Legal Systems in the Law on Shareholders – A Study on Comparative Corporate Governance in the Era of Globalisation*), (Mohr, Tübingen: 2005) at 72 et seq.

¹⁰³ Zetzsche, ‘Explicit and Implicit System’, at B.III.3.b).

¹⁰⁴ On the benefits, see *idem*, at B.III.3.c). On the conceptual weaknesses, see U Noack, ‘Hauptversammlung und Internet: Information – Kommunikation – Entscheidung’ (transl.: *Shareholder Meetings and the Internet: Information, Communication, Decision*), CBC Research Paper, online < <http://ssrn.com/abstract=646723> >.

the same pattern as have all of the reforms that have taken place over the last decade: The German government endeavours to invigorate *the capital markets*, thereby securing their pricing and monitoring functions, by implementing rules that enable both public and private enforcement. Insofar, the current reform steps bring the German securities law more in line with traditionally (more) market-oriented states, such as England and the United States. At the same time, the traditional explicit measures still have a place in the German system of corporate control.

However, all of these reforms 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 methodological flaws.¹⁰⁵ Time pressure also often resulted in an Anglo-American detail-oriented style of drafting, as time for developing self-evident principles (rather than rules) was scarce. Since practice tends to construe detail-oriented rules narrowly, we expect either costs of enforcement to rise or the necessity of subsequent rectification of legislative deficiencies to emerge in the near future. Moreover, the current reform steps require immense effort in corporations, the government, law firms, and German academics, as well. We doubt that there is any corporate lawyer who can seriously claim to be up to date with respect to all reform issues currently on the table. From the perspective of the *corporations*, after ten years of permanent changes in corporate law, it is time for doing business again. From the perspective of the *national legislature*, it is time to get engaged in the European and international discussion with the intention of ensuring that costs of further legislative changes are not imposed on German firms. Eventually, from the perspective of the *law professor*, it is time to concentrate on systemic considerations and teaching the law, after almost a decade of hastily chasing, and commenting on, the new reform steps.

IV. Outlook

Unfortunately, a brief look at the European level provides us with the insight that we cannot reasonably expect the pace of corporate law reform to slow down in the near future. Instead, European Law will likely trigger further reform: the *Disclosure Directive* of 2003,¹⁰⁶ the harmonization of European accounting laws,¹⁰⁷ the *Pro-*

¹⁰⁵ Many of the aforementioned proposals contain multi-layer legislation. European directives and regulations, as well as national laws and regulations, and codes of conduct, needed to be considered. Under these conditions, mistakes are likely in hastily drafted laws.

¹⁰⁶ *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.

¹⁰⁷ A *Law for the Modernization of Accounting Law* that will harmonize the German Commercial Law with the IFRS is planned for summer 2005.

spectuses Directive,¹⁰⁸ the *Transparency Directive*,¹⁰⁹ the *Takeover Directive*,¹¹⁰ and the forthcoming Directives on *Cross-border mergers*,¹¹¹ and the *Cross-border transfer of registered offices*,¹¹² the reform of the Second Directive¹¹³ as well as the Eighth Company Law Directive¹¹⁴ will keep the national legislatures busy. Additionally, three issues of the European agenda deserve particular attention with regard to the German corporate governance system.¹¹⁵ These are: (1) access to company data; (2) shareholder rights; and (3) the structure of the supervisory board and the board of management.

¹⁰⁸ 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.

¹⁰⁹ *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.

¹¹⁰ The *Directive 2004/25/EC of the European Parliament and of the Council on takeover bids* (21.04.2004) OJ 2004 L 142/12, seeks to establish minimum guidelines for the conduct of takeover bids involving the securities of publicly listed companies governed by the laws of Member States, as well as an adequate level of protection for securities holders throughout the European Community.

¹¹¹ The Council adopted the European Commission's proposal for a *10th Company Law Directive on cross-border mergers of limited liability companies* on 25.11.2004. On 10.05.2005, the European Parliament adopted the proposal. See online < http://europa.eu.int/comm/internal_market/en/company/company/mergers/mergers_en.htm >.

¹¹² 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.

¹¹³ Second Company Law Directive covering the formation, maintenance and alteration of capital (77/91/EEC). In fall 2004, the European Commission proposed the following changes to this old Directive: (1) limiting the need for an expert valuation of contributions in kind when a company establishes itself or increases capital; (2) relaxing current rules on the limitation or withdrawal of pre-emption rights, to make the procedure of issuing new shares less burdensome while maintaining shareholders' protection from dilution of their shareholdings; (3) partially relaxing the prohibition on companies providing financial assistance for acquisition of their shares by third parties; (4) introducing "squeeze out"- and "sell out"-rights (ie the right of the majority shareholder, under certain conditions, to buy out minority shareholders at a fair price and the complementary right of minority shareholders to compel the majority shareholder to buy their shares); (5) introducing a right for the company to acquire its own shares up to the limits of distributable reserves. For details, see online: < http://europa.eu.int/comm/internal_market/company/capital/index_en.htm >.

¹¹⁴ See http://europa.eu.int/comm/internal_market/financial-reporting/index_en.htm .

¹¹⁵ See further K J Hopt, 'Europäisches Gesellschaftsrecht und deutsche Unternehmensverfassung' (transl: European Corporate Law and German Company Law Regime), ZEITRSCHRIFT FÜR WIRTSCHAFTSRECHT – ZIP (2005) 461 .

A. Accessibility of Company Data

The first issue pertains to the accessibility of company data. Under European and national law, private and public companies, cooperatives and some forms of partnerships must disclose certain basic data and financial statements. Presently, however, a uniform disclosure system does not exist in Germany. Instead, company data are subject to registration at systems that are organized and administered by local courts (so called "Handelsregister"), and are primarily published in local newspapers. Other information is 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 impose significant costs upon those seeking company information.

In order to curb this uncontrolled growth in the use of media for company disclosure, the Federal German government took a first step by launching an electronic version of the federal bulletin in 2003,¹¹⁶ and mandating that some corporate information is published in this electronic version. However, further legislative steps are required¹¹⁷ to fulfil the conditions of the new *Disclosure Directive* and the *Transparency Directive*.¹¹⁸ These steps include a legislative requirement to register, and store digitally, all company data that are disclosed, and to publish them at one central website. The storage and the website together would constitute the "German Company Register." Such a central, internet-based disclosure system must fulfil three criteria: (1) permanent storage; (2) immutability; and (3) accessibility for all parties who are interested in company data.¹¹⁹

In April 2005, the German Secretary of Justice presented a proposal on how to establish a uniform company disclosure system in Germany that is open to the various needs provided by accounting, corporate and securities law, in a European as well as in a national context.¹²⁰ This *EHUG*-proposal constitutes a step towards the implementation of the European Business Register (EBR), by setting up an integrated storage mechanism (www.handelsregister.de) run by the courts and a dis-

¹¹⁶ Online: < www.ebundesanzeiger.de >.

¹¹⁷ U Noack, 'Digital disclosure of company data in Germany and Europe – Regarding the implementation of the European Directive regarding Disclosure in respect of Certain Types of Companies and the *Transparency Directive* in Germany' CBC Research Paper, online < <http://ssrn.com/abstract=610001> > [Noack, 'Digital disclosure'].

¹¹⁸ *Transparency Directive*, above note 109, at Article 21 (2).

¹¹⁹ A public-private partnership involving private technical and administrative partners and supervision through a public agency may best fulfil these requirements, see Noack, 'Digital disclosure', above note 117.

¹²⁰ Federal Secretary of Justice, Entwurf eines Gesetzes über elektronische Handelsregister, Genossenschaftsregister sowie das Unternehmensregister – *EHUG* (transl.: Proposal for a *Law on the electronic commercial, cooperative and business register*), 07.04.2005, online < <http://www.bmj.de/media/archive/890.pdf> >.

semination mechanism (www.e-bundesanzeiger.de) run by a private entity.¹²¹ This system is theoretically designed to become an advanced version of the American EDGAR-System for Europe.

The Committee of European Securities Regulators (CESR) that currently works on implementing measures for the *Transparency Directive* is, however, critical as to whether the EPR is an apt basis for a capital market database. CESR does not consider the overlap between the information required under the respective directives significant enough to justify the costs of the creation of links between these two separate sets of information in the near future.”¹²² This is unfortunate, given that efficiency arguments support *one* register that contains *all* company data of public *and* close corporations. Further, a distinction between registers that is predicated on the definition of corporations issuing securities that are admitted to trading on a regulated market disregards the many medium-sized corporations that issue shares that are not traded at stock exchanges but effectively turned into quasi-public corporations through dilution of shares. CESR’s distinction appears to be artificial, given that the *Prospectus Directive* pushes for a merge of both types of issuers. Finally, CESR’s argument that company registers are made for business counterparts, while the *Transparency Directive* storage mechanism is exclusively meant for investors, does neither hold true in the one, nor the other direction. Thus, we may suggest that CESR’s stance is at least partly due to the distinction between the jurisdiction for securities law and company law that we observe in European and many national institutions. Requiring both registers to merge would require institutions to cooperate, where these typically compete with each other.

However, CESR does not argue against an integration of the information pools assembled under securities and company law, with the company register being set up to include the storage mechanism, as well. This is the alternative that the German Federal Secretary of Justice was proposing with its *EHUG*-draft. We hope that the German legislature will continue this approach after the federal elections being held in fall 2005.

B. Shareholder Rights

The second issue arises from the *Transparency Directive*, which establishes standards for **shareholder information**, and **shareholder proxy voting**.

With respect to **shareholder information**, the *Transparency Directive* requires,

¹²¹ 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.

¹²² See CESR, Progress Report Regarding Possible Implementing Measures of The Transparency Directive on the Role of Officially Appointed Mechanism (Article 21 2) and the Setting up of a European Electronic Network of Information about Issuers (Article 22) and Electronic Filing (Article 19 4a), Ref: 05-150b (03/2005), at ¶152–154, online <<http://www.cesr-eu.org>>.

in particular, information about the place, time and agenda of shareholder meetings, and the rights of holders to participate in meetings.¹²³ Member States must allow the use of electronic means for the purposes of conveying information to shareholders *if the shareholders so decide*.¹²⁴ If the shareholder meeting decides accordingly, the issuer must organize an electronic dissemination procedure.¹²⁵ We deem several 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: If the controlling shareholder is not interested in timely information being provided to all shareholders (for example, because this information would enable a minority to establish a quorum for the exercise of a minority right), he will vote against electronic information. Consequently, the German *Aktiengesetz* that establishes a well-functioning dissemination procedure regarding meeting-related information enables electronic dissemination of information to all shareholders *without the consent* of the shareholder meeting being required.¹²⁶

2) There is an “apportionment of costs” provision, under which shareholders may be required to bear the costs of dissemination of information by electronic means, which hampers the establishment of cost-efficient solutions to dissemination problems. Rather than making shareholders pay the costs, where such shareholders cannot effectively coordinate their interests vis-à-vis the intermediaries, the issuer should bear the costs for the electronic dissemination. Efficient bargaining between representatives of the banks and the issuers will then lead to cost efficient solutions.

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. Information that is disseminated to the shareholders by the use of a “push-system”¹²⁷ is an appropriate mechanism for

¹²³ Pursuant to Article 17 (2) of the *Transparency Directive*, above note 109, share issuers are required to ensure that all of the facilities and information necessary to enable holders 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.

¹²⁴ Article 17 (3) of the *Transparency Directive*.

¹²⁵ 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.

¹²⁶ Ss. 121, 123 – 128, and in particular s. 125 (2) of the *Aktiengesetz* (since 2001).

¹²⁷ For systems of disseminating information from a comparative perspective, see D A Zetzsche,

triggering shareholder activism, since it significantly reduces the information costs of shareholders for participating in the vote.

Under the *Transparency Directive* shareholders are also entitled to exercise voting rights by **proxy**. The Directive requires that “issuers make available electronic or paper proxy forms to each person entitled to vote.” However, a paper-based solution is not practical with respect to bearer shares, which are widely accepted in Germany. Bearer shares issuers that send a paper proxy form to each shareholder would increase both their own costs and the expenditures of the financial intermediaries that are involved in the process. This is due to the fact that these forms must be channelled through a chain of intermediaries.¹²⁸ In practice, the same is true with respect to registered shares. Digitalisation would reduce these costs. Thus, we would propose that firms which offer an internet-based proxy system should not be required to send paper-based proxy forms to *all* shareholders, but only to those who expressly wish so.¹²⁹

Moreover, we criticize the *Transparency Directive* to the extent that it interferes with the current transition from electronic proxy voting to electronic direct voting¹³⁰ by stipulating “proxy forms” rather than using open expressions. Finally, if a legal regime establishes a proxy system that is primarily based on a proxy *to management*, it requires a default rule that does not favour management: proxies given to a representative of the firm that do not contain directions as to whether the representative should vote in favour or against the management’s proposal should be interpreted as abstention.¹³¹ Otherwise, management may abuse the proxy mechanism to the detriment of shareholders.

‘Corporate Governance in Cyberspace – A Blueprint for Virtual Shareholder Meetings’ CBC Research Paper, online < <http://ssrn.com/abstract=747347> >, at III.1. [Zetzsche, ‘Corporate Governance in Cyberspace’].

¹²⁸ See Simon & Zetzsche, *supra* note 47.

¹²⁹ For details on the virtual shareholder meetings of companies that issue bearer shares see D A Zetzsche, in Zetzsche (ed), *Die Virtuelle Hauptversammlung* (transl.: *The Virtual Shareholder Meeting*), (Schmidt, Berlin: 2002) No. 47 et seq.

¹³⁰ See U Noack, ‘Hauptversammlung und Internet: Information – Kommunikation – Entscheidung’ (transl.: Shareholders’ Meeting and the Internet: Information – Communication – Decision), CBC Research Paper, online: < <http://ssrn.com/abstract=646723> >, and ‘Neue Entwicklungen im Aktienrecht und moderne Informationstechnologie 2003 – 2005’ NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT – NZG (2004) 297, and ‘Zukunft der Hauptversammlung – Hauptversammlung der Zukunft’ (transl.: Future of the shareholder meeting – shareholder meeting of the future?) in D A Zetzsche (ed), *Die Virtuelle Hauptversammlung*, *ibid.*, No. 6, and, co-authored with M Beurskens ‘Internet-Influence on Corporate Governance’ EBOR (2002) 129; Zetzsche, ‘Corporate Governance in Cyberspace’, *supra* note 127, at III.2.

¹³¹ This is the majority opinion under German law, see U Noack, ‘Die organisierte Stimmrechtsvertretung auf Hauptversammlungen’ (transl.: Organized proxies in shareholder meetings), in Festschrift für Marcus Lutter (2000), 1463, 1480 [Noack, in: FS Lutter]; R Pikò & T Preissler in DA Zetzsche (ed), *Die Virtuelle Hauptversammlung*, *ibid.*, No. 348, with further citations; B Riegger, ‘Hauptversammlung und Internet’ (transl.: Shareholder Meeting and Internet), 165 ZEITSCHRIFT FÜR DAS GESAMTE HANDELS- UND WIRTSCHAFTSRECHT – ZHR (2001) 204, 213 f. (dissenting).

We hope that these issues will be addressed in the Shareholder Rights Directive that the European Commission is currently preparing in conjunction with its consultation on the cross-border exercise of shareholder rights in Europe.¹³² We note, however, that the European roadmap on shareholder rights is currently confusing insofar as the *Transparency Directive* is predicated on the assumption that the companies and Member States know who the shareholders are in a cross-border setting. In fact, in light of the de-materialisation of shares and the use of global share certificates,¹³³ the clear identification of shareholders requires further European harmonization. In that respect, we now find a relevant discussion in the consultation on cross-border exercise of shareholder rights. Hence, the *Transparency Directive* took the second step before the first.

If the European regulators finally enact the proposals that the European Commission proposes in the above-mentioned consultation, German law will not need to be significantly altered: The *Aktiengesetz* already vests shareholders with the right to vote by proxy. In addition, the different devices for shareholder identification, which the proposal suggests, are dealt with in mandatory provisions of the German laws relating to shareholder meetings.¹³⁴ Thus, the legislative changes in the last ten years have the German law on shareholder meetings well-prepared for the cross-border exercise of shareholder rights in Europe.

C. Board Structure

Finally, European law aims at regulating details regarding board structures and board remuneration in Europe through two recommendations that the European Commission issued in fall 2004. The recommendation on directors' remuneration¹³⁵ seeks to ensure that shareholders are able to appreciate fully 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. Since the legislature adopted the aforementioned *VorstOG*,¹³⁶ the need for legislative action following from this recommendation merely pertains to the powers of shareholders to decide upon the remuneration of the German board of management. This is due to the fact that German shareholders already have the power to decide upon the remuneration of the supervisory board members.

¹³² European Commission, first and second consultation 'Fostering an appropriate regime for shareholders' rights', and the preliminary results issued April 2005, online: < http://europa.eu.int/comm/internal_market/company/shareholders/index_en.htm>. See U Noack, 'Aktionärsrechte im EU-Kapitalbinnenmarkt' (transl.: Shareholder Rights in the EU Common Capital Market), ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT – ZIP (2005) 325.

¹³³ See above III.2.a).

¹³⁴ Ss. 67, 123 of the *Aktiengesetz* and the construction thereof.

¹³⁵ 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.

¹³⁶ See above III.B.1., notes 61 et seq.

Further, the European Commission issued the recommendation on directors' independence¹³⁷ in the belief that the presence of independent representatives on the board who are capable of challenging the decisions of the management may serve as an effective device to protect 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 implemented¹³⁸) 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 these employee representatives do not have equivalent voting power).¹³⁹ Thus, the legislature refrained from addressing the issue of directors' independence. We criticize this strategy, because the lowering of the independence requirement has substituted for a sound discussion as to whether Europe (and Germany, in particular) needs the independence requirement for corporations with concentrated ownership at all, or whether other measures¹⁴⁰ are more appropriate for these types of firms. At this point in time, we personally believe that the latter is the case.¹⁴¹

The German Codex Commission, however, responded to the independent director debate in its 2005-Codex amendments. It did so with a soft recommendation: "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."¹⁴² Further, "the Supervisory Board shall include what

¹³⁷ 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.

¹³⁸ See T Baums & P Ulmer (eds), *Employees' Co-Determination in the Member States of the European Union* (Heidelberg, Verlag Recht und Wirtschaft: 2004).

¹³⁹ 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 steel production (with approximately 20 firms remaining, including ThyssenKrupp AG).

¹⁴⁰ See the measures presented above II.1., for example *Konzernrecht*, transparency requirements, guaranteed dividends, sell-out rights, etc

¹⁴¹ In firms 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 firms with concentrated ownership that merely limit controlling shareholders' opportunities to exploit minority shareholders without preventing controlling shareholders from effectively monitoring management.

¹⁴² No. 5.4.4 GCGC (as amended).

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 form members of the Management Board shall be members of the Supervisory Board ..."¹⁴³ Thus, significant discretion is vested into German supervisory boards.

In this context, it is noteworthy that three large-scale forces drive the discussion about worker codetermination in Germany: (1) The *flexibility* that the European Company framework¹⁴⁴ provides; (2) The *pressure* that the forthcoming (?) Directives on Cross-border mergers¹⁴⁵ and the Cross-border transfer of registered offices exerts on German corporate law; and (3) The *conflict of interest* of the employee representatives in supervisory boards. Codetermination is perceived to be harmful to the reputation of German corporate law in that in some restructuring proceedings, the vice-chairman of the supervisory board organized the strike against the firm. This is due to the fact that some union representatives on supervisory boards prefer to fulfil their duties as union representatives, instead of exercising their function as corporate fiduciaries. At the end of this discussion, we might find mandatory worker codetermination reduced to 1/3 of the supervisory board members.¹⁴⁶

V. Conclusion

We have seen that the German corporate governance legislature has been active, is active and will likely be active in the future. In many fields of reform, Germany will not require major changes since it has undertaken the most significant steps already. With respect to board issues, Germany was prevented from taking major legislative steps by the Commission's decision to portray worker representatives as independent directors, though reform steps are likely to be taken on the basis of the national reform discussion. Finally, German *substantive* securities law has generally reached the standard of the British and North-American market rules. However, with respect to the disclosure of company data, the German legislature falls behind

¹⁴³ No. 5.4.2 GCGC (as amended).

¹⁴⁴ Above, note 32.

¹⁴⁵ 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."

¹⁴⁶ Ron Gilson commented on this development that a 1/3 ratio would enable venture capitalists to stay in control of the firm when it grows. Thus, in addition to other (possibly positive) effects, a reduction of workers' seats may support private venture capital activity in Germany.

developments in the countries of its European partners. Thus, overall, the result is mixed, but there is a clear tendency in favour of reform and modernization. Returning to our introduction, we hold that with respect to corporate governance, the judgment that Germany exhibits characteristics of the “old Europe” is unjustified.