Corporate Board Elections
and
Internal Controls

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Next, we have Klaus Hopt, who is a Professor, and Director of The Max Planck Institute.

Klaus J. Hopt: Bob Mundheim and Guido Ferrarini have done an excellent job in presenting the problems from an American and a European perspective. The key problem in public corporations both here and in Europe is the entrenched board and the rational apathy of private shareholders. As to the latter, I doubt that the reform proposals in the European Union will change very much in practice.

More important is facilitating cross-border voting of global shareholders, more transparency of voting patterns of institutional shareholders, and of course board reform, including really independent directors and committee work. This having been said, let me add three observations from the German and the European Union perspective: the first is labor codetermination in the supervisory board, and the second and third are brief observations that concern state influence and hedge funds.

1) In Germany the number one board election problem is labor codetermination in the supervisory board. The pros and cons of this rather unique German board feature are hotly debated. Reform proposals have been made by economists, businesspeople, and financial analysts. Before the elections a week ago there even seemed to be some political chances of change. But alas, the German elections have led to a very unstable situation where any reforms will be difficult to bring about, not to mention an even moderate reform of labor codetermination.

Let me quickly sketch out the main characteristics of a German board. Germany and some other European countries have a two-tier board system instead of the one-tier board you have in the United States and in most other countries. This means that the shareholders elect the members of the so-called supervisory board by a simple majority vote of the shareholders present in the annual meeting. The supervisory board then elects the members of the management board again by simple majority and usually for a term of five years. Premature dismissal is more difficult, i.e., only for cause. Both boards are strictly separate. The idea of the legislators was to have management and control institutionally divided. Of course, in many cases this is just theory since the actual influence of the two boards may change according to the circumstances. For example, in the many corporations that are family owned or have a major blockholder, it is obvious that these shareholders will have their way via the supervisory board. In such cases the management board has little or even no independence.

But what about labor codetermination? In German companies with a labor force of more than 2,000, half of the seats in the supervisory board are reserved for labor, i.e., the representatives of the workforce of the corporation and the trade unions. The arguments for labor codetermination are social peace and better cooperation between capital and labor. The counterarguments—at least against a codetermination at parity as in Germany—are in my view more convincing. The result of labor codetermination is a slow-down of the decision-making process, a muddling through in case of economic difficulties, and an overall weakening of shareholder responsibility. Do not be fooled by the statement of the chairmen of some large

German corporations who speak out in favor of labor codetermination. This is hardly surprising since management and the workforce often form a coalition for maintaining the status quo against the shareholders. This has been shown very clearly in cases of threats of hostile takeovers. The standard coalition is between the incumbent management and the workforce. Usually politicians join this coalition, certainly at the level of the Länder for fear of losing jobs and votes, and sometimes even at the federal level as Chancellor Schröder has shown several times.

As I have said before, this is a German sacred cow which cannot be slaughtered as long as there is a de facto coalition of the Social Democratic party (or even worse, the new left-wing party) and the trade unions. It is true that the European Union has provided a new legal European form for corporations, the so-called European Corporation or Societas Europaea. There the codetermination system is basically a question of negotiation between capital and labor and the founding enterprises which usually are located in different EU member states. But under the influence of the trade unions, the German government has insisted on a fall-back solution in case of a negotiation stalemate, and this is the most far-reaching codetermination system at play. This means that in most cases, even in a transnationally formed European corporation, the German system will prevail if one of the partners is a German codetermined corporation.

But let me conclude this first observation on a more optimistic note. Just two weeks ago, the leading German insurance company, the Allianz corporation, announced that it intends to change its legal form from a stock corporation under German law into a European corporation. By the same token, this would allow Allianz to reduce the size of its supervisory board from 20 members (which is mandatory under German law) to 12 members (which is allowed under European law). Labor codetermination will be retained (anything else would be unrealistic in Germany), but labor will have only six instead of ten seats. Furthermore, these six seats will no longer be reserved for German workers, but for all workers of the corporation, i.e., also those in other countries. It is hardly surprising that the German trade union is not pleased. But I trust that economic reality and global thinking will triumph over parochialism and self-interest.

My second observation is linked to this and concerns state influence over normal shareholder influence in European corporations. This concerns the election of board members, but is also true more generally. In Germany and even more so in some other EU member states such as France, Italy, and Spain, the state plays an important role in the economy. Many enterprises are public enterprises, and even if the state or the regions and local communities form stock corporations, the states try to keep their say in them in order to influence their business decisions and be able to place their own people there at good pay. One example is the Volkswagen corporation. There is a specific federal statute which gives special rights to the federation and to the state of Lower Saxony where the headquarters are located. These rights include seats in the supervisory board for the federation and Lower Saxony, two each, provided that they hold shares (even only a few) in the corporation. Accordingly, when Chancellor Schröder was still the president of Lower Saxony, he was a board member of Volkswagen. This explains nicely the close connection between Schröder and Volkswagen and has led to his nickname, "the automobile chancellor." This coalition has been very influential in winning the battle against the European Commission concerning the anti-takeover devices in the European takeover directive. The Volkswagen Statute has another device in favor of state influence, a voting cap at the level of 20 percent. It is interesting to note that Lower Saxony holds slightly less than 20 percent of the votes. The effect of the statute is clear. The state cannot be outvoted by a potential major blockholder. The European Commission has brought Germany before the European Court of Justice for infringing free movement of capital within the European Union by the Volkswagen Statute. It remains to be seen what the court will decide. Its decision is expected at the end of this year.

My time is running out, so my third observation must be very brief. It concerns incumbent management, hedge funds, and institutional investors. As I said, unlike the United States, in Europe family enterprises and blockholders, both private and state, are common. But times are also changing in the Old World. Institutional investors are becoming more and more important, not only in the UK where they are a dominant force in the market, but also in continental Europe. This is partly due to globalization of the financial markets, but also to the reform of the old age insurance system, which in all countries must be changed from a state-guaranteed social security system to a system based on private savings and shareholding. Up to now, institutional investors in Europe have followed the Wall Street Rule, i.e., they sell if they do not like management. There are some changes, but they are slow. Board elections still do not seem to be affected by this.

But this may change with the growing role of foreign hedge funds. The Deutsche Börse, the German stock corporation, was the first German company to suffer under this influence. UK-based hedge funds acted together in opposing an announced friendly takeover of the LSE by the Deutsche Börse and asked instead for distribution of the free reserves to the shareholders. The battle raged fiercely and resulted in the retreat of the Deutsche Börse from the takeover plan, in the distribution of a huge amount of money to the shareholders, and in the overhaul of the whole supervisory board. The German Securities and Exchange Commission, the BaFin, is still investigating whether the hedge funds acted in a concerted manner and therefore should have come up with a mandatory bid to all shareholders. But I predict that this will be much ado about nothing, if only for enforcement reasons. How do you enforce such duties against Cayman Island and similar funds? What happened to the Deutsche Börse may happen to quite a number of other German public corporations. This is a real fear and has led to reform proposals concerning shareholder voting and board elections. The gist of the discussion is how to get more shareholders to vote at the annual meeting and how to motivate and reward long-time shareholding, for example by giving longer term shareholders a double vote like the French do. So you see, these are exciting times in Europe as well, for board members, shareholders, politicians—and lawyers.