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Perspectives in Company Law and Financial Regulation

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15

Corporate governance: directors' duties, financial reporting and liability – remarks from a German perspective

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I. Introduction

The impossible is happening in Germany these days. The management board of Siemens, the jewel in the crown of the German economy, is preparing compensation claims against former management and supervisory board members of the company and thereby supplementing the criminal law investigations which the Munich public prosecutor has instigated against these former executives. That is very embarrassing for those involved! These events are shocking for two reasons: firstly, because management board or supervisory board members have so far hardly ever been made liable in Germany (The sarcastic comment of the former chairman of Deutsche Bank, Hermann Josef Abs comes to mind: 'It is easier to catch a pig by its slippery tail than to make a supervisory board liable.'); and secondly, these proceedings involve Siemens, an icon of the German economy. The former chairman of the supervisory board Heinrich von Pierer was, up to a few days ago, chairman of the Innovation Council, which advises Federal Chancellor Merkel on research strategies of economic significance.

From the point of view of company law, we can here discern the effects of corporate governance and the way it has continued to work better in Germany. And the events at Siemens will certainly significantly increase the already wide acceptance of corporate governance and its mechanisms. In my view, there will soon be a breakthrough in Germany (including a psychological breakthrough) and the regulatory discipline of corporate governance will meet with general approval.

That provides an occasion to trace back the development of corporate governance in Germany and to recall its essential structural elements. This enterprise is dedicated to Eddy Wymeersch with all good wishes.

Years ago, in a group of friends, he introduced me to the still so unfamiliar system of corporate governance; I would like to thank him for that.

II. Development of corporate governance in Germany

Germany initially regarded the concept of corporate governance, as originally developed in Anglo-American circles, with more reservation than interest. The 'principal agent conflict' and its resolution appeared to us to be 'old hat'.

A. Investor protection in company law

In fact, the German legislator, i.e. the Reichsjustizamt and the Reichstag, had considered the economic and therefore highly significant problem of the protection of investors more than one hundred and twenty years ago. Thousands of investors had, in the years after the Franco-German war, invested – and lost – their savings in highly speculative operations. The famous legal scholar Rudolf von Ihering was moved to remark indignantly that there were more criminals gathered together on the boards of German banks than in all the prisons. The German Reichstag responded by passing the major company law amendment of 1884, which is still valid today, making the two-tier system characteristic of German company law.

Even then, the German legislator was concerned to establish the necessary framework for the management structure of listed companies and the effective control of their board members. According to the 1884 amendment, the supervisory board was intended to compensate for the weak position of the numerous investors who were not in a position to genuinely monitor the activities of the management board. That was, and is, investor protection by company law or, in today's terminology, internal corporate governance.

B. Auditor as additional monitor

After 1884, German legislation continued at regular intervals to improve the rights of supervisory boards (and thereby internal corporate governance) in the light of experience gained in practice. The greatest impetus was provided by the Emergency Order of 1931 in reaction to the company failures after 'Black Friday' on the New York stock exchange – one of the major contributors to the growth of National Socialism in Germany.

The Emergency Order converted the 'Liaison Council' or Organ of the hidden Higher Management of the Company into the supervisory board of the company with precise directions on these functions. In addition, so that the supervisory board could effectively perform its tasks, the Emergency Order provided it with especially effective support – the auditor – who pre-audits the accounts of the management board for the supervisory board and reports to the latter on the findings of the audit.

The double function of auditors as guarantors of openness and supporters of the supervisory board, which characterizes their position in Germany, was thereby established. For decades then, auditors permitted themselves in practice to be guided by a third function supplementary to the double function or at least more or less overlapping with it. This consisted of giving friendly advice to the management board, so that the bonds of trust developing between the board and the auditors encroached extensively on their work for the supervisory board. An experienced supervisory board member accurately described the situation regarding the auditor's report: if you compared the draft report discussed in advance with the management board and that presented by the auditor to the supervisory board, you often had the impression that you were dealing with two completely different companies.

The German legislator emphatically remedied this situation in 1998 and ensured by a variety of precisely targeted measures that auditors in their internal company function were entirely directed towards the supervisory board and their bond of trust to the management board was largely loosened. This regime has, in fact, led to change in corporate and auditing practice – not least because the auditor has been recognized as the internal agent of corporate governance. The auditor is now inescapably charged with both functions of reviewing the performance of the management: as guarantor of publicity, and supporting the monitoring by the supervisory board. Advice to the management board has been considerably reduced in importance. This may also be seen from the annual financial statements in the German banking industry at the moment, which, in spite of audits and certificates, still often need to be corrected.

C. German Corporate Governance Code

The auditor and the audited accounts are functional elements of corporate governance in Germany. This is acknowledged in the German Corporate Governance Code of 2002 (now the 2007 version). This Code

is the outcome of a carefully graduated process, initiated by private committees of practitioners and academics, and subsequently taken up by the federal government with the appointment of two governmental commissions in 2000 and 2001. The legislator linked the Corporate Governance Code with company law by means of the declaration of conformity: while companies are not bound by the recommendations and suggestions of the Code, if the management board and supervisory board do not wish to accept a recommendation, this must be disclosed. Both organs must make an annual declaration of what recommendations of the Code have been complied with and what not (comply or explain). The declaration must be published along with the separate company or group accounts.

With the German Corporate Governance Code the legislator pursues two objectives: firstly, foreign investors, in particular, are to be made aware of the characteristic duality of the corporate structure of German companies with their management board and supervisory board, and secondly, the legislator sees in the Code the opportunity to ameliorate the extremely strict company law – testified a hundred years ago to have 'the clunking severity of a Prussian senior public prosecutor (*Oberstaatsanwalt*)'. But together with the deregulation and the legislator's retreat from mandatory statutory impositions, another story must also be told. Where companies are resistant and unmoved by mere recommendations, the legislator does not hesitate to strike, and has now forced even Porsche SE to reveal the individual earnings of Wiedeking and other board members in the finest detail in the annual accounts; in Germany, this adds fuel to the flames of political debate on social justice.

D. *Corporate governance and shareholder value*

All in all, the recommendations of the Code and consequently also its suggestions, enjoy increasing acceptance among companies, in particular the DAX companies, i.e. the top German companies on the Frankfurt stock exchange. The German Corporate Governance Code is contributing significantly to change in the corporate governance practices of German companies. Only four recommendations have met with wide resistance among the DAX companies: the excess in D&O insurance policies; discussing the remuneration structure of the management board in the full supervisory board; ruling out a transfer from the chair of the management board to the chair of the supervisory board; the performance-related remuneration of supervisory board members.

Acceptance by the broader public lags a good way behind this increasing acceptance of the Code among companies. In Germany this is mainly due to the fact that 'corporate governance' is viewed as being linked to 'shareholder value' and that means to the single-minded direction of the management board's actions to the interests of the shareholders and the growth of share value. Such single-mindedness conflicts with widely held values in Germany which are rather aimed at various stakeholder interests and thereby, in particular, those of company employees. In a fairly widespread German view, it is the task of the management board, even of a listed company, to reconcile the various stakeholder interests again and again. That also corresponds to the OECD Principles of Corporate Governance.

It is true that the temperature of this controversy, initially conducted very fundamentally in Germany, has meanwhile noticeably cooled. Even without the one-sided exaggerated pursuit of shareholder interests, increasing company value equally benefits the stakeholders – namely the employees and the security of their jobs. The general approval of corporate governance in Germany is increasing little by little, but the performers are skating on thin ice. The recent description of institutional investors as 'a plague of locusts' is ever present.

III. Duties of organs under the Code

Now let us take a brief look at the obligations, as organs, of the management board and supervisory board as embedded in the German Corporate Governance Code.

A. Interplay between the management board and supervisory board

After a preamble and the first section on shareholders and general meetings, the Code does not immediately go on to deal with the management board and supervisory board: it turns instead to the administrative organs (this strikes German corporate lawyers as unusual) with an introductory section on the interaction between management board and supervisory board. The general prescription of close cooperation of the two organs in the interests of the company is repeatedly broken down into concrete situations: consultation on the strategic direction of the company, and the common concern that the supervisory board is provided with adequate information or the joint corporate governance report of

the management board and supervisory board, in which any deviations from the recommendations of the Code over and above company law requirements, must be explained.

For this unusual 'trailer' the members of the commission engage in some self-praise. It is the first time in 'official' regulations that the significance of proper cooperation of both organs for the quality in a two-tier system is so emphatically highlighted. At the same time – and this may be of special interest to British readers – it describes the practical convergence of monistic and dualistic governance models. Well! I have my doubts whether that would convince Paul Davies. Marked out by German company law, the jurisdiction of each of these organs is fenced off from that of the other: management by the management board and supervision by the supervisory board; logically, the supervisory board does not participate in meetings of the management board. Third-party monitoring and division of powers are maintained in the German public company and in the resultant narrowing of the information channels between both organs and their members.

B. Rejection of commandments

Many readers of the Code will expect to find a list of specific duties for the management board, in the manner of 'the ten commandments for proper corporate management' revealing details about the general statutory duty to exercise the care of a proper and conscientious business concern. But they will be disappointed. The detailed duties of the management board referred to by the Code are those stated in any event in the Stock Corporation Act, or they are a matter of course – including the obligation to ensure compliance with the legal provisions and the company guidelines. Instead, the German Corporate Governance Code concentrates intensively on the remuneration of management board members and their conduct in possible conflicts of interest.

The reluctance to give a detailed list of commandments for proper management is to be welcomed. Rules of conduct applicable to all companies in all situations cannot realistically be drafted beyond more or less general platitudes. Management of a company is, in many respects, specific to that company but also specific to the individual. The Code therefore describes and emphasizes for both organs, i.e. equally for the management board and the supervisory board, the application of the business judgement rule – even this is merely the adoption of the statutory provision.

C. *Improved supervisory board performance*

In principle, these observations apply equally to the Code's recommendations and suggestions to the supervisory board. The statutory provisions are here also repeated – surrounded, however, by many helpful additions and extensions. For example, for the election of supervisory board members, for which the supervisory board itself has, according to statute, to make proposals to the general meeting (AGM), it sets down a qualification profile, compliance with which has already considerably improved the level of German supervisory boards and will continue to do so. Gone are the days when at a general meeting of a major energy company someone could seriously be nominated for the board on the grounds of having successfully worked as a cashier in a church institution. The Code also recommends that each supervisory board member must make sure of having sufficient time to carry out their functions. Logically, it is also recommended (admittedly not mandatory) that the report of the supervisory board to the AGM should state whether a supervisory board member has participated in less than half of the supervisory board meetings in a financial year.

It may be predicted that the quality of the work of the supervisory boards of German listed public companies will improve even more. The proposal in the Code that the supervisory board should regularly review its own efficiency will also contribute. Even today, a remarkable number of supervisory boards have adopted the practice of obtaining the assessment of external third parties. Management consultants and auditing companies offer this evaluation as a well-remunerated service. They apparently find enough retired supervisory board members to conduct the evaluation.

IV. Role of accountancy in the system of corporate governance

In the system of corporate governance, accountancy is in the weld between internal and external corporate governance, i.e. between the company statutes and the capital market. Supplemented and enriched by the specific information instruments of the law of the capital markets, accountancy (meanwhile internationalized) in its published form is designed to support investors' decision-making processes.

A. *Function of the intermediaries*

Granted, it would be politically false to assume that every small investor could derive and evaluate the necessary information from annual accounts, in particular the figures, in the manner needed to provide a basis for investment decisions. They will not have the necessary expertise and experience which are, at most, the domain of the institutional investors, and even they obtain expert external advice. On the capital markets, and thereby for external corporate governance, the intermediaries are of central importance. Finance intermediaries with their broad range of the most varied services as well as the mere information providers – the financial press, which makes company information, namely the figures in the annual accounts, intelligible for readers. The special significance of the financial press precisely for accountancy was already recognized in Germany almost fifty years ago.

B. *Investor information in the management report*

Nevertheless, the German and European legislators have not completely lost sight of the small investor, the individual shareholder with special need of information. The management report, setting out the position of the company or the group – independently of the figures in the annual accounts and notes, but nevertheless in conformity with them – is an important element in accountancy both under the EU Directives and the German Commercial Code. The aim of both legislators was that a degree in accountancy law should not be necessary in order to be able to understand the position of the company or the group from the accounts: some financial knowledge must suffice.

The German legislator in 1998 already raised the significance of the verbal element in the annual accounts and logically considerably tightened the standards to which the report and the reporting are subject – admittedly only vis-à-vis the supervisory board and not really in the direction of the shareholders or the general public. The review of the management report therefore affects internal and not external corporate governance.

The EU legislature treats the verbal part of the accounts with even less care – and that in two directions. Firstly, listed companies are completely exempt from providing a management report because international accountancy according to IFRS does not provide for it and the European legislature, in the IAS Regulation, made this form of accountancy

mandatory for listed companies. Small investors and the general public are thereby to a great extent excluded from any role in corporate governance. Against this background, it is, secondly, hardly surprising that the remaining verbal section has recently become overloaded with all sorts of additional disorganized information thus weakening even further its effects in relation to corporate governance.

C. Audit committee

None of this means that the European legislator has completely lost sight of the relevance to corporate governance. With the obligatory audit committee in all companies, which (irrespective of their securities) are present on the capital market, the European legislator emphatically strengthened internal corporate governance in the amendment to the Eighth Directive because, apart from prescribing the formation of the audit committee, the Directive imposes special quality requirements on its members: at least one member must be experienced in international accountancy and must also be independent. In German companies without a supervisory board, but which, nevertheless, wish to avail themselves of the capital market (for example, a financing limited liability company without a supervisory board but with listed securities) the audit committee is an additional company organ. A draft Transformation Act dealing with this issue has existed in Germany for some time now.

At the same time, the mandatory audit committee will affect the work of the auditor who has, in the committee, a permanent contact centre with which he or she can discreetly have preliminary discussions about specific 'discoveries' made in the course of the audit. In addition, the audit committee is also in a position to review the quality of the preliminary work provided by the auditor to the supervisory organ. All of this, and more, improves the internal corporate governance and proves generally that, according to the conception of the European legislator, corporate governance in companies accessing the capital market should primarily be further developed internally and emphasis placed on its further professionalization.

V. Mechanism of responsibility

The picture of corporate governance painted up to now would remain incomplete without the mechanisms of individual manager responsibility, based on what I would like to term *Sesselhaftung* (the attachment

of board members to their seats). This applies to management board and supervisory board members even before the statutory liability of organs.

A. 'Political' management board responsibility

As is well known, statutory law bars the appointment of a management board member of a German public company for an unlimited period: the appointment can be for five years at most. In addition, the German Corporate Governance Code suggests that, on a first appointment to the management board, this five-year period should not be the rule. On the other hand, a management board member once appointed can be removed prematurely only under specific conditions and not freely, at any time or without grounds. Reappointment then becomes the focus of this provision. A management board member in office will do all in his power to convince the supervisory board by his work, his performance and his success, that his reappointment is in the interests of the company and appropriate in the interests of his stakeholders. This mechanism is backed up by the compulsory annual account the board must give of its work and the obligation to have confidence in it voted on by the general meeting on this basis. If the shareholders withhold their confidence from the management board or one of its members, the supervisory board can remove the member concerned prematurely.

Reappointment and threatened removal are, in the system of allocation of powers in German company law, central pillars of a corporate governance designed to have permanent effects. That applies in the first place to the monitoring of, and feedback from, management board members, but also in a legally less-concentrated form to members of the supervisory board.

B. Enforcement of organ's liability

In comparison to this *Sesselhaftung*, claims for compensation against management board and supervisory board members who may have overlooked some of their obligations, had hardly any practical legal significance in Germany until recently. While the German Stock Corporation Act contains onerous liability provisions, the problem lay rather in their application and enforcement. The enforcing organ, the supervisory board (and management board for former organ members) have had understandable inhibitions against suing their colleagues: 'A crow does

not pick out the eye of another crow' (or in an English version: 'dog does not eat dog'). The German Federal Supreme Court, in its programme of action in the Garmenbeck judgment, did not significantly change this.

The German legislator first brought about a legal U-turn by facilitating the power of shareholders to compel action and logically to initiate a special audit. It enables a relatively small (and achievable) minority of shareholders to ensure that measures are actually taken against management board or supervisory board members who have overlooked some obligation. Politically, this was from the outset discussed primarily from the point of view of a really effective corporate governance. In corporate practice, this is beginning to take effect and has, above all, produced a mental transformation: claims for compensation against management board and supervisory board members are no longer taboo. The current debate is proof of that.

C. *Role of criminal law*

The criminal justice system is developing into a player (admittedly one viewed with reserve and mistrust) in German corporate governance, with proceedings for misappropriation of company assets. The Vodaphone/Mannesmann case already has a place in German legal history. The participation of the prosecution services in the monitoring of company organs is problematic above all because public prosecutors and criminal judges do not rely on typical reasoning processes of civil law or company law but develop these specifically for criminal law. In extreme cases, what is quite permissible in company law may be an offence in criminal law. The discussion of these issues is in full swing in Germany.

VI. Summary

The concept of corporate governance has been adopted widely in German company, accountancy and capital markets law and enjoys general and continuously increasing acceptance among listed companies. But the respect for corporate governance will increase among the public all the more when it is disconnected from the one-sided, exaggerated concept of shareholder value. Outside the circle of listed companies, the major family companies have meanwhile developed a Corporate Governance Code tailored to their specific concerns away from the stock exchange, and the public state companies will follow.

In Germany, corporate governance leads to success. Gone are the days of the banker Fürstenberg with his view that shareholders are stupid and cheeky: stupid because they give their money to companies, and cheeky because, on top of that, they then want dividends in return. Today it is different. Shareholders and their interests have never been taken so seriously in Germany as they are today.