Comparative Corporate Governance

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– Essays and Materials –

Edited by

Klaus J. Hopt

Director of the Max-Planck-Institute
for Foreign Private and Private International Law,
Hamburg, Germany

Eddy Wymeersch

Professor at the University of Ghent, Belgium
Director of the Seminar of Commercial and Enterprise Law


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# Preface

Corporate governance has become an important issue in all industrial economies. Corporate governance relates to the internal organization and power structure of the firm, the functioning of the board of directors both in the one-tier and the two-tier system, the ownership structure of the firm, and the inter-relationships among management, board, shareholders and possibly stake-holders, in particular the workforce of the enterprise and the creditors. These interrelationships include monitoring of the management by the board and external supervisors, and shareholder activism.

Most large companies around the world are facing governance issues, either at the level of the board's composition, role and behavior, or with respect to the company's relationship with shareholders - particularly large shareholders and institutional investors - as well as other stakeholders. These governance issues come up in governance systems that are quite varied. They differ widely from country to country. The Anglo-Saxon scheme and the German-Dutch model are perhaps the most prominent systems. The former is a more market oriented system, while the latter is more oriented towards enterprise organization and bank influence. The differences in governance may be related to substantial differences in financial structures, in particular the prevalence of securities financing in the Anglo-Saxon countries (with the far-reaching separation of credit banks and investment banks imposed by law in the United States) versus the predominant role of the banking system, especially of the universal banking system, in Germanic countries. Other governance systems such as the Japanese keiretsu system lead to different outcomes. The path dependency of these systems is patent, while the evaluation of this dependency is highly complex.

This book has grown out of a conference entitled "Comparative Corporate Governance, An International Conference, United States - Japan - Western Europe" which was held in Brussels on 14 June 1995. It was organized by the Financial Law Institute of the University of Ghent, and the Study Center on Groups of Enterprises in Brussels under the scientific direction of Eddy Wymeersch. The book contains the contributions by the speakers in an enlarged and updated form together with source material and references. The Business Roundtable on Corporate Governance in Belgium was chaired by Professor J.L. Duplat, chairman of the Commission bancaire et financière, Brussels. Although it attracted much attention at the conference, it did not present itself to being printed. Instead we have collected a selection of 18 documents on corporate governance from 7 countries (United Kingdom, USA, Canada, France, Germany, the Netherlands and Belgium). By far the most are in English language with a very few left in their original French and German version. These documents date from the 1990s, most of them from 1995 and

1996, and are to be made available more easily to business and academia in other countries than the one in which they have been elaborated. They offer a wealth of data, insights, self-regulatory experiences and legislative proposals which show that, despite all the national deep-rooted differences, the core problems are very similar indeed.

The book is the first of a series of publications which is to be edited by both of us in collaboration with colleages from the United States and Japan. The next publication will collect contributions on the field with an interdisciplinary and international focus as arising from the Symposion on "Comparative Corporate Governance - The State of the Art and Emerging Research" held from 15 to 17 May 1997 at the Max Planck Institute for Foreign Private and Private International Law at Hamburg.

We thank the sponsors, the contributors and the numerous participants in the Brussels Conference who by their enthusiastic response to the topic made us plan this publication, to the many persons and organizations who kindly contributed the documents and to our assistants and secretaries, in particular Mrs. Stahl at the Max-Planck-Institute who unremittingly and with technical expertise converted the manuscripts and documents into a print ready format.

Hamburg and Brussels, April 1997

*Klaus J. Hopt* *Eddy Wymeersch*

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# The Contributors

**Erik BERGLÖF**

Associate Professor, Director, Stockholm Institute of Transition Economics and East European Economies (SITE), Stockholm School of Economics 1996; Assistant Professor ECARE Université Libre de Bruxelles 1991-1996; Expert for different EC-related panels and teams, i.a.: Invited Expert, Academic Panel for evaluation of the effects of the internal market, Team Leader, EC team to provide advice for the Russian Government; Center for Economic Policy Research (CEPR) Fellow.

Author of: Corporate Control and Capital Structure - Essay on Property Rights and Financial Contracting (1991) IIB; Ownership and Control in the Firm - A Comparative Study of Six Financial Systems (1988) SOU; Corporate Governance Reform - Redirecting the European Agenda, (1997) Economic Policy; Short-term vs. Long-term Interests - Capital Structure with Multiple Investors, Quarterly J. of Economics (1994) (with E.-L. von Thadden); Corporate Governance Structure of the Japanese Financial Keitretsu, 36 J. Fin. Econ. (1994) (with E. Perotti); A Control Theory of Venture Capital, (1994) J. of Law, Economics and Organization; Corporate Governance, Financial Systems and the Transition of Capitalism - Towards a Conceptual Framework, (1977) Property Rights, Incentives and Welfare.

**Paul L. DAVIS**

Fellow and Tutor in Law, Balliol College, Oxford and Professor of Law of the Enterprise in the University of Oxford; born 1944; BA, Oxford, 1966; MA (Oxon); LL.M., London, 1968; LL.M., Yale, 1969; Lecturer in Law, University of Warwick, 1969-73; visiting Assistant Professor, Yale Law School, 1975; Leverhulme Fellow, Centre de Droit Comparé du Travail et de la Sécurité Sociale, Université de Bordeaux, 1980; Research Consultant to the Committee of Inquiry on Industrial Democracy, 1976; Expert appointed by the Commission of the EC on the revision of the Transfers Directive.

Author of: Labour Law: Text and Materials (1st and 2nd editions, with M.R. Freedland); Kahn-Freund's Labour and the Law (3rd edition, 1983, with M.R. Freedland); (with others) Palmer's Company Law (23rd, 24th and 25th editions); Take-overs and Mergers (1976); Editor, Gower's Principles of Modern Company Law, 6th ed., 1997; Labour Law and Public Policy (1993); Various articles in professional journals on employment law, company law and securities regulation.

**Klaus J. HOPT**

Professor of commercial and business law and director at the Max-Planck-Institute for Foreign Private and Private International Law in Hamburg. Dr. iur. h.c. (ULB, Brussels 1997), Dr. iur. h.c. (UCL, Louvain 1997); Professor of Law in Tübingen, Florence, Bern and Munich (1974-1995); Judge, Court of Appeals of Stuttgart (1981-85); Member of International Fcaulty; Visiting professor in Brussels ULB, Paris I, Geneva, Univ. of Tokyo, Univ. of Kyoto, Univ. of Pennsylvania and Univ. of Chicago.

Author of: Kapitalanlegerschutz im Recht der Banken (1975); Legal Harmonization and the Business Enterprise (1988, with Buxbaum); Kommentar zum Handelsgesetzbuch (Baumbach-Duden, 29th ed. 1995); Ed.: Groups of companies in European Law (1982); Corporate Governance and Directors' Liabilities (with Teubner, 1985); European Business Law (with Buxbaum et al., 1991); European Insider Dealing (1991), European Takeovers (1992), and European Company and Financial Law, 2nd ed. 1994 (all with Wymeersch); Institutional Investors and Corporate Governance (1994, with Baums, Buxbaum); European Business and Enterprise Law (with Buxbaum et al., 1996); Börsenreform (with Rudolph et al., 1997).

**Hideki KANDA**

Hideki Kanda is Professor of Law at the University of Tokyo. Mr. Kanda was born in 1953 and received an LL.B. from the University of Tokyo. His main areas of specialization include commercial law, corporate law, securities regulation and banking regulation. Mr. Kanda served as Visiting Professor of Law at the University of Chicago Law School in 1989, 1991 and 1993, and at Harvard Law School in 1996.

Author of several English language articles on corporate and securities law: Debtholders and Equityholders, 21 Journal of Legal Studies (1992) 431; Explaining Creditor Priorities, 80 Virginia L. Rev. (1994) 2103 (with S. Levmore); Politics, Formalism and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan, 12 U.Pa.J.Int'l.Bus.L. (1991) 569; Taxes, Agency Costs, and the Price of Incorporation, 77 Virg. L. Rev. (1991) 211 (with S. Levmore); The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges, 75 Cornell L. Rev. (1990) 1007 (with J. Macey).

**Steven N. KAPLAN**

Professor of Finance at the Graduate School of Business of the University of Chicago. He has been a member of the faculty since 1988. Professor Kaplan earned his Ph.D. in Business Economics from Harvard University. He received

his A.B., summa cum lauda, in Applied Mathematics and Economics from Harvard College. Prior to completing his Ph.D. studies, Professor Kaplan held positions with Kidder, Peabody & Co. and Booz, Allen & Hamilton.

Professor Kaplan's research, teaching, and consulting focus on issues in corporate restructuring, corporate governance and corporate finance. He has published papers in the Journal of Finance, The Journal of Financial Economics, The Journal of Political Economy, The Quarterly Journal of Economics, The Journal of Applied Corporate Finance, and the Journal of Law, Economics and Organizations. Professor Kaplan and his work are cited regularly in the popular press on corporate restructuring and governance issues. Currently, Professor Kaplan serves on the editorial board of The Journal of Finance and Quantitative Analysis, and European Financial Management. He is also a Faculty Research Fellow at the National Bureau of Economic Research.

Professor Kaplan teaches an advanced M.B.A. course financial management. Professor Kaplan was named one of the top 12 business school teachers in the United States in Business Week's 1994 Survey of M.B.A. programs.

**Mark. J. ROE**

Professor of Law at Columbia Law School.

Author of: Strong Managers, Weak Owners, The political Roots of American Corporate Finance (Princeton U. Press, 1994); The Modern Corporation and Private Pensions, 41 UCLA L. Rev. (1993) 75; Political and Legal Constraints of Ownership and Control of Public Companies, 27 J. Fin. Econ. (1990) 7; A Political Theory of Amercan Corporate Finance, 91 Columbia. L. Rev. (1991) 10; Political Elements in the Creation of a Mutual Fund Industry, 24 Securities L. Rev. (1992) 599; Some Differences in Corporate Structure in Germany, Japan and the United States, 102 Yale L.J. (1993) 1927; (with R. Gilson) Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization, 102 Yale L.J. (1993) 871.

**Jack C. SHAW**

Sir John C. Shaw, CBE, (64) has been a Deputy Governor of Bank of Scotland since 1991. He is Chairman of the Scottish Higher Education Funding Council, a member of the Scottish Economic Council and holds a number of other public appointments. He is Chairman of two Investment Trusts and a director of a number of other publicly listed companies. He is Deputy Chairman of the Edinburgh Festival Society. Sir John practised as a Chartered Accountant for over 25 years and was President of the Institute of Chartered Accountants of Scotland 1983/84 and a member of the Financial Reporting Council until May

1996. He held the Johnstone Smith Chair of Accountancy at the University of Glasgow for 6 years until December 1982 and is now a Visiting Professor there. He was the first Executive Director of Scottish Financial Enterprise until June 1990 and was elected non executive chairman in 1995. Sir John is Chairman of the David Hume Institute and a member of the Steering Committee of its (1990/91) study "Corporate Takeovers and the Public Interest", and became Chairman of the Advanced Management Programme in Scotland Limited on its formation in 1995.

**François VINCKE**

Secretary General, Legal Department, Petrofina S.A.; Law Degree, Catholic University of Leuven; Diploma of European Integration, University of Amsterdam (European Institute); Assistant, University of Antwerp; joined Petrofina in 1974, where he has worked principally in the areas of international negotiations in finance and in exploration and production; several titles of distinction at Petrofina (Managing Director to Norske Fina A/S, President of Fina Exporation in Norway, and Board member of several Petrofina affiliates); President of the Commission "Bribery and Extortion" of the I.C.C. Paris (1994); President of the Legal Commission of the 'Federation of Belgian Enterprises' (VBO-FEB).

**Eddy WYMEERSCH**

Professor for Commercial Law, University of Ghent, Belgium; Regent, National Bank of Belgium; has published on subjects of securites regulation, company law, expecially on groups of companies and on legal issues of accounting; acting as consultant to the EC Commission, to the World Bank and IFC and to regulators of securites markets in several European states.

Author: Supervision of the Securities Markets (EC Commission, 3 vol.); Groups of Companies in the EEC, 1993, Berlin; Further perspectives in Financial Integration, 1994, Berlin, 281 p.; with K.J. Hopt: European insider dealing (1991, Butterworths); European Takeovers, Law and Practice (1992, Butterworths); European Company and Financial Law, 2nd edition (1994, Berlin). On Corporate Governance: Institutional Investors and Corporate Governance, (Th. Baums, R.M. Buxbaum and K.J. Hopt, ed.) 1994; Aspects of corporate governance in Belgium, in Prenctice D.D. en Holland, P.J.R. (Ed.), Contemporary Issues in Corporate Governance, Oxford, 219 p.; De regulering van overnamebiedingen in een rechtsvergelijkend perspektief, Kluwer 1994, 66 p.; Elements of Comparative corporate governance in Western Europe, in Aspects of Corporate Governance, Mats Isaksson and Rolf Skog (ed.), Stockholm, Juristförlaget, 1994.

# *Part One:* Essays

# The German Two-Tier Board (Aufsichtsrat)
# A German View on Corporate Governance

*Klaus J. Hopt*

Contents*



## I. The German Aufsichtsrat and Its Roots

### *1. The mandatory two-tier system*

In German corporations the board is divided as a matter of law into the management board (Vorstand) and the supervisory board (Aufsichtsrat). The

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* Lecture given in Brussels, 14 June 1995. The text has been kept, footnotes have been added.

management board manages the company according to its own business judgment and represents the company in its business dealings and in litigation. The supervisory board oversees the management. Members of one board cannot sit as members of the other board.

The supervisory board consists of at least three members and at most 21 members, depending on the stated capital of the corporation. In the case of corporations having at least 500 workers, one third of the supervisory board members must be from the workforce of the corporation.

If the corporation normally employs more than 2,000 workers, half the supervisory board members represent the workforce and some of these must be representatives of the unions. In the case of such corporations the size of the supervisory board varies according to the number of workers employed. If normally there are more than 20,000 workers, the supervisory board consists of 20 members, 10 representing the shareholders, seven the workforce of the corporation and three representing the trade unions. In a case of deadlock the chairman of the supervisory board, who is elected by the shareholders, has two votes, giving slightly greater voting strength to the shareholders. In 1989 the German Supreme Court considered this a crucial consideration when it upheld this provision under the requirements of the German Constitution.[1] However since this landmark decision the bench has changed completely and the Court might reconsider its view if the occasion were to arise.

### 2. *Appointment and dismissal*

The supervisory board appoints the members of the managing board for a term of up to five years. Reappointment is permissible and usual. The supervisory board may designate one member to serve as chairman of the managing board. Members of the managing board may be dismissed only for compelling reasons such as, in particular, gross breach of duty, inability to conduct the corporation's business properly, or a vote of no-confidence carried at a shareholders general meeting, provided it is not based on clearly arbitrary grounds. This gives management a certain degree of security and independence in office for a number of years, which is what the legislator intended and which seems to meet with widespread approval.

The double vote of the chairman can also be used when members of the managing board are nominated or removed; however this calls for a long and complicated procedure, clearly intended to deter the shareholders from using it.

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1 Codetermination Act of 4 May 1976 (German Federal Gazette I 1153); German Supreme Court, BVerfGE 60, 290 = NJW 1979, 699. The legal regime of the supervisory board is described by M. LUTTER and G. KRIEGER, Rechte und Pflichten des Aufsichtsrats, 3d ed. (1993).

In fact, the second vote is rarely used: forcing through important decisions in this way would worsen relations with labor within and beyond the supervisory board.

Remuneration for managing board members is fixed by the supervisory board. Stock participations may be granted, but are not nearly as common as for example in the USA. Accordingly excessively generous payments to managers are very rare in Germany and board remuneration is a much less controversial topic than it is in the USA.

The shareholders elect their representatives on the supervisory board, while the employee representatives are elected by the workers of the corporation or appointed by the trade unions. The members of the supervisory board are elected for a term which results to be between four and five years.[2] Shareholder representatives may be dismissed earlier by a resolution requiring three fourths of the votes cast or by the court if there is a compelling reason. This is one of the many difficulties impeding hostile takeovers.[3] Remuneration for the supervisory board is fixed by the general meeting of shareholders. The usual pay is rather modest (if the job is taken seriously).[4] The chairman of the supervisory board in particular is usually underpaid.

### 3. *The tasks of the supervisory board*

According to the law, the supervisory board has two main tasks: first, as already mentioned, to appoint and if need be to dismiss members of the managing board, and secondly, to supervise the management of the company.

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2 I.e. not beyond the end of the shareholders meeting in the fourth year following the beginning of the term of office.

3 The reasons for the rarity of takeover bids in Germany are complex, cf. K.J. HOPT, European Takeover Regulation: Barriers to and Problems of Harmonizing Takeover Law in the European Community, in: K.J. HOPT and E. WYMEERSCH (eds.), European Takeovers, Law and Practice (1992) 165 at 167 et seq. As to the controversies concerning the Draft 13th EU Directive of 1996 and the voluntary German Takeover Code of 1995 see SAME, Europäisches und deutsches Übernahmerecht, ZHR 161 (1997) issue 3 (in print).

4 The average remuneration of the management board members in 1992 was DM 420,000 (DM 94,000 in 1960), the average remuneration of supervisory board members was DM 16,900 in 1992 (DM 13,100 in 1960). See M. HOFFMANN-BECKING, Rechtliche Möglichkeiten und Grenzen einer Verbesserung der Arbeit des Aufsichtsrats, Festschrift für H. Havermann (1995) 230 at 245. According to F.A. SCHMID, Zeitschrift für Betriebswirtschaft 67 (1997) 67, board member remuneration ranges from DM 3,000 to DM 107,300 with an average of DM 34,400 per annum (sample of 1991). He finds that supervisory board remuneration is positively related with performance as well as with company size. Cf. also L. KNOLL, J. KNOESEL and U. PROBST, Zeitschrift für betriebswirtschaftliche Forschung 49 (1997) 236.

There are a number of additional, more specific tasks such as to call shareholders meetings, to examine the annual financial statements and provide a written report on the result of the audit for the shareholders meeting and to represent the company in its dealings with members of the management board. If the articles of incorporation so provide or the supervisory board so decides, specific types of transactions need to be approved by the supervisory board. However it is made clear in the Act that the supervisory board is not directly involved in management decisions. Indeed the law does not allow managerial functions to be delegated to the supervisory board. This is very different from the one-tier board model.

In order to make supervision possible, the management board must inform the supervisory board of its policies for the future conduct of business, the profitability and in general the business of the corporation. Furthermore the chairman of the supervisory board must be notified of any other important event. The supervisory board may at any time ask the managing board for any other information about the corporation if it considers this necessary.

### 4. *Historical development*[5]

The German two-tier board system dates back to the beginning of modern German corporation law. The Reform Act of 1870 provided for an obligatory supervisory board. It was meant to be a substitute for the state charter and the continuous state control which were abolished. This is the historical reason why the Aufsichtsrat is an outside board, i.e. it links people other than the owners with the enterprise. It performs functions not unlike those historically intended for the disclosure requirements in Britain. Very soon it became clear that the supervisory board did not live up to these expectations. Yet in 1884 and in later years when stock corporation law reform acts were enacted, the legislator adhered to the two-tier board system, hoping to improve its functioning by special reforms, which divided the functions and responsibilities of both organs more clearly, improved the information to be given to the supervisory board and increased the legal duties and liabilities of board members. To this day supervisory board reform has remained a major subject in the debate about legislative reform.

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5 K.J. HOPT, Zur Funktion des Aufsichtsrats im Verhältnis von Industrie und Bankensystem, and N. HORN, Aktienrechtliche Unternehmensorganisation in der Hochindustrialisierung (1860-1920), in: N. HORN and J. KOCKA (eds.), Law and the Formation of the Big Enterprises in the 19th and Early 20th Centuries (1979) 227 et seq. and 123 at 144 et seq. Cf. also G. LANDWEHR, Die Verfassung der Aktiengesellschaften, Rechtsverhältnisse in Preußen vom Anfang des 19. Jahrhunderts bis zum Jahre 1870, Zeitschrift der Savigny-Stiftung für Rechtsgeschichte, Germanistische Abteilung (ZRG GA) 99 (1982).

### 5. *Stock corporations and other forms of companies*

The two-tier structure is obligatory for all stock corporations irrespective of their size and workforce. Yet most German enterprises are not stock corporations. There are some 600,000 limited liability companies (GmbH) as compared with about 3,600 stock corporations, of which only about 700 are listed on the stock exchange.[6]

A limited liability company may have a supervisory board and in fact many GmbHs choose to have one or to have an informal advisory board. Limited liability companies are subject to the same regime of labor co-determination as stock corporations which means that there must be a supervisory board if a limited liability company normally employs at least 500 workers. This is provided for by the Works Constitution Act 1952. However, the range of tasks carried out by these supervisory boards is narrower than that of their counterparts in stock corporations. In particular the appointment and dismissal of managers is the responsibility of the partners of the company. However, in companies with more than 2,000 workers the supervisory boards have the same rights and duties as to appointment and dismissal as do the supervisory boards of stock corporations. This is laid down in the Co-determination Act of 1976 and other co-determination acts.

By the end of 1989, 522 enterprises were covered by the Co-determination Act of 1976: 303 stock corporations, 200 GmbHs, 6 partnerships limited by shares (KGaA), 9 limited liability partnerships (GmbH & Co) and 4 co-operative societies.[7] In Germany stock corporations account for 21.1. per cent of total turnover, limited liability companies for 25.5 per cent (figures for 1986).[8] The break-down of the turnover of the limited liability companies according to their workforce is not known. However it is estimated that German firms which have supervisory boards account for no more than around 30 per cent of total turnover.[9]

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6 H. HANSEN, AG 1995, R 272. The latest figures on stock corporations and stock exchanges in Germany and other countries can be found in K.J. HOPT, B. RUDOLPH and H. BAUM (eds.), Börsenreform, Eine ökonomische, rechtsvergleichende und rechtspolitische Untersuchung (1997) 289 et seq.; Deutsches Aktieninstitut, DAI-Factbook 1996; Deutsche Börse, Fact Book 1996.

7 WSI-Mitteilungen 1990, 468; G. HUECK, Gesellschaftsrecht, 19th ed. (1991) § 24 II 2 a. The latest figures are: 740 enterprises including 406 stock corporations and 329 GmbHs, W. TEGTMEIER, Die Mitbestimmung 10/1996, 28.

8 According to HANSEN, AG 1995, R 228, the AGs and the GmbHs (Kapitalgesellschaften) accounted for 50.7 per cent of the total turnover (as measured by the turnover tax statistics 1992) as compared to only 33.4 per cent in 1962.

9 J. EDWARDS and K. FISCHER, Banks, finance and investment in Germany (1994) 75, 94.

## II. The Functioning of the German Two-Tier Board System in the Real World

The subject of the present study is the Aufsichtsrat, the equivalent of the two-tier board system from a comparative law perspective. Neither labor co-determination nor the influence of the German banks on stock corporations can be dealt with in any detail. Data on the subject of labor co-determination are scarce and their evaluation is difficult;[10] the influence which universal banks may have on German stock corporations goes far beyond the Aufsichtsrat.[11]

### *1. Data on the constitution of the Aufsichtsrat*

A representative interview study was conducted by the micro-economist Bleicher, University of St. Gall, in 1985/86.[12] According to this study the average size of the Aufsichtsrat was then 11 or 12 members.

In only about 75 per cent of the corporations, committees of the Aufsichtsrat had been formed. In these corporations an average of 2 committees were formed (1.5 as to the total). There were personnel committees (58 per cent), chairman s committees (29 per cent), finance committees (24 per cent), investment committees (18 per cent), audit committees (7 per cent) and committees for social affairs, for co-determination and for ad hoc matters (4 per cent each). In order of importance these committees were ranked as follows: finance committee, investment committee, chairman s committee, personnel committee and audit committee (only in fifth place). While in general audit committees

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10 Infra II 4.

11 Infra IV 6. This is also true for the discussion on the networks between large German enterprises, banks, investment funds and insurance companies. The supervisory board is only one of the tools for maintaining these networks. Cf. Monopolkommission, Wettbewerbspolitik in Zeiten des Umbruchs. Elftes Hauptgutachten der Monopolkommission 1994/95, 1996; A. PFANNSCHMIDT, Personelle Verflechtungen über Aufsichtsräte. Mehrfachmandate in deutschen Unternehmen, 1993; P. WINDOLF and J. BEYER, Kölner Zeitschrift für Soziologie und Sozialpsychologie 47 (1995) 1; J. BEYER, Zeitschrift für Betriebswirtschaft, Ergänzungsheft 3/1996, 79; C. LEIMKÜHLER, Wirtschaftsprüfung 49 (1996) 305; T.J. ANDRÉ, Tulane L. Rev 70 (1996) 1819.

12 K. BLEICHER, Der Aufsichtsrat im Wandel, 1987. A short survey of other empirical research concerning particularly the information flow from the managing board to the supervisory board is given by M. THEISEN, Grundsätze ordnungsmäßiger Information des Aufsichtsrats, 2d ed. (1996) 19 et seq. Further data as to II 1 - 5 can be found in E. BREMEIER, J.B. MÜLDER and F. SCHILLING, Praxis der Aufsichtsratstätigkeit in Deutschland - Chancen zur Professionalisierung, 1994; Deutsche Schutzvereinigung für Wertpapierbesitz (ed.), Aufsichtsräte in Deutschland, 1995; KORN/FERRY INTERNATIONAL, Board Meeting in Session. European Boards of Directors Study, 1996; C. LEIMKÜHLER, Wirtschaftsprüfung 49 (1996) 305.

were considered less important, the representatives of the workers held audit committees and personnel committees to be more important.

Informal advisory boards in addition to supervisory boards are rare.

### 2. *Data on the members of the Aufsichtsrat*

44 per cent of all the members sat only on one supervisory board. 10 per cent held seats on the supervisory boards of more than 6 corporations. The average number of seats held was 2.85. Around a third of boardroom mandates were held in groups of companies, namely in subsidiaries. The larger the Aufsichtsrat, the stronger the feeling of members that they were not being given enough information. There was no similar correlation between the wish for more information and the number of seats held by the particular member. Nevertheless 34 per cent of all board members interviewed thought that the number of seats to be held by one person should be further limited by law to around 5 or 6 mandates. Yet it is worthwhile to note that such a limitation would affect only 10 per cent of the board members interviewed.

Only 7.3 per cent of the chairmen of the Aufsichtsrat work full time. Only 20 per cent of the board members interviewed think the chairmen should be full-time, while 77 per cent are opposed, perhaps because they consider a full-time chairmanship not useful or because they fear that it would create too close an affiliation of the chairman with the corporation.

### 3. *Data on the day-to-day working of the Aufsichtsrat*

German supervisory boards meet on average about 3.8 times a year. About half meet 4 times and another quarter meet 3 times. The meetings lasted an average of 3.74 hours. This means that 14 hours 13 minutes per year on average were spent in sessions.

Chairman's committees meet most often, namely 3.5 times a year, finance committees 3.12 times and audit committees 3.07 times. The longest sessions were those of the audit committee which lasted more than 3 hours. Interestingly the board members interviewed did not think that the audit committee should meet more often; they even considered that meetings should last well under 3 hours.

Contact between the Aufsichtsrat and the Vorstand seems to occur a little more frequently than 4 times a year. When asked whether the supervisory board should play a more consultative role in its relationship with the Vorstand, the opinions of those interviewed were evenly divided. It was the opinion of 90 per cent that the Aufsichtsrat has a great deal of influence or at least a good deal of influence with the Vorstand. Contrary to what one might expect, the

possible role of the Aufsichtsrat in helping to establish and maintain external relationships for the corporation is not very often stressed. The representation of the shareholders and the workers in the Aufsichtsrat is considered important; surprisingly the representation of banks is clearly considered less important.

### 4. *The German system of labor co-determination by means of representation on corporate boards*

The traditional one third labor co-determination on corporate boards is not a topic of discussion in Germany. This is different for the quasi-parity co-determination. In the 1970s this far-reaching form of co-determination on corporate boards was highly controversial. In the meantime public controversy has very much died down. It is only in the most recent reform debate that some commentators have criticized boardroom co-determination for weakening effective supervision by the Aufsichtsrat, while others have rejected this criticism on the basis of their boardroom experience.[13] On the whole it is fair to say that, in the last two decades, German business and banks have learned to live with co-determination. Their experience was that it helped to build a consensus between capital and labor and, more recently, that it has also been a formidable weapon against hostile takeovers.[14] True enough, co-determination has its price. It tends to slow the decision-making process, presents dangers for confidentiality and influences decisions to hire and fire. On the other hand, co-determination functions as an early warning system for social conflicts and as an instrument of collective crisis management. The overall economic and social pros and cons are very difficult to evaluate.[15]

### 5. *The role of the German universal banks*

A few introductory remarks should be made about the role of the banks in German corporate governance - a matter which raises many very difficult

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13 Infra IV 3 b.

14 Supra note 2.

15 K.J. HOPT, Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe, International Review of Law and Economics 14 (1994) 203; a more complete version in German language can be found in: K.J. HOPT, Arbeitnehmervertretung im Aufsichtsrat, Festschrift für U. Everling (1995) 475. See also the discussion on this report in: R.M. BUXBAUM, G. HERTIG, A. HIRSCH and K.J. HOPT (eds.), European Economic and Business Law (1996) 261-281. Cf. also W. KOLVENBACH, Die weitere Entwicklung der Betriebsverfassung und Unternehmensmitbestimmung in den Mitgliedstaaten der Europäischen Union, Festschrift für U. Everling (1995) 669.

issues. Detailed figures were given by the German Monopolies Commission in 1978.[16] According to its enquiry the representation of banks on the supervisory boards of the largest 100 stock corporations in 1974 was impressive. The banks representatives were chairmen in 31 stock corporations and deputy chairmen in 35 (the figures for the three big banks were 21 and 19 respectively). Bank representatives held 113 simple board memberships, 62 of these being held by the big three. In toto the banks held 179 seats.

However if one looks at the total number of board memberships, the picture changes substantially. According to a study of supervisory boards of stock corporations with more than 2,000 employees (i.e. where quasi-parity co-determination was obligatory),[17] 39.7 per cent of the shareholder seats (employee seats not being counted) were held by domestic non-banks, 13.2 by governments, 5.7 by private shareholders and only 16.4 by domestic banks.

The most recent study dates from 1995.[18] It shows that of 1,561 boardroom seats available in the largest 100 enterprises, 760 seats were held by labor (trade unions held 211 of these), 427 were held by representatives of other enterprises, 99 by representatives of private banks and 67 by politicians and bureaucrats. Thus the overall boardroom representation of the private banks was 6 per cent of all seats or 12 per cent of the shareholder seats. This is much less than one would have expected even though these figures are merely averages and are not representative of particular groups of co-determined enterprises (e.g. the 10 largest or enterprises in a specific sector) or of private bank representatives (in particular those belonging to the big Three or Five).

However, the influence of the German universal banks on stock corporations must be seen in the wider context, not just that of supervisory board seats. Representation in the boardroom is only part of the picture. The real influence and, according to some, the economic power of the banks stem from the combination of supervisory board seats, stock participations (blocks of shares), bank proxy votes and the banks credit and underwriting business. This is very difficult to evaluate[19] and should not been judged on the basis of ideological premises.[20] In any case, it goes well beyond the German Aufsichtsrat.

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16 Monopolkommission, Hauptgutachten II: Fortschreitende Konzentration bei Großunternehmen (1978) 300 et seq. See also the figures given by EDWARDS and FISCHER (supra note 9) 124, 136.

17 E. GERUM, H. STEINMANN and W. FEES, Der mitbestimmte Aufsichtsrat - eine empirische Untersuchung (1988) 54.

18 Bundesverband Deutscher Banken e.V. (Cologne 1995).

19 Cf. EDWARDS and FISCHER (supra note 9) p. 129 et seq.; K.J. HOPT, Corporate Governance und deutsche Universalbanken, in: D. FEDDERSEN, P. HOMMELHOFF and U.H. SCHNEIDER (eds.), Corporate Governance (1996) 243.

20 Infra IV 6.

## III. Path Dependence[21] and the One-Tier v. the Two-Tier Board Model

### *1. Countries with a one-tier board such as the USA and the UK*

The movement which led, first in the USA and then in Great Britain, to the appointment of outside directors for listed corporations is well known. For the purposes of this paper it is sufficient to realize that there is a clear trend to add outside or independent directors to one-tier boards.[22] While this is certainly helpful in dealing with the problems of adequate remuneration, conflicts of interests and, more generally, control of management and the CEO, it is not necessarily sufficient to solve these problems completely. After all, outside non-executive directors are the very basis of the German Aufsichtsrat, and their introduction has certainly not eliminated these very same problems in Germany. The important point in the context of this paper is that a certain convergence of the two types of board is occurring which is only in part imposed by the legislator and stems in part from the needs and the chosen practice of large enterprises.

### *2. Countries which allow a choice between the two models such as France*

It is only in a few countries that corporations are allowed to choose between the one-tier and the two-tier board model. This has been possible in France since the basic company law reform of 1966. Yet most corporations, whether old or newly established, continue to adhere to the traditional one-tier system: the CEO (PDG) is elected by the shareholders and combines the roles of chief executive and chairman of the board (conseil d'administration). By 1990 only 7.6 per cent of French stock corporations had chosen the new system which divides the directoire and the conseil de surveillance.[23] In 1995 the one-tier model was used by 155,000 companies out of a total of 158,000 and the two-

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21 Cf. P.A. DAVID, Clio and the Economics of QWERTY, Am. Ec. Rev. Vol. 75 No. 2, 332; M. ROE, Chaos and Evolution in Law and Economics, 109 Harv. L. Rev. 64 et seq. (1996).

22 As to the USA cf. American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Vol. 1 (1994) § 3A.01 Composition of the Board in Publicly Held Corporations; as to the UK cf. The Cadbury Committee Report: Financial Aspects of Corporate Governance, 1992: The Code of Best Practice concerning Non-Executive Directors (Annex I/1). Cf. also for Switzerland P. BÖCKLI, Verwaltungsrat oder Aufsichtsrat? Konvergenz der Systeme in der Spitzenverfassung der Aktiongesellschaft, in: A. REIST and G. RAU (eds.), Durchblick, 39 Persönlichkeiten zu Unternehmung und Gesellschaft, Festschrift für Walter Reist (1992) 3.

23 J. CHARKHAM, Keeping good company, A study of corporate governance in five countries (1994) 135.

tier model only by the remaining 3,000.[24] Some of these 3,000 are highly successful companies. Some corporations have changed back and forth between the two systems, each of which has advantages and disadvantages. The fact that such an overwhelming majority of enterprises adheres to the old system may be due mainly to tradition and to many decades of legal and practical experience with the one-tier system.[25]

### *3. Countries with a two-tier board such as Germany*

In Germany the two-tier board system is mandatory for stock corporations, but not for other types of companies, so that very many German companies do not have two-tier boards.

The main reason other than tradition for not allowing all companies to choose freely between the one- and the two-tier models is clearly Germany's system of labor co-determination. The trade unions treat labor co-determination in corporate boards as sacrosanct. The only minor concession made in 1994 in the Stock Corporation Law Simplification Act was to allow companies with fewer than 500 workers to do without such co-determination even if they are not family-owned, but this concession was withheld from stock corporations already in existence. It was surprising that the trade unions made even such a small concession; the relevant provision of the Act may have passed only because the time chosen and the circumstances prevailing in German politics were particularly favorable at the time.

In this political environment it is obvious that giving the companies the choice between the two board systems would be relevant only for stock corporations with fewer than 500 workers. The shareholders of companies with more than 500 workers would not opt for the one-tier board, for that would mean having the labor representatives involved in all management decisions.

Apart from this it is interesting to note that the above-mentioned empirical study (supra II 5) has shown that a full 25 per cent of the board members interviewed were clearly against the strict division of the tasks of management and control between two boards.[26] This view is favored particularly by members of supervisory boards who sit on more than three boards. The reason given is that the German supervisory board cannot really control management and that the

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24 ERNST & YOUNG, La simplification de la réglementation sur le fonctionnement des sociétés anonymes dans l'Union Européenne, Rapport définitif, Décembre 1995.

25 This was mentioned by Swiss practitioners as being a major reason for preferring the stock corporation form and not choosing the limited liability company form which is available in Switzerland. Choosing an unusual company form could lead to unpleasant surprises in court and in other situations.

26 BLEICHER (supra note 12) 50 et seq.

American unitary board is considered preferable. Those board members who were generally satisfied with the two-tier board system liked the clear separation between management and control and thought the supervisory board a good forum for control by and advice from major shareholders, outside directors from other companies, bankers and representatives of the workforce. Nevertheless, they believed strongly that the functioning of the two-tier board system could be greatly improved.

### *4. Implications for harmonisation within the EU*

The consequences for the 5th EU Directive are relatively straightforward. There is no compelling reason for adopting and prescribing one single board system for all member states, be it the two-tier or the one-tier system. While in theory the two-tier system may have some advantages, these advantages can be obtained in countries with a one-tier system by rules on outside directors. Furthermore experience in the UK shows that, at least in circumstances similar to those in this country, such rules need not be part of the law, but may be prescribed by bodies such as the stock exchanges as part of their requirements for admission. Even without such rules there is a tendency amongst large enterprises to add outside directors to their boards.

If the EC Commission chooses to harmonize the structure of the corporation and particularly the board systems (a controversial subject which cannot be analysed here in greater detail[27]), the directive cannot but allow the member states to opt between the two systems, as has indeed been envisaged in all the drafts so far presented. Recently it was proposed that the member states be required to pass on the option to the enterprises in conformity with the French system. Indeed this could be a step forward for the economic benefit of choosing one system or the other is best evaluated by the individual enterprise at the market. Even so, this would probably not lead to major changes in the corporate reality of the member states.

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27 Cf. the controversial concept of competition between the legislators: R. ROMANO, The State Competition Debate in Corporate Law, Cardozo L. Rev. 8 (1987) 709; L. BEBCHUK, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1437 (1992); F. KÜBLER, KritV 1994, 79; H. MERKT, RabelsZ 59 (1995) 545; SCHÖN, ZHR 160 (1996) 221; K.J. HOPT, ZHR 161 (1997) issue 3 sub II 1, 2.

## IV. Present-Day Debate concerning Reform of the German Aufsichtsrat[28]

### *1. No fundamental reforms of the Aufsichtsrat*

As mentioned before fundamental reform of the Aufsichtsrat is not being considered or even seriously debated in Germany. Legal theory and practice overwhelmingly support the two-tier system. It is said that steps which are intended to change the Aufsichtsrat into a kind of supermanagement are going in an entirely wrong direction.[29] Even the German trade unions, for political or economic reasons, have refrained from advocating the introduction of the one-tier board. Instead the reform discussion is concerned with concrete ways and means of improving the functioning of the supervisory board. Labor co-determination is more or less accepted in theory and practice, and for a political party to touch the fine-tuned balance between shareholder and labor interests, would be a recipe for disaster.

### *2. Technical reforms as to size and membership*

a) The number of supervisory board members is generally considered to be too high for efficient work. In large corporations there may be up to 20 supervisory board members and in addition 6 management board members together with a number of collaborators and the auditors. This easily amounts to 30 persons or more. According to some critics, the size of the supervisory board should be limited to 10, but this might create problems for co-determination, in particular for the representation of the trade unions.[30] According to others, the maximum number should be 15. Indeed, according to group interaction theory and experience, the number probably should not exceed 10 or 15 at the very outside. However, the determination of the most suitable size, particularly from the point of view of labor co-determination, is best made by the individual enterprise. The legislator should set only minimum and maximum limits.

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28 The literature is very extensive. Cf. e.g. E. NIEDERLEITHINGER, ZIP 1995, 597 (601 et seq.) and U. SEIBERT, ZBB 1994, 349 (both from the Federal Ministry of Justice); M. LUTTER, AG 1994, 176 and ZHR 159 (1995) 287; BAUMS, ZIP 1995, 11; W. BERNHARDT, ZHR 159 (1995) 310; P. HOMMELHOFF, Ist das bestehende Aktiengesetz im Sinne von Corporate Governance voll genutzt?, in: PICOT (ed.), Unternehmensüberwachung auf dem Prüfstand - Corporate Governance (1995) 1. See now also the very moderate recommendations of the 61th Deutscher Juristentag, Karlsruhe 1996, section Business Law. As to the two controversial draft acts of the Government and the Opposition Party see infra notes 49 and 52.

29 E.g. E.R. SCHNEIDER-LENNÉ, member of the board of the Deutsche Bank, Gesetzesinitiativen auf dem Gebiet des Aktienrechts, Vortrag vor dem Beraterkreis der Deutsche Bank AG am 30.3.1995.

30 The Government draft 1996 (infra note 52) provides for such a reduction, but this has met with resistance by the Ministry of Labor and the trade unions.

b) At present a member of a supervisory board may be not on the boards of more than 10 corporations. A management board member of a parent company may hold an additional five seats on the supervisory boards of the subsidiaries (so-called group clause). This restriction was introduced by the so-called lex Abs. Formerly one person could belong to many more boards. The maximum number known was 40, held by a private banker from Cologne at the turn of the century. The number of seats held by one person is very likely to be reduced to 5 and a chairmanship will count as two.[31] The group clause will remain untouched because representation of the parent company on the board of the subsidiary serves different purposes and may be needed for steering the group.[32]

What may be more important is the effort to reduce conflicts of interests. A member of a supervisory board should not, at the same time, be allowed to be a member of either of the boards of a competing company.[33] Representatives of business and particularly of the banking sector, while not rejecting this suggestion outright, have pointed out that it might be too difficult in particular cases to determine whether a company is a "competing company".[34] However, this difficulty should not be treated as an insurmountable obstacle.

c) According to some commentators, the chairmanship of the supervisory board should be a full-time position if the supervisory board is to be a match for the management,[35] but whether it should be prescribed by law may well be doubtful.[36]

Furthermore, the practice of the chairman of a management board on retirement becoming chairman of the supervisory board of the same corporation has been questioned. Indeed, how could such a chairman correct decisions which he himself made when he still belonged to the management board? On the other

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31 Cf. for example E. SCHEFFLER (business economist), AG 1995, 207 (209), who pleads for a maximum of 6 to 7 seats and for counting the role of chairman as double or triple; a further reduction may be necessary in crisis situations.

32 As to the supervisory board in groups of corporations see M. HOFFMANN-BECKING, ZHR 159 (1995) 325; K.-P. MARTENS, ZHR 159 (1995) 567.

33 According to some authors this is forbidden already de lege lata, cf. M. LUTTER, Die Unwirksamkeit von Mehrfachmandaten in den Aufsichtsraten von Konkurrenzunternehmen, Festschrift für K. Beusch (1993) 509; according to others the legislator should intervene, cf. J. REICHERT/E.R. SCHLITT, AG 1995, 241.

34 SCHNEIDER-LENNÉ (supra note 29).

35 H. FRANZ (chairman of the supervisory board of Siemens) at the Adolf Weber Foundation Forum "Reform of self-regulation within the corporation" at the Dresdner Bank on 7 April 1995 in Frankfurt; M. LUTTER, NJW 1995, 1133; T.M.J. MÖLLERS, ZIP 1995, 1725.

36 According to M. LUTTER, loc. cit, the legislator should even make it obligatory for the stock corporation to provide the chairman of the supervisory board with an office and with adequate secretarial help.

hand the experience of the former chairman of the management board may be invaluable. This is said to be particularly true of the contribution he could make to the work of the credit committees of the supervisory board of banks. Similar, though less acute, problems would arise if the retired chairman or another member of the management board were to join the supervisory board of the same company as an ordinary member.

### *3. Internal control, better information and audit committees*

a) There is widespread agreement that the key to successful reform is better internal control. Traditional internal control within corporations often fails to live up to modern requirements and possibilities.[37] This has been particularly apparent in the case of banks as a consequence of the derivatives movement. The banks themselves, the national bank supervisory agencies and supranational bodies like the Basle Committee and the EC Commission have already done a great deal of work to bring about improvements. Similar needs exist in the case of non-banks. However, this goes beyond the scope of this paper.

b) As far as the Aufsichtsrat is concerned, the key is information. A body which as a general rule meets less frequently than 4 times a year cannot be expected to control effectively the management of a large corporation. The supervisory board should meet 6 to 8 times a year at least and should receive more and better information than hitherto. Monthly reports by the chairman of the management board should be a standard requirement and a general policy report on the stock corporation and its business is indispensable.[38] Most importantly the chairman of the supervisory board should become more involved in his task. At least in certain cases he should be expected to work full-time instead of only part-time.

Furthermore, the supervisory board should make better use of the information supplied by the auditor of the corporation. Members of the supervisory board should receive the auditor's report well before their meeting. Widespread board practice at present is to let them have the report only at the meeting itself. The reason for this is said to be co-determination which, according to some observers, leads to occasional breaches of confidentiality by the labor representatives.

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37 Cf. for example H. GÖTZ, AG 1995, 337. Business economists such as M. THEISEN and E. SCHEFFLER plead for the development of (non-legal) principles of orderly control of the management by the supervisory board. Cf. M. THEISEN, Grundsätze einer ordnungsmäßigen Information des Aufsichtsrats, 2d ed., 1995; SAME, AG 1995, 193; E. SCHEFFLER, AG 1995, 207.

38 E. SCHEFFLER, AG 1995, 207 (210 et seq.).

The supervisory board could also broaden the kind and scope of the transactions which are subject to its mandatory consent. However, it must be remembered that when labor co-determination was introduced by law in the 1970s, a number of stock corporations reduced the range of transactions for which the consent of the Aufsichtsrat was required.

c) Most of this is difficult to prescribe by law. What could be prescribed at least for large or listed companies is audit committees. In other countries this is done by the stock exchanges. Indeed, there is widespread agreement that more committee work is essential, if the performance of the unwieldy German supervisory boards is to be improved. However many companies already have audit committees. It is doubtful whether the legislator should force the establishment of this or indeed of any other committee upon all stock corporations regardless of size, listing and other features of the particular case. A significant shift of the functions of the full Aufsichtsrat to committees is bound to give rise to a difficult legal and political issue: should the composition of these committees fully reflect the principles of co-determination?[39]

### 4. *Responsibility of the members of the Aufsichtsrat*

Members of supervisory boards are jointly and severally liable for mere negligence in the performance of their functions and they even bear the burden of proving that they acted with due care.[40] In practice however suits against members of supervisory boards are very rare. Management boards are reluctant to sue supervisory board members for lack of control over the management board. A suit must be brought if the general meeting of the shareholders so decides or if a minority of shareholders representing at least ten per cent of the stated capital so requires. To reach this quorum in large public companies is rarely possible. In addition there is the risk of having to reimburse the corporation for its litigation costs if the suit fails.

It has been proposed that this threshold be lowered, according to some commentators to five per cent or alternatively to an amount well under 1 million DM.[41] Others suggest allowing derivative suits of single shareholders, possibly under the control of the court.[42] However it is questionable whether this would be a major improvement. Oppressive suits are well-known in

39 C. JAEGER, ZIP 1995, 1735.

40 K.J. HOPT, Die Haftung von Vorstand und Aufsichtsrat - Zugleich ein Beitrag zur corporate governance-Debatte -, Festschrift für E.-J. Mestmäcker (1996) 909.

41 HOMMELHOFF (supra note 28).

42 M. LUTTER, ZHR 159 (1995) 287 (305 et seq.); H. WIEDEMANN, Organverwaltung und Gesellschafterklage in der Aktiengesellschaft (1989) 47 et seq.; similarly TRESCHNER, DB 1995, 661.

German corporations. It may be that other methods would be more effective than retroactive legal liability. Other incentives could be better pay for the board members[43] and a requirement that the chairman of the supervisory board answer questions addressed to him at general meetings.[44]

### 5. *The auditors*

The forthcoming reform of the supervisory board may well comprise reform measures concerning the auditors. After a number of spectacular failures of corporations the auditing profession has been the subject of much critical debate. Auditors, acting fraudulently or at least with considerable negligence, had granted unlimited certification for the financial statements of these corporations not long before they collapsed. The role of auditors as such is not questioned, but the scope of their work, their duties and their responsibilities are being debated critically. One measure would be particularly far-reaching. A draft Act pending in Parliament would fix a non-renewable term of 5 years for auditing firms. This is meant to make auditing firms less dependent upon major clients. Experts in the field oppose this reform arguing that such a measure would be counterproductive, since an auditor needs one or more years of working with a firm in order to know it really well.[45]

Other proposals[46] include changing the auditing team, but not necessarily the auditing firm, after 5 years,[47] requiring the auditor to "blow the whistle" (as prescribed already for auditors of banks and insurance companies who have to inform the supervisory agencies in case of major problems) and reforming the relationship between the auditor, the supervisory board and the general assembly of shareholders. Occasionally one hears criticism of the close contact between the auditor and the management board which usually precedes the actual writing of the report and its submission to the supervisory board.[48] Yet even though this practice leads to interference by management, it is clear that the auditor cannot prepare his report without the cooperation of the management, in particular the information provided by it. It may be expected that some of these proposals will be taken up by the legislator.

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43 J. SEMLER, Unternehmensüberwachung durch den Kapitalmarkt, in: PICOT (supra note 28) 77 et seq.
44 HOMMELHOFF (supra note 28).
45 A. MOXTER, Den Wirtschaftsprüfer nicht zum Sündenbock machen, FAZ 27.3.1995, p. 18.
46 See the survey by M. THEISEN, WPK-Mitt. 1995, 185.
47 Cf. SCHNEIDER-LENNÉ (supra note 29).
48 HOMMELHOFF (supra note 28).

### 6. *The German universal banks*

There is a strong body of opinion which considers that the private banks have too much economic power. Some proposals encourage far-reaching reforms. A draft Act pending in Parliament[49] would cut down the equity participation held by banks, change their depository vote system dramatically and would, indirectly, but considerably, diminish their board room representation. Much of this is based more on populism and ideology than on hard legal and economic facts. The economic interaction of the universal banking system with market structures and with traditional institutions such as the stock exchanges raise very serious and highly complicated questions. These questions and the behavior patterns of enterprises and financial intermediaries have never been sufficiently analyzed.[50] Until these problems are better understood, it is best to prefer limited reforms[51] to the kind of drastic measures of which the German draft Act is an example. That Act has little chance of being adopted which is not a cause for concern or regret. Further study is needed to elucidate these problems. Most recently another draft Act has been introduced which is more moderate and has good chances to be adopted in 1997.[52]

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49 This draft Act was introduced by the SPD parliamentary group. One of the advisers for this draft Act was M. ADAMS; cf. his contributions in ZBB 1994, 77 and AG 1994, 148.

50 Most recently this is improving, cf. f. ex. EDWARDS and FISCHER (supra note 9); E. WYMEERSCH, AG 1995, 299 with a good collection of empirical data on corporate governance in Western Europe; see also the contributions to the Parliamentary Hearing on the Power of the Banks, ZBB 1994, 69 et seq., and FEDDERSEN, HOMMELHOFF and SCHNEIDER (supra note 19).

51 M. LUTTER, NJW 1995, 2766.

52 Entwurf eines Gesetzes zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG), see SEIBERT, WM 1997, 1.

# The Cadbury Report, Two Years Later

*John C. Shaw*

## Contents



## I. Introduction

I am flattered by the invitation to contribute to this international conference and congratulate the organisers on their initiative in bringing us all together today.

### *1. What is a non-executive director?*

Perhaps someone coming from a Bank which has conducted the same business, under the same name, and in the same legal entity over 300 years can try to offer a long-term perspective on some questions of corporate governance. The first point to emphasise is that the British structure of corporate governance reflects its legal, economic and cultural history. As Professor Hopt has pointed out, the corporate legal framework in the United Kingdom depends primarily on accountability as the means of securing relationships between the corporation and its proprietors (shareholders who enjoy limited liability) and between the corporation and the state.

In any comparative discussion it is also essential to distinguish sharply between two quite different elements of what is loosely called the "German model". The origins, structure, and functions of the Aufsichtsrat should not be confused with arrangements for co-determination. Size criteria brings them both into play in the most prominent German companies, and they do interact (for example, in deterring hostile takeover bids) but the "Supervisory Board" is really the Aufsichtsrat - and it is the reform of that body which is currently being debated in Germany. I note the point because of a view that the Cadbury Report is likely to drive institutional convergence between Britain and Germany as far as corporate governance is concerned. The report's identification, within the so-called "Unitary Board" of a specific type of director - the non-executive director or independent director - and the attribution to him of specific and special duties, creates a de-facto type of 'Aufsichtsrat' - or Supervisory Board. But we are not quite there yet!

I would like to ask you to close your eyes and think please of this mental picture.

The occupants of a hot air balloon were being swept along before strong winds and looked down to see a deep ravine.

Stretched across the ravine was a tightrope and balanced on this tightrope was a middle aged, perhaps one might even say elderly man, wearing a kilt, apparently oblivious to the depth of the ravine and the threat of instant death were he to fall.

On the ground a number of people watched, scratching their heads in bemusement while at the far end of the tightrope stood a man proffering the tightrope walker a £1 note.

"What's going on?" the balloonists asked those on the ground. "Well", came the reply, "that's the appointment of a new Scottish Non-Executive Director".

"How do you know?" the balloonists enquired. "Easy" they said, "The people watching don't know what he's up to, the man himself has no idea what it's about and isn't aware of the risks, and the guy at the far end is trying to get him to do it for next to nothing!"

This is probably an extreme picture of the state of corporate governance two years after the introduction of the Cadbury Code, but it is a light hearted view offered by the Chairman of Scottish Power PLC, Mr. Murray Stuart.

## 2. *Why Cadbury?*

Let me now turn to considering the success or otherwise of the Cadbury Report two years on. A study group set up under the auspices of the Cadbury Committee has just published the results of its review of compliance with the Cadbury Code since its publication in December 1992 (see attached appendices

showing the key results of their findings). They have found encouraging evidence of widespread compliance by most of the listed companies to which the Code is addressed. I shall refer to that review briefly later, but am really much more concerned by the substance of corporate governance than by the form of compliance with the Cadbury Code.

But before we go any further we should remind ourselves how the Code came to existence and why the Cadbury Committee was set up.

The Committee chaired by Sir Adrian Cadbury which reported at the very end of 1992 had terms of reference restricted to the financial aspects of corporate governance. Its work focused on the structures and practices of boards of large UK companies. It was set up in May 1991 by a triumvirate of private sector interests: the Financial Reporting Council, the London Stock Exchange and the Accountancy profession. During the winter of 1990/91 there emerged in Britain a perceived lack of confidence in financial reporting and in the exercise of effective supervision of executive management by company boards. There had been a number of high profile corporate collapses such as "Polly Peck", "Exco" and "Coloroll".

Subsequent events elsewhere have demonstrated that corporate collapse and scandal are not unique to the U.K.! We should also remember that the very early years of this decade marked the low-water mark of economic recession in Britain. The buoyancy of economic boom creates cover for corporate mistakes and misjudgements and allows the adverse consequences of such errors to be rapidly recovered. The difficult trading conditions of recession are unforgiving and the speed of transition from "boom" to "bust" exposes incompetence or dishonesty unequivocally at precisely the moment when businesses under pressure will be trying to create camouflage or at least manufacture excuses.

Ironically, as the report was being finalised further high profile corporate collapses provided dramatic evidence of the problem - e.g. the Maxwell saga, and the failure of BCCI. There was therefore substantial public interest in the work of the Committee and in its report. Cadbury was, in essence, a political response to public disquiet in the U.K. about the conduct and effectiveness of corporate governance. Recognition of that political dimension is important to what I shall say later.

## *3. The Cadbury Code*

The 'Cadbury Code ' of December 1992 is intended to improve the way UK companies are run. Its concern is with the whole area of corporate governance "the system by which organisations are directed and controlled" - and puts an emphasis on systems, processes and controls over accountability and decision-making which lie at the heart of every organisation. (It is, interestingly, a very

British characteristic to attribute bad behaviour to weak systems rather than to individual failure to uphold personal standards of conduct. But of course structures and codes *can* influence personal conduct.)

The four primary principles underlying the "Cadbury" approach to improved corporate behaviour and incorporated within its Code of Best Practice are:

1) A clear division of responsibilities at the head of a company to ensure a balance of power and authority, such that no one individual has unfettered powers of decision. (Combining the roles of Chairman and Chief Executive is not prohibited - but certainly discouraged.)
2) Every Board should include *non-executive* directors of sufficient calibre and number for their views to carry significant weight in decisions. (It should be explained that the typical British company "promotes" to its Board as Directors those who have been successful functional executives. There is generally inadequate help given to these people to achieve the transformation from "management" to "governance". A recent Coopers & Lybrand survey found only 7% of companies have formal arrangements in place for training would-be directors.)
3) Institutional investors should take a *positive* interest in the composition of boards of directors, with particular reference to avoiding unrestrained concentration of decision making. They should secure the appointment of a core of non-executive directors of the necessary calibre, experience and independence. In other words, institutional shareholders have a particular responsibility to be active in corporate democracy - not passive. A nominating committee will help to identify potential Board appointees and reduce the risk of chairmen appointing "place men". A Remuneration Committee will help the Board as a whole to determine appropriate rewards for Board members - always a sensitive issue!
4) The Board structure should clearly recognise the importance and significance of the finance function. An Audit Committee will help to secure that recognition .

   It is, of course, expected that these three special committees - nominating, remuneration and audit - will comprise a majority of non executives. The objective of the Cadbury Code is to focus on three fundamental pillars of good corporate governance:- Openness, Integrity and Accountability. Buttressing these pillars by observation of the Code will help organisations to improve standards of management and to enhance levels of accountability to the organisation's proprietors, who provide the assets and resources of the business .