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Hudson T. Hollister

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‘Shock Therapy’ for *Aktiengesellschaften*: Can the Sarbanes-Oxley Certification Requirements Transform German Corporate Culture, Practice and Prospects?

*Hudson T. Hollister**

I. INTRODUCTION

The Sarbanes-Oxley Act (Act) of 2002[1] was the U.S. Congress’s hasty response to the wave of corporate scandals that had begun to devastate U.S. investor confidence during the previous year. Its sixty-six pages contain a wide range of measures designed to enhance the quality and independence of corporate audits and disclosure under the U.S. securities-regulation regime. The Act applies to public corporations—corporations that are required to file regular financial reports under the Securities Exchange Act of 1934 (Exchange Act).

The Securities and Exchange Commission (SEC), in drafting rules to enforce the Act, interpreted it to apply to foreign private issuers (FPIs) registered with the SEC.[2] This surprised many observers because of the

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* J.D candidate, 2005, Northwestern University School of Law.

[1] Public Company Accounting Reform and Investor Protection (Sarbanes-Oxley) Act, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 15, 18 U.S.C.).

[2] A foreign private issuer [hereinafter FPI], defined in SEC Rule 3b-4, is a corporation organized outside the United States, with fewer than 50% of its voting shares owned by U.S. citizens and a majority of non-U.S. executive officers, assets and business. Sabyasachi Ghoshray, *Impact of Sarbanes-Oxley on Multiple Listed Corporations: Conflicts in Comparative Corporate Laws and Possible Remedies*, 10 ILSA J. INT’L & COMP. L. 447, 448-49 (1964). The Sarbanes-Oxley Act applies to, and this article discusses, only those FPIs that become subject to the Exchange Act and SEC regulation by selling their securities on U.S. exchanges or having a minimum number of U.S. shareholders.

SEC's general tendency to exempt foreign corporations from many of its rules.[3]

President George W. Bush signed the Act into law on July 30, 2002. In the ensuing weeks, none of the Act's provisions were more controversial than Sections 302[4] and 906,[5] which require corporate CEOs and CFOs to certify the accuracy of various financial statements filed under the Exchange Act.[6] By providing such certification, the officers become personally liable for inaccuracies. For FPIs, the certifications apply to financial reports to the first fiscal year ending on or after July 15, 2005.[7] Some FPIs see the certification requirements as an insuperable burden and an outrageous incursion into their home countries' regulatory regimes.

Objections from German corporations and observers were particularly vigorous.[8] At least one German FPI registered with the SEC has since deregistered and left the U.S. regulatory regime.[9] The implications and effects of the Act's certification requirements for German FPIs are in controversy.

Part II of this article tells the official story of the Act's certification requirements: their initial conceptualization by the SEC, their inclusion in the Act, and their enforcement in SEC rulemaking. Part III introduces the SEC's landmark decision to apply the certification requirements, along with other of the Act's provisions, to FPIs. The German reaction is discussed in Part IV. For German FPIs, the tangible costs of compliance with the certification requirements are considerable. Part V explains the real reason for the strenuous German objections to the certification requirements: the requirements are a shock to a corporate system very different from the flexible, profit-focused U.S. model. This comment concludes, in Part VI, that although the certification requirements may scare some German issuers

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[3] *See infra* Part III.

[4] Sarbanes-Oxley Act § 302, 15 U.S.C. § 7241 (2002).

[5] Sarbanes-Oxley Act § 906, 18 U.S.C. § 1350 (2002).

[6] *See* Stephan Hutter, Mark Devlin & Johannes Burkard, *US and German Corporate Governance: Principles: A Comparison*, CORP. FIN. MAG., Corporate Governance Guide, Sept. 2002, at 13, 16-17, *available at* http://www.corporatefinancemag.com/pdf/ 122321.pdf (last visited Nov. 15, 2004).

[7] *See* Press Release, SEC, Extension of Compliance Dates Regarding Internal Control Over Financial Reporting Requirements (Feb. 24, 2004), *available at* http://www.sec.gov/news/press/2004-21.htm (last visited Nov. 15, 2004) (extending deadline for non-accelerated filers for compliance with rules promulgated under § 404 of the Sarbanes-Oxley Act. Those rules, discussed *infra*, clarify the procedures for filing certifications under § 302 and § 906.) [hereinafter Extension Press Release].

[8] *See* Daniel Bogler, *Germany's Balance Sheet Police*, FIN. TIMES, Nov. 8 2002, at 13 (noting that "German companies with US listings have complained more loudly than anyone else about the consequences of America's Sarbanes-Oxley Act.").

[9] *See infra* Part IV.

away from U.S. capital markets, the benefits, both for investors and for those issuers who choose to remain, outweigh the costs. Complying with the certification requirements is 'shock therapy,' to be sure, but cheaper capital, higher efficiency, and global competitiveness will be the results.

II. THE SARBANES-OXLEY CERTIFICATION REQUIREMENTS AND THEIR APPLICATION BY THE SEC

Corporations making false or misleading statements in reports filed with the SEC have been subject to liability under Section 10(b)(5) of the Exchange Act for decades.[10] Beginning in 1980, the SEC required U.S. corporations' principal executive and financial officers to sign a Form 10-K, used for U.S. corporations' annual reports.[11] In its ambitious "Aircraft Carrier" proposals, the SEC first raised the possibility of requiring U.S. officers to *certify* as well as sign.[12] Had the proposals been enacted, top management would have been required to certify for each financial report that they had read the report and that it did not contain any false or misleading facts or omissions.[13]

A. The June Proposal

After their company's 2001 collapse, Enron executives testifying in congressional hearings tried to avoid responsibility for the misdeeds that had resulted in massive profit overestimations in the company's financial reports.[14] In March 2002, President George W. Bush outlined a new corporate-responsibility plan, including a requirement that "the CEO's signature [on financial statements] should also be his personal certification, vouching for the veracity and fairness of the financial disclosures."[15] On

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[10] Exchange Act § 10(b)(5), 15 U.S.C. § 78(j) (2000).

[11] *See* Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Acts Disclosure System, Exchange Act Release No. 34-17114, 45 Fed. Reg. 63,630 (Sept. 2, 1980) (to be codified in scattered sections of 17 C.F.R).

[12] *See* The Regulation of Securities Offerings, Securities Act Release No. 33-7506A, 63 Fed. Reg. 67,174 (proposed Nov. 13, 1998) (to be codified in scattered sections of 17 C.F.R.) [hereinafter Aircraft Carrier Release]. The Aircraft Carrier Release proposed a sweeping overhaul of the securities-regulation system; they were never carried out.

[13] *See id.* at 67, 244-345.

[14] *See The Financial Collapse of Enron–Part 2; Hearing Before the Subcomm. on Oversight & Investigation of the House Comm. on Energy & Commerce*, 107th Cong. 91-102 (2002) (statement of Jeffrey Skilling, Former President & CEO, Enron Corp.), *available at* http://energycommerce.house.gov/107/action/107—88.pdf#xml=http://wwws.house.gov/search97cgi/s97_cgi?action=View&VdkVgwKey=http%3A%2F%2Fenergycommerce%2Ehouse%2Egov%2F107%2Faction%2F107%2D88%2Epdf&doctype=xml&Collection=comms&QueryZip=skilling&, (last visited Nov. 16, 2004).

[15] *See* President George W. Bush, Remarks at the Malcolm Baldridge National Quality Award Ceremony (Mar. 7, 2002), *available at* http://www.whitehouse.gov/news/releases/

June 17, 2002, the SEC revived its push for certification requirements in proposed new rules under the Exchange Act of 1934 (June Proposal).[16] The new rules

> require[d] a [reporting] company's principal chief executive officer and principal financial officer to certify that, to their knowledge, the information in the company's quarterly and annual reports is true in all important respects and that the reports contain all information about the company of which they are aware that they believe is important to a reasonable investor.[17]

The SEC justified adding certification on top of the existing signature requirements by stressing corporate officers' responsibilities to personally ensure high-quality disclosure: "[A]ny senior corporate official who considers his or her personal involvement in determining the disclosure to be presented in quarterly or annual reports to be an 'administrative burden,' rather than an important and paramount duty, seriously misapprehends his or her responsibility to security holders."[18]

The June Proposal also included rules requiring every reporting company to maintain internal procedures designed to ensure that "the company is able to collect, process and disclose . . . the information, including non-financial information, required to be disclosed in its . . . reports."[19] The Proposal's rules also required executives to certify that they had reviewed the results of evaluations of the internal procedures.[20]

Importantly, the June Proposal stipulated that the new rules would not apply to FPIs for three reasons. First, Form 20-F, used for FPIs' annual Exchange Act financial reports, did not have the management signature requirement of Form 10-K.[21] Second, FPIs were not required to file quarterly reports, as domestic issuers were.[22] Finally, "mandatory requirements regarding internal procedures raise several issues, since those requirements may be inconsistent with the laws or practices of the foreign private issuers' home jurisdiction and stock exchange requirements."[23] Since reporting requirements for FPIs involved fewer signature

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2002/03/20020307-3.html (last visited Nov. 16, 2004).

[16] Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46079, 67 Fed. Reg. 41,877 (June 17, 2002) (to be codified at 17 C.F.R. pts. 232, 240 & 249) [hereinafter June Proposal].

[17] *Id.* at 41,877.

[18] *Id.* at 41,878.

[19] *Id.* at 41,881.

[20] *Id.* at 41,878 *passim.*

[21] *Id.* at 41,882.

[22] June Proposal, *supra* note 16, at 41,882.

[23] *Id.*

requirements, no quarterly reporting, and allowances for home-jurisdiction regulatory regimes, the SEC apparently felt that it would be inappropriate to impose the same certification requirements on FPIs and domestic issuers.

Eight days later, on June 25, 2002, the second-biggest corporate scandal of the period erupted when WorldCom, Inc. admitted misstatements in financial reports amounting to nearly $4 billion.[24] The SEC reacted to this devastating news on June 27 by requiring the CEOs and CFOs of 947 domestic issuers with annual revenues of over $1.2 billion to provide June Proposal-style certifications by August 15.[25] U.S. corporations had their first executive-certification experience.

B. The Sarbanes-Oxley Act

Congress, at this time, was in the midst of drafting its response to the corporate scandals—the legislation that became the Sarbanes-Oxley Act. Section 302, a provision quite comparable to the June Proposal, was drafted and added to Subchapter III of the Act.[26] Meanwhile, the Sarbanes-Oxley bill, on its way to becoming law, "subsume[d] similar legislation," including the White-Collar Crime Penalty Enhancement Act (WCCPEA).[27] One of the provisions of the WCCPEA also concerned executive certification; it became Section 906 of the Act.[28]

Thus, when President Bush signed the Act into law on July 30, 2002, two separate certification sections came into effect. Section 302 requires each reporting company's principal executive and financial officers to certify "in each annual or quarterly report" that "based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact [and that] the financial statements . . . fairly present . . . the financial condition . . . of the issuer."[29] Like the June Proposal, Section 302 mandates a set of undefined internal procedures designed to ensure accurate financial disclosure.[30] Section 302 further instructed the SEC to promulgate rules implementing it by August 30,

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[24] BRUCE C. BENNETT & GRAHAM ROBINSON, EXECUTIVE CERTIFICATIONS 11 (Covington & Burling) (2002) *at* http://www.cov.com/publications/download/oid6024/311.pdf (last visited Nov. 18, 2004).

[25] Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934, SEC (June 27, 2002), *available at* http://www.sec.gov/rules/other/4-460.htm (last visited Nov. 17, 2004).

[26] Sarbanes-Oxley Act § 302, *supra* note 4.

[27] Christopher Wyant, *Executive Certification Requirements in the Sarbanes-Oxley Act of 2002: A Case for Criminalizing Executive Recklessness*, 27 SEATTLE U. L. REV. 561, 569 (2003).

[28] Sarbanes-Oxley Act § 906, *supra* note 5.

[29] Sarbanes-Oxley Act § 302, *supra* note 4. For the text of Section 302, see *infra* Appendix I.

[30] *Id.* § 302(a).

2002.[31]

Subsection (b) of Section 302 provides that corporations cannot escape Section 302's requirements by reincorporating outside of the United States.[32] Some commentators have suggested this means Congress did not intend for Section 302 to apply to FPIs.[33] If FPIs filing financial reports were subject to Section 302, any U.S. corporation that moved its offices and became an FPI would *still* be subject to Section 302. Without some possibility that U.S. corporations might escape the certification requirements by becoming FPIs, there would be no need for subsection (b). Even so, nothing in Section 302 denied that its provisions would be applied transnationally.

Section 906 of the Act is deceptively similar to Section 302.[34] It, too, requires chief executive and financial officers to certify the veracity of financial statements. But its requirement is different:

> Each periodic report containing financial statements filed by an issuer with the [SEC] . . . shall be accompanied by a written statement by the [officers, certifying that the report] complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act pf [sic] 1934 . . . and that information contained . . . fairly presents . . . the financial condition and results of operations of the issuer.[35]

Section 906 does not include Section 302's protective clause "based on the officer's knowledge."[36]

While Section 302 contemplates enforcement by the SEC through that agency's regular rulemaking, Section 906 contemplates criminal enforcement. Section 906 includes specific criminal penalties for enforcement: a maximum fine of $1,000,000 and ten-year jail term for certifying a faulty financial report, and a maximum fine of $5,000,000 and twenty-year jail term for willfully doing so.[37]

Section 404 of the Act is also important to any discussion of executive certification.[38] It requires management to produce an "internal control report" as part of each annual Exchange Act report.[39] The report must

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[31] *Id.* § 302(c).

[32] *Id.* § 302(b).

[33] *See* Comments of Linklaters on S7-21-02, Aug. 19, 2002, at A.3, *available at* http://www.sec.gov/rules/proposed/s72102/linklaters1.htm.

[34] Sarbanes-Oxley Act § 906, *supra* note 5. For the text of Section 906, see *infra* Appendix II.

[35] *Id.* § 906(a)-(b).

[36] *Id.*

[37] *Id.* § 906(c).

[38] Sarbanes-Oxley Act § 404, 15 U.S.C. § 7262 (2002).

[39] *Id.* § 404(a).

affirm management's responsibility for the establishment and maintenance of an "internal control structure" and assess the effectiveness of that structure.[40] Like with Section 302, the SEC is directed to promulgate rules implementing Section 404, but the section did not impose a deadline.[41]

C. The Amending Release

In order to carry out Section 302's directive to promulgate certification rules by August 30, 2002, the SEC issued another release (Amending Release). It modified the rules suggested by the June Proposal to be consistent with Section 302.[42] The release contained a statement that became one of the SEC's most controversial decisions of the year: that Section 302's certification requirements would apply to FPIs.[43] By reversing the June Proposal's statement that FPIs would be protected from the certification requirements, the SEC set off a firestorm of controversy among FPIs and foreign commentators.[44]

D. The Adopting Release

After receiving comments from the legal community, corporations, and the public, the SEC issued a release (Adopting Release) adopting final rules implementing Section 302 on August 29, 2002.[45] Despite the ongoing international controversy over the application of the certification requirements to FPIs, the release reiterated that FPIs would be subject to the rules. It reasoned that "Section 302 of the Act makes no distinction between domestic and foreign issuers."[46]

The language of the final rules was very close to that of Section 302. However, the final rules eliminated the foreign-reincorporation language of Section 302 and added a provision that CEOs and CFOs would not be allowed to delegate the responsibility of making the required certification to

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[40] *Id.* § 404(a)(1)-(2).

[41] *Id.* § 404(a).

[42] Proposed Rules: Certification of Disclosure in Companies' Quarterly and Annual Reports, Exchange Act Release No. 34-46300, 67 Fed. Reg. 51,508 (Aug. 8, 2002) (to be codified at 17 C.F.R. pts. 232, 240, & 249) [hereinafter Amending Release].

[43] *Id.* at 51,509.

[44] *See infra* Part IV.

[45] Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act and Exchange Act Release Nos. 33-8124, 34-46427, IC-25722, 67 Fed. Reg. 57,276 (Aug. 29, 2002) (to be codified in scattered sections of 17 C.F.R) (adopting new Exchange Act Rules 13a-14 and 15d-14, requiring principal executive and principal financial officers to certify all reports filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F, and Form 40-F under Sections 13(a) and 15(d) of the Exchange Act) [hereinafter the Adopting Release].

[46] *Id.* at 57,278.

any of their subordinates.[47] The Adopting Release also modified each of the forms that would now require certification—including Form 20-F—to include specific language mirroring Section 302.[48]

E. The Section 404 Release

On June 5, 2003, the SEC issued a release adopting new rules that implemented Section 404 (Section 404 Release).[49] This release and its new rules attempted to resolve a variety of conflicts and ambiguities surrounding Sections 302, 906, and 404. It clarified that certifications pursuant to Sections 302 and 906 are to be provided *separately* as exhibits to the reports to which they relate.[50] However, the two certification requirements are significantly different because Section 302 requires its certification to be "in" the financial report, while Section 906 requires its certification merely to "accompany" the report.[51] That is, Section 302 certifications are potentially subject to greater liability.[52] The release set forth detailed standards for the Section 404 "internal control report," which took shape in a highly complex, detailed document.[53] Moreover, it consolidated all of the various rules' internal controls designed to ensure accurate financial reporting under one definition: "internal control over financial reporting."[54]

Recognizing that "foreign private issuers may have greater difficulty in preparing the management report on internal control over financial reporting," the SEC allowed FPIs extra time to comply with the new Section 404 rules.[55] FPIs were instructed that compliance would be required "in annual reports for [the] first fiscal year on or after April 15, 2005."[56] In February, 2004 the SEC extended this deadline to July 15, 2005.[57] By that date, FPIs had already been subject to the basic certification requirements for a year. However, the addition of an internal control report, even with a significant adjustment period, added a substantial new task for management.

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[47] *Id.* at 57,288-90.

[48] *Id.* at 57,923-94.

[49] Final Rule: Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Acts Release Nos. 33-8238, 34-47986, 68 Fed. Reg. 36,636 (June 5, 2003) [hereinafter Section 404 Release].

[50] *Id.* at 36,652-53

[51] *Id.*

[52] *See id.*

[53] *Id.* at 36,642-43.

[54] *Id.* at 36,640-41.

[55] Section 404 Release, *supra* note 49, at 36, 651.

[56] *Id.*

[57] Extension Press Release, *supra* note 7.

To summarize, the current certification and disclosure requirements imposed upon FPIs by the Sarbanes-Oxley Act and SEC rulemaking are as follows:

The Section 302 certification requires that an FPI's principal executive officer and principal financial officer must each certify: (1) that the officer has read the report; (2) that, based on the officer's knowledge, the report does not contain any false or misleading fact or omission; (3) that, based on the officer's knowledge, the report fairly presents the FPI's financial, operational and cash-floor situation; and (4) that the officer has ordained both disclosure controls and procedures *and* internal control over financial reporting, evaluated the effectiveness of the controls, disclosed such effectiveness and any material changes in the controls in the report, and made certain disclosures to the FPI's auditors.[58] False certifications under Section 302 "are subject to SEC enforcement action for violating the Exchange Act and also possibly to both SEC and private litigation alleging violations of the anti-fraud provisions of the Exchange Act."[59]

The Section 906 certification requires that an FPI's CEO and CFO must each certify (1) that the report fully complies with the appropriate section of the Exchange Act and (2) that it "fairly presents, in all material respects, the financial condition and results of operations of the [FPI]."[60]

Important differences between the two certifications include: a knowledge qualification is not required for Section 906 certification,[61] Section 302 certification *but not* the Section 906 certification is required as part of an interim amendment to a Form 20-F report,[62] and the difference in potential liability arising from the language difference discussed above.[63]

The Report on Internal Control over Financial Reporting requires management to provide an internal control report, which evaluates the effectiveness of management's internal control over financial reporting.[64]

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[58] Section 404 Release, *supra* note 49, at Exhibit Table: Certifications; *see also* Extension Press Release, *supra* note 7; Exchange Act Rules 13a-14 and 15d-14.

[59] Paul D. Tosetti & Latham & Watkins LLP, *Latham & Watkins Memoranda: Advanced Doing Deals 2004: Dealmaking in the New Transactional Marketplace*, 1433 PRAC. L. INST. CORP. L. & PRAC. COURSE HANDBOOK SERIES 13, 65 (June 7-8, 2004).

[60] *Id.* at 66.

[61] *Id.*

[62] *Id.*

[63] *See supra* Part II.E.

[64] Tosetti & Latham & Watkins LLP, *supra* note 59, at 66.

III. THE TRANSNATIONAL APPLICATION OF THE CERTIFICATION REQUIREMENTS

The SEC has a history of "liberally granting [FPIs] exemptions" from otherwise applicable Securities and Exchange Act rules.[65] Exemptions from proxy rules and liability rules regarding short-swing profits were granted to FPIs as long ago as 1935 because of sufficient "disparity between the laws and practices existing in the several countries."[66] The SEC's policy in granting the exemptions has been characterized as a "balancing test" that weighs "the risk of deterring foreign issuers from accessing U.S. exchanges heavily against protecting investors."[67] For example, the SEC exempts FPIs from filing quarterly financial reports. Instead, it allows them to abide by their home countries' or home stock exchanges' practices for more-often-than-annual reports.[68] Other accommodations include exemptions from Exchange Act proxy rules, short-swing profit recovery provisions, and individual executive compensation disclosure requirements.[69] Given the exemptions that the SEC has historically granted FPIs, non-U.S. observers were suprised when the certification requirements were imposed with explicit statements that they *would* apply to FPIs.[70] These certification requirements were onerous enough to make U.S. exchanges less attractive to many FPIs.[71] Had there been a shift in the SEC "balancing test"?[72]

Another way to characterize the SEC's dealings with FPIs is to say that the SEC has historically required *disclosure*, but has resisted regulating *governance*.[73] FPIs have been offering securities in U.S. markets since at

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[65] Anupama J. Naidu, *Was Its Bite Worse Than Its Bark? The Costs Sarbanes-Oxley Imposes on German Issuers May Translate into Costs to the United States*, 18 EMORY INT'L L. REV. 271, 272 (2004).

[66] Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715, 720 (quoting Exchange Act Release Nos. 323 & 325 (Class B), 1935 SEC LEXIS 316 (July 15, 1935)).

[67] Naidu, *supra* note 65, at 277.

[68] *See* Letter from Todd M. Malan, Executive Director, Organization for International Investment, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission 2, (Aug. 19, 2002) *available at* http://www.ofii.org/SEC_Letter_081902.pdf (requesting that the SEC exempt foreign private issuers from immediately-effective Sarbanes-Oxley provisions, and requesting "appropriate accommodation" in other areas, including executive certification) [hereinafter Letter of Organization for International Investment].

[69] *Id.*

[70] *Id.*

[71] *See infra* Part IV.

[72] *See* Naidu, *supra* note 65, at 277.

[73] *See* Roberta S. Karmel, *The Securities and Exchange Commission Goes Abroad to Regulate Corporate Governance*, 33 STETSON L. REV. 849, 852 (2004).

least the 1920's.[74] When Congress established the SEC by passing the Securities Act of 1933, "it contemplated the possibility that foreign issuers might make offerings in the United States."[75] But corporate-governance regulation in the 1930's was a matter of state, not national law, so the SEC's task for both U.S. and foreign corporations was one of requiring financial reports, rather than mandating governance structures.[76] As regulation of domestic issuers' governance matured throughout the 1970's, 80's, and 90's, SEC regulation of FPIs' governance lagged behind. For example, the final version of Form 20-F eliminated some controversial proposed disclosure requirements that would have affected governance, and the SEC stated a goal of eventually allowing FPIs to report using international accounting standards, rather than U.S. Generally Accepted Accounting Principles (U.S. GAAP).[77] The certification requirements, together with other Sarbanes-Oxley provisions, represent an unprecedented regulatory expansion in the governance of FPIs by the U.S. system—so unprecedented that a partner at Freshfields Bruckhaus Deringer predicted "massive exempting activity" by the end of August 2002.[78]

The SEC's enforcement power over disclosure rules indisputably extends to FPIs. If an FPI fails to provide required information, the SEC can either initiate an administrative proceeding or file a federal civil suit against it.[79] Fraudulent statements or omissions by FPIs also render those FPIs vulnerable to SEC enforcement action.[80] Federal courts have jurisdiction over FPIs in cases arising under the Exchange Act because FPIs have "purposefully availed [themselves] of the American securities market" by selling their securities to U.S. investors.[81]

U.S. jurisdiction over FPIs for the purpose of corporate-governance regulation has been questioned,[82] but the Act's provisions have now been

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[74] *See id.* at 857-58.

[75] *Id.* at 858.

[76] *See id.*

[77] *Id.* at 859-60.

[78] Nicola Hobday, *Porsche Delays U.S. Listing*, THE DAILY DEAL, Aug. 21, 2002, *available at* 2002 WL 22400483.

[79] Naidu, *supra* note 65, at 302.

[80] *Id.*; *see also* Mark S. Bergman, *Non-U.S. Company Sued for False Public Statements Made During Merger Negotiations*, INSIGHTS, Nov. 2000 at 13.

[81] Pinker v. Roche Holdings Ltd., 292 F.3d 361, 371 (3d Cir. 2002). *See also* McNamara v. Bre-X Minerals Ltd., 46 F. Supp.2d 628, 635 (E.D. Tex. 1999) (holding that defendant, "by encouraging over-the-counter trading of its stock in the United States, knew or should have known that it would be amenable to suit in the United States"); *In re* Baan Co. Sec. Litig., 81 F. Supp. 2d 75, 78 (D.D.C. 2000) (holding that "the defendant's knowledge that the object will be sold in a particular forum combined with his exploitation of the market in that forum would suffice" for the assertion of jurisdiction).

[82] *See* Minodora D. Vancea, Note, *Exporting U.S. Corporate Governance Standards Through the Sarbanes-Oxley Act: Unilateralism or Cooperation?*, 53 DUKE L.J. 833 (2003)

successfully applied against an FPI in a federal civil suit. On December 23, 2003, the SEC settled a civil fraud action against Vivendi Universal, a large French conglomerate.[83] The SEC used Section 308(a) of the Act, which adds civil penalties to disgorgement of funds recoverable from individual securities-enforcement defendants, to freeze the Vivendi CEO's severance package for disgorgement.[84]

The SEC has not been entirely unreceptive to FPIs' pleas for exemptions from specific Sarbanes-Oxley provisions. It has accommodated the German practice of employee representation on supervisory boards by allowing non-management employees to qualify as "independent" for the purposes of Sarbanes-Oxley audit committee membership rules[85] and exempted certain financial statements made outside the United States from U.S. GAAP reconciliation requirements.[86] But these types of exemptions are limited. "Massive exempting activity" has yet to take place. No exemption has been granted from the certification requirements. The SEC has insisted that the Act, by not distinguishing domestic and foreign corporations, did not give it the authority to grant such broad exemptions to FPIs.[87]

IV. THE REACTION OF GERMAN CORPORATIONS AND OBSERVERS TO THE CERTIFICATION REQUIREMENTS

Immediately following its passage, the Act raised hackles around the globe for its perceived "unilateralism" and lack of statutory exemptions[88] — in short, its apparent eagerness to impose U.S.-style governance everywhere. The certification requirements were a focus of early

(arguing that U.S. courts should decline to assert jurisdiction over FPIs' corporate-governance matters because their violations of U.S. corporate-governance rules do not rise to the level of domestic effects required and because asserting jurisdiction would violate valid comity principles).

[83] Press Release, SEC, Commission Settles Civil Fraud Action Against Vivendi Universal, S.A., Its Former CEO, Jean-Marie Messier, and Its Former CFO, Guillaume Hannezo (Dec. 23, 2003), *available at* http://www.sec.gov/news/press/2003-184.htm [hereinafter SEC Enforcement Press Release]; *see also* James Roberts, *Sarbanes-Oxley: The U.S. Experience and the U.K. Reaction*, Mondaq Business Briefing (Aug. 11, 2004) *at* http://www.mondaq.com/article.asp?articleid=27839.

[84] *See* SEC Enforcement Press Release, *supra* note 83.

[85] Final Rule: Standards Relating to Listed Company Audit Committees, Exchange Act Release Nos. 33-8220, 34-47654, IC-26001, 68 Fed. Reg. 18788 (Apr. 9, 2003) [hereinafter Audit Committee Exemption Release].

[86] Final Rule: Conditions for Use of Non-GAAP Financial Measures, Securities and Exchange Act Release Nos. 33-8176, 34-47226, FR-65, 68 Fed. Reg. 4820 (Jan. 22, 2003).

[87] *See, e.g.,* Commissioner Paul S. Atkins, Remarks at *Deutsches Aktieninstitut*, Feb. 4, 2003, *available at* http://www.sec.gov/news/speech/spch020403psa.htm.

[88] Karmel, *supra* note 73, at 856.

international objections.[89] German commentators and corporations, in particular, feared the potential effects of the certification requirements.[90] The German industry federation *Bundesverband der Deutschen Industrie* (BDI) warned that "German companies could be forced to withdraw from U.S. exchanges unless they secured exemptions from the Act."[91] A group of eleven German corporations sent a comment letter to the SEC requesting an exemption for FPIs from the certification requirements.[92] The letter noted that "[t]he Commission's . . . tradition of extending comity [to FPIs] was important in convincing us to become U.S. registrants in the first place."[93]

On August 19, 2002, German automaker Porsche put its previously-announced plans to list its securities on the New York Stock Exchange on

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[89] The certification issue was the basis for many objections. Many comments from international corporations and entitites on the Amending Release, *supra* note 42, focused on the certification requirements. *See, e.g.*, E-mail from Jonathan Bates, Managing Director, Institutional Design, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/jbates1.txt; E-mail from Cleary, Gottlieb, Steen & Hamilton, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/cleary1.htm; E-mail from Todd M. Malan, Executive Director, Organization for International Investment, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/tmmalan1.htm; E-mail from Hideo Hato, Director for Corporate Accounting and Disclosure, Japanese Financial Services Agency, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/hhato1.htm; E-mail from Ian Mullen, Chief Executive, British Bankers Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 23, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/imullen1.htm; E-mail from Darla C. Stuckey, Corporate Secretary, New York Stock Exchange, Inc., to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 27, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/dcstuckey1.htm; E-mail from Dr. Arnold Knechtle, Director, The Federation of Swiss Industrial Holding Companies, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Aug. 19, 2002), *available at* http://www.sec.gov/rules/proposed/s72102/aknechtle1.htm.

[90] *See, e.g.*, Hugh Williamson, *Legal Action Possible over Sarbanes-Oxley Bill*, FIN. TIMES, Aug. 12, 2002, at 24 (citing "tougher rules in the U.S. on possible penalties for management board members" and "the German two-tiered board system" as areas with "potential for conflict"). *See infra* Part VI for a detailed discussion of the conflict between the certification requirements and Germany's two-tiered, shared-responsibility corporate system.

[91] Bertrand Benoit, *German Companies Upbeat on U.S. Rules*, FIN. TIMES, Dec. 17, 2002, at 27.

[92] *See Certification: German Firms Ask SEC Not to Apply Rule On Certification to Non-U.S. Private Issuers*, 34 SEC. REG. & L. REP. (BNA) 1426 (Aug. 26, 2002). The eleven corporations were: DaimlerChrysler AG, Deutsche Telekom AG, Allianz AG, Altana AG, BASF AG, Bayer AG, EON AG, Infineon Technologies AG, Pfeiffer Vacuum Technology AG, SAP AG, and SGL CARBON AG.

[93] *Id.* (internal quotation marks omitted).

hold.[94] After the Adopting Release[95] did not include exemptions for FPIs, and no other exempting activity appeared likely, Porsche announced that it would never join the NYSE.[96] Porsche cited the certification requirements as "the crucial factor" in its decision:

> [T]his new American ruling does not match the legal position in Germany. In Germany, the annual financial statement is passed by the entire Board of Management and is then presented to the Supervisory Board, after being audited and certified by chartered accountants . . . Therefore there is an overall responsibility . . . involving over 20 persons . . . Any special treatment of the Chairman of the Board of Management or the Director of Finance would be illogical [and] . . . irreconcilable with current German law.[97]

According to poll results, Porsche's opinion was shared by corporate management throughout Europe.[98] The new stringency of the regime to which U.S. registrants would be subjected made pursuing a U.S. listing less attractive. A U.S. listing—highly desirable as recently as the summer of 2001—now carried with it more regulatory burden than many European corporations could bear.[99]

Some German corporations already listed in the United States showed a willingness to comply. The *Financial Times* reported in December 2002 that electronics giant Siemens had filed its Form 20-F with the required certifications.[100] Dr. Heinrich von Pierer, president of Siemens's management board, certified the form as Siemens's CEO.[101] By September 2003, Altana AG was even expressing enthusiasm for the "opportunity to

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[94] Hobday, *supra* note 78.

[95] *See supra* Part II.D.

[96] Press Release, Porsche, Balance-sheet oath in the U.S.A. as a K.O. criterion: Porsche dispenses with listing in New York (Oct. 16, 2002), *available at* http://www2.porsche.com/english/int/company/investorrelations/news/presreleases/021016.htm [hereinafter Porsche Press Release].

[97] *Id.* It should be noted that no decision regarding a U.S. listing is so simple that a single consideration can alter it. FPIs large enough to consider U.S. listings must weigh hundreds of variables. Porche's general counsel, Maria Arenz, told an interviewer in the spring of 2004 that "our internal debate predated Sarbanes Oxley, [which] . . . only made the decision easier." Michael D. Goldhaber, *Driving Force: A chat with the Gc of Porsche, which declined to list on the New York Stock Exchange*, CORPORATE COUNSEL, May 1, 2004, *available at* http://www.law.com/jsp/cc/pubarticleCC.jsp?id=1080851389251.

[98] *See* Larry Schlessinger, *Sarbanes-Oxley Scares off European CEOs*, AccountancyAge.com (Jan. 24, 2003), *at* http://www.accountancyage.com/News/1132257.

[99] *See* Michael Gruson, *Global Shares of German Corporations and their Dual Listings on the Frankfurt and New York Stock Exchanges*, 22 U. PA. J. INT'L. ECON. L. 185, 187 (2001).

[100] Benoit, *supra* note 91.

[101] *Id.*

review the company's reporting procedures and governance structures" provided by the Act.[102] In November, Altana's management board chair, Nikolaus Schweickart, called the Act, together with the German Corporate Governance Code, "genuine steps in the direction of a system of good and transparent corporate governance."[103] Mr. Schweickart even opined that the SEC's Sarbanes-Oxley exemptions and granting of additional time in the Section 404 release were evidence that it understood "the needs of foreign companies."[104]

Mr. Schweickart's optimism notwithstanding, the Section 404 Release and its requirement of an internal control report, combined with the certification requirements, seemed to make a U.S. listing intolerable for other U.S.-listed German corporations. Intershop Communications AG (Intershop), listed on the NASDAQ, announced in October 2003 that it would withdraw from the exchange and deregister with the SEC.[105] It finished the arduous deregistration process in June 2004 and is no longer subject to U.S. regulation and reporting requirements.[106] The Wall Street Journal reported in September 2004 that Lion Bioscience AG, another German FPI with a NASDAQ listing, was weighing whether to follow suit.[107]

Intershop's experiences illustrated one of the difficulties facing would-be delisters: the only way to escape the U.S. regulatory regime is to deregister with the SEC, which requires both delisting from U.S. exchanges and demonstrating that fewer than 300 U.S. citizens are shareholders.[108]

The tangible costs for FPIs to comply with the certification requirements are substantial.[109] To the extent that more of management's time is spent verifying financial statements, the time loss represents a cost. The new disclosures—the Section 404 report on internal controls, for example—likewise present significant outlays of money and time. If an

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[102] *The Global Stance on Sarbanes-Oxley: Non-U.S. companies say the benefits outweigh the burdens of complying with U.S. securities rules*, NYSE MAGAZINE (Sept. 4, 2003), *available at* http://www.nyse.com/events/1063105217282.html.

[103] *Id.*

[104] *Id.*

[105] Silvia Ascarelli, *Citing Sarbanes, Foreign Companies Flee U.S. Exchanges*, WALL ST. J., Sep. 20, 2004, at C1.

[106] *Id.*

[107] *Id.*

[108] *See, e.g.*, Kit Bingham, *Lastminute's US flight may face delays*, FIN. NEWS, Jul. 25, 2004 (reporting on U.K. company's deregistration and quoting a Latham & Watkins LLP partner: "Delisting is easy. Deregistering is damn-near impossible these days. The crux of the problem is that you have to keep your U.S. shareholder base below 300. To police that on an ongoing basis is hard. You have to keep tabs on your worldwide shareholder basis on a quarterly basis, which is very difficult for a large company.").

[109] *See, e.g.*, Naidu, *supra* note 65, at 304-05.

FPI is prevented by the certifications from misrepresentations it otherwise would have made (without detection and punishment), the loss of the gains from those misrepresentations constitutes a cost. Finally, the imposition of the certification requirements puts FPIs on notice of new forms of litigation and enforcement. Prudence would require an FPI to prepare for the eventuality of such litigation and enforcement. Such preparation can also be counted among the costs of the requirements.[110]

The certification requirements' tangible costs do not explain all of the consternation the requirements caused in Germany. The Section V explains the direct systemic conflict the requirements brought for German FPIs.

V. GERMAN CORPORATE STRUCTURE, PRACTICES AND VALUES: HOW CERTIFICATION SHOCKS THE SYSTEM

An examination of basic German corporate structure, practices and values provides crucial context for the German objections to the certification requirements. The requirements focus on individual corporate officers in assigning responsibility to prevent misstatements. Their goal is to improve value for only one corporate constituency: the shareholders. To the extent that the requirements prevent corporations from painting deceptively rosy financial pictures, their effect will be to force greater efficiency upon the bureaucracies of large German corporations. The requirements' individual focus, investor-value goal, and probable effect are inimical to the structural, practical and normative realities of the German corporate model. The requirements are "shock therapy" for a rigid, bank-controlled corporate system where risk is shunned and small investors are ignored. Requiring executive certification on German FPIs' financial statements is outrageous in the German context, but it forces those corporations to move toward more investor-focused, responsive and efficient business practices that are better for long-term economic growth.

This Part discusses the fundamental realities of German corporate culture and explains that the culture is inhospitable to individual investors. It next explains the failure of German attempts to reform the system. Finally, it considers the direct systemic challenge the certification requirements have introduced for German FPIs.

A. Basic German Corporate Structure

The German equivalent to the U.S. publicly-traded corporation is the *Aktiengesellschaft* (AG).[111] Unlike a U.S. corporation, which is governed by the laws of the states in which it incorporates, the AG is governed by the

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[110] *See id.*

[111] Franck Chantayan, *An Examination of American and German Corporate Law Norms*, 16 ST. JOHN'S J. LEGAL COMMENT. 431, 434-35 (2002).

federal *Aktiengesetz* (Stock Corporation Act).[112] The AG is tightly regulated; its *Satzung* (articles) "may deviate from the provisions of the Stock Corporation Act only to the extent that the Act itself expressly so permits."[113] Three *Organe* (statutory bodies) govern the AG: the *Vorstand* (management board), the *Aufsichtsrat* (supervisory board) and the *Hauptversammlung* (shareholders' meeting).[114] The supervisory board appoints the members of the management board and is itself elected by the shareholders' meeting and corporate employees; however, none of the three *Organe* can order another to take specific actions.[115]

The management board is the *Organe* most similar to the U.S. board of directors.[116] However, none of its members are independent—the management board can be likened to a board of directors composed entirely of corporate officers.[117] It is charged, collectively, with the day-to-day management of the AG.[118] Its members are appointed by the supervisory board.[119] Unlike the chairman of a U.S. board of directors, the chairman of the management board is not invested with special authority[120]—in fact, some AGs use the title *Sprecher* (spokesman), rather than *Virsitzender* (chairman) for their management-board chair.[121] The management board must report to the supervisory board regarding the AG's "intended business policy;" profitability; "state of business, in particular revenues;" and also report any major transactions.[122] Originally, the Stock Corporation Act specifically directed the management board to take four different interests into account in its activities: the welfare of the AG itself, the stockholders, the employees, and the state.[123] This fourfold enumeration of the board's duties contrasted sharply with the U.S. profit-maximizing ethic. The German legislature removed the provision in 1965, but its stated reasoning for doing so was that the duties were, and would remain, implicit.[124]

The supervisory board is comparable to the external directors on a U.S.

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[112] Hutter, Devlin & Burkard, *supra* note 6, at 13.

[113] *Id.*

[114] *Id.*

[115] *See id.*

[116] Chantayan, *supra* note 111, at 438.

[117] *See* Hutter, Devlin & Burkard, *supra* note 6, at 13.

[118] *Id.*

[119] *Id.*

[120] Florian Stamm, *A Comparative Study of Monitoring of Management in German and U.S. Corporations After Sarbanes-Oxley: Where are the German Enrons, WorldComs, and Tycos?*, 32 GA. J. INT'L. & COMP. L. 813, 827 (2004).

[121] *See* Hutter, Devlin & Burkard, *supra* note 6, at 13.

[122] *Aktiengesetz,* § 90 (F.R.G.) [hereinafter Stock Corporation Act].

[123] *See* Chantayan, *supra* note 111, at 440; Stamm, *supra* note 120, at 827-28.

[124] *See* Chantayan, *supra* note 111, at 440; Stamm, *supra* note 120, at 827-28.

board.[125] Employees elect up to half of its membership,[126] with the remainder selected by the shareholders.[127] The supervisory board theoretically safeguards shareholders' interests by overseeing the management board;[128] however, it may not take on management responsibilities[129] and its members are not legally capable of binding the AG.[130] Members of the management board may not serve on the supervisory board,[131] but a single person may serve on the supervisory boards of up to ten AGs.[132]

The shareholders' meeting is required, by the Stock Corporation Act, to convene annually.[133] Beyond selecting the portion of the supervisory board that is not selected by employees,[134] its involvement is necessary only for the most important of corporate decisions.[135] Like the supervisory board, it is not entitled to take part in corporate management.[136]

One of the most important aspects of any corporate-governance system is the extent to which corporate management can be held legally responsible for derelictions of their duty to shareholders. German management board members' actions are subject to greater potential legal liability than that of U.S. board members because there is no German equivalent to the business-judgment rule.[137] Management board members are individually responsiblefor exercising the care of a "diligent and prudent business executive."[138] Moreover, they bear the burden of proof in litigation over alleged derelictions of this duty.[139] But the German system limits who can bring such a suit. Ordinarily, the management board itself is the only entity capable of suing on the corporation's behalf.[140] When management board

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[125] *See* Hutter, Devlin & Burkard, *supra* note 6, at 14.

[126] *See infra* Part V.B. for a discussion of codetermination.

[127] *See* Hutter, Devlin & Burkard, *supra* note 6, at 14.

[128] *See* Chantayan, *supra* note 111, at 439.

[129] Stock Corporation Act, *supra* note 122, § 111.

[130] Chantayan, *supra* note 111, at 438.

[131] Susan-Jacqueline Butler, *Models of Modern Corporations: A Comparative Analysis of German and U.S. Corporate Structures*, 17 ARIZ. J. INTL. & COMP. L. 555, 563 (2000); Stock Corporation Act, *supra* note 122, § 100.

[132] Stock Corporation Act, *supra* note 122, § 100.

[133] *See* Hutter, Devlin & Burkard, *supra* note 6, at 14.

[134] *See infra* Part V.B. for a discussion on codetermination.

[135] *Id. See also* Stock Corporation Act, *supra* note 122, § 119.

[136] Butler, *supra* note 131, at 571.

[137] *See* Chantayan, *supra* note 111, at 442-43.

[138] Stock Corporation Act, *supra* note 122, § 93; Hutter, Devlin & Burkard, *supra* note 6, at 17.

[139] *See* Butler, *supra* note 131, at 569.

[140] Chantayan, *supra* note 111, at 443-44; Stock Corporation Act, *supra* note 122, § 71(1).

members are sued by the corporation, the only entity capable of bringing the suit is the supervisory board.[141] It is possible for shareholders to force an unwilling supervisory board to do this, but German civil procedure imposes powerful disincentives on such an action.[142] Unlike the United States, Germany does not allow shareholders themselves to sue management by asserting the rights of the corporation.[143]

B. Notable German Corporate Practices

To understand the system into which the Sarbanes-Oxley certification requirements have introduced individual responsibility and a focus on shareholder interests, two integral statutory (or perhaps quasi-statutory) practices must be examined. These practices are the control wielded by German banks over large AGs, and codetermination.

German banks are powerhouses of corporate control. Unlike their U.S. counterparts, they are not restricted from owning majority stakes in corporations.[144] Groups of banks own controlling blocks of most large AGs' shares.[145] Moreover, German law allows for the formation of universal banks—institutions that engage in both investment and commercial services.[146] The common practice of individual investors is to purchase shares through commercial banks, keep the shares deposited with those banks, and allow the banks to exercise the voting rights.[147] Finally, AGs acquire expansion capital from bank loans to a greater extent than by issuing securities.[148] By owning majority stakes in most AGs, exercising proxy voting rights for non-bank shareholders, and serving as the primary source of capital for expansion, German banks have developed enormous influence.

German banks' majority stakes in the nation's large AGs have led to the control of supervisory boards by bank representatives.[149] It is very common for members of banks' management and supervisory boards to sit

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[141] Chantayan, *supra* note 111, at 443-44; Stock Corporation Act, *supra* note 122, § 112.

[142] *See* Butler, *supra* note 131, at 601 (noting that the German *Zivilprozessordnung* requires losing parties to bear the costs of litigation and forbids attorneys to use contingency-fee arrangements).

[143] Chantayan, *supra* note 111, at 443-44.

[144] *See* Stamm, *supra* note 119, at 829-30.

[145] *See* Chantayan, *supra* note 111, at 435.

[146] *See id.*

[147] *See* Bernd Singhof & Oliver Seiler, *Shareholder Participation in Corporate Decisionmaking Under German Law: A Comparative Analysis*, 24 BROOK. J. INT'L. L. 439, 508 (1998); *see also* Stamm, *supra* note 120, at 829-30.

[148] *See* Stamm, *supra* note 119, at 829.

[149] *See* Chantayan, *supra* note 111, at 441-42; Stamm, *supra* note 120, at 840.

on the supervisory boards of AGs where the banks hold large stakes.[150] The result is an "interlocking supervisory board relationship," where a small group of individuals from a relatively small group of banks holds sway over the most important AGs' supervisory boards.[151]

The prevalence of *Depotstimmrecht der Banken* (depository voting rights of banks) reinforces the power banks already wield as majority owners. Banks exercising depository voting rights owe certain duties to the shareholders, but those duties are far less than the duties of U.S. proxy holders.[152] Germany's "big three" banks—Deutsche Bank, Dresdner Bank and Commerzbank—are said to wield sufficient proxy power to have as much influence on the governance of large AGs as their management.[153] For several reasons, most importantly, the fact that the shareholders elect a portion of the supervisory board, rather than directly electing management, German AGs do not experience the bitter proxy fights that are common in the United States.[154]

The third pillar of bank control is the AGs' dependence for funding on loans, rather than private investment.[155] German management boards need not pay as close attention to short-term profits and dividends as U.S. management because their ability to raise capital is not as closely tied to their ability to attract individual and institutional customers for their securities.

Bank control has several important consequences for the management, strategy and culture of Germany's large AGs. Because bank loans fund corporate expansion and banks dominate supervisory boards (both through direct ownership and through proxy power), banks' conservatism is theoretically a more important check on management than is the whim of shareholders.[156] Yet, the bank-heavy supervisory boards tend to give management wide latitude, even tolerating significant inefficiency.[157] This is because the banks see the AGs, not as investments, but as customers with whom they must maintain relationships.[158] Furthermore, banks are more interested in their corporate customers' long-term solvency and stability than in achieving high rates of return on their own investments. Therefore, they are likely to use their influence to encourage AGs' management boards

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[150] *See* Chantayan, *supra* note 111, at 441-42; Butler, *supra* note 131, at 574.

[151] Chantayan, *supra* note 111, at 441-42.

[152] *See* Singhof & Seiler, *supra* note 147, at 511, 513-14.

[153] *Id.* at 517.

[154] *Id.* at 512-13.

[155] *See* Stamm, *supra* note 120, at 829.

[156] *See id.* at 831.

[157] *See id.* at 846.

[158] *See* Singhof & Seiler, *supra* note 147, at 520.

to pursue conservative policies.[159]

Bank control also tends to minimize the influence of non-bank shareholders. Proxy fights[160] and shareholders' associations with significant power[161] do not exist in Germany. For investors who seek high rates of return from lean, mean corporations, bank control "seriously undermines a system that looks promising on paper."[162]

Codetermination, the representation of labor on AGs' supervisory boards, is one of the defining principles of German industry.[163] *Mitbestimmungsgesetze* (codetermination laws) require certain percentages of supervisory boards to be elected by labor.[164] The percentage varies depending on the AG's size and industry.[165] The supervisory board of an AG with two thousand or more employees (unless it is in the mining, iron, or steel industry) must be equal parts labor and shareholder representatives, except that one of the labor representatives must be a "management executive."[166]

Relative to U.S. practice, codetermination adds a corporate constituency. Boards of directors in the United States must worry about pleasing shareholders and lenders; German management boards must consider the demands of shareholders, lenders and labor.[167] Significantly, the labor constituency tends to support conservative corporate policies because its only concern is the preservation of jobs, pay and benefits.[168] Beyond this initial dilution of ownership influence, it is suggested that

> [M]anagers and stockholders sapped the supervisory board of power (or, more accurately, prevented it from evolving into a serious governance institution . . .) to reduce employee influence in the firm. Board meetings are infrequent, information flow to the board is poor, and the board is often too big and unwieldy to be effective.[169]

For small investors, the problem with minimizing the supervisory board's power is that it leaves them with no voice at all.[170] Power devolves

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[159] *See id.* at 519-20.
[160] *See id.* at 512-13
[161] *See id.* at 528-29.
[162] Stamm, *supra* note 120, at 814.
[163] Butler, *supra* note 131, at 561-62.
[164] Stamm, *supra* note 120, at 821.
[165] Butler, *supra* note 131, at 562-64.
[166] *Id.* at 562-63.
[167] Stamm, *supra* note 120, at 834-35.
[168] *Id.* at 835.
[169] Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 167-68 (1998); *see also* Chantayan, *supra* note 111, at 450-51.
[170] *See id.*

to "out-of-the-boardroom shareholder caucuses and meetings between managers and large stockholders,"[171] and blockholding banks benefit. Codetermination does not make economic sense because labor favors institutional survival over efficiency.[172] Over the long term, everyone, including labor, benefits most when corporations keep costs down, invest in expansion and drive economic growth. But labor's "conservatism and one-sided goal of preservation of the employment force . . . have stalled transactions and impeded the efficacy of the German corporation."[173] Professor Helmut Kohl suggests that codetermination is a good example of "path dependency," the survival of inefficient institutions that have become ingrained in the larger social order: "codetermination limits contractual freedom and private property . . . [but] the only scenarios I can imagine that would effectively abolish codetermination are a revolution or an extortion."[174] Although some mitigation of the effects of codetermination has begun to occur,[175] the negative effects of the phenomenon for shareholders—dilution of their influence on the AG and damage to the AG's profit motive—remain significant.

C. German Corporate Values

The structural and practical realities, as discussed above, reinforce, and are reinforced by, three overriding and related values of German corporate culture. These values—conservatism, collectivism and survival—are generally inimical to the interests of individual (non-bank) shareholders. They also are associated with slow economic growth and the continued weakness, discussed below, of German capital markets.

German AGs tend to follow conservative growth patterns for several reasons, some of which are discussed above. In addition to the banks' love of stability and labor's need for security, commentators point out that German investors themselves are risk-averse.[176] Moreover, AGs generally, not only banks, tend to invest heavily in one another, producing a pervasive, almost organic interdependency.[177] Investors' risk-aversion and corporate interconnectedness, combined with the fact that AGs are far less dependent

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[171] Roe, *supra* note 169, at 168.

[172] *See* Butler, *supra* note 131, at 602.

[173] Stamm, *supra* note 120, at 845-46.

[174] Helmut Kohl, *Corporate Governance: Path Dependence and German Corporate Law: Some Skeptical Remarks from the Sideline*, 5 COLUM. J. EUR. L. 189, 193, 195 (1999).

[175] *See* Chantayan, *supra* note 111, at 451.

[176] Naidu, *supra* note 65, at 282; Chantayan, *supra* note 111, at 449-50; Stamm, *supra* note 120, at 837, 855 (stating "German capital has been described as 'patient,' meaning Germans tend to be more tolerant of management inefficiencies before moving capital out of a corporation").

[177] *See* Stamm, *supra* note 120, at 854-55.

than U.S. corporations on investors' capital,[178] all help reinforce a powerful inertia in the German corporate mindset. AGs' structure and control produce a managerial bias in favor of caution and survival, and against aggression and growth.

A pronounced collectivist bent, both internal and external, can be discerned within the German corporate culture. Governance and policy are dictated by consensus, rather than by competitive checks among different constituencies and governance bodies. Critics charge that "in some corporations the [supervisory board] has become a part of the management and thus, lost its ability to objectively monitor" the management board.[179] The U.S. corporate system is characterized by the separation of ownership and control; this separation appears to be much less clear in Germany.[180] If the supervisory and management boards of an AG do not effectively check one another, the interests of minority shareholders are in jeopardy. The problem becomes even more serious when one views all AGs as a whole. With members of banks' boards—both management and supervisory—serving on the supervisory boards of most large AGs,[181] it becomes quite doubtful that ownership and control are distinct in any real sense.

To the extent that Germany, relatively speaking, tends toward political collectivism, its corporations become less attractive investments for individuals. Although the management board is no longer statutorily obligated to give weight to the interests of the AG itself, the stockholders, the employees, and the state,[182] "German political sentiment has been that economic efficiency has been worth sacrificing to 'protect' non-shareholder constituencies."[183]

Institutional survival, for the purpose of preserving jobs, is the overriding value for the labor representatives on the supervisory board.[184] The involvement of labor in the corporate-governance structure renders cost-cutting very difficult.[185] If economic efficiency can be sacrificed for the sake of non-shareholder constituencies, there will be pressure for AGs to continue fiscally indefensible operations in order to keep people employed, maintain service to politically significant groups or geographic areas, or retain a German presence in particular industries more cheaply

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[178] *See id.*

[179] Butler, *supra* note 131, at 602.

[180] Stamm, *supra* note 120, at 845.

[181] *See* Butler, *supra* note 130, at 574.

[182] *See supra* Part V.A. (discussing management board's duties to various constituencies, formerly imposed via statute but now considered "implicit").

[183] Stamm, *supra* note 120, at 854.

[184] *See* Viet D. Dinh, *Codetermination and Corporate Governance in a Multinational Business Enterprise*, 24 IOWA J. CORP. L. 975, 997 (1999).

[185] *See supra* Part V.B. (discussing inefficient economics of codetermination).

pursued in other countries. If serving the interests of the AG itself, the employees and the state are on a par with making a profit for the investors,[186] there are plenty of defenses for fiscally irresponsible decisions. German AGs are seen as institutions that provide benefits for many constituencies beyond investors.

D. Implications of German Corporate Structure, Practices, and Values for Investors

Individual investors wield far less power in Germany than in the United States.[187] First, they are unable to effect change directly in the corporate-governance system. The German system's interposition of the supervisory board between shareholders and management board insulates management from direct accountability.[188] The supervisory board is not likely to represent the interests of individual investors.[189] Their voice, if present at all, is muffled by the dominance of banks and the required representation of labor.[190] Second, individual investors in Germany lack the legal tools provided in the U.S. system to call management to account for derelictions of duty. Only supervisory boards can sue management on behalf of the corporation,[191] and supervisory boards are often too closely identified with management to serve as an effective check.[192] Third, the individual investors are few and insignificant in the German system. The German system uses "the precautionary attitude of banks, and not the threat of individual shareholder liquidity, as a check on management."[193] The significance of individual investors is demonstrated by a banker's comment that has become a cliché in German financial literature: "Shareholders are dumb when they buy stock and impertinent because they also want a dividend."[194] Large AGs are said to "resemble 'semi-private' companies" in their illiquid ownership and lack of concern for minority stakeholders.[195]

In this context, it is not surprising that German AGs do not place a primary focus on investors' interests.[196] As a consequence, the German

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[186] *See supra* Part V.A. (discussing management board's duties to various constituencies, formerly imposed via statute but now considered "implicit").

[187] *See* Chantayan, *supra* note 110, at 455.

[188] *See* Butler, *supra* note 131, at 564-65.

[189] *Id.* at 602-03.

[190] Stamm, *supra* note 120, at 833.

[191] *See supra* Part VI.A.

[192] *See* Stamm, *supra* note 120, at 845.

[193] *Id.* at 831.

[194] Thomas J. André, Jr., *Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany*, 73 TUL. L. REV. 69, 105 (1998).

[195] *See* Roe, *supra* note 169, at 167.

[196] *See* Naidu, *supra* note 65, at 282; Chantayan, *supra* note 111, at 455.

capital markets are poorly developed[197] and are not attractive to foreign investment.[198] For example, required disclosure is much less in Germany than in the United States,[199] and there is no German equivalent to the United State's SEC.[200] The inhospitality of German capital markets is a matter of pressing concern for the country's policymakers. As global competition intensifies, German AGs will fail to remain competitive if they are unable to make the transition from debt financing to equity financing by attracting significant numbers of individual investors.[201]

E. Attempts at Reform from within the German System

It is widely recognized that "the bank-dominated system has hindered Germany's economic growth,"[202] and efforts to modernize German securities markets and make them more attractive for individual investors are under way. But these efforts have met with setbacks during the last four years. The Deutsche Bourse AG, which runs Germany's largest stock exchange, the Frankfurter *Wertpapierborse*, set up a new exchange modeled on the NASDAQ, the *Neuer Markt*, in 1997.[203] The *Neuer Markt* "advertised high standards of disclosure and transparency" and strived to be a vehicle for the expansion of Germany's base of individual investors.[204] But it failed a few years after its founding.[205] The Deutsche Bourse AG's attempts to merge with the London Stock Exchange, Europe's largest stock exchange, came to an end in 2000.[206]

Another recent attempt at improving the investment climate for individual investors was the February 2002 publication of the German

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[197] *See, e.g.*, Andreas J. Roquette, *New Developments Relating to the Internationalization of the Capital Markets: A Comparison of Legislative Reforms in the United States, the European Community, and Germany*, 14 U. PA. J. INT'L. BUS. L. 565, at ¶ 2.2 (agreeing that the German securities market is "narrow, thin and boring," with very few listed corporations, and characterizing German industries as "undercapitalized" compared to U.S. industries).

[198] *See* Singhof & Seiler, *supra* note 147, at 494.

[199] *See* Stamm, *supra* note 120, at 836-37.

[200] *Id.* at 837; Naidu, *supra* note 65, at 299-300 (The German Federal Securities Trading Supervisory Office (BAWe) is not authorized to "implement penalties for manipulation of the market or other violations," and its staff is tiny compared with that of the SEC. Enforcement of securities laws rests with the Land Supervisory Stock Exchange Authorities (Lander), but "their familiarity with this field is limited.").

[201] *See* Singhof & Seiler, *supra* note 147, at 540.

[202] *See* Chantayan, *supra* note 111, at 449. Chantayan concludes that "Germany will have to fundamentally change its system to overcome shareholder distrust of the stock market, as well as other cultural norms, to attract a more diverse group of investors." *Id.* at 455.

[203] Naidu, *supra* note 65, at 306.

[204] *Id.* at 307.

[205] *Id.* at 308.

[206] *Id.*

Corporate Governance Code by a commission established by the Chancellor.[207] The Code, however, does not constitute new binding law.[208] Instead, it reiterates previously existing laws and sets forth two categories of "best practices:" recommendations, indicated by the directive word *shall*; and suggestions, indicated by the words *should*, *may*, and *can*.[209] The recommendations have been given additional force by the passage of the Transparency and Disclosure Law, which went into force as part of the Stock Corporation Act in July 2002.[210] The Transparency and Disclosure Law requires AGs to declare their compliance or non-compliance with each of the recommendations in the Code.[211] A more stringent, earlier version of the law would have required AGs to explain any non-compliance.[212]

Among the most important of the Code's recommendations, in light of this article's discussion above, are disclosure requirements for management board members' potential conflicts of interest; supervisory board approval for "significant transactions" between management board members and the company; and a prohibition on more than two former management board members serving on the supervisory board.[213]

But one commentator, Lutz-Christian Wolff, charges that the Code is more likely a "marketing tool to improve the attractiveness of Germany's capital markets to foreign institutional investors" than a genuine set of reforms.[214] He argues that none of the Code's recommendations require major changes in corporate practice:

> [T]he practical impact of the recommendations is of minor significance either because they simply confirm already existing corporate practice or because the wording is vague and does not require sincere commitment.[215]

To the extent that Wolff is correct, the Code will not significantly improve the hospitability of German AGs to individual investors. Moreover, the Code's recommendations are dependent on market pressure

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[207] *See* Lutz-Christian Wolff, *Law as a Marketing Gimmick—The Case of the German Corporate Governance Code*, 3 WASH. U. GLOBAL STUD. L. REV. 115, 121 (2004); German Corporate Governance Code, *available at* http://www.corporate-governance-code.de/eng/download/DCG_K_E.pdf (last visited Nov. 4, 2004).

[208] Hutter, Devlin & Burkard, *supra* note 6, at 16.

[209] *See id.*; *see also* Wolff, *supra* note 207, at 121-22.

[210] Stock Corporation Act, *supra* note 122, § 161.

[211] *See* Wolff, *supra* note 207, at 122-23.

[212] Hutter, Develin & Burkard, *supra* note 6, at 16.

[213] *Id.*

[214] Wolff, *supra* note 207, at 133.

[215] *Id.* at 132.

for enforcement.[216]

F. The Certification Requirements' Shock to the System

The Sarbanes-Oxley certification requirements, unlike the German system's attempts at self-reform, represent real change for those large German AGs that are FPIs subject to SEC regulation. The requirements' focus, goal, and direct and indirect effects all threaten certain investor-unfriendly aspects of the German system. Imposed by a resourceful, well-funded regulator that has demonstrated its willingness to engage in transnational enforcement, the requirements will compel painful, but ultimately beneficial adjustments for the AGs to apply.[217]

The certification requirements compel executive and financial officers to involve themselves personally in the preparation of financial statements,[218] and make them liable, as individuals, for the failure to do so. This individual focus is inimical to the internal collectivism that characterizes German corporate governance.[219] Forcing the chair of the management board to take on personal responsibility for a financial statement formerly "passed by the entire Board of Management and . . . then presented to the Supervisory Board, after being audited and certified by chartered accountants,"[220]—and vouched for by all of those people, collectively—is beyond a doubt a wrenching and drastic change. But it provides a mighty incentive for that person to do everything possible to ensure the statement's accuracy. Different levels of responsibility and liability will encourage the kind of checks that have suffered under German corporate collectivism.

The certification requirements are imposed with the explicit aim of ensuring the veracity of financial statements, for the benefit of investors.[221] This goal forces a rearranging of AGs' priorities. It is a step toward shareholder-friendly operations for AGs that currently juggle obligations to shareholders, themselves, labor and society. Mandated verity in financial statements can be bad for institutional survival, and subsequently bad for labor if it prevents an AG from misrepresentations and from forestalling bankruptcy by fraudulently attracting new investment. It can be bad for the state; a bankrupt AG pays no taxes. Verity in financial statements benefits the investment community directly; it only benefits the AG, labor and the state over the long term, as the appearance and reality of openness attract

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[216] *See* Hutter, Devlin & Burkard, *supra* note 6, at 16.

[217] *See supra* Part III (discussing SEC enforcement action against Vivendi Universal).

[218] *See supra* Part II.A. (discussing the SEC's characterization of the thrust of the June Proposal).

[219] *See supra* Part V.C. (discussing German AGs' internal collectivism).

[220] Porsche Press Release, *supra* note 96.

[221] *See supra* Part II.

more investments. The certification requirements' goal of benefiting investors, "dumb when they buy stock and impertinent because they also want a dividend,"[222] represents confrontation and conflict for the survival-oriented German way of doing business.

The certification requirements, by improving the quality and veracity of disclosure, indirectly encourage greater corporate efficiency and more ambitious risk-taking for German FPIs. Investors demand efficiency and high growth, and they will be better able to make comparisons between German FPIs and other investment opportunities if the truthfulness of German disclosure improves.

VI. CONCLUSION: CERTIFICATIONS ARE A NEEDED ADJUSTMENT FOR GERMAN FPIS

Some commentators urge the SEC to grant FPIs exemptions to the certification requirements.[223] It is warned that the transnational application of the Sarbanes-Oxley Act will "antagonize foreign countries, undermining the ability of the United States to enforce the Act abroad,"[224] and diminish FPIs' enthusiasm for listing in the United States.[225]

These criticisms miss the point. The certification requirements, together with the rest of Sarbanes-Oxley, may well diminish the short-term appeal of U.S. exchanges for FPIs. But it is not the goal of securities regulation to make exchanges attractive to issuers. The regulation of securities is ordained to protect investors, and particularly to protect individuals whose small holdings do not comprise significant portions of issuers' equity. The activities of such small investors are individually insignificant. Collectively, however, they are responsible for the U.S. markets' extraordinary success.

The SEC's strict regulatory regime has allowed vast numbers of small investors to flourish in the United States. As a result, more investment capital is available in U.S. markets than anywhere else. Hence, the U.S. markets' long history of attracting FPIs.

Germany's regulatory regime is less strict and its AGs, as a rule, are less appealing to small investors. As a result, German AGs and markets are not competitive in the intensifying global battle for investment. The certification requirements force wrenching and counter-cultural but investor-friendly changes on German corporations listed in the United States. The German FPIs that accept the certification requirements' 'shock

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[222] *See supra* Part V.D.
[223] *See, e.g.*, Naidu, *supra* note 65, at 313.
[224] Vancea, *supra* note 82, at 838.
[225] *See* Karmel, *supra* note 73, at 887.

therapy' by keeping their U.S. listings will take a small step toward the competitiveness that German business currently lacks.

Investors will reward corporations that subject themselves to the tough standards, including the certification requirements, of the SEC's regime. The certification requirements may be painful 'shock therapy' for German FPIs, but they represent cultural and practical transformations. The long-term benefits of these transformations will be greater efficiency and improved investor appeal. For far-sighted *aktiengesellschaften*, the "shock therapy" will be justified.

APPENDIX I: SECTION 302 OF THE SARBANES-OXLEY ACT:[226]

Corporate responsibility for financial reports

(a) Regulations required:

The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

(1) the signing officer has reviewed the report;

(2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(4) the signing officers—

(A) are responsible for establishing and maintaining internal controls;

(B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(C) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal

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[226] Sarbanes-Oxley Act § 302, *supra* note 4.

controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) Foreign reincorporations have no effect

Nothing in this section shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

(c) Deadline

The rules required by subsection (a) of this section shall be effective not less than 30 days after July 30, 2002.

APPENDIX II: SECTION 906 OF THE SARBANES-OXLEY ACT:[227]

Failure of corporate officers to certify financial reports

(a) Certification of periodic financial reports.—Each periodic report containing financial statements filed by an issuer with the Securities Exchange Commission pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) shall be accompanied by a written statement by the chief executive officer and chief financial officer (or equivalent thereof) of the issuer.

(b) Content.—The statement required under subsection (a) shall certify that the periodic report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act pf [sic] 1934 (15 U.S.C. 78m or 78o(d)) and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer.

(c) Criminal penalties.—Whoever—

(1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $1,000,000 or imprisoned not more than 10 years, or both; or

(2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than $5,000,000, or imprisoned not more than 20 years, or both.

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[227] Sarbanes-Oxley Act § 906, *supra* note 5.