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# Is the German system of corporate governance converging towards the Anglo-American model?

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**Abstract** This paper analyses whether the German corporate governance is converging towards Anglo-American practices. We summarise the extant empirical evidence on the various governance mechanisms that economic theory suggests ensure efficiency and describe recent legal developments. We find no clear signs of convergence *in form*, i.e. the main distinctive features of the German system have remained largely unaltered. However, changes occurred over the last decade (specially in the legal framework) suggest a certain convergence *in function*, i.e. some governance mechanisms have effectively incorporated aims and/or goals generally associated with the Anglo-American model.

**Keywords** Convergence · Corporate governance · Germany

**JEL codes** G32 · G34 · G38

## 1 Introduction

The German system of corporate governance has traditionally been characterised by the important role that large shareholders and banks play, a two-tier board structure with labour participation on the supervisory board of large companies, the absence

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of hostile takeovers, and a legal framework based on statutory regulations deeply rooted in the German doctrine. Another distinctive feature of the German regime is the efficiency criterion that corporate governance is to uphold. Whereas in Germany (as well as in many other Continental European countries and Japan) the definition of corporate governance explicitly mentions stakeholder value maximization, the Anglo-American system mostly focuses on generating a fair return for investors. Because of its idiosyncratic configuration, German corporate governance has (sometimes rather critically) been labelled “Deutschland AG” or “Germany Inc.”.

Recently, Germany has however witnessed a number of financial operations that do not fit well with this description. We can mention here the initial public offering of Deutsche Telekom AG, the successful hostile takeover of Mannesmann by Vodafone, and the cross-border merger between Daimler Benz AG and Chrysler Corp. The introduction of voluntary regulations such as the Takeover Code of 1995 and the Corporate Governance Code of 2002, however limited, is another major change. Last but not least, there is evidence that listed German firms are progressively applying the principle of shareholder value (Tuschke and Sanders 2003). All these events call into question the “Deutschland AG” paradigm. They have also generated an extensive debate (Krahn and Schmidt 2004). Hence, the question that arises is whether the German system of corporate governance has indeed changed some of its basic features and whether these changes have resulted in a certain degree of convergence of the German system towards the Anglo-American, market-centred system (see e.g. McCahery et al. 2002; Gordon and Roe 2004).

This paper aims at answering this question by providing an exhaustive review of the literature. In detail, we describe the various alternative mechanisms that theory suggests ensure economic efficiency and summarise the empirical evidence on Germany. In particular, we examine the role of the control structure, the board, creditor monitoring, the market for (partial) corporate control, and product market competition as corporate governance devices. We also discuss changes in the legal framework. The picture that emerges from our analysis is not substantially different from “the stereotypical view of German finance” (Jenkinson and Ljungqvist 2001, p. 397). However, we also find that some of the features that underlie this view do not exist anymore (e.g. the use of voting caps and multiple voting shares).

We believe that it is sensible to conclude that the German system of corporate governance is undergoing a process of transformations. Whether this process will eventually make the German system converge towards a market-oriented system remains to be seen. However, it is doubtful that such convergence will ever occur completely in light of the “perceived superiority of governmental and/or collective-corporatist strategies over market-based solutions” (Baum 2004, p. 7) and the “off-hands approach” to corporate governance that is predominant in Germany (Gehrig 2003, p. 661). In any case, to date the existing differences are important enough to claim that “the stereotypical view” of “Germany Inc.” is still a valid paradigm. Convergence, if any, seems to have occurred *in the function* that certain governance mechanisms perform (e.g. the supervisory board and the remuneration policy); the

institutional structure of the system (i.e. its *form*), however, remains largely unaltered.

The structure of the paper is as follows. Section 2 reviews the literature on the convergence debate. In Sect. 3, we address the characteristics of the internal and external governance mechanisms in Germany. The recent regulatory changes are then presented in section 4 and section 5 concludes.

## 2 The convergence debate

Two strands of the literature have preceded the current debate on the convergence of corporate governance systems. Initially, researchers focused on describing the main characteristics of the national systems. In particular, the American and later the German and Japanese cases were deeply investigated. However, comparative studies went soon beyond studying these countries. Evidence from large international data sets revealed that national systems differ greatly along a number of dimensions (such as the control structure and the importance of capital markets) but, at the same time, common patterns can be found within this diversity (such as in terms of the legal framework). These findings made possible a classification of national systems based on two main models or regimes. In some countries, notably the USA and the UK, the ownership structure of the firms tends to be dispersed among a myriad of small shareholders and capital markets are highly developed, thus providing financing and monitoring. In a nutshell, this is the Anglo-American or market-centred model of corporate governance. In contrast, in countries such as Germany and Japan, the role of the stock market in the provision of financing is less pronounced, banks play a central role in both financing and governance activities, and most firms have a large, controlling shareholder. This is the bank-centred model of corporate governance (Barca and Becht 2001; McCahery et al. 2002).<sup>1</sup>

Once national systems were perfectly characterised and classified, the efficiency question arose. In the words of Shleifer and Vishny (1997, p. 739), “which system is the best?” Some authors declared the superiority of the Anglo-American model because the continuous exposure to takeovers keeps managerial autonomy under check. Also, subsequent changes in control enable the acquirer to reallocate the target’s resources more profitably (Jensen 1993). The downside is that managers in market-centred systems may behave myopically if they pay too much attention to the short-term evolution of stock prices. In contrast, a bank-centred system is said to

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<sup>1</sup> An analogous classification emerges in the “varieties of capitalism” literature which holds that corporate governance depends on the presence of “regulatory regimes that are the preserve of the nation state” (Whitley 1999; Hall and Soskice 2001, p. 4). In particular, Hall and Soskice (2001) argue that liberal market economies (LMEs) are associated with political systems that tend to concentrate political power in the executive, whilst coordinated market economies (CMEs) tend to be governed by consociational, coalitional or quasi-corporatist regimes. In LMEs, coordination is based on market mechanisms, favouring investment in transferable assets; in CMEs, coordination is by non-market means, favouring longer term investment in specific assets (see also Soskice 1997; Casper et al. 1999). In summary, within CMEs, a focus on stakeholder interests is associated with both firm level practices and a wider governance regime. Within LMEs, certain firm level employment practices are complementary to an emphasis on shareholder value and a wider political framework.

provide stability and a long-term growth perspective (Porter 1992). However, this is at the risk of an excess of protection facilitating management entrenchment and leading to a misallocation of funds that eventually cause underperformance (Hellwig 2000). In a survey paper on the economics of mergers and acquisitions, Burkart (1999) concludes that although managers shielded from the takeover threat do not necessarily behave like empire-builders they tend to become sluggish. All things considered, each system seems to enjoy certain comparative advantages when it comes to solving agency problems.<sup>2</sup>

This analysis of the pros and cons of each model triggered the current convergence debate (Gordon and Roe 2004). If the observed differences between national systems and regimes have an impact on corporate efficiency, then one should expect that market competition would eventually bring about a convergence between systems. La Porta et al. (1998, 1999, 2000) have developed a new line of research which explains the differences in corporate governance systems by the level of legal protection minority shareholders enjoy and the degree of capital market development. They find that common law systems tend to offer better protection both against the expropriation of shareholders by the management and the violation of the rights of minority shareholders by large shareholders than civil law systems. Likewise, creditor protection is strongest in common law countries and worst in French civil law countries. The Scandinavian and German countries are somewhere in between. The policy implication of La Porta et al.'s work is that countries should move towards the more efficient common law system based on transparency and arm's length relationships (see, however, Berglöf and von Thadden 2000).

At the limit, this trend will mean “the end of history for corporate law” (Hansmann and Kraakman 2001): after a transitional or adjustment period all jurisdictions will end up using analogous rules and practices. However, there are forces acting in the opposite direction (Branson 2001). Bebchuk and Roe (1999) emphasise that national corporate governance systems tend to show strong (structure- and rule-driven) path dependence. The reasons are manifold. Some are purely technical, such as the existence of sunk adaptive costs, complementarities, and network externalities that may result in multiple equilibria. However, we should not underestimate the lobbying activities performed by the individuals and institutions that benefit from the existing structures and may see new developments as a threat to their interests. These actors will tend to oppose changes even if these are to promote efficiency. In general, political and historical factors may hamper convergence (Roe 1994). For example, collective bargaining and co-determination are key elements of the stakeholder approach to corporate governance, the approach

<sup>2</sup> Soskice (1997) and Casper et al. (1999, p. 12) argue that the different comparative advantages of each corporate governance system result in different innovation patterns. For example, “bank-centered financial systems” such as the German system “are ideally suited to incremental innovation patterns” which “generally involve the systematic exploitation of particular technologies to a wide variety of niche markets”, as in e.g. machinery, engineering, chemicals, software and biotechnology firms. “Most [of these] firms have high capital equipment costs that require long-term, but relatively low-risk financing of the sort which German banks have traditionally specialized in (...) On the other hand, German institutional arrangements appear less suited to [radical innovations, i.e.] higher-risk innovation strategies in many newly emerging technologies”.

that has predominated in Germany for decades. This means that any regulatory attempt to modify the former is likely to be rejected by German politicians if it is interpreted as an attack on the latter (Baums 2000; Gehrig 2003).

It therefore seems that a necessary condition for convergence is that the expected gains of a potentially better system outweigh the costs associated with the transition process; otherwise the original system will persist. However, this may not be a sufficient condition. Gilson (2001, p. 338) argues that although “[a] system that allows poor managers to remain in control will not succeed, (...) [w]e do not observe formal convergence because each system’s governance institutions have sufficient flexibility to find a solution within their path dependent limits”. This is what he calls *functional convergence*, i.e. a kind of convergence that occurs “when existing governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions’ formal characteristics” (see, however, Coffee 2000). Reality can be expected to fall somewhere in between, thus resulting in a hybrid composition that combines elements of formal convergence with elements of functional convergence. The EU provides an illustrative example of these multiple equilibria in corporate governance systems (Ferrarini et al. 2004; Wójcik 2004).

In Germany, the convergence debate has been fuelled by a host of economic and legal events that may be interpreted as milestones of a convergence process (Gordon 1999). First, there was the initial public offering of Deutsche Telekom AG (formerly a division of the Bundespost, a public utility providing telecommunications, postal and banking services). This was a turning point for shareholder capitalism in Germany: nearly 2 million Germans subscribed to the offering, which was five times oversubscribed. More importantly, around half a million of these Germans had never owned shares before of. Second, the takeover of Mannesmann by Vodafone was the biggest hostile takeover in German history and only one out of four hostile takeovers in Germany’s post-war history. In the Mannesmann-Vodafone case, shareholders (mostly foreigners) and unions (Mannesmann was subject to full-parity co-determination because its steel and coal businesses) did not follow management opposition and were eventually supportive of the bid. Last but not least, there was the cross-border merger between Daimler Benz and Chrysler Corporation. Although the merged unit listed on the New York Stock Exchange, Daimler Chrysler is in fact a German corporation. As a result, the company had to design its corporate governance under German law but also had to follow American standards on e.g. disclosure and compensation policy. Because of the size and importance of the merged company (at the time it was the largest cross-border merger of two industrial corporations), this meant an injection of American-style business practices into Germany.

At the market level, the statistics have shown a sharp rise in both the number of shareholders and listed companies since the mid-1990s. There has also been a remarkable increase in market capitalization. The percentage of the German population holding stocks in publicly traded corporations practically doubled between 1988 and 2000, and the ratio of market capitalization to the GDP rose from 19.9% in 1991 to 69.6% in 2000 (Gordon 2004). The initial success of the *Neuer Markt*, established by the Deutsche Börse in 1997 as a competitor to NASDAQ for

targeting initial public offerings of high tech companies, can also be interpreted as a step towards a market-centred system. Whereas in 1997 the number of IPOs was only 11, in 2000 it reached 143 (Goergen et al. 2004). All these figures indicate a development of German capital markets on both the supply and the demand side far beyond the anecdotic cases of Deutsche Telekom AG, Mannesmann-Vodafone and Daimler Chrysler (Nowak 2001).

Perhaps the clearest sign that something is changing in German corporate governance is the mere fact that some of its cornerstones are currently being debated. Critical features such as the co-determination system and the structure of boards, to name just two examples, are under scrutiny (Baum 2004; Hopt and Leyens 2004). Admittedly, so far the debate has been rather cautious. Yet it is significant that governance practices that had never been called into question over several decades are now being widely discussed by researchers and policy makers alike. Probably as a result of this debate, the nineties saw a wave of legal initiatives related to corporate governance (some driven by EU directives). These included, among others, the Securities Trading Act of 1994, the Restructuring Act of 1995, the Third Act on the Promotion of Financial Markets of 1998, the Takeover Code of 1995 and the Takeover Act of 2002, and the Code of Best Practice of 2002. However, the regulatory trend still continues. There is a list of forthcoming regulations that include, among others, the Draft Act on Improved Investor Protection (*Anlegerschutzverbesserungsgesetz*); the Draft Act Regulating Exemplary Investor Suits (*Kapitalanleger-Musterverfahrensgesetz*); the Draft Act on Liability for Capital Market Information (*Kapitalmarktinformatiionsgesetz*); the Draft Act on Controlling Accounts (*Bilanzkontrollgesetz*); and the Draft Act on Supervision of Auditors (*Gesetz zur Fortentwicklung der Berufsaufsicht über Abschlußprüfer in der Wirtschaftsprüferordnung, Abschlußprüferaufsichtsgesetz*).

However, is this somehow anecdotic evidence strong enough to conclude that the German system of corporate governance has changed and is definitely converging towards the Anglo-American Model? Studies published in a recent special issue of the *Journal of Institutional and Theoretical Economics* tend to agree that, although a certain convergence may have occurred, most of the distinctive features of the German system are still in place. Hackethal et al. (2003, p. 671), for example, maintains that these changes “do not seem to have a direct effect on the *fundamental structure* of German corporate governance.” As for the legal reforms, Terberger (2003, p. 715) points out that they “seem to have had shortcomings. Some new rules and regulations have lacked enforcement, others left loopholes, and other just did not set the right incentives” (see also Kirchmaier and Grant 2004). The collection of papers in Krahen and Schmidt (2004) provides further caveats on the convergence process. They show that it is difficult to claim convergence in light of the failure to develop a venture capital industry (the *Neuer Markt* collapsed after five successful years of activity) and a market for corporate control (the Mannesmann-Vodafone hostile takeover was a fairly isolated example and the vast majority of the M&A activity is of a friendly nature).

There is therefore a certain controversy in the literature as to the convergence of the German system towards the Anglo-American model, which is reflected in the title of this paper. In the next sections we address this issue by analysing the recent

evolution of the main economic (Sect. 3) and legal (Sect. 4) mechanisms of German corporate governance. We will thus make inferences based on the examination of the fundamental characteristics of the German system rather than on specific effects observed in individual companies. This is a suitable approach for the kind of institutional and comparative analysis developed here.

### 3 Governance mechanisms

In the finance literature, governance systems are usually classified according to the trade-off between liquidity and control (Becht 1999), the differences in the legal protection of investors (La Porta et al. 1998), and “the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment” (Shleifer and Vishny 1997, p. 737). In this paper, we adopt a comprehensive view and define a corporate governance system as the amalgam of institutional and market-based mechanisms which ensure that the agent (i.e. the management) runs the firm for the benefit of one or multiple principals (shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business). The mechanisms available to ensure economic efficiency are manifold and comprise (Becht and Boehmer 2003): (i) internal control mechanisms such as the control structure (degree and locus of control) and the board of directors (structure, turnover, and compensation), and (ii) external mechanisms such as creditor (in particular bank) monitoring, the market for corporate control (both the hostile takeover market and the market for partial corporate control), product market competition, and the legal framework (statutory and voluntary regulations, but also standards established by the stock exchanges). In this section, we first analyse these internal mechanisms and then move onto the external mechanisms. We leave the analysis of the legal changes to Sect. 4.

#### 3.1 Internal governance mechanisms

##### 3.1.1 Ownership structure and control

Table 1, adapted from Becht and Boehmer (2003), provides a summary of the recent evidence on the ownership and control of German firms. This evidence shows that in most German firms ownership and control are indeed concentrated. In particular, Edwards and Nibler (2000) and Franks and Mayer (2001) report that more than half of the listed German firms in their samples have an owner holding more than 50% of the voting equity. Furthermore, Edwards and Weichenrieder (1999) show that the actual proportion of voting rights exercised at the annual general meetings by the largest shareholder in listed German firms gives him/her a comfortable majority (55%). Control is also highly concentrated when it is measured as ultimate control (Gorton and Schmid 2000a, b) and by the Cubbin and Leech (1983) index (Köke 2001). As expected, ultimate control is even more highly concentrated in unlisted firms (Edwards and Nibler 2000; Köke 2004).

**Table 1** Recent selected studies on ownership and control in Germany

Study	Sample	Data source	Block type	Largest block (mean %)
Edwards and Weichenrieder (1999)	102 listed companies extracted from the 158 largest non-financial firms in 1992	Registers (Handelsregister) of annual general meetings	Direct stake (or control rights?)	– Owned: 46.30 – % at the AGM: 54.84
La Porta et al. (1999)	20 largest listed, 1996 data	Hoppenstedt Aktienführer	Direct stake	–
Edwards and Nibler (2000)	156 of the 200 largest non-financial firms in 1992	Registers (Handelsregister) of annual general meetings	Direct stake	– Listed: 47.0 – Unlisted: 80.0
Gorton and Schmid (2000b)	186 firms from the largest 250 corporations that traded at the end of 1993 in at least one of the two-tier market segments of Amtlicher Handel or Geregelter Markt	Saling Aktienführer, ed. by Verlag Hoppenstedt & Co., Darmstadt (various issues)	Control rights	–
Lehmann and Weigand (2000)	361 firms from the mining and manufacturing sectors, 1991 to 1996 period	Commerzbank, Wer gehört zu wem?, Bayerische Hypotheken- und Wechselbank, Wegweiser durch deutsche Aktiengesellschaften, and Hoppenstedt's Börsenführer	Direct stake	– Listed: 73.40 – Unlisted: 97.87
Becht and Boehmer (2001, 2003)	430 population of listed companies on official market in 1996	BAWe (Hoppenstedt KSD)	Voting block	58.9
Franks and Mayer (2001)	171 quoted industrial and commercial companies (subset of the population of 477 quoted industrial and commercial companies in Germany in 1990)	Hoppenstedt Stockguide and Commerzbank	Direct stake	–
Köke (2001)	1,519 manufacturing firms in the legal form of Kapitalgesellschaft, 1998 data	Hoppenstedt KSD	Ultimate control and direct stake	– GmbH: 89.44 – Non-listed AG: 83.23 – Listed AG: 57.66



**Table 1** continued

Study	Sample	Data source	Block type	Largest block (mean %)
Faccio and Lang (2002)	690 publicly traded (financial and non-financial) corporations in 1996	Commerzbank, Financial Times and Worldscope	Cash flow (CFR) and control rights CR	- CFR: 48.54 - CR: 54.50
Van der Elst (2002)	542 listed companies on official and regulated markets in 1999	Hoppenstedt Aktienführer BAWe	Control rights	46.1
Wójcik (2003)	415 and 463 companies listed on Amtlicher Market in 1997 and 2001, respectively	BAWe	Direct and indirect voting rights	- 31.8% in 1997 - 28.9% in 2001

Becht and Boehmer (2001, 2003) show that not only is there a high concentration of voting power in listed companies (82% of them have a large blockholder controlling ultimately more than 25% of the voting rights), but the largest shareholder also often does not face other large shareholders. Only 20% of these companies have more than two registered blockholders and the average size of the second largest block (7.4%) is small. As many important decisions, such as modifications to the firm's charter, mergers, and changes in the firm's capital usually require a super-majority of 75% of the votes, a shareholder with more than 25% of the votes has a blocking minority. Becht and Boehmer (2003, p. 10) look at the frequency of voting blocks in terms of their size and notice that "voting blocks are clustered at 25, 50, and 75%. [This] suggest[s] that block sizes are carefully chosen and control is an important issue for blockholders".

However, the German legal framework allows for dispersed ownership with concentrated voting power through a number of mechanisms. The mechanisms we consider are: (i) ownership pyramids, (ii) proxy votes, (iii) voting pacts, and (iv) dual class shares.

The most widely used mechanism to obtain control with a limited investment is ownership pyramids or cascades. This mechanism enables shareholders to maintain control throughout multiple tiers of ownership while sharing the cash flow rights with other (minority) shareholders at each intermediate ownership tier. Franks and Mayer (2001) and Köke (2001) show that German corporations are often controlled via such pyramids (see also Gorton and Schmid 2000a; Faccio and Lang 2002). On one hand, this reduces the liquidity constraints that large shareholders face while allowing them to retain substantial voting power. On the other hand, there is a risk that these pyramids lead to the expropriation of minority shareholders (Becht 1999). Johnson et al. (2000) and Buysschaert et al. (2004) provide examples of such expropriations in France, Italy and Belgium. For the case of Germany, Köke (2001) argues that at least in 10% of his sample the ultimate shareholder could prevent efficient monitoring, as the cash flow rights of the largest shareholders amount to only 25% or less of their control rights. Edwards and Weichenrieder (1999) show that an increase in the largest shareholder's control rights effectively harms minority shareholders. However, they claim that these negative effects may be somewhat compensated by the benefits obtained from the better monitoring of the management when the largest shareholder is a non-bank firm or a public-sector body.

The second mechanism that gives control with limited cash flow rights is proxy votes. In Germany, banks are the main exercisers of proxy votes given that most shares are in the form of unregistered bearer shares and their holders normally deposit them with their banks. The banks are allowed to cast the votes from these shares (conditional upon the banks announcing how they will vote on specific resolutions at the general meeting and upon the lack of receiving alternative instructions by the depositors). For example, in the failed, hostile bid for Feldmühle Nobel by the Flick brothers, voting restrictions were imposed thanks to a resolution supported by Deutsche Bank that eventually passed with 55% of the shares voted. However, Deutsche Bank only held a direct share stake of about 8%; the rest were proxy votes (Franks and Mayer 1998). Edwards and Nibler (2000) provide further evidence on banks' proxy votes for a sample of 156 listed and unlisted German

companies in 1992. Their data shows that banks typically control more voting rights via proxy votes than via their own stakes. Gorton and Schmid (2000a) present analogous results based on 1975 and 1986 data. All in all, proxy votes seem to provide effective voting power to German banks, especially to the three largest ones (Deutsche Bank, Dresdner Bank and Commerzbank) and mainly in large listed companies.

The third mechanism to separate ownership and control is voting pacts. Voting pacts enable shareholders to exert a much higher degree of control as a group than the members of the pact would individually. As pointed out by Franks and Mayer (2001), in many German corporations a (hypothetical) coalition formed by the two or three largest shareholders could easily gain control. However, apart from the notable exception of Crespi and Renneboog (2002), there is little empirical evidence that long-term shareholder coalitions are formed in Europe because such coalitions may bring about substantial costs. According to Jenkinson and Ljungqvist (2001, p. 431), in corporate governance regimes such as the German one where multiple large shareholders exist, “[control] [b]attles often involve a protracted, and clandestine, shuffling of stakes between rival coalitions and the revising of pooling agreements. Even large blockholders can find themselves, apparently without warning, as members of the suppressed minorities.” Most coalitions are usually formed on an ad hoc basis with a specific aim, such as the removal of badly performing management.

The fourth mechanism is dual class shares. Under a dual class regime, one class (B-shares) has fewer voting rights than the other one (A-shares). Faccio and Lang (2002) estimate that the proportion of firms with dual class shares outstanding in Germany is 18%. Non-voting shares are also used by German firms, although they must not exceed 50% of the stock capital. In any case, Goergen and Renneboog (2003) demonstrate that the issuance of non-voting shares is very effective to forestall any change in control. However, the issuing of multiple voting shares was outlawed in Germany as of May 1998 and the grandfather clause was phased out on 1 June 2003. In addition, German firms can issue preference shares (*Vorzugsaktien*). This is risk-bearing capital without votes, but with special dividend rights.

### 3.1.2 *The nature of control*

Not only does the degree of control matter for corporate governance, but so does the type of the controlling shareholder. In Germany, empirical evidence on the differences in terms of incentives, abilities and costs across different shareholders can be found in Edwards and Nibler (2000), Gorton and Schmid (2000b), Lehmann and Weigand (2000), Franks and Mayer (2001), Januszewski et al. (2002) and Köke and Renneboog (2005). Table 2 compares the average sizes of the stakes held by the different types of shareholders in German firms to those in other European countries. Germany is similar to most other Continental European countries in the sense that the most important type of shareholder is holding and industrial companies. In detail, in Germany, the main shareholders are, in order of importance, (i) holding and industrial companies, (ii) individuals and families, (iii) banks (although, as pointed out in the previous section, proxy votes can make them even

**Table 2** Average cumulative percentage of voting blocks held by different classes of shareholders in Europe

Country	Sample	Individuals or families	Banks	Insurance companies	Investment funds	Holding and industrial companies	State	Directors
Austria	600	38.6	5.6	0.0	0.0	33.9	11.7	0.0
Belgium	155	15.6	0.4	1.0	3.8	37.5	0.3	0.0
France	402	15.5	16.0	3.5	0.0	34.5	1.0	0.0
Germany	402	7.4	1.2	0.2	0.0	21.0	0.7	0.0
Italy (1)		68.6	7.2	0.0	0.0	24.2	0.0	0.0
Netherlands	137	10.8	7.2	2.4	16.1	10.9	1.3	0.0
Spain	394	21.8	6.6	8.8	0.0	32.6	0.0	0.0
UK	248	2.4	1.1	4.7	11.0	5.9	0.0	11.3

*Source:* Renneboog (2000) and Barca and Becht (2001). The table gives the average cumulative percentage of share blocks (above 5%) held by different types of shareholders in listed companies, except for Italy (1). Numbers for Italy refer to both listed (214) and large non-listed (about 8,000) companies. Also, of the listed Italian companies about 25% are directly and indirectly controlled by state holdings and these are classified in the table under 'Holding and industrial companies'. Both direct and indirect shareholdings are considered, except for the Netherlands and the UK (only direct shareholdings). Figures reported are for the year 1996, except for Belgium (1994) and the UK (1993)

more powerful in the general meetings) and other institutional shareholders, and (iv) public authorities.

*a. Industrial and holding companies.* The holding of share blocks by other industrial companies is a well documented feature of the German corporate governance regime (Prigge 1998). Faccio and Lang (2002) show that Germany is the European country with the largest percentage of companies controlled by other firms. This phenomenon is also prominent in the German financial sector. Table 2 shows that German holding companies and industrial companies control an average stake of 21% in other listed German firms, which is largely corroborated by Emmons and Schmid (1998) and Gorton and Schmid (2000b). In fact, according to Becht and Boehmer (2003) about 80% of direct equity stakes in firms listed on the official market belong to other firms (industrial firms, holding companies, investment firms and financial firms). These large industrial shareholders may obtain substantial private benefits at the expense of other shareholders or stakeholders (Grossman and Hart 1988) and cross-holdings may have an important negative impact on competition (Canoy et al. 2001). Moreover, there is evidence that German firms controlled by other companies tend to have higher levels of productivity (Januszewski et al. 2002) and are less likely to be acquired if they are public corporations (Köke 2002).

*b. Families or individuals.* Table 2 also shows that individuals or families are one of the main shareholder categories in Continental Europe (see also La Porta et al. 1999). In particular, Franks and Mayer (2001) have found that large-scale family control is especially pronounced in the largest German firms. This finding was also documented by Edwards and Nibler (2000) and Becht and Boehmer (2001). In 40 and 37% of their samples individuals or families hold blocks of on average 57 and

20%, respectively, of the voting rights. In general, however, these blocks are much more commonly found in small and medium-sized non-financial companies (Köke 2001; Faccio and Lang 2002).

*c. Directors.* A particular category of individuals controlling share stakes is that of the directors, who are insiders and therefore possess superior information on the firms' prospects. However, Table 2 suggests that Continental European managers are not shareholders of the firms they manage. Actually, hardly any information is known about directors' control in Continental Europe for the following reasons: (i) the shareholdings of most directors are below the disclosure thresholds, (ii) although large family blockholders frequently appoint their representatives (which can be family members) to the board, the origin of board representatives does not need to be disclosed publicly, and (iii) the use of intermediate investment companies further obscures directors' control. Whatever the reasons, we have found only two German studies presenting data referring to this category. First, Gorton and Schmid (2000b) show that the management owns at least 50% of the votes in 8% of the firms in their 1992 sample. Moreover, 15% of the firms have their largest shareholder as a member of the management board. Second, Köke (2004) reports the ultimate control for a sample of listed and unlisted firms for the years 1987–1994. The average stake of the (executive and non-executive) directors and their families is 22.5% for quoted firms and 12% for unquoted firms. These figures suggest that in a non-negligible number of German companies there is no separation between ownership and control because “managers own” and “owners manage”.

*d. Banks and other institutional shareholders.* There is an extensive theoretical literature on the role and incentives of bank monitoring (see e.g. Rajan and Diamond 2000). In contrast, bank shareholdings in Germany—as well as other Continental European countries—are generally small and decreasing (Wójcik 2003). Only 5.8% of the large voting stakes of 5% or more are held (directly as well as indirectly) by banks, resulting in an average of 1.2% of the overall votes. One reason for this may be the avoidance of potential conflicts of interest (Canoy et al. 2001; Goergen and Renneboog 2001). However, from what we have said above, it is clear that the influence of banks is understated if one merely looks at their direct and indirect stakes and ignores their proxy votes.

As for the other types of institutional shareholders, Köke (2001) shows that they have a strong preference for listed firms. However, only insurance companies seem to be important. In sharp contrast with the UK and the US, other institutional investors (notably investment funds) do not hold significant stakes in German companies (O'Sullivan 2000; Davis and Steil 2001). Empirical evidence from the firms listed on the German official market (*Amtlicher Handel*) shows that whereas 20 insurance companies hold shares representing around 17% of the market capitalization, the rest of the institutional investors (excluding banks) barely reach 0.5% (Wójcik 2002). Given the close links between insurance firms and banks in Germany, the importance of the former further reinforces the role of banks as major shareholders (Goldman Sachs 2000; Canoy et al. 2001).

*e. Public authorities.* Despite the large-scale privatisation programmes that occurred in Europe over the last decades, in many listed European firms the state is still one of the largest shareholders (La Porta et al. 1999). To this respect, one has to

take into account the privatization of East German firms during the early 1990s (Dyck 1997; Hau 1998). Even when controlling for this specific privatization process, the importance of public authorities as shareholders remains considerable, especially in large firms (Köke 2001; Faccio and Lang 2002). However, their importance has continuously declined. As an illustration, in 1997 the value of their holdings in the firms listed on the official market or *Amtlicher Handel* was about 21% of the total market capitalization. Already in 2001, public holdings represented only 14% of the market capitalization (Wójcik 2002). In terms of the number of firms in which the government was the largest shareholder, figures range from 6% (Franks and Mayer 2001; Emmons and Schmid 1998) to 8% (Edwards and Nibler 2000; Gorton and Schmid 2000b).

### 3.1.3 Summary of control structure

There is considerable evidence showing that control is very concentrated in German firms. Although some of the devices used to separate ownership and control are not legal anymore (e.g. voting caps and multiple voting shares), it is not uncommon to find dispersed ownership combined with strong voting power. German corporate control is very much dominated by wealthy individuals and families. The lack of institutional blockholders (apart from banks, which seem to be losing in importance) suggests that, in contrast to the Anglo-American countries, little shareholder activism is to be expected from these institutions. All these features indicate that the control structure of the German corporation (still) corresponds to that of an insider, bank-centred system of corporate governance.

## 3.2 Boards

### 3.2.1 Structure

To the opposite of most Western economies, Germany has a two-tier board with a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*).<sup>3</sup> The German supervisory board represents the shareholders and employees, but it is usually dominated by representatives of the large shareholders. In large firms with more than 2,000 employees, the 1976 Codetermination Act created a system of quasi-parity co-determination. Employee representatives make up half of the supervisory board but the chairman who is a shareholder representative has a casting vote in case of a stale-mate. Bankers are frequently elected to the supervisory board, even as chairmen (Edwards and Nibler 2000). In small companies with more than 500 but less than 2,000 employees, one third of the supervisory board consists of employee representatives. Finally, full-parity co-determination by shareholders and employees is limited to the steel and coal sectors (which are subject to the 1951 Coal and Steel

<sup>3</sup> However, differences between the one-tier and the two-tier systems are relative, as supervisory and management boards do not meet separately in Germany.

(Montan) Codetermination Act). The only companies that are exempt from having a supervisory board with co-determination are those that can appeal to the constitutional freedoms of faith and free press (e.g. the publishing company Springer). The directors of German firms are usually appointed for a term covering the legal maximum of 5 years, although reappointment at the end of the term is possible.

In a recent paper, Renaud (2007) presents evidence that the introduction of parity co-determination does not reduce the productivity or profitability in the affected companies. Still, the author admits there is a benchmarking problem as data on companies without co-determination, mostly very small companies, is very difficult to collect. Also, Hertig (2006) argues that transparency may be better served by using co-determination as an information channel, rather than by importing the mandatory disclosure requirements that are typical of Anglo-Saxon jurisdictions. There are two reasons for this. First, the evidence about the efficiency of mandatory disclosure requirements is mixed. Second, mandatory disclosure is an intrinsic component of market-oriented financial systems such as the US financial system. The author argues that transplanting a market-oriented component into a bank-oriented financial system brings the risk of inconsistencies, as this affects the complementarities that exist among the intrinsic components of a bank-oriented system.

While the above two papers praise the system of co-determination, they also form a small minority. In contrast, Roe (1999: 194), a representative of the other camp, argues that “German codetermination (...) undermines diffuse ownership for two, related reasons. One, stockholders may wish that the firm’s governing institutions to have a blockholding ‘balance of power’, a balance that, given German’s law mandate that half the supervisory board represent employees, diffusely owned firms may be unable to create. (...) Two, managers and stockholders sapped the supervisory board of power (...) to reduce 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. Instead of boardroom governance, out-of-the-boardroom caucuses and meetings between managers and large shareholders substitute for effective boardroom action”.

### 3.2.2 Turnover

The disciplining of the top management (and in particular of the CEO) as a governance mechanism has received considerable empirical attention (Murphy 1999). For Germany, Kaplan (1994a) presents evidence that management board turnover is closely related to poor stock performance and earnings losses, but not to sales and earnings growth. In contrast, the turnover of the chairman of the supervisory board is more likely to occur when the firm’s net income falls. In addition, poor stock performance also causes supervisory board dismissals. Three additional results are worth mentioning. First, the evidence is consistent with the view that the German corporate governance regime is based on a long-term perspective of the firm (Porter 1992). Second, the sensitivity of executive turnover

to corporate performance in Germany is comparable to that in Japan and the US (Kaplan 1994b; Kaplan and Minton 1994). Third, neither large shareholders nor bank control seem to protect managers from the possibility of being dismissed when their company performs poorly.

These results call into question the view that in bank-based regimes, such as the German one, managers may be entrenched at the expense of minority shareholders (Coffee 1991; Roe 1993). However, the results are not entirely supported by Franks and Mayer (2001). Indeed, their study suggests that supervisory board turnover depends on corporate performance *only* when there is a change in control. In general, supervisory board turnover of firms which are incurring losses is not statistically different from that of firms generating profits. However, it is significantly higher for poorly performing firms with new blockholders. Management board turnover is higher for loss makers than for non-loss makers, but, contrary to the case of supervisory board turnover, it is only statistically significant in the sub-sample of firms with stable holdings.

### 3.2.3 Compensation

Perhaps the simplest economic device for aligning managers' interests with those of the shareholders (or more generally, stakeholders) is a compensation contract that specifies the tasks and rewards of the executive directors for each outcome of corporate performance (Ferrarini et al. 2004). Table 3 compares CEO remuneration in Germany to the rest of Europe and the US. German CEOs are among the lowest paid in Europe. In terms of the share of the basic compensation in the total pay package (47%), German CEOs are no different from their European counterparts, but are substantially different when compared to US CEOs (28%). In particular, German CEOs appear to have the highest total cash pay in Europe but have the lowest non-cash remuneration. This may explain why the total remuneration package of German executives is low compared to other European executives

**Table 3** CEO Remuneration in Germany (as compared to the rest of Europe and the USA)

	Total Remuneration (\$)	Pay Components (As a percentage of total remuneration)			
		Basic Compensation	Variable Pay	Benefits	Perquisites
Belgium	696,697	46	24	28	2
France	519,060	46	26	21	7
Germany	454,979	47	36	12	5
Italy	600,319	43	33	20	4
Netherlands	600,854	47	36	13	4
Spain	429,725	51	36	10	3
Sweden	413,860	46	25	27	2
UK	668,526	43	30	21	6
USA	1,932,580	28	61	6	5

Source: Towers Perrin, Worldwide total remuneration (2001–2002)



(Conyon and Schwalbach 1999, 2000a). In the mean time, large German firms are increasingly adopting variable payments (Tuschke and Sanders 2003). In addition, Schmidt and Schwalbach (2007) report that in the largest German firms, i.e. those forming the DAX stock market index, the variable part now makes out at least 40% of the total remuneration.

The factors influencing the remuneration of German managers have recently been a matter of further systematic research (Kraft and Niederprüm 1999). Elston and Goldberg (2003) investigate the monetary compensation of the members of the management and supervisory boards of German firms and confirm the results of Schmid (1997). First, although the size effect (positively) dominates the compensation equation, there exists a positive sensitivity of managerial pay to company performance in Germany. Conyon and Schwalbach (2000b) confirm this relation. Second, the Elston and Goldberg (2003) study shows that managers and directors of widely held firms receive a substantially higher monetary compensation than those of firms with large blockholders. Third, firms with monitoring house banks (which own an equity stake, are major providers of loan capital and frequently have board representation) generally pay managers and directors comparatively less than widely held firms. Tuschke and Sanders (2003) investigate the adoption of stock-based compensation. They show that the relationship between the likelihood of adopting stock-based incentives and control concentration in listed German firms has an inverted-U shape with the maximum being in the first quartile of control concentration. In addition, Schwalbach (2004) reports that, while in the past it was not linked to corporate performance, recently the remuneration of supervisory board members has become increasingly tied in with performance and has also increased in level.

#### 3.2.4 *Summary of boards*

The idiosyncratic structure for German boards is often seen as a major cause of entrenchment. However, the extant evidence suggests that German directors and CEOs are clearly exposed to being fired if the firm does not perform well. The evidence is as yet limited which makes it impossible to conclude whether large shareholders and banks mitigate this disciplinary action. As for the compensation policies, they seem to have succeeded in aligning managers' and shareholders' interests by creating a pay-performance sensitivity. However, both the variable pay and the pay package of German CEOs look meagre when compared to their US counterparts. In the light of this evidence, it is tempting to conclude that a certain degree of convergence towards a market-model has occurred. Having said this, the differences between a typical German AG and a typical American corporation are still substantial.

### 3.3 External corporate governance mechanisms

We now turn to the discussion of the external corporate governance mechanisms. In particular, we discuss the evidence on creditor monitoring, the market for corporate

control, the market for partial control and product market competition. In Sect. 4, we then address the recent evolution of corporate governance regulation.

### 3.3.1 *Creditor monitoring*

Large creditors in bank-based economies such as Germany typically hold a variety of control rights and have therefore sufficient power to monitor. Consequently, bank monitoring may act as a substitute for alternative corporate governance devices. Shleifer and Vishny (1997) argue that large creditors fulfil a role similar to that of large shareholders because they have large investments in the firm and have therefore a strong incentive to monitor the firm's management. Given the monitoring performed by the bank, there is less need for (other) external disciplining. Köke and Renneboog (2005) provide empirical evidence that German firms, which are exposed to tight creditor control and operate in competitive markets, experience higher productivity growth.

Another important characteristic of bank-centred regimes such as the German one relates to the lending relationships (Deeg 1998; Vitols 1998). Banks owning shares in listed firms are frequently also the main bank or *Hausbank* to these firms (Edwards and Fischer 1994). The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm. Schmidt (2003) states that membership of a supervisory board provides an important source of privileged and valuable information. In contrast, Edwards and Nibler (2000, p. 260) conclude that "German banks do not play a role in the governance of large listed firms which is distinct from their position as one of several types of large shareholder".

In any case, what is clear is that each type of the *Hausbank's* claims (debt and equity) may give rise to a different optimal decision in the wake of financial distress. When there is a danger of bankruptcy and the bank faces a refinancing demand by the firm, its creditor claims may encourage the bank to make the firm file for liquidation whereas the equity claims may lead the bank to revolve its loans. Such conflicts of interest may even be exacerbated by the fact that in Germany (as in Belgium, France and Italy) intricate control-based networks exist such that the bank's decision may be influenced by the objectives of the network/conglomerate. Lehmann and Neuberger (2001) and Edwards and Fischer (1994) document that banks intervene in case their corporate client runs into financial distress. However, Agarwal and Elston (2001) are not convinced about whether firms benefit from better access to capital, as their interest payments to debt ratio is also significantly higher. This suggests that German banks engage in rent-seeking activities.

Finally, Jenkinson and Ljungqvist (2001, pp. 430–431) "identify another important role of banks, namely their role in assisting companies pursuing a strategy of hostile stakebuilding. [...] [B]anks play a pivotal role in building, brokering and concealing stakes. In contrast, it is striking how few examples [they] find of banks actively *defending* target companies from a hostile stakebuilder. Such behaviour may, of course, be compatible with the view that banks actively monitor German companies [...] However, it is important to recognise that this role is

performed not by the companies' *house banks* [...], but by the banks assisting the predator”.

While the above literature demonstrates that banks do indeed perform an important role as monitors (see Degryse et al. 2007 for an overview), some researchers are more sceptical. Banks may put a break on the investment activity of firms, which over the long run reduces the firms' competitiveness. Also, bank-representatives on boards may reduce risk taking, thereby further limiting the competitiveness of the company. Finally, the inside information held by bank representatives leads to asymmetric information between insider and outsider credit banks which reduces the intensity of credit competition due to the “winner's curse” problem (von Thadden 2004).

### 3.3.2 *The market for corporate control*

Hostile takeovers are often considered to be one the most distinctive features of market-oriented regimes. In contrast, a study of the European domestic and cross-border mergers and acquisitions market shows that the market for corporate control in Germany is very limited (Goergen and Renneboog 2003). The main reason for this is that, as shown in previous sections, the vast majority of firms have a large controlling shareholder. Pyramiding and cross-shareholdings further hinder takeover attempts (Prigge 1998; Jenkinson and Ljungqvist 2001). Another reason is that the legal and regulatory framework in Germany has been lagging behind that of other countries in terms of disclosure, transparency and shareholder protection (see McCahery and Renneboog 2003 and Sect. 4 of this paper). Finally, the following takeover codes and legislation have created further barriers to takeover activity:

*a. Taxation.* Prior to 2002, the capital gains resulting from sales of equity stakes by corporations and financial institutions were taxed at the corporate tax rate (see Sect. 4). In practice this imposed a substantial cost on a redistribution of ownership and control.

*b. Court actions by dissenting shareholders.* Prior to 2002, (minority) shareholders disagreeing with decisions taken at the annual general meeting could stall these decisions over long periods of time, even though they had been approved by a qualified majority of 75% of the votes (Beinert 2000; Schmid and Wahrenburg 2003).

*c. Board entrenchment.* The management board is legally entrenched: only the supervisory board can remove the management board members who are usually appointed for a term corresponding to the legal maximum of 5 years. In other words, a new controlling shareholder cannot remove the management board until their contracts have expired. Furthermore, the supervisory board is also legally entrenched: the representatives of the shareholders and employees have contracts for up to 5 years (subject to reappointment). Consequently, a new controlling shareholder may not be able to obtain immediate control of the supervisory board.

*d. Proxy voting.* Shareholders depositing their shares with their bank frequently grant permission to the bank to exercise their votes. Although, in principle, banks have to ask permission and state how they intend to vote on specific proposals, this

was not common practice prior to the Control and Transparency Act (*KonTraG*) of 1998. The importance of proxy voting is confirmed by Schmid and Wahrenburg (2003) who claim that in quoted German corporations with dispersed control the large German universal banks jointly control the majority of the votes at the annual meetings.

*e. Registered shares.* Whereas most shares in German firms are bearer shares, some firms (mainly in the insurance and media industries) have issued registered shares (*vinkulierte Namensaktien*). Such shares are a very effective anti-takeover device, as they can only be transferred with the approval of the directors.

*f. Voting restrictions, multiple votes and non-voting shares.* Voting restrictions restrict the percentage of voting rights any shareholder can exercise. However, the Third Act on the Promotion of Financial Markets (*Drittes Finanzmarktförderungsgesetz*) of 1998 put a stop to the introduction of such voting restrictions. The grandfather clause for existing restrictions ended on 1 June 2000. The law also bans the issue of multiple voting rights, although a grandfather clause was created for such shares outstanding. The grandfather clause ended on 1 June 2003. However, German firms are still allowed to issue non-voting shares, although only for a maximum of 50% of the total equity issued.

The following figures highlight the almost complete absence of disciplining by the market of corporate control in Germany. Whereas during the period of 1984–1989 there were an annual average of 40 hostile bids per annum in the UK (Jenkinson and Mayer 1994), only three hostile takeovers (Feldmühle Nobel in 1988–89, Hoesch in 1990–91 and Continental in 1991–92) have occurred in Germany since WWII (Franks and Mayer 1998). Hence, one can conclude that there is no active market for corporate control in Germany (Franks and Mayer 1996; Köke 2004). The hostile takeover of Mannesmann by Vodafone is simply a *rara avis*.

### 3.3.3 The market for partial corporate control

Jenkinson and Ljungqvist (2001) provide some empirical evidence on the existence of a market for large share stakes in Germany. They find that 64 German companies out of all the listed firms in 1991 were potentially vulnerable to a hostile attack (given their control structure and lack of takeover defences). Moreover, they identify 17 cases of hostile stakebuilding among the 2,511 changes in control that occurred over the period of 1988–1996 and involved German firms as targets. Franks and Mayer (2001) also find evidence of turnover of share stakes over the period of 1988–1991, with new shareholders emerging in 22% of the companies and old shareholders disappearing in 13% of the companies. Still, Franks and Mayer stress the differences between the Anglo-American markets for corporate control and the German market for partial control. First, the German market permits price discrimination between sellers of share blocks and other investors and, second, the overall gains from mergers as reflected in the bid premiums are low in relation to those in the UK and the US. Finally, for the period of 1980–1995, Boehmer (2000) reports 715 purchases by 127 acquiring firms of at least 50% of the votes in the corporations listed on the Frankfurt official market. Part of these purchases can be

considered as hostile and motivated by a disciplining effect. According to Köke (2004), the motive behind a large part of the German block trades is the acquisition of control over the target firm.

However, it is less clear whether this market for share blocks is indeed a substitute for the market for corporate control. Köke (2002) shows that, typically, poorly performing firms are more likely to be acquired. However, Franks and Mayer (2001) find no evidence of higher management board turnover in targets that were performing poorly and thus argue that these block purchases are not disciplinary in nature. Conversely, Jenkinson and Ljungqvist (2001) find some evidence of post-acquisition management turnover in 7 of the 17 cases of stake building analysed and a slight improvement in the performance of the target companies. Still, they stress that the bidder seems to be motivated by strategic investments (overcapacity, market power, etc.) rather than disciplining “wayward managers”. Similarly, Köke (2004) reports management turnover, assets divestitures (only in listed firms) and layoffs (*ibidem*) following control changes, but no significant changes in performance. Goergen and Renneboog (2003) find that the control structure of the bidder has an impact on the link between control changes and past performance. They show that the probability of being (partially) taken over by a bidder who has concentrated control increases if past performance was good, whereas the probability of being taken over by a widely held bidder decreases. Finally, Boehmer (2000) concludes that, especially when the bidder is a non-financial minority blockholder, changes in control tend to increase the value of the acquiring firm.

### 3.3.4 *Product market competition*

Ever since Adam Smith’s celebrated book, economists have argued that product market competition provides incentives for the efficient organization of production. A number of theoretical models have made this point (see e.g. Allen and Gale 2000 for a review) and there is also supportive empirical evidence (see e.g. Nickell 1996). In particular, intense competition in the product market may reduce managerial slack through at least four different channels: income, risk, information and value of managerial actions. Under certain conditions the basic insight that competition improves management performance holds, i.e. the positive income effect dominates. Ultimately, however, the combined result of these four effects is ambiguous, “indicating that there is no definitive theoretical relationship between the level of competition and executive behavior” (Hermalin 1992, p. 361).

Unfortunately, the empirical evidence on the interaction between product market competition and corporate governance is scarce (Klette 1999). The evidence suggests that both product market competition and the level of corporate governance boost firm performance. In a pioneering study, Nickell et al. (1997) analyse the productivity growth of UK manufacturing firms and find that the degree of market competition and shareholder control are associated with high productivity growth. They conclude that competition (and debt) may be a substitute for internal control. Following the same econometric methodology, two recent studies provide evidence on German firms. First, Januszewski et al. (2002) present evidence of a positive

(negative) effect of product market competition on productivity growth (the productivity level). Their results also show that control concentration has a positive effect on productivity growth and that this effect is even larger in firms facing intense product market competition, i.e. competition and tight control are complements (Soskice 1997). In contrast, financial control has a negative impact on productivity growth. Second, Köke and Renneboog (2005) analyse two samples of firms: one from a market-oriented system of corporate governance (the UK) and the other one from a bank-based system (Germany). A lack of product market competition in Germany has a detrimental effect on productivity growth. Blockholder control (at the ultimate level) somewhat attenuates the negative effect of weak competition on productivity changes (while the negative effect of weak competition prevails). This blockholder effect is largely limited to banks, large insurance firms and government stakes.

The results of Köke and Renneboog (2005) are therefore consistent with Cable (1985), who documents a disciplinary role of German banks for the 1970's, and with Elsas and Krahen (1998), who confirm (based on credit-file data) that German housebanks provide liquidity insurance in times of financial difficulties. The results are also consistent with Gorton and Schmid (2000a), Lehmann and Weigand (2000) and Köke (2004) who find a positive impact of bank control on earnings-based performance measures. Overall, Degryse et al. (2007), who reviews the literature, argues that the effect of bank monitoring on corporate performance is positive. All of these findings are at odds with the sceptical view of the German corporate governance model which states that Germany is too dependent on banks and therefore too inflexible compared to the Anglo-Saxon market-oriented system (Hellwig 2000; Edwards and Nibler 2000).

### 3.3.5 Summary of external mechanisms

We find no clear signs of convergence when analysing the external governance mechanisms. Hostile takeovers in Germany face a number of hurdles (including legal hurdles and concentrated control) which makes them a rare occurrence and an unlikely disciplinary mechanism. As for the disciplinary character of the market for partial corporate control, the evidence in this respect is not fully conclusive, but it tends to be unresponsive. Only product market competition seems to be acting as an effective external corporate governance mechanism. All in all, the external mechanisms appear to be fairly unimportant, except for bank monitoring which plays a critical and complex role in German corporate governance.

## 4 Laws, codes and the stock exchange

All of the above corporate governance mechanisms should be studied within a country's specific regulatory context. Since strong shareholder protection reduces the danger of expropriation of minority shareholders, the development of legal rules (such as the mandatory bid rule in the case of takeovers) and codes of best practice

should be priced by the markets. Consistent with this tenet, recent empirical work by Beck et al. (2000) and La Porta et al. (2000) finds that firms operating in jurisdictions with strong shareholder protection have a higher growth potential, as measured by Tobin's Q. In Germany, Drobetz et al. (2003) relate the protection of shareholder rights to the long-run performance of a cross-section of firms. They construct an index based on five categories of corporate governance rules and provide evidence that better shareholder protection leads to higher firm valuations (measured by the price earnings ratio and the market to book ratio). What these studies tend to confirm is the comparative advantage of countries that protect investors' interests. They also document a positive effect of better corporate governance protection on financial market development (see, however, Bebchuk and Roe 1999; Berglöf and von Thadden 2000; Hellwig 2000).

It is therefore important to discuss changes in the German legal framework that may have affected corporate governance. We first address statutory and voluntary regulation. We then review the recent stock exchange developments.

#### 4.1 Statutory regulation

Since the mid 1990s, important new laws have been passed in order to promote the financial markets (*Finanzmarktförderungsgesetze*), increase transparency and accountability, and create a level playing field on the market for corporate control. In this section, we review the Securities Trading Act of 1994 (*Wertpapierhandelsgesetz*), the revised Restructuring Act of 1995 (*Umwandlungsgesetz*), the Act Against Restraints on Competition of 1998 (*Gesetz gegen Wettbewerbsbeschränkungen*), the Third Act on the Promotion of Financial Markets of 1998 (*Drittes Finanzmarktförderungsgesetz*), the Act on the Control and Transparency of Corporations of 1998 (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*), the Takeover Act of 2002 (*Unternehmensübernahmegesetz*), and the capital gains tax of 2002. Next we examine the main elements of these regulations that may affect corporate governance.

##### 4.1.1 *The Securities Trading Act (1994)*

This law is part of the Second Act on the Promotion of Financial Markets and essentially incorporates EU regulation into German law.<sup>4</sup> This act applies to all companies with headquarters in Germany and traded on an EU stock exchange (and not just a German one) and deals with the disclosure of information about the company's shareholder structure and with insider trading regulation.<sup>5</sup> Prior to 1995, little was known about the shareholder structure of German firms as the Stock

<sup>4</sup> In particular, the following EU directives were (partially) implemented into German law: the Insider Directive (89/592/EEC), the Transparency Directive (88/627/EEC) and the Investment Services Directive (93/22/EEC).

<sup>5</sup> The law, however, does not regulate the exchanges, which is a matter of the Stock Exchange Act.

Corporation Act stipulated that shareholders only had to report their stakes if these exceeded the thresholds of 25 and 50%, respectively. The Securities Trading Act, which became effective on 1 January 1995, states that stakes above the thresholds of 5, 10, 25, 50 and 75% of the voting rights (be it from above or below) need to be disclosed to the Financial Supervisory Authority (FSA, *Bundesanstalt für Finanzdienstleistungsaufsicht*). The FSA then makes this information public. However, the stock exchanges may impose stricter disclosure requirements than those of the Securities Trading Act. In addition, the act labels insider trading as a criminal offence (Baums 2002; Schmid and Wahrenburg 2003).

#### *4.1.2 The revised Restructuring Act (1995)*

The Act allows for tax-efficient restructuring and ensures that restructuring is not delayed as a result of lawsuits by minority shareholders. Beinert (2000) states that corporate restructuring (mergers, break-ups, spin-offs, transfers of assets and changes in legal status) can be done at book value (without revaluation). Consequently, capital gains taxation on asset revaluations (write-ups) can be avoided. A corporate restructuring requires the approval of a qualified majority of at least 75% of the voting capital represented at the annual general meeting. However, the Stock Corporation Act generally allows (minority) shareholders to challenge such a restructuring in court even though it has been approved by a supermajority. Such court actions may delay the restructuring for many years. The Restructuring Act supersedes the Stock Corporation Act; shareholders who feel disadvantaged can still sue the firm for damages but cannot stall the restructuring anymore.

#### *4.1.3 The Act Against Restraints on Competition (1957)*

This antitrust law dates back to 1957 and came into force on 1 January 1958. The act has been subject to successive amendments and the latest amendment dates back to 1 July 2005. The act tests whether business combinations lead to the extraction of monopoly rents on the market for goods and services. From a governance perspective the interest of the act lies in the definition of a business combination in the wide sense. The act does not just cover mergers and acquisitions, but also acquisitions of share stakes of 25% and above. This definition makes block trades above the 25% limit subject to the scrutiny of the competition authority. The latest amendment gives the German Cartel Office the authority to intervene when illegal business practices may restrict trade between member states of the European Union.

#### *4.1.4 The Third Act on the Promotion of Financial Markets (1998)*

This Act bans the introduction of voting restrictions and grants a grandfather clause for existing restrictions which was valid until 1 June 2000. The Act also bans the



issue of multiple voting rights, although a grandfather clause was created for existing shares with multiple votes. However, since 1 June 2003 multiple voting shares are no longer permissible. It should be noted that German firms are still allowed to issue non-voting shares, but only for a maximum of 50% of the total equity issued.

#### 4.1.5 *The Act on the Control and Transparency of Corporations (1998)*

This Act amends one of the most important pieces of German corporate law: the Public Corporation Act (*Aktiengesetz*) of 1965. The act was designed to improve transparency and to reform internal corporate governance mechanisms, with particular focus on the supervisory board (Hopt and Leyens 2004). The act abolishes multiple voting stocks or caps on voting rights; allows shareholders holding 5% of the stock to demand the supervisory board to take action against managing directors if there is strong suspicion of negligence or dishonesty; limits to ten the number of supervisory board seats and to five the number of chairmanships a single person can hold; and obliges banks to ask for permission before exercising their customers' votes and to disclose the names of any members of their (supervisory and management) boards serving on the boards of other companies. The act also requires more frequent meetings of supervisory boards and greater disclosure of the candidates credentials; and extends responsibilities on auditing and on the reviewing of (consolidated as well as unconsolidated) financial statements. Finally, the act alleviates restrictions on the use of stock options, which are now permitted subject to shareholder approval (Baums 2000; Gordon 2004).

#### 4.1.6 *The Takeover Act (2002)*

This Act is closely linked to the failure to implement a self-regulatory framework by the Takeover Code of 1995 (see below) and to the German turnabout to the proposed 13th Company Law Directive on Takeovers (Berglöf and Burkart 2003; McCahery and Renneboog 2003). The Takeover Act, which became effective on 1 January 2002, requires that a mandatory tender offer needs to be made for the rest of the equity as soon as an investor acquires 30% of a firm's voting rights. Moreover, the Takeover Act does not allow restricted tender offers (in case a shareholder has acquired at least 30%) but allows conditional tender offers. A restricted offer is an offer applying to e.g. 40% of the shares; a conditional offer is a bid for X percent of the shares which will be purchased provided that the bidder gets at least Y percent of the shares. Finally, paragraph 33 of the Takeover Act also renders golden parachutes offered by the bidder to the target's management/directors illegal. This rule will prevent the payment of huge amounts of severance pay (as in the case of the Mannesmann takeover by Vodafone).

This mandatory bid is likely to reduce block trades that were common prior to 2002 (Köke 2004; Jenkinson and Ljungqvist 2001). On the one hand, the law invokes the principle that the target management should take a neutral stance in a

takeover attempt. On the other hand, paragraph 33 of the Act obliges the management to take any actions in the best interest of the corporation, such as anti-takeover measures. The defensive measures that are allowed are: actions that dilute the share stake of the bidding investor (a new equity issue to friendly parties while excluding pre-emption rights, share repurchases), a pac-man defence (i.e. a counter-bid for the bidder's shares), the sale of the crown jewels, and soliciting bids from white knights. However, all these measures, apart from the last one, are subject to the approval of the supervisory board. Finally shareholders representing at least 75% of the votes can give the management full discretion to set up any anti-takeover action.<sup>6</sup>

Another important change introduced by this law is the introduction of squeeze-out rules. Whereas in the past minority shareholders could stall a merger or acquisition by fighting a squeeze-out in the courts, the Takeover Act states that the shares of the residual minority shareholders can be transferred to a shareholder holding at least 95% of the equity. In this case, the minority shareholders who are 'squeezed out' will no longer be able to stall the takeover process, but can ask for a cash compensation in the courts if their rights are violated.

#### 4.1.7 Capital gains tax (2002)

From 1 January 2002, divestitures of equity stakes no longer incur capital gains tax. Prior to that date, many corporations and financial institutions preferred to retain their stakes in German companies rather than sell them because the resulting capital gains would have been taxed at the full corporate tax rate.

## 4.2 Codes

Until very recently, voluntary regulation and codes of best practice were virtually unheard of in Germany which has traditionally relied on statutory regulation to shape its corporate governance system. The introduction of the Takeover and best practice codes is therefore an important innovation. In what follows, we review the main characteristics of these codes.

### 4.2.1 The Takeover Code (1995)

The Takeover Code of 1995 (*Übernahmekodex der Börsensachverständigenkommission beim Bundesministerium der Finanzen* of 14 July 1995, amended on 1 January 1998) was introduced as a voluntary code of conduct for firms involved in a merger or acquisition. The code, somehow based on the English City Code and early drafts of the 13th Directive, called for mandatory takeover bids as soon as a party had acquired control (50% of the votes or 75% of the votes present at the latest

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<sup>6</sup> This approval needs to be renewed after a period of 18 months.

shareholders' meeting). Still, the code had a limited impact because it was not followed by several of the largest German firms and there were numerous violations of the code by its signatories. The enactment of the Takeover Law of 2002 brought an end to the self-regulatory takeover regime in Germany.

#### 4.2.2 Codes of best practice (2001–2002)

Another attempt to introduce voluntary codes arises from the creation of the German Panel on Corporate Governance in July 2001 (*Bericht der Regierungskommission Corporate Governance*). The Panel, chaired by Professor Baums, urged the federal government to begin drafting a “Transparency and Disclosure Act” which would implement further proposals of the Panel. This would include the legal foundation for the “comply or explain” principle, measures to strengthen the role of supervisory boards (through broader disclosure, the definition of the duties for the management board and tighter confidentiality requirements for supervisory board members) and the use of electronic media for company publications.

Related to the functioning of the management and supervisory boards, the Panel recommended the tightening of the fiduciary duties by extending the civil liability of management and supervisory board members from its current standard of “wilful intent” to include “gross negligence” in connection with the release of false information to the capital market. Furthermore, the number of external supervisory board positions that a supervisory board member may hold should be limited to five in order to strengthen the independence of supervisory board members. A supervisory board member should not hold office in or represent other companies that are in competition with his or her company. The Panel also recommends improving the transparency standards, such as those for management stock option plans and those for the shareholdings of members of the management and supervisory boards, as well as increasing the duties of the management board to provide information to stockholders. In addition, the independence of auditors should be strengthened.<sup>7</sup> The Panel is also in favour of eliminating the requirement that shares be deposited as a prerequisite for voting at the shareholders' meeting.

The Cromme Code (26 February 2002) works under a comply-or-explain regime and partially follows the proposals from the government panel relating to corporate governance principles (see e.g. Hopt 2004 for a detailed account of the Code's recommendations.). Still, the main contribution of this code is a structured summary of the regulatory changes in terms of disclosure and transparency, the duties of the management and supervisory board (the core of the code), remuneration contracts, the formation of committees, etc. The code recommends that firms should allow remote access by shareholders to the general meetings using modern communication media (such as the internet). In terms of accounting

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<sup>7</sup> While the independence of the auditor is a key concept shared by the German as well as the UK and US systems, Hommelhoff and Mattheus (2003) argue that the role of the auditor under the German system is not just limited to being a gatekeeper (“Kontrollfunktion” or “Garantiefunktion”) but also includes assisting the supervisory board in its internal audit of the activities of the management board (“Unterstützungsfunktion”).

standards, the historical accounting conventions of the German *Handelsgesetzbuch* (HGB) demand less disclosure than e.g. the US GAAP-rules of the Federal Accounting Standards Board. However, over the past few years, many German firms have voluntarily adopted the GAAP-rules of the International Accounting Standards Board (IASB) under the *Kapitalaufnahmeerleichterungsgesetz* (KapAEG). EU-listed companies had to report their consolidated financial statements according to the IASB standards by no later than 2005.

### 4.3 Stock exchange developments

During the price run-up of the 1990s, many new stock exchanges or new market segments were created in order to float small and medium-sized firms, predominantly from the high tech, internet and telecom sectors (Goergen et al. 2004). In 1997, Germany set up the *Neuer Markt*, one of the Euro New Markets along with the *Nieuwe Markt* in Amsterdam, the *Nouveau Marché* in Paris, the *Nuovo Mercato* in Milan and the EuroNM Brussels. This was an attempt to develop an IPO market capable of competing with the American NASDAQ. Listing requirements for the *Neuer Markt* included a 20% free float, a 6-month lock-in period for the incumbent shareholders, and adherence to the Takeover Code. Also, firms listed on the *Neuer Markt* had to issue a prospectus based on an international standard, follow IAS or US-GAAP accounting rules, and report quarterly and annually (as specified in the Rules and Regulations *Neuer Markt*, FWB 9).

However, although the *Neuer Markt* experienced a remarkable growth until 2000, blatant violations of insider trading legislation, of lock-in agreements and share price manipulations by several firms forced it to close down in 2002/3. The different market segments—*Amtlicher Handel* (the official, most liquid market), the *Geregelter Markt* (second-tier market) and the *Neuer Markt*—were restructured on 1 January 2003 to form the General Standard and Prime Standard market segments. Small and mid-sized companies, which meet minimum listing requirements (from the former *Amtlicher Handel* and the *Geregelter Markt*) and do not target international investors, are now listed on the General Standard market segment. Companies following the international accounting standards (IFRS or US GAAP) and disclosure rules are listed on the Prime Standard segment. The *Neuer Markt* firms were included in the latter.

One way of signalling firm quality and shareholder focus is by seeking a cross-listing on a stock exchange which imposes strong shareholder protection via its listing requirements or corporate law. While many large Continental European companies were cross-listed in New York and London, the severe stock market crash related to the bursting of the internet bubble in 2000 and the introduction of the Sarbanes-Oxley Act (2002) in the US has led to a reduction of the number of cross-listings by non-US companies and has caused a series of delistings. Litvak (2006, 2007a, b) investigates whether the act has had net costs or benefits for the shareholders of publicly traded corporations. On the one hand, the act may benefit shareholders by improving the monitoring of management and transforming the broader corporate culture. On the other hand, monitoring may be best left to market

forces and the act may needlessly impose bureaucratic burdens (see also Romano 2005; Butler and Ribstein 2006). The act applies not only to US firms, but also to non-US firms listed with levels 2 and 3 ADRs. Litvak (2007b) finds that the introduction of the act has had negative (lasting) effects on the share prices of foreign cross-listed firms, the biggest losers being companies with high levels of disclosure and those with lower needs for external financing. Given that the costs of regulatory compliance in the UK have increased less substantially than in the US, the London Stock Exchange has managed to attract a large share of cross-border initial public offerings and the number of delistings has been relatively more modest.

#### 4.4 Summary of laws, codes and stock exchange developments

A good deal of the transformations in Germany over the last decade have been on the legal side. In particular, there have been important changes in capital market and corporate law. The introduction of codes of best practice, however limited, has also been an interesting innovation. All in all, there is little doubt that the institutional setting has changed and that some of these changes have introduced Anglo-American practices. This is clearly illustrated by the stock exchange developments. However, some of these legislative efforts do not seem to have been accompanied by the necessary enforcement. As a result, they have barely affected the essence of the German corporate governance system. In fact, some even conclude that they have actually reinforced the cornerstones of the German system (see e.g. Baums 2000; Nowak 2001; Hackethal et al. 2003; Terberger 2003; Baum 2004; Kirchmaier and Grant 2004). The picture that emerges therefore casts doubts about the convergence of German corporate governance towards the Anglo-American model.

## 5 Conclusion

Is there an optimal system of corporate governance? Will the Anglo-American model ever become a yardstick in corporate governance? Are national governance systems effectively converging towards a particular (ideally optimal) system of corporate governance? These are questions that have recently attracted the attention of researchers in both law and economics. This paper contributes to this literature by investigating whether the German system of corporate governance is converging towards the Anglo-American model.

We show that most features of “the stereotypical view of the German financial system” are still in place. Barriers to convergence towards the Anglo-American governance regime are: the concentrated corporate control; the separation of ownership and control through devices such as pyramids and proxy votes; the two-tier board with co-determination between shareholders and employees on the supervisory board that provides stability albeit possibly at the cost of entrenchment; the important role played by banks, both directly as large shareholders and indirectly through proxy votes and board representation; a host of institutional, legal and even cultural barriers to hostile takeovers; and a regulatory framework based on

EU directives but firmly rooted in the German legal doctrine. However, the German system has also experienced some noteworthy cultural changes such as the introduction of the principle of shareholder value and stock-based remuneration packages. Some of its existing cornerstones, such as the market for partial corporate control and the disciplinary effects of product market competition, also make the German system more similar to the Anglo-American system than one would expect at first sight. It is also interesting to note that major changes in corporate governance practices have a legal origin. In particular, since 1995, several legislative reforms of corporate law, and stock exchange regulation have effectively modified the institutional framework. An interesting innovation has been the introduction of voluntary codes (such as the Takeover Code and the Cromme Code), although the compliance with these codes still leaves a lot to be desired.

One may argue that these new features indicate a certain trend towards a market-oriented system. However, most of the characteristics traditionally associated with German corporate governance (the so-called “Deutschland AG” or “Germany Inc.”) are still in place. Although the regulatory initiatives have increased transparency and accountability, they have not addressed core competencies. As an illustration, the Takeover Act obliges the management to take the interest of the company at heart, but paradoxically also allows the use of anti-takeover devices.<sup>8</sup> Although there has been some degree of convergence in terms of the adoption of international accounting standards, improvements in stock market regulations, a massive increase in IPOs, and the removal of multiple voting shares, the German system still differs significantly from a market-based system.

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<sup>8</sup> Strictly speaking, this comment also applies to the US system of corporate governance.

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