Corporate Governance in Germany

Corporate Governance v Německu

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Abstract

This will give an overview of the German corporate governance framework which is an important factor in the relationship with institutional investors. The corporate governance codex gives guidelines how the different stakeholder can interact together. In respect to German corporate governance it can be concluded that most of the demands by institutional investors are met, but a few issues of great concern remain. This is of utmost importance because of the dominance of capital markets.

Keywords

institutional shareholder, corporate governance, mutual funds, shareholder value, Companies Act, board composition

JEL classification

M10, D002

Abstrakt

Tento článek přináší přehled o corporate governance v Německu, která je důležitým faktorem ve vztahu s institucionálními investory. Kodex corporate governance dává pokyny, jak se různé zúčastněné strany mohou navzájem ovlivňovat. Ve vztahu k německé corporate governance lze dospět k závěru, že většina požadavků institucionálních investorů je splněna, ale několik otázek velkých podniků zůstává. To má mimořádný význam pro dominanci kapitálových trhů.

Klíčová slova

institucionální akcionář, corporate governance, podílové fondy, hodnoty pro akcionáře, firemní zákon, složení rady

1 Introduction - The Corporate Governance System in Germany

Recent stock exchange scandals as well as spectacular collapses of enterprises[1] resulted in a greater distrust into management of listed corporations by shareholders. The massive abuse of power to make decisions and the disregard of controlling duties by the management and the supervisory boards led to the development of the Corporate Governance

1 *The most famous scandals are ENRON and Worldcom. For more details see Utzig (2002), pp. 594 et seq.*

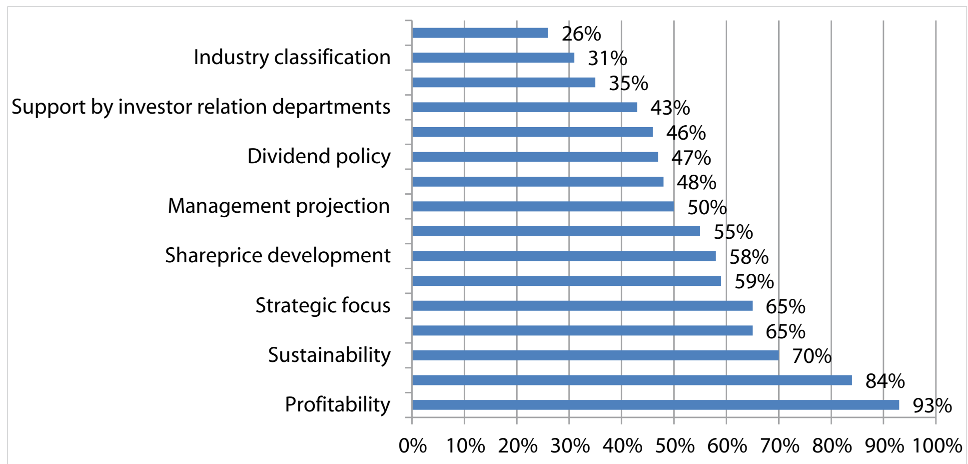
Code in Germany. Meanwhile, corporate governance is seen as a positive attribute which might lead to higher credit of corporations in international capital markets.[2]

This document addresses the German Corporate Governance approach and its impact on institutional investors. After illustrating the two perspectives on informational needs of shareholders and protection of information by the corporation, the chapter will focus on direct monitoring and indirect firm level monitoring.

1.1 The Need for Information versus the Protection of Information

Initially and before analyzing details of the German Corporate Governance Code[3] and the legal framework, which provides informational rights to shareholders, it is important to illustrate the informational needs of institutional investors. Clearly, there is no consistency regarding institutional investors or shareholders. Hence, there is no consistent requirement for information, i.e. investors prefer different information.[4] First of all, it is important to know on which basis institutional investors select their holdings. Empirically, Ernst et al. found that there are several criteria which influence the portfolio selection of institutional investors. These criteria are illustrated in figure 1.

Figure 1: Factors on which institutional investors select their holdings



Source: In accordance with Ernst et al. (2005), p. 33.

Notably, the majority of institutional investors select their holdings according to the profitability of the firm as well as the quality of the management. This is not really surprising

2 *MUELLER, H.; SACH, V., Corporate Governance: Die deutsche Wirtschaft im Spannungsfeld der neuen regulatorischen Anforderungen, 2005, p. 5.*

3 *Commission of the German Corporate Governance Code, 2007, p. 12.*
The most famous scandals are ENRON and Worldcom. For more details see UTZIG, 2002, pp. 594 et seq.

4 *ERNST, E., et al., Verhalten und Präferenzen deutscher Aktionäre, 2005, pp. 10 et seq.*

when considering that institutional investors focus on risk-benefit ratios.[5] Having said that, German institutional investors give more emphasis to personal talks and direct contacts than to annual reports, whereas Anglo-American institutional investors weight these two information channels as equal.[6] The arrangements or/and advocacies of the German Corporate Governance Code were not covered yet. Informational rights and duties can be subsumed under the term transparency. When having a look at the German Corporate Governance Code and to the EU directive transparency is ensured under following circumstances:

The board of directors publishes insider information regarding the corporation immediately, unless the board is, in a particular case, exempted.

As soon as a corporation gets to generally know that someone achieved or fell short of 3, 5, 10, 15, 20, 25, 30, 50 or 75 percent of the voting rights, the board of directors immediately publishes this issue.

The corporation treats all shareholders equal with regard to informational issues. The corporation should immediately publish all new facts which were provided to financial analysts or comparable receivers.

The corporation uses appropriate communication channels for a contemporary and consistent information flow to shareholders, as for example the internet.[7]

Information regarding the different possibilities for exercising voting rights that are currently published separately will now have to be included in the call for the general meeting.[8]

Legal certainty with regard to takeover bids, while protecting the interests of shareholders, employees and any other interested parties.[9]

1.2 Measures and Forms of Corporate Governance

Generally speaking, monitoring is a quintessential activity of professional ownership of corporate equity. It can either be formal, e.g. by submitting proxies, or informal, e.g. when institutional investors develop an idea and communicate it to the management.[10] Both cases comprise an activity which aims at fostering the organizational accountability between corporate management and owners or between the chains of owners.

5 *KENNELLY, J. J., Institutional Ownership and Multinational Firms: Relationship to Social and Environmental Performance, 2000, p. 31.*

6 *ERNST, E., et al., Verhalten und Präferenzen deutscher Aktionäre, 2005, p. 34.*

7 *Commission of the German Corporate Governance Code, 2007, p. 12.*

8 *EU Directive no 2004/25/CE*

9 *EU Directive no 2007/36/CE*

10 *HAWLEY, J. P.; WILLIAMS, A. T., The Rise of Fiduciary Capitalism, 2000, p. 124.*

Following Black, monitoring by institutional investors can be differentiated into institutional "voice" or institutional "control."[11] Institutional voice requires agents to watch other agents. Brought forward to the topic of this paper, it means that institutional owners watch corporate management, because both parties might have different interests. For that reason voice may shed light into the board room in a sort of check and balances approach to corporate governance.[12] Additionally, Black suggests that in order to enhance institutional voice and to overcome, or at least minimize the free-rider problem, institutional investors should hold between 5 and 10 percent of the stock in a particular corporation.

Through slimming their portfolios it is easier for institutional investors to communicate and, hence, it permits stronger influence on the selection of board members. However, at these levels of ownership it is not possible for a single investor to dominate the selection process of the board. As a result, a few owners could collectively influence major corporate issues, but no single owner alone could dominate or act effectively alone.[13] On the other hand, institutional control proposes the dominance by one or a small group of institutional investors as it was the case in Germany.

1.2.1 Institutional Investors and the German Annual Meeting

For a better understanding of the role of institutional investors at German AGMs it is necessary to illustrate the functions and the status of the general meetings in the organizational structure of the company. From a legal perspective, there is no statutory definition of the AGM, but § 118 (1) AktG defines that shareholders can regularly exercise their rights regarding issues of the company. Consequently, the AGM can be understood as a meeting where shareholders make their decisions as well as an essential institution of the German stock corporation besides the supervisory board[14] and the managing board.[15]

In principle, the AGM has the right to organize itself and to arrange the event within the legal framework. For that reason, the AGM can establish its own bylaw.[16] Furthermore, it is important to outline that the AGM has to choose a chairman who leads the AGM, assign the time of speeches, control the ballots and execute, if necessary, the right to call for order.[17]

The prearrangement of the German AGM is, to some extent, different and incumbent to the administration of the corporation. Besides the convening and transmission of the relevant documents to shareholders, most of the time-consuming effort is spend on preparing the discussion with shareholders because the executive board has to response to all

11 *BLACK, B. S., Institutional Investors and Corporate Governance: The Case for Institutional Voice, 1992b, pp. 19 et seq.*

12 *BLACK, B. S., Agents watching agents: The promise of Institutional Investor Voice, 1992a, p. 832.*

13 *BLACK, B. S., Institutional Investors and Corporate Governance: The Case for Institutional Voice, 1992b, p. 21.*

14 *§§ 95 AktG.*

15 *§§ 76 AktG.*

16 *§ 129 (1) 1 AktG.*

17 *This is determined by §§ 130 (2), 122 (3) 2 AktG.*

questions from shareholders which refer to issues of the corporation and to issues which are needed to simplify the process of decision making.[18]

On the one hand, the principle task of the AGM is to inform shareholders. On the other hand, its task is also to exercise internal processes of decision making. As already mentioned in chapter 5.1.2, during the AGM shareholders can opt out their rights, in particular, their voting rights. To be more specific and to incorporate special regulation for different institutional investors, the next sub-section will illustrate different legal regulations for insurance companies, commercial banks as well as mutual funds. Additionally, it will outline positive and negative incentives to be active at the AGM.

1.2.1.1 Commercial Banks

Initially, one has to differentiate between legal regulations which regard shareholdings of a commercial bank and regulation which regard shareholdings on a commercial bank.

For the latter, it has to be noted that there are no particular regulations when an individual acquires shares of a bank. The only restriction can be found in the German Banking Act (Kreditwesensgesetz, further KWG). According to this, the acquirer19 of the stock as well as the bank[20] have to inform the Federal Financial Supervisory Authority (further, BAFIN) when acquiring a stake greater than 10 percent.[21]

It can be stated that commercial banks are regulated in regard with their own shareholdings. According to § 12 KWG, a bank is not allowed to acquire a stake on a non-financial company which exceeds 15 percent of the banks liable equity. Additionally, all shareholdings together have to be smaller than 60 percent of the banks liable equity.[22] As a matter of fact, shareholdings of banks are also restricted through the regulatory statutes of large credits. This means that stocks, investments in other companies as well as shares in affiliated companies belong to assets by law.[23] As a result, all shareholdings, independent from their purpose, are restricted by §§ 13, 14 KWG. A loan is seen as a large credit and therefore restricted, when reaching 10 percent of the liable equity.[24]

In summary, it can be noted that commercial banks are, by law, restricted in their investment policy. It is not possible for banks to acquire a large stake in a non-financial company if the price of the outstanding shares of that particular company is greater than 10 percent of the banks own liable equity.

However, commercial banks do not gain their influence through own shareholdings but rather through proxy voting. If an individual shareholder can not be present at the AGM

18 § 131 AktG.

19 § 2c (1) KWG.

20 § 24 (1) no. 10 KWG.

21 § 1 (9) 1 KWG.

22 § 12 (1) 2 KWG.

23 § 19 (1) 1, 2 no. 6 – 8 KWG.

24 § 13 (1) KWG.

of his shareholding, he has the option to assign his depository bank to vote on his behalf. The process of giving proxies to banks is regulated by the German Stock Company Act.[25] When a commercial bank preserves the shares of a shareholder and the bank intends to vote on behalf of that shareholder, the bank is required to present own suggestions to particular agenda items.[26] In more detail, the bank is required to make its suggestions in the best interest of the shareholder.[27] Simultaneously, the bank is required to ask the shareholder for instructions. In case the shareholder gives instructions, the bank is required to follow these directions.[28] Nevertheless, in practice only a minority of shareholders instruct their banks. Consequently much leeway is left to banks.[29]

1.2.1.2 Mutual Funds

Mutual funds (in the sense of public funds) are, according to the Investment Act (further InvG), separate property (Sondervermögen) which is administrated by an investment company (Kapitalanlagegesellschaft).[30] There is no legal regulation which limits the acquisition of interests on a mutual fund. Solely, the acquisition of large stakes has to be reported to the BaFin.[31] The rules and regulations of the German Banking Act (Kreditwesensgesetz) have to be applied supplemental because mutual funds are financial institutions in terms of the law.[32] The administration of separate property is subject to specific requirements. Particularly, the acquisition of shares is limited. According to the Investment Act, an investment company is only allowed to invest 10 percent of its separate property in shares of one issuer.[33] The background of this regulation can be attributed to the principle of risk diversification.[34]

Further specifications of mutual funds are special funds (Spezialfonds). The most important feature of special funds is their limited quantity of investors. According to the InvG, only 30 incorporate investors are allowed to hold stakes in the fund.[35] In consideration of the limitation of investment decisions, there are no additional regulations for special funds. Only hedge funds have other possibilities concerning investment decisions.[36] However, hedge funds are not considered in this thesis. When it comes to voting rights, mutual funds are allowed to act on their own behalf.[37] Interestingly and in contrast to banks, mutual funds are not required to get proxies from their stockholders in order to execute voting rights.[38]

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25 *For more details see §§ 128, 135 AktG and GADOW, W.; HEINICHEN, E., AktG - Großkommentar, 1993, p. 128.*

26 *§ 128 (2) 1 AktG.*

27 *§ 128 (2) 2 AktG.*

28 *§ 128 (3) 3 AktG.*

29 *FRAUNE, 1996, p. 10.*

30 *§ 2 (1) InvG.*

31 *§§ 2b (1), 24 (1) KWG.*

32 *§§ 6 (1) InvG, 1 (1) no. 6 KWG.*

33 *§§ 47, 52 InvG.*

34 *§ 2 (5) InvG. For more details about portfolio theory and risk diversification, see SPREEMANN, K., Portfolio Management, 2006, p. 48.*

35 *§ 91 (1) InvG.*

36 *§§ 112 InvG.*

37 *§ 32 InvG.*

38 *§ 32 (1) InvG in conjunction with § 129 (3) AktG.*

Normally, mutual funds are also required to execute voting rights by themselves.[39] Only in individual cases, mutual funds are allowed to assign a third party to execute voting rights. In that case, the third party has to follow the directive of the mutual fund.[40]

1.2.1.3 Insurance Companies

Generally and by the law in force, investments in stocks of an insurance company are not limited. Just as in the case of banks and mutual funds, the acquisition of large stakes[41] on an insurance company has to be reported to the BaFin.[42]

Conversely, investments by an insurance company in shares of a listed company are restricted. Before going into detail, one has to differentiate between insurance funds (Deckungsstock),[43] and unencumbered assets (freies Vermögen). Particularly, investments of insurance funds are restricted by the German Insurance Supervision Act (Versicherungsaufsichtsgesetz, further VAG).[44] When insurance companies invest their money, they have to mind principle investment rules. They have to consider the basic principles of safety of their investments, profitability, liquidity and diversification.[45] However, insurance companies are not restricted in their investment decision regarding shares of listed companies.[46] As already mentioned, they only have to inform the BAFIN when they acquire a stake which is larger than 10 percent of the outstanding shares.[47]

1.2.2 Indirect Firm Level Monitoring

After outlining direct-firm level monitoring, which is basically shaped by the German legal background and provides an internal perspective on corporate governance, it is now important to illustrate external approaches to corporate governance mechanism. This section aims at outlining the market for corporate control, which is a mechanism to discipline management of underperforming corporations. Moreover, this section will focus on the influence of institutional investors on German board structure with regard to reducing board size and enhancing board independence.

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39 § 32 (1) 2 InvG.

40 § 32 (1) 3 InvG.

41 Due to the fact that the acquisition of shares is not part of the core business of an insurance company, the Kreditwesengesetz has to be applied. Thus, large stakes refers to 10 percent of the outstanding shares or voting rights of a listed company. See § 1 (3) KWG in conjunction with § 1 (9) KWG and § 54 (4) no. 2 VAG.

42 § 104 (1) 1 VAG.

43 The principle components of insurance funds can be defined as the sum of the book values of actuarial reserves in consideration of the backlog of premiums plus the reserves for not yet transacted insured events plus the provisions for not yet transacted buybacks of several insurance contracts plus the surplus share. For more details see § 66 VAG.

44 §§ 54 - 54d VAG.

45 § 54 (1) VAG.

46 Formerly, insurance companies were restricted in their investment decisions. They were only allowed to invest 30 percent of their investment fund into shares. For more details see § 54a VAG (old version).

47 § 104 (1) 1 VAG.

1.2.2.1 Takeovers or the Market for Corporate Control

Until today, the issue of takeovers as a disciplinary mechanism for corporate management is an unresolved one.[48] In particular, the question remains whether takeovers are a good substitute for direct shareholder monitoring as illustrated in the recent section. Yet, it is necessary to present the background underlying the market for corporate control. In that context, the terms "merger", "acquisition", and "takeovers" are all part of the M&A nomenclature. A typical merger is characterized by an unsolicited incident when firms come together to share their resources in order to realize common objectives. However, in case of a merger the rectifying of corporate management is not of great concern.[49]

A typical takeover is characterized by a tender offer by an investor or a company to dispersed shareholders of the targeted firm. In case shareholders of the targeted company accept the offer, the bidder acquires control of the targeted firm. A more relevant issue regarding corporate control is hostile takeovers. In a hostile takeover the management of the targeted firm opposes the bid and is, thus, likely to be replaced when the bid is successful.[50]

This chapter will solely focus on hostile takeovers as a means of correcting managerial failure. The underlying philosophy of hostile takeovers is conclusively simple. Macey argues that a hostile bidder has an incentive to monitor and search for underperforming firms because he can profit from buying shares of the targeted company and replace the management team through a better one. Nevertheless, the bidder has to consider that the remaining shareholders also profit from a better management team, although they do not bear any costs which is the classical free-rider problem. However, Macey argues that a hostile takeover is still beneficial to the bidder as long as the market pays a risk-adjusted return to the bidder.[51] However, hostile takeovers are not an all-encompassing tool to solve monitoring problems within the corporate governance context.

First, takeovers are very costly. In other words, a bidder has to bear costs to search, find and successfully replace the targeted management of a permanently undervalued company. Additionally, a functioning market for hostile takeovers might be sufficient to affect managerial performance even if there is no announced bid or attempt for a takeover.[52]

In summary it can be stated that the market for corporate control is a good appliance for improving management performance and, thus, corporate governance. However, there are several reasons why this statement is only partly valid. First, there are too few value-improving hostile takeovers. Second, there may be value-reducing hostile takeovers.[53] As already mentioned above, there is the classical free-rider problem which implies that

48 GUGLER, K., Corporate Governance and Economic Performance, 2001, p. 32.

49 GUGLER, K., Corporate Governance and Economic Performance, 2001, p. 33.

50 MACEY, J. R., Institutional Investors and Corporate Monitoring, 1997, p. 606.

51 MACEY, J. R., Institutional Investors and Corporate Monitoring, 1997, p. 606.

52 MACEY, J. R., Institutional Investors and Corporate Monitoring, 1997, p. 606.

53 GUGLER, K., Corporate Governance and Economic Performance, 2001, p. 33.

bidders do not get the full return for their efforts but have to share the gains with the remaining shareholders of the targeted company. These shareholders might have the incentive not to sell their shares to the bidder in order to gain from improvements in post takeover firm value.[54] Another argument which supports the first caveat is that bidders in a takeover do face competition which possibly drives up the price of the target and reduces the incentive to actually make a bid. Last but not least, targeted firms and targeted management may take defense actions such as poison pills et cetera.[55] There are also several reasons why takeovers may be value-reducing. At first, the potential acquirer of a corporation might face his own agency problems, which means that the managing board of the acquirer might not act in the best interest of their shareholders.[56] Additionally, managers might not act under the proposition of profit maximization. As an acquisition is the fastest way to grow, the management of the acquirer might choose takeovers to achieve its own size and growth objectives.[57] Moreover, hostile takeovers might be value-reducing due to distributional costs. It could mean that the gains from target shareholders are not outweighing the losses of other stakeholders, as for example acquiring shareholders, workers, suppliers et cetera and whether these losses are compensated.[58]

Nevertheless, the question remains whether hostile takeovers are a good process to shape corporate management and corporate governance. From an empirical view, one can adhere that takeovers improve deficient management. Jensen found out that hostile takeovers are a good strategy to reduce excess capacities of corporations, which would not have been possible if the incumbent management resists.[59] A further argument for hostile takeovers is that takeovers or other forms of acquisitions are socially desirable when they result in other kind of efficiency gains. Other kinds of efficiency gains could be reached through economies of scale or scope and through savings of transaction costs or multi-use assets.[60] However, several studies indicate that hostile takeovers as well as mergers did not improve firm performance in the post takeover era.[61]

One can conclude that hostile takeovers and mergers are able to discipline managements. Nevertheless, one cannot say that hostile takeovers are a superior process or disciplinary device for shaping corporate governance and corporate management.[62] Although hostile takeovers are not superior, one must admit that this process is able to support corporate governance and that it is a good external process to discipline management.

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54 *GROSSMANN, S. J.; HART, O. D., Takeover Bids, the free rider problem and the theory of the corporation, 1980, p. 43.*

55 *KOKOT, K. S., The Art of Takeover Defense, 2006, p. 18.*

56 *SHLEIFER, A.; VISHNY, R. W., Large Shareholders and Corporate Control, 1986, p. 30.*

57 *MUELLER, H., 1969, p. 657.*

58 *GUGLER, K., Corporate Governance and Economic Performance, 2001, p. 33.*

59 *JENSEN, M. C., The modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, 1993, p. 832.*

60 *GUGLER, K., Corporate Governance and Economic Performance, 2001, p.33.*

61 *For example, RAVENSCRAFT, D. J.; SCHERER F. M., 1987, p. 216 et seq.; MORCK et al., 1989, p. 852 or MUELLER, H., 1985, p. 259.*

62 *GUGLER, K., Corporate Governance and Economic Performance, 2001, p. 37.*

1.2.2.2 Board Composition and Board Structure in Germany

The purpose of this section is to give the reader an overview and an insight to German board structure, its legal back-up as well as to present non-statutory rules from the German Corporate Governance Code. The German Corporate Governance Code was developed by the governmental commission (Regierungskommission Corporate Governance Codex) under the leadership of Mr. Cromme in 2001. In this regard, the German code follows a self-regulatory "comply-or-explain" approach. According to the German company law, companies have to publish a compliance with the code in the annual report.[63]

In contrast to Anglo-Saxon countries, public companies in Germany are characterized by a two-tiered board model, which is mandatory regardless of the size or listing of the company.[64] The two-tiered board model consists of the management board and the supervisory board. Basically, the main task of the management board is to run and operate the business.[65] In comparison to that, the task of the supervisory board is to appoint, supervise and remove the management board.[66] In more detail, the supervisory board supervises the managing board (not the corporation) and its business strategies. However, the supervisory board cannot directly influence operational business but if the statute of the company demands it or the supervisory board decides so, particular transaction can be subject to its approval.[67]

A membership at the supervisory board and the management board of the same corporation, at the same time, is not possible. Additionally, an individual is limited to 10 seats on supervisory boards at maximum.[68] One might question that, before the background of "Germany Inc.", multiple seats on supervisory boards challenge the attributes of independence and objectivity as well as it bears conflicts of interests.[69] Nevertheless, practice has shown that many companies assigned their former managers, which had a seat on the managing board, to the supervisory board. In that context, it is most common that the former CEO takes the chair of the supervisory board. It is also common procedure that further seats on the supervisory board are offered to other stakeholders like business partners, particularly when the corporations are characterized by cross shareholdings.[70] As already mentioned, this procedure bears potential conflicts of interests especially in the case of banks. Due to the German universal banking system, banks take a double position. On the one hand, they are depository banks for their clients. In this regard, banks exercise voting rights for clients who gave a proxy. On the other hand, banks are creditors of corporations and, thus, a conflict of interest is present. This conflict of interest could be even more intensified when the bank holds shares on the company by itself. Practitioners realized that problem and, thus, Deutsche Bank AG was one of the first banks in Germany which addressed this issue in its corporate governance principles. According to

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63 § 161 AktG.

64 § 30 AktG in conjunction with §§ 96 – 99 AktG.

65 § 76 (1) AktG.

66 § 111 AktG.

67 § 111 (4) AktG.

68 HOPT, K. J.; LEYENS, P. C., Board Models in Europe, 2004, p. 5.

69 PRIGGE, S., A survey of German Corporate Governance, 1998, p. 957.

70 HOPT, K. J.; LEYENS, P. C., Board Models in Europe, 2004, p. 6.

this, Deutsche Bank AG complies the German Corporate Governance Code and stated that no member of the managing board, in principle, is allowed to take a seat on a managing board outside the group.[71]

In Germany, the question of independent directors in order to avoid conflicts of interests is also mentioned in the German Corporate Governance Code, which was one of the major demands of institutional investors. However, the German code does not provide a general definition of the term "independence", but it provides a statement. Referring to this, the code basically recommends that the number of former managers from the managing board should be limited to two seats. Additionally, the chair of the audit committee should not be assigned to a former member of the managing board. The code provides a recommendation that parallel seats on the supervisory or managing board of competitors as well as advisory mandates are not compatible with German corporate governance.[72] Especially the issue of multiple seats was addressed by institutional investors who worried that managers will not act in the best interest of the corporation.[73]

A special characteristic of the German corporate governance system is the issue of co-determination. According to the Co-determination Act (Mitbestimmungsgesetz, further MitbestG), companies with more than 2,000 employees must compose half of their supervisory board with representatives of workers.[74] When it comes to votes and there is a stand-off, the vote of the chairman of the supervisory board counts twice, which gives a slight advantage to shareholders.[75] From a corporate perspective, the model of co-determination has proofed its eligibility because it is seen as a warning system for social conflicts as well as it helps to keep down strikes, which is of course, in the best interest of shareholders and in particular institutional investors.[76]

From a more critical perspective, the German system of co-determination is to some extend limiting the efficiency of the boards which is mainly due to size of supervisory boards (up to 21 members).[77] Moreover, the German legal system does not specify concrete qualification standards for members of the supervisory board. Indeed, the German Corporate Governance Code touches this issue and recommends that members of the board should have the knowledge, ability and professional experience[78] but this issue is only described superficial and no one has to proof his qualification by, for example, a degree in finance or accounting.

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71 DEUTSCHE BANK, Significant Differences in Corporate Governance Practices for Purposes of Section 303A, 2008, p. 3. This is consistent with the German Corporate Governance Code, in more detail see Commission of the German Corporate Governance Code, 2007, paragraph 5.4.4.

72 Commission of the German Corporate Governance Code, 2007, paragraph 5.3.2 and 5.4.4.

73 SHLEIFER, A.; VISHNY, R. W., Large Shareholders and Corporate Control, 1986, pp. 27 et seq.

74 § 1 MitbestG.

75 § 29 MitbestG in conjunction with § 108 (3) AktG.

76 HOPT, K. J.; LEYENS, P. C., Board Models in Europe, 2004, p. 7.

77 § 95 AktG.

78 Commission of the German Corporate Governance Code, 2007, paragraph 5.4.1..

Another point of major interest regarding indirect firm level monitoring, are internal control mechanism and auditing in the German corporate governance system. The composition and the functionality of internal control mechanism, as it exist under current law and under the recommendation of the German Corporate Governance Code, are mainly determined by Germany's two-tiered board model.[79] In particular, the supervisory board is excluded from operational management of the company. In addition, the supervisory board has limited rights to directly obtain information from executives. In consequence, it is difficult for members of the supervisory board to develop an objective picture of the company and its performance.[80]

When it comes to internal control, the process of auditing and auditing committees is another important aspect. According to the German Corporate Governance Code, the supervisory board should set-up an auditing committee. The main task of the auditing committee is the coordination of control, revision and auditors. In order to be efficient, the chairman of the audit committee should have professional experience and knowledge in financial accounting.[81] Furthermore, the code recommends that the audit committee should demand a statement of independence from the auditor. This statement should comprise a declaration whether the auditor has any relations to institutions of the company which could cause doubts on the independence of the auditor.[82] The code justifies its request by the argument that auditing companies do a broad spectrum of tasks such as M&A transactions, outsourcing or preparation of initial public offerings, which in consequence could cause conflicts of interests.[83]

From a legal perspective, the German Commercial Code (Handelsgesetzbuch, further HGB) states, that an auditor who has earned more than 30 percent of his earnings exclusively from one company in the last five years, is ineligible.[84] Additionally, the same auditor cannot be assigned for auditing more than five times.

This request is particularly important from a control perspective because the auditor checks the annual report of the company which is an important informational source for shareholders. In this context, it is noteworthy that the external auditor is elected by shareholders at the AGM which makes the auditor a control device of shareholders and thus institutional investors.[85]

1.2.3 Institutional Investors and Board Independence

Before giving evidence whether institutional investors do have influence on corporate board structures in respect to independence and board size, it is again necessary to distin-

79 HOPT, K. J.; LEYENS, P. C., Board Models in Europe, 2004, p. 9.

80 § 90 (1), (2) AktG.

81 Commission of the German Corporate Governance Code, 2007, paragraph 5.3.2.

82 Commission of the German Corporate Governance Code, 2007, paragraph 7.2.1.

83 RINGLEB, H. M., et al., Kommentar zum Deutschen Corporate Governance Kodex, 2005, pp. 288 et seq.

84 § 319 (3) no. 5 HGB.

85 § 318 (1) HGB as well as GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p. 2.

guish between the German two-tiered board model and the Anglo-Saxon one-tire board model. In the Anglo-Saxon capital market and especially in the United States, the board of directors has power to control, authority to ratify major corporate policy initiatives and power to hire, fire and set compensation schemes for the top management.[86]

Gallagher et al. scrutinized in their survey in 2007, for the influence of institutional investors on reducing board size and increasing independence of the board.[87] The outcome of their survey showed that U.S. institutional investor focus on removing inside directors as a mean of reducing board size and, thus, increasing independence.

The underlying philosophy of such a bargaining is that institutional investors take corrective action to improve firm performance and to remove those directors which are seen responsible for poor firm performance.[88] However, their survey also found that due to institutional investor heterogeneity, some institutional investors are not able to, respectively not willing to, exert their influence. This is mostly due to the fact, that some institutional investors (banks and insurance companies) have existing or potential business ties to companies in which they have a stake and, thus, these institutional investors are less willing to challenge management decisions. Additionally, banks and insurance companies face higher costs of monitoring because an intervention with the management could impair their relationship with the company, which could result in losing actual or future businesses. As a result, these investors stay passive.[89]

In contrast, their survey also showed that investment companies as well as public pension funds and independent investment advisors do not have and do not search for such business ties with companies they invest in. Consequently, these investors face lower monitoring costs and no conflicts of interests. They are active in challenging management decisions.[90] However, speaking in numbers, Gallagher et al. found out that the average board size in the U.S. consists of 9.7 members with 63.9 percent being independent. Moreover they gave evidence to the fact that inside or grey directors were replaced over time due to activism of institutional investors and the poor performance of the managers.[91]

In Germany, institutional investors face a different situation. In general, institutional investors with small shareholdings are not represented on the supervisory board.[92] The process

86 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p. 2.*

87 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p. 8. Independent directors are defined as: "[…] those which have no family relations with directors on the board, have not worked for the company in the past, are not current employees and also do not have any business relations with the company."*

88 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p. 4.*

89 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, pp. 11 et seq.*

90 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p. 11.*

91 *GALLAGHER, D. R., et al., Institutional Investor Monitoring and the Structure of Corporate Boards, 2007, p.17 and p. 27.*

92 *STEIGER, M. Institutionelle Investoren im Spannungsfeld zwischen Aktienmarktliquidität und Corporate Governance, 2000, p. 89.*

of selecting members of the supervisory board (from the shareholder side perspective) is usually done by coordination between the supervisory board and the management board. Consequently, the management board has influence on the composition of the supervisory board.[93]

Support for this view is also given by a study from the association of private investors (Deutsche Schutzvereinigung für Wertpapierbesitz e.V., further DSW). DSW analyzed the structure and interdependence of board members within the German DAX 30 companies in 2006.[94] It turned out, that seven out of ten managers changed from the position of the chairman of the managing board to the chairman of the supervisory board. Therefore this issue was additionally noted in the German Corporate Governance Code. According to the code, a changeover from the managing board to the supervisory board of the same corporation should only be an exception. An intention to do so should be explained to the shareholders at the AGM.[95]

In Germany, banks and insurance companies are represented on supervisory boards whereas mutual funds.[96] Moreover, banks and insurance companies have additional business ties with their holdings, e.g. credit links as well as proxy voting. This issue of course raises the question of conflicts of interests and independence of board members. Hence, the German legislator has limited the "power of banks" by the introduction of the Corporate Sector and Transparency Act (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, further KonTraG). For example, § 135 AktG states that a bank with an own stake of 5 percent (or more) is not allowed to exercise proxies for their clients. Additionally, cross-shareholding companies with a share of 25 percent or more are not allowed to exercise their own votes for the election of the supervisory board.[97]

The background of this regulation was the fear of the legislator that public limited companies with low attendance rates at the AGMs will not be controlled by owners but through companies with high stakes. The problem of "the power of the banks" is not of major importance in the Anglo-Saxon capital markets due to the fact that the legislator limited their role through laws and regulations. Additionally and in contrast to Germany, banks provide only short-term loans to companies, whereas long-term debt is usually raised in the bond market.[98]

In conclusion, the German board system cannot be regarded as independent. Empirically, Kim et al. found out that board independence is not found in Germany.[99] Notably, the survey from Heidrick and Struggels revealed slightly different results which are illustrated in figure 2.

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93 *STEIGER, M. Institutionelle Investoren im Spannungsfeld zwischen Aktienmarktliquidität und Corporate Governance, 2000, p. 87.*

94 *DSW, Germany's secret leader, 2006.*

95 *Commission of the German Corporate Governance Code, 2007, paragraph 4.3.5 and paragraph 5.4.4.*

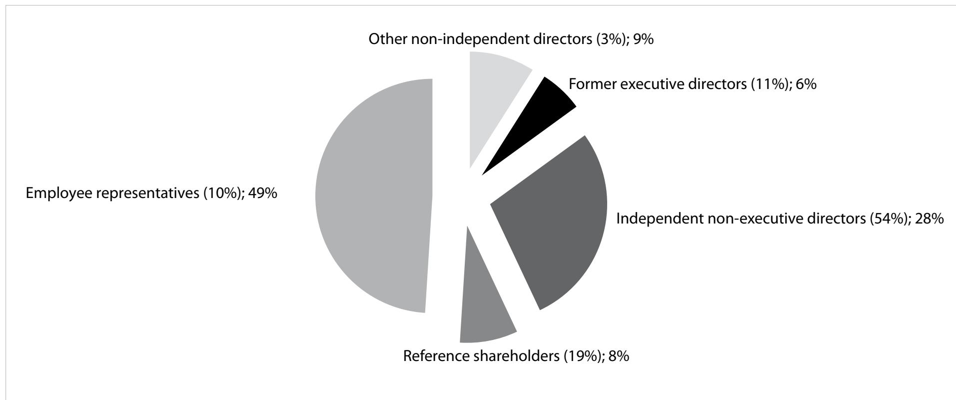
96 *DSW, Germany's secret leader, 2006.*

97 *§ 328 (1), (3) AktG.*

98 *STEIGER, M., Institutionelle Investoren im Spannungsfeld zwischen Aktienmarktliquidität und Corporate Governance, 2000, p. 83. .*

99 *KIM, K. A., et al., Large Shareholders, Board independence, and minority shareholders rights, 2007, p. 867.*

Figure 2: Board composition by category of director



Source: Heidrick & Struggles (2007), p. 23.

Interestingly, 28 percent of the directors are seen as being independent, whereas the European average (in brackets) accounts for 54 percent. Moreover, it can be stated that institutional investors do play a different role in respect to board independence than in the Anglo-Saxon governance system.

For example, mutual funds do not play a significant role in appointing independent directors. Due to their credit links and cross shareholdings banks and insurance companies are traditionally represented on supervisory boards and therefore play a prominent role in appointing independent directors.

1.3 Implementation of the German Corporate Governance Code

Every year, the Berlin Center for Corporate Governance scrutinizes the implementation of the German Corporate Governance Code on the basis of a survey of all listed corporations. Notably, no company within the DAX 30 refuses all recommendations. The Berlin Center found out that five recommendations are of particular interest because less than 90 percent of the DAX 30 corporations do not accept the following points:[100]

1. An adequate percentage share for managers on the supervisory board and management board when concluding "D&O" insurances (Directors and Officers insurance, Managerhaftpflicht, acceptance rate: 82.1%).
2. The forwarding of the invitation to the AGM as well as documents for the AGM via Internet. (Acceptance rate: 85.7%)
3. The consultation of the supervisory board about compensation schemes for the management board. (Acceptance rate: 85.2%)
4. The limitation of changeovers from former CEOs' to the position of the chairman of the supervisory board. (Acceptance rate: 71.4%)

100 V. WERDER, A.; TALAULICAR, T., Umsetzung der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, 2008, p. 2.

5. The performance-related compensation for members of the supervisory board. (Acceptance rate: 82.1%)[101]

It is striking that the limitation of changeovers from former CEOs to the position of the chairman of the supervisory board evokes such a low acceptance rate. However, the German Corporate Governance Code recommends that the supervisory board should establish a nominating committee, consisting of shareholders, to suggest candidates for the supervisory board, which will then be elected at the AGM. The current acceptance rate for this recommendation is 88.9 percent of the DAX 30 companies. In consequence, this recommendation might limit potential conflicts of interest as well as it opens the door to institutional investors to nominate their own candidates.[102]

Conclusions

This paper picked up the issue of corporate governance in Germany and gave an introduction to legal framework Regarding the subject of direct firm level monitoring the paper showed on German AGMs that all institutional investors do have positive incentives to exercise their voting rights. Therefore, "voice" can be confirmed. In respect to indirect firm level monitoring it turned out that activism is not necessarily a superior process to the market of corporate control. Particularly, it can be argued that the threats of takeovers as well as actual takeovers are a possible tool to discipline management. However, takeovers can only be seen as an addition to activism because takeovers do also cause value destruction.

In respect to German corporate governance it can be concluded that most of the demands by institutional investors are met, but a few issues of great concern remain.

First, independence of German supervisory boards is not ensured, although demanded by institutional investors. Second, the limitation of changeovers from former CEOs to the position of the chairman of the supervisory board is only accepted by 71.4 percent of German DAX30 companies.

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101 V. WERDER, A.; TALAULICAR, T., Umsetzung der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, 2008, p. 2.

102 V. WERDER, A.; TALAULICAR, T., Umsetzung der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex, 2008, p. 2.

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