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Recent Developments in German Corporate Governance

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Publication date:
2004

[Link to publication in Tilburg University Research Portal](#)

Citation for published version (APA):

Goergen, M., Manjon, M. C., & Renneboog, L. D. R. (2004). *Recent Developments in German Corporate Governance*. (TILEC Discussion Paper; Vol. 2004-014). TILEC.

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TILEC Discussion Paper

Recent Developments in German Corporate Governance

Finance Working Paper N° 41/2004

May 2004

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ECGI Working Paper Series in Finance

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Acknowledgements: We are grateful to Rafel Crespi, Arif Khurshed, Erik Lehmann, Marina Martynova, Joe McCahery and Christiane Schmetterling for valuable comments on an earlier draft. We acknowledge support from the Netherlands Organization for Scientific Research (Goergen and Renneboog) and the DURSI of the “Generalitat de Catalunya” (Manjon).

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Abstract

We contrast the features of the German corporate governance system with those of other systems and discuss the recent regulatory initiatives. For example, the rules on insider trading and anti-trust have been strengthened. The Restructuring Act has been revised to prevent minority shareholders from stalling corporate restructuring via legal actions. The Takeover Act now prescribes a tender offer as soon as an investor acquires at least 30% of a firm's equity. However, the Act also allows anti-takeover devices. Despite the recent substantial changes, we conclude that the main characteristics of the German system are still in place.

Keywords: Corporate governance, ownership structure, co-determination, mergers and acquisitions, board of directors

JEL Classifications: G32, G34, G38

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Recent Developments in German Corporate Governance

1. Introduction

A corporate governance regime is usually defined as the amalgam of mechanisms which ensure that the agent (the management of a corporation) runs the firm for the benefit of one or multiple principals (shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business). The mechanisms available to ensure economic efficiency are manifold and comprise: (i) the market for corporate control (both the hostile takeover market and the market for partial control), (ii) large shareholder and creditor (in particular bank) monitoring, (iii) internal control mechanisms such as the board of directors, various non-executive committees and the design of executive compensation contracts, and (iv) external mechanisms such as product-market competition, external auditors and the regulatory framework of the corporate law regime and stock exchanges.¹ Within this analytical framework the German regime is characterised by the existence of a market for partial corporate control, large shareholders, cross-holdings and bank/creditor monitoring, a two-tier (management and supervisory) board with co-determination between shareholders and employees on the supervisory board, a non-negligible sensitivity of managerial compensation to performance, competitive product markets, and corporate governance regulations largely based on EU directives but with deep roots in the German legal doctrine. A key characteristic of German business is its consensus-oriented egalitarian approach (*Soziale Marktwirtschaft*), often called ‘Rhineland capitalism’ (Schmid and Wahrenburg 2003). Another important feature of the German regime is the efficiency criterion that corporate governance is to uphold. Whereas in Germany (and in many other Continental European countries) the definition of corporate governance explicitly mentions stakeholder value maximization, the Anglo-American system mostly focuses on generating a fair return for investors.²

These concepts are currently under debate in Germany. Given the importance of the German economy and of the economic policy implications of this debate it seems interesting to provide an up to date overview of the German corporate governance system. This is the aim of this paper. We describe the main theoretical models on the various alternative mechanisms and summarise the relevant empirical evidence on Germany. We also compare Germany to other countries to illustrate the peculiarities of the German case. We have made an effort to review all the relevant literature. However, we do not claim that this survey is exhaustive. As a caveat it is important to notice that, although we have included some references to the legal framework, our approach is essentially based on economics.³

The picture that emerges from our analysis is not far from what is known as “the stereotypical view of German finance”, (Jenkinson and Ljungqvist 2001: 397). However, we also find that some of the features that shape this view do not apply anymore (like e.g. the positive monitoring role of large banks and

¹ Another important corporate governance device is the dividend policy (Correia da Silva, Goergen and Renneboog, 2004): a high payout policy precommits managers to generate sufficient cash flows and to pay them out to the shareholders. As such, a dividend payout policy can be a substitute governance mechanism to the ones listed above. However, in this paper, it is not our intention to give an exhaustive account of all the possible governance mechanisms as we want to focus on the main devices applicable to German firms. For a more exhaustive overview of corporate governance devices, see, e.g. Becht et al. (2002). McCahery et al. (2002) review the debate on the optimal corporate governance system and the convergence of corporate governance regimes.

² However, shareholder-value principles are progressively being introduced in German listed firms –see, e.g. Tuschke and Sanders (2003).

³ A discussion of the different legal approaches to corporate governance can be found in e.g. Blair (1995) and Hopt et al. (1998).

shareholders), whereas new trends seem to be developing (specially in the legal framework). We think it is sensible to conclude that the German system of corporate governance is experimenting a process of transformations. Whether this process will lead to a convergence towards a market-oriented system remains to be seen, although it is doubtful that such converge ever occurs completely in light of the “off-hands approach” to corporate governance that is currently predominant in Germany (Gehrig 2003).⁴ In any case, for the moment the differences are important enough as to claim that “the stereotypical view” is still a valid paradigm (Hackethal et al. 2003, Terberger 2003).

The structure of the paper is as follows. Section 2 discusses the patterns of ownership and control and shows that control is not necessarily the same as ownership, as there are several mechanisms which cause deviations from the one-share-one-vote principle. In this section, we focus on large blockholder monitoring and the nature of control by different types of shareholders, paying special attention to industrial companies and banks. In section 3, we address other internal mechanisms, namely the board of directors and managerial remuneration. Section 4 deals with external mechanisms, i.e. the market for corporate control, changes in control concentration, creditor monitoring, and product-market competition. The recent regulatory evolution is presented in Section 5. Section 6 concludes.

2. Ownership and control

2.1 When is control different from ownership

The potential agency problems in large joint-stock corporations will be different depending on whether the one-share-one-vote principle is upheld or not. Table 1 summarises these cases. When diffuse ownership coincides with weak shareholder voting power, as in Panel A, there may be serious agency conflicts between the management and the shareholders (Berle and Means 1932). Monitoring the management may be prohibitively expensive for small shareholders as the monitor bears all the costs from his control efforts but benefits only in proportion to his shareholding (Grossman and Hart 1980, 1988; Demsetz 1983). As a consequence, only a large share stake provides sufficient incentives to monitor a company. On the one hand, diffuse control improves the liquidity of the stock and increases the company’s exposure to the disciplining role of the market for corporate control. On the other hand, strong ownership and voting power come with low liquidity, but a large controlling shareholder reduces the likelihood that the managers will deviate from the maximisation of shareholder wealth. Given this trade-off, the question is whether either the voting power of large shareholders should be limited to avoid the expropriation of minority shareholder or, whether concentrated voting power should be encouraged to curb managerial discretion (Shleifer and Vishny 1997, La Porta et al. 1998).

[INSERT TABLE 1 ABOUT HERE]

The two basic cases where ownership and control coincide are represented by panels A (dispersed ownership and control) and D (concentrated ownership and control) of Table 1. Most Anglo-American companies fall under panel A whereas most German firms fall under panel D. Firms from most other Continental European and Japanese firms tend to fall under panel B. Table 2 provides a summary of recent evidence on control and ownership of German firms.

⁴ Gehrig (2003: 159) argues: “[the German] stakeholder-oriented system patching corporate governance problems as they arise (...) tends to give away innovative ideas, human capital, and jobs too easily to competitors in global markets”

Edwards and Nibler (2000) and Franks and Mayer (2001) report that more than half of the listed German firms in their samples have an owner holding more than 50% of the equity (see also Edwards and Fischer (1994) and Lehmann and Weigand (2000), Goergen, Renneboog and Correia da Silva (2004) and Correia da Silva et al. (2004)).⁵ Furthermore, Edwards and Weichenrieder (1999) show that the actual proportion of voting rights exercised by the largest shareholder of listed German firms at the annual general meetings gives them a comfortable majority (54.84%). Control concentration is also very high when measured by using an ultimate control criterion which tracks control throughout chains of direct stakes (Gorton and Schmid 2000a, 2000b) and by the Cubbin and Leech (1983) index (as applied by Köke (2001)). Ultimate control concentration is even higher in unlisted firms (see also Edwards and Nibler (2000) and Köke (2004)).⁶

Becht and Boehmer (2001, 2003) show that not only is there a high concentration of voting power in listed companies (82% of them have a large blockholder controlling ultimately more than 25% of the voting rights), but the largest shareholder often does not face other large shareholders (only 20% of these companies have more than two registered blockholders) and the average size of the second largest block (7.4%) is small (see also Edwards and Fischer (1994) and Edwards and Nibler (2000)). As many important decisions, such as modifications to the firm's charter, mergers, and changes in the firm's capital usually require a super-majority of 75% of the votes, a shareholder with more than 25% of the votes has a blocking minority. Becht and Boehmer (2003: 10) look at the frequency of voting blocks in terms of their size and conclude that "voting blocks are clustered at 25, 50, and 75%. [This] suggest[s] that block sizes are carefully chosen and control is an important issue for blockholders".

[INSERT TABLE 2 ABOUT HERE]

In practice, however, a number of large German companies do not fit into panel D of Table 1, but fit into panels C and B. One reason for this is that the one-share-one-vote principle (Grossman and Hart 1988, Harris and Raviv 1988) is not necessarily upheld. In fact, as Table 3 shows, some German companies do not even have "shares that are legal evidence of ownership" (Edwards and Nibler 2000: 241). This is the case for the *Gesellschaft mit beschränkter Haftung* (GmbH), a private company with limited liability, the legal form of 15% of the German firms in 1994 (Van der Elst 2002). According to Köke (2001), the average size of the largest shareholder in these companies is 89% and only 4% of GmbHs (approximately 400,000 in 1994) have dispersed ownership. As for those legal forms that allow the issue of shares and can therefore be listed, about 0.1% of the German companies in 1994 were public companies with limited liability (AGs) and 3.2% were partnerships with shares (*Kommanditgesellschaft auf Aktien, KGaA*), a legal form with at least one fully liable general partner (*Komplementär*) and a number of limited partners (*Kommanditisten*) whose liability is confined to their contribution.

Panel C of Table 1 represents the case where the concentration of voting power is lower than that of ownership. In this case, the deviation from the one-share-one-vote principle is caused by the use of voting caps designed to prevent large shareholders from exercising control. Voting caps may improve the protection of small shareholders against expropriation by large shareholders, but they certainly also entrench the management. Some examples of German firms that, until recently, had such voting caps in

⁵ Van der Elst (2002) reports a slightly smaller figure of 48.5%. The difference in results may be due to the fact that Van der Elst looks at ultimate voting blocks rather than direct stakes.

⁶ Incidentally, shareholdings are also *geographically* concentrated: "The four core *Länder* of North-Rhine Westphalia, Bavaria, Baden-Württemberg and Hesse accounted for almost 90% of the market capitalization of the (...) companies in both 1997 and 2001. (...) In terms of cities, München, Hamburg and Frankfurt were decidedly in the lead", (Wöjck 2002: 889).

place are BASF (5%), Bayer (5%), Deutsche Bank (5%), Linde (10%), Mannesmann (5%), Phoenix (10%), Schering (3.51%), and Volkswagen (20%).⁷ In the past, voting caps have been used in some cases to fend off a hostile raider. For example, Franks and Mayer (1998) show that in each of the three hostile takeover battles in Germany since WWII – this excludes the recent hostile bid of Vodafone plc for Mannesmann AG – voting rights restrictions were used. As a consequence, the voting power of several large share stakes was reduced from for instance 30 per cent to 5 per cent. In the cases of Feldmühle Nobel and Continental, the use of voting caps contributed to the failure of the takeover bid (see below). However, such voting-right limits are now prohibited (see sections 4 and 5.1.4).

[INSERT TABLE 3 ABOUT HERE]

Finally, Panel B of Table 1 shows that it is possible to have dispersed ownership with concentrated voting power. Although such a situation combines the benefits of control – increased monitoring – with those of dispersed ownership – risk diversification –, there is also a danger that concentrated control will be exercised to extract private benefits from minority shareholders (Bebchuk et al., 2000). The corporate law regimes in most Continental European countries include a number of mechanisms that allow controlling shareholders to obtain a return on their investments that exceeds the financial return via private benefits of control (La Porta et al., 1999). The mechanisms we consider are: (i) ownership pyramids, (ii) proxy votes, (iii) voting pacts, and (iv) dual class shares.

The most widely-used mechanism to obtain control with a limited investment is ownership pyramids or cascades. These mechanisms enable shareholders to maintain control throughout multiple tiers of ownership while sharing the cash flow rights with other (minority) shareholders at each intermediate ownership tier. Thus, ownership pyramids reduce the liquidity constraints that large shareholders face while allowing them to retain substantial voting power.⁸ Franks and Mayer (2001) and Köke (2001) show that German corporations are often controlled via such pyramids (see also Gorton and Schmid (2000a) and Faccio and Lang (2002)). However, their samples and definitions differ and so do some of their conclusions. Franks and Mayer (2001) find 33 pyramids in a sample of 38 firms (87%), of which 10 seem to be purely motivated by control because they involve a significant violation of the one-share-one-vote principle. Banks and families prevail at the top of these structures (with an average of 2.2 layers), which were defined on the basis of the presence of “at least one large shareholder holding more than 10% of shares indirectly through another company”. Köke (2001) reports that 45% cases of pyramids in a large sample of about 1500 firms (4638 observations), but the threshold that defines the chains or tiers is 50%. Following this criterion almost 1 out of 2 firms in the sample have a non-financial firm at the ultimate (second or third) level of the pyramid.⁹ This supports our previous claim that a large part of the German business sector belongs to Panel B. Interestingly, the GmbH is the most frequent legal form in the Köke sample (around 82% of the firms). Moreover, many of these GmbHs are part of groups of companies dominated by an AG: the so-called Konzerns.¹⁰

⁷ These examples are taken from Faccio and Lang (2002). See also Gorton and Schmid (2000a) for more examples from the 1970s and the 1980s.

⁸ For instance, if shareholder X owns 51 per cent of the voting equity of firm Y which in turn owns 51 per cent of the voting equity of firm Z, there is an uninterrupted control chain which gives shareholder X absolute majority control at each tier. Still, the cash flow rights of shareholder X in firm Z amount to only 26 per cent.

⁹ It is important to bear in mind that Köke (2001) uses the Cubbin and Leech (1983) index to define ultimate control.

¹⁰ “The general characteristic of a *Konzern* is that at least one legally independent company is under centralized control exerted by the parent company. The law distinguishes between three *Konzern* categories: (1) integration, where the dominating company holds 100% of the integrated dependent company’s shares; (2) contractual groups of companies (*Vertragskonzern*), where dominating and dependent companies enter into a contract of domination (*Beherrschungsvertrag*), in most cases in connection with a profit transfer agreement (*Gewinn-abführungsvertrag*); and (3) groups of companies based on actual dependence (*Faktischer Konzern*), where the relation between

As mentioned above, it is possible that pyramids can lead to the expropriation of minority shareholders. Let us consider the examples. If a car producer requires car seats from a subcontractor, a large shareholding in the subcontractor can yield an important (strategic) advantage. The large shareholder will usually be represented on the subcontractor's board and will thus be able to obtain private information on the firm's cost structure or on supply contracts with competitors. The large shareholder could, for example, after obtaining such strategic information, renew negotiations about the price charged by the subcontractor for the car seats. Consequently, such transactions can lead to the creation of another kind of agency conflict, namely the oppression of minority shareholder rights. Let us consider one more example. Suppose that a shareholder owns 51 per cent of the voting shares in firm A and that he also owns 100 percent of the equity of another firm, firm B. If firm A is a supplier to firm B, the controlling shareholder may be tempted to reduce the transfer price of goods sold to firm B. Profits are then maximized at the level of firm B which is fully controlled and owned by the large shareholder. At the same time, profits are not maximized at the level of firm A, which directly harms its minority shareholders.

Johnson et al. (2000) and Buysschaert, Deloof and Jegers (2003) provide examples of these practices in France, Italy and Belgium. The former study argues that the use of a number of mechanisms to separate ownership and control may also have facilitated the expropriation of minority shareholder rights in Germany. Edwards and Weichenrieder (1999), for example, show that an increase in the largest shareholder's control rights effectively harms minority shareholders. However, they claim that these negative effects may be somewhat compensated by the benefits obtained from greater monitoring of management when the largest shareholder is a non-bank firm or a public-sector body. Köke (2001) argues that in 10 percent of his sample, given that the cash flow rights of the largest shareholders amount to only 25 percent or less of their control rights, the ultimate shareholder "could hinder efficient monitoring".

The second mechanism which gives control with limited cash flow rights is proxy votes. In the US and the UK, the management when making proposals to be considered at the annual general meeting normally solicit proxy votes for their support. In Germany, banks are the main exercisers of proxy votes because, as most shares are in the form of unregistered bearer shares, holders normally deposit them with their banks, and banks are allowed to cast the votes from these shares (conditional upon the bank announcing how it will vote on specific resolutions at the general meeting and upon the lack of receiving alternative instructions by the depositors). For example, in the above-mentioned failed, hostile bid for Feldmühle Nobel by the Flick brothers, voting restrictions were imposed thanks to a resolution supported by Deutsche Bank that eventually passed with 55% of the shares voted. However, Deutsche Bank only held a direct share stake of about 8%; the rest were proxy votes (Franks and Mayer 1998).¹¹ Edwards and Nibler (2000) provide further evidence on banks proxy votes for a sample of 156 listed and non-listed German companies in 1992. Their data show that banks typically control more voting rights via proxy votes than via their own stakes.¹² Moreover, they note that banks' proxy votes only affect the governance of AGs and KGaAs but not that of GmbHs. All in all, proxy votes seem to provide effective voting power to German banks (especially to the three largest ones: Deutsche Bank, Dresdner Bank and Commerzbank) mainly in large listed companies (see also Prigge (1998) and Franks and Mayer (2001)).

dominating and dependent companies is not subject to one of the types of contracts mentioned above. The *faktische Konzern* is the clearly predominating category, and the *GmbH* is the most common legal form of business organization for dependent companies" (Prigge 1998: 952-953).

¹¹ Edwards and Fischer (1994) argue that banks have traditionally supported voting restrictions in Germany because their access to proxy votes made them more powerful in the general meetings as the voting restrictions did not apply to proxy votes.

¹² Gorton and Schmid (2000a) present analogous results from 1975 and 1986 data.

The third mechanism is voting pacts. Voting pacts enable shareholders to exert a much higher degree of control as a group than the members of the pact could individually. As pointed out by Franks and Mayer (2001), for example, in many German corporations a (hypothetical) coalition formed by the two or three largest shareholders could easily gain control;¹³ see also Leech and Manjon (2002) and Leech (2003) for Spanish and British evidence on this, respectively. However, apart from the notable exception of Crespi and Renneboog (2002), there is little empirical evidence that long-term shareholder coalitions are formed in Europe because such coalitions may bring about substantial costs. For example, the regulatory authorities in the UK consider a long-term shareholder coalition as a single shareholder and, as a consequence, the coalition has to comply with all the regulations concerning information disclosure, mandatory tender offer, disclosure of strategic intent, etc. According to Jenkinson and Ljungqvist (2001), corporate governance regimes like the German one in which multiple large shareholders exist, are both “unpredictable and lacking in transparency”. [Control] [b]attles often involve a protracted, and clandestine, shuffling of stakes between rival coalitions and the revising of pooling agreements [(voting agreements)]. Even large blockholders can find themselves, apparently without warning, as members of the suppressed minorities.” Most coalitions are usually formed on an ad hoc basis with a specific aim, such as the removal of badly performing management.

The fourth mechanism to separate ownership and control is dual class shares. Under a dual class regime, one class (B-shares) has fewer voting rights than the other one (A-shares). In the US, dual class shares have become an increasingly important concern to investors since the 1980s, when stock exchanges liberalized the originally restrictive policy on multiple and dual class shares. These shares are also commonly issued by European firms (from e.g. Italy, Scandinavia, and Switzerland), but with large differences across EU member states both in terms of their use and the rights attached.¹⁴ Non-voting shares are used by German firms, although they may not exceed 50% of the stock capital. Faccio and Lang (2002) estimate that the proportion of firms with dual class shares outstanding is 18% in Germany. Goergen and Renneboog (2003) demonstrate that the issuance of non-voting shares is very effective to forestall any change in control. However, the issuing of multiple voting shares was outlawed in Germany as of May 1998 and the grandfather clause was phased out on 1 June 2003 (Beinert 2001: §70). In addition, German firms, as well as firms from certain other countries, can issue preference shares (*Vorzugsaktien*). This is risk-bearing capital without votes, but with special dividend rights (Goergen and Renneboog 2003).¹⁵

2.2 Monitoring by blockholders

In the previous section, we have shown that most German companies have large controlling blockholders. The key question is: do blockholders enhance firm value? Value is expected to be created by the increased monitoring of the management by the large blockholders (see, amongst others, Stiglitz (1985), Shleifer and Vishny (1986), Admati et al. (1994), Maug (1998), and Kahn and Winton (1998), Renneboog (2000), Franks, Mayer and Renneboog (2001)). There is an extensive literature investigating whether blockholders take corporate governance actions when increased monitoring is necessary (e.g. in the case of poor corporate performance or financial distress).¹⁶ In addition, the incentives to correct managerial failure

¹³ Edwards and Nibler (2000), however, argue that it is unlikely to happen if these large shareholders are banks.

¹⁴ As shown by Goergen and Renneboog (2001) for example, they no longer exist in listed UK companies as the result of an active dissuasive policy by the London Stock Exchange during the early 1990s.

¹⁵ A special case of a multiple voting share is the so-called “golden share”, which gives one or more shareholders (e.g. the government) a veto right in certain clearly defined situations. The Italian and Spanish governments, for example, hold golden shares in firms privatised during the early 1990s (e.g. Telecom Italia and Repsol). However, the *Treuhand* (the privatisation agency) does not seem to have employed them in the privatisation of Eastern German firms (Dyck 1997, Hau 1998).

¹⁶ Even in the context of managerial compensation schemes, the role of blockholders is apparent. For example, Mehran (1995) shows that equity-based compensation is used less extensively in US firms with stronger outside blockholders

depend not only on the concentration of ownership or control, but also on its nature as specific classes of shareholders may value control differently.¹⁷

It should be noted, however, that concentrated ownership may also generate substantial costs. First, Demsetz and Lehn (1985), Admati et al. (1994) and Manjon (2004) claim that control by a large shareholder may result in reduced risk sharing. Second, as shown above, ownership concentration may reduce the market liquidity of all the shares (Bolton and Thadden 1998, Becht 1999). Third, in highly leveraged companies, a large blockholder may push management to take excessive risks – especially if the company is performing poorly and the bankruptcy costs are high. In this case, risk increasing investment projects may lead to the expropriation of debtholder wealth (Jensen and Meckling 1976; Coffee 1991). Fourth, Burkart et al. (1997) and Pagano and Röell (1998) point out that even when tight control by shareholders is efficient *ex post*, *ex ante* it may constitute an expropriation threat that reduces managerial incentives to exert effort and to undertake value maximizing strategies (the so-called ‘over-monitoring’ effect). Fifth, although blockholdings are meant to mitigate the agency costs resulting from excessive managerial discretion, they can induce their own types of agency costs as the private benefits usually come at the expense of other shareholders or stakeholders.¹⁸ These private benefits can, for example, be in the form of the squeeze-out of minority shareholders at a price below the value of their shares in a tender offer and the diversion of resources from security holders to entities controlled by a blockholder (Johnson et al. 2000).

In fact, in the empirical literature, there is little evidence on the benefits from having large blockholders (Short 1994; Gugler 2001). Franks, Mayer and Renneboog (2001), for example, investigate whether the presence of blockholders in poorly performing British companies is related to increased board restructuring. They find no evidence of increased managerial disciplining in the wake of poor performance when large outside shareholders are present. The only consistent and significant finding relates to managerial entrenchment as managers with a substantial degree of control are able to ward off any attempts to remove them. Banerjee, Leleux and Vermaelen (1997) investigate the governance role of French holding companies which constitute the dominant shareholder category in France and conclude that the presence of holding companies as major shareholders seems to reduce corporate performance and firm value. Similarly, Renneboog (2000) fails to find a monitoring role for blockholders in firms listed on the Brussels stock exchange, with the exception of controlling industrial and commercial companies which initiate board restructuring when the firm’s accounting and share price performance declines.

[INSERT TABLE 4]

suggesting that blockholder monitoring is a substitute for equity-based compensation contracts. In contrast, Crespi, Gispert and Renneboog (2002) find managerial compensation contracts related to share price performance are complementary to outside blockholdings in Spanish firms. In other words, it seems that in Spain one needs a strong blockholder to impose such contracts. In companies without outside blockholders, the managerial compensation contracts are based on accounting performance (which is subject to managerial control and can thus be manipulated). A similar result is reached by Renneboog and Trojanowski (2003) for the UK in a simultaneous equation system on managerial compensation and turnover.

¹⁷ See e.g. Jensen and Meckling (1976). The thesis that different classes of shareholders have different abilities to extract control rents is empirically supported for the US by e.g. Demsetz and Lehn (1985), Barclay and Holderness (1989, 1991) and Holderness and Sheehan (1988).

¹⁸ Zwiebel (1995) argues that private benefits of control can be extracted even if a company has multiple large shareholders. He claims that these benefits may be divisible and that parties can enjoy them accordingly to their relative control. Beyond some threshold, the control by large blockholders will not be challenged as it may be difficult to build up share blocks of a similar size. Unchallenged control may encourage the extraction of private benefits of control at the expense of dispersed small shareholders.

There have been a number of specific studies on the role of large shareholders in German firms (summarized in Table 4). The evidence is inconclusive. In a pioneering study on listed companies, Thonet and Poensgen (1979) conclude that management-controlled firms outperform those controlled by outsiders in terms of the return on equity (ROE). Similarly, Edwards and Weichenrieder (1999), using a sample of quoted companies, and Lehmann and Weigand (2000), using a sample of both quoted and unquoted companies, find a significant negative relation between on one side control concentration and on the other side the market-to-book ratio and the return on assets (ROA). However, Kaplan (1994b), Goergen (1998) and Franks and Mayer (2001) find no significant impact of control on corporate performance and on board turnover in listed firms. Weigand (1999) and Edwards (1999) show that firms with high control concentration outperform more dispersed firms in terms of the ROA. However, Gedajlovic and Shapiro (1998) find inclusive results, using the return on assets (ROA) as their measure of performance. They find a non-linear relationship between ROA and control (which is negative at low levels of control but positive at high levels) and a positive impact on ROA from a reduction in strong managerial control (entrenchment). Köke and Renneboog (2003) conclude that the relation between strong ultimate blockholders and productivity growth is very limited. Strong blockholders reduce the negative effect of weak product market competition, but only in profitable large firms controlled by banks, insurance firms and the government. Finally, Cable (1985) and Gorton and Schmid (2000a, 2000b) – focusing on bank control – seem to be the only studies reporting a consistently positive control-performance relationship. In contrast, Edwards and Nibler (2000) find such a positive relation only for individuals holding a minority stake and for foreign firms (see also Edwards and Weichenrieder (1999)).

Some studies focus on the monitoring effects of banks as large shareholders (Emmons and Schmid 1998). Cable (1985), Gorton and Schmid (2000a, 2000b), Lehmann and Weigand (2000) and Köke and Renneboog (2003), for example, find that banks as large shareholders improve corporate profitability. However, Edwards and Nibler (2000) report this effect only for the “3 big banks”. Interestingly, bank-controlled firms (or banks strongly influenced by other banks through e.g. board representation) also seem to have higher survival rates (Elston 2004). Conversely, Agarwal and Elston (2001) and Chirinko and Elston (1998) do not find statistically significant differences between the profitability of bank- and non-bank controlled firms. In fact, firms whose ultimate owner is a bank or another financial institution appear to have lower productivity growth (Januszewski et al. 2002).¹⁹

An important caveat that applies to most of these studies is the implicit assumption that it is control or ownership that influences corporate performance and not vice-versa (Demsetz and Lehn 1985; Himmelberg et al. 1999).²⁰ Goergen (1998), who reviews the studies that explicitly address the direction of causality, shows that this conclusion may be premature and there may be a need for a reversal of the direction of causality between firm value and ownership or control in line with Kole (1996). However, most German studies claim that the characteristics of the German governance system make ownership and control exogenous (see, among others, Edwards and Nibler (2000), Gorton and Schmid (2000), Lehmann and Weigand (2000) and Gugler and Weigand (2003)).

It is apparent that control is valuable in Germany; controlling shareholders are likely to derive private benefits of control from large share stakes. Schmid and Wahrenburg (2003) show that the premium of

¹⁹ Moreover, “acquisitions do not increase bidders’ firm value more when financial institutions have partial control over the bidder group, but do decrease firm value when they have full control. [Therefore], there is little empirical support for the widespread contention that German banks provide efficient monitoring. [More precisely, bank involvement is beneficial if the institution holds the second- or third-largest stake, but not if it holds the largest stake” (Boehmer, 2000: 137, 145).

²⁰ Recent studies by Bhagat and Jefferis (2002), Köke and Borsch-Supan (2002), Coles et al (2003) and Manjon (2003) discuss at length the econometric problems that arise in the estimation of these models.

voting over non-voting shares in Volkswagen hovered between 30 percent (1999) and 76 percent (2000). Nenova (2003) and Dyck and Zingales (2001) find that private benefits of control are significant for German firms. Edwards and Weichenrieder (2001) provide some empirical evidence that large blockholders enjoy private benefits of control (at the expense of minority shareholders). They show that the more control rights the largest shareholder holds, the lower is the firm's market value. Conversely, firm value increases with the proportion of control rights held by the second-largest shareholder. This suggests that the largest shareholder is able to extract private benefits of control when his control is uncontested whereas the presence of a second large shareholder redirects the focus of the firm towards the creation of firm value. A similar idea is put forward by Gugler and Yurtoglu (2003) in the context of dividend payout policies. In German firms, characterised by high control concentration, the conflict between the large controlling shareholder and the small minority shareholders is one of the main corporate governance issues. An increase in dividends reduces the funds at the disposal of the large shareholder and increases the market value of the firm. A decrease in dividends implies potentially more severe rent extraction and expropriation of small shareholders. Gugler and Yurtoglu find that the negative price reaction to dividend decreases is much more severe in firms with one controlling shareholder than in firms with several large blockholders.

To conclude, the German evidence on the link between corporate performance and control or ownership is inconclusive. Frick and Lehmann (2003) state that the relationship between ownership or control concentration and profitability has changed over time. In the 1970s and 1980s, there seemed to be a positive relation, which vanished or even turned negative in the 1990s.

2.3 The nature of control

Not only does the degree of control matter, but so does the type of the controlling shareholder (Cubbin and Leech 1983). As shown by Jensen and Meckling (1976), some types of shareholders may be better at monitoring poorly performing companies given their incentives and/or abilities. Similarly, different types of shareholders may be subject to different types of agency costs (Zwiebel 1995; Pagano and Röell 1998). Empirical evidence on the differences in incentives, abilities and costs in the governance of German firms can be found in e.g. Gorton and Schmid (2000b), Lehmann and Weigand (2000), Januszewski et al. (2002), Köke and Renneboog (2003), Edwards and Nibler (2000) and Franks and Mayer (2001).

[INSERT TABLE 5 ABOUT HERE]

Table 5 compares the average sizes of the stakes held by the different types of shareholders in German firms to that in other European countries. The types of shareholders are: (i) institutional investors (banks, insurance companies, investment and pension funds), (ii) individuals or families, (iii) directors and their families and trusts, (iv) industrial and holding companies, and (v) the federal or regional governments. Germany is similar to most other Continental European countries in the sense that the most important type of shareholder is holding and industrial companies, followed by individuals or families. In detail, in Germany the principal investors are, in order of importance, i) holding and industrial companies, ii) individuals and families, iii) banks (although, as pointed out in the previous section, proxy votes can make them very powerful in the general meetings) and other institutional shareholders, and iv) public authorities. We now turn to discussing each of these types in more detail.

2.3.1 Industrial and holding companies

The existence of share blocks held by other industrial companies is a documented feature of the German corporate governance regime (Prigge 1998). In fact, about 80 percent of direct equity stakes in firms listed on the official market belongs other firms (industrial firms, holding companies, investment firms and financial firms) (Becht and Boehmer 2003). Moreover, there is evidence that German firms controlled by

other companies tend to have higher levels of productivity (Januszewski et al. 2002) and are less likely to be acquired if they are public corporations (Köke 2002).²¹

Faccio and Lang (2002) show that Germany is the European country with the largest percentage of companies controlled by other firms. This phenomenon is also prominent in the German financial sector.²² Table 5 shows that German holding companies and industrial companies control an average stake of 21 per cent in other German listed firms, which is largely corroborated by Emmons and Schmid (1998) and Gorton and Schmid (2000b).²³ These large industrial shareholders may obtain substantial private benefits at the expense of other shareholders or stakeholders (Grossman and Hart 1988) and cross-holdings may have an important negative impact on competition (Canoy et al. 2001).

2.3.2 Families or individuals

Table 5 also shows that individuals or families are one of the main shareholder categories in Continental Europe (see also La Porta et al. (1999)).²⁴ In particular, Franks and Mayer (2001) have found that large-scale family control is especially pronounced in the largest German firms. This finding was also documented by Edwards and Nibler (2000) and Becht and Boehmer (2001). In 40 and 37 percent of their samples individuals or families control blocks of on average 57 and 20 per cent (respectively) of the voting rights. In general, however, they are much more commonly found among small and medium-sized non-financial companies (Köke 2001, Faccio and Lang 2002).

2.3.3 Directors

A particular category of individuals controlling share stakes is that of the directors, who are insiders and therefore possess superior information on the firms' prospects. However, Table 5 suggests that Continental European managers are not shareholders of the firms they manage. Actually, hardly any information is known about directors' control in Continental Europe for the following reasons: (i) the shareholdings of most directors are below the disclosure thresholds, (ii) although large family blockholders frequently appoint their representatives (which can be family members) to the board, the origin of board representation does not need to be disclosed publicly, and (iii) the use of intermediate investment companies further obscures directors' control. Whatever the reasons, we have found only two German studies presenting data referred to this category. First, Gorton and Schmid (2000b) show that the management owns at least 50% of the control rights in 8 per cent of the firms in their 1992 sample. Moreover, 15 percent of the firms have a member of the management team as the largest shareholder. Second, Köke (2004) reports ultimate control measures for a sample of listed and unlisted firms for the years 1987-1994. The average stake of the (executive and non-executive) directors and their families is 22.5 percent for the quoted firms and 12 percent for unquoted firms. These figures suggest that in a non-negligible number of German companies there is no separation between ownership and control because "managers own" and "owners manage".

2.3.4 Banks and other institutional shareholders

There is an extensive theoretical literature on the role and incentives of bank monitoring. Diamond (1984), for example, formulates a model that shows that delegation of monitoring to banks is efficient as

²¹ However, Köke (2004) "finds no evidence that complex ownership structures deter control purchases".

²² This kind of relationships has also been observed in other European countries and seems to be related to the consolidation trend affecting the financial services industry all over the world (Goldman Sachs 2000, Walter and Smith 2000).

²³ The average of 21% hides the fact that the ownership stakes are high: industrial shareholders hold average share stakes of 40 per cent or more in 52 per cent of the German companies.

²⁴ The higher importance of family control in Austria and Italy (see Table 5) can be explained by the fact that the samples for the two countries consist of both listed and unlisted companies. Still, even after excluding the unlisted Italian firms, a majority of the listed Italian companies is family-controlled.

duplication of monitoring by small investors (creditors) can be avoided, provided the bank's lending portfolio is sufficiently diversified.²⁵ Krasa and Villamil (1992) study delegated monitoring by considering the role of the intermediary who is to satisfy the different portfolio preferences of both borrowers and lenders. They model the incentive structure of the monitor by determining what intermediary portfolio accomplishes optimal asset transformation between borrowers and lenders. Rajan and Diamond (2000) review the assumptions of Diamond (1984) and show that the bank's incentives to monitor are preserved provided that there is no deposit insurance and that the first-come first-serve feature of bank deposit contracts is maintained. In other words, it is the possibility of a bank-run that preserves the banks' incentive to monitor the firms.

However, as shown in Table 5, bank shareholdings in German – as well as other Continental European – companies are generally small.²⁶ One reason for this may be the avoidance of potential conflicts of interest (Canoy et al. 2001, Goergen and Renneboog 2001). In Germany, for example, only 5.8 percent of the large voting stakes of 5 percent and more are held (directly as well as indirectly) by banks, resulting in an average of 1.2 percent of the votes (see Table 5). However, from what we have said above, it is clear that the influence of banks is understated if one just looks at their direct and indirect stakes and ignores their proxy votes.

Weigand (1999) shows that over the long run, firms controlled by universal banks outperform management-controlled firms. Other evidence on the impact of banks is given by Goergen, Correia da Silva and Renneboog (2004) who examine the flexibility of the dividend policy of German corporations. They find that bank control is associated with a higher likelihood to omit the dividend when the firm suffers a loss. This suggests that bank control mitigates informational asymmetry and reduces agency costs. In contrast, control by other types of shareholders does not influence the dividend decision. In widely-held loss-incurring firms there is even a reluctance to cut the dividend which suggests that these firms are more prone to agency costs than firms with a controlling shareholder and therefore rely more heavily on dividend policy as a corporate governance mechanism.

As for the other types of institutional shareholders, insurance companies also seem to be important.²⁷ In sharp contrast with the UK and the US, however, other institutional investors (notably investment funds) do not hold significant stakes in German companies (O'Sullivan 2000, Davis and Steil 2001).²⁸ Empirical evidence from the firms listed on the German official market (*Amtlicher Handel*) shows that whereas 20 insurance companies hold shares representing around 17% of the market capitalization, the rest of the institutional investors (excluding banks) barely reach 0.5% (Wójcik 2002). Given the close links between insurance firms and banks in Germany, the importance of the former further reinforces the role of banks as controlling shareholders (Goldman Sachs 2000, Canoy et al. 2001).

In general, the lack of institutional blockholders (apart from banks) in Germany as well as of most Continental European countries suggests that, in contrast to the Anglo-American countries, little

²⁵ Hellwig (2000) generalizes Diamond's results by allowing for risk averse banks.

²⁶ It is interesting to note, however, that the German data analysed by Gorton and Schmid (2000) from the 1970s and 1980s suggest that bank shareholdings were not that small in the past.

²⁷ Köke (2001) shows that institutional investors have a strong preference for listed firms. See also Deeg (1998) and Vitols (1998) on the role of German banks in small and medium-sized firms.

²⁸ Pension funds are largely lacking as institutional investors; the reason may be that "[t]he German pension system currently does not involve public funds but rather leaves pension contributions under control of either the government or the employer" (Boehmer, 2000: 121).

shareholder activism is to be expected from these institutions.²⁹ Even in Anglo-American countries, there is not much evidence of monitoring by institutional shareholders and any monitoring seems to be limited to just a few large funds because most institutions prefer to avoid monitoring firms and gathering non-public information. If they were to possess such information, the insider trading legislation would curb their trading such that the liquidity of their investment portfolio would be reduced. Furthermore, the costs of actively monitoring the many firms included in the institutions' portfolios may also be prohibitive (Stapledon 1996; Stapledon and Bates 2002).

2.3.5 Public authorities

Despite the large-scale privatisation programmes that occurred in Europe over the last decades (starting with the UK in the 1980s),³⁰ in many listed European firms the state is still one of the largest shareholders (La Porta et al. 1999). In this respect, one has to take into account the privatisation of East German firms during the early 1990s (Dyck 1997, Hau 1998). Even when controlling for this specific privatisation process, the importance of public authorities as shareholders remains considerable, especially in large (GmbH and unlisted AG) firms (Köke 2001; Faccio and Lang 2002). As an illustration, in 1997 the value of their holdings in the firms listed on the official market or *Amtlicher Handel* was about 21 percent of the total market capitalization. In 2001 the public investments represented only 14 percent of the market capitalization (Wójcik 2002).³¹ In terms of the number of firms in which the government was the largest shareholder, figures range from 6 percent (Franks and Mayer 2001; Emmons and Schmid 1998) to 8 percent (Edwards and Nibler 2000; Gorton and Schmid 2000b).

In the next section we review the evidence on the other internal mechanisms of corporate governance: the supervisory board, management board turnover in the wake of poor performance and managerial remuneration.

3 Internal corporate governance mechanisms

3.1 Supervisory boards

To the opposite of most western economies, Germany has a two-tier board with a management board (*Vorstand*) and a supervisory board (*Aufsichtsrat*).³² The supervisory board represents the shareholders and employees. Baums (2000) compares the fiduciary duties (duty of care and loyalty) in German and UK corporate law and concludes that 'the range of fiduciary duties in the English law system seems wider and more developed than in its German counterpart' (p.8). The German supervisory boards are dominated by representatives for the large shareholders. In large firms with more than 2000 employees, the 1976 Codetermination act has created a system of quasi-parity co-determination. Employee representatives make up half of the supervisory board but the chairman who is a shareholder representative has a casting vote in case of a stale-mate. Bankers are frequently elected to the supervisory board (even as chairmen) (Edwards and Nibler 2000: 241). In small companies with more than 500 but less than 2000 employees, one third of

²⁹ Bratton and McCahery (1999) question whether the Anglo-American style of institutional shareholder activism would lead to improved corporate results in Continental Europe because, in their opinion, a minimum level of takeover activity is a precondition of relational engagement between institutional shareholders and managers.

³⁰ Gorton and Schmid (2000a), for example, show the decline in the participation of German and foreign governments as (largest) ultimate owners of German firms between the 1970's and the 1980's.

³¹ Becht and Boehmer (2003), in contrast, report that the government holds only 2.35 percent of the votes on the official market during 1996-1998.

³² The Netherlands also has a two-tier system with a *Raad van Bestuur* (management board) and a *Raad van Commissarissen* (supervisory board). In France, corporations have the choice between a one-tier board and a two-tier

the supervisory board consists of employee representatives. Finally, full-parity co-determination by the shareholders and employees is limited to the steel and coal sector only (which are subject to the 1951 Montan Codetermination Act). The role of this co-determination system is currently the object of a debate in Germany. The only companies that are exempt from having a supervisory board with co-determination are those who can appeal to the constitutional freedoms of faith and free press (e.g. the publishing company Springer). The directors of German firms are usually appointed for a term covering the legal maximum of 5 years, although reappointment at the end of the term is possible.

There is little evidence that the co-determination system leads to superior corporate governance (Franks and Mayer 2001). Firms with workers' councils have a lower employee departure rate (by 2.4%), pay significantly higher wages (Jifjan and Klodt 1999) and have a lower wage differential between skilled and unskilled labourers (Hübler and Meyer 2000). All in all, there is evidence that workers' councils and employee representatives on the supervisory board unilaterally favour the interests of the incumbent workforce (Frick and Lehmann 2001).

3.2 Management board turnover in the wake of poor performance

The disciplining of top management (and in particular of the CEO) has received considerable empirical attention.³³ The reason is that such disciplining is one of the few observable corporate governance actions by the board of directors. Most other governance actions or discussions by directors are not directly observable, as the minutes of the board meetings are not publicly available. However, good corporate governance cannot simply be equated to the dismissal of badly performing managers from the board for the following two reasons. First, poor (industry-corrected or business-cycle adjusted) corporate performance leading to managerial disciplining may be protracted past poor performance and hence also the result of failed past corporate governance. As such, the dismissal of poorly performing management may come too late.³⁴ Second, the success of the removal of the underperforming management should be considered along with the managerial alternative. For instance, Dherment and Renneboog (2002) study how the French stock market reacts to the appointment of CEOs with different backgrounds. They find that whereas voluntary resignations do not cause share price reactions, the nomination of an external manager following the performance-related forced resignation of a CEO causes a strong significant increase in abnormal returns of more than 2 percent. The abnormal return at the promotion of an internal candidate to the post of CEO in a poorly performing firm is negative (1 percent on the day of the announcement), which presumably occurs because the internal candidate is held (partially) responsible for past poor performance.

For Germany, Kaplan (1994a) presents evidence that management board turnover is closely related to poor stock performance and earnings losses, but not to sales and earnings growth. In contrast, the turnover of the chairman of the supervisory board is more likely to happen when the firm's net income falls. In addition, poor stock performance also causes supervisory board dismissals. Three additional results are worth mentioning. First, the evidence is consistent with the view that the German corporate governance regime is based on a long-term perspective of the firm (Porter 1992). Second, the sensitivity of executive turnover to firm performance in Germany is comparable to that in Japan and the US (Kaplan 1994b; Kaplan and

system; but more than 95% of the listed companies has opted for a unitary board (Dherment-Ferere and Renneboog, 2002).

³³ Several papers examine whether top management dismissal is followed by improvements in corporate performance. Denis and Denis (1995) document performance increases following forced CEO turnover in the US. However, Renneboog (2000) and Franks et al. (2001) do not find evidence of a significant improvement over the two-year period following the CEO's replacement for Belgian and British firms, respectively.

³⁴ In fact, there is evidence on the UK that managerial disciplining only takes place when firms are in the lowest quintile of stock price performance and are incurring accounting losses (Franks et al. 2001).

Minton 1994). Third, neither large shareholders nor bank control seem to protect managers from the possibility of being dismissed when their companies perform poorly. These results call into question the view that in bank-based regimes, such as the German one, managers may be entrenched at the expense of minority shareholders (Coffee 1991, Roe 1993). The results in the Kaplan studies are not entirely supported by the Franks and Mayer study (2001). The latter documents that supervisory board turnover depends on corporate performance but only when there is a change in control. Supervisory turnover of firms which are incurring losses is not statistically different from that of firms generating profits although it is significantly higher when new blockholders acquire stakes in the poorly performing firms. The level of management board turnover provides a similar picture. Board turnover is higher for loss makers than for non-loss makers, but it is only statistically significant in the subsample for firms with stable holdings. These results suggest that block sales are not disciplinary in nature.

3.3 Managerial remuneration

Perhaps the simplest economic device to align managers' actions with the interests of shareholders (or more generally, stakeholders) is a compensation contract that specifies the tasks and rewards of the executive directors for each outcome of corporate performance. However, an important limitation to the use of contracts as an internal governance mechanism is that they are necessarily incomplete (Tirole 1999, 2001). In addition, managerial effort is unobservable such that a number of moral hazard problems may arise. The fact that managers are underperforming may remain undetected for some time whereas, in contrast, good managers may be paid less than they deserve (Holmstrom 1979, Grossman and Hart 1983). Fortunately, the optimal compensation scheme may be relatively straightforward to implement because, as shown by Holmstrom and Milgrom (1987), under certain conditions it simply boils down to a linear function of aggregate measures of firm performance (output, profits, etc.).³⁵

[INSERT TABLE 6 ABOUT HERE]

Table 6 compares CEO remuneration in Germany to the rest of Europe and the US. German CEOs are among the lowest paid not in Europe. German CEOs earn on average a total remuneration of only \$454,979 as compared to \$696,697 for Belgian CEOs. Conyon and Schwalbach (1999, 2000a) show that when differences in tax rates are taken into account the variation across Europe is even larger. The pay package of German CEOs looks even more meagre when compared to their US counterparts. In terms of the importance of the basic compensation in the total pay package (47%), German CEOs are no different to their European counterparts, but are substantially different when compared to US CEOs (28%). In particular, German CEOs appear to have the highest total cash pay in Europe but have the lowest non-cash remuneration. This may explain why the total remuneration package of German executives is low compared to other European executives (Conyon and Schwalbach 1999, 2000a). In the mean time, variable payment is increasingly adopted by large German firms (Tuschke and Sanders 2003).

The influence of remuneration policies on the behaviour of German managers has recently been a matter of further systematic research (see e.g. Kraft and Niederprüm (1999)). Elston and Goldberg (2003) investigate the monetary compensation of the members of the management and supervisory boards of German firms and confirm the results of Schmid (1997). First, although the size effect (positively) dominates the compensation equation, there exists a positive sensitivity of managerial pay to company performance in Germany. This relation is confirmed by Conyon and Schwalbach (2000b). Second, the Elston and Goldberg (2003) study shows that managers and directors of widely-held firms receive a substantially higher

³⁵ Supportive evidence of the Holmstrom-Milgrom model can be found in Garen (1994) and Kraft and Niederprüm (1999).

monetary compensation than those of firms with large blockholders. Third, firms with monitoring house banks (which own an equity stake, are major providers of loan capital and frequently have board representation) generally pay managers and directors comparatively less than widely held firms. The adoption of stock-based compensation is investigated by Tuschke and Sanders (2003). They show that the relationship between the likelihood of adopting stock-based incentives and control concentration in listed German firms has an inverted-U shape with a maximum in the first quartile of control concentration.

In the next section, we review evidence on the external corporate governance mechanisms: the market for corporate control, block trades, creditor monitoring and product market competition.

4 External corporate governance mechanisms

4.1 The market for corporate control

The role of hostile takeovers is controversial. On the one hand, hostile takeovers are considered to be a device to keep managerial autonomy under check and to impose discipline by enabling the acquirer to reallocate the target's resources more profitably (Grossman and Hart 1980; Burkart 1999). On the other hand, there is little evidence that, in practice, the market for corporate control assumes these tasks. While poor performance only slightly affects the probability of a takeover, the main determining factor is size (see Morck et al. (1988), Martin and McConnell (1991), Comment and Schwert (1995), Schwert (2000) for the US, and Franks and Mayer (1996) for the UK). In contrast, Franks et al. (2001) show that poorly performing UK companies are frequently drastically restructured via mergers and acquisitions which lead to the replacement of most of the directors.

Still, the role of the market for corporate control may be rather indirect. First, it is possible that the mere threat of a takeover raises efficiency *ex ante* (Scharfstein 1988; Shleifer and Vishny 1986). Second, companies shielded from the takeover market have lower share prices. The setting up of anti-takeover devices generally coincides with a reduction in share value (Karpoff and Malatesta 1989; Ryngaert 1988; Jarrell and Poulsen 1989). This negative impact can be interpreted as evidence that shareholders fear that managers may take advantage of the increased lack of control by not maximizing shareholder value. The fall in the share price may also reflect the reduction in the probability of the shareholders receiving a takeover premium.

In a survey paper on the economics of mergers and acquisitions, Burkart (1999) concludes that although managers shielded from the takeover threat do not behave like empire-builders they tend to become sluggish. For example, Bertrand and Mullainathan (2003) and Borokhovich et al. (1997) show that increased insulation from takeovers increases managerial salaries and lowers total factor productivity in US corporations. In addition, Garvey and Hanka (1999) provide evidence that anti-takeover legislation leads to fewer new investments and fewer disinvestments. All in all, it seems that the existence of an active market for corporate control is material.

A recent study of the European domestic and cross-border mergers and acquisitions market shows that the market for corporate control in Germany is very limited (Goergen and Renneboog 2003). The main reason is that, as shown in previous sections, the vast majority of firms have a large controlling shareholder. In addition, pyramiding (with multiple layers of financial holdings sandwiched between the ultimate investor

and the target firm) and cross-shareholdings³⁶ hinder takeover attempts (Prigge 1998, Jenkinson and Ljungqvist 2001). Another reason is that the legal and regulatory corporate governance framework in Germany has been lagging behind that of other countries in terms of disclosure, transparency and shareholder protection (see McCahery and Renneboog 2003 and section 5 of this paper).³⁷ Finally, the following takeover codes and legislation have created further barriers to takeover activity:

a. Taxation:

Prior to 2002, the capital gains resulting from sales of equity stakes by corporations and financial institutions were taxed at the corporate tax rate (see section 5).

b. Court actions by dissenting shareholders

Prior to 2002, (minority) shareholders disagreeing with decisions taken at the annual general meeting could block these decisions, even though they had been approved by a qualified majority of 75% of the votes,³⁸ for long periods of time.

c. Board entrenchment:

The management board is legally entrenched: only the supervisory board (balanced by the co-determination of shareholders and employee representatives) can remove the members of the management board who are usually appointed for a term covering the legal maximum of 5 years (Beinert 2000: § 373). In other words, a new large (controlling) shareholder cannot remove the management board instantaneously (unless their contract comes to expiration). Furthermore, the supervisory board is also legally entrenched: the representatives of shareholders and employees have contracts for up to 5 years (with the option of renewing them). Consequently, a new controlling shareholder may not be able to obtain immediate control over the supervisory board. Whereas in some countries, staggered boards are common, this practice is infrequently used in Germany.

d. Proxy voting:

Shareholders depositing their shares with their bank frequently grant permission to the bank to exercise their votes. Although, in principle, banks have to ask permission and state how they intend to vote on specific proposals, this was not common practice prior to KonTraG of 1998. The importance of proxy voting is confirmed by Schmid and Wahrenburg (2003) who claim that in German quoted corporations with a dispersed ownership structure, the large German universal banks (taken together) control the majority of the votes on the annual meetings.

e. Registered shares

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

f. Voting restrictions, multiple votes and non-voting shares

Voting restrictions could cap the percentage of voting rights any one shareholder could exercise. However, the Third Act on the Promotion of Financial Markets (*Drittes Finanzmarktförderungsgesetz*) of 1998 put a stop to the introduction of such voting restrictions. The grandfather clause for existing restrictions ended on 1 June 2000. The 1998 law also banned the issue of multiple voting rights, although a grandfather clause was created for such shares outstanding. The grandfather clause ended on 1 June 2003. However, German

³⁶ If the mutual equity stakes exceed 25%, restrictions will be applied on the votes cast at the annual meeting: see Beinert (2000: §382).

³⁷ For a discussion of the recently proposed takeover legislation by the European Commission, see McCahery and Renneboog (2003) and Berglöf and Burkart (2003).

³⁸ Schmid and Wahrenburg (2003) state that, whereas the decisions at shareholder meetings are usually taken with a simple majority, qualified majorities of 75% of the voting capital are needed for: amendments to the articles of association, removal of shareholder representatives from the supervisory board, control agreements and profit transfer agreements, and mergers or acquisitions. In addition, such a qualified majority is needed for granting the management full discretion to take anti-takeover measures for a period of 18 months. A supermajority of 75% of the voting capital is also needed to cancel the pre-emptive rights with which shareholders are endowed when the firm does a seasoned equity offering (Beinert 2000: § 365)

firms are still allowed to issue non-voting shares, but only for a maximum of 50 percent of the total equity issued.

The following comparative figures highlight the almost complete absence of disciplining by the market of corporate control in Germany. Whereas during the period 1984-1989 there was an annual average of 40 hostile bids per annum in the UK (Jenkinson and Mayer (1994)), only three hostile takeovers (Feldmühle Nobel in 1988-89, Hoesch in 1990-91 and Continental in 1991-92) have occurred in Germany since WWII (Franks and Mayer 1998). Hence, one can conclude that there is no active market for corporate control in Germany. This conclusion is supported by Franks and Mayer (1990) and Köke (2004), although Jenkinson and Ljungqvist (2001) show that there exists a market for partial control stakes which is frequently hostile (see next section).

4.2 Block trades and the market for partial control stakes

In the USA, transfers of control by means of block sales are on average accompanied by positive abnormal stock performance (Holderness and Sheehan 1988; Sudarsanam 1996). In fact, Barclay and Holderness (1989) show that the price reaction is positive regardless of the price paid for the share block. The main reason for the positive market reaction is that changes in control may improve corporate governance, especially when the firm is performing poorly and is in need of a substantial reorganization (Barclay and Holderness 1991). When performance is poor, shareholders without a distinct interest in monitoring are expected to sell their shares, while those with strong monitoring abilities may increase their stakes in order to reinforce their position as (major) shareholders. Consequently, under such circumstances, block transactions giving the purchaser control over the firm may trigger a more favourable market reaction than those transactions that do not confer control to the purchaser. Holderness and Sheehan (1988) provide evidence on this conjecture for the case of the US. They also find that the market reaction is more favourable to block transfers that are accompanied by a tender offer on all shares outstanding. In addition, the market reacts more positively to block transactions in those firms that subsequently experience a full acquisition (Barclay and Holderness 1992). Still, Sudarsanam (1996) concludes that, even when no takeover occurs, the benefits of control concentration outweigh the costs.

Jenkinson and Ljungqvist (2001) provide some empirical evidence on the existence of a market for large share stakes in Germany. They find that 64 German companies (out of all the listed firms in 1991) are potentially vulnerable to a hostile attack (given their control structure and lack of takeover defences). Moreover, they identify 17 cases of hostile stakebuilding among the 2511 changes in control that occurred over the period of 1988 to 1996 and involved German firms as targets. Franks and Mayer (2001) also find evidence of turnover of share stakes over the period of 1988 to 1991, with new shareholders emerging in 22 percent of the companies and old shareholders disappearing in 13% of the companies. Still, Franks and Mayer stress the differences between the Anglo-American markets for corporate control and the German market for partial control. First, the German market permits price discrimination between sellers of share blocks and other investors and, second, the overall gains from mergers as reflected in the bid premiums are low in relation to those in the UK and the US. According to Köke (2004), the motive behind a large part of the German block trades is the acquisition of control over the target firm. Finally, for the period of 1980 to 1995, Boehmer (2000) reports 715 purchases of at least 50 percent of the votes outstanding by 127 acquiring firms (through direct or indirect shareholdings or other contractual arrangements) in the corporations listed on the Frankfurt official market. Part of such purchases can be considered as hostile and be motivated by a disciplining effect (Jenkinson and Ljungqvist 2001).

These transactions are accompanied by significantly positive cumulative abnormal returns (CARs) earned by the target firms' shareholders (Boehmer 2000). However, the bid premium paid to the selling

shareholders is small compared with the US and UK and non-selling shareholders do not obtain abnormal returns (Franks and Mayer 2001). Poorly performing GmbHs, with high leverage and a non-financial owner, are among the most common targets. These acquisitions are usually done for reasons of horizontal or vertical integration. Conversely, AGs with strong ultimate owners are less likely to be sold, even if performance is poor, when the owners are individuals or families, or financial institutions. For these public AG companies, moreover, the impact of control concentration on the probability of being acquired shows an inverted U-shape form (Köke 2002). In a follow-up study, Köke (2004) qualifies this finding: ownership dispersion as well as tight shareholder control increase the probability of a change in the ultimate owner of the firm provided that control is not concentrated in the hands of directors and provided that creditor control is weak. Goergen and Renneboog (2003) find that, for a sample of initially family-controlled German firms that have recently gone public, size, the presence of the founder (or her family) among the shareholders, and the issue of non-voting shares decrease the probability of a transfer of control whereas growth and the level of risk of the firm increase the probability.

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

4.3 Creditor monitoring

An important characteristic of some corporate governance regimes (in particular the German one) relates to the lending relationships (Deeg 1998, Vitols 1998). Shleifer and Vishny (1997) argue that large creditors fulfil a role similar to large shareholders because these creditors have large investments in the firm and therefore a strong incentive to monitor the firm’s management. High gearing can be considered as a bonding mechanism for the management (e.g. Aghion and Bolton 1992; Berkovitch et al. 1997) such that high executive turnover is positively related to high gearing. Denis and Denis (1995), for example, infer creditor monitoring from the fact that high leverage combined with managerial control improves shareholder returns. In contrast, Edwards and Nibler (2000: 260) suggest that “German banks do not play a role in the governance of large listed firms which is distinct from their position as one of several types of large shareholder”.

In Germany, the banks owning shares in listed firms are frequently also the main bank, *Hausbank*, of these firms. Each type of the *Hausbank’s* claims (debt versus equity) may require a different optimal decision process in the wake of financial distress. When there is a danger of bankruptcy and the bank faces a refinancing demand by the firm, its creditor claims may encourage the bank to make the firm file for

liquidation whereas the equity claims may lead the bank to revolve its loans. Such conflicts of interest may even be exacerbated by the fact that in Germany (as in Belgium, France and Italy), intricate control-based networks (which may also comprise banks) exist such that banks' decision may be influenced by the objectives of the network/conglomerate.

Rajan and Zingales (2003) state that relationship-based financing performs better when markets and firms are smaller, when legal protection is weaker, when there is little transparency, and when innovation is mostly incremental rather than revolutionary. Large creditors, especially in bank-based economies such as Germany, typically have a variety of control rights and therefore sufficient power to monitor. Consequently, bank monitoring may act as a substitute to alternative corporate governance devices. A disciplinary change in control is then expected to be less profitable and hence less likely to occur given the bank's monitoring. Köke (2004) analyses corporate governance in the German bank-based economy and confirms that non-market monitoring devices play a larger role because hostile control transactions are rare and because other constituencies such as large creditors typically have considerable power.

The long-term lending relationships give banks considerable power, which is frequently strengthened by bank representation on the supervisory board of the firm. Schmidt (2003) states that membership of a supervisory board is an important source of privileged and valuable information. One reason why bank influence is particularly strong is that historically German banks have acted as so-called house banks, providing long-term loans to long-term clients (Baums 1994; Edwards and Fischer 1994). Köke and Renneboog (2003) provide empirical evidence that German firms exposed to tight creditor control operating in competitive markets experience higher productivity growth, especially if these firms are performing poorly or are in financial distress. Lehmann and Neuberger (2001) and Edwards and Fischer (1994) also document that banks intervene in case their corporate client runs into financial distress. Hopwever, Agarwal and Elston (2001) are not convinced about the firms benefit from increased access to capital, as their interest payments to debt ratio is also significantly higher. This suggests that German banks engage in rent-seeking activities.

Jenkinson and Ljungvist (2001: 430-431) "identify another important role of banks, namely their role in assisting companies pursuing a strategy of hostile stakebuilding. [...] [B]anks play a pivotal role in building, brokering and concealing stakes. In contrast, it is striking how few examples [they] find of banks actively *defending* target companies from a hostile stakebuilder. Such behaviour may, of course, be compatible with the view that banks actively monitor German companies [...] However, it is important to recognise that this role is performed not by the companies' *house banks* [...], but by the banks assisting the predator".

4.4 Product market competition

Ever since Adam Smith's celebrated book, economists have argued that product market competition provides incentives for the efficient organization of production. A number of theoretical models have addressed this issue (see Aghion and Howitt 1996 and Allen and Gale 2000 for a review) and supportive empirical evidence also exists (see e.g. Nickell et al. 1992 and Nickell 1996). In particular, intense competition in the product market may reduce managerial slack through at least four different channels (Hermalin 1992: 361): income (Hart 1983), risk (Scharfstein 1988), information (Holmstrom 1979, 1982; Nalebuff and Stiglitz 1983) and value of managerial actions (Hart 1983, Scharfstein 1988). Under certain conditions the basic insight that competition improves management performance holds, i.e. the income effect dominates. Ultimately, however, the combined result of these four effects is ambiguous, "indicating

that there is no definitive theoretical relationship between the level of competition and executive behavior” (Hermalin 1992: 361).³⁹

Unfortunately, the empirical evidence on the interaction between product market competition and corporate governance is scarce (Kettle 1999). The evidence suggests that both product market competition and the level of corporate governance boost firm performance. In a pioneering study, Nickell et al. (1997) analyse the productivity growth of UK manufacturing firms and find that the degree of market competition and shareholder control are associated with high productivity growth. Moreover, they conclude that competition (and debt) may be a substitutive mechanism to internal control. Following the same econometric methodology, two recent studies – Januszewski et al. (2002) and Köke and Renneboog (2003) – provide evidence on German firms.

First, Januszewski et al. (2002) present evidence of a positive (negative) effect of product market competition on productivity growth (the productivity level). Their results also show that control concentration has a positive effect on productivity growth and that this effect is even larger in firms facing intense product market competition, i.e. competition and tight control are somehow complements. In contrast, financial control has a negative impact on productivity growth. Second, Köke and Renneboog (2003) analyse two samples of firms: one from a market-oriented system of corporate governance (the UK) and the other from a bank-based (Germany) system. This allows them to compare the differences in the impact of alternative governance devices. Notably, whereas in poorly performing and distressed German firms bank-debt concentration is associated with high productivity, in the UK this effect is only observed for firms with strong outside blockholders. In both countries, however, market competition enhances productivity growth.

5. The recent evolution of corporate governance regulation and stock exchange structures

The importance of all of the above corporate governance mechanisms as well as their interactions should be studied within a country’s specific regulatory context. For example, strong shareholder protection reduces the danger of expropriation of minority shareholders. Consequently, the development of legal corporate governance rules (e.g. mandatory bid rule in the case of takeovers) and self-regulation (e.g. corporate governance codes of best practice) should be priced by the markets. La Porta et al. (1998, 1999, 2000) have developed a new line of research which explains the differences in corporate governance systems by the level of legal protection of minority shareholders and the degree of capital market development. La Porta et al. find that common law systems tend to offer better protection both against the expropriation of shareholders by the management and the violation of the rights of minority shareholders by large shareholders than civil law systems. Likewise, creditor protection – measured by creditor rights indices which are based on bankruptcy law and the regulation regarding financial distress – is strongest in common law countries and worst in French civil law countries. The Scandinavian and German countries are somewhere in between. The implication of La Porta et al.’s work is that countries should move towards the more efficient common law system based on transparency and arm’s length relationships.⁴⁰

³⁹ Ambiguous results also arise out of the models of Horn et al. (1994), Meyer and Vickers (1997) and Schmidt (1997).

⁴⁰ Some argue that the framework developed by La Porta et al. (1998, 1999, 2000) is too limited (Berglöf and von Thadden 1999). In particular, by emphasizing the importance of dispersed ownership, the approach of La Porta et al. only appears relevant to the context of developed countries. Others argue that there have been significant changes over the last twenty years in the patterns of finance in developing markets. The differences in corporate and legal rules cannot easily account for the differences in financial arrangements in emerging markets (Glen et al. 2000).

Other studies show analogous correlations (Levine 1999; Beck et al. 2002). For example, the level of shareholder protection relates inversely to the size of the premium over the market price paid for a majority voting block – higher premiums are paid in countries with weak protection (Zingales 1994). Furthermore, there is a direct connection between strong shareholder protection and the volume of IPOs. What these studies tend to confirm is the comparative advantage of countries that protect investors' interests. Recent empirical work by La Porta et al. (2000) and Beck et al. (2000) finds that firms operating in jurisdictions with strong shareholder protection have a higher growth potential, as measured by Tobin's Q. Consistent with this evidence, Drobetz, Schillhofer and Zimmermann (2002) relate the protection of shareholder rights to the long-run performance of a cross-section of German firms. They construct an index based on five categories of corporate governance rules and provide evidence that better shareholder protection leads to higher firm valuations (measured by the price earnings ratio and the market to book ratio). In general, these studies document a positive effect of better corporate governance protection on financial market development.^{41,42}

5.1 Changes in corporate governance regulation

Since 1990, important new laws have been passed in order to promote the financial markets (*Finanzmarktförderungsgesetze*) by increasing transparency and by creating a level playing field in the market for corporate control: e.g. the Securities Act of July 1994 (*Wertpapierhandelsgesetz*), the revised Restructuring Act of 1995 (*Umwandlungsgesetz*), the Antitrust Law (*Gesetz gegen Wettbewerbsbeschränkungen*), the revised German Stock Corporation Act, and the Takeover Act of 2002 (*Unternehmensübernahmegesetz*).

5.1.1 Share stake disclosure and insider trading: The Securities Trading Act (1994)

This act applies to all companies with headquarters in Germany and traded on an EU stock exchange (and not just a German one) and deals with the disclosure of information on the company's shareholder structure and with insider trading regulation. Prior to 1995, little was known about the shareholder structure of German firms as the Stock Corporation Act stipulated that shareholders only had to report their stakes if they exceeded the thresholds of 25 and 50 percent, respectively. The Securities Trading Act, which became effective on 1 January 1995, states that stakes above the thresholds of 5, 10, 25, 50 and 75 percent of the voting rights (be it from above or below) need to be disclosed to the Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) which then makes this information public. However, disclosure requirements beyond those stipulated in the Securities Trading Act can be imposed by the stock exchanges. These requirements differ by market segment: the General Standard and the Prime Standard segments (for the recent changes in stock exchange structure: see below). In addition, this act labels insider trading as a criminal offence (Schmid and Wahrenburg 2003).

The legislation also creates a Federal Supervisory Authority, analogous to the SEC in the US, which has the right to prosecute violation of the insider-trading laws. To endow the FSA with sufficient information to

⁴¹ Lombardo and Pagano (2002) find that better legal institutions influence equity rates of return and the demand for equity finance by companies. They also show that the imposition of legal limits on transactions with companies related through ownership cascades can preserve the income rights of minority shareholders and lead to a reduction in managerial benefits. Better legislation – via class action suits or voting by mail – leads to a reduction in the legal and auditing costs that shareholders must bear to prevent managerial opportunism. The authors conclude that the size of these effects on the equilibrium rate of return is increasing in the degree of international segmentation of equity markets.

⁴² However, some argue that the conclusions that can be drawn from these studies are limited because the direction of causality between the legal system and financial structure may run in the opposite direction, viz. financial structure prompts transformations taking place in the legal regime (Bolton and von Thadden 1999; Bebchuk and Roe 2000).

prosecute violations of insider-trading law, the legislation introduced additional disclosure requirements for insiders who must disclose any information that might affect the firm value even if they have no intention of trading the firm's securities. Since 1994, the tasks of the Financial Supervisory authority have been enlarged.

5.1.2 The Antitrust Act

This act tests whether business combinations lead to the extraction of monopoly rents on the market for goods and services. The act defines a business combination in the wide sense: a business combination does not just cover mergers and acquisitions, but also acquisitions of share stakes of 25 percent and above.

5.1.3 The revised Restructuring Act (1 January 1995)

The Act is an important piece of legislation. First, it allows for tax-efficient restructuring and, second, it ensures that restructuring is not delayed as a result of law suits by minority shareholders. Beinert (2000: § 325) states that corporate restructuring (mergers, break-ups and spin-offs, transfers of assets and changes in legal status) can take place at book value (without revaluation). Consequently, capital gains taxation on asset revaluations (write-ups) can be avoided. A requirement for a corporate restructuring is the fiat by a qualified majority of at least 75 percent of the voting capital represented at the annual general meeting. However, the Stock Corporation Act generally allows (minority) shareholders to challenge such restructuring in court even though it has been approved by a supermajority. Such court actions may delay the restructuring for many years. The Restructuring Act supersedes the Stock Corporation Act: the shareholders who feel disadvantaged can still sue the firm for damages but cannot stall the restructuring anymore.

The big regulatory leap forward in 1998: The Third Act on the Promotion of Financial Markets (*Drittes Finanzmarktförderungsgesetz*); the Law for the Reinforcement of Control and Transparency (*KonTraG*) and the Raising of Equity Relief.

This Third Act bans the introduction of voting restrictions, grants a grandfather clause for existing restrictions which was phased out on 1 June 2000. The 1998 law also bans the issue of multiple voting rights, although a grandfather clause was created for existing multiple votes. However, since 1 June 2003, multiple voting shares are no longer permissible. It should be noted that German firms are still allowed to issue non-voting shares, but only for a maximum of 50 percent of the total equity issued. In addition, this law legalized share buy-backs and facilitated the introduction of stock options.

Another milestone of 1998 was the Law for the Reinforcement of Control and Transparency (*KonTraG*), implemented changes that affected the laws regulating the activity of corporations, stock exchanges, and accounting practices. The main intention of the law was to improve the effectiveness of supervisory boards and to strengthen their monitoring role of top management. The *KonTraG* has led to a certain shift of power in favour of the supervisory board, thus limiting the powers of the management board. This law has also prohibited deviations from one-share-one-vote. The law also imposes some restrictions on the bank ownership (proxy votes) and regulates risk management.

Another significant development in the Raising of Equity Relief Act was the obligation for stock corporations to adopt international accounting standards (IAS or US-GAAP). Finally, the law reduced to 5% (from 10 %, as it was before) the minimum share capital requirement enabling minority shareholders to launch a minority claim (to sue the management for damages on the firm's behalf for detrimental managerial decisions).

5.1.5 The Takeover Code (14 July 1995, revised 1 January 1998) and the Takeover Act (1 January 2002)

In 1995, the Takeover Code was introduced as a (voluntary) code of conduct for firms involved in a merger or acquisition. The code called for mandatory takeover bids as soon as a party had acquired control (50% of the votes or 75% of the votes present at the latest shareholders' meeting). Still, the code had a limited impact because it was not followed by several of the largest German firms and there were numerous violations of the code by its signatories. As a consequence of the failed code of conduct, a new takeover law (the Takeover Act) became effective on 1 January 2002. A mandatory tender offer needs to be made as soon as an investor acquires 30 percent of the voting rights. This mandatory bid is likely to have an impact on the large block trades (even hostile ones) which were common prior to 2002 (Köke 2000 and 2004, Jenkinson and Ljungqvist 2001). On the one hand, the takeover law invokes the principle that the target management should take a neutral stance in a takeover attempt. On the other hand, paragraph 33 of the Act obliges the management to take any actions in the best interest of the corporation, such as anti-takeover measures. The defensive measures that are allowed are: actions that can dilute the share stake of the bidding investor (a new equity issue to friendly parties while excluding pre-emption rights, share repurchases), a pac-man defence (counter-bid on the bidder's shares), selling the crown jewels, and soliciting bids from white knights. All the measures, apart from the last one, need the approval of the supervisory board. However, shareholders representing 75 percent of the votes at least can give the management full discretion to set up any anti-takeover action (for a renewable period of 18 months).

The Takeover Act does not allow restricted tender offers (in case a shareholder has acquired at least 30%) but admits conditional tender offers.⁴³ Another important change in takeover law regards squeeze out rules. Whereas in the past minority shareholders could stall a merger or acquisition by fighting a squeeze-out in the courts, the Takeover Act states that the shares of the residual minority shareholders can be transferred to a shareholder holding at least 95 percent of the equity. In this case, the minority shareholders who are 'squeezed out' will no longer be able to stall the takeover process, but can ask for a cash compensation in the courts if their rights are violated. Finally, paragraph 33 of the Takeover Act also renders golden parachutes offered by the bidder to the target's management/directors illegal. This rule will prevent the payment of huge amounts of severance pay, such as those to Klaus Esser and the other directors of Mannesmann in the takeover battle by Vodafone.

5.1.6 Capital gains tax (Tax Reduction Act of 2000, effective 1/1/2002)

Since 1 January 2002, capital gains tax has no longer been incurred on divestitures of equity stakes (capital gains realised by financial institutions and corporations were taxed at the full corporate tax rate). Prior to that date, many corporations and financial institutions retained their equity positions in German companies rather than sell them. Consequently, this change in tax law may enlarge the market for large voting blocks (Becht and Boehmer 2003: 4). The motivation for this reform was not only to abolish equity interlocks and stimulate market for corporate control, but also to give German banks the incentive to reduce their equity holdings in the corporate sector.

5.1.7 Fourth Financial Market Promotion Act (2002)

In 2002, the provisions on market manipulation (anticipating the 2003 EU directive) and disclosure of director's dealings were introduced.

⁴³ A restricted offer is an offer applying to e.g. 40 percent of the shares. A conditional offer is a bid for X percent of the shares which will be purchased provided that the bidder gets at least Y percent of the shares.

5.2 Recent codes of best practice.

The Government Panel (chaired by Baums in 2000) urged the federal government to begin drafting a "Transparency and Disclosure Act" in which further proposals of the Panel will be implemented.⁴⁴ This should include the legal foundation for the "comply or explain" principle, measures to strengthen supervisory boards (through broader disclosure duties for the management board and tighter confidentiality requirements for supervisory board members), the use of electronic media for company publications and deregulation in corporation law.

Related to the functioning of the management and supervisory board, the Panel recommended tightening the fiduciary duties by extending the civil liability of management and supervisory board members from its current standard of "willful intent" to also include "gross negligence" in connection with the release of false information to the capital market. Furthermore, the number of external supervisory board positions that a supervisory board member may hold should be limited to five in order to strengthening the independence of supervisory board members. A supervisory board member should hold office in or represent other companies that are in competition with his or her company.

The Panel also recommends to improve the transparency standards, such as for management stock option plans and for the shareholdings of members of the management and supervisory boards, as well as increase the duties of the management board to provide information to stockholders. In addition, the independence of auditors should be strengthened. Panel is also in favour of eliminating the requirement that shares be deposited as a prerequisite for voting at the shareholders' meeting.

An important improvement is the strengthening of minority rights of § 147 AktG. Holdings of 1% of the capital stock or stock with an exchange or market value of Euro 100,000 should be sufficient to commence a suit against the company if there are facts substantiating suspected dishonesty or other gross violations of law or the articles of association by relevant members of the management and supervisory boards

The Cromme Code (26 February 2002, amended on 21 May 2003⁴⁵) partially follows the proposals from the Government Panel relating to corporate governance principles. Still, the main contribution of this code is a structured summary of the regulatory changes in terms of disclosure and transparency, the duties of the management and supervisory board, remuneration contracts the formation of committees, etc. The code recommend that firms should allow remote access for shareholders to the general meetings using modern communication media (e.g. the internet). In terms of accounting standards, the historical accounting conventions of the German Handelsgesetzbuch (HGB) demand less disclosure than e.g. the US GAAP-rules of the Federal Accounting Standards Board. However, over the past few years, many German firms have voluntarily adopted the GAAP-rules of the IASB (International Accounting Standards Board) (Tuschke and Sanders 2003).⁴⁶ EU-listed companies will have to report their consolidated financial statements according to the IASB standards by no later than 2005.

The most controversial aspect of the Gromme Code is its requirement of the disclosure of management and supervisory board members' remuneration on an individual basis and subdivided according to fixed, performance-related, and long-term incentives components. It is controversial because the Commercial

⁴⁴ *Bericht der Regierungskommission Corporate Governance* (10 July 2001).

⁴⁵ The amendments consisted in improving and clarifying the Code's recommendations in terms of managerial remuneration and its disclosure.

⁴⁶ Examples of German firms using IASB standards are Addidas-Salomon, Bayer, Deutsche Bank, Dresdner Bank, Henkel, Hochtief and Wella (see <http://www.iascorg.uk/> for further examples).

Code and Stock Exchange Admission Regulation only require that companies publish the total, aggregate remuneration paid to its management board and to the supervisory board. The Gromme Code also provides that the consolidated financial statements must contain specific information on company share option programs and similar security-based incentive schemes. It also makes the disclosure of all directors' shareholdings mandatory.

5.3. Stock exchange developments

During the price run-up of the 1990s, many new stock exchanges or new market segments were created in order to float small and medium-sized firms, predominantly from the high-tech, internet and telecoms sectors). In 1997, Germany set up the *Neuer Markt*, one of the Euro New Markets (along with the *Nieuwe Markt* in Amsterdam (AMEX), the *Nouveau Marché* in Paris, the *Nuovo Mercato* in Milan and the EuroNM Brussels). The firms listed on the *Neuer Markt* had to follow IAS or US-GAAP (as specified in the Rules and Regulations *Neuer Markt*, FWB 9). However, although the *Neuer Markt* experienced a remarkable growth until 2000, blatant violations of insider trading legislation, of share stake lock-in agreements and share price manipulations by several firms forced it to close down in 2002/3 (Goergen, Khurshed, McCahery and Renneboog (2004)). The different market segments – *Amtlicher Handel* (the official, most liquid market), the *Geregelter Markt* (second-tier market) and the *Neuer Markt* – were restructured on 1 January 2003 to form the General Standard and Prime Standard market segments. Small and mid-sized companies, which meet minimum listing requirements (from the former *Amtlicher Handel* and the *Geregelter Markt*) and do not target international investors, are listed on the General Standard market segment. Companies following the international accounting standards (IFRS or US GAAP) and disclosure rules are listed on the Prime Standard segment. The *Neuer Markt* firms were included in the latter.

6. Conclusion

This paper provides an overview of the German corporate governance system. We review the governance role of large shareholders, creditors, the product market and the supervisory board. We also discuss the importance of mergers and acquisitions, the market in block trades, and the lack of a hostile takeover market. Given that Germany is often referred to as a bank-based economy, we pay particular attention to the role of the universal banks (*Hausbanken*). We show that the German system is characterised by the existence of a market for partial corporate control, large shareholders and bank/creditor monitoring, a two-tier (management and supervisory) board with co-determination between shareholders and employees on the supervisory board, a disciplinary product-market, and corporate governance regulation largely based on EU directives but with deep roots in the German codes and legal doctrine. Another important feature of the German system is its corporate governance efficiency criterion which is focused on the maximisation of stakeholder value rather than shareholder value. The German corporate governance system has experienced many important changes over the last decade.

First, the relationship between ownership or control concentration and profitability has changed over time. Whereas, in the 1970s and 1980s there was a positive relation between control and performance, this relationship vanished or even turned negative in the 1990s. There is also no clear answer to the question whether German banks play a positive monitoring role. However, their positive contribution is less ambiguous in financially distressed or poorly performing companies, which can be attributed to the banks' importance as creditors. It has been argued that non-market monitoring devices play a larger role because hostile control transactions are rare and because other constituencies such as large creditors can typically exert considerable power. The long-term lending relationships yield banks considerable influence, which is frequently strengthened by bank representation on the supervisory board of the firm.

Second, German CEOs appear to have the highest total cash pay in Europe and the lowest non-cash remuneration (although variable payment is increasingly adopted). Although there is a positive sensitivity of managerial pay to performance in Germany, the size effect dominates the compensation equation. Importantly, the pay-for-performance relation is influenced by large shareholder control: in firms with controlling blockholders, the CEO receives a lower total compensation and the pay-for-performance relation is no longer statistically significant. When a universal bank is simultaneously an equity- and debtholder, the pay-for-performance relation is lower than in widely held firms or blockholder-controlled firms.

Third, since 1995 several regulatory initiatives have increased transparency and accountability. The rules on insider trading and anti-trust have been strengthened. Also, the revised Restructuring Act no longer allows minority shareholders to stall corporate restructuring for many years via ongoing legal actions. Moreover, voting restrictions and multiple voting shares are no longer permitted. More importantly, the Takeover Act imposes that a shareholder who acquires at least 30% of the equity is required to make a tender offer for the remaining shares. The Takeover Act obliges management to take the interest of the company at heart, but also allows the use of anti-takeover devices.

Some argue that these recent changes indicate a certain trend towards a market-oriented system. However, as Hacketal et al. (2003: 671) point out, “the fundamental structure of German corporate governance” has remained unaltered. Moreover, “[s]ome new rules and regulations have lacked enforcement, others left loopholes, and other just did not set the right incentives” (Terberger (2003: 715). This paper provides supportive evidence on these caveats. Although there has been some degree of convergence in terms of e.g. transparency (accounting rules of the IAS), stock markets (the Neuer Markt, set up in 1997, has more than 300 IPOs), and voting (abolishment of multiple-voting shares), the fundamental differences with respect to a market-based system are still significant. Among the most apparent, we can mention a level playing field on M&A and ownership disclosure requirements.

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Table 1: Ownership and control

		Control	
		Weak	Strong
Ownership	Dispersed	Panel A: Dispersed ownership and dispersed control	Panel B: Dispersed ownership and concentrated control
	Concentrated	Panel C: Concentrated ownership and dispersed control	Panel D: Concentrated ownership and concentrated control
<p>Panel A: Dispersed Ownership and Weak Control</p> <ul style="list-style-type: none"> - where: US, UK. - advantages: a. high potential for portfolio diversification and high liquidity; b. existence of a takeover market - disadvantages: insufficient monitoring: free riding problem - agency conflicts: management vs shareholders <p>Panel B: Dispersed Ownership and Strong Control</p> <ul style="list-style-type: none"> - where: countries where a stakeholder can collect proxy votes, where shareholder coalitions are allowed, where non-voting shares are issued and where shareholding pyramids exist: e.g. in Continental Europe. - advantages: a. monitoring of management, b. portfolio diversification and liquidity; - disadvantages: a. violation of one-share-one-vote, b. reduced takeover possibility - agency conflicts: controlling blockholders vs small shareholders <p>Panel C: Concentrated Ownership and Weak Control</p> <ul style="list-style-type: none"> - where: any company with voting right restrictions; e.g. in some German firms - advantages: protection of minority rights - disadvantages: a. violation of one-share-one-vote, b. low monitoring incentives, c. low portfolio diversification possibilities and low liquidity, d. high cost of capital - agency conflicts: management vs shareholders <p>Panel D: Concentrated Ownership and Strong Control</p> <ul style="list-style-type: none"> - where: Continental Europe, Japan, in any company after a takeover, in recently floated companies. - advantages: high monitoring incentives - disadvantages: a. low portfolio diversification possibilities and low liquidity, b. reduced takeover possibilities - agency conflicts: controlling blockholders vs small shareholders 			

Sources: Renneboog (1998), Correia et al. (2004)

Table 2. Ownership and control in Germany: recent selected studies

Study	Sample Year	Data source	No. of companies and sample definition	Block type	Largest block (mean %)	2 nd largest block (mean %)
Gorton and Schmid (2000b)	1989-93	Saling Aktienführer, ed. by Verlag Hoppenstedt & Co., Darmstadt (various issues)	186 (1993 sample) firms from the largest 250 corporations that traded at the end of 1993 in at least one of the two-tier market segments: Amtlicher Handel or Geregelter Markt	Control rights	-	-
Franks and Mayer (2001)	1990	Hoppenstedt Stockguide and Commerzbank	171 quoted industrial and commercial companies (subset of the population of 477 quoted industrial and commercial companies in Germany in 1990)	Direct stake	-	-
Edwards and Weichenrieder (1999)	1992	Registers (Handelsregister) of annual general meetings	102 listed companies extracted from the 158 largest non-financial firms in 1992	Direct stake (or control rights?)	- Owned: 46.30 - % at the general meetings: 54.84	- Owned: 8.34 - % at the general meetings: 10.11
Edwards and Nibler (2000)	1992	Registers (Handelsregister) of annual general meetings	156 of the 200 largest non-financial firms in 1992	Direct stake	- Listed: 47.0 - Unlisted: 80.0	- Listed: 9.0 - Unlisted: 13.0
Lehmann and Weigand (2000)	1991-96	Commerzbank, Wer gehört zu wem?, Bayerische Hypotheken- und Wechselbank, Wegweiser durch deutsche Aktiengesellschaften, and Hoppenstedt's Börsenführer	361 firms from the mining and manufacturing sectors	Direct stake	- Listed: 73.40 - Unlisted: 97.87	-
La Porta et al. (1999)	1996	Hoppenstedt Aktienführer	20 largest listed	Direct stake	-	-
Bech and Boehmer (2001, 2003)	1996	BAWe (Hoppenstedt KSD)	430 population of listed companies on official market	Voting block	58.9	7.4
Faccio and Lang (2002)	1996	Commerzbank, Financial Times and Worldscope	690 publicly traded (financial and non-financial) corporations	Cash flow (CFR) and control rights	- CFR: 48.54 - CR: 54.50	-

Köke (2001)	1998	Hoppenstedt KSD	1519 manufacturing firms in the legal form of Kapitalgesellschaft	CR)	Ultimate control and direct stake	- GmbH: 89.44 - Non-listed AG: 83.23 - Listed AG: 57.66	-
Van der Elst (2002)	1999	Hoppenstedt Aktienführer BAWe	542 listed companies on official and regulated markets	Block official market; stake regulated market	46.1	8.2	

Source: Adapted from Becht and Boehmer (2003).

Table 3. Main legal forms of business organization in Germany

	Aktiengesellschaft (AG)	Kommanditgesellschaft (KG)	Gesellschaft mit beschränkter Haftung (GmbH)
Description	Public company with limited liability	Partnership partly limited by shares	Private company with limited liability
% of total firms in Germany	0.1	3.2	14.4
Issue of shares representing ownership?	Yes	Yes	No
Listing?	Yes	Yes	No
Supervisory Board (Aufsichtsrat)	Yes	No boards are required by law	Yes, if more than 500 employees
Codetermination (Mitbestimmung)	<ul style="list-style-type: none"> - Full-parity codetermination: Coal, steel and mining firms with more than 1000 employees. - Quasi-parity codetermination: Firms with more than 2000 employees not subject to full-parity codetermination. - One-third codetermination: Firms not family-owned with less than 500 employees registered before 10 August 1994 and firms not family-owned with 500 to 2000 employees not subject to full-parity codetermination. 		<ul style="list-style-type: none"> - Full-parity codetermination: Like AG. - Quasi-parity codetermination: Like AG. - One-third codetermination: Firms not family-owned with 500 to 2000 employees not subject to full-parity codetermination.

Source: Prigler (1998) and Gorton and Schmid (2000b).

Table 4. Large shareholders monitoring in Germany: recent selected studies

Study	Main result*	Sample and period	Estimation method	Dependent Variable	Main explanatory variables**
Thonet and Poensgen (1979)	- /	About 300 listed firms extracted from the universe of manufacturing firms for the years 1961-1970	OLS, GLS	ROE	OC dummy, size, market share
Cable (1985)	+ / +	48 firms extracted from the largest one hundred in 1970	Weighted least squares	1968-1972 average ratio of after tax profits to capital assets	OC, BO, firm size and growth, public ownership, ratio of bank borrowing to total corporate debt
Gorton and Schmid (2000a)	+ / +	Four cross-sections of AGs extracted from: i) the list of the top 100 AGs of the year 1974; ii) all nonfinancial firms listed in Saling Aktienführer 1976; iii) the list of the largest manufacturing firms published in 1986 by the Frankfurter Allgemeine Zeitung. ; iv) all nonfinancial firms listed in Saling Aktienführer 1987	Semi-parametric specification estimated by locally weighted regression year by year	MTB (log), ROE	OC, BO, codetermination, voting restrictions
Gedajlovic and Shapiro (1998)	- /	1030 medium to large-sized publicly traded from five countries (Canada, France, Germany, the United Kingdom and the United States) and 11 industrial sectors extracted from Worscope-Disclosure 1991. Data from 1986 to 1991.	Pooled OLS robust to heteroskedasticity	ROA	OC, firm size and growth, diversification and geographic scope
Edwards and Weichenrieder (1999)	- /	102 listed companies extracted from the 158 largest non-financial firms in 1992	OLS (White heteroskedastic correction)	MTB	OC, debt ratios, idiosyncratic risk, firm size, industry dummies
Goergen (1998)	ns	62 German firms that went public between 1981 and 1988 and were family controlled before their flotation	Generalised Method of Moments (GMM) as a system	cash flow over book value of debt and equity, cash flow over	OC by type of shareholder, performance from previous period

					market value of equity and book value of debt, CARs	
Edwards and Nibler (2000)	ns / ns	103 listed companies extracted from the 158 largest non-financial firms in 1992	OLS (White heteroskedastic correction)		MTB	OC by type of shareholder, debt ratios, voting rights controlled by banks by proxy votes, idiosyncratic risk, firm size, dummy indicating the worker representation in the supervisory board, industry dummies
Gorton and Schmid (2000b)	+ / +	Unbalanced sample (1987-1992) from the largest 250 stock corporations that traded at the end of 1993 in at least one of the two-tier market segments: amtlicher Handel or geregelter Markt	Semi-parametric specification estimated by locally weighted regression year by year		MTB (log)	OC (lagged), BO (lagged), firm size (lagged), dummy for equal representation in the board, industry dummies
Lehmann and Weigand (2000)	- / +	361 firms from the mining and manufacturing sectors,	Fixed Effects (corrections for heteroskedasticity and first-order serial correlation)		ROA, ROE	OC, BO, board representation, firm size and growth, capital intensity, capital structure, market concentration
Agarwal and Elston (2001)	/ ns	100 large listed and unlisted stock held firms for the 1970-1986 period	Fixed effects		Operating income over sales, and interest payments over debt	BO, debt, growth of sales, sales, capital stock to sales
Franks and Mayer (2001)	ns /	75 listed firms, 1990-1994	Fixed effects		Board Turnover	OC, earnings loss
Januszewski et al. (2002)	+ / +	491 manufacturing firms operating in the period 1986-1994	GMM		Productivity Growth	OC, market competition, control dummy, dummies for type of shareholders, cross-

Köke and Renneboog (2003)	+ / -	1074 non-financial firms covering the years 1986-1996	GMM	Productivity Growth	shareholdings OC, market competition, control dummy, dummies for type of shareholders, debt, financial distress
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* Note: “+” means positive effect of ownership-concentration / bank-presence on performance (or related variables), “-” means negative effect and “ns” means no significant effect. Obviously, in many cases the results were not that simple. By and large we have tried to report the interpretation made by the authors of the study.

** Note: OC stands for ownership concentration measure and BO means bank’s ownership measure.

Table 5: Average cumulative percentage of voting blocks held by different classes of shareholders in Europe

Country	Sample	Control	Individuals or families	Banks	Insurance companies	Investment. funds	Holding and industrial companies	State	Directors
Austria	600	(2)	38.6	5.6	0.0	0.0	33.9	11.7	0.0
Belgium	155	(2)	15.6	0.4	1.0	3.8	37.5	0.3	0.0
France	402	(2)	15.5	16.0	3.5	0.0	34.5	1.0	0.0
Germany	402	(2)	7.4	1.2	0.2	0.0	21.0	0.7	0.0
Italy	(1)	(2)	68.6	7.2	0.0	0.0	24.2	0.0 (4)	0.0
Netherlands	137	(3)	10.8	7.2	2.4	16.1	10.9	1.3	0.0
Spain	394	(2)	21.8	6.6	8.8	0.0	32.6	0.0	0.0
UK	248	(3)	2.4	1.1	4.7	11.0	5.9	0.0	11.3

Notes: (1): numbers for Italy refer to both listed (214) and large non-listed (about 8,000) companies; for other countries only listed companies are taken; (2): both direct and indirect shareholdings are considered; (3): only direct shareholdings. (4): Of the listed Italian companies about 25% are directly and indirectly controlled by state holdings; this is classified in the table under 'Holding and industrial companies'.

Source: Renneboog (2000) and Barca and Becht (2001). The table gives the average cumulative percentage of share blocks (above 5%) held by different types of shareholders. The figures reported are for the year 1996, except for Belgium (1994) and the UK (1993).

Table 6: CEO Remuneration in Germany as compared to the rest of Europe and the USA in 2001/02

Pay Components
(As a percentage of total remuneration)

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

Source: Towers Perrin (2001-2002)

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