A COMPARATIVE STUDY OF MONITORING OF MANAGEMENT IN GERMAN AND U.S. CORPORATIONS AFTER SARBANES-OXLEY: WHERE ARE THE GERMAN ENRONS, WORLDCOMS, AND TYCOS?

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I. INTRODUCTION

The stock market bubble has burst, leaving in its wake revelations about corporate wrongdoing. Among the reactions to corporate failures is the Sarbanes-Oxley Act of 2002, which seeks to place additional checks on corporations. Germany is also currently experiencing a recession, yet has not faced the major corporate failures that have plagued the United States. As a result, German commentators have claimed that German corporate law is superior to U.S. corporate law.

The functions of corporate governance are threefold: (1) to provide a check on senior management; (2) to provide a nexus between the corporation and its shareholders; and (3) to satisfy demands of various constituencies, such as directors, officers, employees, creditors, and other stakeholders.


It is the goal of this Note to compare the American and German systems of corporate governance, specifically monitoring mechanisms, to determine whether the presence of corporate scandals in the United States is the fruit of American corporate law and whether German law better addresses the challenge. This Note concludes that corporate failures are not endemic to the

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6 Id. at 146.
7 See Bernd Singhof & Oliver Seiler, Shareholder Participation in Corporate
United States or rooted in Delaware corporations law. This Note further finds that Germany's reliance on banks seriously undermines a system that looks promising on paper. The analysis fits into the context of commentators' current discussions of whether to Americanize German corporate governance.8

Part I provides some historical background and introduces the relativity of comparative corporate governance. Part II provides a brief introduction to Delaware corporations law and describes in detail the German corporate law under the Aktiengesetz. The discussion in Part III focuses on the differences between the two systems with particular attention given to corporate monitoring mechanisms. Several key monitoring mechanisms receive particular attention: (i) separation of ownership from control, (ii) the interplay of various corporate constituencies, (iii) the market, (iv) the board of directors/Supervisory Board, and (v) the availability of courts. Part IV discusses recent U.S. and German corporate failures and the reforms passed to address them. In Part V, this Note reaches the conclusion that the German system does not realize its potential as an effective corporate governance regime and that changes in the German law have failed to adequately address the problem of bank domination. While Delaware corporate law has also failed to prevent corporate failures, the combination of the Sarbanes-Oxley Act and changes in listing requirements does appear to address previous shortcomings sensibly.

A. Historical Background

The late 1990s and its dot-com boom saw unprecedented growth. Some hailed the New Economy as a replacement for traditional economic growth patterns and rang in a new economic era.9 However, the enthusiasm was not to last forever. Investors were shaken by the events of September 11, 2001.10

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8 See generally Susan-Jacqueline Butler, Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures, 17 ARIZ. J. INT'L & COMP. L. 555 (2000) (stating that some commentators believe that German mechanisms for monitoring and controlling corporate managers are inferior to those in the United States).

9 See generally Charles R.T. O'kelley & Robert B. Thompson, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS (3d ed. 1999) (describing the reasons for why most corporations chose to incorporate in Delaware).

Fear of further attacks and general insecurity led many to pull their money out of the already battered markets. The result was a great decline in stock prices and a recession in 2002. In the wake of the stock market collapse, corporate failures in the form of Enron, WorldCom, Tyco, Adelphia, inter alia, surfaced and continued to affect the market by depressing investor confidence.

Political resolve to address the problem of investor confidence grew, and partially fueled by the upcoming election, the U.S. Congress took action when it finally passed the Sarbanes-Oxley Act of 2002. President George W. Bush signed it into law on July 30, 2002.

B. The Relativity, Function & Purpose of Comparative Corporate Governance

Economies are the foundation upon which corporate governance regimes grow. The United States’ peculiar political and ideological fabric led to a system of corporate governance efficient and uniquely suited for its economic reality. Germany’s economic landscape is dissimilar from the United States’ context and thus nurtures a system of corporate governance adapted to


\[15\] See Carrie Johnson, Probe of Adelphia’s Rigas Family Widens: Tax and Mail Fraud also Suspected, WASH. POST, Aug. 8, 2002, at E03 [hereinafter Johnson]. See also Morning Edition: Tyco Holds Phone Conference Denying Rumors that it is Thinking of Filing for Chapter 11 (NPR Radio Broadcast, July 2002) [hereinafter Morning Edition].


\[17\] See generally Charny, supra note 5.
different assumptions. That necessarily means that each corporate governance regime will bring with it its particular features.

Conceptions of multiple equilibria reached by divergent evolutionary pathways . . . were shown to have stunning real-world embodiments in the divergent corporate systems. . . . [T]he broad picture of several radically different corporate systems presented more a set of ideal types than a complete description of the corporate world. Each system spawned deviant cases and evolutionary "mutations," which thrived in their peculiar economic niches. Further, each system involved complex trade-offs between the competing virtues of a governance system: flexibility vs. stability, innovativeness vs. predictable success.

In the course of their evolution, the German and U.S. corporate systems thus necessarily developed different solutions to similar basic corporate functions: (i) corporate governance provides a check on senior management, reducing the likelihood of opportunistic behavior and ensuring that management acts in the best interest of the enterprise; (ii) corporate governance provides a nexus between the corporation and its stakeholders; and (iii) corporate governance serves political functions between the corporate officers, employees, directors, and any other stakeholders. While the topic of this Note is primarily the first function, it will incidentally and necessarily address the latter two as well.

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18 See generally id. One should not be surprised by the assertion that the German system of corporate governance with respect to the German economic landscape is as efficient as the U.S. corporate governance system with respect to its own origins. See generally MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994). An absolute view of relativism, however, may render this Note moot. How can one compare two systems' attempts to address a particular problem, if the two systems are not comparable, because they spring from a different economic/cultural denominator? The answer is either that there must be some limit to relativism or that the concept of cultural relativism does not reach the issue here. Certain foundational assumptions of U.S. and German corporate governance systems are constant. Both regimes provide solutions to the problem this Note seeks to address—opportunism of corporate officers. The answers that German law and U.S. law provide differ. Therefore, the critical reader should ask whether the answers given are locality specific or whether they could as well serve to answer the other jurisdiction's questions.

19 See Charny, supra note 5, at 145-46.

20 Id. at 146-47.
II. BACKGROUND

A. The U.S. Corporation—Structure and Governance

The individual states that comprise the United States have many corporate governance schemes. Since corporations law is state law, each of the fifty states and the U.S. territories has developed different answers to the problems of corporations. Out of the existing systems, two particularly are worth noting: (i) the Model Business Corporations Act (MBCA)\(^{21}\) and (ii) the Delaware General Corporations Law. Many states have based their corporate codes on the former, while the latter is the most important and influential corporations code in the United States, as the great majority of large American corporations are incorporated under Delaware law.\(^{22}\) For that reason, this Note will focus exclusively on Delaware corporate law.

1. The Shareholders

The shareholders in a Delaware corporation are its residual owners. Most significantly, the shareholders elect the board of directors.\(^{23}\) The general avenue for shareholder action is the annual meeting,\(^{24}\) although extraordinary meetings may be called by the directors or by anyone authorized by the certificate of incorporation or the bylaws.\(^{25}\) Certain actions by the directors require shareholder approval by simple or supermajority—these are generally defined by the corporation’s certificate of incorporation or its bylaws,\(^{26}\) the shareholders have the power to remove any director, or the entire board, with or without cause by a majority vote unless the certificate of incorporation provides otherwise.\(^{27}\) Alternatively, the board of directors may serve staggered terms. In the case of cumulative voting, a director may be removed if sufficient votes to elect a director are cast in favor of removal.\(^{28}\)

\(^{21}\) It should be noted that the MBCA was revised in 1984 and has been amended several times since. The revised version is referred to as the RMBCA.

\(^{22}\) See generally O’KELLEY & THOMPSON, supra note 9.


\(^{24}\) Id. § 211.

\(^{25}\) Id. § 211(d).

\(^{26}\) Id. § 102(b)(4), § 109(b).

\(^{27}\) Id. § 211.

\(^{28}\) Id. § 141(k).
2. The Directors

The directors of the Delaware corporation are entrusted with the management of the corporation. They meet several times a year, establish the basic policies of the corporation, hire the corporation's officers, and delegate to them the day-to-day operations of the company.

3. The Officers

The officers are charged with the day-to-day management of the corporation. In this context, they have authority to make decisions for the corporation. In cases involving the long-term plans and policies of the corporation, however, such as mergers and acquisitions, only directors have authority to make decisions.

4. Summary

Overall, the Delaware corporation is a highly flexible vehicle to organize a business. While the basic structure is statutorily described, the Delaware General Corporation Law leaves much room for corporate self-determination. Undoubtedly, such wide latitude gives corporations much play in making decisions—the fact that the majority of U.S. corporations are incorporated in Delaware is evidence of Delaware's flexible system. German corporate governance is more circumscribed.

B. German Corporate Governance—Structure

The German corporate form is the Aktiengesellschaft (AG), which translates literally into Share- or Stocksociety. The relevant law can largely

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29 Id. § 141.
30 Id. § 142(b).
31 Id.
32 Id. § 142(b) (allowing the term and selection of officers to be set in the corporation's bylaws or certificate of incorporation); id. § 141(a) (granting the board of directors the power to manage the corporation except as may be otherwise provided in the certificate of incorporation); id. § 141(b) (permitting the certificate of incorporation or the bylaws to determine the qualifications of directors); id. § 141(c) (allowing the board of directors to form committees as it sees fit).
be found in the Aktiengesetz von 1965 (Sharelaw of 1965). The basic code is augmented by several other provisions, which this Note will introduce as they become relevant.

The AG is composed of and organized around three different entities. These are (i) the Hauptversammlung (stockholder meeting), (ii) the Aufsichtsrat (Supervisory Board), and (iii) the Vorstand (Management Board). The following sections address each of these entities separately.

1. The Stockholder Meeting

The functions, rights, and duties of the stockholder meeting are provided by sections 118 through 146 of the Sharelaw of 1965: "The shareholders exercise their rights with respect to corporate matters in the stockholder meeting unless otherwise provided by law." The stockholder meeting is the vehicle through which the shareholders exercise their power. Stockholders guide the fundamental policies of the AG, but the stockholder meeting is not permitted to interfere with the everyday affairs of the corporation. The quotidian management of the enterprise is the domain of the Management Board. The rights of the shareholders are enumerated in section 119 of the Sharelaw as follows:

33 §§ 1-410 AktG. For a discussion of the reasons for the replacement of the previous corporations law by the 1965 code, see generally Butler, supra note 8.

34 It should be noted that many questions left unanswered by the Aktiengesetz are governed by the laws generally applicable to associations. For example, the Commercial Code of 1897 (Handelsgesetzbuch—HGB) provides regulations regarding commercial records and accounting requirements and § 31 of the Civil Code (Buergerliches Gesetz Buch—BGB) provides that AGs are vicariously liable for wrongful acts of their directors and other senior members of management. See Assmann et al., The Law of Business Associations, in INTRODUCTION TO GERMAN LAW 137 (Werner F. Ebke & Matthew W. Funkin eds., 1996).

35 §§ 76, 95, 118 AktG.

36 § 118 AktG.

37 § 95 AktG.

38 § 76 AktG.

39 See Charny, supra note 5, at 158.

40 § 118 AktG. Translations from the Aktiengesetz are the author’s own. To indicate the use of translated code, the translated sentences have been placed in quotation marks.


42 § 119 AktG.
Rights of the Stockholder Meeting. (1) The Stockholder Meeting decides all matters expressly provided by law and in the articles of corporation (Satzung), as enumerated:

1. the appointment of members of the Supervisory Board, unless such members are required to be delegated to the Supervisory Board, or unless such members are delegated by the employees pursuant to the codetermination laws;
2. the use of retained earnings;
3. the [annual] release from responsibility of the Management Board and the Supervisory Board;
4. the [annual] appointment of an auditor;
5. amendments to the articles of incorporation;
6. measures relating to acquisition and reduction of capital;
7. appointment of auditors for the examination of the events surrounding the formation or transactions of management;
8. the dissolution of the AG.

(2) Questions of management may only be decided if the management so requests.\textsuperscript{43}

The most notable of the powers of the stockholder meeting are the power to appoint members of the Supervisory Board and to decide what use is to be made of retained earnings.\textsuperscript{44} This leaves the stockholder meeting with the power to declare dividends—a power not held by the other organs of the AG.\textsuperscript{45} A shareholder faces liability for damages if he intentionally and through his influence upon the company induces a member of the Management Board or the Supervisory Board to act to the detriment of the company or its shareholders.\textsuperscript{46}

\textsuperscript{43} § 119 AktG.
\textsuperscript{44} § 119 AktG(1)(2).
\textsuperscript{45} ERCKLENTZ, supra note 41, at 93.
\textsuperscript{46} Assmann et al., supra note 34, at 147.
2. The Supervisory Board

a. Structure

The Supervisory Board's primary duty is oversight of the Management Board appointed by it as the latter operates the AG.\(^47\) This is a marked difference from the board of directors under Delaware law, which holds policy and management powers and is responsible to the stockholders for the management of the corporation.\(^48\) Note also that the shareholder meeting and not the Supervisory Board has the power to declare dividends under German law, while in the Delaware corporation, directors have the authority to declare dividends.

The composition of the Supervisory Board is complex, but warrants careful explanation for it is a crucial feature in the AG's system of checks and balances. Several Mitbestimmungsgesetze (codetermination laws) mandate certain compositions of the Supervisory Board.\(^49\) Codetermination laws regulate the involvement of a firm's employees in the corporate decision-making process.\(^50\) These laws provide employees or union groups with seats on the Supervisory Board of certain AGs.\(^51\) This Note will discuss the codetermination laws and their effects separately in the next sections.\(^52\) While there are four codetermination laws on the books, five possible configurations of the size and composition of a Supervisory Board exist. Four stem from the four codetermination laws themselves, while the fifth results from the rare situation in which none of the codetermination laws applies.\(^53\)

Generally, the Sharelaw prescribes that the Supervisory Board shall consist of (i) three members or any multiple of three and (ii) that any board larger than three does not exceed specified limits related to the stated capital of the AG.\(^54\) There are two exceptions to this rule: the board may be larger if the articles of

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\(^47\) ERCKLENTZ, supra note 41, at 94.
\(^49\) See Charny, supra note 5, at 158-59.
\(^50\) Butler, supra note 8, at 561.
\(^51\) ERCKLENTZ, supra note 41, at 96.
\(^52\) This Note will not discuss the mechanics of the codetermination laws; they are complicated and technical issues of labor law not relevant to the thesis of this Note.
\(^53\) ERCKLENTZ, supra note 41, at 97.
\(^54\) § 95 AktG; § 7(1) Gesetz ueber die Mitbestimmung der Arbeitnehmer vom 4. Mai 1976 (BGBI I S. 1153) (referred to as 1976 codetermination law).
incorporation provide for a larger board, or, if any codetermination law other than the 1952 law applies, the size and composition is governed by special provisions of the particular codetermination law. The maximum number of Board members and the permissible number in substantially all publicly traded corporations is twenty-one. If provided in the memorandum of association (the equivalent of the certificate of incorporation), some members of the Supervisory Board may be appointed by certain shareholders.

b. The 1951 Codetermination Law

This law provides for a certain minimum number of members for the Supervisory Board of a covered AG. The law applies to (i) businesses in the coal and iron industries that (ii) regularly employ more than 1000 workers. Under the 1951 law, the board of directors will consist of eleven members, unless the articles of incorporation provide for a larger number. Of the eleven, five are representatives of the stockholders, five are representatives of the employees, and the remaining board member is elected by the stockholders upon motion by the already acting members of the board. If the board is larger than eleven members, the ratio of representation provided for in the law will remain constant.

c. The 1952 Codetermination Law

Generally, the 1952 Codetermination Law applies to AGs with up to 2000 employees unless the AG is engaged in the coal, steel, or iron industry. If this law is applicable, at least one-third of the Supervisory Board must be

55 § 95 AktG.
56 See infra note 64.
57 § 95 AktG. See Chamy, supra note 5.
58 § 95 AktG.
59 § 103 III AktG; Assmann et al., supra note 34, at 148.
60 ERCLENZ, supra note 41, at 99.
62 In the case of the German iron, steel, and coal industries, the government, be it local or federal, traditionally holds a significant stake in the companies.
63 § 4 1951 Codetermination Law.
comprised of representatives of the employees. In contrast to the other codetermination laws, the 1952 law does not impose any size requirements on the board. It follows that under this law, the size of the board will be prescribed by the Sharelaw. There are a number of exceptions to the rule, most notably that in the case where (i) one single individual owns all stock, or that all stockholders are related within the meaning of the tax law and (ii) the AG has less than 500 employees, the AG will not be subject to the law.

d. The Supplementary Codetermination Law

This law applies to holding companies in the coal, iron, and steel industries. It thus applies to companies that dominate an enterprise in which the employees have the right to elect members of the board pursuant to the 1951 Codetermination Law. If the Supplementary Codetermination Law applies, it specifies a fifteen-member board. Of these, seven members will be representatives of the stockholders, seven will be representatives of the employees, and the tie-breaking fifteenth member of the board will be elected on the motion of the members of the board already serving. In certain instances, the law permits more than fifteen board members, but in such a case, the prescribed ratios may not change. Furthermore, the board’s employee representation shall consist partly of employees proper and partly of union representation.

e. The 1976 Codetermination Law

The 1976 Codetermination Law provides similar parity provisions between stockholder and employee representatives as provided in the preceding laws. The law applies to any corporation employing more than 2000 workers and not

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64 ERCKLENTZ, supra note 41, at 100.
65 Id. at 99.
67 Id.
68 Id.
already covered by one of the preceding laws.\textsuperscript{70} If the 1976 Codetermination Law applies, the size and composition of the board is not determined by the capital invested, as generally is the case in the codetermination laws discussed above, but by the number of persons regularly employed.\textsuperscript{71} The size of the board increases with the number of workers regularly employed\textsuperscript{72} and will be divided equally between representatives of the employees and the shareholders.\textsuperscript{73}

There are certain limitations and qualifications for membership on the Supervisory Board. A member of the board must be free of legal disabilities.\textsuperscript{74} No individual is permitted to sit on more than ten Supervisory Boards.\textsuperscript{75} The most important qualification, though, is that a member of the Supervisory Board may not also be a member of the Management Board of the same AG.\textsuperscript{76}

Since it is the statutory duty of the [Supervisory Board] to appoint the management board and to monitor its activities, simultaneous service on both corporate organs is deemed to be incompatible and is thus prohibited in principle. This strict line between [the Supervisory Board] and management board creates the so-called "two-tier" management system of the stock corporation law. The difference between this practice and the tradition in Delaware and in the United States generally, where members of the executive staff are also frequently members of the board of directors, is thus apparent.\textsuperscript{77}

Furthermore, members of the Management Board of dependent enterprises likewise are disqualified for membership on the Supervisory Board of the parent.\textsuperscript{78}

\textsuperscript{70} \textit{Id.}
\textsuperscript{71} \textit{Id.}
\textsuperscript{72} It is worth noting that German labor law, compared to U.S. labor law, makes laying off workers more difficult. Large fluctuations of workforce, common in U.S. recessions, are therefore not widespread in Germany. Should certain events nonetheless necessitate a change in the composition of the board, or otherwise cast into doubt the composition of the board, the law provides mechanisms for correction. §§ 97-98 AktG.
\textsuperscript{73} § 7(1), 1976 Codetermination Law.
\textsuperscript{74} § 100(1) AktG.
\textsuperscript{75} § 100(2) AktG.
\textsuperscript{76} § 105 AktG.
\textsuperscript{77} ERCKLENTZ, supra note 41, at 111.
\textsuperscript{78} § 100(2) AktG.
Should it become necessary to remove members of the Supervisory Board, the removal can be effectuated by a supermajority of three-quarters of the stockholder votes cast: in effect the group or person who elected the member will have the right to remove that member. Alternatively, there is a provision allowing removal by the court for "material cause." The court has authority to remove any member of the board regardless of who elected him. The board itself, by a simple majority vote, can also institute removal proceedings; "This particular provision was intended as an escape hatch in cases where the body of person electing the member either cannot or will not act, [and a particular member of the board has created conditions making his continued membership on the board intolerable]."

**f. Rights, Duties, and Liabilities of the Supervisory Board**

The Supervisory Board appoints the Management Board of the AG. Thereafter the board's principal duty becomes the broad oversight of the Management Board; "This function is [the Supervisory Board's] main 'raison d'être' and it derives its German designation therefrom." Supervision extends to all actions of the Management Board including their "legality and commercial soundness." Yet, the Supervisory Board has no direct power to manage the affairs of the corporation. "The overseeing function of the [Supervisory] Board should thus not be confused with a right to interfere with the activities of the Management Board. The influence of the [Supervisory Board] upon such activities is thus necessarily indirect, in that it is based solely on its power to remove the Management Board."

The articles of incorporation may contain provisions that require the approval of the Supervisory Board for certain types of transactions, but even in the absence of express provisions, the Supervisory Board may assert this

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79 § 103(1) AktG.
80 Id.
81 Id.
82 Id.
83 ERCKLENTZ, supra note 41, at 114.
84 § 84 AktG.
85 ERCKLENTZ, supra note 41, at 147.
86 Assmann et al., supra note 34, at 148.
87 ERCKLENTZ, supra note 41, at 147-48.
88 The author is not aware of how many corporations actually have such provisions in the articles.
power *sua sponte* and demand review by specifying the types of transactions to be subject to its approval after adopting a resolution to that effect. Should the Management Board fail to heed the demands of the Supervisory Board, it subjects itself to liability to the AG for resulting damages. The Management Board may appeal the Supervisory Board’s refusal of approval of a given transaction to the shareholders, who then can override the veto with seventy-five percent of the votes cast at the meeting.

The Supervisory Board will receive reports on the state of the AG. Beyond the simple receipt and review of those reports, the Supervisory Board must make an active effort to keep fully abreast of the financial stature of the AG. This necessitates frequent contact between the Management and Supervisory Boards.

The Supervisory Board has potential liabilities “to the AG and, under some circumstances, to creditors of the AG for any loss or damage suffered by the AG.” The same standards of care apply to the Supervisory Board and the Management Board. The members of the respective boards are required to act with the care of a normally conscientious member. The specific bases for liability are enumerated in section 93(3) of the Sharelaw.

Beyond the general standard of care, there is a duty to act affirmatively on behalf of the corporation. If one member of the Supervisory Board has information with regard to the problems enumerated in the liability provision, it will be the duty of the Supervisory Board member to share that information with the board and to take all reasonable steps to cause the Supervisory Board to act on the matter. Members of the board are absolved of liability if loss or

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89 § 111(4) AktG. Transactions that commonly require approval by the Supervisory Board are investments of assets abroad, the acquisition or sale of real property in excess of a specified value, the issuance of guarantees, or the execution of employment agreements calling for compensation in excess of a specified sum. See ERCKLENTZ, *supra* note 41, at 148. This resolution demand procedure may also be used to request information from the Management Board at any time and the Management Board will be required to respond. § 90 AktG. There is also a collective right of the Supervisory Board to inspect books, records, and assets of the AG.

90 § 111(4) AktG.

91 ERCKLENTZ, *supra* note 41, at 161.

92 §§ 93, 116 AktG.

93 These include, for example, the unlawful payments of dividends, the unlawful reimbursement of capital contributions of shareholders, the unlawful distribution of the assets of the AG, the unlawful grant of credit, and the unlawful payment of compensation to members of the Supervisory Board. See ERCKLENTZ, *supra* note 41, at 162.
damage arises from a lawful resolution of the meeting of stockholders. Liability against the Supervisory Board can be asserted only by the AG, and not by stockholders or by third parties, except creditors, who may assert liability against the board if the AG is unable to satisfy its debts.

3. The Management Board

The branch of the AG that remains to be introduced is the Management Board. It is the body that directs the day-to-day affairs of the corporation and has the statutory duty to manage the AG. The members of the Management Board are appointed by the Supervisory Board. The Management Board is not subject to instructions or demands from the general meeting of shareholders—the shareholders must therefore bring any such concerns or demands via the Supervisory Board.

The main difference between the AG and the Delaware corporation is that the Management Board of the AG bears the ultimate responsibility for the management of the corporation, while that duty in Delaware is borne by the board of directors—the executives act only as agents of the corporation. The Aktiengesetz creates coequal and non-hierarchical Management Board members, but the board is permitted to designate a chairperson, although such chairperson will not have additional powers. The Management Board is not coequal with the Supervisory Board and enjoys the latter's deference. Also, the members of the Management Board are not permitted to serve on the Supervisory Board of the same corporation. "This disqualification is based on the view that simultaneous service on both bodies would involve the dual member in conflicting duties and is thus incompatible."

The Management Board is charged to take into account four different interests while carrying out its executive functions: the AG, its stockholders,

94 § 93(4) AktG.
95 § 93(5) AktG.
96 § 76(1) AktG.
97 Assmann et al., supra note 34, at 148. The coequality of Management Board members does not appear to exist in practical reality.
98 Assmann et al., supra note 34, at 149.
100 § 84(2) AktG.
101 See Charny, supra note 5, at 147.
102 ERCKLENTZ, supra note 41, at 118.
the welfare of the employees, and the community at large. These interests are to be served equally; thus the "profit motive for the benefit of stockholders is not deemed to be the paramount principle governing the obligations of the Management Board." The powers of the Management Board may be limited by the memorandum of association, the Supervisory Board, and by certain resolutions of the general meeting. Most importantly, certain types of transactions and decisions, as determined by the Supervisory Board or memorandum, may only be undertaken with express consent of the Supervisory Board.

When managing the corporation, the members of the Management Board have the duty to act as diligent and prudent managers, and are jointly and severally liable to the Supervisory Board for failure to fulfill these duties. Members of the Management Board are not liable to the corporation if a transaction is grounded in express shareholder approval. Liability is not precluded, however, if the Supervisory Board approved the transaction. The AG may waive the Management Board's liability three years from the date that such liability arose, with approval of the shareholders. Each year the stockholders meeting has the duty to sign off on the actions of the Management Board and the Supervisory Board and release them from responsibility. The release constitutes a deliberated and thoughtful approval of the actions of the boards, the decision being made on the financial statements, the business report, and the report of the Supervisory Board. Release of the boards from responsibility does not represent a waiver of claims for damages.

See Bernard Grossfeld & Werner Ebke, Controlling the Modern Corporation, 26 AM. J. COMP. L. 397, 431 (1978) (discussing Rathenau's "corporate good citizen concept").

ERCKLENTZ, supra note 41, at 198 (stating also that the trifold management objectives are well in line with Germany's "social" market economy).

Assmann et al., supra note 34, at 149.

§ 111(IV) AktG.

See Assmann et al., supra note 34, at 149. But cf. ERCKLENTZ, supra note 41, at 209 (describing the Management Board's duty as that of the "ordinary and conscientious manager").

§ 93(4) AktG.

Id.

§ 120(1) AktG.

§§ 120(2)-(3) AktG.

§ 120(2) AktG.
III. DIFFERENCES IN MONITORING OF MANAGEMENT BETWEEN THE UNITED STATES AND GERMANY

The differences between the German corporate system and the U.S. system can be said to stem from the German reliance on banks as a primary source of funding while the United States relies on private investment. German corporations do not depend as much on exchange-listed securities, but rather on direct loans from banks. This fundamental premise dominates the discussion below. To facilitate a structured analysis, the different monitoring organs are treated in separate categories; however, there is a fair amount of overlap between the categories.

A. Separation of Ownership from Control: Tensions between Owners and Management and the Influence of German Banks

1. The Influence of Banks

German banks are extensively involved in German corporations; they own large blocks of shares, actively vote those shares at meetings, and influence the membership of the Supervisory Board. As such, banks are powerful stakeholders and monitors of management. In this way, ownership and control are intertwined in Germany.

In the United States, stock ownership and control are separated. Early in the twentieth century, this separation allowed U.S. corporations to raise large amounts of capital from a diverse pool of small investors. Nevertheless, U.S. banks have little influence over U.S. corporations. Several laws limit the ability of financial institutions to hold controlling blocks of stock, furthering separation of control and ownership. The Glass-Steagall Act, for example,

116 See Charny, supra note 5, at 151-52.
117 Adolph A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 4-7 (Harcourt, Brace & World, Inc. 1967) (1932) (stating that American corporations are often described as Berle-Means Corporations).
separates commercial from investment banks and prohibits commercial banks from owning and dealing in securities.\textsuperscript{120} Secondly, the Bank Holding Company Act, limits banks' activities further and prohibits even "bank affiliates" from holding more than five percent of a company's voting stock.\textsuperscript{121} The Employee Retirement Income Security Act (ERISA) further discourages large block share ownership.\textsuperscript{122}

There are no comparable laws that limit German banks in this manner.\textsuperscript{123} As a result, banks have significant holdings in and control over German corporations,\textsuperscript{124} reducing the importance of individual investors and allowing German banks to assert large influence over German corporations.\textsuperscript{125} In contrast, pension funds, investment funds, and insurance companies, the most important investors in the United States, have little influence in Germany.\textsuperscript{126} German banks are permitted by law to offer a complete palette of commercial banking and investment services.\textsuperscript{127} Furthermore, individuals holding shares

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\item \textsuperscript{120} Glass-Stegall Act, 48 Stat. 162 (1933) (codified as amended at 12 U.S.C. § 24) (preventing banks from underwriting, distributing, selling, or dealing in investment securities, except on their own account; barring banks from affiliating with any company engaged principally in underwriting securities; making it unlawful for investment banks to accept deposits; prohibiting any officer or director of a commercial bank from managing a company primarily engaged in the securities business).
\item \textsuperscript{123} See Kreditwesengesetz, BgBl. 1472 (1985 I) (regulating commencement and conduct of banking operations, but containing only general safety and soundness provisions for banks' ownership of non-banking companies). For an English translation of the law, see HANNES SCHNEIDER ET AL., THE GERMAN BANKING SYSTEM (4th ed. 1987).
\item \textsuperscript{124} Theodor Baums, Corporate Governance in Germany: The Role of the Banks, 40 AM. J. COMP. L. 503, 506 (1992); see also Jeffery N. Gordon, Deutsche Telekom, German Corporate Governance, and the Transition Costs of Capitalism, 1998 COLUM. BUS. L. REV. 185, 192 (1998) ("From an American perspective, the distinctive feature of German corporate governance is the role of the leading German banks, which have representatives on supervisory boards of most large publicly traded German firms, often as Chair."); see Singhof & Seiler, supra note 7.
\item \textsuperscript{125} See Butler, supra note 8, at 560; see also Hwa-Jin Kim, Markets, Financial Institutions, and Corporate Governance: Perspectives from Germany, 26 L. & POL'Y INT'L BUS. 371, 373 (1995).
\item \textsuperscript{126} See Kim, supra note 125, at 374.
\item \textsuperscript{127} See Butler, supra note 8, at 560 (stating that the "universal" service offered by banks even reaches into the insurance business and mergers and acquisitions consulting); see also Janis Sarra, Corporate Governance in Global Capital Markets, Canadian and International Developments, 76 TUL. L. REV. 1691, 1716 (2002) (stating that lack of laws constraining banks made the role of the bank as intermediary between investors and the corporation key to governance structures).
\end{itemize}
\end{footnotesize}
often permit banks to vote the shares on their behalf. Recently, the importance of banks has been increasing as the separation between banking and insurance industries has been disintegrating—for example, Deutsche Bank now holds ten percent of Allianz and Münchener Rückversicherung, Germany's two largest insurers. When compared to the U.S., the German system relies on the precautionary attitude of banks, and not the threat of individual shareholder liquidity, as a check on management.

The influence of German banks arguably leads to a group of passive minority investors that, because of their relatively small stakes and wide dispersal, lack the ability, information, and incentives to actively monitor their corporations. When investors are relatively passive, managers have more room for independent decision-making. German shareholders are comparatively more concentrated—it is common for banks to own a combined share of twenty percent. Because of the large number of shares held by German banks, they are not as readily saleable as they would be in the U.S. market—the size of the block and lack of market are the primary obstacles. In other words, the well-developed market for corporate debt in the United States is a factor in the comparatively small influence of banks on U.S. corporations. In U.S. companies, concentrations of bank holdings totaling more than five percent are considered large.

2. Shareholder Voting

In order for shareholders to be effective monitors, it is necessary for them to communicate with each other. In U.S. corporations, shareholders directly are the supreme constituency and have various means at their disposal that

128 Baums, supra note 124, at 506.
129 Kim, supra note 125, at 374-75.
130 Baums, supra note 124, at 506.
133 See Roe, supra note 118.
134 Coffee, supra note 115, at 1304.
135 Id. at 1294-95.
136 Mark J. Loewenstein, What Can We Learn from Foreign Systems?: Stakeholder
are designed as checks on the board of directors. Perhaps the most important check is the power to vote. To make voting rights fully effective, shareholders also have inspection rights, preemptive rights, and cumulative voting provisions.\textsuperscript{137} Voting rights exist in a number of situations: (i) election and removal of directors; (ii) situations of significant corporate change, such as mergers and liquidations; (iii) and approval and repeal of bylaws. In some jurisdictions, shareholders have the power to remove management and bring the corporation under shareholder control.\textsuperscript{138}

To allow for rapid deployment of the shareholders' power, special meetings may be called. Although attendance at shareholder meetings is generally poor,\textsuperscript{139} U.S. corporations allow for voting by proxy. U.S. Securities & Exchange Commission (SEC) proxy regulations regulate and, in effect, limit the ability of U.S. shareholders to freely communicate with each other.\textsuperscript{140} This prevents shareholders from exerting control through concerted action. SEC proxy regulations require the corporation to make complete and correct disclosure. A private right to action exists for the violation of disclosure rules, yet the cause of action has recently been narrowed. While the SEC has attempted to revise the proxy regulations to allow shareholders more input in the management of the corporation, the effect of the regulations has been doubtful.\textsuperscript{141}

Whereas SEC regulations hamper communications among U.S. shareholders, the concentration of shares in Germany and less stringent proxy rules make communication less costly.\textsuperscript{142} Historically, proxy voting by banks has been an important feature of the German corporate law.\textsuperscript{143} Since early experience showed that shareholders scarcely attended stockholder meetings, representation of shareholders by banks was thought to be a viable alternative in personam attendance of shareholders.\textsuperscript{144} Many small German investors prefer to have voting decisions made by professionals at their banks.\textsuperscript{145} It should be
noted that German banks tend to vote deferentially to the wishes of management; nonetheless, the ability to wield the full power of their large block of shares remains\(^6\) and makes it possible to elect employees of the bank to the Supervisory Board.\(^7\) Banks occasionally exercise this right and place representatives onto the Supervisory Board when needed.\(^8\) As such, banks are actively involved in corporate governance to protect their investments, improve their position as creditors, and to capture all or at least part of a corporation's financial business.\(^9\) Deutsche Bank, for example, supplies Supervisory Board members to 400 corporations.\(^10\) Herein lies another significant difference from the U.S. system, in that a large German bank, unilaterally and without input or resistance by management, is able to supply directors. Such directors, because they are beholden to the bank instead of to incumbent management, are in theory more impartial than U.S. board members are when evaluating management decisions.\(^11\) Of course, one risks trading dependence to the CEO or board with dependence to the banks.

In German, as compared to U.S., corporations, the voice of minority shareholders is muffled because of bank and labor presence. Nonetheless, some powers remain. Most tangibly, if the Supervisory Board shareholder contingent votes as an undivided block it will maintain a majority of labor representation.\(^12\) However, since bank representatives are members of the shareholder contingent, minority shareholders will depend on banks to pass their agenda.

**B. The Interplay of Corporate Constituencies as Monitoring Device: Tensions between Owners, Lenders, and Labor**

Tensions between corporate constituencies create security at the cost of flexibility and reduced rapidity of decision-making. Differences in interests and degrees of risk acceptance create conflicts and, given an appropriate corporate governance structure, will force dialogue and compromise between the different constituencies. In the case of a proposed merger, for example, well-represented labor constituencies can have a tremendous influence on the

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146 See Roe, supra note 118, at 1927.
147 See Baums, supra note 124, at 505-07.
148 Id.
149 Kim, supra note 125, at 375.
150 Baums, supra note 124, at 505.
151 Benfield, supra note 131, at 631.
152 Loewenstein, supra note 136, at 1677-78.
transaction. While labor representation adds another watchful eye replete with its own set of preferences and demands, it comes at the expense of efficiency.\footnote{153}

The U.S. corporation has two major corporate constituencies: shareholders and lenders.\footnote{154} U.S. corporations use both equity securities (those conferring a slice of ownership) and debt securities (secured bonds and unsecured debentures) to raise capital. Holders of debt securities are not "owners" of a corporation, but rather lenders.\footnote{155} The coexistence of lenders and owners necessarily creates tension since both constituencies have different attitudes towards risks.\footnote{156} Generally, creditors are more risk averse than are shareholders.\footnote{157} U.S. creditors enjoy protection in the form of a liquidation preference.

Since banks are not major U.S. equity shareholders, institutional investors are the next largest and most important equity based constituency as they usually hold significant blocks of shares. Nevertheless, their influence on corporate governance is limited.\footnote{158} Several legal schemes intended to require diversified mutual and pension funds effectively limit the influence of institutional investors.

German creditors are not as well protected as their U.S. counterparts. Their claims are valuable only if "the corporation has received all amounts it claims to have paid in for its [par value] equity securities, and if the corporation is not able to distribute the assets needed to satisfy the creditor to the equity security holders."\footnote{159} In essence, there exists a liquidation preference, at par value, to the equity shareholders. The board representation of German banks gives creditors the level of protection that the legal system fails to provide. On the Supervisory Board, banks not only have access to corporate information, but, more importantly, have the ability to influence corporate decision-making.

\footnote{153} The struggle of UAL management to reduce labor cost prior to filing for Chapter 11 bankruptcy provides an example of the inefficiencies that can be added by labor representation. See, e.g., Marilyn Adams, UAL cites improvements in its financial situation, USA TODAY, May 5, 2003, at 2B.

\footnote{154} In the wake of corporate accountability scandals one might predict a move in state assemblies to propose corporate constituent statutes that would require corporations to take into account the interests of constituencies beyond shareholders and creditors.

\footnote{155} See Butler, supra note 8, at 580.

\footnote{156} Id.

\footnote{157} See Charny, supra note 5.

\footnote{158} See Butler, supra note 8, at 585.

\footnote{159} Id. at 581.
Another watchful constituency in the German corporation is the labor representation on the Supervisory Board as provided by the applicable codetermination law. As mentioned previously, codetermination laws give employees seats on the Supervisory Boards of German AGs. Furthermore, works councils of employees do consider strategic issues and German law requires consultation on specific matters. Employees therefore take part directly in corporate governance and are well informed about the state of corporate affairs. Labor would presumably be risk averse with respect to all issues influencing job security, pay, and benefits.

On balance, Germany’s mix of constituencies has the potential to create an environment in which management misbehavior is more likely to be detected than under U.S. law. The combination of labor as a viable corporate constituency and the relatively more influential lender constituency does not exist to the same degree in the United States. While providing additional security, the German system, however, should be expected to be less efficient and flexible than Delaware law.

C. External Controls on Management by the Market

Structural rules governing the allocation of decision-making power between the directors, managers, and shareholders cannot be considered outside of the market context. While U.S. shareholders have limited power to influence corporate governance directly, their most efficient avenue to express discontent with incumbent management is to sell their shares. Shareholders are expected to watch the market carefully and react to factors affecting the worth of the company whose shares they are holding. “Active trading on a well-informed market gives up-to-the-minute assessments of how managers are performing, while the market for control ideally might provide for quick and ruthless


162 See Charny, supra note 5, at 159.

163 See Butler, supra note 8, at 587.
replacement of managers who are performing badly." The market, thus, is one of the most potent checks on U.S. management.

According to the Efficient Market Hypothesis, all information about a firm’s future income potential immediately affects its stock price. Under good management, share value will be high; under poor management, share value will be low. To facilitate efficient markets, SEC regulations are based on a regime of full disclosure.

With low share values, poorly managed firms are vulnerable to takeovers and replacement of management. This should theoretically lead to the ouster of inefficient incumbent management. Therefore, incumbent management will have an incentive to maintain the short-term value of stock—keeping it high to indicate management efficiency. Tender offers, however, are not equally likely at all times of the economic cycle, occurring mainly during times of growth. Therefore, even efficient markets may at times be less than optimal tools for monitoring.

The German market is not as well developed as the U.S. market. First, of the 2,373 corporations in Germany, only 503 are exchange-listed and the number of listed companies is slow to increase. Many of the listed corporations are largely family-owned and have little public float. This limited market creates a lack of liquidity, perpetuates the banks’ need to exercise their votes, and further strengthens the position of non-shareholder constituencies.

Second, the German information market is less developed than that of the U.S. German securities laws are not disclosure based, contributing to a

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164 Charny, supra note 5, at 159-60.


166 Id.


170 Kim, supra note 125, at 379 (characterizing German markets as “deficient”).

171 Id. at 380.

172 Id. See also Chantayan, supra note 165, at 445-46 (stating that diverse public ownership of German corporations is still a rarity).

173 Kim, supra note 125, at 380.

174 Loewenstein, supra note 136, at 1673.

175 Kim, supra note 125, at 381.
scarcity of available information, which may be wrong or insufficient, and penalties for misstatements under German law are less harsh than under U.S. laws. Accounting standards have not been uniform in the past and new EU directives do not reach the level of U.S. Generally Accepted Accounting Principles (GAAP). Until recently, insider trading has been "widespread and unregulated," lending support to the presence of material, nonpublic information.

Third, there is no German central market regulator like the U.S. SEC. Fourth, existing disclosure standards are lax compared to those in Great Britain and the United States. Fifth, German capital has been described as "patient," meaning Germans tend to be more tolerant of management inefficiencies before moving capital out of a corporation. Finally, individual stock ownership in Germany is surprisingly sparse when compared to the United States. The underdevelopment of the German markets is intertwined with the power and influence of banks, which have prevented the need for capital markets in the past.

Indication of the superiority of U.S. markets and disclosure standards can be found in the recent trend of firms cross-listing on U.S. markets. "Issuers migrate to U.S. exchanges because by voluntarily subjecting themselves to the United States' higher disclosure standards and greater threat of enforcement (both by private and public enforcers), they partially compensate for weak protection of minority investors under their own jurisdictions' laws and

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176 Id.
177 See id.
178 Id.
179 Id. at 382.
182 Loewenstein, supra note 136, at 1678.
thereby achieve a higher market valuation." In effect, firms trade freedom from regulation for higher growth prospects.

The banks' influence over corporations and the corresponding lack of markets also affect the context of mergers and acquisitions. Major corporate changes in Germany are nearly impossible without cooperation of the banks. Hostile takeovers are uncommon and proxy contests for control of the board rare. Bearer shares make direct contact with the target nearly impossible. Banks have little incentives to consent to mergers or takeovers—if they are not satisfied with incumbent management, they can use their own power to replace the Management Board. Furthermore, the codetermination laws, voting rights restrictions, and financial assistance problems restrict acquisitions of German companies.

In summary, the German markets are not effective monitors of German management. While it appears that the German system looks unfavorably on

183 John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 Colum. L. Rev. 1757, 1766 (2002) (showing that strong legal standards attract issuers to list in the U.S. markets and that the ability of European exchanges to attract foreign listings has declined). Germany had a "high disclosure" market, the Neuer Markt. However, lacking enforcement via a central market regulator or private actions, the exchange has been marred by scandals. Confidence in the market dropped with its capitalization and it closed in 2003. *Id.* at 1804-05. *See also*, e.g., Tanja Santucci, *Extending Fair Disclosure to Foreign Issuers: Corporate Governance and Finance Implications for German Companies*, 2002 Colum. Bus. L. Rev. 499 (providing an example of the demands to which cross-listed firms are subjected). There is indication that a certain cultural hegemony has existed in favor of the U.S. model of corporate governance. *See* James A. Fanto, *Persuasion and Resistance: The Use of Psychology by Anglo-American Corporate Governance Advocates in France*, 35 Vand. J. Transnat'l L. 1041 (2002).

184 Kim, *supra* note 125, at 383.

185 Andre, *supra* note 181, at 1820.

186 Kim, *supra* note 125, at 383.

187 *Id.* at 384.

188 *Id.* at 384-85 (stating that worker representation on the board is often supportive of incumbent management in the merger context, presumably because mergers are often followed by layoffs). *See also* Loewenstein, *supra* note 136, at 1681 (stating that where a takeover has the potential to affect labor, labor's influence may lead to a fierce battle that the opponent might well want to avoid), andMary O'Sullivan, *Contests for Corporate Control: Corporate Governance and Economic Performance in the United States and Germany* (2000).

189 Kim, *supra* note 125, at 385 (describing voting rights restrictions limiting the vote of a single shareholder to 5% or 10% as "poison pills"). While shares held by banks are affected, they still retain enormous power due to the shares held in deposit contracts and voted by the banks.

190 *Id.* at 387.
shifts in corporate control and leaves German management more freedom to act than U.S. management, ideally the power of banks replaces the monitoring function falling on markets in the United States.

**D. Board of Directors and Supervisory Board: Internal Monitors**

In a U.S. corporation, the board of directors represents the shareholders' interests before management. By electing directors, shareholders influence the broad policies of the corporation: by enacting and amending its certificate of incorporation and bylaws, shareholders give the board directives. The addition of outside directors should ensure a degree of impartiality in the supervision of incumbent management.

Generally, the board of directors' duties are twofold; it owes shareholders a fiduciary duty of care and a duty of loyalty in dispensing its service to the corporation. While it is difficult to state the extent of the fiduciary duties succinctly, there is some agreement that the duty of care requires management to exercise reasonable skill and diligence in monitoring corporate affairs and in taking board action. The duty of loyalty requires management to put the interests of the shareholders before their own when conflicts of interests arise.

The monitoring function of the board has not worked as well as expected. Incumbent management selects the candidates for board positions, often friends and business partners. Thus, the beholden board might not be diligent in supervising management for fear of losing their board position and out of desire to give incumbent management the level of deference that they would like to have in running their own companies. Furthermore, staggered

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191 *Id.* at 388.
192 Loewenstein, *supra* note 136, at 1683.
193 JACOBS, *supra* note 114.
director terms,\textsuperscript{198} often provided for in the certificate of incorporation, can make it exceedingly difficult to completely replace the board if it does not serve the shareholders. If staggered terms are provided for, shareholders cannot elect an entirely new board of directors at one time.

In the German AG, the Supervisory Board usually contains representatives of the major banks financing the particular business.\textsuperscript{199} Thus, in addition to wielding the traditional power of lenders, banks also control corporations in an ownership capacity. German Management Boards are not very likely to bear in mind the interests of small investors, but are more likely to focus on the interests of key shareholders over minority shareholders.\textsuperscript{200} "One German banker went so far as to say, 'Shareholders are dumb when they buy stock and impertinent because they also want a dividend.' This is not to say that individual investors are always ignored, only that their voice is a faint one that is rarely heard."\textsuperscript{201}

The German Supervisory Board places a check on the Management Board, which is entrusted with the quotidian management of the corporation.\textsuperscript{202} The Supervisory Board is available for intervention in situations of crisis. The intention is that by creating a body that oversees the Management Board, the interests of the shareholders are safeguarded.\textsuperscript{203} Although crises are, hopefully, not on the daily order, the Supervisory Board and Management Board are supposed to interact to enable the Supervisory Board to review management's decisions. The Supervisory Board exercises its power to request reports of any nature, often quarterly, and reviews balance sheets.\textsuperscript{204} Furthermore, recall the Supervisory Board's ability to demand approval in case of certain management decisions.

As mentioned previously, banks have great influence over the membership of the Supervisory Board.\textsuperscript{205} Together, the access to information about the corporation's internal workings and the veto power give German banks insights into the internal workings of a corporation that U.S. shareholders do not possess. The information given to the banks via the Supervisory Board

\begin{itemize}
\item \textsuperscript{198} Del. Code Ann. Tit. 8, § 141(d) (2002).
\item \textsuperscript{199} Butler, supra note 8. While not unthinkable that a U.S. board will have representation by lenders, chiefly bond holders, that scenario occurs only upon default of bond covenants.
\item \textsuperscript{200} Chantayan, supra note 165, at 445.
\item \textsuperscript{201} Id.
\item \textsuperscript{202} Id. at 439.
\item \textsuperscript{203} Id.
\item \textsuperscript{204} See Baums, supra note 124, at 510.
\item \textsuperscript{205} Gordon, supra note 124, at 192.
\end{itemize}
remains confidential. U.S. corporations, on the other hand, are not required to pass along internal information and are not bound to do so in cases of confidential information.\textsuperscript{206} This unique insight into a German corporation’s governance provides shareholders unparalleled access. While such power is in the hands of few—the banks—other investors nonetheless benefit. In the end, the bank’s interest is the same as that of the shareholder: to maximize returns on investment while keeping risk at an acceptable level. On the other hand, the influence of banks over the Supervisory Board risks that the board will be beholden to the bank.\textsuperscript{207}

It is to be expected that the interest of banks as lenders turns the Supervisory Board into a powerful watchdog. This system, however, is not without fault. The Management Board is given great latitude,\textsuperscript{208} meetings of the Supervisory Board may be too infrequent to be effective,\textsuperscript{209} and the Management Board’s replies to Supervisory Board requests for information are often evasive.\textsuperscript{210} Coupled with the fact that management is difficult to remove,\textsuperscript{211} management is generally able to operate free from fear of repercussions.\textsuperscript{212} While the German system in theory provides for closer supervision, it does so at the price of efficiency. Banks as lenders are less risk tolerant than equity shareholders, reducing the possible gains accruing to shareholders under American corporate governance.

\textbf{E. Availability of Courts as Monitors: The Effects of Legal and Equitable Redress}

The availability of judicial redress is arguably the ultimate mechanism ensuring compliance with various corporate duties of care and accountability. The aforementioned forces, the system of separated ownership, constituencies of various interests, the market forces, and the built-in checks of the corporate

\textsuperscript{206} See id.
\textsuperscript{207} Chantayan, \textit{supra} note 165, at 441. The problem is underscored by the fact that a small number of individuals serve on a large number of Supervisory Boards creating a “clubby atmosphere.” Andre, \textit{supra} note 181, at 1822.
\textsuperscript{208} § 82(1) AktG (stating that management’s authority cannot be limited).
\textsuperscript{210} Chantayan, \textit{supra} note 165, at 441. See also Singhof \& Seiler, \textit{supra} note 7, at 559-62 (expressing doubt about the effectiveness of the Supervisory Board in the control and supervision of management).
\textsuperscript{211} § 84(3) AktG (allowing removal of management only for cause).
\textsuperscript{212} Chantayan, \textit{supra} note 165, at 440.
governance regimes are expected to fail in some cases—the legal system will provide the proverbial “last resort.” Both Germany and Delaware effectively restrict access to the courts, albeit though different mechanisms.

In the case of the U.S. board of directors, court review of directorial duties is limited by the business judgment rule, a presumption that the board and management’s decisions are made with sound business judgment. Since the board is not considered an insurer of success, to overcome the presumption, a shareholder will have to show fraud, illegality, bad faith, or gross negligence. It is difficult for plaintiffs to meet this exacting burden designed to preserve risk-taking by management. Combined with the prohibitive cost of shareholder litigation, the presumption of the business judgment rule makes judicial action a viable alternative to influence management’s action only in cases of egregious misconduct. On the other hand, U.S. courts are more rigorous in the enforcement of breaches of duty of care. No business judgment presumptions apply in this case and a mere showing of conflict of interest will be enough to implicate court review.

German courts are less deferential to management than U.S. courts operating under the business judgment rule. “German courts do not hesitate to question whether members of the [Management Board] took unreasonable risks or if [they] crossed a borderline drawn by the corporation’s benefits.” This may lead to the application of the court’s own business judgment, a situation U.S. courts try to avoid. But while purporting to apply an objective standard, there is always the danger that the judge’s personal “subjective risk attitudes” or the benefit of hindsight enters the decision. It is for these reasons that U.S. courts have imposed the broad and powerful presumptions of the business judgment rule.

U.S. corporations also face judicial scrutiny under the Securities Acts. These acts are arguably the U.S. substitute for the judicial audit of German Stock Corporations at formation.

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214 Butler, supra note 8, at 588.
215 Smith, 488 A.2d 858 (Del. 1985).
216 See Benfield, supra note 131, at 623.
217 Butler, supra note 8, at 591.
218 Id.
219 Id.
220 See id.
221 See Butler, supra note 8, at 591.
222 Id. at 592.
However, the former protect the integrity of the security market, while the latter mainly protect creditors. But if we keep in mind that U.S. corporations raise capital through the stock market, while German Aktiengesellschaften heavily depend on loans, both kinds of regulations protect the main financiers of the corporations and thus, in return, secure the sources of corporate funding.223

The U.S. Securities Act of 1933 imposes liability for misstatements of material fact in registration statements.224 The scope of liability under Rule 10b-5 of the Act and its regulations is broad.

In the United States, there are two primary avenues for bringing shareholder suits "neither of which" exist in Germany: the derivative suit225 and the direct class action. In derivative suits, the shareholder sues on behalf of the corporation and any recovery is for the benefit of the corporation.226 The shareholder is allowed to assert the corporation's rights on the theory that the board of directors failed to do so.227 In direct class actions, on the other hand, the shareholder asserts his own rights as against the defendants and is allowed to recover personally. The aforementioned separation of management and ownership leads to frequent lawsuits, and "[a]s a way to align management's interests with shareholders," U.S. law has permitted shareholders to sue to redress the damages caused by managerial misbehavior.228 Some commentators have called into question the effectiveness of derivative suits in controlling management, given their high procedural and substantive requirements. Nonetheless, they are powerful and threatening devices in the hands of shareholders.229

While German law also places strict standards on review of management, derivative suits and class actions are not available to redress misbehavior.230

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223 Id. at 592-93.
225 See Singhof & Seiler, supra note 7, at 544 (providing a good overview of U.S. derivative litigation).
227 Id.
228 Butler, supra note 8, at 598.
229 Rainer Kraakman et al., When are Shareholder Suits in Shareholder Interest?, 82 GEO. L.J. 1733 (1994).
230 Loewenstein, supra note 136, at 1674 (stating that outside the U.S., shareholder derivative action is rare, resulting in a lesser degree of accountability of directors to shareholders).
Several remedial doctrines create further obstacles under German law.\footnote{Butler, supra note 8, at 600.} For example, the conceptualization of the corporation as separate body\footnote{\S 1 AktG.} is applied more rigorously in Germany than in the United States. In Germany, the contractual relationship exists between management and the corporation and not between management and shareholders.\footnote{See Richard M. Buxbaum, Extension of Parent Company Shareholders' Rights to Participate in the Governance of Subsidiaries, 31 Am. J. Comp. L. 511, 513 (1983); Butler, supra note 8, at 600.} Consequently, management owes duties only to the corporation, and not its shareholders. Therefore, the right to sue lies with the corporation only. "The fact that a breach of duty by management usually has a negative impact on the value of the shares, and with this, on the shareholders, is irrelevant, because as an indirect harm, it is considered to be outside the scope of the pertinent doctrinal concept."\footnote{Butler, supra note 8, at 601.} Like in the United States, German management, vested with the sole power to pursue claims against the corporation, is unlikely to sue itself. The Supervisory Board, however, has the power to initiate suit.\footnote{\S\S 78, 112 AktG.} Yet, the Supervisory Board has no duty to file suit and may, in any case, be entangled in the issue. If the Supervisory Board decides not to sue, then the shareholders may initiate suit by majority vote.\footnote{\S 147 AktG.} But since the Supervisory Board is elected by the shareholders, there may be reluctance on the part of the shareholders to bring suit after the board declined to do so.\footnote{Id. See also Singhof & Seiler, supra note 7, at 463 (stating that the net effect of placing the burden of proof on the German Management Board is that they will be less likely to act opportunistically).}

It is also worth mentioning that Germany allocates the cost of litigation to the losing party; contingency fees are not permitted. This system might be another hurdle to suit, as litigation costs quickly become enormous. Since the corporation will recover in case of success and the shareholder will personally be liable for fees in case of loss, this hurdle is large indeed.

In summary, German law gives shareholders slightly less protection than U.S. law provides its shareholders.\footnote{Id. However, other protective mechanisms partially replace the need for derivative and class actions. The Supervisory Board and the watchful eyes of dominant banks act as a check on
While the German two-tier board structure, including creditor and labor representation, is a powerful device, arguably providing more protection than the single board of the U.S. corporation, the tool may fail in those circumstances in which management mischievously fails to provide the Supervisory Board with truthful information. History has shown that the Supervisory Board generally fulfills its management function, but there have been serious failures in the past. Critics maintain that the Management and Supervisory Boards have become too close and do not function as separate organs effectively, jeopardizing management functions. The Supervisory Board, furthermore, has become more beholden to management than previously and now often includes friends and business contacts. Lastly, even if the Supervisory Board effectively monitors management, it still does not effectively represent the shareholders, due to the various codetermination laws.

F. Recapitulation

Separation of ownership and control is a strong feature of U.S. corporate governance. By creating separate owning and managing constituencies, the owners are encouraged to closely watch management. In the United States, the SEC complicates the owner's monitoring function, through proxy regulations. In Germany, the separation of ownership from control is less clear. Banks, as primary owners and as trustees of individual stock deposit accounts, own and vote large contingents of stock. While banks could wield tremendous power, they are deferential to management. Overall, the voice of minority investors is muffled.

Delaware corporations have two major constituencies: shareholders and management. In larger corporations, debt holders form a third faction. Germany adds labor as a constituency. Labor representation on the Supervisory Board is intended to give labor a voice in corporate governance. It also allows labor to exert control on the actions of management. Labor's conservatism and one-sided goal of preservation of the employment force,

\[^{239}\]Butler, supra note 8, at 602.

\[^{240}\]Id. (giving an example of a decision of the Bundesgerichtshof, NEUE JURISTISCHE WOCHEZEITSCHRIFT 1629 (1980), where the members of the Aufsichtsrat were held liable for proposing that management give securities to a company with doubtful credit rating).


\[^{242}\]See Andre, supra note 181, at 1823.
however, have stalled transactions and impeded the efficacy of the German corporation.

The U.S. markets constitute a powerful monitoring force on U.S. corporations. U.S. markets are diversified and efficient. The ability of capital to leave poorly managed firms provides incentives to maintain management quality. Furthermore, SEC rules and active media create and maintain an information market that supports the efficiency of U.S. markets. The German market is not a good monitor. Poor debt markets perpetuate the importance of German banks and public float is small when compared to U.S. companies. Furthermore, accounting standards and the absence of a central market regulator lead to a comparatively less reliable information market.

The board of directors has been an apparent weakness of the U.S. system of corporate governance. Until recently, some corporations lacked adequate outside directors and the independence of the board was questionable. Germany’s two-tiered structure is intended to provide an additional level of monitoring. A two-tier model of governance should work well if the monitoring tier is a vigilant observer of the management tier. As it stands, however, banks dominate the Supervisory Board at the cost of minority investors. Bank employees sit on a majority of Supervisory Boards, yet give management wide latitude. The banks’ pronounced presence on the boards also protects and perpetuates ineffective management in office.

Both the United States and Germany restrict access to their courts in questions of corporate governance. In the United States, the business judgment rule acts as a presumption that management’s decisions are the result of sound business judgment. The rule prevents courts from addressing all but the most egregious instances of misconduct. Furthermore, the SEC allows suits based on its regulations. All suits may be had as derivative or direct actions. In Germany, the business judgment rule is unknown. Other legal doctrines, such as the separate entity doctrine, the absence of class actions, and differing rules regarding the award of attorney’s fees, make suits about corporate governance unlikely in Germany.
IV. WHERE IS THE GERMAN ENRON?

A. The U.S. Corporate Failures: Enron, WorldCom, Tyco and Other Trouble

To be able to appreciate the recent corporate failure and the significance to German and U.S. corporate law, it will be necessary to introduce Enron\textsuperscript{243} and other corporate failures to give some indication about the nature of the failure of the system.

After the long market rally of the mid-and late 1990s, rapidly falling stock prices surprised Enron and ultimately led to its demise. Enron extensively issued special purpose vehicles to take debt off the balance sheets. With an unorthodox but legitimate approach, Enron used its own stock as collateral to secure the investments.\textsuperscript{244} As the share price declined, the collateral Enron put up declined in value. To avoid default, Enron had to issue more stock to its special vehicle creditors. This further diluted its stock value. Enron’s financial structure began to unravel and investors and concerned analysts looked more closely at its accounting practices. This lead to the discovery of Enron’s use of special purpose vehicles. Enron later declared bankruptcy.\textsuperscript{245} Arthur Andersen, Enron’s accounting firm and auditor, was indicted, and found guilty of obstruction of justice, pointing to possibly wide-spread collusion between corporations and their accountants and auditors.\textsuperscript{246}

Enron was not the only corporation for which questionable business practices led to a steady decline once stock prices started to fall. WorldCom, a large telecommunications company, has since filed the largest bankruptcy in corporate history.\textsuperscript{247} Adelphia, a cable communications company, essentially collapsed because of occurrences of what is considered widespread fraud by its major shareholders, the Rigas family.\textsuperscript{248} Tyco provides another example of the kinds of problems involving corporate governance.\textsuperscript{249} Furthermore, there were indications that stock analysts and investment banks were not as independent as free markets demanded.\textsuperscript{250} Analysts took money from

\textsuperscript{244} See Weil, supra note 12.
\textsuperscript{245} Enron, supra note 12; Dynergy, supra note 12.
\textsuperscript{246} Andersen, supra note 12; Kurt Eichenwald, supra note 12.
\textsuperscript{247} Cornwell, supra note 13.
\textsuperscript{248} Johnson, supra note 15.
\textsuperscript{249} Morning Edition, supra note 15.
\textsuperscript{250} Randall Smith & Dan Morse, \textit{Deals & Deal Makers: Merrill Lynch Fires Analyst over
corporations in exchange for promoting and recommending their stock as investment grade.

While the methods that led to the financial failures differed from case to case, management misbehavior provides a common denominator. Board failures reached from outright fraud to a simple failure to inform themselves adequately. For example, the "Enron Board of Directors . . . failed to appreciate the financial condition of Enron because it did not insist on complete, clear explanations of the transactions it approved and the financial statements the company issued."251 As such, U.S. corporate failures are symptomatic of the wide latitude and independence of management.

B. Recent Changes in U.S. Law, Regulations, and Listing Requirements

The U.S. reaction to its corporate failures was immediate and is best characterized by (1) a strengthening of the existing disclosure policies and (2) greater leverage in enforcing the regulations along with harsher punishments for their violation. The Sarbanes-Oxley Act252 provides the symptomatic corrections needed to address the recent corporate failures, by following and strengthening the SEC disclosure philosophy and regime. Specifically, the Sarbanes-Oxley Act reinforces the In re Caremark253 requirement of a compliance program and attending personal director liability. It also provides charges regarding:

- CEO/CFO certification of company reports,
- Forfeiture of executive compensation and trading profits,
- Disclosure of trading activity by insiders,
- Insider today and blackout periods,
- Conflict of interest provisions,
- Off-balance sheet transactions,
- Federalization of audit committees—creation of better "watchdog"254 and an Accounting Board,
Disclosure of audit committee expert,
Enhanced periodic review,
Rapid disclosure of financial changes,
Rules of professional conduct for lawyers,
Code of ethics for senior financial officers,
Criminal penalties, and
Whistle blower protection.  

The new requirements will also affect all cross-listed firms, which in the case of Germany leads to conflicts between U.S. and German requirements.

A second avenue of substantial change in U.S. financial markets is the changes in the listing requirements of major U.S. exchanges. These changes complement the stature of the Sarbanes-Oxley Act. The NASDAQ Board has approved changes designed to enhance investor confidence and has submitted the changes to the SEC for approval. The NYSE has pursued a similar path.

168 (2002) (arguing that there is no potential for disproportionate expansion of audit committee member’s potential liability).


Coffee, supra note 183, at 1826 (showing that the Sarbanes-Oxley requirements of the audit committee create a “mismatch for civil law corporations: Members of the managing board are barred from service on the audit committees [by local law], and members of the supervisory board, who may also be conflicted, are given powers [by the Sarbanes-Oxley Act] that few civil law corporations would willingly entrust to them”).

Summary of NASDAQ Corporate Governance Proposals—The New Disclosure and Corporate Governance Regime: What Every Corporate and Securities Lawyer Must Know Now, 1335 PLI/CORP 413 (2002) (addressing changes regarding stock options, loans to officers and directors, increased board independence, heightened standards of independence for audit committees, a strengthened role of independent directors in compensation and nomination decisions, a mandate for director continuing education, transparency for foreign corporations, establishment of corporate codes of conduct, etc.); but see ABA Committee on Federal Regulation of Securities, Special Study on Market Structure, Listing Standards and Corporate Governance, 57 BUS. LAW. 1487 (2002) (opining that the route taken by NASDAQ and NYSE is not the best and advocating a regime of practice guidelines instead).

Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, August 1, 2002—The New Disclosure and Corporate Governance Regime: What
The U.S. response to its corporate failures evidences U.S. confidence in the current corporate governance regime.

C. German Corporate Failures

Germany has also had its share of corporate failures, several of which have achieved a level of notoriety at least in the European press. While these scandals exhibit a variety of problems, they do have a common basis. The German banking system was involved in each of the scandals and arguably contributed to the failure.

Metallgesellschaft (MG) is an example of a corporate failure rescued only by the effort of large banks contributing more than 1.5 billion dollars. Without intervention, Germany's then fourteenth-largest industrial group would surely have descended into bankruptcy. Deutsche Bank shouldered the rescue effort but nonetheless became the target of criticism. Previously, Deutsche Bank had offered special services for managing risk on the conglomerate's oil products, an area that led to massive losses. The Deutsche's involvement is puzzling, because Ronaldo Schmitz of Deutsche Bank was also the Supervisory Board chairman at MG and should have known of the mounting losses. Mr. Schmitz was finally sued by MG's management.

Every Corporate and Securities Lawyer Must Know Now, 1335 PLI/CORP 421 (2002) (addressing changes regarding a majority of independent directors, the definition of independent director, regular meeting of non-management directors, establishment of a nominating/corporate governance committee and an independent compensation committee, limitations of the fees that audit committee members may receive, increased authority and responsibility of the audit committee, increased shareholder voting on compensation plans, adoption and disclosure of corporate governance guidelines, adoption of a code of conduct/ethics, disclosure of foreign companies explaining differences from corporate governance practices followed by U.S. companies, certification by CEO that there are no known violations of NYSE listing standards, etc.).

259 See Andrew Fisher, Metallgesellschaft: The Oil Deals that Crippled A German Metal-Trading Giant, FIN. TIMES, Mar. 20, 1995, at 20; In the Line of Fire—Metallgesellschaft, EUROMONEY, Mar. 1, 1994, at 40.


261 Id.

262 Id.

263 Id.

264 Id.

265 Germany's Corporate whodunnit (pinning the blame for debts of Metallgesellschaft), ECONOMIST, Feb. 4, 1995, at 71.
who were at the time under criminal investigation as well.\textsuperscript{266} U.S. academics have blamed Metallgesellschaft's troubles on the Supervisory Board.\textsuperscript{267} After shedding the conflicts, MG underwent a remarkable recovery.\textsuperscript{268}

The Schneider Affair\textsuperscript{269} of the mid-1990s is illustrative of a scandal that focused on one person. Mr. Jurgen Schneider presided over a real estate empire worth several billion dollars.\textsuperscript{270} He obtained construction loans based on forged paperwork and when the business failed he filed for bankruptcy with $3.2 billion of debt.\textsuperscript{271} "The Schneider affair sent tremors through Germany's financial community, raising alarms that lending institutions were too careless with their biggest clients."\textsuperscript{272} Deutsche Bank was criticized for its "loose lending and lax supervision" and accepted the resignation of four of its executives over the matter.\textsuperscript{273} Schneider was sentenced to six years and nine months in prison after a conviction for credit fraud and forgery.\textsuperscript{274}

There has also been trouble at the engineering group KHD,\textsuperscript{275} where international competition pushed prices so low that the company was forced

\begin{footnotes}
\item[266] Germany Begins Inquiry: Troubles at Metallgesellschaft continue to surface, NAT'L POST, Jan. 11, 1994, at 8, available at 1994 WL 6182776.
\item[267] Id.
\item[268] Metallgesellschaft Out Of Sick Bay and Rallying: The company that was nearly Germany's biggest corporate disaster is finding itself back in favor with investors who have sent shares soaring 40\% since May, NAT'L POST, Sept. 21, 1995, at 58, available at 1995 WL 4348185.
\item[269] Nicholas Bray, Scandals Knock Deutsche Bank's Image, WALLST. J., July 5, 1994, at A8; John Eisenhammer, All Fall Down: Jurgen Schneider Had Everything, INDEP. (London), June 17, 1995, at 34.
\item[270] Associated Press, German real estate scandal ends with Schneider fraud conviction, Dec. 23, 1997, available at 1997 WL 4889027; see also Terence Roth, Turmoil at Germany's Schneider Takes Toll on Banks, Contractors and Others, WALL ST. J., Apr. 14, 1994, at A10, available at 1994 WL-WSJ 296870 (stating that not only German banks found themselves exposed to the Schneider affair and detailing that Morgan Stanley's Frankfurt office was fearing for its doors when unpaid contractors had slipped in with the predawn cleaning team and were taking doors off hinges and carting them out of the building they had recently renovated for property developer Juergen Schneider).
\item[271] Roth, supra note 270.
\item[272] Id.
\end{footnotes}
to accept contracts for building factories at levels below the break even point. Accountants then “corrected” these negative balances on the books. Wall Street Journal Europe asked: “Is anybody minding the store at Germany, Inc.?” German banks intervened to rescue the firm, in particular Deutsche Bank, who owned 48.7 percent of KHD’s shares. With such a large share, Deutsche Bank should have been very aware of the events at KHD, especially since Deutsche provided KHD’s chairman of the Supervisory Board. But “KHD offers a prime example of the lack of supervisory control and of management screening itself off from responsibility. . . . There’s a clique of supervisors who exert no real control.”

In 1994, sports flooring manufacturer Balsam filed for insolvency. Balsam’s management, including chairperson Friedel Balsam, ran the business into $1.6 billion of debt and were later indicted for “falsifying orders, bills and other documents to obtain credit on accounts receivable.”

Most recently, Deutsche Telekom, the privatized state telecommunications provider, has also made news. Although Deutsche Telekom has not collapsed, it has seen its share values decline by ninety percent over the past two years. Ousted CEO Ron Sommer contributed to his own demise by failing to cut Deutsche Telecom’s sixty-seven billion euro debt, dragging out the sale of a cable television network, and “spend[ing] lavishly” in the acquisition of struggling U.S. mobile-phone company, VoiceStream. Deutsche Telekom shares are Germany’s most widely held stock and were “supposed to be the harbinger of a new business culture in a nation traditionally averse to stock

277 Id.
278 Id.
279 Id.
282 Id.; see also PW Germany plans suit against Procedo, Balsam, INT’L ACCT. BULL., Jan. 24, 1995, at 1.
284 Id. See also Deutsche Telekom’s Sommer May Seek Another Big Telecommunications, Deal, WALL ST. J., July 28, 2000, at B6.
Political pressure led to the eventual ouster of the widely unpopular Ron Sommer. The German government continues to hold a forty-three percent stake in Deutsche Telekom.

These scandals created an atmosphere of investor unease and attracted political attention. Specifically, a series of smaller scandals not discussed here have deeply troubled and eventually led to the closing of Germany's technology bourse Neuer Markt. The scandals and corporate failures underscore the problems of self-regulation and lack of enforcement as well as difficulties with the way Supervisory Boards currently function.

D. Recent Changes in German Law

In response to German corporate failures, there has been significant discussion about whether German corporate law should undergo changes. Opinions on the issue differ. Yet, the Aktiengesetz has undergone significant changes in the last decade, some of which were intended to address the aforementioned problems. Most significantly, Germany is trying to lessen the influence of banks on corporations.

285 Karnitschnig & Rhoads, supra note 283.
287 Karnitschnig & Christopher Rhoads, supra note 283.
289 Coffee, supra note 183, at 1805-06.
291 Chantayan, supra note 165, at 448.
In 1998, the Gesetz zur Kontrolle im Unternehmensbereich (KonTraG) introduced changes to the internal control mechanisms, limited the exercise of proxies by banks, and introduced limiting provisions on the issuance of stock options to board members. Those changes were brought about by (i) the failure of the Supervisory Board and auditors to recognize early and prevent dramatic collapses and bankruptcies and (ii) fear of the power of the banks over German businesses due to their depository voting rights. The 1998 amendments largely affected the Management and Supervisory Boards. They reduced the size of each board allowing for greater access to information, strengthened the control of shareholder meetings, modified the depository voting by banks, improved the quality of account audits, and amended the regulations dealing with the acquisition of the corporation’s own stock.

Yet, changes to the controversial two-tier system itself remain unlikely. Historically, the German legislature has been supportive of the system despite doubts about its economic efficiency and effectiveness as social policy. Furthermore, German political sentiment has been that economic efficiency has been worth sacrificing to “protect” non-shareholder constituencies.

German commentators have frequently complained of the influence of banks and maintained that cross-holdings between German corporations are not desirable. German corporations tend to hold significant amounts of shares of other German corporations, creating corporate interconnections. This further increases the inflexibility of German corporate governance. Legislation introduced in 2001 has abolished a fifty percent tax on capital

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294 See Butler, supra note 8, at 559.

295 Id.


297 Loewenstein, supra note 136, at 1676.

298 Id. at 1676-77.

299 Id. at 1679; see Singhof & Seiler, supra note 7.

300 See Singhof & Seiler, supra note 7.
gains companies obtain from selling equity stakes in other companies and had the effect of encouraging firms to reduce their cross holdings.\textsuperscript{301}

German corporations are trying to broaden their shareholder base.\textsuperscript{302} Germans have historically been more reluctant than Americans to invest in stock. This is likely because German investors are more risk averse than Americans.\textsuperscript{303} To encourage participation in the market, shareholder voting restrictions are being eliminated,\textsuperscript{304} and the eight German exchanges are trying to move closer towards the dominating Frankfurt exchange.\textsuperscript{305} There has also been some talk about tougher disclosure standards,\textsuperscript{306} which would likely increase the market capitalization of German corporations and encourage investment.

The changes to German corporate law are piecemeal and do not go far enough to remedy the deep-seated problems. As the above described scandals show, the banks continue to have great influence on German corporations.

V. CONCLUSIONS

The functions of corporate governance, as described above, are threefold: (1) to provide a check on senior management, (2) to provide a nexus between the corporation and its shareholders, and (3) to satisfy the demands of various constituencies such as directors, officers, employees, creditors, and other stakeholders.\textsuperscript{307} Each system involves complex trade-offs between the competing virtues of a governance system: flexibility vs. stability, innovation vs. predictable success.\textsuperscript{308}

The German and U.S. systems take different approaches to monitoring management within their respective corporate government structures. This raises the question of whether German mechanisms for controlling managers

\textsuperscript{301} Cheffins, supra note 180, at 502-03.
\textsuperscript{302} Andre, supra note 181, at 1821.
\textsuperscript{303} See Singhof & Seiler, supra note 7, at 542 (commenting generally on German investor conservatism); see also Christina Escher-Weingart, The Development of Corporate Governance in Germany—Some Annotations to Jeffrey Gordon, 5 COLUM. J. EUR. L. 243, 245-46 (1999) (noting that loss in two world wars led to economic instability historically keeping Germans away from capital markets).
\textsuperscript{304} Andre, supra note 181, at 1821.
\textsuperscript{305} Id.
\textsuperscript{306} David Woodruff, Investor Demand for Details of Executive Pay Helps Change the Rules, WALL ST. J. EUR., Sept. 11, 2000, at 27.
\textsuperscript{307} See Charny, supra note 5, at 145.
\textsuperscript{308} Id. at 146.
are inferior, equivalent, or superior to those employed in the United States.\textsuperscript{309} The German system, in theory or on paper, is a system that appears more effective in monitoring management. The reality, however, is that bank domination and concentrated stock ownership give German management wide latitude in handling business, encourage collusion between banks and business, and dangerously concentrate ownership and control.

Separation of ownership and control is a strong feature of U.S. corporate governance. By creating separate ownership and management constituencies, the owners are encouraged to closely watch management. In the United States that monitoring role is complicated, but not made impossible, by SEC proxy regulations. The SEC regulations greatly increase the transaction costs of shareholders communicating with each other. In Germany, the separation of ownership from control is less clear. Banks own and vote large contingents of stock, both as primary owners and as trustees of individual stock deposit accounts. That concentration of ownership leads to a vigorous and powerful exertion of the banks' interest. Yet, the reality is different. Banks, through their presence on Supervisory Boards, leave Management Boards wide discretion. The concentration of shares in the hands of the banks, combined with the deferential attitude towards banks of individual deposit account owners, creates a class of passive minority investors. The voice of these minority investors is muffled.

The prototypical Delaware corporation has two constituencies: shareholders and management. In larger corporations debt holders become a third pro forma constituency. Germany adds to the mix a fourth group; labor representation on the Supervisory Board is intended to give labor a voice in corporate governance. It also allows labor to exert control on the actions of management. Labor's conservatism and one-sided goal of preserving the employment force, however, have stalled transactions and impeded the efficacy of the German corporation.

The U.S. markets constitute a powerful monitoring force on U.S. corporations. U.S. markets are diversified and efficient. Capital flows freely. The ability of capital to leave poorly managed firms provides an effective incentive to maintain management quality and integrity. Furthermore, SEC rules requiring complete disclosure, as well as active media, create and maintain an information market that supports the efficiency of U.S. markets. German markets are not a good monitor. Poor debt markets perpetuate the importance of German banks. Public float is small when compared to U.S. companies.

\textsuperscript{309} Singhof & Seiler, \textit{supra} note 7.
Furthermore, accounting standards and the absence of a central market regulator lead to a comparatively less reliable information market.

The board of directors has been an apparent weakness of the U.S. system of corporate governance. Until recently some corporations lacked an adequate number of outside directors and the independence of the board of directors was, in many cases, questionable. Germany’s two-tiered structure is intended to provide an additional level of monitoring. A two-tiered model of governance should work well if the monitoring tier is a vigilant observer of the management tier. As it stands, however, banks dominate the Supervisory Board at the cost of minority investors. Bank employees sit on a majority of Supervisory Boards and give management wide latitude. The banks’ pronounced presence on the boards also makes management difficult to remove.

Both the United States and Germany restrict access to their courts in questions of corporate governance. In the United States, the business judgment rule acts as a presumption that management’s decisions are the result of sound business judgment. The rule prevents courts from addressing all but the most egregious instances of misconduct. Furthermore, the SEC allows suits based on its regulations. All suits may be filed as derivative or direct actions. In Germany, courts are less deferential to management. No business judgment rule exists and courts are willing to second guess management’s decisions. Nonetheless, a variety of legal doctrines, such as the separate entity doctrine, along with the absence of class actions, make suits over corporate governance unlikely in Germany.

In both Germany and the United States, recent corporate failures indicate that the respective governance systems are not free from fault. Illustrating the path dependence of the two systems, the latest changes are not radical but along the lines of the existing structure. The Sarbanes-Oxley Act in the United States primarily strengthens disclosure rules and provides harsher punishments for violations. The Act falls in line with the existing SEC disclosure regime. Also along existing lines are new listing requirements of the New York Stock Exchange and the NASDAQ. Among the most significant contributions of the new listing requirements are enhancements in the structure of the boards to ensure independence and critical evaluation of numbers provided by management. Germany’s manifold changes came in effect over the course of the past few years. Intended to reduce the influence of banks, they were not introduced with the resolve of the Sarbanes-Oxley Act in the U.S. Half-hearted piecemeal changes have not succeeded in providing the promised relief. While banks’ importance is reduced, they do remain the predominant players on the German
corporate field. Deutsche Telekom’s current state testifies to the changes that must still occur in Germany.

What accounts for the lack of total corporate failures such as Enron, WorldCom, and Tyco in Germany? Speculatively, the size of the German economy and its comparatively smaller corporations would allow one to expect fewer large corporate failures. Next, there is some indication that the German and U.S. corporate cultures differ. Such cultural differences might well be the reason for the lack of large German corporate failures. In the particular circumstances of Enron, even well-designed corporate governance structures might not have led to discovery of the problems and successful intervention. Enron’s demise might well have been a result of the “on the edge” atmosphere prevalent at the firm. Large options packages in U.S. corporations entice managers to manipulate the stock price. In Germany, lower executive pay and fewer options give managers less of an incentive to manipulate. Finally, the perceived goal of the German corporation is not profit alone. The head of a major German company recently told Der Spiegel that German companies are unlikely to accept “Anglo-Saxon cold capitalism, which exclusively focuses on maximizing profits, [because it] will lead to a crisis in our system and to a decline of acceptance for the pillars of the social free market economy.”

Should one system be replaced by another? Should Germany Americanize its system of corporate governance, or vice versa? With regard to certain

310 See Chantayan, supra note 165; see also Thomas J. Andre, Jr., Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, 73 TUL. L. REV. 69 (1998); see Charny, supra note 5, at 145; John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 NW. U. L. REV. 641 (1999); Janis Sarra, Corporate Governance in Global Capital Markets, Canadian and International Developments, 76 TUL. L. REV. 1691 (2002) (describing countervailing pressure resisting the international convergence of corporate law in other countries situated in their differing cultural, political, and economic structures and reflected in capital market and corporate law regimes); Jacoby, supra note 290 (indicating that the German system would not be sustainable absent social norms); Mark J. Roe, German “Populism” and the Large Public Corporation, 14 INT’L REV. L. & ECON. 187, 190 (1994) (“[H]ow a nation regulates capital’s deployment will affect how large firms are organized.

311 Wachtell et al., Memoranda on Corporate Governance And Audit Committees Post-Enron, in Disclosure & Other Lessons Learned After Enron: What You Need to Know Now to File Your 10-K & Other Forms, 1303 PLI/CORP 345 (2002).

312 Cheffins, supra note 180.

313 DER SPIEGEL, May 21, 1999, quoted in Dore et al., Varieties of Capitalism in the Twentieth Century, 15 OXFORD, REV. ECON. POL’Y 102, 104-17 (1999).

314 Michael Adams, Bankenmacht und Deutscher Juristentag, 37-38 ZIP 1590, 1591 (1996) (stating that Americans have examined the German bank-dominated systems in reviewing their
features, change might be feasible, but rapid change of the entire system is unlikely.\textsuperscript{315} Cultural relevance includes aspects of legal relevance and "it is" worth realizing that the German and the U.S. systems of corporate governance have different priorities. The hallmark of the U.S. system remains its flexibility. Germany places its priorities elsewhere. "The [German] Stock Corporation Act [AktG] is so strict and inflexible that many American lawyers wonder how German companies manage to reasonably accomplish corporate transactions under this statute."\textsuperscript{316} The German system is set up to grant more power to a wider variety of corporate constituencies. In practice, however, banks dominate German corporations. Thus, Germany sacrifices flexibility in corporate governance without reaping the potential benefits of a vocal diversity of corporate constituencies that its two-tiered, labor-inclusive model set out to achieve.


\textsuperscript{316} Schnorbus, \textit{supra} note 293, at 582.