Role and responsibilities of the board of directors from a prospective of large German companies

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Ladies and Gentlemen,

I. I shall comment on the recent German experience of corporate governance with the intention of highlighting the potential for change in what seemed to be a very settled legal framework and business culture. You will see that whilst we all depend in our choices on the roads taken or not taken a long time ago - path dependency it’s called these days - corporate systems have considerable potential for change under outward demands -- both institutionally and, yet more importantly, culturally.

Which were the outward pressures for Germany?

They were:

a) the increasing access of German corporations to international capital markets as evidenced by the listing of, e.g., Daimler or SAP ADRs on the NYSE, triggered, of course by the need to procure capital at the international cost level,

b) the increasing volume of foreign financial and strategic investments in German companies,

c) the greater mobility in the investment behavior of institutionals who look out more for performance than for long term stability and for institutional influence,

d) the recent stock boom and the appearance of highly mobile and performance oriented new strata of private investors,

e) the going public of numerous young and smaller firms,

f) the decrease in bank ownership of productive enterprises and the banks’ intensified concentration on core business and investment banking, and

g) the spectacular failure of the Metallgesellschaft board to recognize and even understand oncoming exceptional, almost fatal losses due to speculative transactions in oil futures.
II. Let me give you a sense first of the basic layout of company law for large German firms:

Most German enterprises are incorporated, i.e. enjoy limited liability and constitute separate legal entities. By far the most German companies - more than 600,000 - are limited liability companies (GmbH), only some 3,600 are stock companies (AG) with only some 700 companies listed on the stock exchange.

By large firms we shall denote those that ordinarily employ directly or indirectly (via subsidiaries) more than 2,000 permanent employees. In 1996, among these companies were 406 stock corporations and 329 GmbH, totaling 740 enterprises. All such enterprises have a supervisory board beside the executive board (Vorstand) (so called two-tier system of management).

Large enterprises are subject to labor codetermination under the 1976 Mitbestimmungsgesetz, certainly one of the unique creations of the German legal mind.

A supervisory board is mandatory in such enterprises which has an equal number of shareholder and labor representatives. Depending on the size of the company, the ratio of outsider union representatives versus employees of the enterprise varies from 2:4 to 3:7 depending on the size of the enterprise.

The supervisory board hires (appoints) and fires managers with a two thirds majority. If such a majority does not come about, time consuming mediation in a committee with equal representation of shareholders and labor is needed before a majority vote will suffice for an appointment or cancellation. Only if a deadlock vote comes about, the chairman (who due to institutional safeguards is practically always a shareholder representative) has a dual vote which is practically never used in personnel matters (see the recent exchange of the CEO at BMW). One member of the executive board (Arbeitsdirektor) is to enjoy special trust with labor and is practically never appointed against the will of labor.

Evaluating the pros and cons of codetermination is a difficult task. Among the advantages named are consensus building, early warning of social conflicts, and staving off hostile takeovers. Obviously decisionmaking is slowed down, a fear of information leaks (often quite real) induces management to withhold information from the board, and at times personnel decisions are negatively affected (see, e.g., the recent board battle over the CEO of BMW).
Beside codetermination probably the second most conspicuous feature of German company law is an extreme concern for creditors, much more concern than for shareholders who according to a classical German phrase are stupid and impertinent - stupid because they invest money in corporations, and impertinent because they want to be paid a dividend.

A very elaborate system of rules requires that capital is fully paid in by the founders, that existing capital (for which minimum amounts are statutory) is protected against withdrawal or payout as fictitious profits or reduced by the „repurchase“ of the company’s own shares which is possible only under rather narrow constraints. Most shareholder loans are subordinated loans and treated as constructive equity. Upon a loss of one half of the statutory capital, a shareholder meeting must be convoked in stock companies. If illiquidity or insolvency are present each manager in a corporation has a duty individually to file a bankruptcy petition within three weeks even if promising rescue negotiations are under way which might protect equity. Shareholders have no say in this. There are civil and even criminal sanctions for a breach of this duty. Insolvency is a very real threat even to large corporations. E.g., the largest shipbuilding company recently failed (Bremer Vulkan). No less real is the threat to managers to be sued both civilly and criminally for dealing insolvent or squandering assets near the advent of insolvency.

A third prominent trait of our corporate culture is the power wielded by banks and bankers.

Germany has a system of universal banks, i.e. banks may engage in commercial and investment banking. They own securities, and they trade in stock on their own behalf and on behalf of customers, and they appear, under German law, very substantially on shareholders’ meetings as representatives of the shareholders (bank proxy votes) who entertain stock deposits with them. In addition, banks wield considerable leverage and often very far-reaching information rights stemming from their credit and underwriting businesses. Especially in the case of multiple entitlements against a company (creditor rights and equity), banks may reap synergetic effects from sitting on the supervisory board.
III. The traditional outsider perception of the German system is one of

- relative immobility, considerable conservatism with stronger incentives for long term financial stability than for shareholder value and stock performance,

- a lack of transparency owing to undue and often secret influence by large institutional investors, notably banks, and an essentially self-recruiting, self-perpetuating, and closed managerial class,

- a sort of political coalition regime, with labor and capital defending their common in the status quo, and a lack of response to market forces,

- a disregard for the smaller investor and the hiding away of profits in the balance sheets of companies (so called secret reserves),

- absence both of efficient control of management and lack of clear agency relationships between management and investors and of control by the market for corporate control (in an environment were take-overs, especially the hostile kind, are extremely rare.

Before I discuss how the German business culture and corporate law reacted to the outward pressures I mentioned before, you should have some more detail about the practical functioning of governance, especially in the supervisory board:

IV. The supervisory board:

The mandatory number of board members depends on the number of persons employed. It varies from 6 to 20 members according to the number of employees in the company. The standard and maximum legal term is four years. The statutory minimum number of sessions is now four per year for listed companies. Extraordinary sessions which may be convoked by the executive board or by a quorum of two members are quite rare. Often charters allow the chairman’s committee to approve of emergency measures in between regular session intervals. On average, according to empirical surveys, only about 14 hours per year were spent in sessions.

According to empirical studies, only about 75 percent of supervisory boards created standing committees whose role is to prepare, and advise on, subsequent decisions by the plenary; only the terms and conditions of the employment contracts of managers (but not the appointment as such and
Multiple memberships in different companies are not as frequent as the German business folklore has it. Only 10 percent of members held parallel seats in the boards of more than 6 companies. The average number of seats held is about three. The statutory maximum is ten seats, and chairman’s functions are counted doubly in this context now. Only some seven percent of members work full time for their board membership. Full-time chairmen are sometimes found in the very largest companies. The typical remuneration for membership varies, to my knowledge, between some DM 3,000 to some DM 75,000 a year, and the chairman and vice chairman sometimes receive considerably more. I have not seen performance oriented remuneration schemes in my practice so far. The chairmanship often incumbers upon senior managing directors of the company after their discharge, and some have made a profession of sitting as chairmen in a number of companies.

Bank representatives held, in 1995, only 99 seats out of 1,561 seats in the supervisory boards of the 100 largest German companies (6 percent of all seats, and 12 percent of available shareholder representative seats. This figure is surprisingly low, and the general impression is that banks are becoming quite reluctant to hold supervisory board seats, perhaps due to the unpleasant damage action brought against a representative of Deutsche Bank in the notorious crisis of Metallgesellschaft.

Among the functions of the supervisory board are, other than the appointment and dismissal of managers, advising, and supervising the activities of, management, hearing the latter’s periodical reports, approving the annual statements or referring them to the shareholders’ meeting for approval, the appointment of auditors (since 1998), and approval of basic transactions such as fundamental strategic or structural measures, the acquisition, liquidation, or sale of subsidiaries, and the staffing of supervisory boards in subsidiaries. The supervisory board may subject any activity of management to prior scrutiny and reserve its approval. This can be achieved on a case-to-case basis or in a generalized way in the rules of procedure adopted by the supervisory board. From my perspective, supervisory boards are reluctant to take formal decisions on management measures for which approval is neither legally required nor formally reserved in advance. Members have broad information rights in sessions and, in practice, in session intervals. All information obtained must, in principle, be shared with all members. In the case of highly sensitive information, management often resorts to informing only the chairman or the chairman’s committee, and information is then not necessarily always shared with the plenary. It is important to note that the supervisory board cannot legally take the initiative and force management to take certain measures; the only lever the
supervisory board has is to threaten inactive managers with dismissal. This is not only a difficult threat to make because of the requisite majorities, but it will often be costly also because dismissal from the managerial function will usually leave the manager’s employment contract (contracts for four years are typical) intact and result in substantial unearned salaries, or, more frequently, in large settlement payments.

V. Recent reforms

In 1998 Germany witnessed what politicians named a „corporate governance reform“¹, triggered in large measure by the shock of the Metallgesellschaft’s near collapse and by the pressures of international financial markets.

The measures introduced by it go about as far as one can go without challenging the German system in its fundamentals.

Key issues addressed were:

A. Strengthening the effective functioning of the supervisory board and bring flesh blood into the traditional class of old wise men sitting on boards, i.a. by

1. the reduction of multiple supervisory board seats to a maximum of ten for each member, with chairman seats counted doubly,
2. the duty for supervisory board candidates to disclose other professional activities and possible conflicts of interest, and the disclosure of multiple seats in the report to the shareholders’ annual meeting,
3. the increase of the minimum number of annual sessions from two to four for listed companies, and the disclosure of the number of sessions and the creation of committees to the annual shareholders’ meeting

¹ Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), 27 April 1998 (Bundesgesetzblatt 1, p. 786-794).
B. Reaffirm the accountability of managers to the supervisory board, by, i.a.

1. the duty of management to install workable risk management systems in enterprises,
2. the duty of management to report periodically to the supervisory board on future business policy and financial, investive, and personnel plans,

C. Strengthening outside control by independent auditors

strengthening the independence of auditors by having them appointed by the supervisory board and not by management,

D. Increase transparency of the corporate power structures and of the performance of corporations, by, i.a.,

1. the duty for listed corporations to disclose in the annex to their annual financial statement stakes of more than five percent in other large corporations,
2. the abolition of shares with multiple voting rights and of the possibility of setting upper limits for the number of votes for any shareholder,
3. segment reporting and capital flow statements in the annual financial statements of groups whose parent is listed on the stock exchange. Voluntarily (or under the influence of the NYSE some of the biggest companies have adopted US accounting standards, sometimes in parallel Accounting under German and American standards

E. Reducing and disclosing the power wielded by banks, by i.a.

1. disclosure by banks of board seats and ownership stakes in the company for shareholders who are represented by bank proxy in shareholder meetings,
2. excluding bank proxy voting in companies where the bank owns more than 5 percent of stocks
3. the duty for banks to disclose board seats in another company and stakes of more than 5 percent.

F. Orientating management toward shareholder value, by i.a.

1. facilitating the repurchase of a companies own shares,
2. authorizing the annual shareholders’ meeting to create stock options plans for managers.
Some of the largest companies have developed such schemes. Courts have measured them by rather strict standards. The dilution of voting and ownership rights by issuing stocks or stock options to management requires some exceptional performance, generally measured against the development of a broader stock index (such as DAX) or a more specific industry index. Some authors suggest that an outperformance of hypothetical other investments, say, bonds, must be shown to allow the exercise of options. There is still great reluctance to accept what are felt excessive overall compensation levels for managers. There is also a fear of insider dealing or of manipulation of stock prices by management. Some of the largest German companies were forced by shareholder litigation temporarily not to go forward with the stock option plans they had developed.

Thank you very much.