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An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union, 1990-2000

Law Working Paper N° 006/2003
February 2003

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Abstract

The corporate convergence debate is usually presented in terms of competing efficiency and political claims. Convergence optimists assert that an economic logic will promote convergence on the most efficient form of economic organization, usually taken to be the public corporation governed under rules designed to maximize shareholder value. Convergence skeptics counterclaim that organizational diversity is possible, even probable, because of path dependent development of institutional complementarities whose abandonment is likely to be inefficient. The skeptics also assert that existing elites will use their political and economic advantages to block reform; the optimists counterclaim that the spread of shareholding will reshape politics. This article tries to move the corporate governance convergence debate away from these familiar (and important) arguments towards an international relations perspective. This move has two implications. First, the pace of convergence in corporate governance is understood to depend crucially on a country's, or, perhaps more importantly, on a group of countries' commitment to a project of transnational economic and political integration. Second, this transnational project may be best advanced by the spread of diffusely-held public firms on the Anglo-American model, because such ownership structures facilitate the contestability of corporate control, which, crucially, helps curb economic nationalism. In particular, such contestability may be necessary for state-level acquiescence to crossborder merger activity, which creates economic organizations that are special conduits for the transnational flow of capital, good, services, and people, and, no less, a transnational attitude. So both as a positive and normative matter, strong form convergence responds to a particular sort of political aspiration, not necessarily efficiency objectives conventionally understood. Examples drawn from the evolution of German shareholder capitalism during the 1990s in the context of the European Union project will illustrate the argument.

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The corporate convergence debate is usually presented in terms of competing efficiency and political claims. Convergence optimists assert that an economic logic will promote convergence on the most efficient form of economic organization, usually taken to be the public corporation governed under rules designed to maximize shareholder value. Convergence skeptics counterclaim that organizational diversity is possible, even probable, because of path dependent development of institutional complementarities whose abandonment is likely to be inefficient. The skeptics also assert that existing elites will use their political and economic advantages to block reform; the optimists counterclaim that the spread of shareholding will reshape politics.

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Keywords: corporate governance, comparative corporate goverance, takeover bid, takeover law

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Introduction

This article tries to move the corporate governance convergence debate away from the familiar arguments over efficiency and politics towards what I will call the international relations perspective. This move has two implications. First, the pace of convergence in corporate governance is understood to depend crucially on a country's, or, perhaps more importantly, on a group of countries' commitment to a project of transnational economic and political integration. Second, this transnational project may be best advanced by the spread of diffusely-held public firms on the Anglo-American model, because such ownership structures facilitate the contestability of control, which helps curb economic nationalism. So both as a positive and normative matter, we may understand such "strong form" convergence as responding to a particular sort of political aspiration, not just efficiency grounds conventionally understood. Examples drawn from the evolution of German shareholder capitalism during the 1990s in the context of the European Union project will illustrate the argument.

The corporate convergence debate is usually presented in terms of competing efficiency and political claims. Convergence optimists assert that an economic logic will promote convergence on the most efficient form of economic organization, usually taken to be the public corporation governed under rules designed to maximize shareholder value.[1] Convergence skeptics counterclaim that organizational diversity is possible, even probable, because of path dependent development of institutional complementarities whose abandonment is likely to be inefficient.[2] The skeptics also assert that existing

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[1] See, e.g., Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439 (2000).

[2] See, e.g., Lucian Bebchuk & Mark. J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999). In the German context, compare, e.g., Erik Lehmann & Járgen Weigand, Does the Governed Corporation Perform Better? Governance Structure and Corporate Performance in Germany, 4 Eur. Fin. Rev 157 (2000) (concentrated ownership can be suboptimal) with Jens KÅke, Corporate Governance, Market Discipline, and Productivity Growth, (Center for Eur. Econ. Res. WP) (Octoberr 2001) (available on SSRN) (concentrated ownership enhances productivity growth). The general theoretical case is contestable and the

elites will use their political and economic advantages to block reform; the optimists counterclaim that the spread of shareholding will reshape politics. These considerations are obviously important, yet the debate thus far omits a crucial variable: national choices over strategies of corporate governance convergence (or divergence) may be based on their effects in integrating (or not) the country within transnational systems of economic and political life. These choices are usually the product of elite opinion with differing degrees of democratic ratification. In other words, convergence may proceed or be hindered irrespective of efficiency considerations at the corporate level, or even irrespective of conventional domestic politics, depending on the role that convergence plays in an explicitly state level transnational drama.

On this view shareholder capitalism, which means to reference the Anglo-American model of public ownership and strong equity markets, is particularly well-suited as the optimal convergence form not necessarily because of organizational or productive efficiencies but because it offers the best hope for the control of economic nationalism, the tendency to which is a major obstacle to the transnational integration project. That is, the longterm willingness of states to pursue transnational integration depends upon the control of economic nationalism because no state wants to participate in a regime of potential systematic national disadvantage. The construction of international trading regimes such as the WTO on the basis of principles of mutuality and reciprocity bears out this point. As the transnational project becomes more advanced, the problem of economic nationalism arises at the level of the firm. Shareholder capitalism helps police economic nationalism by reducing the role of the state in economic decisionmaking, by decentralizing such decisions to the level of the firm, and by subjecting such firm-level decisions to a neutral, transnational standard of the share price. In particular, shareholder capitalism opens up the contestability of corporate control.

The contestability of control is particularly important in relation to cross-border combinations, which are crucial to the integration project. Cross-border mergers can create entities of optimal size and scope for transnational enterprise. But apart from such efficiencies, cross-border mergers can build businesses that are particularly good conduits for the transnational free flow of capital, good, services, and people, and, no less, a transnational attitude. Nevertheless cross-border mergers entail a special sort of risk. The government of the state of the target's organization will be legitimately concerned that investment and divestment decisions will be influenced by economic nationalism benefitting the state of the acquiror's organization. Will the acquiror show home country bias in either facilities location decisions or in layoffs or downsizings? Another way to put the question: Will the minister insist that the new plant be located in Lyon rather than Düsseldorf?

What best protects against the potential for such economic nationalism is the mutual vulnerability to takeover bids by both putative acquiror and target that is the hallmark of shareholder capitalism. To see this, assume the acquiror begins to show significant home country bias. This inefficiency in the acquiror's operations will lead to a fall off in shareholder value that would create an opportunity for a control entrepreneur, if the acquiror was also exposed to the potential for a hostile bid. In other words, exposure of firms to the threat of hostile takeover on roughly equal footing will help constrain economic nationalism while permitting very valuable cross-border merger activity. This is not to say that mutual exposure to takeovers is a complete solution to the economic nationalism problem. A government could make payments or provide subsidies to cover the costs to the firm of economic nationalism and thus protect shareholder value. But such payments might be fiscally infeasible, they could be matched by a competing government, and, of course, such payments could be forbidden by the transnational regime. Takeover vulnerability makes it harder for a government to promote economic nationalism simply by

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empirical evidence is mixed. The argument and the evidence are canvassed in Brian R. Cheffins, Corporate Law and Ownership Structure: A Darwinian Link? (Cambridge Univ. WP) (June 2002)(available on SSRN).

imposing the costs on shareholders.

One implication of this view is the importance of what might be called "strong form" convergence on the shareholder capitalism model, that is, the spread of public firms with relatively diffuse ownership. The control of economic nationalism requires more than the simple privatization of former state owned enterprise; even for firms with a long history of public ownership, concentrated ownership may conduce to economic nationalism.[5] Some have argued that concentrated ownership should cut the other way: that governments will have less sway over the managers of private firms or public firms with concentrated ownership because shareholders in such firms are better able to police managerial behavior and can better resist government pressure. In my view, the behind-the-scenes deal making between the government and concentrated or private owners – the national elite – in the service of economic nationalism is, over the long term, more likely to resist solution than such pressure brought against the managers of truly public firms. This is because government compensation for the cost of economic nationalism will be harder to observe and police for concentrated or private ownership firms than for public firms. For example, the government can compensate a controlling shareholder through a transaction or a concession involving an unrelated business; it would be impossible to compensate all shareholders in a public firm in the same way. Thus managers of a diffusely-owned firm who accede to a costly government request will face public equity market response and will be unprotected by concentrated owners. In a regime of contestable control, this should constrain managerial behavior. Finally, the evolving international share ownership of diffusely-owned public firms can, over time, make economic nationalism seem more anachronistic. In these respects, the transnational integration objective generates a case for diffuse ownership that does not necessarily follow from efficiency-based arguments for convergence. Diffusely-owned firms may not be more efficient (indeed, to the contrary) but the contestability of control may more effectively restrain economic nationalism.[6]

This article develops these arguments in the context of the evolution of German shareholder capitalism in the 1990s in the context of the EU project of transnational economic and political intergration. First I present two examples in which this transnational project did in fact affect the pace of convergence. Then I show how EU integrationists have understood the problem of limited contestability and are trying to fashion rules whose ultimate effect would promote migration away from concentrated ownership toward diffuse ownership structures – in other words, how the transnational project is bound up with strong form convergence.

The first example is the 1996 privatization of Deutsche Telekom, triggered by the European Union's project of building a continental telecommunications system. The Telekom privatization in turn led the German government, eager to obtain a high price, to promote shareholder capitalism by cultural, market, and legal intervention. So here the state's commitment to a transnational project fostered convergence beyond what could have been expected solely from efficiency considerations and despite the

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[5] For a recent example of government involvement in a privatized firm with cross-border implications, see John Tagliabue, Mobilcom's Fate is in the Hands of the French Cabinet, N.Y.Times, Sept. 12, 2002, p. W1. (French government, as controlling shareholder of France Télécom, must decide on capital infusion needed by German telecommunications firm.); Germany Considers Financial Aid To Keep MobilCom Afloat, WSJ.com, Sept. 13, 2002 (in the midst of election campaign focusing on economic issues, German government is reluctant to see another large company go bankrupt).

[6] This is not to say that efficiency has no role to play. An important motive for cross-border mergers is presumably to attain scale or scope efficiencies. But diffuse share ownership enters the picture not as the necessarily most efficient organizational form but as creating conditions in which economic nationalism is subdued to the point that cross-border mergers become feasible in the international relations sense.

unsettling of the local status quo. .

The second example is the way the economic nationalism by its EU partners in the protection of state champions led Germany to pull back from ratification of the "board neutrality" position of the proposed 13th Company Law Directive on Takeovers. Instead, Germany adopted a takeover law that permits the supervisory board to approve defensive measures without a shareholder vote. This can be understood as a move of "aggressive reciprocity" in the trade negotiation sense – a raising of barriers by Germany with the goal of precipitating a negotiation that will in the end produce lower barriers and a more level playing field.[7] This move, played out in pursuit of transnational integration, will lead away from convergence in the short run and, like many such acts, may produce a degenerate spiraling away from the cooperative outcome and, ultimately, less convergence. In both of these cases, simple economic efficiency and the standard political stories may play a subsidiary role to overarching transnational objectives.[8]

European integrationists came to realize that some of the ratification difficulties of the 13th Directive arose from the non-contestability of control in many ostensibly public European firms. This meant that the condition of mutual vulnerability necessary for the satisfactory control of economic nationalism was absent. In a remarkable report proposing a revised 13th Directive, an group of EU company law experts called for a mechanism by which a hostile bidder could "break through" certain ownership structures or legal barriers and obtain control.[9] On first inspection, these extraordinary, awkward measures are simply substitutes for the contestability that would naturally arise from diffuse, rather than concentrated, public ownership. On further examination, they offer an evolutionary path away from patterns of concentrated ownership toward the diffuse ownership of shareholder capitalism. Yet the

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[7] See Michael J. Trebilcock & Robert Howse, The Regulation of International Trade 7-9 (2d ed. 1999). Although classical trade theory argues that a country is better off with unilateral trade liberalization, it is better off still if its trading partners also liberalize. Reciprocity to achieve this result can take two forms, passive and active. Parties can passively reciprocate by conditioning their entry into a liberalizing regime on liberalizing agreements by their partners, in the hope that recognition of mutual self interest will avoid a non-cooperative outcomes. After entering a regime that is otherwise non-enforceable, parties can also engage in aggressive reciprocity: for example, by the withdrawal of previous concessions or the imposition of new restrictions in the event of the breach of commitments by a counterparty. In the corporate governance context, if a country observes that a counterparty is shaping a governance system that facilitates economic nationalism, it may constrain its own version of shareholder capitalism in retaliation. The goal of such aggressive reciprocity is to reinforce the "level playing field" that shareholder capitalism serves, and such a nonconvergent move should be so understood. Retaliation can, of course, fail as a strategy. Not only may the counterparty persist, but it may respond with counter-retaliatory measures that move the parties even further from the convergence path.

[8] Another example where the push for transnational integration may prevail over efficiency grounds is in competition policy. For example, the European Court of Justice has construed Article 81 of the Treaty of Rome to forbid country-based exclusive distributorships on the ground that these arrangements maintain barriers between states – despite the arguments (accepted now in the US as common wisdom) that such vertical restraints generally strengthen competition between producers and thus enhance consumer welfare. See, e.g., Consten and Grundig v. Commission, Cases 56, 58/64, [1966] ECR 299. The Court also ruled on similar grounds against an importer which sold unripened bananas to its distributor in Ireland (where the fruit was not popular) at a significantly lower price than distributors for other EU countries, because "[t]hese discriminatory prices, which varied according to the circumstances of the Member States, were just so many obstacle to the free movement of goods." United Brands v. Commission, Case 27/76, [1978]ECR 207 (¶ 232). Such price discrimination, especially by non-monopolist, is not generally regarded as anticompetitive. Ed Iacobucci suggested this analogy.

[9]Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Jan 10, 2002.

origins and explanation for this far-reaching convergence agenda are to be found in the transnational integration project, not in the conventional arguments about efficiency.

I. The Privatization of Deutsche Telekom and the Fostering of Shareholder Capitalism

Privatization of state-owned enterprises (SOE's) swept the world in the 1980s and 1990s.[10] The movement was stimulated by the privatization program of Thacherite Great Britain, which was deemed a great, even surprising, economic success. Highlighted by the initial public offering of British Telecom in November 1984, the program reduced the role of SOE's in the UK economy from more than 10 percent of GDP in 1980 to virtually nothing by the mid-1990s.

Privatization moved to other industrialized countries (for example, the privatization program of France after the election of Jacques Chirac in 1986) and to several other European countries in the 1990s, especially France (under the Socialists), Italy and Spain.[11] Many Asian countries also began to implement privatization programs, including Japan's sale of Nippon Telegraph and Telephone in three huge public offerings in the period February 1987 to October 1988, for approximately $80 billion. Privatization has also been extremely widespread in Latin America, including, most notably, Mexico, which, through the sale of more than 350 SOE's, reduced the government's subsidy burden from almost 13 percent of GDP to nearly zero. Privatization also played a critical role in the economic restructuring of post-communist countries of Eastern Europe, although the typical privatization mechanism, using vouchers, was different from the share issue privatizations of the industrialized West.

Ironically this privatization movement was not particularly important in the political economy of Germany. Most of the country's significant businesses were already privately owned.[12] For example, in 1978 the central German government owned enterprises that accounted for approximately 4 percent of total turnover, compared with France, 25 percent; Italy, 52 percent, the UK, 12.5 percent, and a European average of approximately 14 percent.[13] This was in part the result of the country's post-World War II politics, presided over by the conservative Adenauer governments, which avoided major nationalizations. Nevertheless privatizations of various state enterprises were initiated in the 1960s and the 1980s with decidedly mixed results. For example, in 1961, a 60 percent block of Volkswagen was sold to the public

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[10] See generally William L. Megginson & Jeffry M. Netter, From State to Market: A Survey of Empirical Studies on Privatization, 39 J. Econ. Litt 321 (2001).

[11] See Tony Jackson et al, "State-run Groups Get Used to New Identity: Europe's Governments Are Finding Both Political and Commercial Reasons for Turning to Privatisation," Financial Times, Jan. 24, 1994, p. 15.

[12] There were two exceptions. The first was enterprises in (East German) government hands at the time of German reunification. Their refurbishment and privatization was handled by a special agency, the Treuhand See gnerally I.J. Alexander Dyck, & Karen H. Wruck, Government as Venture Capitalist? The Role of Organizational Structure and Contract Design in Germany's Privatization Process, 5 Eur. Fin. Mngmnt (No. 1)(March 1999) (available on SSRN). The second was enterprises owned by the German Länder (states), which range from "governmental functions" like trash collection, transport, and municipal utilities, to very substantial financial institutions, including two banks that rank among Germany's 10 biggest banks. These have not been significantly privatized.

This account draws from Josef Esser, Privatisation in Germany: Symbolism in the Social Market Economy? in David Parker, ed., Privatisation in the European Union: Theory and Policy Perspectives 102-04 (1998)

[13] Id. at 105-06.

but stock price declines led to a government bailout of small shareholders later in the decade.[14] A new privatization wave in the mid-1980s led to the sale of the federal government's remaining stakes in Volkswagen (although one of the *Lände*r, Lower Saxony, retained 20 percent) and in the industrial conglomerate VIAG (although another *Land*, Bavaria, bought a 15 percent stake, which it sold off in the 1990s). The federal government also sold its stake in another industrial conglomerate VEBA in 1985, but contrary to its goal of obtain wide distribution of the shares, virtually all of them were purchased by existing large holders.[15]

Thus prior privatizations in Germany, unlike the experience in the UK, were not part of general economic liberalization, much less the creation of a shareholder culture. Rather, the goal had been to "share the wealth," to create a "Volks-aktien" ("people's share") in significant industrial enterprises. Even by this more modest standard, privatization had not been a great success.

Yet in the privatization of Deutsche Telekom in 1996 the parties executed what was then the largest-ever initial public offering of a European company and succeeded in placing a large amount, 40 percent of the total shares, worth approximately $5 billion, with German retail purchasers. Nearly 2 million Germans subscribed to the offering, including 400,000 who had never previously owned shares. The argument is this: the transaction was precipitated by the EU's new telecommunications regime, a product of the transnational impulse. In the name of fostering competition and controlling economic nationalism, the new regime would end the privileged monopoly position of a state-owned telecommunications carrier like Deutsche Telekom. This is in turn made privatization and access to equity capital markets important to Telekom's success if not survival. In order to make the transaction itself successful, German political and business elites promoted shareholder capitalism much more vigorously than otherwise would have been the case. The Deutsche Telekom transaction became a moment of high social mobilization, in which an idea that was the province of the elites was successfully argued to the populace generally. The immediate effect was obvious: a high price for Deutsche Telekom shares. But there were immediate secondary effects as well: for example, the quick ramping up of a new stock market aimed especially at raising equity from public shareholders for high tech startups, the Neuer Markt, modeled on NASDAQ; the development of German corporate law in a public shareholder-protective direction; and the acceptance only three years later of an unprecedented hostile bid for a German public company, the Vodafone takeover of Mannesmann. These social and institutional developments are set in wet concrete. The post-2000 stock market swoon, including the fall of the "T-share" below the initial offering price, and the worldwide recession may yet be their undoing.

A. The Opening of European Telecommunications to Competition

The European Union story of transnational economic and political integration is a familiar one

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[14] See William L. Megginson et al, The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis, 49 J. Fin. 403, 406-07 (1994). See also "Questions for Heinz Brestel," Frankfurter Allgemeine Zeitung, Nov 17, 1996, p. 6 (Virginia Tent transl.) ("I am 20 years old and took part in the Telekom-shares subscription. It is the first share ownership decision of my life. When I told this to my father, he only smiled tiredly: 'When you absolutely insist on burning your finger…' Then he told me the story of the first Volks-shares in the 60s. Back then people also fought over the shares. There was a 'chambermaid bull market' when little people bought. But the markets then quickly fell apart. Most of the Volks-shareholders then tripped over their feet to sell their VW, Veba and Preussag shares when the markets fell. Will the T-shares have the same fate?")

[15] Esser, note 6 supra, at 107-110.

(though perhaps not so familiar in US corporate governance debates). [16] Starting with three distinct "communities," the European Steel and Coal Community (1951), the European Atomic Energy Community (1957), and the European Economic Community (1957, the Treaty of Rome), Europe moved in fits and starts over a 30 year period towards economic integration, the creation of a "Common Market." In 1986 Community members rededicated themselves to removal of the remaining substantial barriers to a single internal market through the Single European Act, which also buttressed the executive and legislative foundations of European integration.[17] Particularly important was the shift from a unanimity rule in the Council (where states were represented) to qualified majority voting; this transformed the Community from an intergovernmental to a supranational organization. The crucial next step was the Treaty on European Union, Maastricht, in 1992, which entailed a commitment to full "economic and monetary union" (EMU), including a common currency. This commitment required a single European central bank and coordination of macroeconomic policy and thus ramified broadly. This was followed by the Treaty of Amsterdam (1996), which, at a time when potential enlargement of the EU to include the formerly communist countries of Eastern Europe became pressing, expanded the EU's commitment to human rights and a potentially broad social agenda. Within the framework of this economic and political integration, the constitutional structure also contemplated a "variable geometry" within which member states may choose "differentiated integration" in certain areas, for example, the UK's current opt out from the common currency and the EU's Social Chapter.

In 1987, one year after the Single European Act, the EU started down the road of telecommunications liberalization that concluded a decade later, January 1, 1998, in the full opening of national telecommunications markets to competition, including services, networks and equipment.[18] The process began with a "Green Paper" issued by the Commission that focused on the importance of telecommunications:

> "The strengthening of European telecommunications has become one of the major conditions for promoting a harmonious development of economic activities and a competitive market throughout the Community and for achieving the completion of the Community-wide market for goods and services by 1992.[19]"

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[16] This potted account draws from Paul Craig & Grainne De Burca, EU Law: Cases, Text, Materials (2d ed. 1998).

[17] See Joseph Weiler, The Transformation of Europe, 100 Yale L.J. 2403 (1991).

[18] This account draws from Morris H. Crawford, The Common Market for Telecommunications and Information Services, Harvard Univ. Program on Information Resources Policy, P-90-6 (July 1990); Wilson P. Dizard, Europe Calling Europe: Creating an Integrated Telecommunications Network, in Alan W. Cafruny & Glenda G. Rosenthal, eds., The State of the European Community: The Maastricht Debates and Beyond 321-336 (1993); Fernando Pombo, European Telecommunications Law and Investment Perspectives, 18 Fordham Int'l L. J. 558 (1994); Steven D. Lando, The European Community's Road to Telecommunications Deregulation, 62 Fordham L. Rev. 2159 (1994); Pierre Larouche, Telecommunications, in Damien Geradin, The Liberalization of State Monopolies in the European Union and Beyond 15-47 (2000); Joachim Scherer, ed., Telecommunication Laws in Europe (4th ed. 1998).

[19] Towards a Dynamic European Economy – Green Paper on the Development of the Common Market for Telecommunications Services and Equipment, Report COM 87(290 final) (1987). The Green Paper was endorsed by the Council of Telecommunication Ministers, 88/C 257/01, OJ C257/1, 04.10.1988, and was implemented by a series of Commission directives under Article 90 of the EC Treaty. The Commission's authority to undertake such actions was sustained by the European Court of Justice in, e.g., ECJ Judgment of 19 March 1991, Case-202/88, *French Republic v. Commission of the European Communities*, [1991] ECR I-1233.

At the time of the Green Paper in 1987, telecommunications in most European countries was the province of a "post-telephone-telegraph" entity ("PTT") within the government that was both the monopoly operator and regulator of telecommunication services. The Commission's initial regulatory actions (undertaken in 1988) were first, to require a separation between the telecommunications operator and the regulatory authority; second, to restrict the scope of the telecommunications monopoly to voice telephony and infrastructure (but not new services); third, to liberalize the telecommunications equipment markets by requiring open procurement and interconnection with non-proprietary equipment, and fourth, to facilitate increased competition by new entry through "open network" access to the basic infrastructure . The Commission also pushed for "harmonized" equipment standards and transmission standards that would sustain a trans-European market. There were multiple reasons for this agenda, including the special role that efficient telecommunications would play in knitting together the economic and political life of the European Union as well as the realization that a large common market would facilitate the rollout of cutting edge telecommunications services and products. The economies of scale and scope would be particularly important in the competition with US telecommunications equipment manufacturers.

The process of telecommunications liberalization received additional impetus from the 1992 Maastricht Treaty, adding Article 129b to the Treaty of Rome, which called for the "establishment and development of trans-European networks in the areas of transport, telecommunications and energy infrastructure." The provision also called for a particular regulatory strategy: "Within the framework of a system of open and competitive markets, action by the Community shall aim at promoting the interconnection and interoperability of national networks as well as access to such networks."[20] High level EU conferences subsequently endorsed a "Trans-European Networks" project whose aims were not only economic but also "intended to support the EU's goal of social and economic cohesion..."[21] Thus there were dual objectives. Rapid development of integrated telecommunications networks was seen as crucial to the development of the "single European market," because this sort of infrastructure would make it easier and cheaper for firms to coordinate economic activity across nominal national borders.[22] Integrated telecommunications networks would enable greater economic payoff from the existing reduction in legal and practical barriers to intra-EU activity and in turn would create greater demand for further reduction. But it was also understood that telecommunications liberalization would help foster the dense communications exchange that creates integration and cohesion.

Thus after a 1992 Commission review (and in light of the Maastricht Treaty), the Council of Telecommunication Ministers decided in July 1993 on full liberalization of the European telephony market by January 1, 1998.[23] Mobile telephony was quickly opened to full competition (despite its competitive threat to the landline voice monopoly) and by January 1, 1998, all telecommunications services and networks was opened to competition. In accord with the call of Article 129b there ultimately proved to be two crucial elements to the regulatory program: standard setting to enhance the creation of interstate networks and anti-monopoly competition policy, in particular, the breakup of state domination of telecommunications services and networks and guaranteed cost-based access to the exiting

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[20] 1 CMLR 719 (1992).

[21] Debra Johnson & Colin Turner, Trans- European Networks: The Political economy of Integrating Europe's Infrastructure 18-20 (1997).

[22] Id. at 14.

[23] 93/C 213/01, OJ C 213/1, 06.08.1993. There were certain transition periods of 2 or 5 years for certain smaller states.

infrastructure. The goal was to substitute competition for economic regulation. This in turn led over time to state divestment of ownership over telecommunications assets. In 1987 most telecommunications services were provided by the state-owned monopolist in most EU countries; by 2000 most of these companies were privatized (although in many cases governments retained substantial stakes).[24]

B. Germany's Response to EU Telecommunications Reform

Germany's PTT, the Deutsche Bundespost, has deep historical roots. Its creation was associated with the unification of the German states and the establishment of the German Empire in the 1870s.[25] The Bundespost was founded as government department in 1876, then called the *Reichspost und Telegraphenverwaltung,* and received an additional mandate, telephony, in 1877. An 1882 enactment granted an exclusive franchise for telegraph and telephony rights of way (*Telegraphenwege-gesetz*); this was butressed by the Telecommunications Installation Act of 1928 (*Fernmeldeanlagengesetz*). The Bundespost also came to include a financial services branch, which provided credit union-type services through the post office, the Postbank. The Bundespost was operated as separate entity for budgetary purposes and was headed by the Minister of Posts and Telecommunication, a cabinet member of the government. Its employees were federal civil servants.

Germany's first response to the new EU telecommunication policy and directives could be described as minimalist. "Post Reform I", adopted in 1989,[26] separated the regulatory functions from entrepreneurial activity, gave a new telecommunications entity a small amount of entrepreneurial freedom, and partially opened the telecommunications market. More specifically, the three activities of the Bundespost were converted into separate entities explicitly set up as "businesses" with a managing board and a supervisory board in the fashion of the two-tier board structure for private corporations. The

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[24] See Peter Curwen, Restructuring Telecommunications: A Study of Europe in a Global Context 73-90 (1997).

[25] This account draws from Arval A, Morris, Germany's New Telecommunications Law, 16 Syr. J. Int'l L. & Com 65 (1989); Hans-Willi Hefekauser, Die Deutsche Telekom AG: Von der öffentlich-rechtlichten zur privatrechtlichten Zielsetzung in Unternehmen der öffentlichen Hand, 25 ZGR 385 (1996) ("From Public Law to Private Law Rationale in Businesses of Public Concern" (David Blass, transl.); Carl Kress, The 1996 Telekommunikationgesetz (The Telecommunications Act of 1996): Toward More Competitive Markets in Telecommunications in Germany and the United States, 49 Fed. Comm. L. J. 551 (1997); Joachim Scherer & Ulrich Ellinghuas, Telecommunication Law in Germany, in Joachim Scherer, ed., Telecommunication Laws in Europe 134- 154 (4th ed. 1998); Axel Spies & Jan F. Wrede, The New German Telecommunications Act, 4 Mich. Telecomm. & Tech. L. Rev. 1 (1999). See also Jeffrey N. Gordon, Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. of European L. 219 (1999).

[26] Gesetz zur Neustrucktierung des Post und Fernmeldewesens und der Deutschen Bundespost (Postruckturgetsetz) (PostStrukturG), vom 08.06.1989, BGB1.I/1989, S. 1026 ff; vgl. Buchner, JA 1990, 194 ff; Hermann, ZPT 9/1991, 8 ff. The stated objectives of Post Reform I was:

> "The promotion of competition in the telecommunications market by introducing new regulatory conditions, and a restructuring of the Deutsche Bundespost by separating the sovereign from the entrepreneurial tasks and by implementing a market-oriented business organization to insure that it can fulfill the infrastructure obligations and improve its performance in competitive markets."

Morris, note 11 supra, 16 Syr. J. Int'l L. & Com at 94 n. 68 (citing and translating Federal Government Cabinet, Substantiation of the Draft Law Concerning the Restructuring of Posts and Telecommunications and of the Deutsche Bundespost 4 (May 11, 1988).

autonomy of the telecommunications entity, "Deutsche Telekom," was quite limited, however. The Ministry appointed managing board members as well as supervisory board members, and although the ostensible purpose of Post Reform I was to separate "sovereign" and "entrepreneurial" decisionmaking, the Ministry wore both hats. Moreover, under the Post Reform I structure, Deutsche Telekom profits went to cross-subsidize losses at the Postdienst Postbank and were also subject to an additional 10 percent tax going to the Federal Treasury. Additionally, in the period Deutsche Telekom was obliged by government mandate to make a heavy (DM 40 billion) investment in the telecommunications infrastructure of the former East Germany.

The emphasis in the Maastricht Treaty (1992) on telecommunications and the ensuing Commission directives calling for complete liberalization of telecommunication markets by 1998 made it clear that the Post Reform I regime did not sufficiently address the status of Deutsche Telekom. The coalition government (Christian Democrats and Free Democrats) and Deutsche Telekom management vigorously promoted privatization as the necessary next step to equip Telekom to compete in the liberalized environment.[27] Privatization would serve many ends for Deutsche Telekom: new equity to overhaul its networks (and to complete the modernization of the East), flexibility to downsize and reorient its workforce, freedom to pursue cross-border alliances, and stimulus for an entrepreneurial and innovative spirit in the company. The matter was complicated by the government's desire to privatize all three functions of the Bundespost and by the need to obtain a constitutional amendment, since Article 87 of the Grundgesestz was read as requiring direct government provision of postal services, including telecommunications, rather than mere regulation to that end. Amendment required a two-thirds approval in both houses of the German parliament, which gave the Social Democrats (SPD) a veto. An important SPD ally, the Post Trade Union, strongly opposed privatization because of the threat to employment security and perks, and others were concerned about the loss of the "Bügerpost" ideal of high quality universal service.[28] Nevertheless the case for privatization of Deutsche Telekom in light of the EU-wide telecommunications policy proved decisive and led to the adoption in 1994 of "Post Reform II,"[29] which formally privatized the three Bundespost business entities.[30]

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[27] See Ariane Genillard, "Telekom Urges More MP's to Support Sell-Off," Fin. T., Aug. 25, 1993, p. 2. For a retrospective account, see Gautam Naik & William Boston, "Telecoms Liberalization: A Year of Competition," Wall St. J. Europe, Jan. 8, 1999, available at 1999 WL-WSJE 5504578.

The temporizing in telecommunications reform between the two Postreform enactments seems to have been to give Telekom and German equipment manufacturers time change their attitude towards and otherwise prepare for a fully liberalized EU regime. See Jette Knudsen, Integration of West and East European Markets: Changing Trade Preferences in Manufacturing Sectors, 31 Comparative Political Studies188 (1998).

[28] See Ariane Genillard, "Survey Of International Telecommunications (4): Beset by Political Wrangles, German Privatization Plans," Financial Times, Oct. 18, 1993.

[29] Postneuordnungsgesetz (PTNeuOG) vom 14.09.1994, BGB1, I/1994, S. 2325 ff.

[30] The SPD initially wanted to give the government holding company, the Federal Institute, a large role in important decisions on service and employment issues, in particular, to retain the power to negotiate employment agreements. A careful compromise gave almost all such authority to Deutsche Telekom and created a complicated sharing arrangement for pension and other social welfare costs of existing employees, who retained civil service status. See DEUTSCHE TELEKOM AG Prospectus for the Offering of 85,000,000 Ordinary Shares in the form of American Depositary Shares, Nov. 17, 1996 (hereinafter, DT Prospectus), at 18-21 ("Relationship with the Federal Republic"). The Federal Institute was to remain the majority owner of Deutsche Telekom until 2000, but the main effect was to protect the company's exclusive market access.

On January 1, 1995 Deutsche Telekom became a private corporation subject to the general German corporate law, the Aktiengesetz but 100 percent owned by the government. Its management was entirely separate from the other two former Bundespost entities and its financial responsibility to them ended. It became subject to the general system of tax. In other words, although Deutsche Telekom was regulated as a public utility, meaning some government involvement in rate-setting and other terms of service, it was financially independent and accountable for its financial results. Of particular importance, Post Reform II explicitly contemplated the sale of a substantial stake in the company through a public offering, so the goal was not just formal privatization but the creation of a publicly owned company. The legislative history established that the government would not try to sell its shares until 2000, to protect the company's access to equity markets.[31]

C. The Privatization and Shareholder Capitalism

So the forces flowing from EU integration were an important catalyst in the privatization of Deutsche Telekom. To be sure, state-owned telecommunication utilities were favorite candidates for privatizations throughout the world[32] and Deutsche Telekom would have faced the same competitive and capital-raising pressures that led to other such transactions. Yet the EU liberalization added to that pressure, in no small part by catalyzing privatizations of virtually every state-owned European telecommunications company. Privatization in Germany was a close case and certainly the timing owed much to EU project.

But what is the connection between the decision to privatize Deutsche Telekom and the effort to use the transaction to promote the cause of shareholder capitalism in Germany? The privatization could have been handled in different ways. For example, in more typically German fashion, the shares could have been placed with German financial intermediaries and other institutional investors. There had come to be consensus among German business elites and political actors that the development of shareholder capitalism was important for German's economic development.[33] Germany was eager to replicate the success of Silicon Valley in spinning out technological innovation that produced highend jobs as well as investor returns. An active stock market that provided a successful entrepreneur with a lucrative exit strategy through an initial public offering seemed integral to the Silicon Valley model.[34] Yet initial public offerings historically were rare in Germany–only 10 in all of 1994, and the stock markets were

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For a useful summary of some of the politics of Germany's path to telecommunications liberalization, see Gautam Naik & William Boston, "Telecoms Liberalization: A Year of Competition," Wall St. J. Eur., Jan. 8, 1999, available at 1999 WL-WSJE 5504578.

[31] DT Prospectus, at 18.

[32] See Bernado Bortolotti et al, Sources of Performance Improvement in Privatized Firms: A Clinical Study of the Global Telecommunications Industry, W.P. 26.2001FEMI (April 2001), available at <http://papers.ssrn.com/abstract=263219>

[33] Some of this follows Jeffrey N. Gordon, Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. of European L. 219 (1999).

[34] See Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks vs. Stock Markets, 47 J.Fin. Econ. 243, 246-52 (1998) (comparing venture capital markets in the US and Germany).

famously illiquid[35] and volatile.[36] This stemmed in large part because of public retail investor reluctance to take on the risk associated with stock purchases, especially IPOs. For example at the beginning of 1996 (the year of the Deutsche Telekom transaction), only 5 percent of Germans owned common stock, as opposed to 18 percent of the British and 21 percent of Americans.[37] From a balance sheet perspective, in Germany, common stock holdings accounted for 6.9 percent of household assets, in Britain, 9.1 percent, and in the US, 18.7 percent, at the beginning of 1996.[38] Market capitalization as a percentage of GDP was 23 percent in Germany, 120 percent in Britain, and 92 percent in the US, at the beginning of 1996.[39] In general German investors preferred bonds to stocks and markets had rewarded their conservatism: the cumulative bond returns over the 10 year period ending 1995 exceeded stock returns, 103.5 percent to 52 percent.[40]

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[35] In 1994, just three companies--Deutsche Bank AG, Daimler-Benz, and Siemens AG, accounted for a third of the volume in German public markets; the top six firms accounted for almost 50%. Peter Gumbel, Cracking the German Market: The Hard Sell: Getting Germans to Invest in Stocks, Wall St. J., Aug. 4, 1995, available at 1995 WL-WSJ 8736770. There were 810 publicly traded firms in 1994. Firms ranked 50-810 accounted for less than 12 % of volume. Harmut Schmidt et al, Corporate Governance in Germany 59 (1997).

[36] See generally Stefan Prigge, A Survey of German Corporate Governance, in Klaus Hopt et al, Comparative Corporate Governance — The State of the Art and Emerging Research 943, 986-990 (1998)

During the 1981-88 period, there were 96 German initial public offerings, approximately 10 a year, only 51 of which were on the principal, or "Official" market. By contrast, 764 British firms went public in the period, 284 on the Official Market. See See Marc Goergen, Insider Retention and Long-Run Performance in German and UK IPOs (W.P. UMIST School of Management, Dec. 7, 1998) (on file with author). This is consistent with an even longer term German pattern. For example, during the 1970-1991 period there were 179 German IPOs, or approximately 10 a year over a 20 year period. See Olaf Ehrhardt & Eric Nowak, Private Benefits and Minority Shareholder Expropriation – Empirical Evidence from IPOs of German Family-Owned Firms (WP March 2002) (available on SSRN).

Over the period 1975-1995 the approximate ratio of average annual nominal returns to risk (standard deviation) on German equity markets was 8.6%/18%. See Charles Olivier, Unlocking Germany's $200 Billion Corporate Pension Pot, Euromoney, June 1996; Euromoney Survey, Germany, Equities (June 1996)(Table 4). By contrast, German investors can earn a nominal yield of 7%-8% on a portfolio of government bonds and local mortgage bonds, with risk below 6%. Olivier, supra.

[37] See Silvia Ascarelli, "Good Connection: Deutsche Telekom IPO Draws Bullish Response From Skittish Germans", Wall St. J. Eur., October 9, 1996, available at 1996 WL-WSJE 10752128 (citing survey by the German Share Institute.)

[38] Bank of Japan, International Department, Comparative Economic and Financial Statistics: Japan and Other Major Countries (2000).

[39] Author's calculation based on OECD data.

[40] WSJ-E, 8/22/96, 1996 WL-WSJE 10749319 (quoting Solomon Brothers' study).

German political and business elites had another motive in developing shareholder capitalism through the Deutsche Telekom transaction. German demographics – namely, the relative ageing of the population as the birthrate declined – was beginning to undermine the existing pension system, in which workers looked almost exclusively to the state for a generous defined benefit pension payment. Ultimately, financial solvency would require at least partial replacement of the state plan, funded from tax revenues on a "pay as you go" basis, by a private contributory plan, whose payout would depend upon its investment returns. Appropriate equity investments could deliver greater longterm returns than fixed income investments and thus make the shift more politically palatable; fostering shareholder capitalism would help investors obtain better outcomes in contributory plans.

Finally the government (and the management) had a particular reason to sell Deutsche Telekom shares to the public rather than to financial intermediaries and other institutions. As became clear as the transaction unfolded, this would maximize the sale price for the shares. Since the proceeds were flowing directly to the company, this would increase the value of the government's remaining 76 percent stake (independent of the pricing effect) and of course make more funds available for corporate purposes. This became visibly important shortly after the transaction, when the government arranged partial "sales" of its stake to an affiliated financial institution, the Kreditanstalt für Wiederaufbau (Credit Bank for Reconstruction) over three successive years, 1997-99. The sales, which amounted to a 25 percent stake in Deutsche Telekom, helped address budgetary shortfalls that were made critical by need to satisfy the participation criteria for "economic and monetary union," the common EU currency regime.[41] (There was a risk in a high initial offering price, of course that the immediate aftermarket trading would show a loss, which would damage the efforts to encourage future equity offerings.)

D. How the Deal Was Sold to the German Public and to Institutional Investors

The transaction planners in the Deutsche Telekom offering followed what appears to be a two-pronged strategy to obtain a high price for the offering: work hard to enhance retail demand for the offering by the German public and take other measures to that would lead institutional investors to buy in the aftermarket to bolster the price. In contrast to privatizations in countries such as Britain and France, where shares were often sold at a discount to comparable private equity offerings, the Deutsche Telekom offering was fully priced, yet the that price came to be supported by the structure of demand generated by the transaction planners.

The planners knew that they had a substantial uphill battle to transform German attitudes toward stock ownership. For example, in June Focus magazine reported survey results that 57 percent of Germans did not want to buy Telekom shares "under any circumstances". "Otto-Normal-Anleger has a panicking desire to stay as far from stock market risk as possible," preferring federal bonds and savings accounts. Focus noted that if anything, Germans had less appetite for equity risk than before: In the 70s, every 10th German owned shares; in 1996, less than half that number did. [42]

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[41] Indeed, the push for EMU – a paradigmatic example of transnational economic and social integration – could be independently be analyzed as a force for corporate governance convergence. It is not only that governments sought budgetary relief through privatizations but also that the common currency would foster cross-border equity investment, reducing the home country bias. See Gikas A. Hardouvelis et al, EMU and European Stock Market Integration (WP Sept. 2001)(available on SSRN).

[42] "Telekom-shares: A People Agrees," Focus Magazin, no. 24, June 10, 1996, p. 180 (Virginia Tent transl.). This was at least in part because of the unhappy experience with Volkswagen and Veba discussed previously.

There were a number of economic and purely promotional steps taken to bolster retail German demand. On the economic side:

•German retail purchasers were given a 1.75 percent discount up to a maximum of 300 shares per investor.

•To discourage "flipping" of shares, German retail purchasers were promised "loyalty shares" – one bonus share for 10 shares continuously held for a three year period (until Sept. 30, 1999), up to a maximum of 30 bonus shares (i.e., covering the 300 share maximum covered by the discount).[43]

•To appeal to risk averse German investors, the company announced that it expected to pay a 2 percent dividend in 1997 and a 4 percent dividend in 1998 (measured against the offering price).[44] Taking into account the tax credit for the corporate level tax paid on dividends that was then available to German (but not foreign) purchasers, that would produce a 1998 yield above then prevailing longterm German bond yield of 6 percent.[45]

On the promotional campaign: Beginning in March1996 Deutsche Telekom undertook an extensive campaign helped make stock ownership seem a natural, even fashionable, investment choice, among those who had traditionally looked for fixed income investments. The yearlong campaign cost DM85 million.[46] Early on the company established a toll-free telephone number (staffed 8 a.m. to midnight 7 days a week) for prospective investors to talk about the stock market generally or Deutsche

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The Telekom offering prompted considerable speculation about the sources of German investment caution. See, e.g, DeutsWolfgang Schmidbauer, Anneliese Hieke, Christian Baulig, "Volks-trauma shares," Die Woche, Nov 22, 1996, p. 15 (Psychoanalyst Wolfgang Schmidbauer article traces the campaign for German shareholding back to Adenauer's plan against communism – class warriors should become economic citizens of a real economic democracy. Schmidbauer then notes that Germans never had healthy stockmarkets like the French and the British in the 19th Century and that Hitler fueled antisemitism with claims that Jewish capitalists undermined the economy. Schmidbauer seems to think that the Depression and two lost wars merely added to this horror of risk. Germans are the most heavily insured people in the world.) (Virginia Tent transl.)

[43] In this, as in many other aspects of the sale, Deutsche Telekom followed the pattern pioneered by the privatization of British Telecom. See Greg Steinmetz, "Mixed Signals: Deutsche Telekom IPO May Prove a Hard Sell For Chairman Sommer; Success of $10 Billion Offering Hinges on German Politics As Well As Cost-Cutting", Wall St. J. Eur., March 20, 1996, available at 1996 WL-WSJE 3338395.

[44] DT Prospectus, 15-16. This also served the Government's desire for budgetary support. Indeed, the government's majority's interest meant it received more cash than the public shareholders, in ways that subsequently would lead to tension. Despite the post-2000 reversal in the global market's assessment of the desirability of telecom expansion, the government resisted Telekom's desire to cut dividends and use the freed-up funds to pay down debt. See Mathew Karnitschnig & Christopher Rhoads, "Disconnected: CEO Ron Sommer Is Forced to Leave Deutsche Telekom," Wall. St. J, July, 17, 2002, available at 2002 WL-WSJ 3400889.

[45] See E.S. Browning and Susan Pulliam, "For Deutsche Telekom IPO, A Weak Ring", Wall St. J., November 6, 1996, available at 1996 WL-WSJ 11805114.

[46] Rick Butler, "Last Call for Germany's Equity Market: Deutsche Telekom's Privatization Launches Government Effort to Spur Retail Investment in Economy," Inst'l Invstr, Nov. 1, 1996, available at 1996 WL 9951579.

Telekom specifically and circulated glossy brochures on both the stock market and the company.[47] This was followed up by a "blitz of print ads, radio spots and television commercials proclaiming 1996 as the year of the Telekom share, ... set to the Cole Porter tune 'Who Wants To Be a Millionaire.'"[48] The commercial endorsers included the star of a popular TV detective series.[49] Perhaps the high moment was a nationally-televised awards program hosted in September at Deutsche Telekom's headquarters in which CEO Ron Sommer gave out prizes to contestants who had assembled the best-performing stock portfolios over a 3 months period..[50] The "T-share" became a brand name, and people would signal one another with hands in perpendicular, a "T." There was undoubted giddiness to the national mood, captured by the headline on one commentary: "Run on the Telekom shares: 500 Mark gain is sure; Buy, buy, buy. Why students and pensioners alike are suddenly interested in bulls and bears,"[51] The hoopla even prompted an editorial from a leading national newspaper complaining about the lack of serious discussion of the issues involved. [52] The marketing campaign was an obvious success: eventually 3.2 million people responded with some level of interest,[53] more than half of whom subscribed for shares.

The German commercial banks also played a significant role in steering German investors into the offering. Enlisting the banks support was important, because in many cases share purchases would be funded with money that might otherwise go into certificates of deposit or other bank products. Thus it seems that all of the major German banks were members of the underwriting syndicate. (German banks are "universal banks," meaning that unlike US banks of the time, they could directly underwrite securities.) As further encouragement to the banks, the retail purchaser incentives described above

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[47] Silvia Ascarelli, "Deutsche Telekom Will Offer Toll-Free Line, Brochures to Snag Private Investor," Wall St. J, March 22, 1996, available at 1996 WL-WSJ 3095874; Silvia Ascarelli, "Group Wants Ad Campaign to Lure Folks to Market; Did Someone Says IPO?,"Wall St. J, March 21, 1996, available at 1996 WL-WSJE 3338476. The idea for the telephone line was borrowed from the British Telecom privatization in the mid-1980s, which set up "share shops" throughout the country. Id.

[48] See Silvia Ascarelli, "IPO Campaign Aims To Dip Into Pockets Of German Savers; Deutsche Telekom Will Offer Toll-Free Line, Brochures To Snag Private Investors", Wall St. J., March 22, 1996, available at 1996 WL-WSJ 3095874. The advertising agency Speiss, Ermisch & Andere apparently played a significant organizational role. See "Turning Germany Into Shareholders," Media International, Feb. 1, 1997, available at 1997 WL 9476300.

[49] See Karen Lowry Miller & Brian Bremmer, "Europe's Sell-Off To End All Sell-Offs; Huge Stakes Are Riding On The Fate Of Deutsche Telekom's November Offering", Business Week, October 21, 1996, available at 1996 WL 10771125.

[50] See Rick Butler, "Last Call For Germany's Equity Market: Deutsche Telekom's Privatization Launches Government Effort To Spur Retail Investment In Economy", Inst'l Invstr, Nov. 1, 1996, available at 1996 WL 9951579.

[51] Alexander Boeker, Süddeutsche Zeitung (SZ), Oct. 28, 1996, Muenchen section. (Virginia Tent transl.)

[52] Opinion, "T as in Transparency," FAZ June 18, 1996, p. 15 (Telekom's offering is only months away and despite lots of advertising, there is still not enough deciding information. It's time for the image campaign to turn into an information campaign. People should care a lot about the future of the telecoms market, the result of layoffs in productivity, and the future position of Deutsche Telekom in the national and international markets. So far, T does not stand for transparency) (Virginia Tent transl.)

[53] See "Turning Germany Into Shareholders", Media International, Feb. 1, 1997, available at 1997 WL 9476300.

were limited to investors who purchased through a account maintained at one of the participating banks in the German part of the offering.[54]

Many of the banks organised special programs to encourage retail purchase of Deutsche Telekom shares. For example, Dresdner Bank offered a special interest rate for funds set aside in a special account to purchase shares (5 percent vs. 2 percent).[55] Commerzbank advertised special "T-Share" savings account and accumulated more than DM100 million.[56] Commerzbank also offered a "risk-free" way of buying shares, the so-called "Safe T": customers could deposit the shares in trust until the day after the Deutsche Telekom 2002 annual meeting (six years later!) with the option of receiving the shares or the initial public offering price. In turn, during the trust period, the bank would receive annual dividends (and the associated tax credit) and voting rights in the shares. The customer could obtain the shares at any time during the six-year period but without the price protection.[57]

These promotional efforts were remarkably successful. The offering was five times oversubscribed. As this demand became apparent in the period before the definitive offering documents, it undoubtedly strengthened the resolve of Deutsche Telekom to set a high offering price and it led to a lowering of the discount that retail purchasers eventually received. Earlier in the marketing process, a discount of up to 5 percent had been discussed;[58] as noted, the final figure was 1.75 percent.

But the transaction planners also understood that a truly successful offering required substantial institutional participation worldwide. Ultimately Germany wanted to sell off substantial amounts of its remaining interest in a secondary offering (although in the privatization legislation restricted the government from further public stock sales until 2000 in order to give Deutsche Telekom priority on public market access.[59]) Deutsche Telekom also wanted to be able to access the equity capital markets for corporate purposes or to spin-off parts of its business, or to engage in merger activity, all of which would go better with a substantial institutional following.

Thus the company organized a global public offering that included a leading US underwriter, Goldman, Sachs & Co, as a "global coordinator" along with local favorites Deutsche Bank and Dresdner Bank. The issue was vigorously marketed by dozens of banks in the underwriting syndicate to 3,700 institutional investors throughout the world participating in 60 road shows and presentations held in 30

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[54] DT Prospectus, 13.

[55] WSJ-Eurpe, 8/22/96, 1996 WL-WSJE 10749319. Dresdner also agreed to forgo its usual DM50 commission for purchases in the initial public offering, id, which is of course partly offset by the DM0.713/share underwriting concession and the 100 share minimum lot size. DT Prospectus 1, 13.

[56] WSJ-Europe, 8/22/96, 1996 WL-WSJE 10749319.

[57] WSJ-Europe, 9/19/96, 1996 WL 10750897; Business Week, 10/21/96, 1996 WL 10771125.

[58] WSJ-Europe,10/9/96, 1996 WL-WSJE 1075218; WSJ-Asia, 10/22/96, 1996 WL-WSJA 12476309.

[59] See DT Prospectus, 18 (describing legislative history of Post Reform II).

cities.[60] In addition to its primary listing on the Frankfurt Stock Exchange (and several German regional exchange), the stock was listed on the New York Stock Exchange (where it would trade as ADR's) and the Tokyo Stock Exchange.

If German retail demand could be described as overwhelming, worldwide institutional demand was not. The matter came down to price. The underwriting syndicate banks initially proposed a price range of DM20 to DM25. Deutsche Telekom insisted on a price range of DM 25 to DM30, which many institutional investors felt could not be supported on the fundamentals, not withstanding the marketing push at the retail level. Thus the eventual offering price of DM28.50 – despite retail bookbuilding and "when issued" (or "gray market") trading that would have supported at least DM30 – was something of a concession to institutional investors.

Institutional participation in the offering was fostered by a Deutsche Telekom's arrangements with the Deutsche Börse for a 5 percent weighting of Telekom's stock in the Frankfurt Stock Exchange DAX-30. This weighting was based on its nominal capital rather than its subscribed capital, which gave the company credit for the remaining government stock. This meant that index funds and German country funds would have to take a larger position in the stock than otherwise.[61] The stock also received an unusually heavy 8.5 percent weighting in the Morgan Stanley Capital Index for Europe, based on 80 percent of its market capitalization, rather than the more limited public float.[62] This MSCI weighting increased pressure in European indexers and Europe stock funds to take substantial positions.[63] Demand for the offering, led by German retail demand, led to an increase in the public offering from 500 million to 600 million shares, to the underwriters' exercise of their over-allotment or "greenshoe" option to sell another 90 million shares, and to an enlargement of the special employee allocation to a total of 23.7 million.[64] The ultimate offering, 713.7 million shares, netted the company approximately DM 19.4 billion (US $12 billion).

Deutsche Telekom's organization of the underwriting syndicate seems to have been an important factor in its ability to achieve a high price for the offering. Virtually every significant bank in Germany and, indeed, throughout much of the world, was given a place in the syndicate. The offering was deemed to be subject to the "gun-jumping" rules of the US securities laws, which meant that the syndicate banks were disabled from any public comment on the offering from the time of its preliminary announcement to the break-up of the syndicate after the offering was launched. The effect was to quash the possibility

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[60] Laura Covill, "Deutsche Telekom: Telekom Rules OK," Euromoney (December 1996).

[61] See "Deutsche Telekom IPO to Price This Week," Going Public: The IPO Reporter, Nov. 11, 1996, available at 1996 WL 13940059.

[62] See Silvia Ascarelli, "Deutsche Telekom Sizzles, Stealing Show in Frankfurt", Wall St. J. Eur., Nov. 19, 1996, available at 1996 WL 10754479.

[63] The Deutsche Telekom promotion also may have positively affected institutional investor attitudes toward German equities more generally. See Sylvia Ascarelli, "Survey Shows Better View of Equities in Germany Among fund Managers," Wall St. J. Eur., January 23, 1997, available at 1997 WL-WSJE 3805179.

[64] Employees were permitted a preferential allocation of 200 shares at the DM0.50 discount, plus a further discount up to DM300. They were also given the right to buy up DM1500 in shares at the discount price of DM300 and on concessionary financing terms, so long as the shares were held in a special trust until 2002. Prospectus, 13-14. Deutsche Telekom had 230,000 employees at the time of the offering, so obviously the average employee purchase was around 100 shares.

of high profile analyst reports that might have cast doubt on the DM28.50 price. As one commentator put it, "By getting all the players on your side, there is effectively no opposing team around to argue about miscalculating company value or overpricing the deal." [65]

The scene on Monday, November 18, the day that Deutsche Telekom opened for trading on the Frankfurt Stock Exchange was striking. "'The Stock Market Is Bubbling,' cheered a banner front-page headline in the mass-market *Bild*."[66] Mounted policeman kept control of the crowds that gathered outside. Deutsche Telekom had erected a corporate promotional sculpture – "71 big, flashing lighted cubes in Telekom's new official color, magenta – which incongruously covered most of the plaza in front of the stately renaissance facade of the Frankfurt Stock Exchange."[67] The day's trading (including special afterhours trading on the electronic trading system IBIS) ended at DM 32.58, up 14 percent.

Ultimately German investors received a 67 percent allocation, 60 percent of which (meaning 40 percent of the entire offering) went to German retail customers, 14 percent went to the Americas, mostly the US, 8 percent for Britain, 6 percent for continental Europe, and 5 percent for Asia and the rest of the world.[68] The orginal plan had called for only a 25 percent placement with the German retail public.[69] Shareholder capitalism in Germany had received a major boost.[70]

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[65] See "Banks Bow to Price Pressure," Corporate Money, January 29, 1997, available at 1997 WL 9405629.

[66] See Mary Williams Walsh, "High Marks Frenzied Deutsche Telekom Trading Ushers In New Era", LA Times, Nov.19, 1996, available at 1996 WL 12757682.

[67] Id.

[68] See Laura Covill, "Deutsche Telekom: Telekom Rules OK," Euromoney (December 1996)

[69] See Silvia Ascarelli, "Good Connection: Deutsche Telekom IPO Draws Bullish Response From Skittish Germans", Wall St. J. Eur., October 9, 1996, available at 1996 WL-WSJE 10752128 (citing survey by the German Share Institute.)

[70] Deutsche Telekom successfully concluded two subsequent follow-on underwritten public share offerings and a merger that substantially increased the retail shareholding base (close to 3 million shareholders now) and reduced the government's ownership position to 43 percent, as of yearend 2001.

In June 1999 the company raised EU 11 billion ($11.37 billion) in the first pan-European public offering. The retail allocation was available to purchasers throughout Europe (in 1996, only to German retail purchasers), which reflected both a strong marketing effort in countries other than Germany and the effects of EMU, which meant the offering could be priced in a common currency, the euro. The offering was twice oversubscribed. Sixty two percent of the offering went to retail investors; 70 percent of the retail orders came from Germany, 30 percent from the rest of "Euroland." As of yearend 1999, the government ownership stake was approximately 65 percent. See William Boston, "Deutsche Telekom Expects a Windfall of $11.37 Billion From New Share Issue," Wall St. Journal, June 28, 1999. See generally DEUTSCHE TELEKOM AG, Prospectus for the Offering of 250,000,000 Ordinary Shares in the form of American Depositary Shares, June 4, 1999, and Prospectus Supplement, June 26, 1999.

In June 2000 the company conducted a secondary offering of shares owned by a German Government affiliate, *Kreditanstalt für Wiederaufbau,* selling 230 million shares for approximately EU 15 billion ($14.3 billion).

The retail side of the offering was made globally, although two thirds of the retail interest came from Germany, followed by other European countries. The offering was 3.5 times oversubscribed. Two-thirds of the shares went to retail investors, one third to institutional investors. FT, 6/19/2000 (Lexis). The offering was very popular with the Germany retail public. A survey at the time revealed that 1 in 7 Germans had owned Telekom shares; that 1 in 7 wanted to buy shares from the 3rd tranche, that 24 percent of higher income households planned to buy and 20 percent of the employees. See "People keep asking about the 'Volks-share': every seventh German wants to subscribe for shares from the Telekom's new offering," Börse Online, June 7, 2000, text preserved by OTS Originaltextservice) (Virginia Tent transl.) .

As of yearend 2000, the government ownership stake was approximately 60 percent. The 2000 Deutsche Telekom annual report estimated that as of yearend 2000 institutional investors held 24 percent (60 percent of the public float) and individuals held 16 percent (40 of the public float).

Following a $50 billion part shares-part cash acquisition of the US firm Voicestream Wireless in 2001, Deutsche Telekom may be thought of as a public company with an international following. As of May 2001, the German Government held only 43 percent; the free float was 57 percent. As to its international distribution: German investors held 34 percent, the rest of Europe, 24 percent; the US and Canada, 32 percent; and Asia/Pacific, 10 percent. (The high level of US ownership in May 2001 may be the temporary result of the closing of the Voicestream transaction, in which a substantial amount of Deutsche Telekom stock was received. "Flow back," a common feature of cross-border mergers, is likely to substantially the increase the German percentage.)

As Deutsche Telekom stock has fallen below the initial market price, there has been concern that retail investor dissatisfaction would lead to a wholesale exodus. See William Boston, "Telekom Breaches IPO Price; Stock Recovers But Dip Helps Undermine Confidence in Company." Wall St. J. This has not yet happened despite the disappointment, even bitterness. Some measure of the successful rooting of shareholder capitalism in German may be that anger is directed against the company rather than in a call for a government bailout, as per Volkswagen in the 1970s. See, e.g., Associated Press, "Pressure Mounts on Deutsche Telekom," May 29, 2001, posted on New York Times website of that date (leading German institutional investor issues criticism at company's annual meeting); Von Reinolf Reis, "Ron Sommers' pink glasses have fallen into disuse – Caterwauling for the 5th birthday of T-shares – Shareholder protectors go after the Telekom Vorstand in court," Agence France Presse – German, Nov 15, 2001 (Virginia Tent transl.). A politician's populist call for the sale of the remaining government stock to shareholders at a discount "to restore faith in the capital markets" found no footing. "'This is the old way of doing business,'" says Reinhild Keitel, a prominent shareholder rights activist." Alfred Kueppers, "Public Spat Shows Old Ties Are Fraying," Wall St. J. Eur., Aug. 20, 2001, available at 2001 WL-WSJE 21835554. Ironically a major reason for Deutsche Telekom's loss of value has been the government's decision to speed the pace of telecommunications deregulation. William Boston, "Deutsche Telekom, Once a German Sensation, Falls Hard," Wall St. J. Aug. 17, 2001.

On the other hand, the widespread public ownership of a stock which, as of July 2002, had plunged 90 percent from its March 2000 peak, led to the ouster of CEO Ron Sommer. Despite public support of Sommer as recently as May 2002, Chancellor Schröder – in the midst of parliamentary elections campaign in which his economic stewardship was an important issue – found the need to take action. (Arguably politics had played a double role: first, in retaining an executive despite the collapse in stock price to avoid public acknowledgment of a bad business strategy; and then second, in driving the timing and messy manner of his firing.) In a further irony, however, the government quickly found itself subject to a market check in its choice of a replacement: when the government wanted to name a senior manager from Telekom's pre-privatization past supported by the unions whose supervisory board votes were crucial to deposing Sommer, an immediate 15 percent decline in the company's stock price upon the rumor of this appointment forced the interim choice of a senior Telekom executive deemed to be more market-friendly. See Mathew Karnitschnig & Christopher Rhoads, "Disconnected: CEO Ron Sommer Is Forced to Leave Deutsche Telekom," Wall. St. J, July, 17, 2002, available at 2002 WL-WSJ 3400889; Mark Landler with Andrew Ross Sorkin, "Chief Executive of Phone Giant in Germany May Be Ousted," N.Y.Times, July 15, 2002, p. C1, col. 2; Mark Landler, Proposed Successor at Deutsche Telekom Chills Market," N.Y. Times, July 16, 2002, p.C11, col. 1.

E. Evidence that Shareholder Capitalism Took Deeper Root Following the Transaction

You might ask: how can the Deutsche Telekom transaction count as much of an advance of shareholder capitalism in Germany when there are so many features that fit with the established insider governance system? After all, the government remained as 76 percent owner with an understanding that it would preserve its majority stake at least until 2000. Even after another primary offering, a secondary offering of German government stock, and a stock acquisition of a major US firm (VoiceStream Wireless), the government owned 43 percent (as of yearend 2001). The supervisory board was designated with five year terms in 1995; virtually the entire board was recently reelected for another set of 5 year terms. It takes a 75 percent shareholder vote to remove a supervisory board member, meaning the government has a veto over removal. This means that, as practical matter, Deutsche Telekom is protected from a hostile takeover bid. Moreover, the initial public offering was sold as much on its risk-avoidance steadiness as on on the risk-taking upside. As noted above, the company virtually promised a high dividend payout that would be comparable to a bond yield.

Nevertheless the Deutsche Telekom privatization was a turning point (if not necessarily an irreversible one) because it demonstrated that it was possible to raise large amounts of equity capital from German retail investors. The promotional effort succeeded in its most ambitious project: to sell to the German public the idea of stock market-investing generally, not just the T-share in particular. It achieved a necessary precondition for the development of shareholder capitalism because it showed the potential benefit of institutional change: access to large amounts of capital, no strings attached. The availability of public equity capital demonstrated by the Deutsche Telekom transaction fit well with a corresponding change in the availability of public debt via the growth of public bond markets in Germany, and then, after EMU, the explosive growth of a European bond market. Insider governance lost its privileged position in the supply of outside capital.[71]

The Deutsche Telekom transaction also changed the politics of shareholder capitalism in Germany. It added at least a million people to the German shareholder roles and, even more important, heightened the saliency of shareholder value and shareholder protection. An idea that had been the

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Additional evidence of retrenchment in Germany's move to shareholder capitalism was the July 2002 dismissal of Thomas Middlehoff, CEO of Bertelsmann, the global media conglomerate. Apparently he lost the support of the controlling family over his plan to take the company public – the family owns 17 percent of the stock but controls 58 percent through the Bertelsmann Foundation. Mark Landler with David D. Kirkpatrick, "Bertelsmann Chief is Fired After Clash with the Ownership," N.Y. Times, July 29, 2002, p.A1, col. 6.

[71] A monopoly on debt finance provided insider financial institutions with a conduit for rents that justified the monitoring expenses of the insider system. The greater development of public debt markets gave managers the means to "cheat" – ie, to obtain market rate capital – and to slip free of the implied threat behind the insider monitoring of not only trouble in the board room but trouble in corporate finance. In turn, the banks have turned from a "hausbank" to an "investment bank" model and have been lessening their traditional company ties. Deutsche Bank, for example, reduced its supervisory board seats from 29 to 17 over the 1996-98 period and helped Krupp in its hostile takeover bid for Thyssen (on whose supervisory board it sat). See Martin Hopner, Ten Empirical Findings on Shareholder Value and Industrial Relations in Germany (working paper 2001) (available on SSRN).

province of of a certain business and academic elite was transformed into an element of popular understanding.[72] Moreover, the transaction gave the German government a direct interest in public shareholder protection. Much as the "entrepreneur" in the classic Jensen and Meckling account of agency costs, the government bore the costs of the corporate governance arrangements. The market price of the initial and subsequent offerings of Deutsche Telekom stock (including the government's secondary offerings) would reflect (with an appropriate discount rate) the public shareholder protections that would apply after the government lost its control position. Thus the government came to have a distinct budgetary interest in better protection of public shareholders.

Evidence for the impact of the Deutsche Telekom privatization on the rise of shareholder capitalism is found in a number of places: the supply side and demand side for equity capital, institutional changes that facilitate public offerings (most particularly the Neuer Markt), changes in the legal infrastructure of public shareholder protection, changes in academic opinion, and, perhaps most dramatically, the change in attitudes about hostile takeover activity, as reflected in the widespread view that the outcome of hostile bid by for the venerable German firm Mannesmann by a U.K. raider Vodafone was a question of shareholder choice.

1. Empirical Evidence: Changes in Ownership Patterns and Market Valuations

There are a number of empirical indicia of the opening to shareholder capitalism in the period following the privatization of Deutsche Telekom. One important measure is market receptivity to initial public offerings because this opens a new channel of finance that is, almost by definition, sensitive to shareholder interests. But the increased availability for such a capital-raising route also reflects various institutional, even legal, developments, that foster and protect shareholder interests generally, and cultural changes that encourage investors to make investments through direct share ownership. In other words, a change in the potential supply of public equity capital not only enhances shareholder capitalism – extends its reach – but indicates the spread of background conditions for its success. As Table I indicates, there has been a sharp increase in the number of IPOs in the period. Early in the decade, there were on average of 15-20 IPOs annually. This reflects only a limited increase over the prior period 1970-1990 of a approximately 10 IPOs annually.[73] The number of IPOs exploded towards the end of the decade, when many high tech startups went public on a newly-formed German rival for NASDAQ, the Neuer Markt. As Table 2 illustrates, IPOs provided increasingly larger infusions of equity capital over the period, not just in absolute dollar terms, but normalized for increases in GDP. As in the United States, there has been a significant fall-off in IPOs both in number and in dollar amount in light of increased investor skepticism. But Germany's first exposure to the IPO cycle is part of the conditioning of sophisticated capital markets.

Table 1 – Number of Initial Public Offerings (1990-99)

[72] See, e.g., Fidelity Investments, Fidelity's Targeted International Equity Funds, Semiannual Report 47 (April 30, 1998)(comments of Alexandra Edzard, portfolio manager of Fidelity Germany Fund)("The market was strong, driven by German investment in thestock market. This pro-investment sentiment reflected a sea change in German attitudes.... [Previously] The stock market market was viewed with suspicion. In 1996, Deutsche Telekom ... listed shares on the Frankfurt exchange. Since then, Germans have begun to embrace a new equity culture facilitated by financial market reforms.")

[73] See note 35 supra. (Discussing German IPOs).

	1990-92	1993-95	1996	1997	1998	1999	Total	Total new/ total 1990
	51	39	20	35	67	168	380	69,3%

Source: Christoph Van der Elst, The Equity Markets, Ownership Structures and Control: Towards an International Haromínisation? (Univ. of Ghent Financial Law Inst. Working Paper 2000), Table 7.

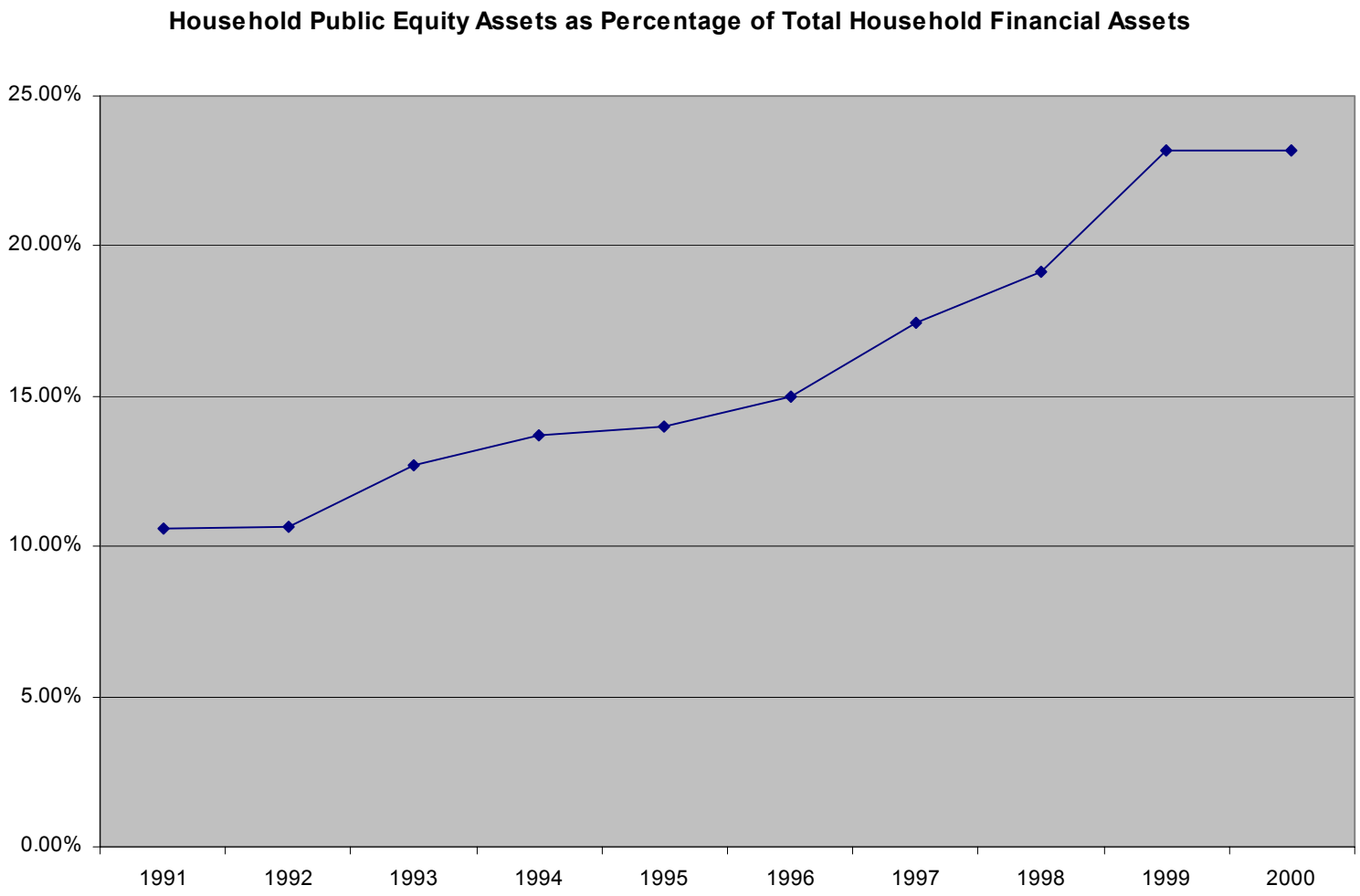
Table 2 – Equity raised by IPOs as percent of GDP (1990-99)

	1990-92 avg.	1993-95 avg.	1996	1997	1998	1999	1990-99 avg.
	0.10%	0.11%	0.65%	0.15%	0.20%	0.91%	0.25%

Source: Christoph Van der Elst, The Equity Markets, Ownership Structures and Control: Towards an International Haromínisation? (Univ. of Ghent Financial Law Inst. Working Paper 2000), Table 8.

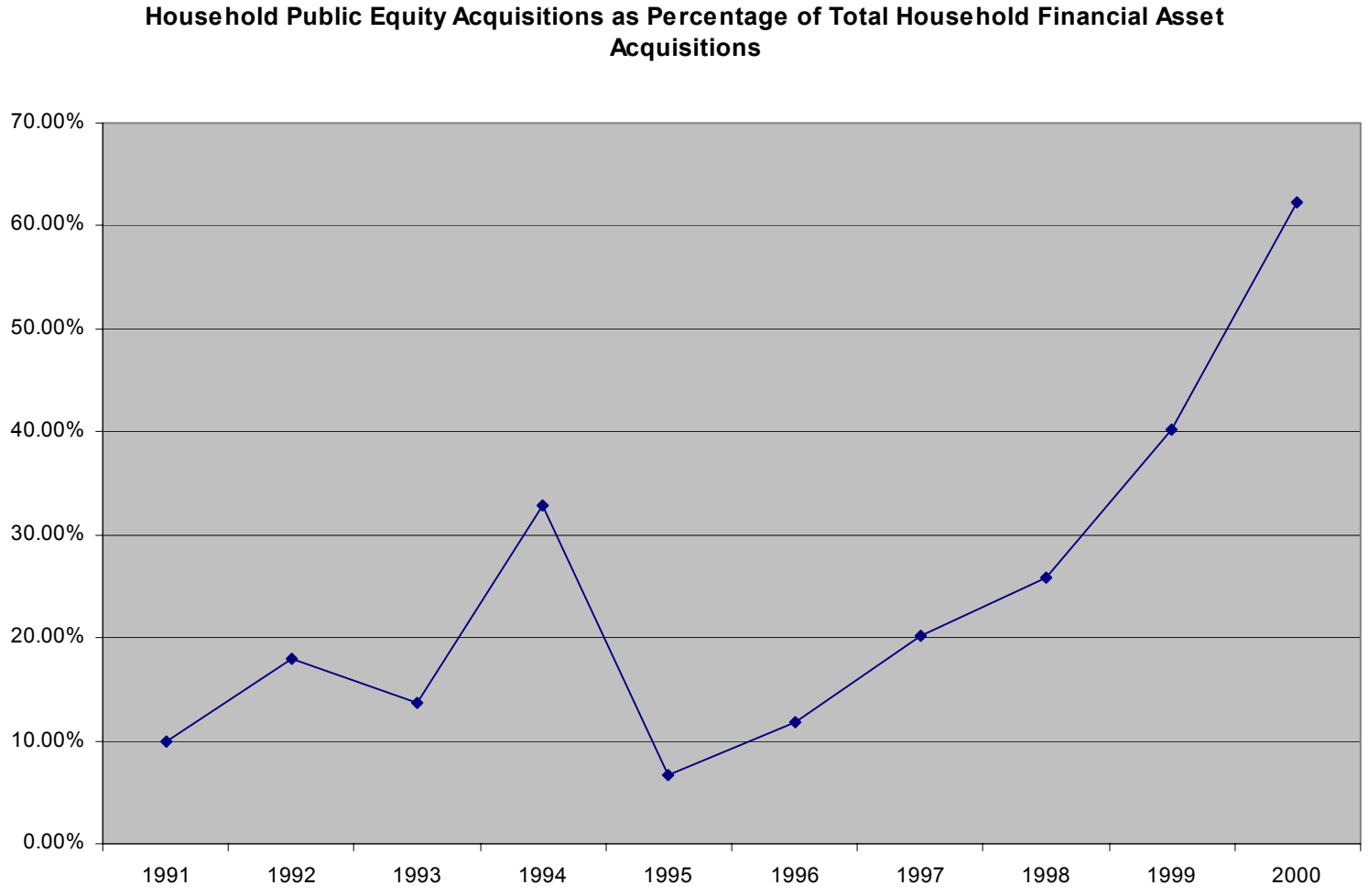
Another measure is the increasing importance of equity to the portfolios of individuals, both as "stock" and "flow." This is a measure of the demand side – the willingness of individuals to acquire and hold equity assets. As chart I shows, the value of household holdings of public equity as a percentage of total financial assets significantly increased in the post-1996 period (and at a faster rate than in the pre-1996 period). Chart II, which tracks equity acquisitions as a percent of total household financial asset acquisition, reflects a surge in equity additions in the post-1996 period. Undoubtedly some of this increase came from the increase in stock market values in the period; hence the flattening of the curve in the 1999-2000 period. But nevertheless, by the end of the decade, most of the marginal gain in household wealth derived from public equity. Even if some portion of the increase derives merely from appreciation of existing equity holdings rather than new purchases, it still draws the connection between household wealth and shareholder value. This connection helps establish a political economy conducive to further developments favorable to shareholder capitalism.

Chart I



[Source: Bundesbank, Own Caculations]

Chart II



[Source: Bundesbank, Own Caculations]

This evidence of a strengthening of the demand for equity capital is also reflected in the significant increase in the number and percentage of shareholders in Germany (see Table 3). Equity mutual funds became a particularly popular way for individuals to participate in the stock market, much as in the United States. "Banks are making an effort to lure depositors away from relatively low-yielding savings vehicles and into stock mutual funds."[74] Growing from essentially negligible importance in the early 1990s, equity mutual funds became as important a vehicle for equity investment as direct stock ownership. (See Table 4.) By the end of the decade, the penetration of stock ownership including ownership of equity mutual funds increased almost four-fold over the prior level. (Table 5)

Table 3 – Shareholders in publicly traded companies
(in millions; as percentage of population)

Year	1988		1992		1994		1996	1997	1998	1999	2000
No.	2229		2661		2736		2675	2767	3218	3775	5121
% pop	4.9		4.2		4.4		4.2	4.4	5.1	5.9	8

Source: DAI Factbook, April 2001

Table 4 - Shareholders in Stock Mutual Funds
(in millions; as percentage of population)

Year	1990		1992		1994		1996	1997	1998	1999	2000
No.								1751	2458	3582	6601
%pop								2.8	3.9	5.6	10.3

Source: DAI Factbook, April 2001 (Time series begins in 1997)

[74] See, e.g., Fidelity Investments, Fidelity's Targeted International Equity Funds, Semiannual Report 47 (April 30, 1998)(comments of Alexandra Edzard, portfolio manager of Fidelity Germany Fund).

Table 5 – Shareholders in public companies (including through employee stock ownerhip plans) and in mutual funds (including "mixed funds"
(in millions; as percentage of population)

Year	1990		1992		1994		1996	1997	1998	1999	2000
No.								5601	6789	8231	11828
%pop								8.9	10.7	12.9	18.5

Source: DAI Factbook, April 2001 (Time series begins in 1997)

One classic way to think of the influence of shareholder capitalism is in terms of ownership structure. Concentrated ownership is associated with insider governance system, dispersed (or "diffuse") ownership, with outsider governance systems, and often the debate about convergence comes down to a question about the persistence or not of that particular systemic difference. The best evidence suggests that there has been a significant increase in the number and percentage of public firms in Germany with diffuse ownership. In 1990, approximately 10 percent of the public firms were either widely held or otherwise lacked a 25 percent "blocking" shareholder.[76] By 1999, approximately 25 percent of a larger number of public firms were diffusely held.[77] This is a significant change that would be unlikely in the absence of the development of better minority shareholder protection and in the gradual unwinding of the cross-holding

[76] Tim Jenkinson & Alexander Ljungvist, The Role of Hostile Stakes in German Corporate Governance, 7 J. Corp. Finance 397, 405 (2001). Jenkinson & Ljungvist have a bigger sample than Julian Franks & Colin Mayer, Corporate Ownership and Control in the U.K., Germany, and France, in Donald Chew, ed., Studies in International Corporate Finance and Governance Systems 281-296 (1997), which found 15 percent of the 1990 firms had either dispersed or non-blocking ownership.

[77] See Christoph Van der Elst, The Equity Markets, Ownership Structures and Control: Towards and International Harmonisation? (Financial Law Institute, Univ. of Ghent, WP 2000-4) (available at http://www.law.rug.ac.be/fli/WP/wp2000-04.pdf), forthcoming in, E. Wymeersch (ed.), Company Law and Financial Markets (2002). Van der Elst also finds an increase the number of firms with individual or family stakes over 25 percent (20 percent, 1990 vs. 40 percent, 1999). This is likely to be from the increase in the number of IPOs in the period. The evolution of ownership structure in those firms will of course be important empirical evidence as it develops. In the past control stakes after an IPO have diminished more slowly in Germany than in a strong shareholder culture like the UK. See Marc Goergen & Luc Renneboog, Why Does the Concentration of Control Differ in German and UK Companies: Evidence from Initial Public Offering (using IPO database covering 1981-88), available on SSRN, forthcoming 2002, JLEO.

Alternative measures of the extent of diffusely-owned firms are provided in Raphael LaPorta et al, Corporate Ownership Around the World, 54 J. Fin. 471(1999). Using 1995-96 data and different definitions of diffusely held (presence of 20 percent blockholder or 10 percent blockholder), LaPorta et al find that 50 percent (35 percent) of the largest German public firms are diffusely held, but only 10 percent (10 percent) of medium sized German firm. Id. at 492-95, Tables II-III.

inducements of the insider system.[78]

One familiar way of illustrating the increasing importance of equity to a country's political economy is the ratio of market capitalization to GDP. As might be expected this ratio significantly increases for Germany over the period, from approximately 20 percent in 1991 to 67 percent in 2000, and the sharpest part of the increase comes in the post-1996 period. As Chart III also shows, however, Germany's ratio increased at approximately the same rate as for other EU countries, suggesting the presence of a common underlying phenomenon that enhanced shareholder capitalism throughout the EU.[79]

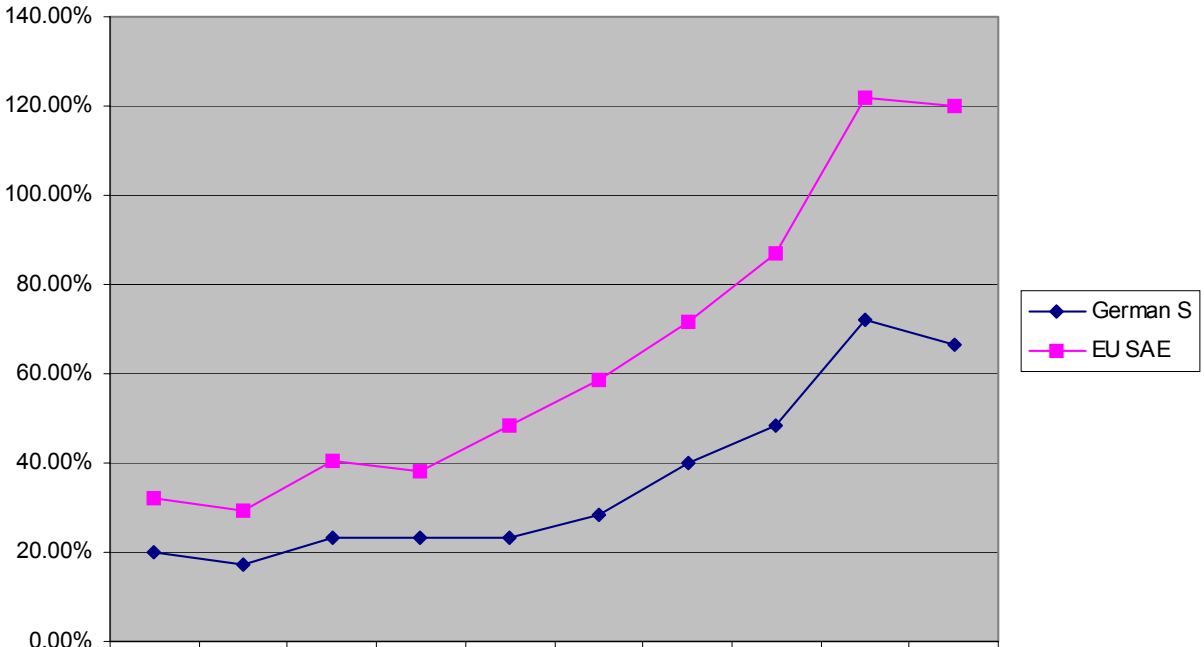
One possible objection to the significance of changes in the market capitalization/GDP ratio is that the increases in the ratio may reflect only general market factors associated with the 1990s stock market boom rather than any deeper change, such as greater use of public equity in external finance, enhanced value of minority shares because of greater shareholder protection, or more rapid growth of public firms. This caveat is at least partially addressed by Chart IV, which compares the market capitalization/GDP ratio of Germany and the UK. Here the UK, whose commitment to shareholder capitalism did not significantly change during the period, serves as a control against general market factors. In the early 1990s until 1996, the ratio of ratios, Germany to UK, was around 20 percent. The curve sharply kinks after 1996; as of 2000, the ratio of ratios was 35 percent. This suggests a significant element of convergence by Germany on the shareholder model in the period.

[78] Somewhat to the contrary is ambiguous evidence that ownership concentration over the 1994-98 period, as measured by the Herfindahl index, increased in more listed German manufacturing firms than it decreased; on the other hand, the median decrease is greater than the median increase. See F. Jens KÅke, New Evidence on Ownership Structures in Germany, ZEW Discussion Paper 99-60 (June 2000) (available on SSRN). But this work also classifies 37 percent of these firms as "widely held ," meaning no identifiable controlling blockholder.

[79] One candidate would be the privatization of SOEs, which accounted for a much larger share of the economy in many other EU countries (France, Italy, Spain, e.g.) and whose impact in jump-starting a shareholder culture was significant. See generally, Megginson & Netter, supra, note xx; Maria Boutchkova & William L. Megginson, Privatization and the Rise of Global Capital Markets, Financial Management, Fall 2000 (available on SSRN).

Chart III

Ratio of Market Capitalization to GDP: Germany vs. EU (Value-Weighted)

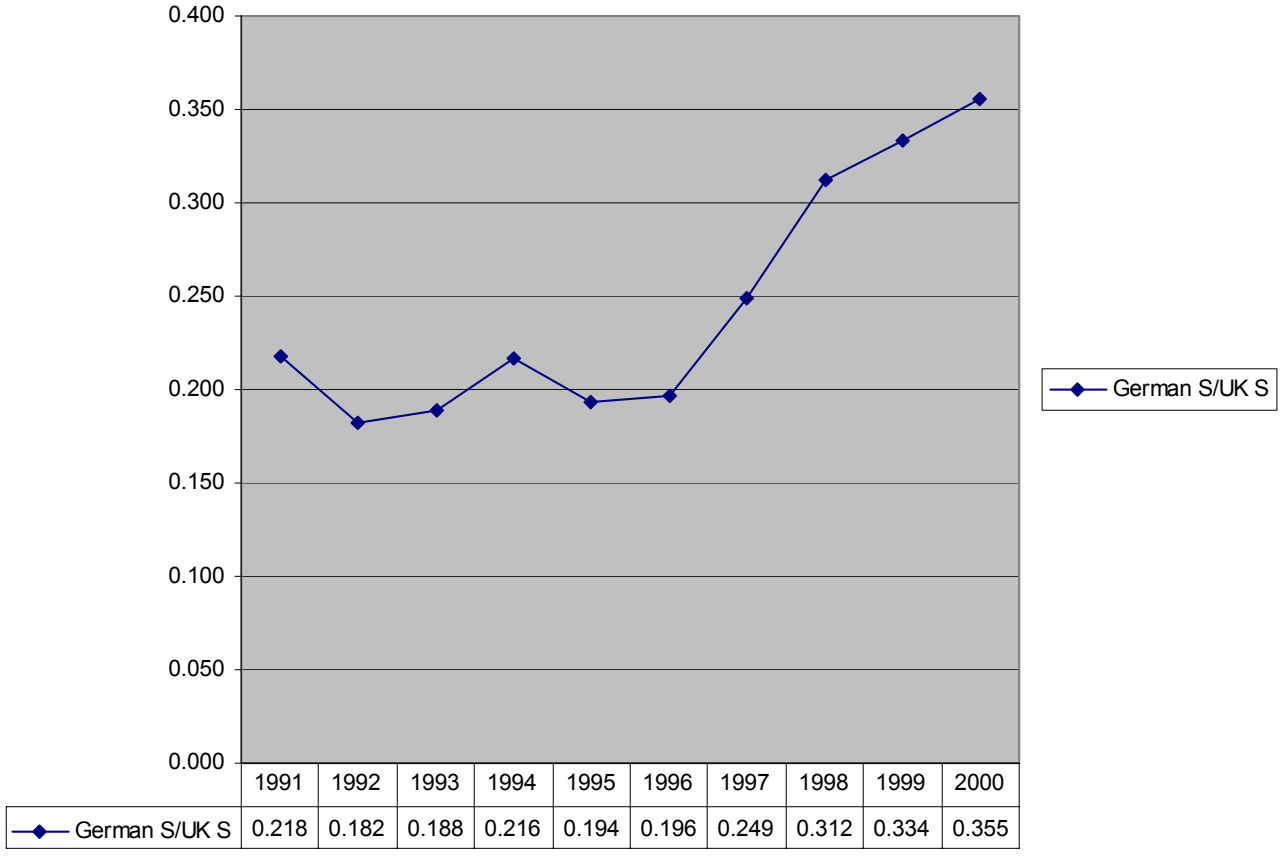


	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
German S	19.90%	16.99%	23.42%	23.28%	23.33%	28.30%	40.21%	48.43%	72.08%	66.55%
EU SAE	32.03%	29.40%	40.56%	38.33%	48.42%	58.59%	71.74%	87.18%	121.74	119.84

Source: Federation of European Stock Exchanges; Own Calculations

Chart IV

German Market Cap/GDP vs. English Market Cap/GDP



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
German S/UK S	0.218	0.182	0.188	0.216	0.194	0.196	0.249	0.312	0.334	0.355

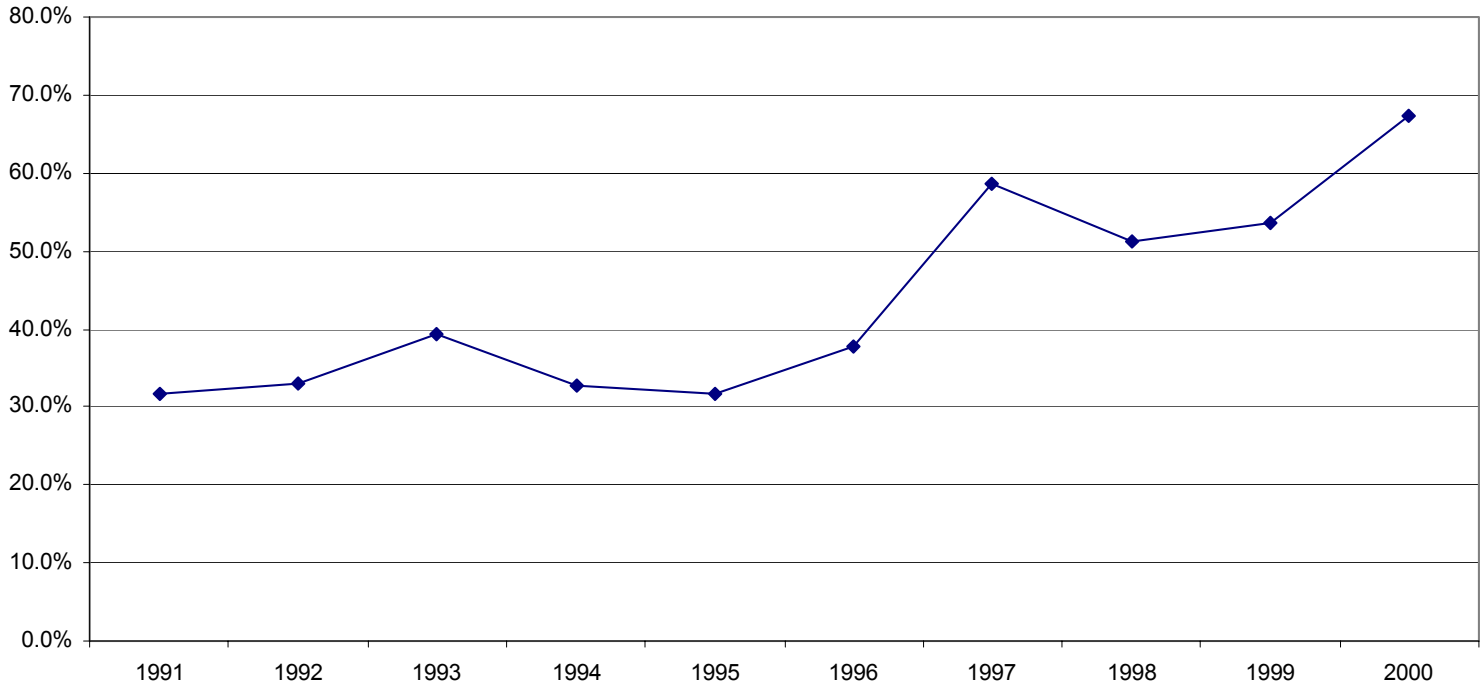
Source: Federation of European Stock Exchanges; Own Calculations

There are different levels at which to frame the convergence question, as the market capitalization/GDP ratio makes us aware. One question is whether the managers of an existing set of public firms are more likely to seek to maximize shareholder value in ways that predictably should lead to a higher stock price for a given underlying cash flow. That question points in the direction of convergence of governance arrangements and, perhaps even more important, ownership structures, concentrated or diffuse, that affect how a particular set of legal rules will play out in practice (and what legal rules will be chosen). But another question is the extent to which the economy is organized through public firms: whether economy activity is guided by managers who are exposed to capital market signals or not. Germany's relatively low market capitalization/GDP ratio and yet its convergence toward the UK may say less about changes at existing public firms and more about the evolution of the German economy towards a system in which much more of the activity is conducted by public firms. Germany has been famous for its *Mittelstand,* its medium size enterprises, mostly family owned, which account for an unusually large part of its economy activity. The changing market capitalization/GDP ratio may indicate the shrinking of this sector. Even if the ownership structure of large German firms has not radically changed in the 1990s, convergence may express itself even more importantly in the increasing extent to which public firms account for economic activity – because even classic insider governance of a public firm will be more sensitive to stock market signals than a private firm. As more of the economy is exposed to such signals, it is bound to affect governance even at insider firms.

The empirical conjecture from the market capitalization/GDP ratio is borne out by directly tracing the importance of public companies to German GDP over time. We collected data on the sales of the largest 100 German companies over the 1991-2000 period, determined which of those companies were public, and then mapped a ratio of those large public company sales to GDP. (Sales and GDP are not strictly comparable, since the latter is a value-added measure). As Chart V shows, this ratio increases sharply in the post-1996 period, from .8 to nearly 1.4. A number of possibilities suggest themselves: public firms are growing faster than private firms (suggesting the value of capital market signals and pressure to firm performance) or, perhaps, public firms are acquiring private firms, using their appreciated stock as acquisition currency. But in any event, this evidence, along with other quantitative evidence, suggests significant movement toward shareholder capitalism, tied in time to the privatization of Deutsche Telekom.

Chart V

Sales of German Public Companies in Top 50 as Percentage of GDP



Source: ELC International; Own Calculations

2. Institutional Evidence: the Launch of the Neuer Markt

Perhaps the most striking evidence of institutional change following the Deutsche Telekom transaction was the founding and explosive growth of the Neuer Markt, which was established by the Deutsche Börse in 1997 as a NASDAQ-competitor in the launch of initial public offerings for high technology companies of minimal seasoning. The main "official" exchange of the Deutsche Börse was a notoriously inhospitable place for an initial public offering, because of listing rules that required several years of profits and other signs of financial soundness. In offering a home for "young growth companies" the Neuer Markt substituted disclosure and transparency for seasoning. For example, its rules required an issuing prospectus on an international standard, IAS or GAAP accounting standards, and periodic reporting, quarterly and annually, also on an international standard. In particular, this continuous reporting requirement was an innovation in Germany; issuers listed on the "official" market (Amtlichter Handel) or the "regulated" market (Geregelter Handel) were not subject to similar requirements. There were additional Neuer Markt listing requirements, including at least a 20 percent free float, a 6 month lockup period for existing shareholders, and acceptance of the voluntary Takeover Code of the Stock Exchange Commission of Experts (modeled on the UK City Code)[80]

The Neuer Markt was very successful, especially in light of the prior German history. It opened for business in March 1997 and the pace of IPO activity rapidly increased:

1997	–	13
1998	–	43
1999	–	133
2000	–	139

As of 2001, more than 340 companies were listed on the Neuer Markt, 56 of them headquartered outside of Germany. Unlike the "official" market, individual investors were especially vigorous market participants, owning approximately 50 percent of the free float of listed companies.[81]

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[80] See Rules of Neuer Markt, available at http://deutsche-boerse.com/nm/index_e.htm. This description that follows is based on other materials and reports on the website, especially Neuer Markt Report: Gateway to European Capital Markets, Key to Growth (2001), which was commissioned to address a crisis in confidence following the collapse of share values in 2000-01.

[81] An account of the importance of the Neuer Markt as evidence of the change in German shareholder culture in the 1990s would be incomplete without discussion of the Neuer Markt's problems and the September 2002 decision of the Deutche Börse to shut it down by yearend 2003. Instead, the Börse will create a technology segment of its main market, based on disclosure requirements similar to the Neuer Markt (though supported by a better enforcement regime) and a technology-focused index. See Silva Ascarelli & G. Thomas Sims, "Germany's Neuer Markt Exchange Will Be Shut Down Amid Scandals," Wall St. J. Sept. 27, 2002; "Deutsche Börse Presents New Equity Market Segmentation" posted on Deutsche Börse website, visited Oct. 3, 2002.

The Neuer Markt had come under sharp criticism not only because of the sharp decline in share values over 2000-2002 but also price volatility, which led to allegations of price manipulation, and cases of outright fraud in publicly issued financial reports. Characteristically for a market which gained credibility through high quality listing standards, the interested parties initially pursued tightening the standards. See Neal Bondette & Alfred Kueppers, Frustrated Neuer Markt Members Push for Tightening Listing Rules, Wall St. J., July 11, 2001, at C12. See also Neuer Markt Report, supra, (Shearman and Sterling chapter). Subsequent commentary focused particularly on enforcement mechanisms, in light of the importance of credibly accurate and honest disclosure in investor evaluation of unseasoned companies. See Anne d'Arcy & Sonja Grabensberger, The Quality of Neuer Markt Quarterly Reports – An Update (Fin. & Acctng. WP No. 88, Goethe-Univ. Frankfurt am Main, Jan. 2002) (on file

The impulse to create the Neuer Markt may have come from the concern about German competitiveness with Silicon Valley in creating high technology enterprise, but the turn to shareholder capitalism to remedy the situation might not have been possible without the prior Deutsche Telekom transaction. It appeared that part of the US success had been the role of particular entrepreneurial intermediary, the venture capitalist, who functioned best with an exit route via a stock market. But the creation and ultimate success of such a market for Germany depended on investor demand and liquidity, which in turned depended (at least on the NASDAQ model) on the participation of retail investors. Neither industrial companies nor financial institutions were likely to buy significant shares for their own account (since these startup firms were certainly not going to be governed on the insider model). Unlike the US, Germany had no cash rich pension funds. Thus retail demand, either through mutual funds or direct purchases, was going to be crucial, and while the Deutsche Börse worked very hard to attract foreign market participants, a high level of German participation would be essential. The Deutsche Telekom transaction proved that Germans would buy stock and, in the huge marketing push, it persuaded many Germans that equities were a legitimate part of an investment portfolio. Undoubtedly the appreciation in the DAX and the by-then famous appreciation of the NASDAQ index played a critical role in the successful launch of the Neuer Markt, but the prior success of the Telekom IPO was a powerful reassurance.

3. Subsequent Legal Changes: Toward Protection of Shareholder Rights

Following the Telekom transaction, there were a number of reforms that added to public shareholder protection and increased the exposure of public firms to capital market pressures. The most important of these changes was the 1998 Act on Control and Transparency of Enterprises (KonTraG).[82] The legislation was adopted in response to a number of high visibility monitoring failures by supervisory boards, in particular

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with author).The absence of an omnibus antifraud provision like Section 10b of the 1934 Securities Exchange Act and the ambiguous legal status of disclosures filed under private listing standards created an enforcement deficit. This enforcement question was addressed by enactment in 2002 of the Fourth Financial Markets Promotion Act, which gives the Börse the delegated power to put its listing requirements – including the elements of a high quality disclosure regime – into public law Exchange Rules, "which insures enforceability and thus the confidance of investors." "Deutsche Börse Presents New Equity Market Segmentation," supra.

The Börse will use its new power to create a "Prime Standard" segment of its market based on extensive disclosure on the international standard that will include most of the significant firms now traded on the main exchange as well as the Neuer Markt companies which will be included in the technology segment. The new segment preserves the Neuer Markt's general strategy but replaces the Neuer Markt as a listing and trading venue in recognition of the Neuer Markt's credibility problems.

More important than the demise of the Neuer Markt is the persistence and spread of its disclosure-based listing strategy, and the augmentation of private efforts to create a high quality disclosure regime with a public enforcement backstop. These are both important element in drawing in creating condition for the development of public equity markets and ultimately to the spread of diffusely-owned firms. See generally, Rafael LaPorta et al, What Works in Securities Laws?, Harv. Econ. WP, available on SSRN.

[82] Gesetz zur Kontrolle und Transparenz im Unternehmensbereich, Bundesgesetzblatt I vom. 30.04.1998, 786 ff. See Theodor Baums, Corporate Governance in Germany - System and Current Developments. (Working paper, Univ. of Osnabruck, 1998), web-posted at http://www.uni-frankfurt.de/fb01/baums; Uwe Seibert, Control and Transparency in Business (KonTraG): Corporate Law Reform in Germany, 10 Eur. Bus. L.Rev. 70 (1999).

instances of apparent negligence by "Hausbank" representatives on supervisory boards.[83] The legislation was also designed to cut back the traditional bank influence over the proxy system of dispersed public companies and to limit various antitakeover strategies at German firms. In particular, the Act

- Requires the managing board to establish an internal monitoring system and submit regular reports on companys operations and long term business plans to the supervisory board, which can require special reports at any time.

- Requires the supervisory board to review not only the company's annual financial statements, but its consolidated statements as well.

- Specifies that the official auditor will be retained by the supervisory board rather than the managing board.

- Requires more frequent supervisory board meetings and greater disclosure to shareholders of supervisory board member credentials, and limits the number of supervisory board chairmanships to a maximum of 5.

- Permits shareholders who own, in total, at least 5% of the stock, to demand supervisory board action against negligent managing directors.

- Limits the voting prerogatives of a bank that itself owns more than 5% of the shares of a particular firm; in such a case, the bank can vote deposited shares only upon explicit instructions.

- Forbids the creation of multiple voting stock or caps on voting rights. This protects public shareholders by restricting the separation of voting rights from cash flow rights.

The Act was a political compromise.[84] The governing coalition of the CDU and FDP parties that were the motor behind the privatization of Deutsche Telekom promoted the legislation because they believed better shareholder protection and better governance would foster the German competitiveness. The Social Democrats favored limitations on bank powers. Managers were unhappy with the governance interventions and in particular the limits on a favorite antitakeover protection of capped voting. The reform package had been first tabled in 1994 in response to an emerging consensus about the weakness of the governance system for public companies, underscored by dissatisfaction expressed by international institutional investors.[85] It finally passed in 1998.[86]

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[83] See Jeffrey N. Gordon, Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. of European L. 219,220-21 (1999) (discussing cases of Daimler-Benz, Metallgesellschaft, Schneider, Klöckner-Humboldt-Deutz, in which bank supervisory board presence failed to detect and avert financial failures).

[84] See Gregory Jackson, Corporate Governance in Germany and Japan: Liberalization Pressures and Responses during the 1990s, forthcoming in Wolfgang Streeck and Kozo Yamamura, eds., The Furture of Nationally Embedded Capitalism in a Global Economy (2002), available on SSRN.

[85] Lex, "Geman Corporate Governance," Fin. T., Nov. 7, 1994, p.20.

[86] A contemporaneous legislative change moved German accounting towards greater transparency, the Kapitalaufnahmeerleichterungsgesetz (KapAEG). Many large German firms wanted to move away from traditional German accounting methods that called for hidden reserves and other non-transparent features because of regulatory

The Telekom privatization played a significant role in its adoption in two ways. First, most obviously, the popular mobilization on behalf of shareholder capitalism associated with the Telekom transaction made "public shareholder protection" a populist cry and changed the political calculus But second, the government could see immediate budgetary benefits from corporate law that better protected public shareholders and that thereby should narrow the "minority discount."[87] The government's plan sell a significant part of its stake to the *KfW* to help achieve the budget deficit targets associated with EMU meant that, like many selling shareholders, it wanted to book the highest possible sale price. Thus public shareholder protection became both politically popular and fiscally prudent.

4. Changing Attitudes Toward Hostile Bids: The Path to Mannesmann/Vodafone

Perhaps the most visible evidence of a shift toward shareholder capitalism in Germany in the course of the 1990s has been the change in public and elite response to hostile takeover bids, away from shock, even horror, at the disruption of established relationships towards grudging acceptance of shareholder choice. This evolution is vividly illustrated by the contrasting outcomes of Pirelli's failed bid for Continental in 1991 and Vodafone's successful bid for Mannesmann in 1999. In both cases, the hostile bidder was a foreign raider; in both cases the target was embedded in the German industrial establishment. If anything, the Vodafone bid was much brasher, since the UK bidder was an upstart (founded in 1985) and the German target, founded almost 100 years earlier, exemplified German industrial prowess as well as economic adaptability. Moreover, the size of the transaction, $180 billion, and the acceptance of acquiror's stock as consideration, suggested that size didn't matter when it came to takeover protection. Thus the takeover of Mannesmann, apparently the first successful hostile tender offer for control of a German public corporation, both reflected a transformation and may hasten a further one.

Continental/Pirelli. In September 1990 Pirelli, the Italian tire manufacturer approached the German tire manufacturer Continental with what Americans would call a "bear hug."[88] The overture was ostensibly friendly. Pirelli and Continental were the fourth and fifth largest tire manufacturers in the world, each with about an 8 percent market share and each with significant production in Europe and North America.

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requirements of countries and exchanges on which they wanted to cross-list their stock, especially the U.S. SEC and the NYSE. The KapAEG gave them leeway to use international accounting standards, IAS or GAAP, rather than the German standards even for German tax accounting purposes. Now all 30 German firms of the DAX 30 use international standards, 17 IAS and 13 either US GAAP or both. Id. This change too is part of a shareholder culture and makes the disclosing firms more vulnerable to a takeover bid. For a discussion of other legislative and institutional changes over the 1990-99 period, see Nowak, supra, note. Xx [immediately preceding].

[87] For example, the "voting rights premium" for Germany – the price differential between voting and non-voting shares – declined over the 1990-98 period (from approximately 30% to 20%). See Eric Nowak, Recent Developments in German Capital Markets and Corporate Governance, 14 Bank of Am. J. of Applied Corp. Fin. 35, 37 (2001). A change in this premium is widely taken as reflecting changes in minority shareholder protection. See also Olaf Ehrhardt & Eric Nowak, Private Benefits and Minority Shareholder Expropriation – Empirical Evidence from IPOs of German Family-Owned Firms (WP March 2002) (available on SSRN) (narrowing minority shareholder discount in the later 1990s).

[88] Unless otherwise indicated, this account draws from Theodor Baums, Hostile Takeovers in Germany: A Case Study on Pirelli vs. Continental A.G., Univ. of Osnabrück, WP 3/93 (May 1993), available at www.jura.uni-osnabrueck.de/institut/hwr/arbeitsp.htm. See also Tim Jenkinson & Alexander Ljungvist, The Role of Hostile Stakes in German Corporate Governance, 7 J. Corp. Finance 397 (2001) (Appendix).

Significant overcapacity in the worldwide tire industry tire industry made a compelling case for economic rationalization and consolidation.[89] But Pirelli said its offer was backed by a "support group" of German and Italian investors that held more than 50 percent of Continental's stock, and so the overture carried the implied threat of action against managerial resistance. As a pre-condition to negotiations, Continental's management insisted on a standstill agreement, which Pirelli rejected. Continental then deemed the offer "hostile."[90] Its CEO also vowed that there would be no job cuts if Continental remained independent, an obvious appeal to the employee members of the supervisory board.[91]

Continental's most significant antitakeover defenses were first, a capped voting provision, which limited the voting rights of any individual (or group) to 5 percent irrespective of actual holdings, and the 75 percent shareholder vote that would be required to surmount the technical barriers to such a cross-border transaction.[92] These defenses came under challenge at a special shareholders meeting in March 1991, when shareholders were asked to eliminate capped voting and to adopt a precatory resolution on behalf of the proposed transaction and the various necessary charter amendments. Adoption of the capped voting resolution required only a simple majority but the charter amendments would require a 75 percent vote and thus apparently so did the precatory resolution.

At this point Morgan Grenfell, the investment banking subsidiary of Deutsche Bank, organized a Continental support group to obtain a "blocking majority" of at least 25 percent of Continental's shares. The participants were leading companies of the German corporate establishment: Allianz, Deutsche Bank, Dresdner Bank, BMW, Volkswagen, Daimler Benz, and other smaller financial institutions.[93] The defensive action was successful. Although the capped voting provision was eliminated from the charter (at least until the repealer was judicially voided), other resolutions, which required a 75 percent vote, were defeated. [94]

The post-meeting situation was something of a stalemate. Even without capped voting (although litigation raged over its purported elimination), no transaction would be possible over the opposition of the

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[89] See Investors Chronicle, "Pirelli Proposes Continental Tyre Merger," Sept. 21, 1990; Jonathan P. Hicks, "Continental, Still Digesting General Tire, Battles Pirelli", New York Times, Aug. 25, 1991, Sec. 5, at 3.

[90] "Not like this, Mr. Pirelli," the Continental CEO is alleged to have responded to a Pirelli proposal that it obtain majority control of the merged enterprise. Andrew Fisher, "Continental Rejects Pirelli Offer," Fin. T., Sept. 25, 1990, at 23.

[91] See Wolfgang Münchau, "Pirelli to ask Continental investors for Coup Support," The Times, Dec. 10, 1990.

[92] Many large German firms then had such a capped voting provision, see David Waller, "In Defence of Voting Restrictions," Fin. T, June 12, 1992, p.25 (citing 1991 study by Swiss bank Julius Baer), which seems to have been added in 1970s "amid fears that the crown jewels of German industry would be bought up by oil-rich countries." David Waller, "Assault on corporate Germany's Defences," Fin. T. Dec. 22, 1992, at 6. Note that capped voting was eliminated in 1998 by the KonTraG, see notes 80ff supra.

[93] Economist, "Corporate governance in Germany; Our crowd," February 23, 1991, at 66.

[94] The approval of the capped voting repeal was subsequently voided by a court decision that held that the agreeement among Pirelli and its support group members (which included an undertaking by Pirelli to indemnify them for any losses) was a "pool agreement" that gave Pirelli more than 25 percent of Continental stock and which therefore should have been explicitly disclosed. Landgericht Hannover, Urteil vom 29.5.1992, Die Aktiengesellschaft 1993, at 187, 188.

blocking group. The parties fitfully negotiated but could not come to terms; eventually both CEOs resigned under pressure. Skirmishing broke out at the regular shareholder meeting in July 1992, when Pirelli and its allies were precluded from voting because of failure to make appropriate disclosure of their 25 percent blockholdings.

In March 1993 Pirelli ran up the white flag and sold out virtually the entire interest of its support group to a buyers group put together by Deutsche Bank that included a group of companies in Lower Saxony, the *Land* where Continental was based and which had the greatest local interest in job preservation. The Lower Saxony companies paid for their shares with state-guaranteed bonds.[95] Pirelli received a 21 percent premium on the disposal of its block over the then market price (although it suffered a significant loss overall). Perhaps the timing and premium was influenced by a Pirelli threat to sell its block to a Japanese investor. Continental's new managing board chairman said that the firm had "won back full freedom of action and will use it in the best interests of the group of its customers, shareholder, and workers."

The Pirelli-Continental battle shows the Germany corporatist system in full defensive battle at the beginning of the decade. An important German firm fell under hostile attack and Deutsche Bank organized leading corporate actors to rally around both in the moment of crisis and then as part of a total explusion of the Pirelli threat. As the Economist put it, "Corporate Governance in Germany: Our Crowd."[96] In victory, Continental proclaimed stakeholder values.

Mannesmann/Vodafone. The Vodafone takeover bid of Mannesmann, although like the Pirelli bid for Continental a cross-border hostile bid, proceeded to an entirely different conclusion. Mannesmann management pursued no preclusive defensive measures, sought no defensive blockbuilding by industrial or financial allies, and turned down political help that might have been forthcoming. Instead, it argued the merits of its strategy against the Vodafone alternative, an argument pitched to its shareholders and the equity markets. Its capitulation came when became clear that Mannesmann's shareholders found Vodafone's offer economically compelling.

Mannesmann was founded in 1890 as the manufacturer of seamless tubes, expanded into steel and coal at the beginning of the century, evolved by the 1970s into a multinational firm with important machine

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[95] Now Chancellor Gerhard Schröder was then prime minister of the Lower Saxony.

[96] The Economist, Feb. 23, 1991, at 66. Even then there were some German voices who objected to the German system of corporate governance: "Can it even be unfriendly when someone wants to have influence over that which he owns?" Meite Thiede, "Mutes with Voting Rights," SDZ, March 16, 1991. The piece criticized the marshaling of German industry against Continental's largest shareholder.

A partial counterexample is Krupp's acquisition of Hoesch over the same time period,1991-92, apparently the first successful large-scale hostile takeover in post-War Germany. With the help of its allied banks, Krupp secretly accumulated a 24.9 percent block and then initiated a tender offer that brought it a majority stake and eventual approval of the merger. Subsequently Krupp-Hoesch closed more efficient Krupp mills in favor of less-efficient mills located in a high unemployment area, a move interpreted as necessary to insure the cooperation of the state government, Northrhine-Westphalia.

After identifying other situations of aggressive tactics in the German mergers market, the Economist concluded: "Foreigners can win control of German firms, but usually only when the target company is in trouble and when no leading German firm objects to the acquisition…. But when Germans decide a national asset is at stake, and the old-boy network starts buzzing, a foreign buyer's chance of victory is almost always low." (Economist, "Corporate Governance in Germany: Our Crowd,." Feb. 23, 1991, at 66).

tools and auto products divisions, and, most remarkably, after the liberalization of the German telecommunications market in the 1990s, transformed itself into one of the most significant telecommunications companies in Europe.[97] Indeed, In 1999 Mannesmann announced its intention to spin off its "classic" industrial elements to focus on the telecommunications business.

In the wake of telecommunications liberalization throughout Europe, a number of firms were competing to build pan-European networks, especially in wireless. In October 1999 Mannesmann made a significant move: it agreed to acquire Orange, Britain's third largest mobile-phone operator, for $32.9 billion in cash and stock. This would make Mannesmann one of the largest wireless operators in Europe, with more than 10 million subscribers and strong networks in Germany, Italy, and the UK.[98] Mannesmann's move into the UK was taken as a strategic threat by Vodafone Airtouch, the largest wireless operator in the UK, and after its 1999 merger with Airtouch, the world. Within days of the public announcement of the Orange transaction, Vodafone began planning its bid for Mannesmann.[99] (The two companies participated in joint ventures in other markets, especially Italy, and there had been previous rumors of Vodafone's interest in a possible combination.)

On November 14, Vodafone's CEO, Chris Gent, traveled to Mannesmann headquarters in Düsseldorf to present a "friendly" merger proposal to Klaus Esser, his counterpart. The offer, which valued Mannesmann at $106 billion at current market prices, was rebuffed as inadequate and Esser's rejection of it was backed up by the Mannesmann supervisory board at a meeting later that month. Battle was formally joined when Vodafone presented a stock-for-stock exchange offer to Mannesmann shareholders December 23, 1999, on a ratio that would give Mannesmann shareholders 47.5 percent of the combined company and which placed a value at current market prices of $131 billion on Mannesmann.[100] After a three months battle, Esser capitulated to an offer plainly favored by a majority of his shareholders: 49.5 percent of the stock of the combined company, which valued Mannesmann at $180 million at current prices. The shareholders had realized an almost 100 percent gain in the value of their shares since Mannesmann's October move on Orange.

In the course of the takeover battle, Mannesmann and Vodafone waged a remarkable public battle, reminiscent in its media intensity of the Deutsche Telekom privatization. The dueling CEO's gave press interviews and made numerous personal appearances. The companies took out full page ads in national and large regional newspapers to argue their case. There was a remarkable series of photo ads. Mannesmann struck first, with a picture of a baby identified by the name of its telecommunications company and the caption: "It has a lot planned." Vodafone responded with a photo of a nursing mother (one breast uncovered) and the tagline: "Every *Mann* knows: if you want to grow, you need a good mother." Mannesmann's surrebuttal was an ad with the original baby but with the caption: "A hostile mother is the worst thing in the world."[101] Most of the media campaign was more substantive and less graphic though no less heartfelt.

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[97] See Martin Höpner & Gregory Jackson, An Emerging Market for Corporate Control? The Mannesmannn Takeover and German Corporate Governance (Max-Planck-Institut für Gesellschaftsforschung MPIfG WP 2001/4 (Sept. 2001) (available on SSRN). I draw on Höpner & Jackson in some of the description that follows.

[98] 10/21/99 WSJ.

[99] Vodafone Airtouch Offer for Mannesmann AG, Exchange Offer Prospectus 47 (Dec. 23, 1999).

[100] 12/27/99 WSJ.

[101] See Höpner & Jackson, supra note xxx (their translation). A shareholder activist group, disturbed by the expense and frivolity of the media campaign, brought suit; the court dismissed the action.

There were two reasons for the public nature of the contest. First, the bid's success required acceptance by public shareholders. Unlike the relatively few previous hostile control contests in Germany, Vodafone proceeded through a public tender offer, not through the "stakes-building" that characterized Pirelli's bid.[102] That is, instead of putting together a control block through open market purchases or through a series of principal trades (what Americans would call a "creeping tender offer"), Vodafone made its bid directly to the public market.[103] Mannesmann's ownership structure was genuinely dispersed. At the time of the bid, the only 10 percent holder was Hutchinson Whampoa, which received its stock as result of Mannesmann's acquisition of Orange. (Hutchinson had entered into a voting agreement with Mannesmann at the time of the Orange transaction, so its shares had to be counted for management.) Approximately 25 institutional investors held a total of 25 percent.[104] An unusually large percentage of shareholders, 60 percent, was said to be foreign; such a high figure must be at least partially attributable to the Orange transaction. So the case for and against the bid needed to be made to a broad national and international market of shareholders.

The second, perhaps more important reason for the extensive publicity, was that the bid triggered a far-ranging debate over hostile takeovers as an appropriate mode of economic behavior. This had particular valence because only two years before (in 1997), in the wake of Krupp's hostile bid for Thyssen, 30,000 workers had taken to the streets to demonstrate against such "Wild West" tactics.[105] So Vodafone and its CEO emphasized the synergy motives for the merger: that the combination of networks would create value, that no layoffs were planned, that Düsseldorf would remain a headquarters city, that the bid was rooted in an industrial logic, not one of those objectionable US-style speculative bids. But the larger issues were always in sight: whether shareholder capitalism would become increasingly influential in Germany, including but not limited to acceptance of public control contests for large German public corporations.[106]

While German newspapers and magazines mostly avoided overtly nationalistic rhetoric (except for the tabloid *Bild*, which consistently referred to Gent as a "shark" and Esser as a "superbrain"[107] references in the media to Mannesmann's tradition as a German concern or simply as Deutschland AG make it clear that a

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[102] See See also Tim Jenkinson & Alexander Ljungvist, The Role of Hostile Stakes in German Corporate Governance, 7 J. Corp. Finance 397 (2001) (documenting 17 instances of hostile stakes building over the period 1988-1996). Krupp's 1997 bid for rival steel manufacturer Thyssen was the first Anglo-American style hostile tender offer in Germany, since the offer proceeded through a premium bid made to all public shareholders. Vodafone's bid for Mannesmann was the second, and the first to succeed.

[103] Presumably a major reason for this was Vodafone's desire to use its own stock as 100 percent consideration and the resulting regulatory and practical difficulties in the stakes-building alternative.

[104] Id., Table 5.

[105] Gordon, supra note xx, at 240. Not long after withdrawal of the hostile bid, a "friendly" merger occurred, accompanied by downsizings.

[106] Compare, e.g., "While the new seat of the government was Berlin, the fate of German capitalism would be decided in Düsseldorf. A defeat of Mannesmann's incumbent management would mean the end of the German economic model. No longer would decisions be made in boardrooms connected with banks and unions. It would be international institutional investors who called the shots." Martin Kessler, Der Kampf um Mannesmann erschüttert die deutsche Wirtschaft, Rheinische Post RP, November 16, 1999. (Matthias Baudisch transl.)

[107] Spiegel, 2-7-00, p. 6.

certain sense of Germanness was at stake.[108] The rhetoric was at times intense. For example, *Die Zeit*, the centrist weekly, after earlier explaining that a "hostile" is a term of art in business combinations, became more colorful.

> "Last week, in the case of Mannesmann, one thought that barbarians were at the gates of the factories of Germany, Inc. One had heard that they had come from far away to rob and plunder. ...
>
> "In the 80s, there were unscrupulous firms in America who went marauding with their billions to slaughter the firms they unbuilt. Now the plunderer is named Vodafone and the victim Mannesmann. In a takeover coup, the British firm wants to swallow the Düsseldorf firm and then fillet it."[109]

Purple prose was common in the German press when discussing the Mannesmann takeover. Although the Lexis-Nexis database includes only 30 German-language periodicals, a search geared to the transaction found 542 uses of "takeover slaughter/battle," 448 references to "war," 183 instances of "swallowing," 217 characterizations of Mannesmann as a "victim" or "sacrifice," 37 times Mannesmann is "filleted."

Nevertheless much had changed in the period beginning after the privatization of Deutsche Telekom, even after the failed Krupp bid. Telekom itself had raised another $11 billion in a primary offering. The Neuer Markt had taken off. Perhaps most important in practical term, German firms had been acquirors in high visibility takeovers: British targets, for example, Rolls Royce (VW), Rover (BMW) and Orange(Mannesmann); US targets, Bankers Trust (Deutsche Bank) and Chrysler (Daimler); even Italian targets, Omnitel, Infostrada (Mannesmann). German firms had also suffered from the nationalist policies of others, for example, Deutsche Telekom's thwarted bid for Telecom Italia. Mannesmann itself was 60 percent owned by foreigners at the time of the bid.

The German unions approached the transaction with sophistication.[110] Arguably IG Metall and the local works councils had much at stake. Mannesmann had been subject to the most rigorous form of codetermination (because of its roots in the steel and coal business); the takeover could affect union power on the supervisory board and throughout the enterprise; jobs were also potentially at risk. But the union also appreciated some of the economic logic of the transaction. In particular, they apparently had at least some sympathy to spinning off the "classic" divisions of Mannesmann, on the ground that all the cash flow had been directed to telecom investment and that these divisions would fare better as stand-alones.[111] Although the union leadership vigorously opposed the transaction along the way, what was more important is what they avoided: no "general strikes" at the company and no effort to raise the political stakes to a fever pitch.

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[108] See, e.g., Die Zeit 47/1999 (Mannesmann as the "most innovative traditional German concern"), FAZ 11-13-00 (Title: "the taming of Deutschland AG"), Die Zeit 48/1999 ("one thought that barbarians were at the gates of the factories of Deutschland AG"), Die Zeit 7/2000 (headline: "the company buyers are coming to Germany") and manager magazin March 1, 2000 ("The siege lasted three months. Then Germany's fortress fell. The 15 year old British upstart Vodafone had swallowed the more than 100 year old traditional concern Mannesmann."). (Virginia Tent, transl.)

[109] Die Zeit 48/1999. (Virginia Tent transl.)

[110] This follows Höpner & Jackson, supra note xx.

[111] Notice that this pattern reverses one possible conglomerate problem of profitable new tech subsidiaries subsidizing unprofitable traditional industrial subsidiaries. Arguably Mannesmann was the rare case in which workers in both parts of the company saw themselves better off after the transaction and should not be taken as indicating general worker acceptance of more typical conglomerate break-ups.

By the end, the labor bench of the Mannesmann supervisory board voted in favor of the transaction.

There seemed to be no political traction in opposing the takeover bid. Indeed, Chancellor Schröder's efforts to intervene came in for harsh criticism. He was initially quoted as indicating that the market should decide: "Whoever wants to buy a British company – like Mannesmann with Orange – can't say: We're allowed, but they're not."[112] But then in apparent response to pressure from SPD party leaders, he began tacking in opposition: "Hostile takeovers destroy an enterprise's culture. They harm the target, but also, in the medium-term, the predator itself." He played the nationalism card: "I much prefer Franco-German cooperation because it is friendly."[113] His comments ignited a storm of criticism in Germany,[114] England,[115] and elsewhere.[116]

The most remarkable performance, however, was by Kurt Esser, who was determined to fight the transaction solely on the economic merits for the shareholders. In contrast to the managerialist rhetoric in Continental/Pirelli, Mannesmann's defense was based on its chairman's insistence that ultimately shareholders would be better served by Mannesmann's business plan. The claim was that Mannesmann's telecommunications strategy, which called for the integration of fixed-line and wireless service, was superior to Vodafone's, based almost exclusively on a wireless platform. Esser did not challenge the legitimacy of hostile bids, threaten the possibility of job losses, nor invoke the interests of other possible stakeholders. He rejected preclusive defenses and nationalist political intervention. In an interview shortly after Vodafone

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[112] William Boston, "Hostile Deal Could Breach German Resistance – Mannesmann Has Weapons In Vodafone Contest, But Others Hang Back," Wall. St. J., Nov. 17, 1999, p. A 17, available at WL-WSJ 24922274.

[113] "Anglo-Saxons at the Gates," Wall. St. J., Nov. 24, 1999, p. A 18 (editorial), available at 1999 WL-WSJ 24923243.

[114] See, e.g,, *Süddeutsche Zeitung* ("SZ"), 11-22-99, p. 4 ("Schröder, Ruettgers, Clement and others have done the German economy a disservice by taking sides with Mannesmann. The fact that Tony Blair got mixed up with the Vodafone side doesn't make the matter any better… Inside [Germany], Schroeder raises the idea that one must protect German jobs from foreign grabbers; outside [Germany], he gives the impression that "Germany AG" is playing hedgehog." (Virginia Tent, transl.)

A similar position was taken in the *Frankfurter Allgemeine Zeitung* (FAZ), which remarked that the previous week had been "a disappointment for the German shareholder culture." It criticized the attempt of influencing the imminent takeover as an example for Germany's hostility towards structural changes. "Feindliche Übernahmen und deutsche Ängste," FAZ, November 22, 1999, p. 33. (Matthias Baudisch, transl.)

An editorial in *Die Welt*, "Precedent with Consequences" noted that in many European countries national interests prevailed over market logic. The newspaper cited Deutsche Telekom's failed bid for Telecom Italia as an example of a government giving preference to a domestic solution and the French habit of promoting national champions as another. It noted that mere rumors about a potential bid for a traditional German corporation were enough to trigger irresponsible talk of a fire sale of the German economy. It mentioned the United States as an example for how to deal with the phenomenon of (hostile) acquisitions in a more relaxed way. In a global economy, there was no room for national reservations concluded the article. Marco Dalan, Präzedenzfall mit Folgen, Die Welt, Nov. 15, 1999. (Matthias Baudisch transl.)

[115] The Times editorial of 11-20-99 warned that "By warning off Vodafone from pursuing its latest, hostile, bid, for £79 billion - the largest in history and the first such hostile bid in Germany - Herr Schröder lays himself open to charges of nationalism, populism and plain bullying."

[116] According to the FAZ, the Italian newspapers "accuse Schröeder of blatant protectionism". (FAZ 11-29-99, p. 49). In early 1999, Mannesmann took over Omnitel and Infostrada in Italy.

hostile overture, he objected that "poison pills and white knights are detrimental to the shareholders interests.... We have to subject ourselves [i.e. the Mannesmann management] to the public opinion whether we are better than Vodafone's management."[117] In response to Chancellor Schröder's comments, he said: "We really have no use for national pathos right now. That does not fit in with our time, and especially does not fit in with Mannesmann's strategy." [118]

In the course of the contest Esser turned away from a number of substantial tactical defenses that in light of the size of the transaction could have created delay and uncertainty. For example, a five percent voting cap in the Mannesmann bylaws did not expire, under the KonTraG, until June, 2000. The need to spinoff Orange to satisfy competition review may well have required a 75 percent shareholder vote under the *Konzernrecht* but Esser did not pursue the implications of this tactically either, for example, by trying to assemble a blocking coalition. He delivered for the shareholders, as he pledged at the beginning.

So in barely the space of a decade public and elite attitudes have dramatically shifted.[119] What was

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[117] "Giftpillen und Weiße Ritter sind nicht im Interesse der Aktionäre", FAZ, November 16, 1999, p. 22. (Matthias Baudisch, transl.) Nevertheless, at the end he pursued a failed white knight strategy with Vivende.

[118] SZ 11-22-99, p. 1

[119] In light of the success of Vodafone's hostile bid for Mannesmann, it is hard to read the lasting significance of Krupp-Hoesch's failed hostile bid for Thyssen. The bid was defeated not by corporate governance machinations by Thyssen management but rather by an effective political campaign waged by IG Metall (including mass demonstrations of 30,000) that made particular use of the arguably conflicted roles of Deutsche Bank in aiding Krupp's bid despite a seat on Thyssen supervisory board. The takeover was characterized as an unwelcome intrusion of "Wild West capitalism" into the German scene and the bonanza for Thyssen shareholders (a 25 percent premium over market from a cash tender offer) was contrasted unfavorably with job losses in the 10,000s (at a time of 11 percent unemployment). See, e.g, Zuviel Unruhe an Rhein und Ruhr, SZ March 22, 1997, at 21. Eventually, however, the firms entered into a "friendly" merger brokered by political leaders that entailed significant consolidation of their steel operations. (For accounts of the transaction see, e.g., Matt Marshall, Thyssen, Krupp Opt for 2 CEOs, Removing Barriers in Merger Talks, Wall Street Journal (Europe), Jan. 12, 1998, at 3; Thomas Kamm & Matt Marshall, The Next Wave: Global Forces Push European Companies into Merger Frenzy, Wall St.J. (Europe), April 4, 1997, at 1; Kristi Bahrenburg, Takeover Flop Dins German Shares' Sheen, Wall St. J. (Europe), Apr. 2, 1997, at 12.)

Although there were fears that the failure of the transaction and the manner in which it failed amounted to a serious demerit for German capital markets (See, e.g., Ein Verständigungsproblem, BZ, March 25, 1997, p.1; Die Aktionäre kamen nicht vor, HB, March 21, 1997, p.1; Auf zum letzten Gefecht, FAZ, March 25, 1997, p.1; Für die Stahlkocher reimt sich Banker auf Henker, Die Welt, March 26, 1997), the subsequent Mannesmann takeover agues to the contrary. The most enduring impact of the Krupp bid may have been with respect to German banks. First, the participation of Deutsche Bank and Dresdner Bank put the good-housekeeping seal on hostile deal activity, much as Goldman, Sachs and Morgan, Stanley's advice to raiders in the 1970s reflected changing attitudes in the US financial establishment. Moreover, the anti-bank sentiment that was stirred up (see, e.g., Der Stahlpoker an der Ruhr, FAZ, March 26, 1997, p.21; Banken als Fusionshelfer feindlicher Parteien, HB, March 26, 1997, p.2) contributed to the pro-shareholder cutbacks in the banks' governance power in the 1998 KonTraG, in particular, limitations on the banks' power of proxy voting, *Depotstimmrecht*. See generally Theodor Baums, Lehren aus dem Fall Krupp - Thyssen, in Wirtschaftsdienst, 1997, S. 259 f. ("Lessons from the Case of Krupp-Thyssen") (Sven Hodges, transl.)

Finally, although worker opposition torpedoed the hostile bid, the episode showed the breakdown in worker solidarity on which the German corporatist model of Rheinish capitalism was based. As Höpner puts it, "While IG Metall was fighting hostile takeovers as an illegitimate instrument of economic behaviour, Krupp employees were supporting the takeover attempt." See Martin Höpner, Corporate Governance in Transition: Ten Empirical Findings

seemingly unthinkable, the "loss" of a German firm to a foreign interloper, has now become part of the economic landscape. The process that began with the privatization of Deutsche Telekom has pushed Germany very far towards on the road to shareholder capitalism. The ownership structure stands in the way, yet as we shall see, the "strong force" of institutional complements that holds stakeholders in the governance nucleus is dissipating. Yet a seismic event like the Mannesmann takeover has aftershocks. If previously the assumption was that nationalist economic protectionism was objectionable but relatively unimportant (because the Germany financial and industrial community would organize the necessary defense), now the protectionist problem becomes critical.

II. The Collapse of the 13th Directive and Germany's New Stance on Target Defenses

A. The Origins of the 13th Directive

The harmonization of European corporate law (or "company law") has been a difficult topic, both theoretically and practically. Although a harmonized, if not necessarily uniform, law has some obvious scale-economies in a continent-wide legal system, the process by which this harmonization occurs is problematic. American scholars particularly have argued that imposition of harmony through a political process rather through competition is likely to produce an inefficient result that, worse, will be rigidified by the political barriers to modernization. American corporate law is a harmonized product, in significant measure because of the competitive triumph of Delaware, and highly adaptive because of these competitive forces.[120] The EU law-making process that would generate a uniform corporate law is, by contrast, a study in complex politics, complicated by a multi-tiered structure in which a law proposal must achieve acceptance by the eurocrats (the European Commission), the particular states (the Council), and then, in important cases, a popularly elected body of uncertain mandate (the Parliament). Thus some have criticized the prospect of European corporate law harmonization as susceptible to strong influence by groups not particularly interested in the efficiency of corporate law.[121] This opposition to regulatory harmonization runs up against the fact that European choice

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on Shareholder Value and Industrial Relations, MPIfG WP No. 2001/5 (Oct. 2001) In other words, employees were focusing on firm specific outcomes rather "class" outcomes. This is consistent with the claim that one effect shareholder capitalism is the decentralization of decisionmaking, with the welfare of the firm as the variable of interest.

[120] The purported importance of regulatory competition to US corporate law is undercut, or at the very least complicated, by the fact that significant amount of US corporate law is determined at the federal level, most notably through SEC regulation of the disclosure and proxy process, and by forms of self-regulation under SEC guidance, most notably though stock exchange listing requirements. In the wake of the accounting scandals of 2001/2002, Congress intervened in US corporate governance in the Sarbanes-Oxley Act of 2002, which, among other things, imposed requirements on the makeup and function of boards and limited certain forms of executive compensation.

[121] More recently "harmonization" has been replaced as an explicit EU goal in favor of "minimum standards," which, under the principles of subsidiarity, permit some national diversity within a common framework. The generation of minimum standards presents many of the same problems of political economy as harmonization. See Wolfgang Schoen, Wolfgang, "Mindestharmonisierung im Gesellschaftsrecht", Zeitschrift fuer Handelsrecht (ZHR) Vol. 160, 1996, 221 - 249; Theodor Baums, Theodor, "Zur Harmonisierung des Rechts der Unternehmensuebernahmen in der EG", in Rengeling (ed.), Europaeisierung des Rechts, 1996, 91 - 112, at 97 - 106.

of law rules do not readily permit the jurisdictional competition that might otherwise lead to harmonization,[122] so, as a practical matter, the EU level law-making or fortuitous national copying are the only options.

But harmonization has also come under attack from the localists, who argue that harmonized law will threaten cherished local values. A law that settles on a dual board structure and codetermination in the boardroom is opposed by the British, but a law that settles instead on the single board model is vigorously rejected by the Germans and the Dutch.[123] The consequence of these cross-cutting claims is that the project of harmonized company law in the EU has yielded relatively little fruit. Thus far eight company Directives have been adopted, mostly between 1968 and 1978, of relatively meager content; most of the corporate law in Europe is internal to member states.[124] A statutory framework for a new "Societas Euoropeae, a "European Company," was finally adopted in 2001, 30 years after the first draft.[125] The impact of this new European entity, which becomes possible as of 2004, is highly uncertain, however, since the framework provides for worker participation rights similar to the works council elements of codetermination, strongly objected to by UK firms at least.[126]

Into this gridlock comes the proposed 13th Company Law Directive on Takeovers, proposing to regulate key terms of takeover bids and the relative positions of boards and shareholders in responding to hostile bids, highly contentious issues that go to the core of corporate structure and to the shareholder capitalism debate. Remarkably, after a 15 year gestation period, the 13th Directive almost passed in summer 2000, defeated at the last minute by a turnabout from Germany, one of the staunchest supporters. Some

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[122] But see Centros v. Erhvervs-OG Selskabsstyrelsen, C-212/97, [1999], ECR 1-1459 (permitting establishment in a member state of a business that uses a shell incorporation in another member state). The direct effects of *Centros* are limited, since it applies to new businesses only, rather than reincorporations of existing businesses. Moreover, reincorporation of an existing business in another EU state will often trigger significant tax liability, since it may be treated as liquidation of the business. On the other hand, a more recent ECJ case, In re Überseering , C- 208/00, [2002], ECR ----, goes further in undermining the legal seat rule, since it apparently clarifies that a German national, say, can acquire (or, presumably, establish) an English corporation and use it to conduct business activities in Germany, thereby evading various German corporate governance rules, including codetermination.

[123] See generally George Berman et al, Cases and Materials on European Union Law 803-05 (2d ed. 2002).

[124] For the tenor of the debate see Walter Ebke, Company Law and the European Union: Centralized Versus Decentralized Lawmaking, 31 Int'l Law. 961 (1997); Terence L. Blackburn, The Societas Europea, The Evolving European Corporation Statute, 61 Fordham L. Rev. 695 (1993). See also Eddy Wymeersch, Company Law in Europe and European Company Law, Univ. Gent Financial Law Inst. WP 2002-06 (April 2001)(available on SSRN). Nevertheless there has been a considerable degree of harmonization in securities regulation, which is seen as raising fewer issues of national identity. See Amir Licht, International Diversity in Securities Regulation: Roadblocks on the Way to Convergence, 20 Cardozo L. Rev. 227 (1998).

For recent developments and a general overview see Report of the High Level Group of Company Law Experts On a Modern Regulatory Framework for Company Law in Europe, Nov. 4, 2002, web-posted at http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf (visited Dec. 30, 2002).

[125] Council Regulation on the Statute for a European Company (EC) No. 2157/2001(Oct. 8, 2001).

[126] Council Directive supplementing the Statute for a European Company with regard to the Involvement of Employees, 2001/86/EC (Oct. 8, 2001).

version may yet be adopted. [127] Both the manner of its defeat and the effort to revive it demonstrate quite powerfully the "international relations" thesis: that convergence on the shareholder model is profoundly influenced by the pursuit (or avoidance) of economic and political integration.

The 13th Directive grew out of a 1985 White Paper on completing the Internal Market.[128] The Commission presented its initial proposal to the Council and the European Parliament in January 1989, and after comments and negotiations, an amended proposal in September 1990. The amended first proposal was criticized as too detailed an intervention into member states' law. It set forth detailed bid procedures, including the content of mandatory disclosure documents to be produced for shareholders by both the acquiror and the target. It required state supervisory authorities to assure the equal treatment of shareholders and set forth the obligation of target boards to act "in the interest of all the shareholders." In many respects it followed the UK City Code in requiring the board to obtain shareholder approval before employing defense tactics and in enacting a "mandatory bid"
provision that required a party obtaining one third of a company's voting rights to make a bid for the rest at an equitable price. It contemplated recourse to the courts for enforcement, however, rather than the self-regulatory model of the City Code.

The Commission withdrew the proposal and tried again, in February 1996, in a shortened version, a "framework directive," that stated general principles and left states with much more discretion over the particulars. For example, the 1996 proposal, unlike the first one, did not set forth a specific percentage threshhold for a mandatory bid. It did, however, retain the "board neutrality" position of its predecessor. After further deliberations that extended over a three year period, in June 1999 the Internal Market Council came to a political agreement on the Directive. The final version of the board neutrality provision in Article 9 the June 1999 Council draft, obliged member states to require that

> "during the period [beginning when the offer is publicly noticed and ending when the results are announced or the bid is withdrawn] the board of the offeree company shall obtain the prior authorisation of the general meeting of the shareholders, given for this purpose, before taking any action which may result in the frustration of the bid, other than seeking alternative bids, and notably before the issuing of shares which may result in a lasting impediment for the offeror obtaining control of the offeree company."[129]

This agreement crashed on the Rock of Gibraltar. The Council agreement was made contingent on a

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[127] See Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Jan 10, 2002, (webposted at <www.europa.eu.int/comm/internal_market/en/company/company/official/> (hereinafter "Experts Report on Takeovers"); Proposal for a Directive of the European Parliament and of the Council on Takoever Bids, COM (2002) 534 Final, 2002/0240(COD) (Oct. 2, 2002) (discussed at nn. – infra).

[128] This history draws on the Experts Report on Takeovers, at 13-17, and George Berman et al., Cases and Materials on European Union Law 804-05 (2d ed. 2002). For a concise account, see Gabriele Apfelbacher et al, German Takeover Law – A Commentary 4 (2002). See generally Christian Kirchner and Richard W. Painter, A European Modified Business Judgment Rule for Takeover Law, 2 Eur. Bus. Org. L. Rev. 353-400 (2000).

[129] For the Council text and the proposed amendments of the European Parliament, see European Parliament, Recommendation for Second Reading, 8129/1/200 - C5-0327/2000-1995/0341 (COD). The ultimate Council common position was put forth on June 19, 2000. Article 9 also provided that state laws could nevertheless permit a target to "increase the share capital" during the period of bid pendency if authorization for the issuance had been received no more than 18 months prior to the initiation of the bid so long as preemptive rights were preserved.

resolution of dispute between Spain and the UK arising from the contested status of Gibraltar.[130] The dispute arose because Article 4 of the directive specified that "Member States shall designate the authority ..., which will supervise all aspects of the bid." Spain wanted to avoid the creation of a separate authority for bids in Gibraltar. (!!) This pivotal issue of commerce found its eventual resolution almost a year later and the Council adopted a common position June 19, 2000. But by now Germany had changed its view on the 13th Directive, especially because of the board neutrality provision which it had once championed. Its opposition was pivotal to the ultimate rejection of the Directive by the European Parliament in July 2001.

B. Germany's New Vulnerability

The world changed for corporate Germany between the June 1999 Council agreement and Parliament's vote. Vodafone had successfully concluded its hostile takeover of a famous German company, Mannesmann, after the first successful Anglo-American style hostile tender offer in Germany. Moreover, in December 1999 the German government made the surprise revelation of its intention to propose repeal of the capital gains tax on shareholdings of corporations, which was eventually adopted in July 2000.[131] The repealer, to take effect January 1, 2002, made it possible for firms to dispose of their cross-holdings without a ruinous tax penalty (an estimated 52 percent rate on realized gains).[132] At the time the proposal was announced, these cross-holdings were valued at € 250 billion, approximately 15 percent of German's then stock market capitalization.[133] Indeed, some have attributed the web of cross holdings that characterized current ownership structures for many German firms and the resulting political economy principally to the lock-in effect from the high capital gains rate.[134] Regardless of the past role of the insider stakes, many financial firms obviously now wanted to dispose of their corporate holdings, invested capital on which they earned a substandard rate of return, in order to reposition themselves for competition in the global economy. Deutsche Bank, for example, had already spun off its corporate holdings into a separate subsidiary in anticipation of a selloff or spinoff.

There had been important prior institutional changes as well: "Hausbanks" were repositioning themselves as investment banks. This seems the significance of the willingness of Deutsche Bank and Dresdner Bank to finance and otherwise aid Krupp-Hoesch's hostile bid in 1997 for Thyssen, despite their seats on the Thyssen supervisory board – an event that arguably would validate hostile bids much like the 1970s decisions of US blue chip banks like Morgan Stanley and Goldman Sachs to represent raiders. Moreover, the adoption in 1998 of the KonTraG eliminated capped voting, which had been such a useful defensive feature against Pirelli's bid for Continental. Thus law firms rushed to staff up for what was anticipated to be a "big bang" of merger and restructuring activity in Germany beginning in 2002.

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[130] For a discussion of recent efforts to resolve the conflict, see "A deal too far? Britain and Spain are talking of joint sovereignty. Gibraltarians are twitchy," Economist, Jan. 17, 2002.

[131] See generally, Mark H.Lang et al, Bringing Down the Other Berlin Wal: Germany's Repeal of the Corporate Capital Gains Tax (Working Paper Jan. 2001)(available on SSRN).

[132] Id. at 40.

[133] Benjamin W. Johnson, German Corporate Culture in the Twenty-First Century: The Interrelation between the End of Germany, Inc. and Germany's Corporate Capital Gains Rate Reform, 11 Minn. J. Global Trade 69, 71 (2002).

[134] See Friedrich Kübler, Comment: on Mark Roe, German Codetermination and German Securities Markets, 5 Colum. J. Eur. L 213 (1999).

Germany had moved profoundly towards shareholder capitalism. Hostile takeover bids, even of the largest firms, were for the shareholders to resolve. This seemed to be the upshot of Vodafone/Mannesmann. The state would no longer provide an artificial barrier to the unwinding of inefficient control positions, an artificial determinant of the character of shareownership. This was the result of the tax law change. Perhaps corporate blockholders would merely reshuffle the cards among themselves in the traditional German pattern of transactions in control,[135] but after the successful hostile tender offer in Vodafone, the door was now open to genuine outsider bids, including foreign bids. Banks were giving up their supervisory board seats and whatever commitment that entailed.[136] If the banks were now pursuing investment banking and the corporate blockholders were sellers at the right price, then the complementarities that sustained concentrated ownership would disappear and a new form of ownership structure would emerge. German managers and unions were obviously concerned about these possibilities, which would disturb existing economic and political settlements. The board neutrality position of the 13th Directive now become the center of an intense lobbying effort to persuade the government to oppose the directive. A particularly effective supplicant was Ferdinand Piëch, the CEO of Volkswagen, whose supervisory board was once chaired by Chancellor Schröder. (Recall that Schröder was also once prime minister of Lower Saxony, which held a 20 percent VW stake.)

But there was a separate concern which could not be dismissed as mere self-seeking protectionism: the "level playing field" problem. At the same time that the European Parliament was in its final deliberations on the 13th Directive, the EU Advocat General issued a surprising blanket rejection of several actions brought by the Commission before the European Court of Justice against "golden shares" held by member countries that protected privatized former SOEs.[137] The Commission had contended that golden shares, which give governments veto rights over recapitalizations, takeovers, and other fundamental transactions in privatized companies, violated the EU rules and treaties on competition policy and the free movement of capital. The Advocat General's opinion (which does not bind the ECJ but which is ordinarily persuasive) sustained:

– Portugal's requirement of ministerial approval for a 10 percent stock acquisition in a privatized company;

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[135] See Julian Franks & Colin Mayer, Ownership and Control of German Corporations, 14 Rev. Fin. Stud. 943 (2001). For an assessment of the immediate effects of the tax law change, see "The Tax Man Goeth: The Abolition of Tax on Sales of Shareholdings Has Already Made an Impact ," Economist, Jan 10 2002 (reasons not to expect a "rush of sales," including previous ability to maneuver around tax law, longrun strategic objectives, remaining tax barriers, and decline in German stock market values).

[136] Supervisory board seats held by banks in the largest 100 corporations declined from 29 in 1996 to 17 in 1998. Deutsche Bank announced in March 2001 that it would no longer chair the supervisory board of nonfinancial corporations. See Höpner & Jackson, supra note xx.

[137] Commission v. Portuguese Republic, French Republic and Kingdom of Belgium, C-367/98, C-483/99, C-503/99 (Opinion of Advocate General) (July 3, 2001) (available at Eurolex). See "EU Advocat General Would Allow 'Golden Shares,'" Fin. T. July 3, 2001. The action was particularly a surprise because of the May 2000 decision of the European Court of Justice, EU Commission v. Italy, [cite], which struck down golden shares maintained by Italy in Telecom Italia and ENI. See John E. Morris with Robert Galbraith, "Trying to Kill the Golden Share," Corporate Control Alert, June 2000, at 7–9.

The Commission's threatened action against golden share-like antitakeover protections for Volkswagen backfired, since it led VW to intensify its lobbying against the directive. See Paul Hofheinz & Scott Miller, "EU Questions German State's VW Veto," Wall St. J. May 11, 2001, at A12; Edmund Andrews, "Europeans Open Door for Hostile Takeovers," N. Y. Times, June 7, 2001.

– France's requirement for ministerial approval of a stock acquisition above a certain threshold in Elf Aquitaine;

– Belgium's requirement of ministerial approval of a significant stake in the Société Nationale de Transport par Canalisations on the test of whether it disserved Belgian national interests.

Countries like France, Italy, and Spain, had undertaken large scale privatizations of SOEs in the 1990s and retained golden shares in some of the most substantial enterprises in the country.[138] By contrast, Germany's privatization program was relatively small (except for Deutsche Telekom) because the level of prior state ownership was much less, and, as to the privatized firms, Germany did not retain a golden share. Thus Germany faced a situation in which large acquisitive enterprises might pursue hostile cross-border acquisitions of German firms, secure in the knowledge that they were shielded from countermeasures by the golden shares.[139] Moreover, on occasion state-owned firms, totally protected from a takeover bid, had pursued acquisitions. The implications were very serious. Obviously cross-border mergers were important to the integration of the European economy and ultimately its political economy. The single market called out for firms large enough to achieve appropriate scale economies. It was forseeable that this might entail consolidating facilities or divestments or downsizings, which might mean that a given firm would direct resources to one particular country, and away from another, despite the origins of the constituent firms. The risk to the project of economic and political integration is economic nationalism, mercantilism redux in the making of those resource allocation decisions. Economic geography matters. It would quickly become intolerable if French acquirors (for example) of German targets began to shift facilities and resources to French venues in response to explicit or implict direction of the French government, to bolster French jobs at the expense of German jobs. Yet this was the threat of the golden shares.

One important protection against nationalist behavior was mutual vulnerability in the market for corporate control. In such a world, an inefficient diversion of resources to France would be punished in the capital market – which cares about cash flow, not favor curried with the Minister – and would send a signal to a control entrepreneur. The behavior of management would be appropriately constrained. But this feedback system would be at serious risk in the case of a firm in which France retained a golden share. In other words, a golden share interferes with the mutual vulnerability that assures the credibility of the non-national basis for resource allocation.

The point is more general. Golden shares exemplify the more general problem of national law (voting caps, for instance) that protects the control position of national elites who will be susceptible to entreaties and expectations about favoritism on national grounds. Even if the French government is not a shareholder it may be tempted to exert nationalist pressure on controlling shareholders or perhaps intercede

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[138] A large percentage of share issuance in the EU is a consequence of privatization of SOE's, in which governments often retain a signficiant ownership stake. See Steve Jones et al, Share Issue Privatizations as Financial Means to Political and Economic Ends, 53 J. Fin. Econ. 217 (1999). For example, in the case of France, four large privatized companies (France Telecom, TotalFina, STMicr, and BNP) account for 20 percent of the market capitalization of the Paris Bourse. In Italy, the comparable figure for the Rome exchange is 36 percent (TI, TIM, ENEL, , ENI). See William L. Megginson & Jeffry M. Netter, From State to Market: A Survey of Empirical Studies on Privatization, 39 J. Econ. Litt 321 (2001) (Table 11, using firms in the Global 1000)

[139] In some of these cases, states had exercised golden share provisions to protect newly privatized companies. The Commission nevertheless had pursued an aggressive agenda against all golden shares. See Victorya Hong, "Golden Era Over for Golden Shares?" The Daily Deal, April 5, 2001.

with managers in the diffusely held firm. It's the mutual vulnerability to the control market that checks those tendencies. Thus local takeover protection, which is hardly limited to golden shares, may encourage and sustain the economic nationalism that disrupts economic and political integration.

Thus the "level playing field" objection was the special concern that now drove German resistance to the 13th Directive, which it had strongly advocated over the prior decade.[140] In other words, the standard story of private rent-seeking by managers and union does not do justice to the other compelling issue at stake: the prospects for economic and political integration

C. The Final Act in the the European Parliament

The Council had come up with an agreed position in December 2000. In spring 2001 the Parliament took a different tack, proposing 20 amendments, adding, for example, a right of employees to receive information and to be consulted about a bid and a board's right to resist a hostile offer. As part of the EU's codecision procedures, the Commission and the Parliament entered a conciliation process in which an agreeement was hammered out that gave the employees certain information rights and that crucially preserved the right of prior shareholder approval for target board defensive measures. The Conciliation Commitment drafted a joint text on June 6, 2001.[141] Indeed, the Gemany government was nominally on board on this final draft (although it later allegedly rallied its MEPs to vote against) because of a compromise that permitted a five year postponement of the effective date of Article 9's board neutrality provsions.[142] The Advocat General opinions in favor of golden shares came down on July 2. Parliament took up the measure almost immediately thereafter. It failed on a tie vote, 273-273, on July 4, 2001.

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[140] See Paul Meller, "Europe Plan on Mergers Hits a Snag; Germany Switches on Crucial Element," N,Y. Times, May 3, 2001, at D1. Germany wanted the board neutrality provision amended to permit boards to get blanket authority from shareholder good for up to five years for target defenses, i.e., eliminating the need to put specific defenses for a specific bid to shareholder vote. A spokeswoman spoke about the various protective provisions in other national laws, singling out golden parachute provisions. "This is a level-playing-field argument in favor of the German government's new position."

Indeed, the "Daily Notebook" of the European Parliament for July 4, 2001, describes the defeat of the 13th Directive in these terms:

> "Parliament has therefore in effect followed the recommendation made by its rapporteur Klaus-Heiner **Lehne** (EPP-ED, D), who opposed the conciliation agreement mainly on the grounds that the requirement for the board of a company which is the object of a takeover bid to refrain from taking defensive action until it has consulted its shareholders could only be justified if a 'level playing field' existed. Since, according to Mr. Lehne, there is no level playing field either at [the] international or European level and the joint text resulting from the Conciliation committee did not resolve this problem, he argued that the conciliation agreement should be rejected."

Europarl Daily Notebook: 04-07-2001, available at <www2.europarl.eu.int.http://www.europarl.eu.int/press/index_publi_en.htm> (follow links under Daily Notebook).

See also Paul Meller, "European Parliament Rejects Measure to Ease Takeovers," N.Y. Times, July 4, 2001(quoting Lehne: the directive "would not produce a level playing field for cross-border investment, it would create a complete imbalance in Europe.")

[141] 1995/0341 (COD), C5-0221/2001; PE-CONS 3629/1/0, Rev 1, DRS 27, CODEC 493. (June 19, 2001).

[142] See Paul Hofheinz, "Europe Gives Muted Applause to Mergers Bill,"Wall St. J., June 7, 2001, at A18; Deborah Hargreaves, "Germans Seek to Kill Off EU Takeover Directive," Fin. T., July 2, 2001.

D. Germany's New Takeover Law

Even before the final vote on the 13th Directive, Germany moved to adopt a law regulating takeovers. It had previously operated without one, relying instead since on a voluntary Takeover Code (*Übernahmenkodex*) adopted in 1995 based on the English City Code. As of 1997 approximately 80 percent of the DAX 30 companies but only 60 percent of the MDAX companies had agreed to comply.[143] Foreign offerors, however, rarely tied themselves to the Code and there was no enforcement machinery.[144] The Mannesmann transaction and the prospect of bids stimulated by the unwinding of blockholdings after the tax law change put takeover legislation on the agenda.

In many respects the proposed legislation tracked the 13th Directive in its then current form, adding additional protection for workers, and, more controversially, limiting the right to make exchange offers to companies that listed on a European exchange.[145] The May 2000 draft also contained the provision that Germany was then pushing for in the Directive, namely, permission for pre-bid shareholder authorization of defensive measures.

In draft legislation as of October 2001, the exception to board neutrality was relatively narrow. In addition to actions that a "prudent and diligent manager" would otherwise take, or a search for a competing bid (a "white knight"), management could employ only those defensive measures that had obtained shareholder approval **prior** to the announcement of the bid, and only to the extent that the measures had been authorized by a vote of at least 75 percent of the share capital. The authorization period was limited to 18 months.[146] In a draft of November 8, 2001, from the government's public finance committee, a remarkable addition to management board authority appeared: *"or actions which have been approved by the target's*

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[143] See Karl-Herman Baumann, Takeovers in Germany and EU Regulation Experience and Practice, in Klaus Hopt et al, Comparative Corporate Governance: The State of the Art and Emerging Research 659-665 (1998). For an account that includes adoption of the new law, see Gabriele Apfelbacher et al, German Takeover Law – A Commentary 1-7 (2002).

[144] Ralf Thaeter & Keith Frederick (Gleiss Lutz Hootz Hirsch), The German "Securities Acquisition & Takeover Act." (firm memo, undated mss, Dec. 2001). See generally Christian Kirchner and Richard W. Painter, Takeover Defenses under Delaware Law, the Proposed Thirteenth EU Directive and the Proposed German Takeover Law: Comparison and Recommendations for Reform (forthcoming American Journal of Comparative Law 2002).

[145] See Ralph Atkins, "Germans Agree on Code to Govern Takeovers," Fin. T. May 18, 2000. To be sure, the Act is more than an "anti-takeover law." It regulates all aspects of public bids in Germany, and insofar as it establishes clear rules and procedures and brings some useful innovations to German corporate law such as the freezeout merger, it may aid the making of offers for German firms, including hostile offers. Nevertheless its distinctive feature, the subject of extended debate during the legislative process, is the anti-takeover element.

The Act is formally cited as "Wertpapiererwerbs- und Übernahmegesetz" v. 20 Dezember 2001 (BGBl. I. S. 3822). A useful summary of its provisions are found in the Int'l Fin. L. Rev. (March 2002). A more extensive, very useful account, including a legislative history, is provided by Gabriele Apfelbacher et al, German Takeover Law – A Commentary (2002).

[146] Draft of a Bill on the Regulation of Public Offers for the Acquisition of Securities and the Regulation of Takeovers (Wertpapiererwerbs-und Übernahmegesetz – WpÜG) (Cleary Gottlieb Steen & Hamilton transl.) (Section 33)

supervisory board."[147] In other words, the supervisory board is now empowered to approve target defensive measures without any shareholder approval whatsoever. Although the scope of this discretionary power is not yet clear,[148] this appears to eliminate the general shareholder veto as well as the shareholder veto over particular defensive measures. The supervisory board is well insulated from pressures that might produce independent scrutiny of the requested defensive measures on behalf of shareholder interests. Recall that half the members of the supervisory board are employee representatives and that even shareholder representatives are elected for 5 year terms, removable only upon a 75 percent shareholder vote. The actions of the supervisory boards are subject to the usual fiduciary duties under German company law of care and responsibility in acting in the company's best interest, but Germany does not have a robust tradition of judicial review of board action, certainly not in the quick-paced timeframe of a contested bid, nor does it permit contingent-fee litigation, which has policed fiduciary duty compliance in the United States. The new legislation, effective in January 2002, may well unleash a broad range of target defensive measures in contested takeover bids in Germany.

It is notable that defensive tactics in Germany will evolve differently from the US pattern. This is because the US favorite, the "poison pill," would not be feasible under German corporate law because its discriminatory feature would violate strong mandates for preemptive rights.[149] If so, German anti-takeover measures will resemble those used in the US in the 1970s and early 1980s: for example, defensive acquisitions to create competition policy problems for the acquiror, setting up a blocking position for a "white knight" through a sweetheart sale of securities; selling off assets that an acquiror might prize, the "crown jewels"; reshaping the capital structure, as through additional leverage, to make the target less desirable;

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[147] Section 33(1) (Thaeter & Frederick transl.). So Sec. 33(1) reads: "After announcement of a decision to make an offer, up to the publication of the results of the offer, the management board may take no actions that could frustrate the offer. This does not apply [to certain action] ... as well as for actions which have been approved by the target's supervisory board."

> The notes accompanying the new draft point out the rationale behind some of the changes:
>
> "The change in the first Paragraph enables the management board of a target company, within the range of its management authority, to implement defensive measures if the supervisory board has first consented thereto.
>
> Defensive measures that normally are the responsibility of the shareholders' meeting to approve under general corporate law thus remain the responsibility of the shareholders' meeting. . . . In general, the possibility of shareholder authorization of defensive measures under paragraph 2 does not restrain the right of the management board to implement measures authorized by paragraph 1.
>
> . . . [Under] the new formulation of sentence 1 . . . it is both required and sufficient that the pre-authorization that is given through the shareholders' meeting of defensive measures describe their general type (for example: raising additional capital . . .)"

Kirchner & Painter, supra note –.

[148] See generally Gabriele Apfelbacher et al, German Takeover Law – A Commentary, 281-315 (2002).

[149] This follows Jeffrey N. Gordon, Das neue deutsche „Anti"-Übernahmegesetz aus amerikanischer Perspektive [An American Perspective on the New German Anti-takeover Law], 12 *Die Aktiengesellschaft,* December 2002. German law requires a 75 percent vote for the limitation of preemptive rights [AktG § 186(4)] and requires an explicit written explanation before the shareholder vote. A poison pill has never been put to shareholder vote in the US principally on the belief that the shareholders would reject it.

creating so-called "tin parachute" agreements that promise large bonus payments to rank and file employees upon a control shift; exotic tactical moves, such as the so-called "Pac-Man" defense of responding to a hostile bid with a counterbid for the putative acquiror. Unlike the pill, which can be redeemed by the board to permit a bid proceed, these tactics are often irreversible. They reduce value; they disrupt the economic logic of the firm; they can destroy the firm in order to save it. Such self-destructive measures are now used by virtually no firm in the US, but they may be inevitable in light of other features of German corporate law.[150]

One way to understand Germany's protectionist move in the Takeover Act is as frustrated response to the 13th Directive's failure to promote adequate European-wide takeover regulation, in particular the failure to address the level playing field problem. The Takeover Act can be seen as a move in a trade negotiation, an example of "aggressive reciprocity." When trading partners fail to lower barriers, one response is to raise your own. This move, which imposes costs on partners as well as oneself, may stimulate a negotiation to achieve the first best cooperative outcome, a mutual lowering of barriers. In the context of cross-border mergers, the way for Germany to promote its objective of economic and political integration, and its strategy of mutual vulnerability to control transactions, is to raise its barriers. This is what added takeover protection does: in permitting new target defense measures it raises the barriers to obtaining control of German-based firms. Such a move makes hostile transactions more difficult, both entirely domestic and cross-border, and in that sense may be seen as a step away from shareholder capitalism. So in this context the desire for economic and political integration slows down the move to shareholder capitalism.

Yes, the standard rent protection and domestic interest group stories are undoubtedly a significant contributor to Germany's antitakeover move, and represent to that extent a resistance to shareholder capitalism on the Anglo-American model. But there is an important additional element that may be pivotal. The ambition for economic and political integration is shaping German attitudes to shareholder capitalism, for the most part towards convergence but here, crucially, a move away. Ultimately it may be that Germany's aggressive reciprocity evokes a cooperative response, a joint move towards easier cross-border bids. But the attainment of that first best outcome may not be possible in light of the political economy of Germany's partners. The result may be a degenerate equilibrium of increasing takeover protection and more economic

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[150] Some might argue that existing German cases and statutes would limit management flexibility to act without shareholder approval. For example, the *Holzmüller* doctrine, see Entscheidungen des Bundesgerichtshofes in Zivilsachen [BGHZ] [Federal Supreme Court] 83, 122 et seq. (Feb. 25, 1982), requires the management board to obtain shareholder approval for a transfer of substantial assets. Section 33(1) arguably does not change the "competence" of the supervisory or management board versus the shareholders meeting, only that it negatives a particular objection (anti-takeover motive) to actions that those boards were otherwise empowered to take. Moreover, the duty of conscientiousness and prudence required for both management and supervisory board decisions, AktG §§ 93, 116, may lead parties concerned about personal liability to seek shareholder approval for defensive measures. Nevertheless the courts may well decide to give broad scope to the legislative delegation of authority in § 33(1) to the management and supervisory Boards to act unilaterally in the face of a hostile bid. In any event the courts are likely to employ a form of "business judgment rule " review, which in the US has meant a great deal of deference to board decisions taken in good faith after a reasonable process of investigation and deliberation. Boards may be reluctant to seek shareholder approval, either "reserve authorization" within eighteen months of the offer, much less authorization after the offer, out of concern that shareholders will refuse and will thereby make subsequent unilateral management actions harder to justify.

The reach of the law is evidenced by the recently proposed "Kodex" of corporate governance produced by the Chancellor's standing committee on corporate governance, a way of infusing "best practices" into German corporate governance (as recommended by the Baums Commission in summer 2001). The current Kodex draft did not caution management against overreaching under the new Takeover Act, but rather "took pains to reiterate that German comapnies can now adopt takeover defenses without shareholder consent." Global Proxywatch, Dec. 21, 2001 (vol.v. no. 46).

nationalism. In effect, the trade negotiation may fail, leaving trade war in its wake. Member states may also understand the economic and political integration that shareholder capitalism will bring, and may resist it for precisely that reason. The point is that this divergence away from shareholder capitalism, much like the convergence in the wake of the Deutsche Telekom privatization, needs telling not just in the terms of the standard stories of efficiency and politics, but as part of a country's international aspirations, its conscious effort to pursue (or avoid) a greater sense of union with its neighbors.

III. The Effort to Revive the 13th Directive Within a Framework of Mutual Takeover Vulnerability

The response within the European Commission to the defeat of the 13th Directive and to Germany's new takeover law bears out the claim that the transnational integration motive plays a large role in the push for shareholder capitalism. As part of the Parliamentary debate, the Commission agreed to convene a "High Level Group of Company Law Experts" to address some of the open issues, in particular, the level playing field concerns that ultimately proved fatal to the Directive. That Experts Group issued its report in January 2002. [145] The Report is a bold proclamation on behalf of European economic integration, the role that shareholder capitalism plays in its achievement, and the importance of eliminating national barriers to control transactions. It endorses eliminating "technical" elements that foster concentrated rather than diffuse ownership, such as the control prerogatives of dual class common stock against a hostile bid, and remits to further study problems associated with "structural" elements, such as interlocking or pyramidal ownership structures.[146]

The Experts Report states:

> "An important goal of the European Union is to create an integrated capital market in the Union by 2005. The regulation of takeover bids is a key element of such an integrated market.
>
> "Many European companies will need to grow to an optimal scale to make effective use of the integrating internal market .... Takeover bids are a means to achieve this for those engaged in business of both bidder and target."
>
> "Takeover barriers existing in various Member States more often tend to result in control over listed companies being uncontestable. ... this is undesirable in the European context [even if done in the US], as an integrated capital market has to be built up in order for business to fully benefit from and make effective use of the integrating internal market in Europe."[147]

In order to operationalize this objective, the Experts Report calls for a new directive that reaffirms the importance of board neutrality and shareholder choice found in the prior draft of the 13th Directive. But its crucial move is to call for the overcoming of golden share and most other state-created barriers to control via a potent "break-through"provision that lets a holder of majority or required supermajority (but in no event more than 75 perecent) of cash flow rights take over the firm. The Experts Report summarizes its conclusions in this area as follows:

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[145] Experts Report on Takeovers supra note xx.

[146] The distinction between "technical" and "structural" barriers to takeovers was apparently coined by Ron Gilson. See Ronald J. Gilson, The Political Ecology of Takeovers, in Klaus Hopt & Eddie Wymeersch, European Takeovers: Law and Practice 65 (1992).

[147] Id. at 18, 19, 41.

> "Companies will be required to disclose complete information about their capital and control structures.... After announcement of the bid, the board of the offeree company should not be permitted to take actions frustrating a takeover bid on the basis of a general meeting authorisation given prior to the bid .... A rule should be introduced which allows the offeror to break-through mechanisms and structures which may frustrate a bid, as defined in the articles of association and related constitutional documents, in the case of a takeover bid which achieves such a measure of success as clearly to justify this. The threshhold for exercising the break-through right should not be set a percentage higher than 75% of the risk bearing capital of the company on the date of the completion of the bid. ... Provisions in the articles of association and other constitutional documents deviating from the principles of shareholder decisionmaking and proportionality between risk bearing capital and control shall be overridden."[148]

The key intellectual move of the Experts Report is to insist on the "proportionality between risk bearing capital and control ... once a takeover bid has been announced." This means that all post-bid decisions, including whether to authorize particular defensive measures, should be taken in proportion to what an American would call common share ownership, not voting rights.[149] The Report wants to reject the prerogatives of shareholders who currently possess majority control rights but minority cash flow rights to determine the outcome of a bid. To be sure, its break-through remedy is incomplete, since it applies only to internal governance arrangements, not to pyramid structures or, apparently, cross-holdings or shareholders agreements, despite the recognition that such ownership structures present analytically the same proportionality problem.[150] The Experts Report seems to draw a distinction between what might be called "technical disproportionality" and "structural disproportionality." It rejects the "technical disproportionality" that arises from direct "state action" such as capped voting or super-supermajority provisions (which it would bar) or from "corporate action" such as dual class capital structures or transfer restrictions (which it would break-through). But it would not take on "structural disproportionality" that arises from ownership decisions that do not depend on such state or corporate action for their effectiveness, despite the analytic similarities. The Experts Report remits such structural problems to further Commission review. Arguably the failure to take on such problems is a major weakness in the Report's effort to create mutual takeover vulnerability.[151]

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[148] Id. at 42-43. Such overriding of charter provisions, which seems startling from an American perspective, has substantial EU precedent. For example, the Listing Condition Directive of 1979, Part II, No. 2, Schedule A (C.D. 79/279 EEC), purports to limit share transferability restrictions by generally requiring free negotiability of shares as an exchange listing condition. Different states have break-through type provisions with respect to various takeover impediments; e.g., in France and Italy various voting restrictions, including non-voting stock, are forfeited upon a acquisition of a majority of the share capital. In Italy, parties to a shareholders' voting agreement may back out upon the making of a bid for at least 60 percent of the stock. These matters are covered in Guido Ferrarini, Corporate Ownership and Control: Law Reform and the Contestability of Corporate Control (WP 2000) (available on SSRN). See also Report at 30 n.4, 36

[149] Compare, for example, the 2002 amendment of Del. Corp. Code § 212, which clarifies that "votes" rather than "shares" count for the 85% percent threshold in the antitakeover provision § 212 or the 90% threshold in the short form merger provision, § 253.

[150] Id. at 38-39.

[151] Contra Lucian Bebchuk and Oliver Hart, A Threat to Dual Class Shares, Financial Times, May 31, 2002, I do not believe that the failure to address pyramidal structures undoes the Report. To be sure, the Report would have much less immediate impact in Italy, say, where pyramids are common among public firms, than the

The Experts Report has a strained reliance on efficiency arguments that suggests the importance of transnational considerations apart from efficiency. The Report rejects what might be called "national efficiency" in favor of "transnational efficiency." That is, the Report concedes that particular ownership structures and voting arrangements that restrict takeovers might be efficient in light of national financial institutions (institutional complementarities, it might have said).[152] The Report also acknowledges theoretical arguments that firms efficiently use different ownership and control structures; it further acknowledges that in at least for some states, these control mechanisms may be accurately impounded in share prices. (Indeed, the Report could have cited the evidence on differential market prices that may compensate non-controlling shareholders for the loss of control and the fact that these differentials vary systematically across countries, suggesting that investors are sensitive to different levels of protection.[153]) Nevertheless, this level of efficiency is not good enough, a mandatory rule is required, because "most" markets are not adequate:

> "These more and less developed markets must be integrated on a European level to enable the restructuring of European industry and the integration of European securities markets to proceed with

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Netherlands, which uses dual class stock. But pyramids are not a low-cost substitute for dual class stock in firms newly going public, as Bebchuk and Hart suggest. A pyramidal structure that would give an owner the same level of control as dual class stock requires the creation of multiple levels of public firms; this would generate considerable resistance in markets where they are not established and could easily be controlled through listing requirements. In a stylized case where an owner wants to put up $10 in capital, absolute majority voting control of a public entity with a a value of at least $100 would require a 3 or 4 level pyramid (depending on how you count), as against a single public company with dual class stock with 10 votes per supervoting share. Moreover, Bebchuk-Hart assume that fiduciary duties would remain stable in the face of a move to a form which so obviously gains its value from weak legal protection of minority shareholders. See generally Ronald J. Gilson & Jeffrey N. Gordon, Controlling Controlling Shareholders: New Limits on the Operate, Sale of Control and Freeze Out Alternatives (work in progress).

The Expert's Report is flawed in another, perhaps more basic sense, however: its break-through remedy would not work against golden shares, which give the government the right to limit accumulation beyond certain threshhold percentages, meaning that an unwelcome bidder would never achieve the break-through trigger. (These accumulation barriers are transfer restrictions outside the usual stock exchange prohibitions of transfer restrictions on listed shares.) However, a few months after issuance of the Experts Report, the European Court of Justice greatly restricted the availability of golden shares to circumstances of a precisely-tailored fit to particular national interests. See Commission v. France, C-483/99 (June 4, 2002); Commission v. Portugal, C-367/98 (June 4, 2002); Commission v. Belgium, C-503/99 (June 4, 2002). In particular the ECJ (which rejected the opinion of its Advocat General) regarded golden shares as presumptively restricting the free movement of capital, and, to an American eye, adopted something like a "compelling state interest/less restrictive alternative" framework for evaluting them. This vigorous endorsement of the basic commerce clause-like implications of Article 73b(1) of the EC Treaty (now Article 58(1)(b) has surely strengthened the basic appeal of the Expert Report's efforts to enhance the cross-border contestability of control. See generally Johannes Adolff, Turn of the Tide? The "Golden Share" Judgments of the European Court of Justice and the Liberalization of the European Capital Markets," 3 Germ. L. J. No. 8-1 (August 2002) (available online only at www.germanlawjournal.com)

[152] Id. at 22.

[153] See, e.g., Alexander Dyck & Luigi Zingales, Private Benefits of Control: An International Comparion, CRSP WP 535 (Dec. 2001)(value of control varies between -4% and +65%, with average value of +14%); see also Tatiana Nenova, The Value of Corporate Control and Control Benefits: A Cross Country Analysis (forthcoming 2002 J. Fin. Econ.).

reasonable efficiency and speed."[154]

In other words, control structures that impede takeovers – even if efficient on a national scale – are objectionable because the interfere with the project of transational economic integration. This consists of two elements, first, industrial restructuring on a European scale, and second, the creation of European-wide capital markets. No one can really know about the comparative efficiency of those two industrial/financial set ups, but the transnational project becomes the driver.

Indeed, the importance of the transnational project is reflected in the Experts Report's resolution of what an American might think of as a "regulatory takings" question. The holders of disproportionately-voting shares would lose a prerogative of significant economic value, reflected in the differences between the value of supervoting and limited voting shares throughout the EU.[155] Presumably that price difference impounds the private benefits of control in such shares. But in general "[T]he bidder should not be required to offer compensation" after a break-through.[156] The reason: "The loss of these special rights would be the result of a public policy choice might by the European Union and the Member states in order to create a level playing field for takeover bids across the Union."[157] It's the creation of a transnational market that justifies this extraordinary shift in value.

So the Experts Report would foster convergence on shareholder choice in the takeover setting, based on proportional ownership of residual cash flow rights. In a sense the Experts Report can be read as proposing substitute mechanisms and rules to produce the contestability that would naturally arise from diffuse ownership. But the effect, and perhaps the ambition, of the Experts Report would go much further. Its shareholder proportionality rule for takeovers would have broad implications for ownership structure more generally, favoring evolution toward the diffuse ownership pattern of shareholder capitalism. This is because it will become more difficult for controlling shareholders to retain the private benefits of control that sustain concentrated ownership patterns. Under the proposed break-through rule (based on shares, not votes), any significant pricing gap between supervoting and limited voting shares creates an potential arbitrage opportunity for a control entrepreneur. In other words, private benefits are always at risk from a hostile bidder. There is a double effect favoring the growth of diffusely held firms. The break-through mechanism both creates conditions of greater minority shareholder protection said to be necessary for development of public equity markets with diffusely held firms and also reduces incentives to create and maintain concentrated ownership structures in the first place. In the United States, robust articulation and enforcement of fiduciary duties of controlling shareholders offers adequate minority shareholder protection; takeovers help solve arising from the managerial agency problems arising from the diffusely-held firm. In the EU, where legal protection of minority shareholders is weaker, takeovers under the break-through rule help solve controlling shareholder agency problems and thereby make the diffusely-held firm a plausible option, perhaps even a favored option. Moreover, the relatively free market in corporate control that would result from a regime on a revised 13th Directive will also reduce managerial agency costs, in a way that may substitute for some of the corporate governance and stock option based mechanisms that have arisen in the US to control

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[154] Report of Experts, 23. Compare, e.g., Jeffrey N. Gordon, The Mandatory Structure of Corporate Law, 89 Colum. L. Rev. 1549 (1989).

[155] See sources cited in n. xxx supra.

[156] Report, 7. The Report remits to further review the possibility of appraisal in "exceptional" cases.

[157] Id. at 5, 35

such problems.[158]

But note that such convergence on shareholder capitalism is not necessarily efficient, at least in the national setting.[159] Concentrated ownership offers some distinct advantages in controlling managerial agency costs; some of the private benefits may be appropriately compensatory.[160] Yet concentrated owners of less than 50 percent of the share capital may feel their appropriate returns are always at risk from a hostile bidder. Moreover, establishing the appropriate set of financial institutional complements for shareholder capitalism may be difficult and expensive. Indeed, a particular form of corporate ownership structure may fit with a set of social institutional complements as well. This has been the source of purported efficiency advantages of the German corporatist model.[161] But the Experts Report bespeaks commitment beyond such potential national efficiencies to EU project of transnational of economic and poltical integration.

The prospects for proposal and adoption of a revised 13th Directive along the lines of the Experts Report are uncertain, perhaps diminished by the sharp decline in stock market values, the related decline in cross-border merger activity throughout the world, and the loss in prestige of the shareholder capitalism model in light of the potential weaknesses revealed by the Enron and WorldCom financial frauds.[162] Nevertheless the Experts vision of a 13th Directive is still a powerful signal and a beacon. In substantially increasing the control contestability of corporations in the EU it would work a revolution in EU corporate governance and a revolution in much else besides.

In most respects Germany (ex the expansion of supervisory board antitakeover authority of its recent Takeover Law) would comply with the Expert Report's directive. The principle barrier to contestability in Germany is the share ownership structure, in which large blocks (greater than 25 percent) are common – although insofar as these blocking positions are held together through shareholder agreements, they would be subject to "break-through." So Germany's "aggressive reciprocity" in rejecting the prior draft of the 13th Directive and its adoption of a Takeover Law with heightened takeover defenses might well have been a genuinely catalytic event.

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[158] On the US model and some recent concerns, see Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U.Chi. L. Rev. 1233 (2002).

[159] See sources cited in n. 2 supra.

[160] See, e.g., Ronald J. Gilson, Evaluating Dual Class Common Stock: the Relevance of Substitutes, 73 U.Va. L. Rev. 807 (1987) (offering an efficiency explanation of dual class capital structures in an efficient IPO market).

[161] See generally Mary O'Sullivan, The Political Economy of Corporate Governance in Germany (Jerome Levy Institute WP No. 226) (Feb. 1998); Gregory Jackson, Corporate Governance in Germany and Japan, Liberalization Pressures and Reponses during the 1990s, forthcoming in Wolfgang Streeck & Kozo Yamamura, eds., The Future of Nationally Embedded Capitalism in a Global Economy. (available on SSRN).

[162] Indeed, In October 2002 the European Commission proposed a revised 13th Directive that would eliminate capped voting and various transfer restrictions, but, in a retreat from the Experts Report, would permit maintenance of dual class structures. Proposal for a Directive of the European Parliament and of the Council on Takoever Bids, COM (2002) 534 Final, 2002/0240(COD) (Oct. 2, 2002). Germany apparently is threatening to oppose the new proposal because it at once threatens the so-called "Volkswagen law" that imposes a 20 percent voting cap for that firm (meaning a hostile bidder could not outvote Saxony, the German state that holds a nearly 20 percent block in Volkwagen) while not addressing other level playing field problems. Paul Hofheinz, 'Germany Will Again Oppose EU Reform of Takeover Rules," Wall St. J, Sept. 25, 2002, A11.

Conclusion

The recent accounting and corporate governance embarrassments in the US may offer an interesting test of whether convergence is driven principally by efficiency reasons or by the international relations theory presented here. The US problems have somewhat damaged the prestige of the US model of shareholder capitalism and the efficacy of high-powered incentives in aligning manager and shareholder interests in the diffusely-held firm. The episode has grim parallel to the monitoring failures of the German banks in the 1980s: in both, a purported strength proves not so strong. So the efficiency-based argument on behalf of convergence in corporate governance seems less powerful, especially the argument for strong form convergence on diffuse share ownership. Yet the US scandals do not undermine the importance for transnational economic and political integration in the EU and elsewhere, nor do they undercut the peculiar advantages of shareholder capitalism for those purposes. If convergence continues in the face of stock market declines, the general loss in investor confidence, and the uncertainties about the risk inherent in a US-style system, this will suggest a powerful alternative motive at work, the desire to pursue the transnational project.

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