WP/08/179

IMF Working Paper

Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?

Jürgen Odenius

INTERNATIONAL MONETARY FUND

 WP/08/179

IMF Working Paper

European Department

Germany's Corporate Governance Reforms: Has the System Become Flexible Enough?

Prepared by Jürgen Odenius

Authorized for distribution by Ashoka Mody

July 2008

Abstract

This article reviews Germany's corporate governance system and the effectiveness of recent reforms. Since the early 1990s far-reaching reforms have complemented the traditional stakeholder system with important elements of the shareholder system. Instead of taking a view on the superiority of either system, this article raises the important question whether these reforms created sufficient flexibility for the market to optimize its corporate governance structure within well established social and legal norms. It concludes that there is scope for enhancing flexibility in three core areas, relating to (i) internal control mechanisms, especially the flexibility of board structures; (ii) self-dealing; and (iii) external control, particularly take-over activity.
10B

JEL Classification Numbers: G30, G38

Keywords: Corporate governance, internal control, self-dealing, external control

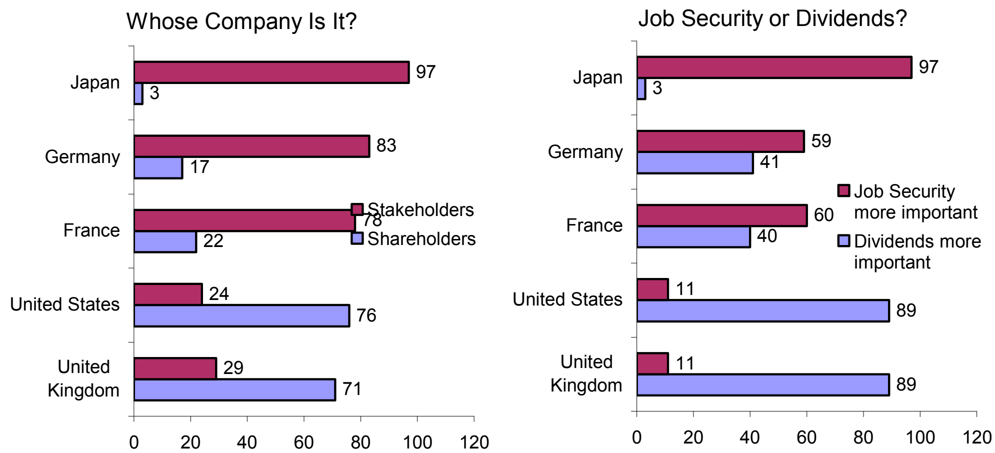
Author's E-Mail Address: jodenius@imf.org

Contents

I. Introduction

Notwithstanding recent convergence, corporate governance systems worldwide remain diverse. Corporate governance in Anglo-Saxon countries aims to maximize shareholder value, while in many other countries, including in Europe and Asia, it continues to target stakeholder value, despite major reforms that strengthened shareholder value considerations. These differences in objectives have a profound impact on managerial behavior. It is instructive to recall Yoshimori's survey[1], although its findings do not reflect the reforms undertaken in many countries since the survey's publication in 1995. Yoshimori highlights that managers in stakeholder corporations prefer to provide job security over dividends to shareholders, indicative of labor's high rank among stakeholders.

Survey of Corporate Managers 1/



Source: Yoshimori (1995).
1/ Number of firms surveyed: Japan, 68; United States, 82; United Kingdom, 78; Germany, 100; France, 50.

The stakeholder- and shareholder-oriented corporate governance systems are deeply rooted in countries' distinct traditions and ownership structures. Ownership tends to be dispersed in Anglo-Saxon countries, while it is relatively concentrated in Europe and parts of Asia. Ownership is commonly viewed as concentrated, if a single shareholder owns at least 20 percent. Enriques and Volpin (2007, p. 119) assemble a range of indicators that illustrate relatively high concentration in Europe, including in Germany. The first three measures in the below text table refer to the 20 largest companies by stock market capitalization, whereas the other two indicators—'median largest voting block' and 'family wealth'—refer to a larger universe of listed companies. It is particularly noteworthy that a single blockholder held at least 57 percent of Germany's companies in 1999, although there has been a marked decline in blockholdings this decade.

[1] As cited in Allen et al (2007).

Ownership Concentration 1/

	Widely held	Family control	Pyramid control	Median largest voting block	Family wealth
France	60%	20%	15%	20%	29%
Germany	50%	10%	20%	57%	21%
Italy	20%	15%	20%	55%	20%
United Kingdom	100%	0%	0%	10%	6%
United States	80%	20%	0%	5% (NYSE) 9% (NASDAQ)	N.A.

Source: Enriques and Volpin (2007).

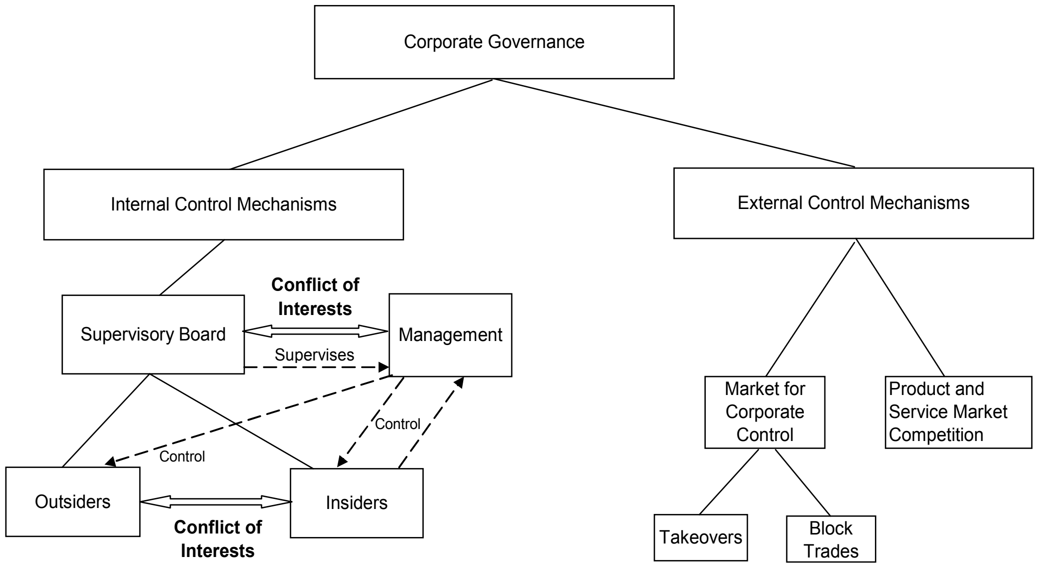
1/ For "Widely held" and "Family control," La Porta, Lopez-de-Silanes, and Shleifer (1999, Table 2); for "Pyramid control," La Porta, Lopez-de-Silanes, and Shleifer (1999, Table 4); for "Median Largest voting block," Barca and Becht (2001); for "Family wealth," Faccio and Lang (2002, Table 10).
Notes: "Widely held" is the fraction of firms with no controlling shareholder among the 20 largest companies by stock market capitalization at the end of 1995. A company has a controlling shareholder if the some of a shareholder's direct and indirect voting rights exceeds 20 percent. Family control is the fraction of the 20 largest companies, where the controlling shareholder exercises control through at least one publicly traded company. "Median largest voting block" is the median size of the largest ultimate voting block for listed industrial companies. "Family wealth" is the percentage of total stock market capitalization controlled by the ten richest families.

The coexistence of different corporate governance systems raises the obvious question of a possible superiority of either system. Unfortunately, neither the theoretical nor the empirical literature provides an unambiguous answer to this question, and this article refrains from attempting to provide a definite view. According to the fundamental theorems of welfare economics, maximizing shareholder wealth is Pareto efficient, provided that markets are complete, competition is perfect, and information is symmetric. However, if any of these premises is violated, as recalled by Allen et al. (2007), the resource allocation resulting from profit maximization is no longer efficient. Moreover, the findings of the empirical literature do not allow to draw definite conclusions.[2]

At the same time, the emerging theoretical literature underpinning stakeholder systems has its own limitations. Allen and Gale (2000) and Allen et al. (2007) illustrate that incorporating the welfare of stakeholders other than shareholders in the welfare maximization problem can resolve the inefficiencies in environments that do not meet the premises of the fundamental welfare theorems. These models, however, are based on strong assumptions, and Tirole (2001) questions the existence of an adequate measure of stakeholder welfare.

Given this theoretical and empirical ambiguity, the design of corporate governance systems should aim to maximize flexibility. Noting that both shareholder and stakeholder systems have their comparative advantage and specific agency risks, Hofstetter (2005, p. 50) concludes that system selection should be left to "markets as final arbitrators," and therefore the "normative challenge is to devise regulatory frameworks within which the open competition between different forms of ownership structures can take place without distortion."

[2] Hofstetter (2005) surveys recent empirical studies, with some concluding that firms with concentrated ownership outperform those with dispersed ownership, and others concluding the opposite.



Despite far-reaching reforms, this article concludes that there is scope to further enhance the flexibility of Germany's corporate governance system. It follows the notion that system selection should be left to markets and reviews Germany's corporate governance reforms in this light. It concludes that several reform waves indeed contributed to fostering competition between the stakeholder- and shareholder- oriented systems, but underscores the need for further flexibility and reforms in three core areas. Following an overview of Germany's corporate governance system and its recent reforms in the next section, the effectiveness of internal control mechanisms, especially the two-tier board structure and mandatory labor representation, are discussed in Section III. Legal mechanisms designed to control self-dealing are reviewed in Section IV. The role of external control mechanisms, especially hostile takeovers, in disciplining ineffective insiders is discussed in Section V. The final section draws policy conclusions.

II. Germany's Corporate Governance System

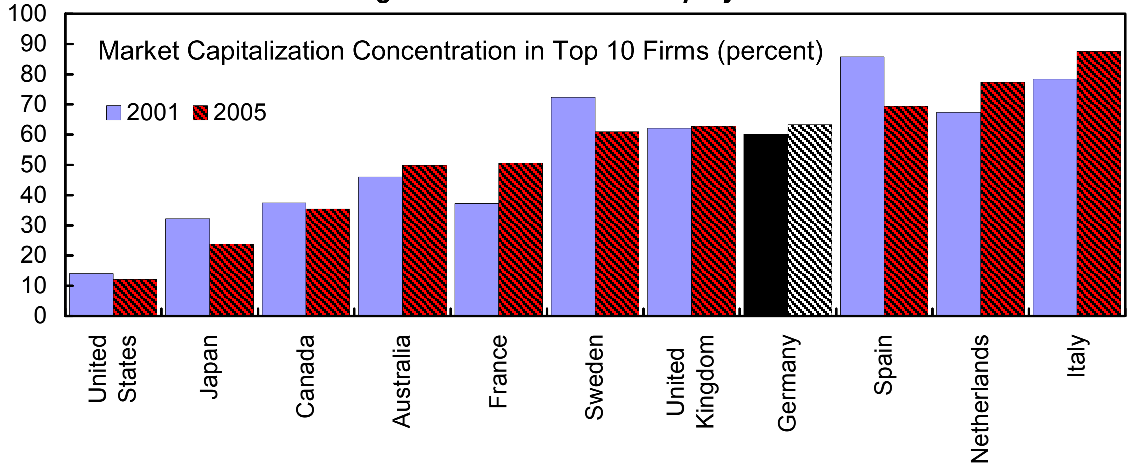
A. The Hallmarks of the System

Concentrated ownership and "insider" control remain prominent characteristics of Germany's corporate governance system (Figure 1), notwithstanding far-reaching reforms. Besides management, insiders include large shareholders, lenders, and labor.[3] The importance of large shareholders is derived from the high degree of ownership concentration, despite the substantial unwinding of cross-holdings catalyzed by changes in capital gains taxation in 2002. Ownership structures remain complex and work against transparency in corporate control. Pyramidal ownership remains prevalent, allowing a dominant shareholder to exercise control of one company through the ownership of another.

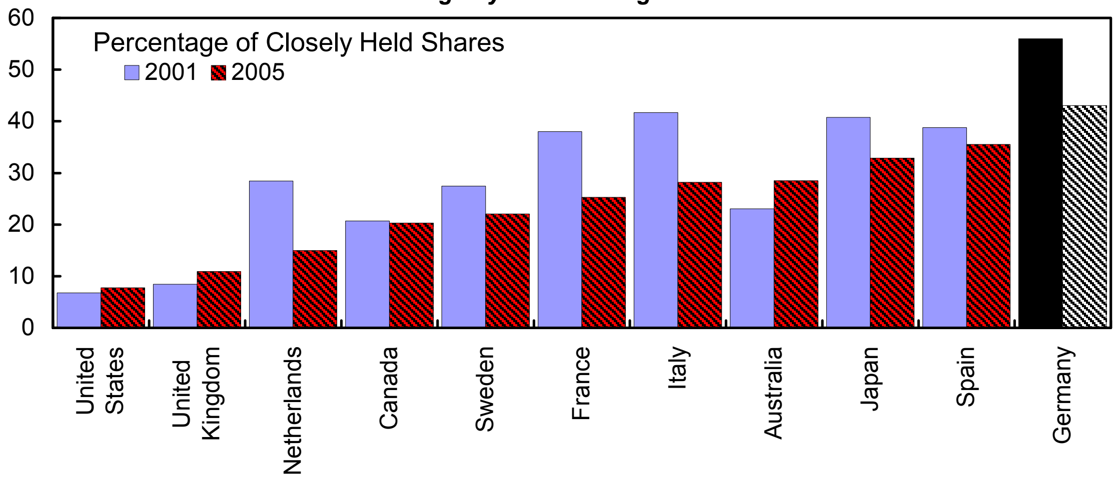
[3] See Schmidt (2004).

Figure 1. Equity Market Characteristics

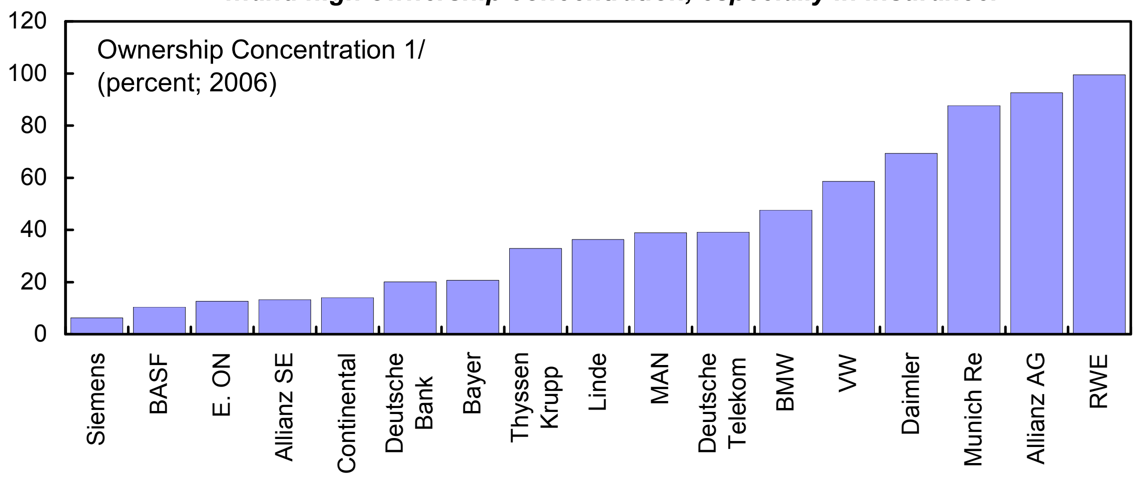
Large firms dominate the equity market...



…with shareholdings by insiders larger than in other countries...



…and high ownership concentration, especially in insurance.



Sources: World Bank Financial Sector Development Indicators; Hoppenstedt; and IMF staff calculations.

1/ Defined as shares issued minus dispersed shareholdings.

The elevated role of lenders is a reflection of the continued heavy, albeit declining, reliance on bank financing over capital market financing. Finally, labor representation is mandated by law and is more pronounced than in most other European countries.

These specific features add to the difficulties in achieving corporate governance objectives. The divergence of management's objectives from those of owners is a well-established phenomenon in the literature. Addressing this innate conflict of interest is the core task of any effective corporate governance system. [4] A closely related issue is the problem of self-dealing: asset-diverting behavior on the part of insiders to the detriment of outsiders, typically minority shareholders. Managerial fraud at Adelphia, Paramalat, and Tyco, to name only a few of this decade's high-profile corporate scandals, serves to underscore the potential damage from such behavior. High ownership concentration and managerial control by insiders raise the risk of such behavior.

A proper resolution of these conflicts of interest is of considerable importance for long-term economic prospects, not only in Germany. Competition in product, service, and capital markets continues to intensify, given the forces of globalization, not only in terms of price but also regarding the suitability of legal, regulatory, and institutional frameworks. According to OECD (2004, p. 30), corporate governance frameworks exert "key importance to overall economic outcomes" and "promote transparent and efficient markets." By affording companies the requisite flexibility, an effective framework helps to enhance productivity, the creation of value added, and, ultimately, the efficiency of the allocation of resources.

B. Corporate Governance Reform: An Overview

Corporate governance reforms were set in motion in the early 1990s.[5] Broadly speaking, these reforms served the dual objective of (i) improving the functioning of the traditional insider-controlled corporate governance structure, while (ii) fostering capital market development. Noack and Zetzsche (2005, p. 1039) note that "…recent reforms did not strive for a *dominant* role of a market-based system of corporate control" and pursued a "hybrid system," with corporate governance intended to rely on both insiders and outsiders.

- A series of reforms established basic institutions and regulations to foster capital market development. These reforms included the prohibition of insider trading (1994), the establishment of the Federal Securities Supervisory Office (1995),[6] the mandatory disclosure of stakes that result in substantial voting rights (1995),[7] the

[4] Adam Smith 1776 discusses the benefits from separation of ownership and control, noting the potential for conflict of interest inherent to this separation.

[5] Seibert (2002) provides a comprehensive overview of reforms and their motivation.

[6] Integrated into the Bundesanstalt für Finanzdienstleistungsaufsicht in 2002.

[7] The Securities Trading Act mandates disclosure of stakes resulting in voting rights above 5, 10, 25, 50, and 75 percent.

1998 Antitrust Act, and the usage of International Accounting Standards or US Generally Accepted Accounting Principles by parent companies (1998).[8]

- In parallel, additional reforms aimed to enhance the functioning of the existing corporate governance structure. A milestone among these was the 1998 Law for Reinforcement of Control and Transparency (KonTraG), which aimed to enhance control by the supervisory board (SB) over the management board (MB). The KonTraG also phased out voting caps and shares with multiple voting rights, typically held by insiders to buttress their corporate control.

Capital market reforms intensified this decade amid efforts to bolster investor confidence and a series of European Union (EU) initiatives. Nowak (2004, p.437) notes: "A number of scandals involving misleading disclosure practices, insider trading, and, in some cases, outright fraud…" served to undermine investor confidence and ultimately led to the closure in 2003 of the Neuer Market, the exchange listing "new economy" companies. In an attempt to restore confidence, the authorities' implemented a Ten-Step Program during 2003–05. At the core of this program were measures to bolster the protection of minority shareholders by enhancing transparency and disclosure, limiting the scope for market manipulation, and raising the liability of management and the SB. EU initiatives provided an umbrella for many of these reforms.

In addition, the German Corporate Governance Code (GCGC) has made major strides in creating a better understanding of Germany's governance framework. The code, first published in 2002 and amended last in 2008, stresses the need for transparency and clarifies shareholder rights in order to promote the trust of investors and capital market development. It enhances investors' understanding of the complex civil law-based corporate governance framework by setting out key principles in one document. Moreover, the code's "comply-or-explain principle" helps to foster transparency by requiring an explanation from those corporations not complying with the provisions of the code.

III. The Effectiveness of Internal Control Mechanisms

The two-tier board structure and extensive labor representation are defining features of Germany's internal control mechanisms. Most other European countries have opted for a single-tier board structure—that is a board that combines management and supervisory responsibilities. Denis and McConnell (2003, p. 8) note that "boards of directors in Europe are most often unitary, as in the United States."[9] Moreover, labor representation is most extensive within the EU-25.[10] Both of these features are closely intertwined, given that labor is represented on the SB. Their effectiveness remains an ongoing subject of political and academic debate.

---

[8] Raising of Equity Relief Act.

[9] However, a two-tier structure is mandatory in some countries other than Germany, including Austria, and optional in others, including France and Finland.

[10] See Tagesschau.de (2007).

Codetermination allocates half of the SB representation in large companies to labor and the law determines the size of the board**.** Germany's system of codetermination entitles labor to half of the SB representation in companies with more than 2,000 employees, and with 1,000 employees in the iron, coal, and steel sector. Mandatory labor representation drops to one-third for companies with employment ranging between 500 and 2,000. The number of SB members ranges from 12 to 21, depending on company capital. In most other EU countries, labor representation is limited to one-third, or fewer board seats.

More than three decades after the broad-based introduction of codetermination, the debate on its effectiveness is far from settled. As discussed in Hauser-Ditz (2002), labor representatives tend to stress the advantages of creating a wider acceptance of managerial decisions and resolving conflicts better, resulting in fewer labor disputes by international standards. In contrast, capital representatives point to the high costs of codetermination and its adverse effects on Germany's desirability as a business location. Based on a relatively large sample, Stettes (2007) finds that two-thirds of management teams in enterprises with parity in labor representation consider codetermination as exerting a negative effect on Germany's desirability as a business location.

The academic evidence on the impact of codetermination on company performance is inconclusive. Both Hauser-Ditz (2002) and Stettes (2007) conclude that econometric studies do not deliver clear lessons from the impact assessments of codetermination on enterprise performance. Hopt and Leyens (2004, p. 8) raise additional concerns. They conclude that "…the dividing lines within the supervisory board are detrimental to efficient cooperation with the management board. The basic problems of size (up to 21 members) and the inability of the German system to impose adequate qualification standards are further consequences of codetermination." Tollet (2005) notes that the absence of executives in the SB limits the information flow, restrains informed debates, and results in "ineffective monitoring."

At the same time, the challenges of globalization and European integration have raised questions as to whether the system remains appropriate. The coalition government recognized these challenges, stating in its 2005 coalition agreement (Bundesregierung, 2005, p. 38) that "…Germany's successful model of co-determination needs to keep pace with global and European challenges." A high-profile commission—consisting of trade unions, employers, and academic experts—was called upon last year to devise reforms; however, deep-rooted disagreements over proposals to scale back labor representation in the SB of large enterprises to one-third ultimately led to the failure of this commission.[11]

A recently introduced European Union-wide framework aims to enhance the flexibility in the corporate governance of public companies. Since late 2004, public companies operating in at least two EU markets can convert their legal form to a Societas Europea (SE). A conversion to SE status offers significant flexibility in terms of internal controls, including by offering the possibility of moving to a one-tier board, smaller board sizes, and reduced labor

[11] See Tagesschau.de (2007).

participation (see Box 1). At the same time, the costs of converting to SE status are deemed relatively minor.

Box 1. The Societas Europea—A Step Towards More Flexible Corporate Governance?

After more than three decades of difficult negotiations, a framework establishing the rules for European public companies—referred to by the Latin term Societas Europea (SE)—became law in the EU in late 2004. SE status allows public companies to operate across the EU and avoid the legal and practical constraints arising from the existence of 27 different national legal frameworks.[1] Key aspects include:

Formation. An SE can be formed by merger, formation of a holding company, formation of a joint subsidiary, or conversion of a public limited company previously formed under national law. However, the company needs to be active in at least two EU countries, and the law, therefore, tends to be relevant for larger public companies only.

Governance. Given the different governance structures across the EU, the SE provides a choice between single- and two-tier board structures. This provides the flexibility of moving to a single-tier board, including for those SEs registered in Germany. The law does not prescribe the size of the boards, and thus leaves room for moving away from the large SBs mandated by law in Germany.[2]

Labor participation. It is the outcome of negotiations in a special committee comprising management and labor representatives from all countries of operations of the supranational company, including those countries with a tradition of limited labor participation. However, should an agreement not be reached, labor representation, by default, will be in accordance with the most labor-friendly standards prevailing in any of the countries of operation. If, as result of a merger with a foreign company, the share of German labor is less than 25 percent of company-wide labor, the special committee has the power to lower labor representation to below German standards by simple majority vote. A two-thirds majority is required if the share of German labor is higher than 25 percent. Appreciable differences in labor participation across the EU may, therefore, result in labor participation at the SE level that falls short of codetermination requirements.

[1]See Tollet (2005).
[2]See Kallmeyer (2003).

Although it is premature to draw firm conclusions, early indications suggest the improved flexibility created by SE statute is spurring competition between different governance structures**.** Companies are using the SE statute to enhance the flexibility of internal control mechanisms. Until September 2007, 33 of the 94 established European companies that adopted SE status were German. [12] Among eight prominent companies—with employment of at least 2,000—three adopted a one-tier board and granted information rights only but no

[12] However, these 33 companies comprise shelf companies and several companies for which information is not readily available; see ETUI-REHS (2007).

participation rights to labor. Among the five companies that maintained two-tier boards and codetermination, all of them chose small SBs, with a size well below the maximum of 21 members. The conversion of Allianz—a case closely followed given the company's reach—illustrates these findings. Management made it explicit that the conversion was in part motivated by its desire to streamline its governance structure in order to reduce costs, enhance flexibility and strengthen international competitiveness. In agreement with labor, the size of the Allianz SB was halved to 12 members. These developments suggest that the SE reforms, to once more quote Hoffensted (2005), have left "markets as final arbitrators."

German Societas Europea: Changes in Board Structure

SE	Employment	Board Structure	Labor Participation in Supervisory Board	Labor Participation Rights
Allianz	177,000	Two-tier	6 out of 12	Yes
Conrad Electronic	2,314	One-tier	Not applicable	No
Donata Holding	3,922	One-tier	Not applicable	No
Fresenius	100,000	Two-tier	6 out of 12	Yes
MAN Diesel	6,625	Two-tier	5 out of 10	Yes
PCC	3,756	One-tier	Not applicable	No
Porsche Holding	11,500	Two-tier	6 out of 12	Yes
Surteco	2,109	Two-tier	3 out of 9	Yes

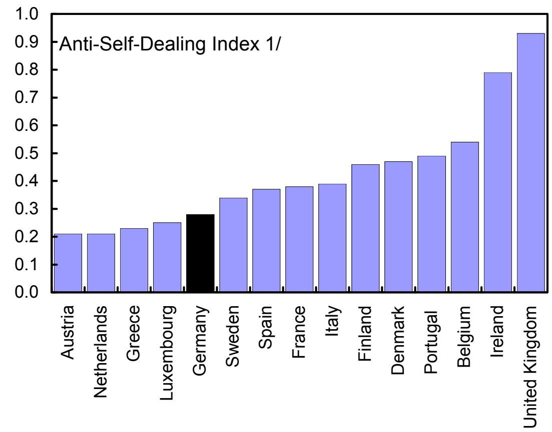
Source: ETUI-REHS.

EU initiatives are under way to supplement the SE statute with a similar statute for private companies. As part of its 2003 Action Plan, the EU undertook a feasibility study with respect to the creation of a European Private Company (EPC). Baums (2007) expects that first proposals on the EPC may be presented as early as 2008. However, just as in the protracted negotiations regarding the SE, the issue of labor participation and codetermination may once more prove difficult.

The corporate governance framework would benefit from broader flexibility. The companies that converted to SE status revealed their preference for more flexibility, especially in regard to the size of the SB and the extent of labor participation. This flexibility, however, is limited to public, international companies. In order to allow a broader market test of the existing corporate governance framework the flexibility afforded by the SE statute should be provided to all companies.

IV. CONFLICT OF INTEREST: SELF-DEALING

High ownership concentration has long been recognized as giving rise to material conflicts of interest. The agency problem under concentrated ownership is fundamentally different from that under dispersed ownership. While the primary agency problem for dispersed shareholders is to control powerful management, an additional agency problem arises under concentrated ownership, namely, the control of dominant shareholders and their influence over management. Such a constellation is well known to provide scope for self-dealing, that is asset-diverting transactions. These involve the corporation and its insiders, including often its dominant shareholder who may also be part of management. They are designed to generate private benefits for the insider at the expense of minority shareholders. Notorious examples include above-market compensation for management, asset sales by the corporation at below-market prices, or a dilution of minority stock holdings through mergers.



1/ Lower index value indicates lower legal barriers to self-dealing.

According to the law, the control of these conflicts relies in large part on the SB. Given the nature of the agency problem, German corporate law (Konzernrecht) focuses on regulating conflicts between minority and large shareholders. Consistent with the two-tier board structure, control relies on the SB, and the law requires SB approval for specified self-dealing transactions.

However, legal barriers to self-dealing are found to be relatively low in Germany. In a widely cited comparative study, Djankov, La Porta, Lopez de Silanes, and Shleifer (2005) find that legal protection against self-dealing is low by EU standards.[13] These empirical results are consistent with suggestions in the literature that the SB is ineffective in controlling self-dealing, given the incentives faced by its major constituent groups. Noting banks' and labor's prominent role in the SB, Enriques (2000) states that "as fixed claimants, in fact, banks and employees will not be particularly concerned with managers' diversion of assets, as long as there is no risk of the company defaulting." Baums and Scott (2005) question whether SB members, even if disinterested in relevant transactions, have the requisite independence to effectively control self-dealing, notwithstanding legal provisions intended to guarantee their independence. In cases of concentrated ownership, large shareholders are seen dominating both the MB and SB. In cases of dispersed ownership, management is seen as exercising control over the SB. In either case, the authors see mutual "back-scratching" as diluting SB effectiveness.

[13] The methodology underlying these findings, however, is not uncontroversial, see Conac et al (2007).

Involving shareholders could strengthen control over self-dealing. Enriques and Volpin (2007) call for improved regulation of self-dealing, based on their assessment that little has been done to improve the law in this matter. Both Enriques (2000) and Baums and Scott (2005) note that shareholder involvement in the approval of self-dealing transactions is absent under German law. While an annual report detailing control relations must be produced in order to ensure that transactions take place at arm's-length prices, this report is exclusively shared with the SB. However, given the limited effectiveness of the SB, existing laws to deter self-dealing are unlikely to be enforced.[14] To address this enforcement issue, the annual report detailing control relations should be distributed to all shareholders, including minority shareholders.[15] Such a requirement would enhance transparency and allow shareholders to better protect their interests by stepping up pressure to curtail self-dealing or, in the final consequence, by selling their stakes. Either way, the information about self-dealing transactions would become subject to a broader market test.

V. External Control Mechanisms: The Market for Corporate Control

External control is an important, complementary mechanism to internal control. Grossman and Hart provide a theoretical basis for the takeover market's disciplining function in their groundbreaking 1980 article. A potential failure of internal control mechanisms would eventually cause a substantial deviation of a firm's market value from its potential, thereby inviting possible takeover bids. While the literature provides little empirical evidence that the market for corporate control effectively carries out this function, Goergen, Manjon, and Renneboog (2004) nevertheless conclude that the "existence of an active market for corporate control is material."

Germany's market for corporate control is considered small by international standards.[16] The market was largely dormant prior to the hostile takeover of Mannesmann—a traditional German manufacturer turned into a mobile phone operator—by the British Vodafone in 2000.[17] The dominance of large shareholders is widely seen as a major reason for the virtual absence of takeovers until this decade. In addition, Goergen, Manjon, and Renneboog (2004) attribute this outcome to the prevalence of pyramidal structures and extensive, albeit declining, cross-shareholdings. Schmid and Wahrenburg (2004, p.278) also point to the two-board structure and codetermination as a further obstacle, stating: "To an unwelcome bidder, attaining control over the supervisory board might prove a challenging task. For one thing, shareholders have no power of removing labor representatives."

---

[14] German criminal law imposes sanctions on directors for self-dealing.

[15] The introduction of International Financial Reporting Standards, however, may improve transparency and information flow.

[16] The literature discusses the role of block trades as a potential for corporate control; for an overview, see Goergen et al (2006).

[17] See Schmid and Wahrenburg 2004.

In response to the arrival of hostile takeovers, parliament adopted a legal framework earlier this decade. The 2001 takeover law (WpÜG) replaced the earlier voluntary takeover code and combines elements of legislation enacted in the U.K. and U.S.A. starting in the 1960s. Just like the U.K. framework, the German takeover law aims at protecting minority shareholders and stipulates a strict mandatory bid requirement. This requirement aims to provide minority shareholders with an acceptable exit option, as takeovers fundamentally change company policy. More precisely, in transactions that exceed 30 percent of voting rights, the law requires a mandatory offer by the acquiring party to all shareholders. The mandatory bid requirement tends to raise the costs of takeovers and, therefore, is also seen as benefiting management.

In contrast to U.K. law, German law allows for defensive measures to stave off takeovers bids—consistent with the EU framework. A further important feature of German takeover law is how it resolves the question whether management is granted the right to interfere with hostile takeover bids through defensive measures, or whether management is obliged to abstain from intervention and retain its so-called neutrality. German takeover legislation grants management the right to interfere with takeover attempts, allowing four different types of defensive measures, although not all are considered effective. While some of these measures require shareholder approval, the MB with the approval of the SB may also use specified defensive measures without shareholder approval, including the purchase or sale of important assets.[18] The 2001 law, however, is consistent with the EU Takeover Directive that came into force in 2004, after some 30 years of protracted negotiations.

Creating a level playing field in the market for corporate control requires restoring management neutrality. There is broad-based agreement in the literature that the takeover law falls short of creating a level playing field and, therefore, it does not leave markets as final arbitrators. Both the mandatory bid requirement and the appreciable scope granted to management to engage in defensive measures are seen as raising the costs of a takeover. Against this background, Baum (2006) concludes: "Together with Austria, the German takeover regime is probably the most intensely regulated takeover law worldwide." In the words of Baums and Scott (2005, p. 22) the decision to give the MB power to use defensive measures without SB approval "…has entrusted the wrong people with the decision whether the market for corporate control should operate." Enhancing the effectiveness of the market for external control, and especially involuntary takeovers, could serve as a major step toward enhancing corporate governance, especially given the inherent weakness of internal control mechanisms.

[18] Unlike in the US, the use of poison pills is illegal and, in case of a takeover attempt, management is not allowed to extend rights to existing shareholder to acquire stock at a deep discount. However, Gordon (2002) suggests that the absence of poison pills may inflict more damage on shareholders than their use, since firms may instead resort to irreversible, value-decreasing measures.

VI. Conclusions

Germany's traditionally insider-dominated corporate governance system has undergone substantial reforms since the early 1990s. These resulted in a "hybrid system," complementing the traditional stakeholder-oriented system with important elements of the shareholder-oriented system. As a result, the control of outsiders, especially minority shareholders, has increased and insider control has been reined in. Moreover, these reforms fostered flexibility and instilled some competition between corporate governance structures, especially for public companies operating under the SE statute.

Nevertheless, consideration should be given to further raising the system's flexibility and broadening the scope for market-based decision-making in three core areas:

- First, internal control mechanisms would gain effectiveness from a more extensive introduction of flexibility. Germany's legally mandated two-tier board structure, its large SBs, and high labor representation remain a topic of continued political and academic controversy. At the same time, early experiences with the introduction of the SEs illustrate that public companies are "voting by their feet," using the SE statute to render their corporate governance structures more flexible. Broadly speaking, they are reducing the size of their SBs and, at times, trimming labor involvement. Given this evidence, consideration should be given to broadening the market test of the corporate governance framework—in a first step—by extending the flexibility afforded under the SE statute to all companies.

- Second, the problem of self-dealing remains a material challenge to effective internal control—aggravated by high ownership concentration. The principal-agent problem under concentrated ownership is fundamentally different from that under dispersed ownership. While the primary agency problem for dispersed shareholders is to control powerful management, an additional agency problem arises under concentrated ownership, namely the control of dominant shareholders and their influence over management. Such a constellation is well known to provide scope for self-dealing, that is, asset-diverting transactions. Consistent with Germany's two-tier board structure, the control of these transactions primarily relies on the SB. However, in line with the literature, this article finds that the SB's effectiveness in controlling self-dealing is limited. Improving control requires broadening the involvement of shareholders in the review and approval of self-dealing transactions. As a first step, the annual report detailing self-dealing transactions, currently made available to the SB, should be made available to all shareholders. This would allow shareholders to better protect their interests by stepping up pressure to curtail self-dealing or, in the final consequence, by selling their stakes. Either way, the information about self-dealing transactions would become subject to a broader market test.

- Finally, given these inherent weaknesses of internal control, external control needs to be bolstered. The market for corporate control continues to be stifled by legal barriers, including measures allowing incumbent management to take defensive action to stave off involuntary takeover bids. In light of pronounced weaknesses in internal control, the effectiveness of external control needs to be strengthened to raise the efficiency of corporate and, thereby, economy-wide resource allocation. Striking defensive measures from the German takeover law and empowering markets could be a major step in this direction.

References

Allen, Franklin, and Douglas Gale, 2000, "Comparing Financial Systems," (Cambridge, Massachusetts: MIT Press.)

———, Elena Carletti, and Robert Marquez, 2007, "Stakeholder Capitalism, Corporate Governance and Firm Value," European Corporate Governance Institute—Finance Working Paper No. 190/2007. (Brussels: European Corporate Governance Institute).

Baum, Harald, 2006, "Takeover Law in the EU and Germany: Comparative Analysis of a Regulatory Model", University of Tokyo Journal of Law and Politics, Vol. 3, (Spring), pp.60–72.

Baums, Theodor, and Kenneth E. Scott, 2005, "Taking Shareholder Protections Seriously? Corporate Governance in the United States and Germany", "European Corporate Governance Institute" – Law Working Paper No. 17/2003 (Brussels: European Corporate Governance Institute).

———, 2007, "European Company Law beyond the 2003 Action Plan", European Corporate Governance Institute – Law Working Paper No. 81/2007. (Brussels: European Corporate Governance Institute).

Bundesregierung, 2005, Working Together for Germany – with Courage and Compassion. Available via Internet: http://www.bundesregierung.de/Webs/Breg/EN/Federal-Government/CoalitionAgreement/

Conac, Pierre-Henrie, Luca Enriques, and Martin Gelter, 2007, "Constraining Dominant Shareholders' Self Dealing: The Legal Framework in France, Germany, and Italy," European Corporate Governance Institute—Law Working Paper No. 88/2007. (Brussels: European Corporate Governance Institute).

Denis, Diane K., and John J. McConnell, 2003, "International Corporate Governance," European Corporate Governance Institute – Finance Working Paper No. 05/2003. (Brussels: European Corporate Governance Institute).

Djankovic, Simeon, Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 2005, "The Law and Economics of Self-Dealing," NBER Working Paper No. 11883 (Cambridge Massachusetts:National Bureau of Economic Research).

Enriques, Luca, 2000, "The Law on Corporate Directors' Self-Dealing: A Comparative Analysis," *International & Comparative Corporate Law Journal*, Vol. 2, pp. 297–314.

———, and Paolo Volpin, 2007 "Corporate Governance Reforms in Continental Europe," *Journal of Economic Perspectives*, Vol. 21 No.1, pp. 117–40.

ETUI-REHS, 2007, SEEurope SE Factsheets, September.Available via Internet: http://www.workerparticipation.eu/about_wp/what_s_new/news_on_european_companies_se.

German Council of Economic Experts, 2007, *The Gains Must Not Be Squandered, Annual Report 2007/08*. Available via Internet: http://www.sachverstaendigenrat-wirtschaft.de/en/gutacht/.

Goergen, Marc, Miguel C. Manjon, and Luc Renneboog, 2004, "Recent Developments in German Corporate Finance," European Corporate Governance Institute—Finance Working Paper No. 041/2004. (Brussels: European Corporate Governance Institute).

Gordon, Jeffrey N., "An American Perspective on the New German Anti-takeover Law," ECGI – Law Working Paper No. 02/2002 (Brussels: European Corporate Governance Institute); and Columbia Law and Economics Working Paper No. 209 (New York: Columbia Law School).

Grossman, S.J, and O. Hart, 1980, "Takeover Bids, the Free–Rider Problem, and the Theory of the Corporation," *Bell Journal of Economics*, Vol. 11 (Spring) pp. 42–64.

Hauser-Ditz, Axel, 2002, "Involving the Workers—Does It Add to Costs or Improve Performance?" in *Mitbestimmung International Edition 2002*, (Düsseldorf: Hans Böckler Foundation).

Hofstetter, Karl, 2005, "One Size Does Not Fit All: Corporate Governance for 'Controlled Companies,'" revised draft, Harvard Law School. Available at SSRN: http://ssrn.com/abstract=802705

Hopt, Klaus J., and Patrick C. Leyens, 2004, "Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy," European Corporate Governance Institute – Law Working Paper No. 18/2004 (Brussels: European Corporate Governance Institute).

Kallmeyer, Harald, 2003, "Die Societas Europea—Innovation für deutsche Unternehmen oder praxisuntauglicher Kompromiss?" in Die Europa AG—Eine Perspektive für deutsche Unternehmen? Dokumentation des Seminars vom 31. Oktober 2002, Studien des Deutsche Aktieninstituts, Heft 21, März.

Noack, Ulrich, and Dirk A. Zetzsche, 2005, "Corporate Reform in Germany: The Second Decade," European Business Law Review, Vol. 16 No. 5, pp. 1033–64.

Nowak, Eric, 2004, "Investor Protection and Capital Market Regulation," in *The German Financial System*, ed. by Jan Pieter Krahnen and Reinhard H. Schmidt, (Oxford and New York: Oxford University Press).

Organization for Economic Co-operation and Development, 2004, *OECD Principles of Corporate Governance*: 2004 (Paris: OECD).

Schmid, Frank A., and Mark Wahrenburg, 2004, “Mergers and Acquisitions in Germany: Social Setting and Regulatory Framework,” in *The German Financial System*, ed. by Jan Pieter Krahnen and Reinhard H. Schmidt. (Oxford and New York: Oxford University Press).

Schmidt, Reinhard H., 2004, “Corporate Governance in Germany: An Economic Perspective,” in *The German Financial System*, ed. by Jan Pieter Krahnen and Reinhard H. Schmidt. (Oxford and New York: Oxford University Press).

Seibert, Ulrich, 2002, “Aktienrechtsreform in Permanenz?,” in *Die Aktiengesellschaft, Heft 8/2002, 47. Jahrgang.*

Smith, Adam, 1904, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. by Edwin Cannan (London: Methuen and Co, Ltd, 5th ed.).

Stettes, Oliver, 2007, “Die Arbeitnehmermitbestimmung im Aufsichtsrat—Ergebnisse einer Unternehmungsbefragung,” IW Trends—Vierteljahresschrift zur empirischen Wirtschaftsforschung aus dem Institut der Deutschen Wirtschaft Köln, 34. Jahrgang, Heft 1/2007.

Tagesschau.de, 2007, *Keine Einigung auf Reform der Mitbestimmung,* Available via the Internet: http://www.tagesschau.de/inland/meldung90100.html.

Taylor, Robert, 2006, “Worker Participation at Board Level—Tour D’Horizon Across the EU-15 Countries and Norway,” in *The European Company—Prospects for Worker Board-Level Participation in the Enlarged EU*, ed. by Norbert Kluge and Michael Stollt. (Brussels: Social Development Agency ASBL (SDA) and European Trade Union Institute for Research, Education and Health and Safety).

Tirole, Jean, 2001, “Corporate Governance,” *Econometrica*, Vol. 69, pp. 1–35.

Tollet, Nicolas, 2005, “The Societas Europea: Europeanization via Americanization of Corporate Law. Corporate Governance: Only One Model?” Global Jurist Topics, Vol. 5 No. 2.

Yoshimori, Masaru, 1995, “Whose Company Is It? The Concept of the Corporation in Japan and the West,” *Long Range Planning,* Vol. 28, No. 4, pp. 33–44.