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# ARTICLE

## SHAREHOLDER PARTICIPATION IN CORPORATE DECISIONMAKING UNDER GERMAN LAW: A COMPARATIVE ANALYSIS

*Bernd Singhof*<sup>\*</sup>  
*Oliver Seiler*<sup>\*\*</sup>

### INTRODUCTION

Corporate Governance issues are on the national agenda in Germany for two reasons: economic struggle on one hand, and promotion of equity investment and robust capital markets on the other. The first reason is quite obvious: Writing in the depths of a bad economic situation, commentators bemoan the competitive failures of German corporations and the depressingly large number of unemployed people. While German stock markets are booming and generating high profits, the increase in shareholder value does not correlate with other benefits for the economy, such as high employment rates. The market members fail to push the development into the right direction. Quite naturally, under those circumstances, the debate among

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commentators focusses on whether German mechanisms for monitoring and controlling corporate managers are inferior to those of the United States. The second main impact on the current German debate on corporate governance issues flows from concern over the promotion and competitiveness of German capital markets. These markets are undergoing a fast and breathtaking change regarding their legal framework, their depth, and the creation of new market segments. Meanwhile, the third Financial Market Promotion Act (*Finanzmarktförderungsgesetz*) has passed the legislative process, and the fourth act of this kind seems to be on the way. Although corporate law and capital markets law in Germany traditionally have never been regarded as intimately related as they are in the United States, there is an increasing awareness of their interactive influence. Scholars and practitioners are equally sensitized to the globalization of securities markets. They are worried that certain features of German corporate law may deter foreign (institutional) investors from seeking offshore investment in Germany (for example, banks' influence on proxy voting and the lack of derivative shareholder litigation).

While the degree of influence a certain corporate governance system may exert on a firm's performance is somewhat imponderable, it is for these reasons that there is great temptation to transplant legal rules from one system to another. Some years ago, when American corporations were struggling, exactly the same debate was sparked from an American perspective, and the debate has not yet been extinguished. Critics suggested that commercial bank involvement in corporate governance is desirable, because it fosters a type of "relational investing" that is supposed to lead to effective monitoring by sophisticated intermediaries. These critics wished that American institutional investors would exercise their corporate influence with the vigor of German banks. Unlike their American counterparts, the latter have never been legally barred from taking an active role in corporate decisionmaking.

Today, some German scholars cast doubt on the desirability of this feature of German corporate governance. In particular, they argue that banks' influence among others (such as cross holdings among corporations) is one of the main reasons for inflexibility in German corporate governance. At the same time, the critics yearn for more active and interested, yet dispersed shareholders. Also, there have been doubts about the

quality of the performance of the supervisory board (*Aufsichtsrat*) which is supposed to control and supervise management and, in particular circumstances, to file a lawsuit against management. Thus, it is now recognized that shareholders may need a more powerful weapon to threaten management immediately after some kind of failure. The experience in the United States with derivative litigation, however, suggests that the results often are not promising. In the United States, which has been called, "the most lawsuit-crazy country in the world"<sup>1</sup> a group of plaintiffs lawyers frequently has taken advantage of some legal loopholes, by filing suits that have no merits save one: attorneys' fees.

Scholars in both countries who are looking for "offshore improvement" to their present national corporate governance system may realize that adaption of legal structures in most cases might be difficult, or even impossible, since they are a reflection of complex cultural, social and economic forces unique to a particular country.<sup>2</sup> Nevertheless, as the great impact of American law on German and European Capital Markets Law, and the cautious but significant liberalization of the scope and geographical range of bank activities in the United States show, scholars both in Germany and the United States may recognize the array of foreign corporate alternatives and think about how to shape (or amend) them to fit in their national system.<sup>3</sup>

Much of the confusion in the debate and evaluation of the foreign system stems from lack of legal and factual information, simplifications, and a related failure to appreciate the complex legal and economic forces in the particular country. In this article, we want to shed light on two selected and interrelated aspects of shareholder participation in corporate decisionmaking under German law.

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1. David S. Jackson, *Litigation Valley*, TIME, Nov. 4, 1996, at 72. For a critical voice as to the "derivative dilemma," see Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 437 (1996) (cautioning that the "corporation, not court, should resolve internal business conflicts") [hereinafter Swanson, *Corporate Governance*].

2. James A. Fanto, *The Transformation of French Corporate Governance and United States Institutional Investors*, 21 BROOK. J. INT'L L. 1, 4 (1995) [hereinafter Fanto, *Transformation*]; Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2021 (1993).

3. See Fanto, *Transformation*, *supra* note 2, at 4.

As Berle and Means described more than half a century ago,<sup>4</sup> large publicly-held entities, which are most commonly thought of as the prototype of the modern corporation, share one striking feature—the separation of stock ownership and control. Shareholders collectively own the corporation but do not, as a general rule, manage it. Despite some remarkable differences, especially as the degree of shareholder dispersion is concerned, this is the case in both the United States and Germany. The separation of ownership from control creates a fundamental tension between shareholders and management. In order to bridge this tension, each system of corporate governance demands mechanisms that ensure accountability. Experience demonstrates that, although managers hold their power in trust, they do not always carry out the business according to their fiduciary obligations because of their inherent self-interest. Corporate law both in Germany and the United States, although significantly different from each other, provides *inter alia* two devices which enforce the fiduciary duties imposed upon the managing group:<sup>5</sup> First, shareholders can protect their interests by initiating or participating in permanent decisionmaking on fundamental corporate matters. This idea suggests that monitoring should be relegated to those who provide equity capital to the corporation. However, since there is just one shareholder meeting per year, shareholders may be manipulated, disinterested, or face “collective action problems,”<sup>6</sup> therefore, their monitoring function is quite sporadic and random at best. Second, there is almost always some kind of legal device by which shareholders or corporate organs representing shareholders may “pull the emergency break,” if management is slack and makes disastrous decisions on behalf of the corporation: Shareholders or their representatives may

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4. See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* xix (4th ed. 1968).

5. The inherent conflict of interest between management and shareholders is often referred to as an “agency problem.” German and American lawyers view this issue from different perspectives. While German lawyers emphasize the interest of the corporation as an entity, American lawyers make clear that shareholders, as owners and principals, must establish control devices at certain costs to ensure management’s self-interest while not reducing the outcome of the investment. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *FIN. ECON.* 305, 308-10 (1976).

6. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 67 (1991).

commence legal proceedings to hold management accountable.

Thus, we focus on "structural rules"<sup>7</sup> that govern the allocation of decisionmaking power between the corporate organ "management board" (*Vorstand*) and those people who provide equity capital to the corporation—the shareholders.<sup>8</sup> The article is subdivided into two similarly structured main parts, corresponding to the above-mentioned topics. Understandably, the emphasis in both those parts is on the situation under German law. As such, the article concentrates on companies that are subject to the Stock Corporation Act of 1965 (*Aktiengesetz*).<sup>9</sup> Since only shares issued by these corporations (*Aktiengesellschaften*) can be quoted on a stock exchange (*Börsengesetz*),<sup>10</sup> the *Aktiengesellschaften* are regarded as the equivalent to the American publicly-held corporation.<sup>11</sup> Short summaries of the American legal situation preceding the discussion of German law do not claim sufficiency, but may serve as a common basis for the legal analysis and comparison.

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7. Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1462 (1989).

8. *Id.*

9. See Aktiengesetz (AktG) [Stock Corporation Law], v. 06.09.1965 (BGBl. I S.1089). See also HANNES SCHNEIDER & MARTIN HEIDENHAIN, *THE GERMAN STOCK CORPORATION ACT 94* (1996) (translating the Stock Corporation Act of 1965 into English).

10. See Börsengesetz [Stock Exchange Act], v. 27.05.1908 (RGBl. I S.215) § 36.

11. It is noteworthy that, although the legal framework of *Aktiengesellschaften* is designed for large publicly-held corporations, in the majority of AG's the shares are in the hands of a relatively small group of investors. See Heribert Hirte, *The European Private Company, A German Perspective*, in *THE EUROPEAN PRIVATE COMPANY?* 95, 95-96 (Harm-Jan De Kluiver & Walter Van Gerven eds., 1995) (estimating that in 1993 only approximately thirty AGs were public in the sense that they were not controlled by a majority shareholder or shareholder group); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1302 (1991). One should also keep in mind that the vast majority of companies in Germany are organized in the form of private limited liability companies or *Gesellschaft mit beschränkter Haftung* (GmbH). In 1991 there were about 465,650 GmbHs as opposed to 3,500 AGs, of which only about 650 were listed on the stock exchange by 1995. See Hirte, *supra* at 96; Dieter Feddersen et al., *Corporate Governance—eine Einführung*, in *CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENS-KONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT 2* (Dieter Feddersen et al. eds., 1996).

PART I. SHAREHOLDER VOTING IN PUBLICLY-HELD  
CORPORATIONS UNDER U.S. AND GERMAN LAW

No matter which country we focus on, the mechanism by which stockholders can actively participate in a publicly-held corporation's decisionmaking process is said to be one of the most important elements of corporate governance.<sup>12</sup> Regardless of minor distinctions in different systems of corporate governance, shareholder decision making is required in three areas of corporate affairs: the election of directors, major changes in the corporate contract (charter amendments), and major changes in the corporate structure (such as a merger, sale of substantially all assets, or liquidation).<sup>13</sup> Notably, the voting right attached to a share is meant to mitigate the typical hazards that flow from the separation of ownership and control. Given the fact that, in Germany, shares with voting rights usually receive a higher value than those without, a shareholder's suffrage is not only a residual device of control, but also an asset of economic value.<sup>14</sup> However, it is equally true that, regardless of national differences in the legal framework for shareholder voting, only a few shareholders seem to have some incentive to exercise their right to vote on fundamental corporate matters, or to elect officers and directors. This may be caused either by a lack of money, time, or interest. Instead, they subscribe to the "Wall Street Rule," in other words, they "vote with their feet" and get rid of a bad investment.<sup>15</sup> When evaluating this "investment attitude" we should

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12. See, e.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970) (noting that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange").

13. See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 534 (1990) [hereinafter Black, *Shareholder Passivity*].

14. Previously, even the New York Stock Exchange did not list shares of a corporation which also had an issue of non-voting stock. See Henry G. Manne, *Some Theoretical Aspects Of Share Voting*, 64 COLUM. L. REV. 1427, 1429 (1964). Today, the Exchange's voting rights policy permits the listing of voting common stock of a corporation which also has outstanding non-voting stock, as well as the listing of non-voting stock, but has established restrictive "safeguard regulations." See, e.g., *New York Stock Exchange Listed Company Manual*, in CORPORATIONS AND BUSINESS ASSOCIATIONS 704, § 313.00(B) (Melvin A. Eisenberg ed., 1996).

15. It is noteworthy, however, that even though dissatisfied shareholders sell their shares and thereby exit the company, they disseminate important signals to securities markets participants, thus increasing management accountability. The greater the liquidity of securities markets, the better the repercussions of the marketplace may serve as a corporate governance device, supplementing internal

not go to extremes. Nor should we blame the shareholders for their inertia,<sup>16</sup> which for some practical reasons may be desirable. Nor should we underestimate the importance of shareholder control in corporate governance systems worldwide. Since management of a large corporation tends to pursue its own interests, shareholder participation in corporate decision making remains, in addition to other devices, an essential constituent of monitoring officers and directors. Therefore, under corporate law not only must shareholders be able to authorize other persons to vote shares on their behalf (proxy voting) but also a form of workable shareholder activity must be encouraged. Although the theoretical concept of proxy voting with its classical agency background is quite similar across nations, cultural, economic and legal circumstances have shaped some characteristic variations. As will be discussed in this paper, the proxy systems in the United States and in Germany show remarkable distinctions, but also do not seem to be too far away from each other.

#### A. Proxy Voting Under U.S. Law

Since a full discussion of the details and developments of voting by proxy under U.S. law is beyond the scope of this paper, only some basic features need to be set out to create a basis for the following evaluation.<sup>17</sup>

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monitoring structures in a corporation. See Jonathan R. Macey & David D. Hadlock, *Shirking at the SEC: The Failure of the National Market System*, 1985 U. ILL. L. REV. 315, 326 (1985); Norman S. Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 886 (1981) (defining liquidity as "a market characteristic that enables investors to dispose of or purchase securities at a price reasonably related to the preceding price").

16. Some authors call it "rational apathy." See ROBERT CHARLES CLARK, *CORPORATE LAW* 390-92 (1986). See also Harm Peter Westermann, *Vollmachtstimmrecht und Streubesitzaktionäre in der Hauptversammlung deutscher Aktiengesellschaften*, in *CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT* 264, 264-65 (Dieter Feddersen et al. eds., 1996).

17. See CLARK, *supra* note 16, at 357-400 (providing an overview of federal proxy regulation). See also Bernard S. Black, *Next Steps in Proxy Reform*, 18 J. CORP. L. 1, 2 (1993) [hereinafter Black, *Proxy Reform*]; Thomas W. Briggs, *Shareholder Activism and Insurgency Under the New Proxy Rules*, 50 BUS. LAW. 99, 99 (1994); Douglas G. Smith, *A Comparative Analysis of the Proxy Machinery in Germany, Japan, and the United States: Implications for the Political Theory of American Corporate Finance*, 58 U. PITT. L. REV. 145, 190 (1996) (providing an over-

The above-mentioned situation concerning the reluctance of shareholders to attend annual meetings seems to be even more true in a giant publicly-held American corporation, in which there is generally no controlling shareholder, but a widespread mass of shareholders.<sup>18</sup> The high degree of ownership fragmentation reduces the likelihood of shareholders coming together to efficiently supervise management from the outset.<sup>19</sup> Proxy voting was provided by New York State Law as early as 1811 and became the dominant method in all states soon thereafter.<sup>20</sup> At that early stage, however, the question of who would exercise the proxies on behalf of the shareholders remained to be answered. Interestingly enough, management itself, i.e., the corporate agent that was supposed to be overseen by the shareholders, could fill the gap. Strong nationwide intermediaries, such as banks, or large stockholders, both of whom had an incentive to monitor, did not exist in the fast developing country. Additionally, the state laws did not consider classical conflict of interest situations and therefore did not impose restrictions on those who could act as proxy holders.<sup>21</sup> These factual and legal circumstances were an open invitation to management to take over and to start soliciting proxies for the shareholders of their corporation.

This, of course, amplified an inherent problem of (proxy) voting and agency relationships in general: In order to exercise the suffrage intelligently, to give instructions on how to vote to the proxy holder or to take advantage of the revocability of the proxy, one needs material (correct and full) information on corporate affairs. In this respect, management acting as proxy holder gains from the overwhelming strategic advantage of access, not only to the corporate treasury for the sometimes substantial costs of solicitation, but also to the detailed information on the performance of the corporation and management

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view of the 1992 revisions).

18. One example is AT&T, which remains the nation's most widely held stock corporation with 3.2 million shareholders. See Daniel Kadlec, *Ailing AT&T Hires A Printer*, TIME, Nov. 4, 1996, at 70.

19. See BERLE & MEANS, *supra* note 4, at 4-7.

20. See Leonard H. Axe, *Corporate Proxies*, 41 MICH. L. REV. 38, 42-46 (1942) (detailing the origins of express charter authority to vote by proxy).

21. See WILLIAM C. CARY & MELVIN A. EISENBERG, *CORPORATIONS: CASES AND MATERIALS* 331 (7th ed. 1995) (stating that "[s]tate law hardly regulated proxy voting except in the extreme case in which proxies had been fraudulently solicited").

itself. The shareholder's inferior knowledge puts him at the mercy of a proxy holder who is very likely to be self-interested. Unregulated, this proxy system sounds like an irresistible temptation for self-perpetuating and irresponsible management.<sup>22</sup> And in fact, in the 1930s, when there were periods of major changes and high volatility in the capital markets, endangered management often abused the proxy system.<sup>23</sup>

This abuse came to an end when federal securities laws were promulgated in 1934. The newly-created Securities and Exchange Commission (SEC) became a type of state guardian of the proxy system, and it was furnished with the power to draft even more detailed rules. The regulations have supplemented state law from that period on. However, these regulations did not limit the ability of management to solicit proxies.<sup>24</sup> Not surprisingly, a primary emphasis of the federal laws had to be on "*full disclosure*." As the important Regulation 14a now stands, it consists of 14 rules and specifies, together with Schedule 14A, the information required in the proxy statement.<sup>25</sup> This document, in writing, must be sent to the SEC prior to management's (or others') solicitation of shareholders' approval for a specific corporate matter. Among other things, this ensures sufficient and understandable information about the action, a standard form of presentation, as well as timely delivery of the information to the shareholders. The SEC is supposed to examine the filed proxy material. However, the SEC examines whether the information given satisfies the proxy rules, rather than formally investigates whether the information is materially accurate and complete. The material accuracy of management communication with the shareholders in the proxy statements is mainly subject to the federal antifraud rule barring material misstatements and omis-

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22. See LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 431 (3d ed. 1995).

23. See CARY & EISENBERG, *supra* note 21, at 331 (observing that "[a]buses were notorious and widespread").

24. See ALFRED F. CONARD, *CORPORATIONS IN PERSPECTIVE* 329 (1976) (commenting that "[p]erhaps the most striking omission of the proxy system in the U.S. is the absence of any imperative provision for independent representation. The proxies . . . commonly are . . . solicited on behalf of the officers. Thus the directors are elected by the same officers whom they will appoint").

25. For a critical analysis of the underlying behavioral assumptions of the proxy rules, see EASTERBROOK & FISCHEL, *supra* note 6, at 82.

sions.<sup>26</sup> Additionally, a shareholder aggrieved by disclosure failure may bring a civil suit against the corporation,<sup>27</sup> although this private cause of action has been increasingly narrowed by courts.<sup>28</sup> Therefore, even under federal law, it has not been easy to police management disclosure in proxy statements. Even today, it is still true that management controls the "proxy machinery" and that shareholders tend to vote overwhelmingly in support of management's recommendation.<sup>29</sup> Given the grossly excessive costs of drafting a proxy statement and triggering a proxy fight, it is extremely difficult for small, widely-scattered shareholders to contest management's proposals.<sup>30</sup> In order to overcome the concentration of managerial power, the federal laws have always provided shareholders with a device to end their passive role through contacting other shareholders, or to regard non-management proposals and statements on corporate matters. Under the so-called "proposal rule" an individual shareholder with a minimum stake in the corporate enterprise may prepare his or her own resolution and demand that it be included in the management's proxy statement and voted on by other shareholders at the annual meeting.<sup>31</sup> However, even though this sounds like a powerful right to challenge a badly-performing managing group, it is quite limited. It cannot relate to the election of directors or to a management proposal, and it may not reach the "ordinary business operations" of the company.<sup>32</sup> When looking for oth-

26. See Federal Proxy Rules, 17 C.F.R. § 240.14-a9(a) (1997).

27. For a more thorough discussion of corporate disclosure, see JAMES A. FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW* 42 (1997); CLARK, *supra* note 16, at 386-89; *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970).

28. See, e.g., *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).

29. WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 123 (6th ed. 1996). See also EASTERBROOK & FISCHER, *supra* note 6, at 86 (emphasizing that there is no evidence that shareholders have any interest in the information provided).

30. To contest management's recommendations, a shareholder is supported by the "mail their stuff or give them a list" rule, which provides that management must also mail out proxy materials supplied by a security holder that deal with the same subject matter as the management's proposal does. See Federal Proxy Rules, 17 C.F.R. § 240.14-7 (1997). Instead of forwarding the security holder's materials, management may give the securities holder a current list of the names and addresses of the security holders that are to be solicited. See CLARK, *supra* note 16, at 370-71.

31. See 17 C.F.R. § 240.14a-8 (1997). Under this rule, the printing and mailing expenses are borne by the company rather than by the shareholder.

32. See FANTO, *supra* note 27, at 41. 17 C.F.R. § 240.14a-8(d) provides that if

er, less formal and less restricted possibilities of communication, shareholders have long been deterred by the proxy rules themselves. The sweeping legal definition of "solicitation" and "proxy," which was intended to prevent management from circumventing the effect of the rules, unintentionally served to bar shareholders from contacting each other in order to gain support to oppose managements' policies.<sup>33</sup> Thus, in 1992, the SEC amended those rules. In particular, shareholders are now permitted to publicly announce how they want to vote and to give reasons for that.<sup>34</sup> In this respect, a shareholder who delivers an announcement simply tries to convince others to vote in a certain way. Having no proxy statement, he still cannot vote as a proxy for other shareholders. Most likely, large shareholders, such as the increasingly important pension, mutual, or bank trust funds (so-called institutional investors), or even outsiders having an incentive to influence the business policies of the corporation, in one way or another will take advantage of the new rules. Having been "sleeping giants"<sup>35</sup> for quite some time, they seem now fully aware of their potential to monitor management. They may try to replace incumbent management, rather than bear the transaction costs of selling their significant stake in a company. In light of the new proxy regulations, the development of corporate structures might be similar to those found in Germany in the long term.<sup>36</sup>

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management believes a shareholder proposal can be excluded from the corporation's proxy statement under Rule 14a-8, it must submit to the SEC a statement ("no-action letter") stating the reasons why it deems omission of the proposal to be proper. The SEC has been highly inconsistent in applying the notion of "ordinary business matters." See, e.g., *Roosevelt v. E.I. DuPont*, 958 F.2d 416, 428 (D.C. Cir. 1992).

33. See FANTO, *supra* note 27, at 31; Black, *Shareholder Passivity*, *supra* note 13, at 537-41; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 894-95 (1991).

34. See 17 C.F.R. § 240.14a-1(2)(iv) (1997).

35. See Robert A.G. Monks, *Schlafende Riesen*, in CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT 331, 331 (Dieter Feddersen et al. eds., 1996).

36. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 230 (1994).

### B. "Depository Voting" in Germany

More than thirty years ago, when the last substantial reformation of the German Stock Corporation Act (*Aktiengesetz*) took place, one of the most important issues was the regulation of the proxy voting system. As can be seen from the official records of the law-making process and commentary on the outcome, the lawyers who were involved in the legislation carefully studied U.S. proxy voting and its development after the promulgation of the Securities Exchange Act of 1934. However, possibly due to some kind of "path dependance,"<sup>37</sup> the legislators decided not to adopt the American system, as was weakly proposed in the early 1960s.<sup>38</sup> Instead, they agreed to improve the legal framework for the special form of proxy voting which had been prevalent since the beginning of corporate law in Germany: Ever since, banks have been exercising voting on behalf of the shareholders in the annual shareholder meetings. Although it worked fairly well, this "depository voting" (*Depotstimmrecht*) has been subject to ongoing discussion for various reasons. In 1996, even the "Deutscher Juristentag," a convention of more than two thousand lawyers which takes place every other year, put this important corporate governance issue on its schedule. However, the convention did not agree to a proposal that included major changes.<sup>39</sup> Its resolution reflects a mixture of uneasiness, a feeling that there has to be some kind of modification, as well as reluctance to move away from a successful model. This is equally true regarding the rather minor amendments that have come into force recently (so-called *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)*, reform of the *Aktiengesetz* suggesting better control and transparency in corporate law). In the context of the present economic development in Germa-

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37. See Mark J. Roe, *Chaos And Evolution In Law And Economics*, 109 HARV. L. REV. 641, 641 (1996). For the current changes, see *infra* Part C.

38. See RUDOLF WIETHÖLTER, INTERESSEN UND ORGANISATION DER AKTIENGESSELLSCHAFT IM AMERIKANISCHEN UND DEUTSCHEN RECHT 334-36 (1961).

39. See *Deutscher Juristentag beendet kein Scherbengericht über Karlsruhe. Kongress schwächt seine Forderungen in vielen Punkten deutlich ab*, SÜDDEUTSCHE ZEITUNG, Sept. 21, 1996, available in LEXIS, World Library, Zeitng File; *Karlsruhe: Juristentag; Abendmeldung—Einschränkung des Vollmachtsstimmrechts abgelehnt*, AP WORLDSTREAM - GERMAN, Sept. 19, 1996, available in LEXIS, World Library, Allwns File; Carsten Schäfer, *Tagungsbericht zum Deutschen Juristentag, Abteilung Wirtschaftsrecht*, 52 JURISTENZEITUNG 137, 139 (1997).

ny, especially in its capital markets, and more frequent disruptions on the corporate landscape,<sup>40</sup> the issue seems unsettled at this point. Even after the recent amendment, the question remains whether some features of the present proxy voting system can remain the same in different circumstances, or whether there should be some kind of change, either by further enhancing the regulations of the proxy holders' duties, by providing a legal alternative in form of a modified "European version" of proxy voting American style, or even by leaving the old ways behind and radically transferring to the American way.

### 1. A Brief Historical Retrospective

At first glance, there appears to be no real equivalent to those American proxy rules under German corporate or securities laws. That is not to say that the German Stock Corporation Act (*Aktiengesetz*) does not provide for voting by proxy. In fact, it mentions this device explicitly.<sup>41</sup> Concurrently, it recognizes the common practice that is often referred to as "depository voting right of banks" (*Depotstimmrecht der Banken*).

At the outset, it is important to mention that this notion is somewhat misleading. It is an illustrative description of a factual observation rather than a legal term. Since the beginning of corporate law in Germany, country banks have most commonly exercised the proxy voting on behalf of the shareholders who deposited their shares in the vaults of these banks. To gain a better understanding of this, it seems useful to highlight some background information on the close, or even symbiotic relationship, between banks and industry in Germany.

Historically, the dominance of banks is closely tied, if not

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40. A striking example is Krupp AG's hostile takeover bid for its bigger rival Thyssen AG in March 1997, which eventually could not be consummated. There are very few examples of hostile takeovers in German corporate history. There has only been one successful large hostile takeover in recent years, Krupp's hostile takeover of Hoesch AG in 1991. Another attempt, namely Hochtief AG's bid for Philipp Holzmann AG, is still bogged down in legal wrangling with the Federal Cartel Office (*Bundeskartellamt*). See Thyssen says Krupp-Hoesch takeover bid sets 'bad precedent', EXTEL EXAMINER, Mar. 18, 1997, available in LEXIS, Europe Library, Alleur File; Crash in Revier, DER SPIEGEL, Mar. 24, 1997, at 92.

41. See AktG § 134(3). "The voting rights may be exercised by proxy" (*Vollmachtsstimmrecht*).

inseparable, from the development of corporate law in Germany, and vice versa. When discussing corporate law in Germany, we have to keep in mind that the Aktiengesellschaft (stock corporation) was designed mainly for large enterprises. As lately as 1965, German legislation abolished a provision demanding a minimum par value per share of 1000 Deutschmarks. This law attracted only a "happy few" to invest in corporations.<sup>42</sup> In the middle of 19th century, Germany (then comparably underdeveloped), tried hard to keep up with the then-more industrialized countries, especially England. Being politically divided into different countries with their own domestic markets and currencies, raising capital across the borders was not easy. A patent deficiency of savings, coupled with a lack of well-developed capital markets, did not create a positive starting point for German industry. A successful incorporation<sup>43</sup> needed to be leveraged: The upturn of the corporate form could be achieved only after the foundation of banks being corporations themselves. Some of those banks still exist today, known as "Grossbanken." These banks were designed as a type of financial supermarket, offering commercial credit, brokering and investment services, among other services. In other words, the German universal banks rocked the cradle of the stock corporation.<sup>44</sup>

In those days, the average attendance of shareholders at annual meetings was disappointingly low, which made it easy for management to control, or even buy votes if necessary. It was not until the concept of "shareholder democracy" was introduced in the German Commercial Code in 1884 (*Allgemeines Deutsches Handelsgesetzbuch*),<sup>45</sup> and the number and disper-

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42. See Bernhard Grossfeld, *Zur Stellung des Kleinaktionärs im Wirtschaftssystem*, 30 DIE AKTIENGESELLSCHAFT 1, 2 (1985). For a brief description of the most recent developments concerning the so-called "Kleine Aktiengesellschaft" (small corporation), see discussion *infra* Part D.

43. As one scholar has noted, corporate legislation at this time was still confined to the various German countries. "The first statute to regulate corporations in Germany was the Prussian Law of 1838 relating solely to railroad corporations. A few years later, the more general Prussian Law of 1843 was enacted." 1 ENNO W. ERCKLENTZ, JR., *MODERN GERMAN CORPORATION LAW* 3 (1979).

44. See WILHELM VALLENTIN, *DIE STIMMRECHTSVERTRETUNG DURCH BANKEN* 8 (1966).

45. *Id.* at 9. See also KARSTEN SCHMIDT, *GESELLSCHAFTSRECHT* 770 (1997) (stating that the reform of 1884 is one of the most important in the history of stock corporation law in Germany).

sion of small shareholders slowly increased, that proxy voting by banks became a significant feature of German corporate governance. Since the inertia of the larger number of shareholders remained the same, the underlying idea was to protect the continuity and independence of decisions on fundamental corporate matters.<sup>46</sup> A permanent representation of the shareholders by banks was supposed to guarantee a well-attended meeting. The decisions made were supposed to reflect the opinions of all the shareholders, not only of those few who were present at the annual meeting. For this reason (contrary to the American practice), there was no need for quorum requirements, although the articles of incorporation could specifically provide for them.

Of course, it was not only proficiency in financial questions and the above-described close relationship with the corporations which seemed to make the banks a perfect intermediary between a company and its shareholders. At the same time, the banks deposited, and currently still do, the shares in their vaults.<sup>47</sup> Although the law provided for registered shares as in the United States,<sup>48</sup> German corporations and shareholders who wanted to remain anonymous for tax and other reasons overwhelmingly preferred shares in bearer form.<sup>49</sup> A bearer share does not require an endorsement by its owner to be conveyed, but is transferred simply by agreement and delivery of the certificates.<sup>50</sup> Thus, it is a highly negotiable piece of paper

46. VALLENTIN, *supra* note 44, at 10.

47. It should be noted that the usual practice of banks today is to pass on their holdings to the licensed security holding bank (Deutsche Clearing AG, formerly Deutscher Kassenverein), which credits the bank with the number of securities deposited. See HANS WÜRDINGER, GERMAN COMPANY LAW 30-31 (1975).

48. In fact, until 1965, registered shares were deemed the legal rule, whereas bearer shares had to be provided for explicitly in the charters and by-laws, although the corporate practice had long embarked on a different track. See HGB § 183(1), AktG, v. 30.01.1937 (RGL. I S.107) § 17(1); Bernhard Frhr. von Falkenhausen, *Das Bankenstimmrecht im neuen Aktienrecht*, 11 DIE AKTIENGESELLSCHAFT 69 (1966).

49. See Detlev F. Vagts, *Reforming The Modern Corporation: Perspectives From The German*, 80 HARV. L. REV. 23, 53-56 (1966) [hereinafter Vagts, *Perspectives From The German*]. This preference is quite stubborn. It not only survived attacks by the Nazis, who deemed the "anonymity" of the corporation to be highly dangerous, but also from the American-led allied occupation authorities, who were troubled by greatly concentrated enterprises and the influence in the hands of the banks. *Id.*; von Falkenhausen, *supra* note 48, at 70.

50. See Bürgerliches Gesetzbuch (BGB) [Civil Code] § 929.

which demands, just like cash, secure deposit to prevent theft, destruction, or loss.<sup>51</sup> Since the banks already had the shares in their custody, it was convenient to add another service for the mainly disinterested shareholders: the exercise of the right to vote.<sup>52</sup>

Initially, there was no need seen for statutory guidance of the voting function of the depositing banks. This made it easy for the banks to appropriate this function to themselves, simply by including a blanket authorization as a kind of preprinted term of business in every deposit agreement. This of course put the shareholders more or less at mercy of the performance of the banks and raises questions of the original link between "shareholder democracy" and depository voting. Parallel to the situation in the United States, it was the struggling economy in the 1920s and 1930s which caused widespread misuse of voting rights that did not fully reflect the shareholder interests.<sup>53</sup> Following legislative activism in the United States, the customarily developed depository voting was regulated statutorily as late as 1937. Since the statute<sup>54</sup> solely concentrated on the form and duration of the authorization in order to narrow the banks' leeway, it was up to the last great reform of the *Aktiengesetz* in 1965 to address conflict of interest issues which had also been a strong part of the previous criticism.<sup>55</sup>

51. Today, however, the influence of this feature on corporate governance issues should not be overestimated. Shareholders almost always receive no individual share certificates, but their stock is embodied in a single "global share certificate." See BERND SINGHOF, *DIE AUßENHAFTUNG VON EMISSIONSKONSORTEN FÜR AKTENEINLAGEN* 210 (1998); AktG, v. 06.09.1965 (BGBl. I S.1089) § 10(5) amended by Gesetz für kleine Aktiengesellschaften und zur Derogulierung des Aktienrechts [Small Stock Corporation and Deregulation of the Stock Corporation Law] v. 09.08.1994 (BGBl. I S.1964) art.1 (stating that "the right to receive individual share certificates may be excluded or restricted in the articles").

52. See Vagts, *Perspectives From The German*, *supra* note 49, at 54.

53. See Johannes Köndgen, *Duties of Banks in Voting Their Clients' Stock*, in *INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE* 531, 533 (Theodor Baums et al. eds., 1994); ERCKLENTZ, *supra* note 43, at 4. Interestingly, even the *Reichsgericht* (former German Supreme Court) was not concerned about the protection of shareholders' rights at the time. It upheld the legal commitments of shareholders to vote according to the directions of management. See Dieter Eckert, *Shareholder and Management: A Comparative View On Some Corporate Problems in the United States and Germany*, 46 *IOWA L. REV.* 12, 33 & n.116 (1960).

54. For a more thorough discussion of § 114 of the 1937 Stock Corporation Act, see VALLENTIN, *supra* note 44, at 31-35; Vagts, *Perspectives From The German*, *supra* note 49, at 54-55.

55. As this historical background suggests, the strong central banking system

## 2. The Legal Framework for Proxy Voting<sup>56</sup>

### a. Banks as "Information Carriers"

One feature of proxy voting in Germany warrants discussion at the outset. In its present codification, the Stock Corporation Act (*Aktiengesetz*) not only provides for proxy voting in general,<sup>57</sup> but explicitly acknowledges the central role of banks in the proxy system as a given element. The Banks' legal function as intermediaries between a corporation and its shareholders begins as early as the preparation for an annual meeting. As elsewhere, information to shareholders is regarded as an essential prerequisite for voting. At the same time, it is inherent to the dominance of the bearer shares that shareholders are widely unknown to the corporation, making direct communication virtually impossible. For this reason, the corporation publishes the agenda of the annual meeting and the invitations in the press.<sup>58</sup> The publications to be used for such purposes are listed in the articles of incorporation.<sup>59</sup> In addition to this rather insufficient device, AktG section 125 requires that the managing board send copies of the agenda prior to the annual meeting to all banks that exercised the right to vote at the last assembly, or asked for the information. Management has to include its recommendations and comments on

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in Germany is not of recent origin. In other words, it is not, as some authors allege, a consequence of economic struggle and related strategy in the aftermath of World War II. For an example of such an opinion on the matter, compare Corinne A. Franzen, *Increasing The Competitiveness of U.S. Corporations: Is Bank Monitoring The Answer?*, 2 MINN. J. GLOBAL TRADE 271, 287 (1993), and Robert E. Benfield, *Curing American Managerial Myopia: Can The German System Of Corporate Governance Help?*, 17 LOY. L.A. INT'L & COMP. L.J. 615, 645 (1995) (stating that "Germany was more interested in protecting an entire country than in protecting the rights of individual shareholders") with Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 539 ("[a]fter the war, the debate was resumed and has not yet subsided").

56. See generally AktG. The following discussion is based on the *Aktiengesetz* of 1965. Current amendments of the AktG through the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)* will be discussed *infra* Part C. See *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)*, v. 27.04.1998 (BGBl. I S.786).

57. See AktG § 134(3).

58. See AktG § 124(1).

59. Invitations to the meeting, as well as any other communications which the corporation is legally required to make, must be published additionally in the Federal Gazette (*Bundesanzeiger*). For an example of such a public notice, see ERNST C. STEEFEL, *GERMAN COMMERCIAL LAW* 99 (1963).

every subject to be voted on. Furthermore, management is obliged to send both insurgent shareholders' counter-proposals,<sup>60</sup> and nominations for the supervisory board to the banks.<sup>61</sup> Such a counter-proposal may only be rejected by management if it judges that it is illegal, based on obviously false, deceptive or defamatory statements, or the same proposal has failed twice within the past five years to win approval of at least 5% of the votes cast at annual meetings.<sup>62</sup> It is the banks' duty then to promptly forward those communication materials to the shareholders who deposited shares of the corporation with the bank. In summary, at this stage, which necessarily precedes an election, the bank is merely a "carrier of information."<sup>63</sup>

#### b. Banks as Proxy Holders: The Mechanics of Proxy Voting

The difficulties of communication, as noted above, may sound familiar to an American reader: With respect to securities widely held by brokers for their clients "in street name," even under the U.S. preference for registered shares, it has become increasingly difficult to identify the "beneficial" shareholder.<sup>64</sup> Whereas under American law this seems to be a problem for management, or opposing shareholders who want to solicit proxies, German law presupposes that the depositing banks who can identify the shareholders almost exclusively exercise the proxy voting.<sup>65</sup> At the core of the proxy process at

60. See AktG § 126(1).

61. See AktG § 127.

62. See AktG §§ 126(1), 126(2). This rule has been modeled after the U.S. Securities and Exchange Commission's "proposal rule." See Rule 14a-8, 17 C.F.R. § 240.14a-8 (1997). See also Ernst C. Steefel & Bernhard von Falkenhausen, *The New German Stock Corporation Law*, 52 CORNELL L.Q. 518, 543 (1967). Although similar on its face, there are some striking differences: (i) there are no restrictions for eligibility to make a proposal (minimum stake) in Germany; (ii) contrary to its American counterpart, a proposal is much shorter and may not exceed 100 words; (iii) on the other hand, there is no concern expressed directly in the code that proposals may challenge the "ordinary business operations" of the company; (iv) due to the two-tier system, a proposal can relate to the election of supervisory board members; (v) finally, German shareholders make their counterproposal without incurring any financial risk because the expenses are borne by the banks and the corporation. *Id.*

63. For a thorough examination of the underlying duties, see Klaus Burmeister, *Weitergabe-, Mitteilungspflichten und Stimmrechtsvollmacht für Kreditinstitute* (§§ 128, 135 AktG), 21 DIE AKTIENGESELLSCHAFT 262 (1976).

64. See Vagts, *Perspectives From The German*, *supra* note 49, at 56-57.

65. The portfolio-managing banks account for over 90% of the voting rights at

this point, it should be kept in mind that, converse to the "carrier function," the proxy voting is not mandatory, but is instead left to the discretion of the bank. As will be seen, *infra*, banks do not have to be pushed anyway, because there seems to be a strong incentive which makes them overly receptive to exercising the proxy votes.

Banks cannot do so, however, unless authorization has been given in writing by clients.<sup>66</sup> This authorization, which no longer can be part of the depository contract, may not exceed fifteen months and is revocable at any time.<sup>67</sup> A bank which intends to exercise a vote must inform the shareholder of its own proposals, regarding the exercise of the right to vote with respect to each item on the agenda. The bank must also ask the shareholder to give instructions on how to vote, and point out that if the shareholder does not send in contrary orders together with the authorization, the bank will exercise the vote in accordance with its own suggestions communicated to the shareholder.<sup>68</sup> Even though this process implies some sort of solicitation, it almost completely lacks the sometimes aggressive process of systematically contacting shareholders and urging them to execute and return proxy forms in the United States. It is rather a boring and dry formality. As some statistics show, in general shareholders blindly rely on the statement of the bank, and on the average only about 1% of the shareholders come up with their own proposals.<sup>69</sup> At this

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the annual shareholder meetings. See Hermann H. Kallfass, *The American Corporation And The Institutional Investor: Are There Lessons From Abroad? The German Experience*, 1988 COLUM. BUS. L. REV. 775, 782 (1988).

66. See AktG § 135(1).

67. See AktG § 135(2). Similarly, the Safekeeping of Securities Act (*Depotgesetz*) provides that the document containing the authorization to deposit shares may not refer to other documents or be joined with other statements of the depository. See Gesetz über die Verwahrung und Anschaffung von Wertpapieren (*Depotgesetz*) [Safekeeping of Securities Act] v. 11.01.1995 (BGBl. I S.38) § 15(2).

68. See AktG §§ 128(2), 135(5).

69. See Martin Peltzer, *Empfehlen sich gesetzliche Einschränkungen des Einflusses der Kreditinstitute auf Aktiengesellschaften?*, 51 JURISTENZEITUNG 842, 844 (1996). Other sources state that in 2-3% of all cases a special instruction occurs. See Theodor Baums, *Takeovers Versus Institutions in Corporate Governance in Germany*, in CONTEMPORARY ISSUES IN CORPORATE GOVERNANCE 151, 159 & n.24 (D.D. Prentice & P.R.J. Holland eds., 1993) [hereinafter Baums, *Takeovers*]. See also Uwe H. Schneider & Ulrich Burgard, *Maßnahmen zur Verbesserung der Präsenz auf der Hauptversammlung einer Aktiengesellschaft*, in FESTSCHRIFT FÜR KARL BEUSCH 783, 787 (1993) [hereinafter Schneider & Burgard,

stage there is almost no competition among the banks. Of course, they fight for the favor of small investors who need bank services in order to buy and sell securities. However, once they have them as clients, there is no question that the banks vote only the shares that are deposited in their vaults.<sup>70</sup>

Given this framework, proxy voting seems quite smooth and far less disruptive than in the United States. At this stage of the examination, it seems that a proxy contest for corporate control (i.e., a purely personal power contest) does not occur for at least four reasons:<sup>71</sup> First, as will be explored, *infra*, it seems to be a well-established rule under German law that the board of directors, as an agent of the corporation, is not allowed to solicit proxies or to act as a proxy holder.<sup>72</sup> Second, even though the law explicitly states that the proxy regulation *mutatis mutandis* applies to the exercise of the voting rights by shareholders' protective associations, they have not played a significant role in corporate history so far. Third, the anonymity of the bearer share creates significant impediments to direct shareholder communication. Finally and most importantly, management (*Vorstand*) is not elected by the shareholders, but is appointed by the supervisory board (*Aufsichtsrat*).<sup>73</sup> As far as the authors can determine, this final aspect renders the solicitation of proxies by opposing shareholders largely uncommon, if not futile.<sup>74</sup> A contest would be staged to gain supervi-

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*Hauptversammlungspräsenz*] (analyzing reasons and legal remedies to the decreasing number of shareholders participating at annual meetings).

70. Also, even though shareholders may switch from one depository bank to another for the purpose of giving the latter one the proxy for their stock, factual and legal circumstances create hurdles too high to make this a real alternative. See Horst Hammen, *Das Vollmachtsstimmrecht der Banken in der Aktienrechtsreform*, 51 WERTPAPIERMITTEILUNGEN 1221, 1225 (1997) [hereinafter Hammen, *Vollmachtsstimmrecht*].

71. See Heinz-Dieter Assmann et al., *The Law of Business Associations*, in INTRODUCTION TO GERMAN LAW 137, 146 (Werner F. Ebke & Matthew W. Finkin eds., 1996). There may currently be more incentives for opposition in a contest over corporate policy. Due to this lack of restrictions, German corporations recently faced problems when some of their shareholders tried to abuse the annual meeting, making it a forum to raise political issues. See Dieter Feddersen et al., *Einführung*, *supra* note 11, at 5.

72. See Philipp Möhring, *Proxy-Stimmrecht und geltendes deutsches Aktienrecht*, in FESTSCHRIFT FÜR ERNST GESSLER, 127, 127 (1971); Wolfgang Zöllner, *Die Ausübung des Stimmrechts für fremde Aktien durch die Aktiengesellschaft auf ihrer eigenen Hauptversammlung*, in FESTSCHRIFT FÜR HARRY WESTERMANN 603, 603 (1974).

73. See AktG § 84.

74. However, it is noteworthy that under AktG § 127, a shareholder may

sion, instead of corporate control. Quite understandably, under this presupposition, the law sees little danger in this regard. For example, there exists no sophisticated formal standard for the bank's proxy statement (as opposed to the onerous SEC filings necessary in the United States). The drafters of the 1965 statute obviously expected abuse from another direction: A bank might only be willing to exercise the votes of those shareholders who accept its proposals, and reject opposing shareholders who nevertheless wish to be represented by banks at the annual meeting. To prevent such (disapproving) selectivity, the law imposes a legal duty on a bank to accept a client's request to cast the vote for the client, if it previously offered to vote another client's shares.<sup>75</sup> This is not to say that a bank must solicit all the votes of the shares in its vaults. It is the shareholders' task to demand proxy voting, in order to put the duty of acceptance on the banks. However, empirical research shows that banks do not tend to be selective in their voting behavior at all. Since some sort of shareholders' activity hardly existed in the past, they rather wanted to accumulate voting power.

### c. Duties of Banks and their Judicial Enforcement

The relationship between shareholder and proxy holder raises classical principal-agent problems. At this point, an American reader may be concerned about the allocation of duties on the agents' (banks') side. This "duty of care" and "duty of loyalty" type of problem is even more striking when one considers that the banks have remarkable leeway when exercising the voting rights. However, in this regard, German law is not as detailed as American law: It simply requires that a bank, when drafting its proposals, be guided by its views of the best interest of the shareholders,<sup>76</sup> and only deviate from

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make proposals for the appointment of members to the supervisory board. See AktG § 127.

75. See AktG § 135(10).

76. See AktG § 128(2). The shareholders' interests are defined by academics as those of the company, not those of the management. This is based on the interest in the development of the share price and in the receipt of dividends, or as the interests of a reasonable shareholder in possession of information known by the bank. Both criteria are vague, and it may be difficult to decide whether, defined in this manner, the shareholders' interests speak for or against a certain transaction. See Georg Maier-Reimer, *Protection Against Hostile Takeovers in Germany*:

a communicated voting exercise in exceptional cases. Should it encounter materially changed circumstances at the meeting,<sup>77</sup> the bank can depart from its generally binding proposals, if it can assume that the shareholders would approve a different exercise of the voting rights upon full knowledge of the facts.<sup>78</sup> After such a deviation, a bank must inform the shareholders and state the reasons therefor.<sup>79</sup> Additionally, in order to align shareholders' and banks' interests, AktG section 135 paragraph 11 provides for a private cause of action which can be neither waived, nor limited in advance: A bank is liable for any damage caused by a violation of paragraphs one to 3, 5, 7, 8 or 10. At the same time, under German law, the validity of any vote cast is generally not affected by misleading proposals or wrongly motivated deviation,<sup>80</sup> and a poll in an annual meeting cannot be challenged later by means of a special lawsuit (*Anfechtungsklage*), which is based on an alleged violation of the banks' duties as set forth in AktG section 128.<sup>81</sup>

It is hard to tell whether all of this creates efficient shareholder protection, since shareholders have been reluctant to file suits against banks, which could have given courts the opportunity to "breathe life into" the regulations.<sup>82</sup> Later, in this paper, it will be necessary to more closely examine this problem. For now it may suffice to note another problematic aspect: the conflict-of-interest-situation. Here, one notes some disclosure rules that may strike Americans as both familiar and comparatively underdeveloped. This is because the disclo-

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*Banks and Limitations on Voting Rights, in EUROPEAN TAKEOVERS: LAW AND PRACTICE* 242, 243 (Klaus J. Hopt & Eddy Wymeersch eds., 1992).

77. It is noteworthy that upon request at the meeting, the management board must provide information to shareholders if the information on corporate matters is required to enable the shareholders to reach an informed opinion concerning any item on the agenda. However, if such information causes considerable detriment to the corporation, in their reasonable business judgment, managers may refuse to furnish this particular information. See AktG § 131.

78. See AktG § 135(5).

79. See AktG § 135(8).

80. See AktG § 135(6).

81. See AktG § 243(3).

82. One remarkable exception is a recent court judgment which imposed a duty on the defendant, Hypo-Bank, to give reasons for a certain voting proposal which it had drafted. Once again, "Scary" Ekkehard Wenger, a professor of economics, acted on behalf of the plaintiff shareholders. See *Themen des Tages: Ein Urteil mit Fernwirkung*, SÜDDEUTSCHE ZEITUNG, Feb. 12, 1994, available in LEXIS World Library, Zeitng File.

sure rules only address three points. First, a bank clearly has to state whether it votes its own stock or whether it votes on behalf of a principal.<sup>83</sup> Second, if a member of the bank's managing board is also a member of the company's supervisory board, or, if a member of the company's managing board is a member of the bank's supervisory board, the bank has to disclose this fact in its proxy statement.<sup>84</sup> Third, it is noteworthy to mention that at least the big, most influential banks are giant, publicly-held corporations themselves. They may vote in their own annual meetings as a proxy only so far as the shareholder has given express instructions with respect to the items of the agenda. In contrast to German industrial corporations, here the American and the German proxy systems seem to be quite similar: A bank's management, just like its American counterpart, may vote the bank's own stock on the annual meeting, if specifically instructed. Obviously, German law wants to protect the banks' institutional function in the proxy system and elsewhere by barring any (in particular other banks) influence from outside.

*C. Path Dependence versus Transition: The Present Discussion and Reform in Germany*

Looking back over the past thirty years, one can say that the makers of the 1965 Stock Corporation Act failed to settle the discussion about the advantages and disadvantages of depository voting. It has been going on since then, sometimes with more, sometimes with less vigor. As mentioned above, recently Germany had "peak season." But once again it did not lead to major changes. This time, however, not only did German lawyers endeavor to enhance the present system by addressing its various conflict-of-interest problems, but also came up with revolutionary proposals: After having been taboo for ages, even the abolition of depository voting was not beyond debate any more.

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83. See AktG § 135(4). As a rule, however, a depository bank has special authority from its client to exercise voting rights on a basis of "to whomsoever the voting right belongs." *Id.* In this case the attendance list sets out only the name of the bank and the amount and class of shares which the bank votes in this way. Thus, the corporation may never know who its shareholders are! See WÜRDINGER, *supra* note 47, at 34.

84. See AktG § 128(2).

### 1. The Notion of "Bank Power" (*Macht der Banken*)

To get a complete impression of the criticism, one has to consider that it has not been sparked by bad performance of banks as proxy holders, but by the accumulated involvement of banks in corporate affairs. In the absence of a Glass-Steagall Act, a Bank Holding Company Act or an Investment Company Act, German universal banks offer the whole range of classical banking services.<sup>85</sup> In other words, the banks give commercial loans and investment advice, engage in underwriting and trading new securities issues, organize rescue operations for firms in financial distress, and are active in the mergers and acquisitions sector. Most importantly, banks own stock in industrial firms.<sup>86</sup> It is easy to see that all of these give them ample opportunity to play an important role in corporate governance. The characteristic German situation has been discussed and statistically backed up with quite impressive numbers elsewhere, and therefore need not to be repeated here.<sup>87</sup> Most people are aware of the striking example of Deutsche Bank holding about 25% of Daimler Benz' equity. This figure becomes even more striking when recognizing that the bank's subsidiaries, such as investment funds, may add other shares to its voting power. Together with the proxy votes, all this can add up to a controlling minority voting power which can both

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85. See AktG § 135(1); Hwa-Jin Kim, *Markets, Financial Institutions, and Corporate Governance: Perspectives From Germany*, 26 LAW & POL'Y INT'L BUS. 371, 377 (1995); Hans E. Büschgen, *The Universal Banking System in the Federal Republic of Germany*, 2 J. COMP. CORP. L. & SEC. REG. 1 (1979).

86. For a description of the factual and legal background of bank participation in Germany, see Ulrich Immenga, *Participatory Investment By Banks: A Structural Problem Of The Universal Banking System in Germany*, 2 J. COMP. CORP. L. & SEC. REG. 29, 31-35 (1979); Michael Gruson, *Banking Regulation and Treatment of Foreign Banks in Germany*, in REGULATION OF FOREIGN BANKS: UNITED STATES AND INTERNATIONAL § 15.07 (Michael Gruson & Ralph Reisner eds., 1995). Investments must not exceed a specified percentage of the capital of the investing bank. See Gesetz über das Kreditwesen [Banking Law], v. 30.01.1996 (BGBl. I S.65), §§ 12(5), 13. Also, investment in banks by insurance companies, and vice versa, is restricted. See Michael Gruson & Uwe H. Schneider, *The German Landesbanken*, 1995 COLUM. BUS. L. REV. 337, 341 & n.3 (1995).

87. For a profound analysis, see JEREMY EDWARDS & KLAUS FISCHER, *BANKS, FINANCE AND INVESTMENT IN GERMANY* 111-21, 198-214 (1994); Theodor Baums & Christian Fraune, *Institutionelle Anleger und Publikumsgesellschaft: Eine empirische Untersuchung*, 40 DIE AKTIENGESSELLSCHAFT 97 (1995). See also 6 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT 69 (1994) (documenting bank power provided at a parliamentary hearing of the *Deutscher Bundestag* in December 1993).

initiate and block certain decisions.<sup>88</sup> Additionally, members of the managing or supervisory board of a bank, even if the bank does not own stock in the firm, are encouraged to become members of the supervisory board of the firm. Today, this is the case in more than half of the 100 largest publicly-held corporations in Germany.<sup>89</sup> Nevertheless, those examples often tend to oversimplify and open the floodgates to a rather irrational discussion. In the proxy setting, it is said that the "big three" (Deutsche Bank, Dresdner Bank and Commerzbank), exercise a corporate governance role similar to that of management in the United States.<sup>90</sup> This is true to some degree. However, no single bank holds, as far as can be seen, a majority of depository votes. The "giant banks" have to share their direct influence on the corporation with many small, regional, private banks and municipal savings banks (*Sparkassen*).<sup>91</sup> It is no exception that as many as fifty banks show up at the annual meeting.<sup>92</sup> In general, it should be noted that the bankers' vote implies the advantage that power over the corporation is more widely spread.<sup>93</sup> Of course, the

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88. See Jeremy Edwards & Klaus Fischer, *An Overview of the German Financial System*, in CAPITAL MARKETS AND CORPORATE GOVERNANCE 257, 273 (Nicholas Dimsdale & Martha Prevezer eds., 1994). Bank's control of voting rights is greatest among the top ten German publicly-held corporations by nominal capital. *Id.* Prior to the recent amendment of the *Aktiengesetz*, limitations on voting rights of shareholders (*Höchststimmrechte*, e.g., no single shareholder can vote more than 5% of the total share capital), when included in the articles of incorporation as a hostile takeover protection, increased the bank's influence even further. A bank voting shares for several customers was not affected by the limitations because they exclusively related to the shareholder. See Maier-Reimer, *supra* note 76, at 244, 247. *Höchststimmrechte* are nothing but history as regards corporations whose shares are listed on a stock exchange. After a transitional period the limitations on voting rights will become void. See AktG § 134(1); Einführungsgesetz zum Aktiengesetz (EGAktG) [Implementing Legislation], v. 27.04.1998 (BGBl. I S.786) § 5(7).

89. See Marcus Lutter, *Macht der Banken*, 34 NEUE JURISTISCHE WOCHENSCHRIFT 2766 (1995) [hereinafter Lutter, *Macht der Banken*].

90. See ROE, *supra* note 36, at 170-71.

91. On average the "big three" banks together exercise 45-47% of all proxies at an annual meeting. See Edwards & Fischer, *supra* note 88, at 272.

92. Günther H. Roth, *Supervision of Corporate Management: The "Outside" Director and the German Experience*, 51 N.C. L. REV. 1369, 1379 (1973).

93. Bernhard Grossfeld & Werner Ebke, *Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe*, 26 AM. J. COMP. L. 397, 415 (1978). See also ROE, *supra* note 36, at 171 (stating that "an American intermediary trying to control 5 percent or 10 percent of the largest industrial firm's stock would be akin to a pup trying to grab a lion").

small regional banks that seem to seek a closer relationship with private clients, such as small shareholders, cannot afford a paper-wasting monitoring function, and, parallel to their clients, they may realize how limited their influence is. They rely to a large extent on the proposals of the big banks. It seems in this context that it is "collective action" of the banks that is feared most. When turning to the banks' possible incentives for corporate control in order to carve out inherent conflict of interest problems, it is inevitable to focus solely on the big banks.

## 2. Incentives to Exercise Proxy Votes and Related Conflicts of Interest

Banks do not charge extra fees for voting their clients' stock. There is only a basic fee for their depository service, which is not tied to performance.<sup>94</sup> From a corporate point of view, this is very cost-efficient for the corporation itself because its funds are not burdened with the (as the American experience shows) sometimes enormously high costs in a proxy process. Theoretically, the shareholders also benefit from this distribution of the costs: It leaves more assets to the corporation, which makes it more likely that the shareholders' return (dividend) is higher than otherwise. On the other hand, it is hard to believe that the banks, when exercising the voting rights, act solely as a selfless proxy with no return and without pursuit of their own economic interests. They could not have stayed in the market, had that been their 'philosophy' of doing business in the last thirty years. This creates a latent risk that the banks deviate from shareholders' interests, if this fits their interests better. However, it also does not suggest that the banks interests and the shareholders' interests can never be the same. To some degree, an agent with some incentive to care and to investigate the market situation is even more desirable than a completely disinterested agent who is just performing a job. Empirical data on how banks actually make use of their voting power is not obtainable. There is only one often-cited finding that banks exercising the proxy votes usually side

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94. See Theodor Baums, *Corporate Governance in Germany: The Role of the Banks*, 40 AM. J. COMP. L. 503, 506 (1992) [hereinafter Baums, *Corporate Governance*].

with the company's management.<sup>95</sup> Still, we cannot conclude from this that the outcome of the voting process is not distinct from proxy voting by management itself. Banks may well put recognizable pressure on badly performing management in previous internal negotiations and force management to modify its proposals.<sup>96</sup> To make a long story short, it is best to start from the hypothesis that the banks' incentive to monitor flows mainly from their various other stakes in German industry, and then to evaluate on these hypothetical grounds whether the shareholders' prerogative in deciding how to cast their votes is safeguarded efficiently under the present law.

To begin with, banks are shareholders themselves and therefore may try to protect their own equity investment.<sup>97</sup> The additional voting power by proxy votes, which is not tied to a higher financial stake in the company (power without property) gives them an ideal leverage to pursue this aim. Even though equity holding seems to put them on the side of their clients, their interests can still differ. Probably, a bank sees stock simply as an investment that helps to diversify its portfolio in order to maintain stability, rather than to receive a high dividend return. This leads to the dividend policy of firms in general. Because of their conservative image in the public, banks have been suspected of having supported the restrictive dividend policy of management, instead of pleading for a profitable policy that aims at maximizing share value.<sup>98</sup> Also, as providers for external credit finance, banks seem to prefer that a company retains its earnings, in order to make sure that its

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95. See generally Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 538; Alfred E. Conard, *The Supervision of Corporate Management: A Comparison Of Developments in European Community and United States Law*, 82 MICH. L. REV. 1459, 1470 (1984); Thomas Raiser, *Empfehlen sich gesetzliche Regelungen zur Einschränkung des Einflusses der Kreditinstitute auf Aktiengesellschaften?*, 35 NEUE JURISTISCHE WOCHENSCHRIFT 2257, 2261 (1996) [hereinafter Raiser, *Einfluß der Kreditinstitute*].

96. As Westermann and Hopt point out, German banks frequently vote against management's proposals and even support initiatives that demand special auditing of the corporation. See Westermann, *Vollmachtstimmrecht*, *supra* note 16, at 270; Klaus J. Hopt, *Corporate Governance und deutsche Universalbanken*, in CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFUEHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND IM AMERIKANISCHEN AKTIENRECHT 243, 258 (Dieter Feddersen et al. eds., 1996) [hereinafter Hopt, *Corporate Governance*].

97. See Baums, *Takeovers*, *supra* note 69, at 170.

98. *Id.* at 174-75.

credit claim can be satisfied.<sup>99</sup> Again, there is another version of the story: Since this credit investment in particular is leverage to discipline management, its interests may depart from banks' interests at this point. Understandably, it must be management's aim to become increasingly independent from external finance through piling up the internal corporate funds. In response, this may lead banks to favor the distribution of dividends.<sup>100</sup> Idealistically, a bank can therefore reconcile detrimental extremes and help to stay in the middle of the road, to the best interest of the corporation and its shareholders: From a long term perspective, neither excessive distribution of dividends nor stubborn retaining of earnings serves the best interests of the involved parties.

This, of course, demands much from a bank as a monitor. It may be reluctant to fulfill this role diligently because, beyond a certain input, it does not pay off. Additionally, German banks seek a more stable relationship with corporate customers than is the case in the United States. As house-bank (*Hausbank*), a German bank can deliver all the banking services a corporation needs. This "principle of relationship banking," along with the universal bank system, offers German banks a great deal of business opportunities.<sup>101</sup> Even though publicly-held corporations establish up to ten "house-bank relationships," and a number of connections with other banks, the common reluctance of the banks to be deprived of this impor-

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99. Under German law, bank credit is not repayable capital of the corporation in a bankruptcy proceeding if the credit is given by banks with major holdings in the corporation (i.e., more than 25% of the outstanding stock). See BGHZ [Supreme Court] 90, 381 (382). See also Klaus J. Hopt, *Inside Information and Conflicts of Interest of Banks and Other Financial Intermediaries in European Law*, in EUROPEAN INSIDER TRADING 219, 232 (Klaus J. Hopt & Eddy Wymeersch eds., 1991) [hereinafter Hopt, *Inside Information*].

100. It is noteworthy that generally the dependence of large publicly-held corporations on debt financing is only approximately 8.8%. This small percentage is due to their ability to raise equity capital and accumulate substantial amounts of liquid assets through internal financing. It is true that German companies rely on debt financing rather than on equity financing, considering the large number of limited liability companies (*Gesellschaften mit beschränkter Haftung*). See Ellen R. Schneider-Lenné, *The Role of the German Capital Markets and the Universal Banks, Supervisory Boards, and Interlocking Directorships*, in CAPITAL MARKETS AND CORPORATE GOVERNANCE 284, 286 (Nicholas Dimsdale & Martha Prevezer eds., 1994). However, for huge projects which require much more money for a certain period of time, even big enterprises may hire a credit consortium.

101. *Id.* at 286.

tant business relationship might be a disincentive to bother management with close monitoring until after a bail-out situation arises.<sup>102</sup> Late in 1995, Deutsche Bank experienced how embarrassing such a snub can be. Daimler Benz, Germany's largest industrial company, rejected the German banking titan when it needed investment banking prowess. Instead, Daimler turned to Goldman, Sachs & Company for help revamping its A.E.G. industrial unit, and later picked J.P. Morgan as lead manager to raise \$500 million.<sup>103</sup> One can only hope that the branch of the highly competitive commercial banking sector, or stated differently, an undoubtedly increasing consciousness about a good performance in buying, selling and administering shares for small investors, outbalances this hesitation to monitor efficiently. However, it seems hard to rebut the presumption that a bank commits its heart and soul to an individual corporation, rather than to a widely dispersed mass of silent investors. Stated differently, from time to time management of one of the big three banks (which themselves are corporations with scattered ownership), is overly sympathetic with the management of an industrial company.<sup>104</sup> Again, Daimler Benz is a striking example which supports this contention. In 1996, the members of the managing and the supervisory boards were released from responsibility by a shareholder's resolution,<sup>105</sup> which was dominated by banks exercising the proxies. As a matter of law, by this release the shareholders approved the conduct of the company's management,<sup>106</sup> although the company faced heavy losses, and some managerial decisions were clearly wrong, such as the acquisition of Fokker. Even though

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102. See Baums, *Takeovers*, *supra* note 69, at 172; Vagts, *supra* note 49, at 61; Bernhard Grossfeld, *Management and Control of Marketable Share Companies*, in 8 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 99, 99 (A. Conard ed., 1973). A recent case of an emergency intervention by banks which suggested that they had been "sleeping" for a while was the derivatives-related financial distress of *Metallgesellschaft*. It required a collective effort by several big banks and probably could have been prevented by a more effective *ex ante* control. See Joseph L. Motes, III, *A Primer on the Trade and Regulation of Derivative Instruments*, 49 SMU L. REV. 579, 608 (1996).

103. See Peter Truell & Edmund L. Andrews, *Accelerating a Risky Strategy—Deutsche Bank Continues Plunge Into Global Banking*, N.Y. TIMES, Oct. 31, 1996, at D1.

104. See Baums, *Takeovers*, *supra* note 69, at 172.

105. See AktG §§ 120, 119(1).

106. See AktG § 120(2).

this release could not imply a waiver of claims for damages,<sup>107</sup> and of course some managers were informally forced to resign, it transmitted a wrong signal: "business as usual."<sup>108</sup> From here, it is not far to discover another weak point in the system: the representation of the banks in the supervisory boards of industrial corporations. In our example, the fact that banks' representatives were sitting in the supervisory board renders the conflict of interest issue one of first impression.

However, as seen from the above discussion, things are not always that obvious, and we have investigated highly speculative grounds. The fact pattern is anecdotal, imprecise, if not opaque.<sup>109</sup> This makes it even more difficult to design an efficient improvement of the present system. To sum up, one can say that, regardless of its advantages, the German system certainly bears potential for abuses triggered by conflict-of-interest situations. Even though the issue is supposedly stronger in the management-dominated U.S. proxy system, in this dimension both systems are more like each other than one may have expected at the outset. It is questionable whether conflict-of-interest situations are properly addressed by German law.<sup>110</sup>

### 3. Selected Aspects of Recent Proposals for Reform

Over the last couple of years German lawyers and political parties have come up with a series of proposals on how to enhance, or substitute, the present depository voting without losing the advantage of having a professional and responsive outside monitor whose presence overcomes a still prevalent shareholder passivity. Not all of the proposals were new, and now, particularly after the Deutscher Juristentag dismissed changes of far-reaching importance in 1996, they seem nothing

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107. See AktG 120(2).

108. See Peltzer, *supra* note 69, at 845.

109. It is noteworthy that banks find themselves in a catch-22 situation at the present stage of the debate; they are heavily criticized no matter what they do. For example, the participation of Deutsche Bank in a syndicate secretly preparing the Krupp-Thyssen hostile takeover attempt in March 1997 was heavily criticized since one of Deutsche Bank's managers was sitting on the Thyssen supervisory board. Under these circumstances, a market for corporate control may not spark off in Germany.

110. See Baums, *Takeovers*, *supra* note 69, at 175; Köndgen, *supra* note 53, at 539.

but history.<sup>111</sup> Yet, this temporary peak most likely has not marked the final end to a longstanding discussion, even though the above mentioned amendments of the Aktiengesetz have just come into force regarding *inter alia* proxy voting of banks.<sup>112</sup> Rather, the search for the best legal framework remains an elusive quest. All this reveals how far apart the positions still are: Some claim that the lawyers were not ready for a drastic turn, and some suggestions will be revived in time. On the other hand, major change may not be necessary at all. To assert their value, and to get an impression of the present stage of a seemingly ongoing discussion, it is worthwhile to glimpse some of the contributions as well as the outcome in the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*.

#### a. Proxy Voting by Auditors

The two most striking and similar proposals were made by the Social Democratic Party,<sup>113</sup> and the scholars Baums and von Randow<sup>114</sup> as to which independent, professional agents, preferably auditors (*Wirtschaftsprüfer*) or attorneys, should exercise the proxy votes on behalf of the shareholders. According to the proposal, in each corporation five proxy holders would have to be elected by the shareholders. The later exercise of the proxy votes would be supervised by the Federal Supervisory Office for Securities Trading (*Bundesaufsichtsamt für den Wertpapierhandel*). The proxy holders would receive compensation from the corporation, the amount of which must be fixed by the Federal Minister of Justice (*Bundesministerium der Justiz*).

Although reasonable and promising at first glance, the amendment entails weak aspects which may raise old problems in different circumstances. The proposal merely substi-

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111. See generally Schäfer, *supra* note 39. See also 36 NEUE JURISTISCHE WOCHENSCHRIFT 2998 (1996) (providing the results of voting).

112. The KonTraG legislation anticipates better control and transparency in corporate law. See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786). Draft federal legislation and the latest improvements are reprinted in 18 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2059 (1997); 19 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 487 (1998).

113. See Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2262.

114. See Theodor Baums & Philipp von Randow, *Der Markt für Stimmrechtsvertreter*, 40 DIE AKTIENGESELLSCHAFT 145, 156 (1995).

tutes a new interest group (the auditors) for an old one (the banks). To be sure, the auditors would not have a stake in the corporation, but even without comparable equity holdings they would exercise a remarkable voting power without risk. To this power adds the suggestion that the auditors may exercise proxies even for those shareholders who have not given their authorization beforehand, and then do not show up at the meeting. It is highly doubtful whether this penalty-like solution to shareholder passivity ("if you do not vote your share, someone else will") adequately alerts shareholders to the necessity of voting or giving the express authorization to proxy holders. Both legal history and "rational" shareholder conduct indicate otherwise.<sup>115</sup> "Automated" authorization is at odds with the accountability of agents, in particular of those who act on behalf of large, non-homogeneous and a mainly silent group of principals. The lack of a sufficient monitoring scheme (feedback) may even result in an exacerbation of skewed incentives as compared to the banks. That is, an individual (auditor) somehow seems more receptive to influence by dishonest management than to a bank with a stake in the company. At the same time, the number of five auditors, instead of 30 to 50 banks in one annual meeting, suggests less plurality and expertise deficiencies. Given the fact that the auditors are complete outsiders to the corporation, it is furthermore doubtful that they could gather as much information as the banks in order to make their recommendations on how to vote. To implement such a vague alternative does not seem worth the high transition costs it would cause.<sup>116</sup>

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115. If the promotion of the capital markets is taken seriously, it is imperative to accept that small shareholders may regard their shares simply as some kind of investment instead of forcing them by law to act like responsive owners of the corporation; See Westermann, *supra* note 16, at 273. Presently, there are many discussions about the necessity to deregulate the rather firm German Stock Corporation Act. In this light, creating new constraints seems to send the wrong signal. As stated above, it is essential that shareholders who diversify their risks in their portfolios may simply regard their shares as investment devices.

116. See Lutter, *Macht der Banken*, *supra* note 89, at 2767; Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2262. It should be noted that in a pending suit a shareholder protection group (*Deutsche Schutzgemeinschaft der Kleinaktionäre*) demands that Deutsche Telekom refrain from hiring auditing companies for the purpose of exercising proxy votes in future shareholder meetings. Prior to its first annual meeting in 1997, the managing board of Deutsche Telekom asked small shareholders to give their proxies to Price Waterhouse, which later in fact exercised about 6 million votes. The plaintiff alleges that contrary to prior announce-

## b. Limitation of Firm Ownership by Banks?

Other suggestions did not touch the legal framework of proxy voting, but rather addressed the potential for conflicts of interest of banks. Among those was the proposal to reduce the maximum percentage of firm ownership by one bank to 5%.<sup>117</sup> However, notwithstanding the relatively liberal provisions of the German Banking Act (*Gesetz über das Kreditwesen*) as to direct stock holdings by banks,<sup>118</sup> the banks themselves have exercised a kind of self-discipline and overwhelmingly do not exceed this proposed ceiling anyway.<sup>119</sup> The impressive holdings of some large German banks are rather exceptional, and do not blur the impression that banks carefully diversify risk in their portfolios, and a much greater voting power accrues to them from the exercise of proxies. Therefore, this proposal would not change much with respect to conflict-of-interest problems, but could be a signal for more confidence in the present system.<sup>120</sup> On the other hand, such limits are to be evalu-

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ment, Price Waterhouse was not a neutral and independent trustee, but received a fee of about DM 250,000 from the corporation. Furthermore, it is asserted that Price Waterhouse was contractually obligated to vote in accordance with management's proposals, provided the shareholders had not given instructions on the exercise of their voting rights. See *Die Schutzgemeinschaft der Kleinaktionäre verklagt die Telekom*, FRANKFURTER ALLGEMEINE ZEITUNG, Oct. 7, 1997, at 21.

117. There is dispute on where to draw the line. See Hopt, *Inside Information*, *supra* note 99, at 238. See also Lutter, *Macht der Banken*, *supra* note 89, at 2767 (suggesting that a bank should not hold more than 10% of a single corporation's outstanding stock. This is the percentage suggested in the Second European Bank Supervision Law Harmonization Directive).

118. Under the provisions of the Banking Act, the total book value of a bank's investments in shares (real estate, ships etc.) may not exceed its capital and reserves. See *Gesetz über das Kreditwesen* [Banking Act], v. 11.07.1985 (BGBl. I S.1472). See also Immenga, *supra* note 86, at 30 (providing more information about the Banking Act).

119. Of Germany's 500 biggest companies, there are only about 30 in which banks hold stock of more than 10%. See Schneider-Lenné, *supra* note 100, at 288-89. On the other hand, the companies with remarkable bank-holdings are among Germany's largest.

120. With respect to the existing large blocks, it would be necessary, however, to allow a long period of transition in order to prevent a market depression triggered by an immediate sale of large amounts of shares. A total ban of non-bank holdings of banks would clearly run counter to the trend which has some influence on other countries. For example, American academics currently look upon direct holdings as a desirable financial investment for banks, helping to stabilize their profit base by way of asset diversification. See Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 110 (1995).

ated cautiously, since the corresponding restriction of entrepreneurial freedom for banks may be easily deemed discriminatory under constitutional law.<sup>121</sup>

A somewhat similar approach is now taken by sentence 3 in AktG section 135, par. 1 ("*KonTraG*").<sup>122</sup> It provides that banks with direct or indirect ownership of 5% and above in one single firm are obligated to vote either their own stock or the proxies. Through this method, smooth but firm pressure is put on banks to reduce their firm ownership. However, it seems arbitrary that everything seems to be fine at 4.9% of stock in the firm, while holdings of 5% and above are deemed a problem. Considering the above mentioned self-discipline as regards investments, this suggestion hardly helps to solve conflicts of interest. Rather, it is the "collective action" of banks when voting as proxy holders that is feared, rather than the influence of one single bank. Also, the implied assertion that banks dispose of their own shares to exercise the power without risk provided by the proxies is highly speculative: Banks may decide differently: They keep their own stock but vote the proxies, thus keeping their influence with a minor reduction. Otherwise, given shareholders' inertia, the average attendance at annual meetings may be reduced significantly, if no one is ready to step in.<sup>123</sup>

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[hereinafter Macey & Miller, *Corporate Governance*]. Also, due to the financial expertise of banks, it does not make sense to stop their employees from sitting on the supervisory board of industrial companies. The proposed compromise to reduce the number of seats a single person can have on supervisory boards of different companies does not eliminate any possible conflict of interest. Rather it would improve the efficiency of the supervisory board itself.

121. See Peter O. Mülbert, *Empfehlen sich gesetzliche Regelungen zur Einschränkung des Einflusses von Kreditinstituten auf Aktiengesellschaften*, 49 NEUE JURISTISCHE WOCHENSCHRIFT, BEILAGE ZUM 23. HEFT, 24, 27 (1996); Uwe H. Schneider & Ulrich Burgard, *Transparenz als Instrument der Steuerung des Einflusses der Kreditinstitute auf Aktiengesellschaften*, 49 DER BETRIEB 1761 (1996) [hereinafter Schneider & Burgard, *Transparenz*].

122. See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786) (citing AktG § 135(1), as amended).

123. See Hammen, *Vollmachtsstimmrecht*, *supra* note 70, at 1227; Friedrich Kübler, *Empfehlen sich gesetzliche Regelungen zur Einschränkung des Einflusses der Kreditinstitute auf Aktiengesellschaften?*, in VERHANDLUNGEN DES EINUNDSECHZIGSTEN DEUTSCHEN JURISTENTAGES 13 n.11, 14 n.20 (1996) [hereinafter Kübler, *Referat*].

c. Increasing Influence of Shareholder Associations and Institutional Investors?

Another modification to the present system can be referred to as a "market solution," because it leads to a market for proxy holders. Stated differently, in the future the banks should face competition by shareholders' protective associations, institutional investors, and self-employed persons, such as the above-mentioned auditors. Partly, this again is not a new legal approach, since the 1965 Stock Corporation Act already provides a provision which lays down that the sections ruling the exercise of proxies by banks will apply, *mutatis mutandis* to the exercise of the voting rights by shareholders' protective associations and persons who professionally solicit from shareholders the exercise of the voting rights at annual meetings. Rather, this idea tries to signal psychological support for greater activity by proxy holders (other than banks), than amend the present system legally.

Theoretically, in particular, shareholders' associations seem to be ideal proxy holders, because they are interested and responsive by nature, do not suffer from any conflicts of interest, and can concentrate exclusively on the maximization of share value. However, in hoping that they will play a more important role soon and concurrently push the banks to a better performance, supporters do violence to the German experience of the last thirty years. Less than 1% of the shareholders in Germany have been represented by those shareholders' protective associations at annual meetings.<sup>124</sup> This number is not promising at all. Even if one takes into account the fact that expert observers noticed a new kind of shareholder activism and a respectable shareholder protection association (*Deutsche Schutzvereinigung für Wertpapierbesitz*) which arrived on the German scene in the early nineties,<sup>125</sup> one cannot rely on this. It is hard to tell whether this development is going to wane, or whether it is just the first step in a new era. It requires much from the shareholders, because the

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124. See Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 541.

125. See Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 21 & n.78 (1991) [hereinafter Buxbaum, *Institutional Owners*].

majority of them still have to overcome long-lasting inertia. Undoubtedly a positive development, shareholders' activism needs strong leverage to be put into life. For the reasons stated above, one may express doubts as to whether there really is a market for proxy voting.<sup>126</sup> As discussed above, in an economy preferring the bearer share, the depositing banks are important intermediaries which have access to the body of shareholders, and therefore facilitate communication between a corporation and its shareholders. They hold a strategic position. In order to promote more active shareholders' associations, banks, similar to the brokers in the United States, should become legally obligated to send shareholder name lists to those associations, in order to enable them to communicate not only with shareholders who are already members, but also with shareholders who are not yet organized. According to the recently-amended AktG,<sup>127</sup> it is now mandatory for banks to inform their clients about alternative proxy holders.<sup>128</sup> Concurrently, in the obligatory announcement and communication prior to an annual meeting,<sup>129</sup> the corporation itself must highlight the possibility of voting rights being exercised by shareholders' associations. However, the reform failed to take a further step. Ideally, the section would obligate the corporation to inform shareholders' associations about the agenda, no matter whether they voted rights for shareholders at the last meeting or not. In this case, the scope of information should be extended materially as well, since the shareholders' associations cannot have as much inside information as banks do. Finally, this leads to the fact that the shareholders' associations must hire experts who are able to digest and evaluate the information given, to observe the markets, etc. They cannot do so without money, which has to be collected through membership fees, or, through payment by the corporation itself (which is more sound since it prevents free rider problems). In either case there is no further change without high transaction costs and increasing expenses for both shareholders and corpora-

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126. See Westermann, *supra* note 96, at 274; Hopt, *Corporate Governance*, *supra* note 96, at 259.

127. See AktG § 135(2) (as amended by KonTraG).

128. Compare Lutter, *Macht der Banken*, *supra* note 89, at 2767, and AktG § 135(2), with Hammen, *Vollmachtsstimmrecht*, *supra* note 70, at 1222, and Kübler, *Referat*, *supra* note 123, at 15 n.21.

129. See AktG § 125(1).

tions. Today one cannot say whether all this creates enough incentive for more active shareholders and shareholders' associations.

It is equally debatable whether non-bank institutional investors, as now has been proposed, can become a more responsive and interested "outside manager." Compared to their American counterparts, they are not as large yet, and are mainly bank-influenced.<sup>130</sup> This, of course (discussed *infra*), seems to change all over Europe. German insurance companies could play an important role but they have not detected their potential for stock investments yet.<sup>131</sup> However, experience in the United States has proven that institutional shareholders until recently have been predominantly passive.<sup>132</sup> According to their growing size they are now regarded increasingly as an independent supervisor, and they themselves are (slowly) beginning to accept and practice the idea that voting is important.<sup>133</sup> Legal scholars have been strongly advocating in order to motivate them to exercise their voting power with the vigor of German banks.<sup>134</sup> Again, this suggests that at least some interest to monitor on the proxy holder's side is desirable in order to make them fulfill their function. Given those similar ingredients, the institutional investor is not on its face the preferable proxy holder compared to a bank.<sup>135</sup> On the con-

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130. See Friedrich K. Kübler, *Institutional Owners And Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97, 98-100 (1991) [hereinafter Kübler, *German Dilemma*]; Westermann, *supra* note 16, at 270.

131. According to their individual investment philosophies, life insurance companies invest their money in the markets, however not more than 10% in equities. See Michael Hauck, *The Equity Market and its Dependency on the System of Old Age Provisions*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 555, 558 (Theodor Baums et al. eds., 1994).

132. See Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2198 (1991); CARY & EISENBERG, CORPORATIONS, *supra* note 21, at 245-46 (stating that "there seems to have been a club culture shared by many institutional investors, under which voting against management 'wasn't done'"). In Germany, it seems that even most of the institutional investors have given proxies to the banks. See Westermann, *supra* note 16, at 274.

133. For a more in-depth background of this shift, see CARY & EISENBERG, *supra* note 21, at 248; Gilson & Kraakman, *supra* note 33; Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

134. See Conard, *supra* note 132, at 2198. See also CARY & EISENBERG, *supra* note 21, at 246-48 (considering the legal requirement that U.S. pension funds actively vote their shares).

135. See Buxbaum, *Institutional Owners*, *supra* note 125, at 36 (suggesting

trary, once again the question arises, whether and to what extent monitoring or even proxy holding by large institutional investors with own business or equity interests in the firm is favorable or detrimental to the small, dispersed investors.<sup>136</sup> Thus, the task in German corporate governance cannot be to replace one self-interested proxy holder with another who may be only slightly less self-interested, but to impose more sophisticated or to elaborate duties to the proxy holders, no matter if they are banks or non-bank institutional investors.

#### 4. The Elaboration of Proxy Holders' Duties

##### a. Disclosure and Compliance

Since the success of the supplement by shareholder associations is rather uncertain, and other modifying proposals that tried to cut out some of the conflict-of-interest situations banks have to face were rejected, it seems necessary to further enhance the present tight proxy mechanism. Stated differently, the current myriad of proposals and amendments should not distract the lawyers from the real issue of how best to discipline an agent. As previously indicated, the performance of banks in the proxy process happens in a classical agency setting. Agents (banks) are watching agents (management). The law itself affirms that the bank has to act in the shareholder's best interest—that the relationship is a fiduciary one.<sup>137</sup> The question is how to control (not to say to tame), a quite powerful agent, and how to prevent him from being tempted by certain enticements that occur along the way. At the end of the road, there should be an undivided and unselfish loyalty to the shareholders that is still exercised in light of what is best from a long-term perspective.<sup>138</sup>

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some kind of interchangeability in "the German version of the institutional investor is the universal bank."); Schneider & Burgard, *Transparenz*, *supra* note 121, at 1761 (criticizing that the discussion about undue influence on German corporations is limited to banks).

136. See Baums, *Takeovers*, *supra* note 69, at 180; Grossfeld, *supra* note 102, at 101.

137. See AktG § 128(2).

138. It may be a good idea to further stress this by making the exercise of proxy voting into a financial service, which the bank is fully compensated for via corporate funds. See Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 537 (outlining the recent Swiss practice). As discussed above, shareholders' associations will also require more expenses. If the money is not

As the American experience suggests, the key to this duty of loyalty and duty of care and "structural implementation of shareholder democracy"<sup>139</sup> is "full disclosure." Disclosure has a longstanding tradition in the United States and can be easily extended in the German Corporation Act without violating a deep-rooted corporate tradition. It is just a small step, since the present provisions, as indicated, are already American-influenced. Hence, in their proxy statements banks not only should disclose their employees who sit on the supervisory board of the corporation, their membership in underwriting groups, and their relevant stock holdings,<sup>140</sup> but also their credit arrangements and other stakes in the firm which might influence their proposals.<sup>141</sup> Also, special circumstances in the firm, such as severe financial distress, may trigger special interests of banks and therefore require disclosure. However debatable the proper scope of information to be provided, it seems a common view among scholars that enhanced transparency is desirable.<sup>142</sup> Certainly, it seems imperative that the

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taken directly out of the small shareholder's pocket, this will not affect the shareholder's voting conduct. *Id.*

139. For an explanation of this term, see Richard M. Buxbaum, *Comparative Aspects of Institutional Investment and Corporate Governance*, in INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE 3, 4 (Theodor Baums et al. eds., 1994) [hereinafter Buxbaum, *Institutional Investors*].

140. See AktG §§ 128(2), sent. 6, amended by Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786). See also Schneider & Burgard, *Transparenz*, *supra* note 121, at 1763-1765 (arguing that it is imperative that existing disclosure obligations be harmonized to avoid loopholes and practical problems from the array of different information requirements). See Wertpapierhandelsgesetz (WpHG), v. 26.07.1994 (BGBl. I S.786) § 21.

141. See Schneider & Burgard, *Transparenz*, *supra* note 121, at 1765 (suggesting an amendment to WpHG § 22(1) to include in the disclosure obligation the number of voting rights to be exercised at the annual meeting without specific instructions given by the shareholders alongside the major investments and disinvestments in the stock of a listed company). As they point out, such numbers are subject to permanent change, and should therefore be delivered shortly before the annual meeting. *Id.* However, despite the significant costs of such procedure, this kind of information does not seem to weed out the major concerns. As opposed to the other pieces of information to be provided in the future, it is leverage for pursuing its own interests but a source of the classical conflicts of interests. Rather it seems urgent to discuss the abolishment of shareholder anonymity in German corporate law. See AktG § 129(2) (list of participants present at the annual meeting). "The names of the shareholders who have granted the proxies need not be mentioned." *Id.* In part, this anonymity has led to the discussion about the "power of banks," since an agent without a personified principal does not seem to be required to account for his conduct.

142. See Mülbart, *supra* note 121, at 28; Schneider & Burgard, *Transparenz*,

amount of disclosed information be carefully determined. The ability and willingness to absorb information decreases as its amount increases.<sup>143</sup>

At any rate, it would not be a big hurdle if the banks were obligated to give material *reasons for their proposals* in writing to acquaint the shareholders with what is going on.<sup>144</sup> This would lead to a more informed shareholder, and possibly deter the bank from secretly weighing its own possible gain against the interest of its principal.

In addition, the latter problem should be addressed by the implementation of another well-established American rule: Disclose or abstain. While developed for insider trading, the rule can be easily transferred to the proxy context: A bank that is not willing or able to give the above-required information (i.e. to disclose) must abstain from exercising proxy votes.<sup>145</sup> For example, it may be constrained as a matter of law<sup>146</sup> to refuse to provide information to the extent that providing such information is, according to sound business judgment, likely to cause material damage to the corporation or an affiliated enterprise. Therefore, a bank that faces a current conflict of interest deriving from a certain business arrangement should be excluded from exercising proxies.<sup>147</sup> To avoid a significant drop in shareholder participation at an annual meeting, the abstaining bank should be obligated to transfer all files to other banks or shareholder associations who are willing to step in and exercise the proxies.

*supra* note 121, at 1762.

143. See Hammen, *Vollmachtsstimmrecht*, *supra* note 70, at 1223.

144. See Lutter, *Macht der Banken*, *supra* note 89, at 2767. It is noteworthy that German corporations offer much less insight into their financial substance than, for example, American enterprises. See Klaus J. Hopt, *European Takeover Regulation: Barriers to and Problems of Harmonizing Takeover Law in the European Community*, in *EUROPEAN TAKEOVERS* 165, 170 (Klaus J. Hopt & Eddy Wymeersch eds., 1992) [hereinafter Hopt, *Takeover Law in the EC*].

145. See Hopt, *Inside Information*, *supra* note 99, at 240; Köndgen, *supra* note 53, at 552. See also Mülbart, *supra* note 121, at 28 (suggesting that a bank should refrain from delivering a proposal if members of its personnel or those of its subsidiaries are to be elected). But see CLAUS WILHELM CANARIS, *BANKVERTRAGSRECHT* 1103, n.2187 (2d ed., 1981) (arguing against broader disclosure).

146. See, e.g., the rationale of AktG § 131(3).

147. See Mülbart, *supra* note 121, at 28. See also AktG § 136(1) (providing that "[n]o person may exercise voting rights on his own behalf or on behalf of any other person in respect of a resolution concerning ratification of his acts, his discharge from liability, or enforcement by the company of a claim against him").

Finally, another legal device that seems to be en vogue in banking law may weaken conflict of interest issues: *Compliance*. That is to say, if we realistically can reduce universal banks' influence on corporate affairs only to a certain degree, mandatory rules should be drafted that require banks to structure their internal organisation and division of business fields (such as underwriting, commercial loans, equity investments, securities trading and depositing) so that they may not exert undue influence on each other. A sophisticated compliance code ("conduct of business regulation and self-control") therefore is expected not only to enhance banks' performance in proxy voting, but also to dampen the somewhat irrational criticism of "depository voting," even in cases in which a supposedly slack performance of a bank employee on the supervisory board of the corporation was the sole reason for not having stopped bad corporate decisions. Also, this internal division of powers and creation of "chinese walls" might create new incentives for the depository branch to pay attention to shareholders' interests more intensely. Caring about "shareholder value" is increasingly deemed a competitive advantage among market players of banking and investment services in Germany.<sup>148</sup> In conclusion, the amendments in the AktG<sup>149</sup> as to compliance deserve approval; they are a first step into the right direction. However, they set up a rather vague frame, thus affording remarkable leeway for the methods for implementing the required organizational precautions.

#### b. Liability of Proxy Holders

Regardless of the amendment of the Stock Corporation Act, the judicial trend is currently slowly turning to examine the duties of proxy holders more closely.<sup>150</sup> First, it seems natural to further investigate the private cause of action held by those shareholders for which the proxy holder was an agent. This is well-established on the grounds of breach of con-

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148. See Schneider & Burgard, *Transparenz*, *supra* note 121, at 1762.

149. See AktG § 128(2), amended by Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786).

150. See, e.g., Horst Hammen, *Zur Haftung bei der Stimmrechtsvertretung durch Kreditinstitute in der Hauptversammlung der Aktiengesellschaft*, 5 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT 239 (1993) [hereinafter Hammen, *Haftung bei der Stimmrechtsvertretung*].

tract<sup>151</sup> but courts so far have not had a chance to lay out firm principles regarding the violation of the duties of a proxy holder. According to the AktG, the liability may not be waived or limited.<sup>152</sup> In addition, the shareholders may have a tort claim under BGB section 823(2), which covers the infringement of the "protective provisions" of AktG sections 128 and 135 by the proxy holder.<sup>153</sup>

More importantly, in a recent judgment ("*Girmes-Entscheidung*")<sup>154</sup> the *Bundesgerichtshof* (Private Law Supreme Court) held a self-interested acting proxy holder liable for the damages caused to the corporation, or to those shareholders he had not represented at the annual meeting.<sup>155</sup> The proxy holder had refused to assent to the financial reorganization of the Girmes AG by way of capital reduction. Shortly after, the corporation had to file for bankruptcy. A shareholder filed a law suit against the proxy holder to compensate the loss on his shares. The Court held for the plaintiff and remanded the case for further discovery on the facts. The Court did not decide the case on the grounds of corporate law, but simply drew an analogy to a well-established rule in agency law<sup>156</sup> in order to reach the holding.<sup>157</sup> The underlying rationale is that

151. This is known as *positive Vertragsverletzung* [des Auftrages, BGB § 662]. This doctrine, which is not contained in the Civil Code, was developed by the courts soon after the BGB came into effect to cover breach of contract other than delay and impossibility of performance, including default in performance or insufficient performance. See Ingeborg Schwenzer, *The Law of Contracts*, in INTRODUCTION TO GERMAN LAW 173, 182 (Werner F. Ebke & Matthew W. Finkin eds., 1996).

152. See AktG § 135(11).

153. Under the provision of the BGB, a person who infringes a statutory provision intended for the protection of others (*Schutzgesetz*) is liable for any damage arising from the infringement. See Klaus Vieweg, *The Law of Torts*, in INTRODUCTION TO GERMAN LAW 197, 209 (Werner F. Ebke & Matthew W. Finkin eds., 1996). See also von Falkenhausen, *supra* note 48, at 77 (pointing out that the provisions of §§ 128 and 135 AktG have been designed to protect shareholders).

154. See Judgment of Mar. 20, 1995, Bundesgerichtshof [BGH], available in 50 JURISTENZEITUNG 1064 (1995). This judgment has been widely recognized as a landmark case because the Court imposed fiduciary duties (*Treuepflichten*) to minority shareholders which are owed to their fellow shareholders. See Marcus Lutter, *Das Girmes-Urteil*, 50 JURISTENZEITUNG 1053, 1056 (1995) [hereinafter Lutter, *Girmes-Urteil*].

155. Ironically, the defendant in the case was not a powerful proxy holder on its face but a kind of "self-appointed knight" who solicited proxies in order to fight the "greedy banks" on behalf of the small shareholders.

156. BGB § 179(1).

157. See Bundesgerichtshof, *supra* note 154, at 1067-1068. Compare BGB §

an agent who does not disclose the identity of the principal to a third party (and therefore makes it impossible for the third party to sue the principal), can be held liable. This is an exception to the general rule, which states that only the principal is liable for damage caused by the agent.<sup>158</sup> Also, the Court concluded that a liability of the proxy holder may be based on BGB section 826, which provides that "a person who wilfully causes damage to another in a manner contrary to public policy is bound to compensate the other for the damage."

Unfortunately, the question before the Court was not whether the same principles apply to a factual background in which a bank exercises the proxies of many small, uninformed shareholders who must rely on the bank's possibly misleading proposal. What might happen in this scenario if the exercise of the voting rights caused damage to the corporation and the bank decided to disclose the names of the shareholders? Shareholders might be sued by their fellow shareholders (or the corporation), although the failure is clearly on the shoulders of the superior bank. The liability of shareholders would definitely deter others from investing in equity, even if we only consider the possible scope of damages. In this case, where an "institutional proxy holder"<sup>159</sup> acts more or less independently, and is hardly controllable by a single shareholder, the shareholders themselves must be protected: The proxy holder should be the only one who is sued. To achieve this, it is not necessary to impose corporate duties of loyalty (*Treupflichten*)<sup>160</sup> (owed by shareholders regardless of their "controlling minority" or majority) on the bank because it has aggregated proxy voting power. It is sufficient to subject the bank to another well-established rule of German agency law: the notion of a self-interested agent who "plays the boss."<sup>161</sup> Admittedly, this requires

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179(1), with RESTATEMENT (SECOND) OF AGENCY § 322 ("Principal Undisclosed" provides "[w]hoever has entered into a contract as agent is, if he has not given proof of his authority, bound to the other party at his choice either to carry out the contract or to compensate him, if the principal refuses to ratify the contract").

158. See §§ 164(1), 164(3) & 278 Bürgerliches Gesetzbuch (BGB) [Civil Code].

159. See Lutter, *Girmes-Urteil*, *supra* note 154, at 1056.

160. For the majority view, see Hammen, *Haftung bei der Stimmrechtsvertretung*, *supra* note 150, at 242.

161. See Lutter, *Girmes-Urteil*, *supra* note 154, at 1056; KARSTEN SCHMIDT, *supra* note 45, at 861; Joachim Hennrichs, *Treupflichten im Aktienrecht—zugleich Überlegungen zur Konkretisierung der Generalklausel des § 242 BGB sowie zur Eigenhaftung des Stimmrechtsvertreters*, 195 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS

that the prerequisites for such liability can be extended, as carved out by case law. So far, only an agent who has some economic interest in closing the deal, or who induces additional firm reliance regarding the correctness of his or her statements, may be subjected to personal liability.<sup>162</sup> However, it also seems plausible that an agent with 'immaterial interest' may be held liable. Thus, the bank itself becomes a "quasi shareholder" with the inherent duties. This notion of the self-interested agent would give fellow shareholders who are not clients of the damage-causing proxy holder an efficient, tort-like private cause of action.

However promising and far-reaching all this may sound, it is not firmly grounded in German law. In the *Girmes* judgment, the *Bundesgerichtshof* explicitly declined to rely on the doctrine of the self-interested agent. Also, the judgment of *Oberlandesgericht Düsseldorf*<sup>163</sup> (district court of appeals), the court to which the case was remanded, reveals that the holding of the *Bundesgerichtshof's* judgment is narrow and under-inclusive: Both BGB section 179 paragraph 1, and section 826 require "intent" (*Vorsatz*) as a precondition to liability. As a general rule, intent implies awareness of the violation of the duty (*Bewußtsein von der Pflichtwidrigkeit*), thus providing the proxy holder with a powerful defense. This presents a threshold that is possibly too high to ever hold a proxy holder liable.

It may be true that in a classical arms-length principal-agent relationship, the general rule in BGB section 164 paragraph 1 is followed. However, it should be recognized that this constellation is not comparable to the bank-shareholder relation in which the agent benefits from the advantage of "asymmetric information." The small shareholder's inferior knowledge compels him to rely entirely on the bank.<sup>164</sup>

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222, 262-67 (1995).

162. For a comprehensive discussion see Hennrichs, *supra* note 161, at 266; Joachim Hennrichs, *ENTSCHEIDUNGSSAMMLUNG ZUM WIRTSCHAFTS- UND BANKRECHT* (WuB) II A. § 135 AktG 1.95. *But see* Bundesgerichtshof, *supra* note 154, at 1072; Hammen, *Haftung bei der Stimmrechtsvertretung*, *supra* note 150, at 244; Markus Brender, *ENTSCHEIDUNGSSAMMLUNG ZUM WIRTSCHAFTS- UND BANKRECHT* (WuB) II A. § 135 AktG 1.94.

163. Oberlandesgericht Düsseldorf, judgment of June 14, 1996, *reprinted in* 49 *WERTPAPIERMITTEILUNGEN* 1366 (1996). For a critical review, see Joachim Hennrichs, *ENTSCHEIDUNGSSAMMLUNG ZUM WIRTSCHAFTS- UND BANKRECHT* (WuB) II A. § 135 AktG 1.95.

164. See Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note

In sum, despite those remaining problems, the judgment of the *Bundesgerichtshof* has opened a new door to the issue of liability of proxy holders. The development is not yet concluded. It seems not beyond contemplation that this trend might eventually spread to other grounds of liability. All of this raises other, rather complex questions concerning burdens of proof, and of the correct assertion of damages.<sup>165</sup> However, if it is further pursued, it hopefully will (together with the proposed enlarged disclosure requirements), elaborate the duty of loyalty, police the banks' performance and restore reliance to the present system.

*D. Other Legal and Economic Pressures for Reforming or Supplementing the German Proxy System*

1. The European Perspective

After having examined the proxy system in Germany, and having tried to suggest some modification, another problem remains to be discussed. We do not address the question of whether the present system should be changed because of its weakness, but rather whether it *has* to change, in order to respond to outside legal or economic pressure.

At the outset, one of the forces that push different proxy systems toward convergence may be the increased law-making output of the European Community (EC). Here, one may assume, competing systems such as the depository voting in Germany, or the American-like proxy voting in England (both are not perfect) will merge and create a third alternative.

As a matter of fact, quite the opposite seems to be occurring. The European Company Law is presently not among the high priorities or first class legislative plans, even though there are 13 Directives dealing with this subject.<sup>166</sup> Over the last 20 years the EC has published those "proposals" focussing

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53, at 547.

165. See *Bundesgerichtshof*, *supra* note 154, at 1065. As to the Court, the decline of the stock market price may be a factor to assert the damages.

166. Also, there is a proposal to create a European Corporation ("societas europaea") which is not supposed to substitute but to supplement the national corporation laws of the Member States. Like the European Economic Interest Group (EEIG), it is believed to facilitate cross-border incorporations and mergers. However, after twenty years of discussions it seems naive to expect a major reform to result from this. See KARSTEN SCHMIDT, *supra* note 45, at 38.

primarily on stock corporations and limited liability companies. However, most of them seem to be nothing but rough guidelines for harmonization. Only the Fourth<sup>167</sup> and Seventh<sup>168</sup> Directives (the so-called financial statement directive and the directive on public disclosure of consolidated accounts) had significant impact.<sup>169</sup> The Fifth Directive<sup>170</sup> reflects the variety of different corporate governance systems in the European countries, rather than pushes the Member States of the Community into one certain direction. Certainly, a directive that enables the Member States to choose among six different corporate governance systems (out of which two could exist in parallel fashion under the transformed national law) is not a strong and carefully thought out model that calls for harmonization of laws.<sup>171</sup> However, given the development in other fields of European law (e.g., banking regulation and supervision), the influence of the directive should not be underestimated. For our discussion, the following should be observed: Even though the proposed model recognizes proxy voting by management,<sup>172</sup> the model seems to favor proxy voting by professional intermediaries holding themselves out for just this type of financial service.<sup>173</sup> From a German perspective, it would not make sense to simply replace a proxy system with conflict-of-interest issues, only to implement another with even more severe problems of the same type that demand high administrative (and costly) efforts to correct fiduciary abuses.<sup>174</sup> The

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167. See Council Directive No. 78/660 O.J. (L 222) 11 (1978) (on the annual accounts of companies).

168. See Council Directive No. 83/349 26 O.J. (L 193) 1 (1983) (on consolidated accounts of companies).

169. Uwe H. Schneider, *The Development of European Private Law and its Relationship to Domestic Systems of Law*, 10 BANKING & FINANCE L. REV. 301, 324 (1995). For more on these directives, see MARCUS LUTTER, *EUROPÄISCHES UNTERNEHMENSRECHT* 40, 53 (1991).

170. See *Amended Proposal for a Fifth Council Directive based on Art. 54 of the EEC Treaty*, in 2 EUROPEAN COMPANY AND FINANCIAL LAW [EUROPEAN COMMUNITY LAW: TEXT COLLECTION] 781 (Klaus J. Hopt & Eddy Wymeersch eds., 1994) [hereinafter *Amended Fifth*].

171. See LUTTER, *EUROPÄISCHES UNTERNEHMENSRECHT*, *supra* note 169, at 50.

172. See *Amended Fifth*, art. 28(2).

173. See Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 535.

174. See Zöllner, *Die Ausübung des Stimmrechts für fremde Aktien*, *supra* note 72, at 605-07; Eike von Hippel, *Zur Problematik des Aktionär-Stimmrechts*, in *IUS PRIVATUM GENTIUM: FESTSCHRIFT FÜR MAX RHEINSTEIN*, 1081, 1092 (1969).

decisive factor is that through a committee, directors and officers can act as proxy holders for the shareholders of their corporation:<sup>175</sup> Under present German law, the rationale of AktG section 71b and section 71d, which provide that the corporation may not exercise rights flowing from its own shares, clearly shows that management is not supposed to have that kind of influence on voting on corporate affairs.<sup>176</sup>

Regarding the procedure and restrictions on conferring discretionary authority on proxies, the European law appears to be substantially identical to the German Stock Corporation Act.<sup>177</sup> Concurrently, European Law is clearly in favor of the universal banking system which theoretically enables German banks to maintain their role as influential intermediaries.<sup>178</sup> The Second Banking Directive<sup>179</sup> not only provides for mutual recognition of banking licenses among European Union Mem-

175. See KLEIN & COFFEE, *supra* note 29, at 119 (pointing out that the right to vote is much like that of a citizen's right in a representative democracy). German scholars argue that if the directors to be elected control the election system, a system of control by (small) shareholders develops into a means to divest control from them. This is bound to increase management power and to violate the principle of "separation of powers." See Möhring, *supra* note 72, at 135; Bernhard Grossfeld & Werner Ebke, *Probleme der Unternehmensverfassung in rechtshistorischer und rechtsvergleichender Hinsicht (II und Schluß)*, 22 DIE AKTIENGESELLSCHAFT 92, 95 (1977) [hereinafter Grossfeld & Ebke, *Unternehmensverfassung*]. See also BERLE & MEANS, *supra* note 4, at 138 (outlining the American perspective). "The proxy machinery has thus become one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him." *Id.* Even after the implementation of the Securities Acts, this remains to be true to some degree.

176. See KARSTEN SCHMIDT, *supra* note 45, at 862. See also AktG § 136(1) (considering the rationale of the law). But see FRANKFURTER ALLGEMEINE, *supra* note 116 (outlining the dispute over Deutsche Telekom's "trust model").

177. See Köndgen, *Duties of Banks in Voting Their Clients' Stock*, *supra* note 53, at 535. For a closer look at the differences, see *Amended Fifth*, *supra* note 170, arts. 27, 28; Wendy N. Munyon, *Shareholders' Rights in the Common Market: A Comparative Study*, 9 CORNELL INT'L L.J., 191, 219 (1976).

178. See CORPORATE GOVERNANCE IN EUROPE, CENTRE FOR EUROPEAN POLICY STUDIES, Working Party Report No. 12, 27, iii ("Banks or institutions that keep shares under custody should be instrumental in this activity."); Hopt, *Takeover Law in the EC*, *supra* note 144, at 169. In the U.S. the "Glass Steagall barrier" seems to erode slowly. See Buxbaum, *Institutional Owners*, *supra* note 125, at 19; Macey & Miller, *Corporate Governance*, *supra* note 120, at 110.

179. See Second Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions, and Amending Directive No. 77/780/EEC, 89/646 O.J. (L 386) 1 (1989).

ber States, but also does not contain restrictions on bank holdings in non-bank firms. Its annex is based on the universal banking model, since it does not distinguish between commercial and investment banking, and is liberal as to securities powers.<sup>180</sup> In sum, one should not expect too much from European law regarding a dramatic change of German corporate law.

## 2. The Proceeding Economic and Legal Reform in Germany

A convergence of economic, technological and social forces distorts prevalent conditions, and may make it necessary to react in legal terms. At present, there is much occurring in Germany that may influence corporate governance and lead its legal framework toward a new direction. As elsewhere, the application of enhanced computer and communication technologies has facilitated international competition among financial centers. Much attention has been given to the globalization of capital markets, particularly in Germany, since the clear export orientation of its economy triggers many financial transactions which are international by nature.<sup>181</sup> By virtue of this growing concern on the competitiveness and efficiency of German capital markets ("*Finanzplatz Deutschland*"), a number of supposedly supporting laws have already been enacted. Broadly speaking, the Financial Market Promotion Act (*Finanzmarktförderungsgesetz*) intends to promote a development of increased quantity, quality and diversity in Germany.<sup>182</sup> These laws, which may also encourage foreign investors to become active in German markets, address the shallowness of German capital markets. Scholars and practitioners have realized that, in order to stay competitive in the European (if not worldwide) markets, a larger number of German companies should acquire capital in equity, rather than in debt. In order to fight an evident liquidity problem of smaller German companies, and to promote more stock listings, another Ger-

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180. Gruson & Schneider, *supra* note 86, at 342.

181. See Rolf Breuer, *Foreword*, in 5 GERMAN CAPITAL MARKET LAW (Rolf U. Siebel et al. eds., 1995). It is noteworthy that increasing numbers of German scholars point out that German corporate law must submit to the realities of the global capital markets, for example with respect to international accounting standards. See Schäfer, *Tagungsbericht*, *supra* note 39, at 137.

182. See Breuer, *supra* note 181, at v.

man law, the Small Stock Corporation Act (*Kleine Aktiengesellschaft-Gesetz*)<sup>183</sup> tries to make equity financing more attractive to small or medium-sized German businesses, which are traditionally the backbone of the German economy. It is currently easier for a company to go public through selling equity shares.<sup>184</sup> Most importantly, the minimum par value of a single share has been reduced from DM 50 to DM 5.<sup>185</sup> Experts estimate that there are about two thousand companies, many of them still held by the founding family, which are well-suited to go public by selling shares.<sup>186</sup> Considering that the number of stock corporations listed on one of the eight German Stock Exchanges in 1991 was about 630,<sup>187</sup> this would create a remarkable increase. German lawyers are quite optimistic that the *Aktiengesellschaft* as a corporate form will become increasingly attractive to entrepreneurs, who in the past preferred the limited liability company (*Gesellschaft mit beschränkter Haftung*). Since there is also the question of mentality, it is uncertain if German companies and investors will choose this new alternative, which breaks with the prevailing reluctance to disclose details of one's income or wealth to the public. However, the first generation of heirs with a great deal of wealth excessively concentrated in their family founders' firms may well embark on this course. If this occurs, German capital markets will become notably deeper. In 1996, we witnessed the formerly state-owned Deutsche Telekom go public.

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183. See Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts [Small Stock Corporation Act], v. 02.08.1994 (BGBl. I S.1961).

184. More specifically, the Act deregulates some of the more rigid provisions concerning formation, shareholders' meetings and employees' codetermination. See James H. Freis, Jr., *An Outsider's Look Into The Regulation Of Insider Trading in Germany: A Guide To Securities, Banking, And Market Reform in Finanzplatz Deutschland*, 19 B.C. INT'L & COMP. L. REV. 1, 105-06 (1996).

185. See AktG § 8(1), as amended 02.08.1994 (BGBl. I S.1967). But see Assmann et al., *supra* note 71, at 142 (observing that to date, only few companies have made use of the possibility either to reduce the nominal value of outstanding shares to the minimum of DM 5 or to issue new shares with such minimum nominal value).

186. See Freis, *supra* note 184, at 106-07.

187. See Kübler, *German Dilemma*, *supra* note 130, at 101. The number of truly public corporations seems to be even smaller. The estimates range from forty to eighty companies. *Id.* at 102. At present, the total value of all stock traded at German stock exchanges is only about 800 billion Deutschmarks. Trading in stock of the 30 biggest corporations comes to 86% of the turnover at German stock exchanges. See Dieter Feddersen et al., *Einführung*, *supra* note 11, at 2.

As never before, a six-month advertising campaign preceding the issuance of the new shares. The campaign attempted to promote the shares as "the shares for the people," and to induce as many small investors as possible to buy the shares. Both the Government and the top echelons of German business hoped that the Deutsche Telekom offering would be so big and so successful that it might fundamentally dissuade Germans from a deep-rooted cultural conviction that shares are too risky, and create a new *Aktienkultur* (equity culture).<sup>188</sup> Issues of new shares have been heavily oversubscribed. It is not beyond contemplation that this might eventually be only the beginning of a new trend. Other privatization will follow.<sup>189</sup> Also, the development may be slowly strengthened by increased retirement funding through private pension funds. Right now these funds play a minor role in Germany because of the very comprehensive social security system. Given the aging of German society, and the permanent concern of the financing of social security, it is likely that private retirement plans will become more important in the future.<sup>190</sup>

It is conceivable that all of this, along with a larger number of active international investors in German capital markets, eventually will trigger a new ownership structure.<sup>191</sup> Even though there is hope for more private-party equity investment, the "institutionalization and globalization"<sup>192</sup> of equity investments seems to be determinant. Concurrently, the

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188. See Edmund L. Andrews, *Eager Germans Drive Up Deutsche Telekom on Opening Day*, N.Y. TIMES, Nov. 19, 1996, at D5. It is noteworthy that the number of individual shareholders has declined over the years. Right now only 17% of German shares are held by small private investors. See Dieter Feddersen et al., *Einführung*, *supra* note 11, at 2.

189. In 1997, the German government sold its remaining stake in Lufthansa AG, in an initial public offering. Government officials also hope to hold public offerings in the postal service and in the postal bank, and to sell another big stake in Deutsche Telekom. See N.Y. TIMES, *supra* note 103, at D5; FRANKFURTER ALLGEMEINE ZEITUNG, Aug. 2, 1997, at 13; FRANKFURTER ALLGEMEINE ZEITUNG, Sept. 30, 1997, at 17.

190. This seems to be a European trend. See CORPORATE GOVERNANCE IN EUROPE, *supra* note 178, at 29-31; Hauck, *supra* note 131, at 555.

191. See CORPORATE GOVERNANCE IN EUROPE, *supra* note 178, at 34-36 (analyzing the increased activism of institutional investment-oriented shareholders). See also U.S. Equity Markets and the New York Stock Exchange, 1997 NYSE WORKING PAPER 29-39 (on file with the authors) (stating that with regard to George Sofianos, the move into non-U.S. Equity will continue).

192. See Schneider & Burgard, *Hauptversammlungspräsenz*, *supra* note 69, at 789.

greater investor diversity might break up the intimate German "relational banking" and distort the conditions for corporate control in Germany. The corporations might also go to foreign markets to raise capital,<sup>193</sup> or simply ask foreign banks for financial services.<sup>194</sup> Also, large foreign investors might not give German banks the power to exercise proxy votes for them.<sup>195</sup> As the performance of the Deutsche Bank suggests, German banks are aware of these new risks and try hard to avoid them. The banks seem to have realized that the durability (or at least adaptability) of existing bank-industry networks is at stake and demands a new move.<sup>196</sup> Beginning with its acquisition of Morgan Grenfell in 1990, Deutsche Bank has moved aggressively to establish itself as a global investment bank.<sup>197</sup> This, of course, is not only an economic issue, but also a legal corporate governance issue. If German banks loosen, or even give up<sup>198</sup> their function as intermediaries in the proxy process as an economic consequence, there will again be a danger of decreasing attendance at shareholders' meetings, and create subsequently random majorities. As stated above, nobody knows whether shareholder associations or institutional investors can fill this gap. The obvious lack of interest in monitoring demonstrated by foreign institutional investors is a problem.<sup>199</sup> It is equally likely that regional banks, which are

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193. In the nineties, we have experienced a dramatic increase of non-U.S. companies at the NYSE. In 1990 there were 96, but in 1996 there were 290. See NYSE WORKING PAPER, *supra* note 191, at 31-32. It was Mercedes Benz AG which was listed on the New York Stock Exchange in 1993.

194. See Conard, *supra* note 132, at 2193.

195. The increasing offshore investments by United States institutional investors, with their new importance and activism in U.S. corporate governance, are likely to have a significant impact on foreign corporate governance in the long run. See Fanto, *Transformation*, *supra* note 2 (outlining the situation in France).

196. See Buxbaum, *Institutional Owners*, *supra* note 125, at 18.

197. See N.Y. TIMES, *supra* note 103; Schneider-Lenné, *supra* note 100, at 302.

198. German bankers have announced that they will not fight curbs on their control over proxy machinery. They have also stated that after a significant reform, a cost-benefit analysis might force them to give up their proxy services. See Hopt, *Corporate Governance*, *supra* note 96, at 259. But see Mark J. Roe, *German "Populism" and the Large Public Corporation*, 14 INT'L REV. L. & ECON. 187, 198 (1994) (stating that this announcement was simply an attempt "to dampen public protest" which may lead to American-style legal restrictions on banks). This is clearly not the case, because despite all discussions, there has never been doubt cast upon the universal banking system.

199. See Kübler, *German Dilemma*, *supra* note 130, at 105-106; Schneider & Burgard, *Hauptversammlungspräsenz*, *supra* note 69, at 789. But see Fanto, *Trans-*

generally regarded as more small investor-oriented, might see their chance and offer voting services with greater vigor, if more private persons are attracted by equity investment.

In any event, at some point, it may even be possible to provide for proxy voting by management, regardless of its apparent disadvantages. Therefore, the tentative lesson that EC Law might teach is that the different proxy systems should be considered as supplementary, rather than as mutually exclusive.<sup>200</sup> As this paper has discussed, they are not very different. Also, both systems have proven to be vital elements in successful different corporate governance systems, whereas other proposals seem to be highly theoretical. Whether they can exist alongside each other within one national corporate governance system, whether they merge, or if one extirpates the other, is a question of empiricism: What will the preference of global market participants be? Only the future will determine the result of this type of "corporate evolution."

## PART II. JUDICIAL ENFORCEMENT OF DIRECTORS' DUTIES IN PUBLICLY-HELD CORPORATIONS UNDER U.S. AND GERMAN LAW

### A. *Derivative Shareholder Suits under U.S. Law*

As can be seen from the above discussion, the exercise of voting rights is a necessary, yet insufficient feature of shareholder participation in corporate decisionmaking. It sets principles for fundamental corporate affairs, rather than immediately solving current agency problems. This is where (derivative) shareholder litigation steps in.

The stark separation between shareholders and management has resulted in an enormous number of shareholder suits in the United States. As one way of aligning managers' incentives with shareholders' interests, American law, since at least the middle of the 19th century, has permitted shareholders to sue to redress the damages caused by managerial misbehavior.

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formation, *supra* note 2, at 3 (stating that it is too costly for institutional investors to always use the "Wall Street Rule" of selling their significant stakes if they are discontented with management).

200. See Baums, *Takeovers*, *supra* note 69, at 183.

### 1. Management's Fiduciary Obligations

Shareholders of large, publicly-held companies must inevitably rely on management to run the company's business. In carrying out their functions, however, managers act only as agents of the shareholders. The agency relationship between shareholders and managers creates strict fiduciary obligations on the part of management. Two components can be distinguished: The duty of care and the duty of loyalty.<sup>201</sup>

Regarding the duty of care, New York corporate law expressly requires that "[a] director shall perform his duties . . . in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."<sup>202</sup> In other states, comparable requirements exist. While it is far from clear exactly what this standard suggests in a particular situation,<sup>203</sup> U.S. courts and scholars seem to agree that the duty of care primarily places upon management an obligation to exercise reasonable skill and diligence in monitoring corporate affairs and taking board action.<sup>204</sup>

The duty of loyalty, on the other hand, generally requires managers to maximize investors' wealth rather than their own, and creates a duty of fair dealing in self-interested transactions. Whenever conflicts of interests arise, the duty of loyalty requires management not to profit at the corporation's expense.<sup>205</sup> However, almost all states have procedures for cleansing such transactions through a process of disclosure and approval by either disinterested directors or shareholders.

Breaches of the duty of loyalty are regarded as more serious than failure to exercise reasonable care. Hence, different liability standards exist. In the duty of care context, the business judgment rule reflects the nature of profit-maximizing

201. Both duties have in common that the violation of either involves increased agency costs, economic conflicts of interests, and a reduction of shareholder wealth. See EASTERBROOK & FISCHER, *supra* note 6, at 103.

202. N.Y. BUS. CORP. L. § 717(a) (McKinney 1998).

203. For a thorough analysis, see Richard M. Buxbaum, *The Duty of Care and the Business Judgment Rule in American Law Recent Developments and Current Problems*, in DIE HAFTUNG DER LEITUNGSORGANE VON KAPITALGESELLSCHAFTEN 79-102 (Karl Kreuzer ed., 1991) [hereinafter Buxbaum, *Business Judgment Rule*].

204. Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 56 (1991).

205. See Swanson, *Corporate Governance*, *supra* note 1, at 436.

decisionmaking: i.e., it requires the taking of risks.<sup>206</sup> The business judgment intends to preserve managerial risk-taking by presuming managerial diligence and good faith in making business decisions. In effect, it regularly shields the board from liability.

## 2. The Mechanics of Derivative Enforcement

U.S. law allows shareholders to enforce the obligations of management.<sup>207</sup> In doing so, however, they can act only on the corporation's behalf. Because corporate officials owe their duties of loyalty and care primarily to the corporation as their contractual partner, and only indirectly to shareholders,<sup>208</sup> a lawsuit on the basis of a breach of these duties primarily "belongs" to the corporation.<sup>209</sup> Therefore, a lawsuit generally can only be brought by those who are the company's agents, i.e., its managers. However, since the agents might understandably be reluctant to sue themselves, shareholders may in such situations step in to enforce the manager's obligation.<sup>210</sup> Because their right to sue only derives from the corporation, such a lawsuit is called derivative.<sup>211</sup>

Because the lawsuit primarily is the corporation's, a shareholder who intends to commence an action against faulty board members must first demand that the board of directors initiate

206. See Buxbaum, *Business Judgment Rule*, *supra* note 203, at 81.

207. To be sure, under U.S. law shareholders may litigate against any party against whom the corporation has a legal claim. This article, however, focuses on suits brought against a corporation's own managers.

208. See FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW*, *supra* note 27, at 104.

209. See *Levine v. Smith*, 591 A.2d 194, 200 (Del. 1991).

210. See *Ross v. Bernhard*, 396 U.S. 531, 534-35 (1970) (making a "valid claim on which the corporation could have sued" a precondition of a derivative action).

211. See N.Y. BUS. CORP. L. § 626(a) ("Action . . . in the right of a . . . corporation to procure judgment in its favor . . ."). See also Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops The Ball*, 77 MINN. L. REV. 1339, 1339-43 (1993) [hereinafter Swanson, *Derivative Litigation*]; Richard M. Buxbaum & Uwe H. Schneider, *Die Fortentwicklung der Aktionärsklage und der Konzernklage im amerikanischen Recht*, 11 ZEITSCHRIFT FÜR UNTERNEHMENS UND GESELLSCHAFTSRECHT 199, 204 (1982). Shareholders may additionally sue managers directly on the basis of an alleged wrong that effects their individual capacities. Insofar as they do not have to refer to any harm caused to the corporation. See 2 AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS*, Part VII, Remedies 18-20 (1992); RALPH C. FERRARA ET AL., *SHAREHOLDER DERIVATIVE LITIGATION, BESIEGING THE BOARD*, § 1.02[2] (1998).

the necessary proceedings.<sup>212</sup> If the directors respond affirmatively by deciding to bring the action, a derivative suit is usually precluded. Generally, however, an affirmative response to a demand does not occur. The board is likely to be very tolerant toward the performance of one of its own members.<sup>213</sup> Recognizing the probability of reluctance on the side of the board, state corporate law under certain circumstances permits the plaintiff-shareholder to omit such a demand.

According to a recent decision of the New York Court of Appeals, a demand is considered futile: (1) When either the board's majority is directly interested in the challenged transaction<sup>214</sup> or the alleged wrongdoers control a majority of the directors; (2) When the board members did not adequately inform themselves about the transaction in question; or (3) When the challenged transaction was so egregious that it could not have been the product of sound business judgment.<sup>215</sup> However, general declarations of such circumstances do not suffice. To bypass the board, the plaintiff-shareholder must present particularized facts that support the alleged misbehavior or interest in the transaction.<sup>216</sup>

Interestingly, the demand requirement (and its futility under special circumstances) is by no means only a procedural issue. To the contrary, the "demand excused" situation also has an impact on the substantive aspect of the lawsuit.<sup>217</sup> Any demand necessarily suggests that the situations of the "demand excused" do not apply. Stated differently, a shareholder-plaintiff who considers such a demand necessary does not

212. N.Y. BUS. CORP. L. § 626(c) (McKinney 1998). See also CARY & EISENBERG, *supra* note 21, at 1034. Besides choosing to go forward with a lawsuit, the board may decide to use intracorporate remedies to avoid litigation. See *Grimes v. Donald*, 673 A.2d 1207, 1216 (Del. 1996).

213. See FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW, *supra* note 27, at 116 (noting there is a "natural human tendency to downplay the misbehavior of one . . . of its members").

214. Directors are self interested in a transaction if they will receive a personal financial benefit from the transaction not shared by stockholders generally.

215. See *Marx v. Akers*, 88 N.Y.2d 189, 189-200, 666 N.E.2d 1034, 1040-41 (1996). For a summary of the "reasonable doubt" approach pursued by the Delaware Supreme Court, see *Grimes v. Donald*, 673 A.2d, at 1216.

216. See N.Y. BUS. CORP. L. § 626(c) (McKinney 1998).

217. Since the demand requirement is one of the core problems of the derivative suit in U.S. law, this survey concentrates on some of its main features. Other aspects, such as the contemporaneous ownership rule or the requirement to post security for possible defendant expenses are not mentioned any further.

challenge a transaction in which board members are interested, but questions an alleged misfeasance by one or a few board members.<sup>218</sup> In failing to allege that the demand is futile, the shareholder therefore has actually admitted that the board is not controlled by the wrongdoer. In such cases, after the corporation has declined to initiate any legal proceeding, the board's refusal would be protected by the immunizing effect of the "business judgment rule."<sup>219</sup>

Unsurprisingly, therefore, shareholders often suggest that a demand is futile.<sup>220</sup> In a situation in which no demand on the board is necessary, however, a further question arises as to whether the board may still take control over the initiated proceedings. Broadly speaking, the answer appears to be as follows: The board might set up a committee of supposedly disinterested directors, which, after having investigated the challenged transaction, would generally recommend not to go forward with the lawsuit. Controversy has centered on the scope of judicial review to be applied to such decisions that terminate derivative suits. Under New York law, this decision would only be subject to minimal judicial review under the business judgment rule.<sup>221</sup> Delaware seems to pursue a somewhat less generous approach. According to the highest court in the state, the corporation holds the burden to establish "the independence and good faith of the committee and the basis supporting its conclusion."<sup>222</sup> Even when the burden is met, the court may also apply its own business judgment to consider the conflicting interests. The latter approach is considered to be favorable because it provides that courts, notwithstanding the board's decision, may in their own discretion balance the conflicting interests in allowing the lawsuit to proceed, thereby ensuring "that the derivative suit has at least some possibility of a corporate governance impact."<sup>223</sup>

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218. See FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW, *supra* note 27, at 108.

219. *Id.* at 118.

220. *Id.*

221. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979). See also CLARK, *supra* note 16, at 646 (summarizing the issue).

222. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (adopting balancing test for reviewing board committee's decision).

223. FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW, *supra* note 27, at 110.

Given that the plaintiff-shareholders meet all the requirements and win the case, any recovery will be paid to the corporation, and not to the shareholders prosecuting the lawsuit.<sup>224</sup> However, the corporation is at the same time obliged to pay for the plaintiff-shareholders' legal expenses.<sup>225</sup> Moreover, indemnification and insurance provisions in the corporate law, or in the by-laws of a corporation, regularly cover judgments against directors, unless they misbehaved intentionally or entered into self-interested transactions.<sup>226</sup> On the other hand, if the action is unsuccessful, the plaintiff's attorney and not the shareholder may bear the cost risk. In many cases lawyers are the driving force behind a lawsuit<sup>227</sup> and the shareholder, who may own only a few shares, serves only as a nominal plaintiff without any cost risk. Much has been said about the "nuisance value" of possible "strike suits." It has been argued that because the real party in interest is the lawyer, there might be an incentive to settle the lawsuit not for the benefit of the aggrieved shareholder but for the lawyer's own enrichment.<sup>228</sup> This observation appears to be supplemented by the fact that corporation's management might be eager to put the lawsuit behind it without a finding of liability, thereby possibly allowing the corporation to pay high plaintiff-attorney's fees.<sup>229</sup> However, since the corporation (and, indirectly, its owners the

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224. See Buxbaum & Schneider, *supra* note 211, at 204; FERRARA, *supra* note 211, § 1.02[2]. On rare occasions, however, the recovery is paid directly to the shareholders in order to prevent windfall gains by offending shareholders. See *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955).

225. See KLEIN & COFFEE, *supra* note 29, at 195 (noting the legal rule).

226. See FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW*, *supra* note 27, at 126-28; CLARK, *supra* note 16, at 664-674; Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 284-85 (1986).

227. See, e.g., *Joy v. North*, 692 F.2d 880 (2d Cir. 1982) ("The real incentive to bring derivative actions is usually not the hope of return to the corporation but the hope of handsome fees to be recovered by plaintiffs' counsel."), *cert. denied*, 460 U.S. 1051 (1983); KLEIN & COFFEE, *supra* note 29, at 196.

228. See KLEIN & COFFEE, *supra* note 29, at 196; Fischel & Bradley, *supra* note 226, at 263. But see Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney Rule in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 78 (1991) (suggesting that "strike suit litigation is relatively uncommon.")

229. See 2 AMERICAN LAW INSTITUTE, *supra* note 211, at 6; FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW*, *supra* note 27, at 110.

shareholders), would have to pay these fees, courts have wide discretion in reviewing the settlement of a derivative action and may well consider the probable corporate governance impact of allowing the lawsuit to go forward.<sup>230</sup>

In light of the enormous procedural complexity and numerous substantive requirements, commentators have doubted the importance of the derivative suit as a means of assuring management's performance. However, the decision by the Delaware Supreme Court in *Smith v. Van Gorkom*<sup>231</sup> appears to be a striking counter-example to this conclusion.

### B. *Shareholder Suits under German Law*<sup>232</sup>

Despite substantive limitations to the scope of liability rules and procedural obstacles to enforcement mechanisms, shareholder suits in the United States are still regularly described as one of the most striking and threatening ways that shareholders are able to monitor and exercise control over managers.<sup>233</sup> In contrast, such shareholder activity has hardly been a common feature of the German corporate landscape. At first glance, this might be somewhat surprising. This is because the pertinent language of the German Stock Corporation Act (*Aktiengesetz*) suggests, as we will see, that the requirements regarding the directors' duties are at least as strict as the requirements imposed upon their American colleagues.

#### 1. Germany's Statutory Approach Toward Managers' Liability

Members of the *Vorstand* (board of directors or board of managers) of a German corporation are under an obligation to carry out their functions "with the care of a diligent and conscientious manager."<sup>234</sup> As in the United States, this stan-

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230. See N.Y. BUS. CORP. L. § 626(d) (McKinney 1998).

231. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

232. The following outline is based on the *Aktiengesetz* of September 6, 1965 (BGBl. I S.1089). Current Amendments through the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)* of April 27, 1998 (BGBl. I S.786) will be discussed *infra*, Parts E & F.

233. For a discussion of some of the "intriguing phenomena" of the shareholder derivative suite, see CONARD, *supra* note 24, at 399; FERRARA, *supra* note 211, § 1.04; Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733, 1733 (1994).

234. See AktG § 93(1). For this translation, see SCHNEIDER & HEIDENHAIN,

dard places a burden on management to act in a fiduciary capacity and undertake activities which are *bona fide* in the company's best interest (*Unternehmensinteresse*). Managements' fiduciary duties toward the company under German corporate law are repeatedly referred to as *Loyalitäts- und Treuepflichten*.<sup>235</sup> Since the shareholders are the "ultimate owners" of each corporation, courts and scholars interpret the somewhat sweeping language of *Aktiengesetz* section 93 paragraph 1 as primarily embracing the notion of aggregated shareholder interest and long-term profit maximization. However, there is a long-standing debate in Germany about the strong emphasis on protecting shareholder interest.<sup>236</sup> Some scholars maintain that corporate officers owe fiduciary duties not only to shareholders, but also to other constituents, such as employees.<sup>237</sup> Creation and maintenance of "shareholder value" as the first and foremost goal of management is still a source of discussion and is not easily explained.

AktG section 93, paragraph 3 enumerates specific actions

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*supra* note 9, at 94.

235. See Willi Joachim, *The Liability of Supervisory Board Directors in Germany*, 25 INT'L LAW. 41, 56 (1991) (citing further references). Joachim puts into question whether the *Loyalitäts- und Treuepflichten* of German managers should be translated as "fiduciary duties." Despite differences between the concepts of trust and responsibility under Anglo-Saxon law and the pertinent doctrines under German law, for the purposes of this article, *Loyalitäts- und Treuepflichten* may nevertheless be translated as "fiduciary duties."

236. In the U.S., a somewhat similar discussion about broadening the scope of fiduciary duties has taken place. See Oliver Hart, *An Economists View of Fiduciary Duty*, 43 U. TORONTO L.J. 299, 303-05 (1995) (indicating a critical economic viewpoint).

237. See Klaus J. Hopt, *Directors' Duties to Shareholders, Employees and Other Creditors: A View from the Continent*, in COMMERCIAL ASPECTS OF TRUST AND FIDUCIARY OBLIGATIONS 115, 116 (Ewan McKendrick ed., 1992) [hereinafter Hopt, *Directors' Duties*]. To be sure, no scholar has yet maintained that shareholders' and employees' interests should be put on a par. Under the Amended Proposal for a Fifth Company Law Directive of 20 November 1991, management is required to "carry out their functions in the interest of the company, having regard to the interest of the shareholders and the employees." See *Amended Fifth*, *supra* note 170, at 788 (emphasis added). See also EUROPEAN COMPANY AND FINANCIAL LAW, [EUROPEAN COMMUNITY LAW TEXT COLLECTION] 781, 788 (Klaus J. Hopt & Eddy Wymeersch eds., 1994) (indicating the text); Clark D. Stith, *Federalism and Company Law: A "Race to the Bottom" in the European Community*, 79 GEO. L.J. 1581, 1596 (1991) (criticizing the provision as "hopelessly vague"). Due to objections to other provisions of the Fifth Directive, however, this provision has not been enacted. See Terence L. Blackburn, *The Unification of Corporate Laws: The United States, the European Community and the Race to Laxity*, 3 GEO. MASON INDEP. L. REV. 1, 81 (1994).

which are regarded as *per se* violations of managers' obligations. For example, managers are liable for corporate damages if they, contrary to the law's provisions, repay capital contributions to shareholders, issue share certificates before capital is paid in, or distribute company assets.<sup>238</sup> Yet, the standard of care and loyalty is not confined to the duties that are expressly spelled out by the *Aktiengesetz*. The broad wording of section 93 of the AktG, the general clause, is clearly intended to encompass duties which are not explicitly mentioned in the statute.<sup>239</sup> Cheating, personal self-dealing, and the use of corporate opportunities is (although not explicitly regulated in the *Aktiengesetz*), undoubtedly regarded as a violation of AktG section 93, paragraph 1.<sup>240</sup> Besides, the German standard of loyalty and care remains flexible to a large extent, leaving room for a closer determination on a case-by-case basis.

Failure to adhere to the standards imposed on the *Vorstand* results in managers' liability to the corporation. Whereas the standards of care and loyalty are objective, subjective elements are taken into account when the individual's personal liability is determined.<sup>241</sup> Managers' liability may be joint or several. While any manager who acted faultily is initially accountable for all damages, other board members incur liability if their failure to notice the transaction or to intervene effectively is a violation of their own fiduciary duty to keep themselves informed.<sup>242</sup> In a proceeding to recover damages

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238. See Georg A. Wittuhn, *Liability of Corporate Directors, Chapter 8: Germany*, in *LIABILITY OF CORPORATE DIRECTORS* 295, 304-06 (Dennis Campbell & Christian T. Campbell eds., 1993) (providing a brief analysis). It should be noted that members of the supervisory board (*Aufsichtsrat*) are subject to the same standard of care. See AktG § 116. However, due to the different scope of activities, there is some discussion in Germany about whether the distinction should be made. See Hopt, *Directors' Duties*, *supra* note 237, at 116-17. In any event, different liability standards may only result from the different nature of their duties, rather than from a different legal concept of liability. See Joachim, *supra* note 235, at 44. Accordingly, AktG § 116, the section that deals with *Aufsichtsrats'* liability, simply refers to AktG § 93, the section which sets out *Vorstands'* accountability.

239. See Joachim, *supra* note 235, at 59.

240. See Joachim, *supra* note 235, at 53-55 (although he focuses on the *Aufsichtsrat*, the author states that similar duties arise as far as the *Vorstand* is concerned).

241. See Joachim, *supra* note 235, at 41, 62; Eckert, *supra* note 53, at 39 (observing that "a defense based on subjective grounds such as unfitness or inexperience has not been successfully employed") (citations omitted).

242. See UWE HÜFFER, *AKTIENGESETZ* 398 n.13 (3d ed. 1997); GÜNTER HENN, *HANDBUCH DES AKTIENRECHTS* 243 (1991).

for wrongful acts, managers bear the burden of proving adherence to the required standard of conduct.<sup>243</sup> And, although managers are sheltered from liability if they act pursuant to a valid shareholders' resolution, authorization by the supervisory board (*Aufsichtsrat*) does not preclude responsibility.<sup>244</sup>

## 2. Enforcing Liability Under German Corporate Law Framework

As we have seen, the German Stock Corporation Act, on its face, sets a considerably high standard of duties, and thus seems to provide for strong shareholder protection against board members' wrongdoing.<sup>245</sup> However, statutory regulations designed to establish managerial liability mean little if no efficient mechanism for their enforcement is available.<sup>246</sup> In fact, closer examination reveals great differences between the way the *Aktiengesetz* addresses managers' obligations, and the mechanics the statute provides for their enforcement. Perhaps the most substantial barrier to shareholder suits in Germany is the doctrinal framework which embraces the statutes' remedial provisions.<sup>247</sup>

The first hurdle placed before the prospective shareholder plaintiff appears when the principle of the corporation as a separate entity comes into view.<sup>248</sup> While U.S. corporate law also adheres to this idea, the German doctrine, different from the somewhat more pragmatic U.S. approach, applies it literally without any exception.<sup>249</sup> Under the Stock Corporation Act, the following line of argument evolves: No contractual relationship exists between the managing group and the shareholder

243. See AktG § 93(2).

244. See AktG § 93(4); Steefel & von Falkenhausen, *supra* note 62, at 530.

245. See Marc von Samson-Himmelstjerna, *Persönliche Haftung der Organe von Kapitalgesellschaften*, 89 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFTEN 288, 303 (1990) (indicating the similarity of the U.S. and German standards). But see Steefel & von Falkenhausen, *supra* note 62, at 531 (stating the fiduciary duty "falls short of the standard set in American case law and statutes").

246. See Grossfeld, *Management and Control*, *supra* note 102, at 56.

247. See generally Munyon, *supra* note 177, at 231. For the current changes, see *infra*, Part F.

248. See AktG § 1(1) (stating "The stock corporation is a company which constitutes a separate legal entity").

249. See Eckert, *supra* note 53, at 12. See generally Kübler, *German Dilemma*, *supra* note 130, at 98 ("The general structure of German corporate law is very rigid").

group.<sup>250</sup> Managers are officers of the corporation and their employees only. Therefore, directors can owe their duties only to their contractual partner, the corporation.<sup>251</sup> And, since the procedural side of suing usually mirrors the substantive law, i.e., the right to bring an action on the basis of a breach of duty follows this duty and its beneficiary, enforcement of managerial duties has to lie in the hands of the corporation. Although it is obvious that any violation of duty that harms the corporation is likely to have a negative impact on the value of the shares (and thus to its shareholders as well), such "indirect" harm is deemed to be outside the scope of the pertinent doctrinal concept.<sup>252</sup> In other words, as far as enforcement is concerned, "indirect" harm to shareholders is regularly regarded as legally irrelevant.<sup>253</sup>

Under German law, the pursuit of all kinds of claims is, in principle, left to the managers.<sup>254</sup> At the same time, however, as in the United States, there is some apprehension that managers will not take an action on behalf of the company against

250. See Eckert, *supra* note 53, at 60; Richard M. Buxbaum, *Extension of Parent Company Shareholders' Rights to Participate in the Governance of Subsidiaries*, 31 AM. J. COMP. L. 511, 513 (1983) [hereinafter Buxbaum, *Governance of Subsidiaries*].

251. See Buxbaum, *Governance of Subsidiaries*, *supra* note 250, at 513; Peter Schlechtriem, *Schadenersatzhaftung der Leitungsorgane von Kapitalgesellschaften*, in DIE HAFTUNG DER LEITUNGSORGANE VON KAPITALGESELLSCHAFTEN 9, 61 (Karl Kreuzer ed., 1991); Uwe H. Schneider, *Haftungsmilderung bei fehlerhafter Unternehmensleitung?*, in FESTSCHRIFT FÜR WINFRIED WERNER 795, 799 (1991) [hereinafter Schneider, *Haftungsmilderung*]; von Samson-Himmelstjerna, *supra* note 245, at 291; Joachim, *supra* note 235, at 64.

252. A mere depreciation of equity holdings in a corporation does not constitute a direct damage under German law. However, case law has established liability in a situation in which management sells shares to a purchaser with the "conditional intent" (*bedingtem Vorsatz*) that the stock price would subsequently fall. See Eckert, *supra* note 53, at 67.

253. See HÜFFER, *supra* note 242, § 93, cmt. 19; HANS-JOACHIM MERTENS, 2 KÖLNER KOMMENTAR ZUM AKTIENGESETZ § 93 (2d ed., 1990) (both leading commentators in the field of corporate law); Eckert, *supra* note 53, at 43. See also Aharon Barak, *A Comparative Look at Protection of the Shareholder Interest: Variations on the Derivative Suit*, 20 INT'L & COMP. L.Q. 22, 39 (1971) (stating that the "company is the party affected, and, therefore, it alone is entitled for relief"). Based on tort principles, shareholders certainly have, in exceptional contingencies, individual causes of actions. See AktG § 117; Wittuhn, *supra* note 238, at 310; HÜFFER, *supra* note 242, at cmts. 1-14 (stating further details). However, since these actions are typically based on fraud or deceit, courts need not invoke a fiduciary relationship between the manager and the harmed shareholder. See Eckert, *supra* note 53, at 61.

254. See MERTENS, *supra* note 253, § 93, cmt. 51.

themselves. It has therefore been provided by statute that, in the case of breach of a fiduciary duty, both the power to decide whether the company should sue and the responsibility to file the suit has to be exercised by the supervisory board (*Aufsichtsrat*).<sup>255</sup> Yet, the *Aufsichtsrat* might also be reluctant to sue the allegedly faulty managers. One reason may be that the board deems the evidence insufficient for establishing a *prima facie* breach of duty case. Or members of the *Aufsichtsrat* may be too closely involved in management's activities to objectively perceive the supposed misconduct.<sup>256</sup> Finally, the board may, at times, even have been involved in a breach of fiduciary duties themselves. AktG section 147 provides that under such circumstances, a shareholders' meeting may be held upon the request of the shareholders. At this meeting, a majority of shareholders can decide (the *Aufsichtsrat's* reluctance notwithstanding), that the company should go ahead with an action against the supposed managerial wrongdoers. However, since the *Aufsichtsrat* is mainly elected by shareholders, and is supposed to represent them in any matter (including the issue of whether or not to initiate a lawsuit), it is somewhat unlikely that the majority of shareholders will contradict the *Aufsichtsrats'* decision not to sue and decide to vote in favor of enforcement.

Both the supervisory board's refusal, and the concurring vote of the majority, can be set aside by a group of minority shareholders. To be heard, such a group must represent at least one tenth of the stated capital for a minimum of three months prior to the date of the shareholders' meeting.<sup>257</sup> A class action is traditionally unknown in Germany.<sup>258</sup> Assuming shareholders meet this high capital requirement,<sup>259</sup> they

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255. It should be noted that, on the other hand, actions against members of the supervising group have to be asserted by the managing group. See AktG § 78.

256. See Barak, *supra* note 253, at 39.

257. See AktG § 147(1). But see discussion *infra* Part F.

258. See Joachim, *supra* note 235, at 41, 66. Once this capital holding requirement is met, such shareholders may prevent any waiver of the claim being approved by a general meeting. See AktG §§ 50, 93(4).

259. See Roger Kiem, *Diskussion zu den Referaten Mertens und Coffee*, in CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT 214 (Dieter Feddersen et al. eds., 1996) (summarizing the contribution of a German participant who remarked that, in the case of *Metallgesellschaft*, the minimum stated capital required to initiate a lawsuit against management would have been

may, for the purpose of redressing the damages, also appoint a special representative (*Besonderer Vertreter*).<sup>260</sup> However, they are not entitled to sue the directors derivatively on behalf of the corporation. In deciding to bring the suit, both the shareholder group and the *Besonderer Vertreter* only act as "internal" agents of the company, "standing in the shoes" of the genuinely competent organ, the *Aufsichtsrat*.<sup>261</sup> The lawsuit inevitably remains the action of the corporation. It follows that, unlike American law, the company itself functions as a plaintiff in suits against members of its management board.<sup>262</sup> A minority suit by way of a class action is also traditionally unknown in Germany.<sup>263</sup>

### C. A Tentative Analysis

Under American law, a group of shareholders is not considered a genuine corporate organ for the purpose of enforcing directors' duties. Rather, U.S. corporate law focusses on each individual shareholder, and allows him or her to take over the litigation against faulty managers and prosecute it on behalf of the corporation (although not in its name). The current law in Germany, in contrast, does not permit individual shareholders to sue. Under the *Aktiengesetz*, the corporation itself has the ultimate authority to enforce managerial duties. Any action that is ultimately brought on the shareholders' demand must originate in the shareholders' meeting, and be filed in accordance with the pertinent internal procedures of the shareholders assembly.<sup>264</sup> Only a group of shareholders whose combined holdings amount to no less than ten percent of the outstanding capital can overcome the denial of both the *Aufsichtsrat* and the majority of shareholders, and force the corporation to redress the manager faults. The German ap-

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no less than DM 44 million).

260. See AktG § 147(3).

261. See JÖRG H. GESSLER, KOMMENTAR ZUM AKTIENGESETZ ANN. § 147, cmt. 6 (1988); HERBERT WIEDEMANN, ORGANVERANTWORTUNG UND GESELLSCHAFTERKLAGEN 49 (1989); Barak, *supra* note 253, at 40.

262. See Steefel & von Falkenhausen, *supra* note 62, at 548; Eckert, *supra* note 53, at 73. By contrast, in a derivative suit under American law, the corporation is an indispensable party on the side of the defendant. See Buxbaum & Schneider, *supra* note 211, at 204.

263. See Joachim, *supra* note 235, at 66.

264. See Eckert, *supra* note 53, at 72.

proach has therefore been characterized as a "group approach" as opposed to the American "individualistic approach."<sup>265</sup>

In addition to the high hurdles created by the *Aktiengesetz*, there is yet another aspect that distinguishes the United States and the German system, and deters German minority shareholders from forcing the company to sue its directors: rules dealing with litigation expenses. Even though the problem of indemnification for litigation expenses is not a question governed by German corporate law (but rather an issue of Civil Procedure), it nevertheless has a strong impact on the practical nonexistence of a shareholder suit in Germany.<sup>266</sup> Like many other civil law countries, the German Civil Procedure Code (*Zivilprozessordnung*)<sup>267</sup> dictates that the losing party alone, and not its lawyer, bears the litigation costs of both parties involved.<sup>268</sup> Contingency fee devices, common in the United States, are unknown in German law. Allowing a lawyer to file a suit under a contingency arrangement is regarded as unethical and inconsistent with public policy. Thus, if a private party brings an action, he or she takes the risk of losing, regardless of the fact that possible benefits, if any, belong to someone else (e.g., to a corporation). Applying this rule in the context of shareholder suits, one might think that, since under German law the plaintiff necessarily is not a shareholder but the corporation, shareholders may in return not be responsible for the cost incurred. Yet, despite the soundness of this assumption,

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265. Thomas Raiser, *Das Recht der Gesellschafterklagen*, 153 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT 1, 24 (1989) [hereinafter *Gesellschafterklagen*]; Eckert, *supra* note 53, at 70; Barak, *supra* note 253, at 40. It should be noted that this "group approach" has a long tradition. See § 268 Handelsgesetzbuch (HGB) [Commercial Code] as of May 10, 1897; AktG, v. 04.02.1937 (RGBl. I S.219) § 122. In 1937, the German law of the *Aktiengesellschaft*, previously contained in the Commercial Code, was re-enacted and amended in a special statute of 1937, the "*Aktiengesetz*." Although "[c]ertain features of this . . . law reflect[ed] the influence of Nazi ideology the provisions pertinent to [the concept of the corporation as a separate entity and the shareholder suits are] hardly more than a restatement of the law prior to the Nazi regime." Maximilian Koessler, *The Stockholder's Suit: A Comparative View*, 46 COLUM. L. REV. 238, 251 (1946). For more information about the historical background, see Grossfeld & Ebke, *Unternehmensverfassung*, *supra* note 175, at 97.

266. See Grossfeld, *supra* note 102, at 110.

267. See § 91 Nr. 2 ZPO, 92 [Civil Procedure Code].

268. For a discussion of comparable rules in Japan, see Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 NW. U.L. REV. 1436, 1463 (1994).

the legal situation is different. AktG section 147, paragraph 4 expressly provides that if the suit is lost, the party which pressed the claim will be liable to the corporation for the cost incurred. The Legislature deemed such regulation necessary to prevent any abuses of this minority right. Actually, however, meritorious suits have been discouraged as well.

Because complaining shareholders may only enforce a company's right of recovery against the *Vorstand* under the special circumstances described above, the pertinent sections in the *Aktiengesetz* ironically have been evaluated as "dead letters."<sup>269</sup> Sparse use of the *Aktiengesetz*' devices can easily be attributed to requirements which are so strict that they are virtually impossible to overcome.<sup>270</sup> Under the *Aktiengesetz*, a shareholder having less than the required capital investment of ten percent would have to contact, and then convince, other shareholders to join his or her interest.<sup>271</sup> Given the widespread apathy of small shareholders, and the lack of organized shareholder groups with both sufficient access to information about actionable events and expertise to represent minorities, the necessity of requiring such concerted action generally poses great difficulties.<sup>272</sup> Further, as briefly stated above, such groups face a high and deterrent cost risk. Due to these impediments in overcoming the problem of enforcement, over the

269. See Thomas Raiser, *Pflicht und Ermessen von Aufsichtsratsmitgliedern*, 49 NEUE JURISTISCHE WOCHENSCHRIFT 552 (1996) [hereinafter Raiser, *Aufsichtsratsmitglieder*]; Joachim, *supra* note 235, at 41, 66. Although both authors explicitly address only the judicial enforcement of *Aufsichtsrats*' liability, their observations are to the same extent true for *Vorstands*' accountability. See also Grossfeld, *supra* note 102, at 110; Munyon, *supra* note 177, at 231. Hermann Abs, former CEO of Deutsche Bank AG and perhaps the most prominent manager of the German postwar era, stated that "It is easier to grab a pig at its soapy tail than to hold the manager of a German corporation liable."

270. See Hans-Joachim Mertens, *Organhaftung*, in CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT 155, 157 (Dieter Feddersen et al. eds., 1996).

271. Shareholders holding ten percent of a corporation's capital, on the other hand, might be able to accomplish their objectives either through informal means of control or through their representative at the *Aufsichtsrat*. See Barak, *supra* note 253, at 40. See also discussion *infra* Part F (for the current amendments of the *Aktiengesetz*).

272. Until now, not many minority suits initiated by shareholder groups pursuant to AktG § 147 have been reported. These groups so far seem to focus on resolutions at the shareholders' meeting and on frequent appearance in the media. But see SÜDDEUTSCHE ZEITUNG, *supra* note 82.

years of its existence, managerial liability has hardly ever been found pursuant to a shareholder request according to AktG section 147.<sup>273</sup>

All this seems to compel a conclusion that the rather weak substitute German law offers for the U.S. model of derivative litigation may under no circumstances sufficiently protect shareholders' interests. However, shareholder litigation is only one of a range of devices to redress uncovered misconduct. And, as a matter of fact, corporate law in Germany provides another mechanism of assuring directors' performance that distinguishes it from American corporate law: the supervisory board (*Aufsichtsrat*). If the members of the supervisory board effectively control those who manage the corporation, there might be less, or even no need for a strong system of judicial enforcement guided by shareholders.<sup>274</sup>

#### *D. The Supervisory Board as an Efficient Control Mechanism?*

Like all modern corporate laws, both the American and the German systems provide for special organs to carry on the business of the corporation. However, the technical structure varies. Whereas American corporations are run under the supervision of a single board, German corporations (*Aktiengesellschaften*) are organized under the Stock Corporation Act, and have a two-tier system.<sup>275</sup> On one side, there is the *Vorstand*. The *Vorstand* is the executive body or "board of management."<sup>276</sup> Its members decide the corporation's policy,

273. An analysis that simply asserts that German shareholders do not sue because they "may be more passive than the Americans" fails to take into account that it appears to be the given enforcement system which is responsible for their "passivity." See Vagts, *Perspectives from the German*, *supra* note 49, at 60.

274. See Eckert, *supra* note 53, at 72 (pointing to the "inseparable connection" between the system of judicial enforcement and the function of the *Aufsichtsrat*). Commentators have also emphasized that due to differences in the social structure of both countries, Germany should be cautious in adopting the strong American shareholder litigation mechanism. Since this article is limited to a discussion of some legal issues of corporate governance in both countries, more fundamental socio-cultural questions are not further discussed here. For a thorough investigation, see Grossfeld & Ebke, *Unternehmensverfassung*, *supra* note 175, at 98; Grossfeld, *supra* note 102, at 130-31.

275. See Roth, *supra* note 92, at 1373 (stating that the personal and functional separation of management and supervision clearly distinguishes the German *Aufsichtsrat* from the U.S. board of directors); CONARD, *supra* note 24, at 8; Eckert, *supra* note 53, at 28.

276. See AktG § 76(1) (stating that the *Vorstand* has "direct responsibility for

and actually run the corporation's day-to-day affairs.<sup>277</sup> The *Aufsichtsrat*, as the second tier, is created for the sole purpose of supervising the *Vorstand* as the managing group.<sup>278</sup> As a kind of continuous representative of the shareholders between their meetings, the *Aufsichtsrat* is supposed to be the guardian of their interests.<sup>279</sup> The *Vorstand* is obliged to provide information about the business performance of the firm on a regular basis.<sup>280</sup> Frequently, the charter, or the by-laws of the corporation, additionally require *Aufsichtsrats* approval for specific kinds of transactions.<sup>281</sup> The power of the *Aufsichtsrat* to challenge managers' decisions is by no means restricted to legal issues. Rather, it covers any aspect that is related to the corporation.<sup>282</sup> On the other hand, typical managerial functions cannot be transferred to the *Aufsichtsrat*.<sup>283</sup> Extensive contractual transfer of managerial competencies would blur the fundamental distinction between the two organs.<sup>284</sup> The independence of the *Aufsichtsrat* is maintained by a provision in the Stock Corporation Act that prohibits simultaneous membership in both the managing and the supervising group.<sup>285</sup> Its members, which are elected by the shareholders, appoint and remove the members of the *Vorstand* as the executive body.<sup>286</sup>

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the management of the company").

277. Joachim, *supra* note 235, at 43 (noting that members of the *Aufsichtsrat* are "somehow" comparable with U.S. outside directors).

278. See AktG § 111(1).

279. See Raiser, *Aufsichtsratsmitglieder*, *supra* note 269, at 554.

280. See Wittuhn, *supra* note 238, at 311.

281. See Detlev F. Vagts, *The European System*, 27 BUS. LAW. 165, 167 (1972) [hereinafter Vagts, *The European System*].

282. See Joachim, *supra* note 235, at 46 (giving further references). An additional approval by the shareholders' meeting is only required for issues which would result in a fundamental change in corporate structure. *Id.*

283. See AktG § 111(4).

284. See Wittuhn, *supra* note 238, at 311; Joachim, *supra* note 235, at 45; Eckert, *supra* note 53, at 23. An exception from this principle is the representation of the *Aktiengesellschaft* in a lawsuit against the *Vorstand*. Here, the *Aufsichtsrat* takes over the duty to represent the corporation. See AktG § 112.

285. See AktG § 105.

286. See AktG § 84. On the other hand, management is usually able to elect some of its candidates as members of the *Aufsichtsrat*. Moreover, the *Vorstand* has also a decisive role in the selection of its own members. See, e.g., Padraic Fallon, *The Battle Plans of Hilmar Kopper*, EUROMONEY, Jan. 1994, at 39 (containing an interview with the CEO of Deutsche Bank, who explains that the *Vorstand* usually requests that the *Aufsichtsrat* approve recommendations given by the *Vorstand*).

In light of this statutory approach, one might conclude that supervision by an independent group such as the *Aufsichtsrat* in fact may replace, or render superfluous, the U.S.-like shareholder action as a means to align the interests of directors and shareholders.<sup>287</sup> Indeed, in the last 30 years the supervisory board has, in general, successfully fulfilled its "watch dog" function to prevent serious abuses and react in case of management's gross negligence. Nevertheless, the past has also shown serious failures on the part of the board.<sup>288</sup> Because of this, it has been questioned whether German corporate law should rely on the *Aufsichtsrat's* supervision. A review of criticisms of the performance of the supervisory board in largely held public corporations reveals mainly four weak points: (1) according to some commentators, the *Aufsichtsrat* has, in some corporations, become a part of the management and therefore has lost its ability to objectively monitor the *Vorstand*;<sup>289</sup> (2) It has changed into an "organization for business contacts and friendships," where members occasionally work to perpetuate each other's "power and perks;"<sup>290</sup> (3) The *Aufsichtsrat* still effectively exercises supervision, but does not represent all shareholders. One example is especially prominent: The traditionally strong position of banks in the German corporation and its *Aufsichtsrat* has lead critics to conclude that by representing both themselves<sup>291</sup> and their trustees, e.g., through the voting rights conferred on them, banks exert control, in pursuit not of the interest of all of those individual shareholders who have given their proxies, but mainly in pur-

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287. See CONARD, *supra* note 24, at 403 (claiming that the supervisory board is compensation for the weakness of shareholder suits); Raiser, *Gesellschafterklagen*, *supra* note 265, at 9 (summarizing this viewpoint).

288. See, e.g., Judgment of Dec. 21, 1979, Bundesgerichtshof, 33 NEUE JURISTISCHE WOCHENSCHRIFT 1629 (1980) (holding member of the *Aufsichtsrat* liable for proposing to the *Vorstand* to give securities to a company with a doubtful credit standing).

289. See Raiser, *Aufsichtsratsmitglieder*, *supra* note 269, at 553.

290. See generally GÜNTER OGGER, NIETEN IN NADELSTREIFEN—DEUTSCHLANDS MANAGER IM ZWIELICHT (1992) (giving examples for German management's misbehavior). Ogger's book, which was a long time bestseller in Germany, may be translated as "Dummies in Business Suits." See also Thomas J. André, Jr., *Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards*, 70 TUL. L. REV. 1819, 1822 (1996) (briefly summarizing this viewpoint).

291. Banks are significant shareholders in their own right in most German publicly-held corporations. See Immenga, *supra* note 86 and accompanying text for more detailed information.

suit of their own and possibly conflicting interest.<sup>292</sup> Moreover, the current system, which allows individuals to be a member of the supervisory board of several corporations (a system of interlocking directorates), has given rise to conflict of interest issues,<sup>293</sup> and (4) There are situations in which the members of the supervisory board are so closely connected to management that they become unwilling to act in compliance with the statutory requirements imposed upon them. Collegiality might thus make them hesitant to commence an action against those who run the business, even when uncovering clear evidence of managerial misbehavior.<sup>294</sup> This observation is supplemented by evidence which shows that the additional power of the *Aufsichtsrat* to dismiss members of the management board is rarely used.<sup>295</sup>

### *E. Is the German System Changing?*

Although German legal scholars and the *Bundesgerichtshof für Zivilsachen* as the highest German Court for, i.e., corporate law have widely remained hesitant to change the strong doctrinal framework governing corporate law, or even to partially recognize the American derivative suit concept,<sup>296</sup> there is now agreement among the majority of academics and politicians that some change in the given system of shareholder protection is desirable.<sup>297</sup> While keeping in mind the observations broadly outlined above, it is therefore worthwhile to

292. See Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2258. See also Roth, *supra* note 92, at 1378 (summarizing this point and the preceding observations).

293. See, e.g., André, Jr., *supra* note 290, at 1822; Joachim, *supra* note 235, at 53 (describing the "dilemma of multiple loyalties"). Under the *Aktiengesetz*, however, cross-membership on the *Aufsichtsrat* and *Vorstand* of two or more corporations is prohibited. See AktG § 100(2).

294. Norbert Horn, *Die Haftung des Vorstands der AG nach § 93 AktG und die Pflichten des Aufsichtsrats*, 18 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1129, 1130 (1997).

295. On the other hand, it has been established that there is a certain level of non-renewal of contracts. See Baums, *Corporate Governance*, *supra* note 94, at 505-06; Horn, *supra* note 294, at 1130.

296. See WIEDEMANN, *supra* note 261, at 42 (stating that German corporate law traditionally has a hostile attitude toward shareholder suits and suggesting that this attitude is at least partly due to the fact that managers as an interest group were successful in convincing legislatures in the German post-war era not to ease judicial mechanisms to enforce fiduciary standards).

297. For current proposals and changes, see text *infra* Part 3.

examine the current discussion and the reasons for this development more closely.

### 1. Economic Incentives

Traditional arguments against a tough mechanism of shareholder litigation formerly were based on the successful performance of German corporations under the present law, and a skeptical view of allowing individual shareholders access to the courts. The fact that Germany has developed one of the world's largest and most successful economies has been at least partially attributed to its corporate governance and regulatory standards. For years, there simply seemed to be no serious economic incentive to change the doctrinal framework that governs corporate law. However, at least since the early 1990s, Germany realized that economic success under a particular system, and its legal and regulatory devices in the past, does not guarantee economic success in the future. The fact that over the last five years quite a few well-known German corporations have crashed, or sustained huge losses has, *inter alia*, raised fundamental doubts about the quality of the given system, and has made observers more sensitive to corporate governance issues.<sup>298</sup> A number of widely-publicized financial difficulties of German companies, and an array of spectacular "scandals" (most notably the affairs at IBH, Neue Heimat GmbH, Co-op, Bayerische Raiffaisenbank, Girmes AG, Hammer Bank, Harpener AG, Schneider<sup>299</sup>, Metallgesellschaft<sup>300</sup>, and, more recently, the Bremer Vulkan matter), has triggered substantial criticism of the manner in which German corporations monitor those who run the business.<sup>301</sup>

Moreover, while politicians and economists widely agree that liberalization and opening of the German financial markets is inevitable in order to attract more investors,<sup>302</sup> law-

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298. See Assmann et al., *The Law of Business Associations*, *supra* note 71, at 148; Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2260; Feddersen et al., *Corporate Governance*, *supra* note 11, at 4 (stating that the performance of German corporations recently has been subject to some serious criticism).

299. See, e.g., Nicholas Bray, *Scandals Knock Deutsche Bank's Image*, WALL ST. J., July 5, 1994, at A8.

300. See also Andrew Fisher, *Metallgesellschaft: The Oil Deals That Crippled a German Metal-Trading Giant*, FIN. TIMES, Mar. 20, 1995, at 20.

301. See generally Joachim, *supra* note 235, at 41.

302. See Breuer, *supra* note 181, at v; Buxbaum, *Institutional Owners*, *supra*

yers feel forced to think about impediments caused by the embodying legal system. Observers raise concern that if, for example, an institutional investor from abroad, (who, it is assumed, highly values liability rules as a governance mechanism), finds evidence that the pertinent legal framework in Germany is insufficient, he or she might decide to put money elsewhere.<sup>303</sup> Beside the growing importance of international investors, it is worth remembering that German politicians intensively try to make investment in equity more attractive for private households, too. Given the partial success of these efforts, the number of small shareholders will further increase. Consequently, the demand for additional control mechanisms, including the judicial enforcement of managers' liability for misbehavior or negligence, will become greater.<sup>304</sup> As individual and institutional investors expand their use of stock purchases, and the need for investor protection correspondingly increases, it seems predictable that the impact of gaps in the regulatory environment will become more significant.

## 2. The Deterring Effect of Abuses

Possibly the most serious concern German commentators have voiced is the danger that lessening the requirements for shareholder litigation will inevitably result in over-enforcement, and trigger an avalanche of litigation. More specifically, it has been conjectured that the implementation of a U.S.- like shareholder suit would not be of any benefit for the corporation, but rather of benefit for the shareholder-plaintiffs and their lawyers.<sup>305</sup> This assumption is supplemented by a prevalent feeling that German managers should be free to take

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note 125, at 26-27; Feddersen et al., *Corporate Governance*, *supra* note 11, at 2 (pointing to the increasing number of international institutional investors in Germany).

303. See CORPORATE GOVERNANCE IN EUROPE, *supra* note 178, at 30 (stating that American pension funds "bring their corporate governance standards with them").

304. See CORPORATE GOVERNANCE IN EUROPE, *supra* note 178, at ii, 30 (suggesting that, institutional investors "can be expected to introduce a more active form of shareholding"). See generally CLARK, *supra* note 16, at 20. It should be kept in mind that in 1995, only 17% of the shares in German corporations were held by individual investors. See Feddersen et al., *Corporate Governance*, *supra* note 11, at 2-3.

305. For a recent statement, see Feddersen et al., *Corporate Governance*, *supra* note 11, at 5, 8.

risks<sup>306</sup> and has been buttressed by pointing at the U.S. scene.<sup>307</sup> Indeed, support for the claim that shareholder litigation might have these negative effects can easily be found in U.S. courtrooms. Looking to the U.S. experience, it does seem reasonable to argue that giving each individual shareholder a right to sue might lead to undue pressure upon the company and pointless court decisions. Corporations, driven by the desire to prevent negative publicity, have in the United States, even occasionally agreed to settle suits despite their questionable merits. Therefore, American commentators have repeatedly questioned the positive impact of shareholder suits, especially of those who attack typical managerial business decisions.<sup>308</sup> Yet, those proponents who emphasize the occurrence of strike suits should not ignore that American courts have found ways to significantly reduce the likelihood of such frivolous suits, e.g., the demand requirement and the business judgment rule.<sup>309</sup> And just like American state and common law, German corporate law may within its own framework be able to prevent pressure and interference with the business of the company—not by strictly denying the shareholders' right to intervene, but rather by appropriately shaping the scope of shareholder litigation and establishing legal provisions which ensure that this device would not be wrongly exploited.<sup>310</sup>

### 3. Aspirations for Reform

In light of both a rapidly-changing economic scene, and the partly poor performance of German corporations, reformers have begun to argue for change in the German corporate law

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306. See Steefel & von Falkenhausen, *supra* note 62, at 532. The present system which bars minority shareholders from commencing a suit if they do not represent the required percentage has so far at least incidentally prevented "strike suits." See Eckert, *supra* note 53, at 81.

307. European scholars regularly emphasize this aspect. See, e.g., André Tunc, *Corporate Law*, in *EUROPEAN BUSINESS LAW LEGAL AND ECONOMIC ANALYSES OF INTEGRATION AND HARMONIZATION* 199, 211 (Richard M. Buxbaum et al. eds., 1991) (stating that U.S. directors "whatever they do or do not do, are threatened by law suits").

308. See KLEIN & COFFEE, *supra* note 29, at 149 ("it is far from obvious that [managers] should be liable for damages" and that "the prospect of judicial second guessing" might make corporate officials overly risk averse").

309. See KLEIN & COFFEE, *supra* note 29, at 150.

310. See WIEDEMANN, *supra* note 261, at 43.

structure. Critics have recently filled the field of German corporate governance with wide-ranging proposals covering a broad spectrum of corrective measures. Nearly all of these suggestions come, *inter alia*, as direct changes of the current laws regarding minority shareholder protection. Aspirations for reform focus on a strengthened system of judicial control of managerial misbehavior on the level of both the *Vorstand* and the *Aufsichtsrat*. With respect to their substance, recommendations in this field basically fall into two categories:<sup>311</sup> One body suggests that the curtailing capital holding limitation in AktG section 147 be changed.<sup>312</sup> According to this proposal, it should suffice for a lawsuit against faulty managers to go forward if shareholders representing five percent (instead of ten percent of corporate capital under the given law) or a minimum stated capital of one million *Deutsche Mark* so decide.<sup>313</sup> Legal scholars, most of them familiar with the U.S. model of corporate governance, on the other hand, recommend that an additional device be established which gives even a single shareholder the right to press a claim against members of the *Vorstand* and the *Aufsichtsrat*, respectively.<sup>314</sup> However,

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311. *But see* Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786) (amendment of the *Aktiengesetz* that combines different approaches, as discussed *infra*, Part F).

312. For a summary of this approach and further details, see Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2260. *See also* John C. Coffee, Jr., *Organhaftung im amerikanischen Recht*, in CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFÜHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT 165, 206 (Dieter Feddersen et al. eds., 1996) [hereinafter Coffee, *Organhaftung*] (evaluating proposals from an American viewpoint on how to change the European system of shareholder litigation).

313. *See* Ulrich Seibert, *Aufsichtsrats-Reform in der 13. Wahlperiode: Zum aktuellen Stand der rechtspolitischen Diskussion*, 5 ZEITSCHRIFT FÜR BANKRECHT UND BANKWIRTSCHAFT 349, 352 (1994). A similar approach is taken by the Amended Fifth concerning the structure of public limited companies and the powers and obligations of their organs. Art. 16 provides that:

[P]roceedings on behalf of the company . . . may also be commenced if so requested . . . by one or more shareholders: (a) who hold shares of a certain nominal or accounting par value which the Member States shall not require to be greater than 5% of the subscribed capital.

Amended Fifth, *supra* note 170, at 790.

314. *See* Kübler, *Referat*, *supra* note 123, at n.23; Marcus Lutter, *Defizite für eine effiziente Aufsichtsrats-tätigkeit und gesetzliche Möglichkeiten der Verbesserung*, 159 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT 287, 306 (1995) [hereinafter Lutter, *Verbesserung der Aufsichtsrats-tätigkeit*]; Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2261; WIEDEMANN, *supra* note 261, at 40-56.

there is so far no consensus about how far this individual right should be extended.

#### *F. Reforming the Shareholder Action in Germany*

The past years have shown that the supervisory board (*Aufsichtsrat*) does not always exercise control at the level required by the German Stock Corporation Act.<sup>315</sup> Deficiencies in internal monitoring and economic need to increase the capitalization of the German stock market may leave few doubts about the necessity of a change toward better shareholder protection. As scholars and politicians in Germany continue to revise their approaches for the pertinent regulation, difficult questions remain: What exactly should a change look like? Can the American system provide an effective model for Germany? Or should any proposal stop short of requiring fundamental changes in the existing judicial framework and its rules of standing and procedure? And, perhaps even more importantly: What kind of change, if at all, is most likely to take place under the prevailing circumstances?

##### 1. Changing the Minimum Capital Requirement?

A decrease in the capital requirement for minority litigation from 10% to, e.g. 5% appears to be an attractive compromise for both sides of the debate. Not surprisingly, the newly enacted AktG section 147 paragraph 3 adheres to this approach. It now requires that a motion must be brought by shareholders whose aggregate holdings equal or exceed one-twentieth of the share capital or the par value of two million *Deutsche Mark*. Yet such bright-line rules always run the risk of being both under-and-over-inclusive. Indeed, on one hand, this amendment may not go far enough. The threshold can still be too high with regard to those large publicly listed companies which have widely dispersed owners. It still carries the defect of denying access to the court for a "small" shareholder who does not represent 5% of the stated capital, but who nevertheless genuinely believes that an action against management is

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315. See Hopt, *Directors' Duties*, *supra* note 237, at 131 & n.81 (listing the decisions).

warranted.<sup>316</sup> Such deprivation admittedly has no negative impact if shareholders' belief is only based on singular and erroneous impressions of managerial performance. But when managers objectively violate their duties they owe to the corporation, the consent (or the apathy) of a vast majority of shareholders should not automatically constitute an absolute defense against a meritorious claim.<sup>317</sup> Too much injury might go unremedied if commencement of suits against faulty managers always required coordinated action of five percent of the entire holdings. Without a shareholder right to force the corporation to go forward with a lawsuit, managers may, under circumstances short of criminal fraud, even decide to distribute their firms' most valuable assets to someone with a highly doubtful credit standing without being held accountable.<sup>318</sup>

On the other hand, an approach demanding a certain minimum capital investment appears to be somewhat inflexible and overinclusive.<sup>319</sup> Shareholders are not a homogenous group. An action that is not in the interest of the majority may be—for whatever reason—in the interest of some.<sup>320</sup> Since the *Aktiengesetz* clearly favors majoritarian decisions over any “mi-

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316. See WIEDEMANN, *supra* note 261, at 50; Barak, *supra* note 253, at 48.

317. However, one could make the argument that, at least in principle, there should be no recognition at all of a shareholder's interest in intervening in managers' activities. It could be asserted that the shareholder, since he has invested money in the company, is only a creditor of the company and thus should only be treated like all creditors. See Don Berger, *Shareholder Rights under the German Stock Corporation Law of 1965*, 38 FORDHAM L. REV. 687, 689 (1970) (asserting that because shareholders collectively are regarded as the ultimate owners does not alter the conclusion that the individual shareholder's rights are not equivalent to ownership rights). However, neither U.S. corporate law nor the German Stock Corporation Act seem to accept such reasoning. The argument overlooks that there is an essential difference—not only economic but legal as well—“between a creditor and a shareholder. The former has [only a contract with] the company, the latter has not only [a contract], but also personal rights in the company.” See Barak, *supra* note 253, at 45 (citations omitted). Taking into account shareholders' role as claimants on the residual value of the enterprise, managers have an obligation to increase this residual value, rather than the wealth of the contractual partners like creditors or employees. See generally CLARK, *supra* note 16, at 18; Hart, *supra* note 236, at 303 (for an economic perspective).

318. See WIEDEMANN, *supra* note 261, at 40-41. It should be kept in mind that dismissal as another way to stop the directors under German law is not within the competence of the shareholders, but in the exclusive competence of the *Aufsichtsrat*.

319. See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786).

320. Hart, *supra* note 236, at 307.

nority concept,"<sup>321</sup> a deviation from the Stock Corporations Act's prevalent tendency to respect shareholder democracy should only be accepted if such an divergence would be in the best interest of the corporation.<sup>322</sup> A mechanical rule cannot guarantee this.

## 2. A Push Toward the American Model?

Taking this into consideration, it becomes clear that the clear-cut concept of a capital holding limitation on shareholder suits is not a preferable option. Proposals to let even shareholders with only small stakes in the venture redress damages caused by managerial misbehavior or negligence, by contrast, should be aware that a certain material threshold is needed to balance the likelihood of strategic or opportunistic actions.<sup>323</sup> It therefore has been suggested, for example, to prescribe by law that no shareholder should compel the company to go forward with the lawsuit without prior permission from either a court or a special representative.<sup>324</sup> AktG section 147, paragraph 3, as amended by "KonTraG," sets up a two step proceeding: First, a minority shareholder attacking a managerial decision has to either come forward with a *prima facie* case of "gross violation" of the managers' standard of care, to substantially allege a knowing and culpable violation of law, or, finally, to establish particular facts showing a managerial breach of the duty of loyalty, such as self-dealing.<sup>325</sup> Second, it is upon this court-appointed representative's diligent and conscientious discretion to evaluate the merits of such claim. If he or she considers that the action is clearly unfounded, he or she may refuse permission.<sup>326</sup>

321. Buxbaum, *Governance of Subsidiaries*, *supra* note 250, at 513.

322. See WIEDEMANN, *supra* note 261, at 50; Raiser, *Gesellschafterklagen*, *supra* note 265, at 15; Lutter, *Verbesserung der Aufsichtsratsstätigkeit*, *supra* note 314, at 306 n.77. Admittedly, it could be argued that AktG § 147 is already based upon a partial recognition of a "minority concept."

323. See Fischel & Bradley, *supra* note 226, at 271-72 (suggesting that shareholders with tiny investments have only little incentive to consider the effect of the action on other shareholders).

324. See Coffee, *Organhaftung*, *supra* note 312, at 207; Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2261.

325. See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), v. 27.04.1998 (BGBl. I S.786). See also KLEIN & COFFEE, *supra* note 29, at 151 (listing comparable amendments of U.S. state corporate statutes).

326. See Gesetz zur Kontrolle und Transparenz im Unternehmensbereich

Other models involve a U.S.-like "demand" requirement, suggesting that shareholders have to prove that the supervisory board, as well as the majority of shareholders, have refused to initiate a legal proceeding against the manager.<sup>327</sup> All this has been regarded as a useful device to prevent exaggerated shareholder activism and its possible negative effects.<sup>328</sup> These models also claim the advantage of ensuring, to some degree, that small investors believe they have access to a remedy if management is cheating and therefore offers considerable, albeit limited protection for minority shareholders.

Doctrinal justification for such a remodeling has been borrowed from the *Bundesgerichtshof's* well-recognized *Holzmueller* decision.<sup>329</sup> In this landmark case, the *Bundesgerichtshof* expressly affirmed the possibility of an individually-initiated shareholder action. Admittedly, this was a case where management acted without the required assent of the shareholder meeting. But an analogy to such a situation where an internal irregularity in the decision-making process of the corporation was in question, has been drawn here in the managerial liability setting.<sup>330</sup> In both cases management is

(KonTraG), v. 27.04.1998 (BGBl. I S.786); Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2261; Lutter, *Verbesserung der Aufsichtsratsstätigkeit*, *supra* note 314, at 306.

327. *But see* WIEDEMANN, *supra* note 261, at 48 (arguing against an "internal demand" requirement).

328. *See generally* CARY & EISENBERG, *supra* note 21, at 1034; CORPORATE GOVERNANCE IN EUROPE, *supra* note 178, at 36.

329. *See* Judgment of Feb. 25, 1982, *Bundesgerichtshof*, *reprinted in* 37 JURISTENZEITUNG 602 (1982).

330. *See* MERTENS, *supra* note 253, § 93, cmt. 174; WIEDEMANN, *supra* note 261, at 50; Raiser, *Gesellschafterklagen*, *supra* note 265, at 3-4; Buxbaum, *Governance of Subsidiaries*, *supra* note 250, at 511.

[D]ecision of the German Supreme Court . . . itself indirectly but clearly influenced by American principles . . . not only extends German doctrine beyond its primarily statutory framework [,] but also breaks new ground in developing a shareholder's remedy that may be a first step towards a 'common law' derivative suit.

*Id.* It should be noted, however, that the traditional concept of German corporate law makes a distinction between a case in which the managers are in breach of their fiduciary duty and the case in which an "internal irregularity" in shareholder meeting procedures has occurred. In the first case, as previously mentioned, the company is the party affected and therefore, it alone is entitled to relief. Where an illegal act falls within the category of an "internal irregularity," shareholder rights are infringed, and they are, therefore, eligible to bring an action against the company. *See* Grossfeld, *supra* note 102, at 107. However, taking the decision of the *Bundesgerichtshof* into consideration, this doctrinal concept has arguably lost

in breach of duties it owes to the corporation. Moreover, as has been emphasized, closer examination of the legislators' intent, as well as of the legislative history, fails to prove conclusively that the Stock Corporation Act was designed to establish a comprehensive and exclusive plan for dealing with the problem of corporate agents' misbehavior.

The extension of individual shareholder suits as it is pursued by some legal scholars, seems more desirable than a complete adoption of the existing U.S. derivative suit regime. First, it would not require a substantial change in the foundation of the German corporate governance system, but rather it would add an additional device to the given law. Secondly, since the *Aufsichtsrat* has proven to be an effective control mechanism for preventing the majority of egregious derelictions by corporate managers, a general push toward the American structure of shareholder suits might well turn out to be beyond necessity. Existing evidence still refutes brash assumptions such as, for example, corporate managers and members of the supervisory board systematically act contrary to investors' best interest.<sup>331</sup> Reformers should keep in mind that the German two-tier regime of oversight diminishes the plausibility of the investors' demand for legal protection. Effective "contractual" ex ante monitoring of breaches of trust in the majority of cases alleviates the demand for monitoring ex-post through the legal system. And, after all, whereas legal proceedings as a practical certainty occur after managerial misbehavior has already lead to damages, monitoring the agents internally gives at least a chance for timely intervention and an internal solution.<sup>332</sup> In other words, whereas the control exercised by the *Aufsichtsrat* can be preventive, a shareholder suit to recover damages is, by definition, only a post-transaction remedy.<sup>333</sup>

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part of its strict authority.

331. But see Roth, *supra* note 92, at 1382. Roth is of the opinion that the *Aufsichtsrat* is in fact "unable to counterbalance the dominance of management within the corporation." He concludes that supervision "in the proper sense of the word" requires that the supervisory body be separated not only from the management, "but also from the enterprise itself." He suggests, *inter alia*, the establishment of a self-policing, industry-wide association.

332. See Vagts, *The European System*, *supra* note 281, at 168 (stating that "if things start to slip, [the *Aufsichtsrat* is] expected to start to take action").

333. See von Samson-Himmelstjerna, *supra* note 245, at 304. For the purpose of supervising, for example, the *Aufsichtsrat* may, at any time, request from the management group written report about corporate matters. Moreover, the supervi-

A push toward the American derivative suit would encounter yet another difficulty: Under the German Stock Corporation Act (unlike in the United States), no explicit business judgment rule exists to balance groundless shareholder activism, and to shelter directors from liability for decisions that prove only in hindsight to have been wrong.<sup>334</sup> German courts, of course, recognize that management needs wide discretion in running the company, and that the factfinder has to take into consideration all special circumstances and relevant facts of the particular situation before liability can be assumed. However, the sparsity of actual decisions has made an elaborate case-by-case determination of typical business judgment situations impossible. In Germany, there is, unlike in the United States, so far no array of case law to provide definitive "signposts" of liability. Besides, it is far from certain if the judges under the German civil-law system (where both procedural and substantial conditions, as a general rule, must be laid down in provisions of a code or statute), would show the flexibility with which important substantive features of the derivative action such as the business judgment rule and the "demand" or "demand excused" rule have been molded by the American courts.<sup>335</sup>

Unless German courts have exactly determined the margins of deference toward managerial discretion on a case-by-case basis, minority-shareholders might be inclined to forget

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ing group has the right to inspect all corporate books, records and inventories according to AktG § 111.

334. See Buxbaum, *Business Judgment Rule*, *supra* note 203, at 79-102 (including information about the historical background of American law); Fischel & Bradley, *supra* note 226, at 283-84. See also WIEDEMANN, *supra* note 261, at 55; Raiser, *Aufsichtsratsmitglieder*, *supra* note 269, at 552 (describing the German statutory regulations as "colorless general-clauses"); Steefel & von Falkenhausen, *supra* note 62, at 532; Eckert, *supra* note 53, at 41. See also Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2261; MERTENS, *supra* note 253, at 156 (proposing the adoption of the business judgment rule). The scope of the business judgment rule is occasionally criticized in the U.S. as being too broad. See Glenn E. Hess, *Corporate Governance—zum Stand der Diskussion in den Vereinigten Staaten*, in *CORPORATE GOVERNANCE: OPTIMIERUNG DER UNTERNEHMENSFUEHRUNG UND DER UNTERNEHMENSKONTROLLE IM DEUTSCHEN UND AMERIKANISCHEN AKTIENRECHT* 9, 17-18 (Dieter Feddersen et al. eds., 1996).

335. See Coffee, *Organhaftung*, *supra* note 312, at 205; Grossfeld, *supra* note 102, at 107; Berger, *supra* note 317, at 689. The absence of German jurisprudence on such features is due to the fact that suits against directors have yet not been widely used.

about their limited stake in the company,<sup>336</sup> and use their eased access to courts to question typical managerial business-decisions, each time forcing the management to meet the burden of proving the correctness of their behavior.<sup>337</sup> Moreover, there is fear that if minority shareholders might sue whenever performance that seems optimal *ex ante* turns out poorly *ex post*, managers may tend to avoid risky projects.<sup>338</sup> As it is known to the American reader, U.S. scholars have shown that risk-adversity would run counter to the interests of shareholders because of their ability to diversify their portfolio.<sup>339</sup> The assumption that German managers might become more risk-averse gains support from the fact that German corporate law does not yet have an elaborate system of indemnification and insurance for management in situations where they might have committed egregious errors of judgement, but have not gained personally.<sup>340</sup>

In light of all this, it is predictable that German policymakers will respect their nation's path dependence<sup>341</sup> and decide to modestly expand upon the rules the legislator has recently developed.<sup>342</sup> The doctrinal framework governing the corporate structure and the relationship between the legal entity and its owners appears to be too deep-rooted to be subject to a fundamental push toward a system whose benefits,

336. See Coffee, *Organhaftung*, *supra* note 312, at 206; Eckert, *supra* note 53, at 42 (suggesting that in the U.S. the business judgement rule has evolved primarily as a tool of "self defense" against "nuisance" shareholder litigation).

337. See Schlechtriem, *supra* note 251, at 78; MERTENS, *supra* note 253, at 159; Swanson, *Corporate Governance*, *supra* note 1, at 449 (stating that "shareholders for the most part simply desire the advantages of holding an investment that provides a beneficial return").

338. See Raiser, *Gesellschafterklagen*, *supra* note 269, at 7. See also 2 AMERICAN LAW INSTITUTE, *supra* note 211, at 6; Fischel & Bradley, *supra* note 226, at 266 (stating that shareholders prefer risky projects because of their ability to diversify); FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW*, *supra* note 27, at 103 (summarizing the argument).

339. See Buxbaum, *Business Judgment Rule*, *supra* note 203, at 81.

340. See Schneider, *Haftungsmilderung*, *supra* note 251, at 797-98. See Hopt, *Directors' Duties*, *supra* note 237, at 131; Schlechtriem, *supra* note 251, at 77. For the corporate governance impact of such protection, see FANTO, *CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW*, *supra* note 27, at 118.

341. See generally Roe, *supra* note 37, at 641. See von Samson-Himmelstjerna, *supra* note 245, at 305; Kübler, *German Dilemma*, *supra* note 130, at 111-12 (stating Germans' "widespread inclination to mistake formal organizations for living autonomous entities").

342. See Coffee, *Organhaftung*, *supra* note 312, at 199.

even when seen from the U.S. perspective,<sup>343</sup> do not clearly outweigh its possible disadvantages.<sup>344</sup>

On the other hand, we have seen that, despite controversy about the economic outcome of such suits, a strong argument can be made that a real prospect of being held accountable for breaches of the duty of loyalty is helpful to more effectively deter managers from future wrongful conduct, such as cheating.<sup>345</sup> All guessing about the "real benefit" of such suits and the effects of strike litigation loses much of its weight when managers have engaged in self-dealing transactions, or have extracted corporation's secrets for their own benefit.<sup>346</sup> Some observers have also expressed hope that more frequent action might help to provide greater certainty about the duties of German directors under the particular circumstances.<sup>347</sup> They argue that more suits will lead to more concrete rules because courts have more chances to define the scope of the law.

Thus, an approach that attempts to strike a balance between the dangers of improperly preventing proceedings

343. See 2 AMERICAN LAW INSTITUTE, *supra* note 211, at 6; KLEIN & COFFEE, *supra* note 29, at 153; FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW, *supra* note 27, at 114; Romano, *supra* note 204, at 84 (finding little empirical evidence of specific disciplining influence, thus concluding that "shareholder litigation is a weak, if not ineffective, instrument of corporate governance"); CARY & EISENBERG, *supra* note 21, at 1126-29 (criticizing Professor Romano's approach). For a more optimistic view of the role of derivative suits, see Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322, 328 (1986).

344. See Raiser, *Aufsichtsratsmitglieder*, *supra* note 269, at 553. Generally speaking, a U.S. reader may get the impression that important features of German corporate law are still left to more or less operate mechanically and are, therefore, somewhat inflexible regulations. The relationship between management and shareholders appears only to some extent penetrated by the fiduciary duty concept.

345. See KLEIN & COFFEE, *supra* note 29, at 199-200; FANTO, CORPORATE GOVERNANCE IN AMERICAN AND FRENCH LAW, *supra* note 27, at 104 n.3; Hess, *supra* note 334, at 24; Fischel & Bradley, *supra* note 226, at 287 (stating a limited, albeit important justification for the derivative suit). See also MERTENS, *supra* note 253, at 163 (suggesting the German perspective).

346. See Kenneth E. Scott, *The Role of Preconceptions in Policy Analysis in Law: A Response to Fischel and Bradley*, 71 CORNELL L. REV. 299, 301-02 (1986). A recent example in Germany is the "Steinkuehler-case" in which a prominent union manager used inside information obtained in his position as a member of the supervisory board in a big corporation to engage in stock trading. See Feddersen et al., *supra* note 11, at 5-6.

347. See 2 AMERICAN LAW INSTITUTE, *supra* note 211, at 12 (addressing the "educational and socializing" function of shareholder suits).

against managers, and the dangers of obstruction by a small group of dissenting shareholders seems most likely to be pursued. In any event, attempts to remodel shareholder protection do not remain silent on the important issue of who bears the litigation costs. Even after the recent amendment, the rules governing litigation expenses will be subject of the debate.<sup>348</sup> This is predictable, since AktG section 147, paragraph 4, as amended, achieves only a minor change: Under the old provision the minority that had requested that a claim for damages be asserted was obligated to reimburse the costs of litigation to the (unsuccessful) company; it now only must reimburse costs that exceed the benefits received because of the action. Since, after all, recovery may at best accrue to the corporation, and not to the shareholders compelling the corporation to sue, it already has been proposed that the Stock Corporation Act should rely on the general rule of ZPO section 91 (Civil Procedure Code, *Zivilprozessordnung*), and let the corporation as the plaintiff take the cost risk. Consequently, the conflicting statutory provision<sup>349</sup> would have to be repealed. Policymakers say that over-enforcement in the form of strike suits and detrimental settlements between a plaintiff and the directors would still be less likely to arise under German law. They argue that where the corporation sues, no personal shareholder interest can directly affect the course of the litigation. This is said to be true even in "minority" suits because any plaintiff-shareholder is only a representative of the corporation.<sup>350</sup> Additional proposals have been made suggesting that, if the court on examining the substance of the allegations should come to the conclusion that the suit has been poorly grounded, it should be in its discretion to order the shareholders involved personally to pay all or part of the court costs and legal fees so far incurred.<sup>351</sup>

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348. See Grossfeld & Ebke, *Controlling the Modern Corporation*, *supra* note 93, at 98; Raiser, *Einfluß der Kreditinstitute*, *supra* note 95, at 2261.

349. See KonTraG, amending AktG § 147(4).

350. See Eckert, *supra* note 53, at 77.

351. See *Amended Fifth*, *supra* note 170. For a different approach see KLAUS BRONDICS, *DIE AKTIONÄRSKLAGE* 175-76 (1988) (suggesting no change to the rules governing the costs of a lawsuit, but allowing shareholders insurance covering such litigation expenses).

## CONCLUSION

Shareholder participation in corporate decisionmaking plays an important role in corporate governance of large-publicly-held corporations both in Germany and in the United States. One can think of amendments that strengthen this value in German corporate law. However, any reform should consider a cost-benefit analysis and avoid "overregulation" that leads only to negligible improvement to the present practice.

A seemingly desirable more pluralistic proxy system with active outside monitors and proxy holders, such as banks, institutional investors and shareholder protection groups, will not set aside or even solve the major principal-agent problems.

Banks and non-bank institutional investors are likely to continue to be the 'big players' in the exercise of voting rights. The increasing number of intermediaries in the corporation-shareholder relation is not a problem related to banks only. Rather, the institutional investors will cause similar problems. Since we may not succeed to activate the rationally apathetic small principals, the main focus should be on the elaboration of the proxy holder's duties.

As to the enforcement of German management's fiduciary obligations, American readers may have realized that even an improvement in the current corporate law structure in Germany is unlikely to bring shareholder litigation against managerial misfeasance to the forefront of German corporate governance. Remaining differences between each law's system of meeting litigants' expenses still assure that shareholders suits, even if in fact aided by the recently discussed devices, will not become as frequent an occurrence as in the United States.<sup>352</sup> Yet, discussion about the scope of managerial accountability is ongoing and, hence, further steps in the direction of a more active shareholder protection may be taken. It remains to be seen to what extent such ideas may be harmonized with the overall concept of the German *Aktiengesetz*.

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352. American scholars have repeatedly described attorney's fees as the force that drives derivative actions. They have even stated that, without the prospect of recouping attorneys' fees, many if not most of the cases in the U.S. would never be brought. See, e.g., John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 26-33 (1985).