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Restructuring “Germany Inc.”
The Politics of Company and Takeover Law Reform in Germany and the European Union

by

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Abstract

The reform of German company law by the Control and Transparency Law (“KonTraG”) of 1998 reveals politics of corporate governance liberalization. The reforms strengthened the supervisory board, shareholder rights, and shareholder equality, but left intra-corporate power relations largely intact. Major German financial institutions supported the reform’s contribution to the modernization of German finance, but blocked mandatory divestment of equity stakes and cross-shareholding. Conversely, organized labor prevented any erosion of supervisory board codetermination. Paradoxically, by eliminating traditional takeover defenses, the KonTraG’s liberalization of company law mobilized German political opposition to the EU’s draft Takeover Directive and limited further legal liberalization.

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I. Introduction

By establishing the institutional structure of the corporation, company law forms the core of any corporate governance system. What makes corporate governance an important area of policy and theory is its intermediation of the primary three corporate constituencies—shareholders, managers, and employees.\(^1\) In an era in which state-led intermediation appears to be receding, corporate governance regimes performs an increasingly important intermediation function in the coordination of opposing political constituencies and bodies of regulation. Company law in particular plays a central role in this process by mediating the competing demands of financial market law and regulation and labor relations law. The politics of securities regulation pit managers against shareholders (and other holders of financial assets) over issues of transparency, disclosure, and rules governing participation in the capital markets. The politics of labor relations primarily entails a perennial battle between managers and organized labor over the rules governing labor organization, collective bargaining, and the representation of employee interests within the firm. These areas thus involve different sets of interest groups in conflict over different salient economic and normative issues. The resulting divergent political dynamics increase the risk that these bodies of law, and the policies they embody, will conflict with each other as changes in one area are not matched by corresponding and complementary changes in the other. The political system and adjudication in the courts coordinate these areas imperfectly at best. By creating the basic corporate structure that integrates these three constituencies, company law plays a crucial mediating role between the norms of securities regulation and those of labor relations law and thereby contributes to the systemic coherence essential to both a dynamic and competitive economy and a functional legal system.

This paper analyzes the recent evolution of German company law as a case study of how this area of law reflects the political struggles over the form of the corporation and corporate governance and how its development reconciles opposing interests and otherwise divergent legal structures. The analysis focuses on the politics that resulted in the passage of the Control and

\(^1\) See Cioffi, 200a, cf. Cioffi, 2000b.
Transparency Act (the “KonTraG”) in 1998—‐the only major reform of German company law since 1965—and how the new structure of company law reflects the tension between securities market development and neo‐corporatist labor relations. The paper then considers how the KonTraG reconstituted the interests of German political and economic elites in domestic and European politics. By rendering German firms more vulnerable to hostile takeovers, the KonTraG and related tax reform legislation galvanized opposition to further liberalization and shareholder‐friendly reforms. As a result, German opposition to encroaching neo‐liberalism spearheaded, in rapid succession, the ultimate defeat of the EU Takeover Directive and the successful effort to adopt a domestic takeover law that sanctioned more potent anti‐takeover defenses in July 2001.

The negotiation and drafting of the KonTraG shows how politics drives the development of company law and its reconciliation of the conflicting interests of shareholders, managers, and employees. The politics of company law reform was pulled in two different directions. First, the legislative reform was the product of intense interest group competition for power within firm governance (and the rents that come with it) and fueled by populist fears of concentrated financial power. Second, company law performs the crucial political economic function of reconciling the demands of securities regulations and labor relations law—and the interests of the different clusters of constituencies most keenly interested in these areas of law and regulation—while fashioning a reasonably efficient structure for the corporate form. Failure in satisfying this function would erode the utility of the corporate form itself and render the corporate governance system dysfunctional as different areas of law made incompatible demands on the corporation. The politics surrounding the adoption of the KonTraG indicates that the populist resentments of concentrated financial power were manipulated for partisan political gain, but did not determine the substance of the legal reform. The KonTraG was the product of elite interest group politics and the technical expertise of professionals within the federal ministries, the peak associations, and industry. The moderates in the SPD and the then‐ruling CDU‐led coalition fashioned the terms of the political deals that made the law possible and the Ministry of Justice supplied the technical expertise that transformed the deals into legislation. The process of legal change depended not only on the structural and interest group pressures

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generated within the financial sector and the labor relations system, but also on entrepreneurial state actors seeking reform for their own political and ideological ends. However, as subsequent EU and domestic developments show, these reforms unleashed a host of unintended consequences that constrained later efforts by the SPD (by then in power) and the European Commission to liberalize company law and corporate governance.

In Germany, company law reform implicated the conflict between the conceptions of shareholder value and shareholder supremacy in Anglo-American shareholder capitalism and corporate governance, and Germany’s post-war commitment to the neo-corporatist stakeholder conception of the firm and the social market economy. This clash gave rise to a debate over the definition and arrangement of legitimate interests within corporate governance and decision-making. The resolution of this debate in the context of company law reform had to satisfy the intensifying demands for securities market modernization and more stringent, shareholder-protective regulation, as well as normative commitment to effective employee representation on supervisory boards under codetermination law. The KonTraG legislation reconciled these countervailing demands by fostering greater transparency, shareholder democracy, and accountability in corporate governance without altering the core legal duties of directors or the structure of the supervisory board under codetermination.

Once amended and reformed, the new company law framework substantially reshaped the interests of management, labor, and shareholders with respect to corporate governance. Financial market reform and legislation had been closely related to the EU’s programmatic commitment to the integration of European capital markets. This modernization program had met with only partial success in the absence of substantial changes in company law. The KonTraG was seen as necessary to advance the modernization of securities markets in Germany by lowering the risks of owning shares by small shareholders. Ironically, the initial liberalization brought about by the passage of the KonTraG ultimately doomed the further liberalization of takeover law. The law also exposed German corporations to greater takeover vulnerability in an emerging European market for corporate control. The KonTraG (along with subsequent tax reform legislation) deprived German managers of the use of “golden shares” and cross-shareholdings that had long served as anti-takeover defenses. This set in motion a conflict over

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3 *I.e.*, the development of the regulatory infrastructure to facilitate the increased securitization of finance and the move away from bank-centered finance.
the Takeover Directive in the EU in which the German government and European Parliamentarians argued that the measure favored the firms of some member states over others. The German members of the European Parliament mobilized opposition from other national contingents to defeat the Takeover Directive. Immediately thereafter, the Germany passed its first takeover law, not to protect shareholders but to legally sanction American-style anti-takeover defenses. The rejection of the Takeover Directive by the European Parliament ended over twelve years of tortuous negotiations among the member states and was the first time a major policy initiative of the European Commission had been thwarted by Parliament. The adoption of the protective German Takeover Law entrenched the commitments of German political and economic elites against further liberalization of corporate governance that has been a core concern of EU integrationists. This complicated story reveals both the divisive domestic political battles triggered by corporate governance reform and their increasingly important international political implications.

II. Origins of the KonTraG: The Structural Problems in German Company Law

A. Crisis of Confidence: The German Corporate Governance Model in the 1990s

By the mid-1990s a crisis of confidence was growing in Germany. The country was running persistently and unsustainably high unemployment rates, economic growth was anemic, the integration of the former East Germany had stalled badly and triggered a severe recession, and some observers believed that many of the country’s firms and the economy as a whole were losing their innovative capacity and competitive edge. Further, a series of serious corporate scandals had erupted throughout the early and mid-1990s that suggested deeper systemic problems in Germany’s bank-centered corporate governance regime. For example, Metallgesellschaft AG nearly collapsed from previously undisclosed debts despite the fact that Deutsche Bank, Dresdner Bank, and Commerzbank were all substantial shareholders and were expected to monitor the firm’s affairs. Likewise, when Daimler Benz AG chose to list its

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4 For the following general observations on the German economic and political situation in the late-1990s, I am indebted to many German interviewees whom I spoke to in the summer, autumn, and winter of 1999, and the summer of 2000. Prof. Dr. Marcus Lutter, one of Germany’s leading company law scholars, was particularly helpful in placing the corporate governance and company law reforms into historical context. Interview, Prof. Dr. Marcus Lutter, University of Bonn, Department of Law, Bonn, November 31, 1999.


American Depositary Receipts on the New York Stock Exchange it restated its finances under American Generally Accepted Accounting Principles (US GAAP) and suddenly disclosed over a billion dollars in losses when it had previously reported a healthy profit under German accounting rules. In the subsequent scandal the former CFO committed suicide. This extraordinary financial reversal was not disclosed prior to the switch to US GAAP despite the fact that a Deutsche Bank representative was the chairman of Daimler’s supervisory board and the bank owned over twenty percent of the company.

To many, these scandals revealed the failures of the German corporate governance regime’s reliance on banks to monitor firms and their managers. Many among the general public, and especially those on the political left, the recurrent financial scandals suggested that the banks themselves were exploiting conflicts of interest by using their central position in corporate governance to ensure repayment of loans rather than to protect shareholder interests. In fact, it is extremely difficult to tell what the role of the banks was in these scandals—whether they were ill-informed or acting in their own conflicted self-interest—because the corporate governance system and financial disclosure rules in the early 1990s yielded such an opaque image of firm finances and affairs. But the opacity of corporate Germany served to intensify popular suspicions of the effectiveness and fundamental fairness of the German system in the shadow of these recurrent financial scandals.

Developments in European and international capital markets also prompted a reassessment of the German corporate Governance regime. The EU had begun a revolutionary attempt to harmonize and integrate member states’ securities markets through a series of financial services directives. The pervasive feeling of unease about the German economic model grew throughout the decade as the German economy continued to stumble while the United States began an extraordinary economic boom driven by securities markets and the financing of new technologies. At the same time, the international corporate governance movement spread throughout the advanced industrialized world during most of the 1990s as capital markets grew more integrated and investment funds spanned the globe seeking investment opportunities. The traditional German financial model of strong banks, undeveloped securities markets, and weak minority shareholders had begun to look anachronistic. Opaque finances, poor financial disclosure, feeble and passive supervisory boards, and weak legal rights and remedies available to shareholders had led to low levels of securitized finance, financial and managerial risk
aversion, and firm governance on behalf of insiders (managers, controlling shareholders, and creditor banks).

The low levels of transparency in corporate finances pervaded the internal governance of the firm as well. The weakness of the supervisory board and dominance of the management board virtually ensured low levels of transparency. Management controlled the auditing and disclosure of firm finances. The imbalance of power between supervisory and management boards was so great that managers engaged in a fairly common practice of providing supervisory board members with the auditor’s report on the corporation’s finances at the meeting in which they were to approve it—and then collect the report at the end of the meeting to preserve the confidentiality of the information it contained. This practice effectively kept the firm’s finances confidential from the supervisory board as well and resulted in the rubber-stamping of the accounts.

In addition, the law (and stock exchange rules, unlike those of the NYSE) permitted the use of “golden shares,” dual class share voting rights, and voting caps that enabled a dominant shareholder or shareholder group to wield control over a corporation without putting a commensurate amount of capital at risk. Shareholder inequality further discouraged shareholding by prospective investors. These voting structures preserved the control of founding families and dominant shareholders, but at the price of shareholder democracy and at the risk that the corporation would be run on behalf of these controlling interests and that rents would be diverted from shareholders as a whole to a class of insiders. As policy makers, financiers, and scholars became increasingly interested in developing the efficiency and utilization of securities markets, these arrangements have been criticized for their economically inefficient diversion of resources and for rendering securities riskier and less prevalent as a mode of saving, investment, and financing.

German company law deprived managers of a number of modern financial tools that can be useful in improving shareholder value and corporate financial performance. In particular, the company law prohibited corporations from repurchasing their own shares and placed substantial restrictions on the ability of the firm and its managers to issue new shares and options. The inability to repurchase shares deprived firms of a means of increasing shareholder value by raising the ratio of capital per share outstanding and further entrenched incentives to retain earnings for inefficient activities by depriving managers of a way to increase shareholder wealth.
without the double taxation incurred by paying dividends (a tax on the firm’s income as it earns a profit, and a second tax on individual income when a dividend is paid).

Finally, supervisory board codetermination exerts a fundamental impact on the structure and operation of the board in corporate governance. At the very core of corporate governance, supervisory board codetermination precludes the development of a clear normative hierarchy such as that represented by the concept of shareholder primacy. The Codetermination Act of 1976 grants employee representatives half the board seats in firms with over 2,000 employees and one third of the seats in firms with 500 to 2,000 employees. Codetermination legitimates at least two sets of interests—those of the shareholders and those of employees—that must be reflected in the law’s conception of directors’ fiduciary obligations. As a result, outside of the most egregious misconduct it is difficult to fashion a framework of fiduciary duties that can define clear standards for the conduct of the director’s office. Moreover, critics charged that supervisory boards (particularly of major corporations) were too large and unwieldy to engage in effective deliberation or efficient decision-making. The presence of employee representatives on supervisory boards encouraged, and to some degree mandated, the enlargement of the board to make room for them. Critics also argued that employee representation discouraged the development of more active boards. More powerful and informed supervisory boards would empower employees and unions as much as they would shareholders—thus reducing the incentives for shareholders and their representatives on the board from becoming more active. Court rulings in codetermination cases effectively prohibited the formation of board committees of directors (e.g., audit or finance committees (akin to those comprised of outside directors in American corporate governance) that systematically excluded employee representatives. While these rulings protected codetermination and its commitment to a form of economic democracy, they also precluded one principal means of addressing conflicts of interests and collective action problems deriving from the large board size. By the mid-1990s, protecting shareholders and increasing the use of securitized finance had become important policy goals. Political elites began to craft reform agendas to promote modernization of the German economy, while economic elites sought to increase returns on capital and improve the dynamism and competitiveness of the German corporation.

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B. Problems in the Housebank Model

During the 1980s and early 1990s, a school of thought emerged touting the advantages of the German bank-centered financial and governance model on the ground that it provided a mechanism for the monitoring and discipline of corporate managers while supplying stable long-term finance. Underlying this claim was the theory (or assumption) that the German financial system aligned the interests of strong, centralized, and well-represented financial institutions with those of individual shareholders. This sanguine view of German corporate governance eroded during the 1990s.

Recent empirical research indicates that banks act primarily as debt-holders, which means that their interests do not align with those of shareholders. Hence, bank influence over corporate governance, even to the extent it exists, may give rise to a variety of conflicts between the banks and other shareholders. Most of these conflicts stem from the fact that banks generally act as debt-holding creditors first and shareholders second. The banks’ primary interests in corporate governance are generally the payment of interest on loans and the recovery of collateral in the event of corporate collapse. Moreover, Peter Mülbert has shown how large German universal banks use long-term equity stakes in client firms to stabilize their earnings streams and buttress their deposit taking and lending business. Because the banks seek stable, rather than maximized, earnings in order to maintain the confidence of depositors, their interests conflict with those of other shareholders and they cannot be relied upon to monitor management in the shareholders’ collective interest.

Mülbert’s analysis suggests that Germany may soon witness a substantial reconfiguration of corporate governance in favor of shareholder interests as major banks shift their business models from traditional deposit-taking relational finance towards greater reliance on securities trading and investment banking services. This change may, in turn, increase pressures for

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10 See Mülbert, 1998.
11 The controversy over bank conflicts of interests is of long-standing. See Vagt, 1966: 57-58. In a crisis, a bank may seek to reduce its loan exposure by cutting off credit or calling prior loans due even though such actions may push a firm into bankruptcy. A bank also may have an interest in withholding financial information from the public in order to raise more capital from shareholders to protect its capital. These potential conflicts of interest are weaknesses of the German model.
12 Mülbert, 1998; see also Deeg, 1999.
13 This analysis takes on increased importance now that the German federal government has passed tax legislation to encourage the banks to liquidate their equity holdings.
short term increases in profits and return on equity.\textsuperscript{14} Increased competitive pressures on the big German universal banks suggest that the banks will have to modernize their operations and business models.\textsuperscript{15} Ongoing reform of securities law and regulation since the early 1990s formed one dimension of legal and institutional infrastructure needed for this shift. Company law reform constituted the second dimension. Yet, because of the multiple interests mediated by company law, reform of this legal area proved more difficult than that of securities law. The most difficult of these interests to accommodate in company law reform were those of organized labor.

\textbf{C. The Symbolic Politics of Supervisory Board Codetermination}

Supervisory board codetermination remains a defining feature of German corporate governance and a significant constraint on the development of shareholder capitalism in Germany along Anglo-American lines. Principles of shareholder primacy and the economic theory of corporate governance as a principal-agent relationship between shareholders and managers lead to an analytical focus on the board and the degree to which it protects and maximizes shareholder interests. Not surprisingly, substantial attention has been lavished on the exceptional level of employee representation on the supervisory boards of major German corporations as part of a debate over codetermination’s efficiency, effects on share and/or firm performance, and normative justifications. As Anglo-American theories of the firm, finance, and corporate governance made their way among intellectual and policy circles in Europe and specifically in Germany, they provided additional ammunition in a long-running debate over board codetermination.\textsuperscript{16}

Many, if not most, businessmen, attorneys, labor leaders, and others involved in corporate governance in Germany minimize the importance of supervisory board

\textsuperscript{14} Cf. Mülbert, 1998: 485-486. However, different institutional forms taken by equity investment also alter the interests of shareholders in terms of time horizons for returns and appetite for risk. A mutual fund faces far more intense pressures for immediate returns than a pension fund with a stable (i.e., locked-in) pool of capital and an investment and payout horizon of twenty-five years. Thus, conflicts between shareholder value and patient capital do not necessarily conform to the distinction between debt and equity. Germany therefore may be able to preserve patient capital within its own emerging and distinctive form of shareholder capitalism.

\textsuperscript{15} See Breuer, 1998: 542.

\textsuperscript{16} This debate over the economic, legal, and normative dimensions of board codetermination has gone on as long as the institutional arrangement has existed. Following the enactment of the Codetermination Law of 1976, German firms and business associations brought a landmark suit to hold the statute unconstitutional. \textit{See Codetermination Case}, 50 BverfGE 290 (1979), European Commercial Cases, vol. 2, pp. 324-386 (1979) (challenging the constitutionality of the Codetermination Act (Gesetz über die Mitbestimmung von Arbeitnehmern) of May 4, 1976 (BGBl. I 1153), as amended October 28, 1994 (BGBl. I 3210) (“MitbestG”).
This relative indifference to supervisory board codetermination derives from the political impossibility of repealing or scaling back employee representation, as well as a widespread understanding that codetermination does not impose significant costs on German firms. The available evidence suggests that the focus on the impact of codetermination on the board’s functioning is misplaced. Just as the board is not a particularly effective institutional form for firm governance and the monitoring of management, codetermination of the board appears to have had at most a modest impact on the operations and governance of major German corporations. Some commentators have argued that codetermination impedes takeovers and rapid organizational changes that might harm employee interests, thus bringing about an alliance of managers seeking to entrench themselves and employees guarding against threats to employment security and redistribution to shareholders. Corporate restructuring and legal reforms since the mid-1990s to date call this alleged function of codetermination into question. Indeed, notwithstanding the presence of labor on the supervisory board, German firms have been able to restructure and retrench, and these moves have often been accompanied by significant downsizing of the workforce. For example, during the late 1990s corporate giants such as Daimler Benz and Deutsche Telekom shed tens of thousands of employees as their business and financial positions deteriorated. Downsizing in Germany is far more likely to be accomplished through attrition and early retirement packages, rather than the harsher and more rapid layoffs common in the United States. Yet the works council, rather than the employee representatives on the supervisory board, plays the dominant role in protecting employee interests in corporate restructuring situations. The marginal import of supervisory board codetermination has contributed to the path dependence of the institutional form. No significant interest group gains or loses much on account of board codetermination.

During the mid to late-1990s, organized labor and the center-left in Germany shifted their attitudes towards shareholder value and finance capitalism. Senior labor leaders came to understand the limits of power and influence that supervisory board codetermination bestows

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17 This was the uniform impression received from numerous interviewees in law, business, labor relation, policy makers, and academics. For a superb review of the literature on supervisory board codetermination, and other subjects relating to the structure and operation of the German corporate board, see Prigge, 1998.


19 See the discussion of the Mannesmann hostile takeover case in this paper, infra.

20 Supervisory Board may actually facilitate restructuring and limited downsizing by providing employee representatives, including the head of the works council, with sufficient information on the state of the business to justify drastic measures.
upon employees. During the 1990s, it became increasingly clear that the rise of global finance, the push to modernize German capital markets, and the increasing presence of Anglo-American shareholders would further diminish the importance and usefulness of board codetermination. During the late-1990s, leaders of the SPD’s dominant centrist s, led by Gerhard Schröder and lieutenants such as Hans Martin Bury, began to advocate these modernization attempts and modified notions of shareholder value—with appropriate checks to curtail the perceived excesses of American “casino capitalism”—as an economic plank of their Neue Mitte program. Officials at the top of the labor movement came to accept the validity and potential benefits of these new economic principles and capital market reforms. By the end of the 1990s a growing number of senior union officials and their policy advisors conceded that the German economy could use the greater dynamism, managerial discipline, and financial flexibility supplied by the increased availability of securitized finance.\(^{21}\) This led to the concomitant conclusion that the supervisory board would tend to protect shareholder interests more vigorously in the past and that it would lose more of its already modest value to employees.

However, board representation retains widespread public support and substantial symbolic power within German politics, and all interest groups recognize that any attempt to eliminate or significantly roll back codetermination would unleash a popular backlash across the political spectrum.\(^{22}\) The continued symbolic importance of board codetermination is particularly potent among the rank and file of the industrial unions and within the left wing of the Social Democratic Party.\(^{23}\) As Mark Roe has described it, board codetermination is one of the “sacred cows” of German politics.\(^{24}\) The unions and Social Democrats cannot afford to alienate their bases by negotiating over the subject, despite a growing realization at the senior levels of the labor movement and the SPD that it is losing its significance and already limited utility to

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\(^{21}\) Anonymous interviews with German labor union officials, summer 1999, winter 1999, and summer 2000. It is noteworthy that these officials were consistently unwilling to be identified with this position because of its sensitivity within the labor movement and the hostility of the rank and file to shareholder interests and finance capitalism generally.

\(^{22}\) Interviews, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999; Otto Fricke, Attorney at Law and Counselor, FDP, Berlin, November 1, 1999. This fear of political backlash against company law reforms that compromise codetermination also operates at the level of the European Union. Interview, Peter M. Wiesner, Head of Legal Affairs, Legal, Competition Policy, and Insurance Department, Federation of German Industry (BDI), Brussels, Berlin, July 11, 2000.

\(^{23}\) This point was repeatedly made by too many interviewees to list individually. The legitimacy and popularity of board codetermination and anticipation of fierce political and industrial resistance to efforts to weaken or end it is simply the accepted political and socio-economic state of affairs in Germany.

\(^{24}\) Roe, 1998; see also Pistor, 1998.
labor. Thus, symbolic politics has locked into place an institutional form that has little effect on the actual distribution of power and resources.

No major corporate stakeholder (management, labor, banks, and shareholders or their representatives) has been willing to expend the political capital and incur the political risks required to alter codetermination on the supervisory board. The rhetoric surrounding the issue has been both heated and lofty, but in reality the political stakes are too high and the economic stakes too low to allow for any significant legal and institutional change. On the political right, employers and the more liberal-leaning political conservatives are unwilling to pay the political and potential economic price of challenging codetermination. Even the Free Democratic Party (the FDP), Germany’s small neo-liberal party, has refrained from any significant attacks on the institution of board codetermination. When they had their best chance to alter the practice, during the final years of the Kohl government’s Christian Democrat-Free Democrat coalition, they saw no reason to provoke a battle over codetermination that might jeopardize more important and urgently needed reforms of securities and company law. Corporate managers did not have an interest in refashioning the supervisory board as a more effective disciplinary and oversight mechanism and thus did not press for changes in codetermination. Finally, like the Free Democrats, financial interests led by the large universal banks did not savor the prospect of political combat over changes in codetermination rules and sought major reforms of securities laws and markets that fostered their interests through increased transparency and market liquidity, and were content to restrict company law reforms to those that left codetermination untouched.

III. The Control and Transparency Act (KonTraG)

In contrast with the United States, German company law is the exclusive province of federal law. Consequently, company law reform culminated in a centralized legislative process at the federal level that produced the KonTraG. The reform aimed at facilitating the transition from a bank-centered financial system to a more securities-driven model. It also supplied the preconditions for sweeping federal tax reform legislation in the autumn of 2000 that took direct aim at the web of bank-centered cross-shareholdings among German corporations that has defined “Germany Inc.” throughout the post-war era. At the same time, the KonTraG

25 Interview, Prof. Dr. Theodor Baums, University of Osnabrück, Osnabrück, July 13, 1999.
maintained the established balance of powers among managerial, employee, and shareholder interests to a greater extent than in the United States. Countervailing political pressures during the struggle for company law reform ensured that codetermination remained undiminished by the KonTraG. The result was a rather modest reform that strengthened the position of the supervisory board in relation to that of the management board while increasing financial transparency and managerial accountability. The KonTraG did not, however, embrace shareholder primacy, nor did it signal the triumph of American-style shareholder capitalism in Germany. 26

A. Bashing Banks and Oblique Liberalization: Political Entrepreneurialism, Economic Modernization, and the SPD’s Proposed Legislation

The KonTraG was the brainchild of Theodor Baums. One of Germany’s finest young legal academics and long a vociferous advocate of corporate governance reform, he approached Hans Martin Bury, an up-and-coming member of the SPD in the Bundestag, to pitch an idea to put governance reform on the national political agenda. 27 Baums envisioned a legislative strategy that would play well with the left-wing of the SPD, would help establish the SPD as the party of economic modernization, and have a reasonable chance of delivering beneficial

26 The structure of federalism in the United States relegates company law primarily to the sphere of state legislation, while the federal government has taken the lead role in securities regulation and labor law. The long-established legal and political practice of the chartering and structuring of corporations under state law, the patterns of federal regulation focusing on securities and labor markets rather than the internal structure of the corporation, and Supreme Court doctrine vindicating the latitude of state legislation in ordering corporate affairs have preserved the centrality of state law in the internal governance of corporations. Within this federalist structure, the relative political and economic strength of managerial interests against both organized labor and shareholders gave managers a decisive advantage in developing (and litigating) anti-takeover defenses and drafting state anti-takeover laws that co-opted the interests of employees while giving them no role in firm governance. American takeover defenses were sanctioned by the courts, including those in Delaware, within highly complex—and frequently unstable—judicially created doctrines that sought to balance the powers of managers to exercise their business judgment in the conduct of firm affairs and to change corporate charters and by-laws with fiduciary obligations to shareholders. Anti-takeover statutes were the more highly politicized response to the upheavals wrought by the hostile takeover era. Taken out of the deliberative and technical context of the courts, legislation designed to curb takeovers reflected anti-financier populism that enabled managerial elites to mobilize labor and the public at large against shareholder interests as represented by financial institutions and others involved in hostile takeovers. The legislative outcomes consistently embodied a balance of interest group power in state politics that tilted substantially towards management. As a consequence, the most prevalent form of anti-takeover legislation, the “corporate constituency law,” allowed managers to take employee interests into account when responding to a hostile takeover bid, but gave employees no voice in firm governance even in the context of a takeover battle. For an overview of the American hostile takeover movement and political and legal responses thereto, see Alcalay, 1994; Wallman, 1990, 1991; see also essays collected in Blair, 1993; Bhagat, Shleifer, and Vishny, 1990; Shleifer and Vishny, 1990. The presence of populist resistance to concentrated and powerful financial elites is consistent with Roe’s historical analysis (1991) of the role played by anti-financier populism in the shaping the distinctive U.S. financial market structure during the 19th and 20th centuries.

27 Interview, Prof. Dr. Theodor Baums, University of Osnabrück, Osnabrück, July 13, 1999.
company law reforms that the long-ruling CDU CSU had resisted for years.\(^{28}\) He suggested that the SPD propose the first major legislative reform of the country’s company law since 1965 by targeting excessive bank power in the financial and corporate governance. By attacking the big banks, the SPD would maintain the support of its left wing and the unions. The party could mobilize a form of anti-financier populism that had been smoldering already as a result of financial scandals. The SPD hierarchy saw this as an opportunity to demonstrate that the party was serious about restructuring the economy, while portraying the CDU-CSU as perpetuating the cozy insulated financial and corporate relationships that no longer appeared to be serving Germany so well.

The draft legislation introduced by the SPD in the Bundestag mandated the divestment of the banks’ equity stake in corporations, imposed a limit of five board mandates (seats) per person, and the total prohibition of bank voting of share proxies. The SPD draft also favored regulation that gave the BAKred, Germany’s federal bank regulator, expanded authority to investigate the activities of banks in corporate governance. According to Baums, he and the SPD sponsors of the proposed legislation knew that the draft had absolutely no chance of passage and had constructed it to set up a bargaining position that would produce final legislation that would reform corporate governance without alienating the big banks to the degree that they would mobilize to kill the legislation. The strategy was to get public attention and pressure the government to support a compromise bill that would be far less radical, but still useful in improving corporate governance.\(^{29}\) The strategy worked.\(^{30}\)

\(^{28}\) The neo-liberal FDP, the CDU-CSU’s coalition partner during the Kohl government, had sought some measure of company law reform to benefit shareholder interests for much of the 1990s but had been rebuffed and endlessly delayed by the more traditionalist CDU. The governing coalition had set up a working group on company law reform, but the CDU made no serious effort to address the issues of corporate governance and company law reform until the SPD proposal was made public. Interview, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999. For a scholarly discussion of the role and influence of the FDP and neo-liberal ideas on company law reform, see Ziegler, 2000: 203 -204.

\(^{29}\) Interview, Prof. Dr. Theodor Baums, University of Osnabrück, Osnabrück, July 13, 1999.

\(^{30}\) Three developments reveal the extraordinary success of this political and legal strategy. First, there is the successful passage of the KonTraG reform legislation—even in its ultimate compromise form—discussed below. Second, Hans-Martin Bury became one of the pre-eminent SPD politicians of his generation and one of Chancellor Schröder’s principal lieutenants in the Chancellery as a Staatsminister and Bundeskanzler after the party came to power. Third, Theodor Baums rose in prominence and influence in parallel with the rising fortunes of Schröder, Bury, and the SPD. He has become one of Schröder’s most important legal advisors and the head of the government-sponsored Corporate Governance Commission (popularly known as the Baums Commission and on which Bury played a prominent role) charged with reviewing the practice and legal structure of German corporate governance and submitting proposals for reform. See German Law Journal, July 16, 2001; Government Commission on Corporate Governance (Baums Commission) Press Release, June 21, 2000; Jahn, 2001;
B. Interest Group Politics and Parliamentary Compromise

Under pressure from the left and from the FDP within its own coalition, the CDU threw its support behind a compromise law. Although the Bundesrat also had worked on a company law reform bill, under German law the upper house has no veto over issues of company law and thus played virtually no role in the legislative process. Ranier Funke of the economically liberal FDP headed the Bundestag committee that handled the bargaining over the terms of the compromise legislation and worked with Ulrich Seibert, a company law expert and the senior official responsible for drafting the legislation in the Ministry of Justice.\textsuperscript{31} The banks and the BDB (“Bundesverband deutscher Banken,” the banks’ peak association), demanded substantial tax concessions in the event that they were forced to liquidate their equity holdings. \textsuperscript{32} In addition, they stated plainly that their voting of proxies was an increasingly unprofitable service for their brokerage clients and that if the law made this process any more expensive and complex they would simply cease to provide it.\textsuperscript{33} In the absence of a substitute for the voting of proxies by the banks, the withdrawal of the banks from this function would result in even fewer shareholders participating in corporate decision-making and more unpredictable shareholder votes.\textsuperscript{34} The CDU and FDP politicians involved in the legislative process had thought that the bank power debate was merely populist rhetoric.\textsuperscript{35} The banks called the politicians’ bluff, as anticipated by all sides. Neither the government nor the SPD was willing to risk a direct and bitter conflict with the banks, nor were they in a position to advocate a vastly more complicated

\textsuperscript{31} By a quirk of bureaucratic jurisdiction, the Ministry of Justice has control over the preparation and drafting of company law legislation, while the Ministry of Finance handles these responsibilities in the area of banking and securities market law. In practice, however, this is a small group of talented professionals who often consult with each other when addressing issues that relate to each other’s substantive areas of legislation in order to gain access to valuable expertise and to prevent conflicts among the ministries.

\textsuperscript{32} Interview, Dr. Ulrich Seibert, Leiter des Referats für Gesellschaftsrecht und Unternehmensverfassung, Ministry of Justice, Berlin, July 5, 1999. They would receive these tax breaks two years later without the compulsory divestment.

\textsuperscript{33} \textit{Id.}

\textsuperscript{34} Bank proxy voting thus solves a collective action problem in corporate governance. Representatives of the Deutsches Aktieninstitut (DAI), an organization set up by the Deutsche Börse and its members to advance the development of shareholding and securitized finance in Germany, estimated that without bank voting of proxies only 10% to 15% of individual shareholders would vote at the AGM. To avoid the unpredictability of voting under conditions of such low turnout, firms, banks, and most policymakers concur that the bank’s role cannot be abolished without some replacement. Interviews, Markus Herdina, Deutsches Aktieninstitut, Frankfurt, December 6, 1999; Helmut Achatz, Deutsches Aktieninstitut, Frankfurt, December 6, 1999.

\textsuperscript{35} Interview, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999.
and divisive tax reform agenda that would benefit the banks.\textsuperscript{36} The government and Bundestag agreed to remove the provisions most objectionable to the banks and business, in particular the compulsory divestments and the outright elimination of proxy voting by banks.

The compromise over bank power reached in parliamentary negotiations called for banks to make a choice between voting their own shares in a corporation and voting the proxies of deposited shares where banks stakes exceeded 5\% of the firm’s equity. Following these concessions in the political bargaining, the banks and the BDB fell surprisingly silent.\textsuperscript{37} Given the anti-bank sentiment that had driven corporate governance reform onto the political agenda, it appears that the BDB and the individual banks saw the benefits of keeping a low profile in the ongoing debate. The BDB did not even offer any strong opinions on the compromise that would dilute the banks’ voting power. It appears that the major banks were largely in agreement with the agenda of corporate governance reform in order to improve and deepen German securities markets.\textsuperscript{38} They had already targeted financial services and the consulting business generated by these markets as their growth area and had reconsidered their traditional role in corporate governance. Likewise, they acceded to modest limitations placed on the number of board mandates that could be held by one person. In the banks’ view, large numbers of interlocking board mandates had generated increasingly bad publicity without contributing to their profitability. With the most controversial items removed from the agenda, the attack on bank power faded as the issues of financial transparency, the role of the board, and the use of new mechanisms of financing and compensation emerged as the core concerns of the reforms.

The CDU and FDP proposed a number of additional terms that sparked further controversy. One was a limit on the maximum size of supervisory boards. A second was an FDP attempt to bar or at least limit cross-shareholding among corporations. Both of these initiatives were blocked in short order. Allianz and Munich Re, the German insurance giants, in particular fought against any mandatory abolition of their large and extensive cross-

\textsuperscript{36} Moreover, it is not clear that the SPD was interested in pushing the divestiture provision. The publicly owned Landesbanken own a large amount of corporate stock, generally in smaller but locally important firms. Many SPD politicians were not eager to see a law that broke the tight financial linkages that ensured stable credit and financing to firms in their jurisdictions.

\textsuperscript{37} Interviews, Markus Herdina, DAI, Frankfurt, December 6, 1999; Helmut Achatz, DAI, Frankfurt, December 6, 1999; Marcus Becker-Melching, BDB, Berlin, November 11, 1999; Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999.

\textsuperscript{38} Interviews, Markus Herdina, DAI, Frankfurt, December 6, 1999; Helmut Achatz, DAI, Frankfurt, December 6, 1999. A representative of the BDB also suggested that this was generally the case, though with reservations on the particulars of the reforms. Interview, Marcus Becker-Melching, BDB, Berlin, November 11, 1999.
shareholdings. Compulsory divestment, as in the case of bank equity stakes, would force the insurers and a large number of other firms to incur huge capital gains tax liabilities. The CDU and FDP saw that the provision was likely to trigger potent opposition throughout corporate Germany and quickly dropped it.\textsuperscript{39}

The proposed limitation on the size of the supervisory board entangled the legislation in the politics of codetermination. The limit was ostensibly justified as a way to ease the inevitable collective action problems of coordinating the activities of a large number of people. A smaller board would be more cohesive and effective. However, diminishing the size of the board would reduce or eliminate the board seats granted to the unions. Under the Codetermination Act of 1976, firms with more than 2,000 employees received equal representation on the supervisory board. A number of these employee seats had been reserved for the unions that represented employees in these firms. While the proportion of employee representative seats would have remained stable, the number of employee seats as a whole would have to be cut. Because the legislation would have left mandatory representation for blue-collar, white-collar, and managerial employees intact, the reductions would have fallen disproportionately on union representatives who have taken board seats as a matter of established practice, not as a legal requirement.\textsuperscript{40} The unions and the SPD therefore justifiably saw this proposal as an attack on codetermination and organized labor. The heads of the DGB (the umbrella association of the industrial unions) and the more conservative white-collar union association went to the Economic Ministry to protest the proposal. Further, the reduction of board size would leave the representatives of \textit{managerial} employees with a stronger position. Because this outcome would strengthen management in corporate governance advocates of shareholder value did not support the board size reduction proposal. Thus, the array of interest groups and policy makers advocating shareholder value policies retreated from a divisive political and economic fight over the role of labor in firm governance and focused on more important issues in the reform of company law. Faced with the prospect of intense opposition from both the left-wing and

\textsuperscript{39} Interviews, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999; Dr. Ulrich Seibert, Leiter des Referats für Gesellschaftsrecht und Unternehmensverfassung, Ministry of Justice, Berlin, July 5, 1999 and November 11, 1999.

\textsuperscript{40} Thus, the unions would be caught in a dilemma: either they lost their board seats or they fought to keep their seats and risked alienating their rank and file employees. Interview, Dr. Roland Köstler, Deutscher Gewerkschaftsbund (DGB-the German Federation of Trade Unions) and Hans Böckler Stiftung, Düsseldorf, December 12, 1999.
centrist unions on an issue of great symbolic importance but relatively little practical value, the CDU quickly retreated and dropped the provision from the draft law.\textsuperscript{41}

The political constraints created by codetermination also precluded any serious consideration of adopting shareholder primacy as the basis for directors’ fiduciary duties. Under codetermination, German company law expressly recognizes and protects the interests of multiple constituencies. As a result, directors’ duties are conceived as requiring them to act in the best interests of the “enterprise,” rather than those of the shareholders as is generally the case under American law.\textsuperscript{42} Consistent with employee representation and the stakeholder model, company law does not privilege shareholder interests. Directors owe fiduciary obligations to the corporation as a whole, to employees no less than shareholders. Any attempt to impose a hierarchy of legal interests and norms would have eroded the practical effect of employee representation and would have been seen as an assault on the institution of board codetermination. Thus, a legal norm of shareholder primacy was regarded as politically impossible and not worth considering by those inside and outside the political system.\textsuperscript{43}

\textbf{C. Final Form: The Control and Transparency Act (KonTraG)}

The final product of the negotiations was drafted in the Ministry of Justice and entitled the Control and Transparency Act (Kontrol und Transparenz Gesetz), or KonTraG. Because company law is an exclusive concern of the federal government, the Bundestag alone determined the substance of company law. Neither the Länder (states) nor the Bundesrat\textsuperscript{44} played any appreciable role in the process. Also in contrast to the American legislative process, the drafting of legislation in Germany is centralized in one government ministry and under the control a single responsible official.\textsuperscript{45} As the primary drafter of the KonTraG, Dr. Ulrich Seibert, a senior

\textsuperscript{41} Interviews, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999; Dr. Ulrich Seibert, Leiter des Referats für Gesellschaftsrecht und Unternehmensverfassung, Ministry of Justice, Berlin, July 5, 1999; November 11, 1999.

\textsuperscript{42} However, many American states have enacted statutes allowing corporate directors and officers to consider the interests of non-shareholder constituencies such as employees, suppliers, customers, and local communities in responding to a hostile takeover bid. The case law in the United States, including the decisions of the Delaware courts, is frequently ambiguous and inconsistent with respect to the recognition of non-shareholder interests by corporate fiduciaries in the takeover context. See Cioff, 2002, Chap. 6.

\textsuperscript{43} Interview, Dr. Rainer Funke, Member of the Bundestag, FDP Bundesfraktion, Berlin, November 2, 1999.

\textsuperscript{44} The Bundesrat forms the upper house of the German parliament where Länder representatives must approve legislation implicating Land jurisdiction or interests.

\textsuperscript{45} In the United States, the drafting of major pieces of legislation is dispersed among multiple congressional committees, subcommittees, and individual members, and their respective staffs. This fragmented structure makes authorship much harder to determine and diminishes the technical and conceptual consistency, clarity, and coherence of legislation. On the other hand, the German system of professionalized legislative drafting tends to
civil servant in the Ministry of Justice, had substantial influence over the specific terms and technical details of the provisions. However, the substance of the law was determined by the political bargaining in the Bundestag.

Despite the fact that the KonTraG was Germany’s first significant company law revision since comprehensive overhaul of the Aktiengesetz in 1965, the final reforms were fairly modest in scope. For political reasons, they steered clear of the core concepts and structural features of German company law and corporate governance. Though not nearly so extensive as the 1965 revision, the KonTraG does institute a number of significant changes in company law and, perhaps more significantly, embraces a number of Anglo-American conceptions and practices imported from the increasingly international corporate governance debate. A brief summary of the law’s provisions follows.46

**Bank Power and Ownership**

As discussed above, the law sought to trim the influence of Germany’s powerful universal banks by forcing them to make a choice: if their holdings exceed 5% of a corporation’s stock, they can vote their own equity stakes or vote the proxy votes of the shares deposited by their brokerage customers.47 Banks must also disclose all other board mandates held by their representatives and their ownership stakes in firms. These provisions were the remnants of the SPD’s mobilization of populist outcry against bank power that had been instrumental in placing company law reform on the political agenda. In addition, the KonTraG requires banks to inform their share depositors of alternative ways to exercise their votes and strengthens their statutory fiduciary obligation to vote proxies in the best interests of the average shareholder. Banks voting depositors’ proxy votes must also name a management board member as responsible for monitoring the voting of proxies.48 These provisions sought to utilize and strengthen the German bank-based system of proxy voting, rather than undermine it, while creating opportunities for alternative mechanisms of proxy voting to emerge (such as shareholders’ associations). In its final form, the KonTraG did not threaten critical bank interests. The 5% rule did create an

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46 A thorough and useful summary of the KonTraG’s provisions is provided by the law’s principal drafter, Ulrich Seibert (1999).
47 The Act also formally recognizes the primary duty of custodian banks in voting proxies to protect the interests of the shareholder, thus importing a version of shareholder primacy into the normative framework of corporate governance.
48 See Stock Corporation Act (AktG), § 128(2).
incentive for banks to reduce their equity stakes in corporations, but a steady liquidation of these holdings was already part of the banks’ plans to modernize their operations and develop into global investment banks and financial services companies. Thus, this reform was largely a piece of symbolic legislation rather than a significant structural reform of the post-war bank-centered financial system.

**Auditing, Transparency, and the Role of the Supervisory Board**

The KonTraG shifts information—and power—to the supervisory board by requiring that the external auditor be hired by, and report to, the supervisory board instead of management board.\(^{49}\) This provision sought to redress the massive imbalance of information and power favoring the management board and to promote internal transparency of corporate finances. The annual audit must also now include an assessment of risk management and monitoring systems.\(^{50}\) The law contains additional auditing reforms (of particular interest in the wake of the Enron scandal in the United States) to improve the transparency of corporate finances by ensuring the independence, reliability, and accountability of auditors:

- An auditor is precluded from auditing a firm if it has earned more than 30% of its revenues from the client over the past five years.
- The auditor must rotate the signatory of the audit if the same person has signed the report more than six times in ten years.
- The limitation on auditor liability was raised from 500,000 DM to 8 million DM for listed corporations (2 million DM for unlisted companies).

The KonTraG also marginally strengthened the independence and activism of the supervisory board by reducing the maximum number of supervisory board mandates from ten per person by counting the supervisory board chair as two positions. The law requires the disclosure of the other board mandates held by nominees to the supervisory board to the AGM and regular reporting of board mandates held by members of both the management and supervisory board so that shareholders can discern potential conflicts of interest. The KonTraG also raises the minimum number of board meetings in listed firms from two to four per year.

**The One Share-One Vote Principle and Cross-Shareholding**

A second important provision protected and empowered minority shareholders by prohibiting unequal voting rights among shares of common stock and therefore imposed a “one

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\(^{49}\) Stock Corporation Act (AktG), §§ 170.1, 171.1 (superseding Commercial Code, § 318.1).
share, one vote rule” for the first time in Germany. This provision instituted shareholder democracy as a general principle of company law that weakens the control of insiders, and benefits smaller shareholders by ensuring that the degree of a shareholder’s control over a corporation would be equal to the amount of capital at risk. Accordingly, the KonTraG also abolished voting caps that limited the maximum number of votes by one shareholder. These caps had prevented changes in control through the accumulation of shares on the markets, thereby reducing managerial accountability as well as the liquidity and dynamism of the securities markets. The one share-one vote rule simultaneously promised to reduce the control premium that attached to the shares of certain favored insider shareholders (such as founding families of their successor controlling shareholders) and encourage the development of more diffuse shareholding by reducing the rents that insiders could potentially divert to themselves through the exercise of their controlling stakes. In other words, the KonTraG reduced the risks of being a small or dissident shareholder.51

In contrast to the general principle of one share-one vote, the KonTraG prohibits the voting of cross-shareholding stakes above 25% in supervisory board elections.52 A firm with an ownership stake of 25% or more may not vote any of its shares in board elections. This provision was designed to prevent managers from wresting control from shareholders by engaging in reciprocal voting with the managers of other firms involved in cross-shareholding relationships. However, these provisions would expose German firms to the threat of hostile takeover to an unprecedented degree by depriving them of these traditional defensive ownership structures. Although a number of the backers of the KonTraG saw the increased threat of takeovers as a beneficial mechanism of governance and accountability, this new vulnerability would transform the interests of German interest groups and politicians in an unfolding domestic and European debate and political struggle over takeover regulation that continues to this day.

Stock Repurchases and Stock Option Plans

50 Stock Corporation Act (AktG), § 93.1.
51 However, controlling shareholders, particularly the founders of family controlled firms and their heirs, put the government and Bundestag under intense pressure to preserve their voting rights. These interests portrayed the proposed elimination of existing voting structures and caps as a taking of private property. With the support of major firms and industrial association, the KonTraG contained a compromise grandfather provision that maintained existing multiple voting share structures for a five-year grace period and prospectively mandated the one share-one vote share voting structures. Seibert, 1999: 72 (discussing abolition of voting caps and limited grandfathering of multiple voting rights).
52 The 25% figure is significant in that this represents a blocking minority under German company law with respect to important corporate decisions.
The KonTraG incorporated Anglo-American concepts of shareholder value and financial practices by allowing stock repurchases and the use of stock options as executive compensation for the first time. Repurchases would allow the corporation, through its managers and only with the shareholders’ approval, to acquire up to 10% of the corporation’s own stock in order to increase its market price and the ratios of capital, assets, and/or earnings per share. Share buybacks are governed by norm of equal treatment of shareholders, typically (in the case of listed firms) through open market acquisitions. This would also allow shareholders to capture capital gains rather than immediately taxed dividends and remove the incentive for managers to use retained earnings for inefficient investment projects. The corporation can hold acquired shares in reserve for resale in the future or for use in share deals to effect mergers and acquisitions.53 Enabling corporations to increase the amount of equity capital for stock options was deliberately structured to align the interests of managers and shareholders along the lines of neo-classical economics and American practice in the 1980s and 1990s. However, in contrast to the controversial American practice of granting large options packages without fixed conditions or performance criteria, the KonTraG requires that the shareholders approve of all option plans, and that the plan set benchmarks for the issuance of options. It also prohibits the repricing of options if the company stock sinks below the price paid per share under the option’s terms (the strike price of the option). Having examined the abuses of the American system of executive compensation and working within a more egalitarian political and economic tradition, German policymakers were under pressure from across the political spectrum to ensure that options would not become an efficient method to siphon off the corporate treasury and the shareholder’s capital.

**Accountability and Litigation Rules**

Finally, the KonTraG contains very limited reforms of shareholder litigation rules. These measures balance the utility of litigation and civil liability for breaches of fiduciary duties against the threat of abusive shareholder litigation. Frivolous shareholder litigation is commonly associated with corporate governance and legal practice in the United States but has also increased in Germany. The KonTraG lowered the quorum threshold of minority shareholders required to demand the filing of a claim against supervisory and management board members on

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53 Within three months of the passage of the KonTraG, 48 corporations had adopted share buy-back plans, including Metallgesellschaft, SAP, SGL Carbon, BASF, Schering, Möbel Walther, and Hofbrau. See Seibert, 1999: 74 & nn. 37-43.
behalf of the corporation for gross breaches of the fiduciary duty of loyalty.\textsuperscript{54} This quorum was reduced from a vote of 10% to 5% of shares or 1 million DM of nominal capital. However, the KonTraG did not alter the \textit{substance} of fiduciary duties. Although the law lowered the ownership threshold for those seeking to compel the filing of a lawsuit against directors, the KonTraG did not substantially enhance the mechanisms and procedures of enforcing shareholder rights against the management and supervisory boards to make them more effective or prevalent in practice. German law still has no true equivalent of the derivative suit, the class action, or even the contingency fee for attorneys that have made litigation an effective—but also frequently abused—corporate governance enforcement mechanism in the United States.

\section*{IV. The New Legal Infrastructure: Company Law, Financial Market Reform, and Labor Relations}

The KonTraG was quite deliberately constructed to introduce an element of neo-liberal corporate governance into a traditionally bank-centered neo-corporatist regime. In this the legislation was consistent with the securities law reforms that had transformed the terrain of German, and European, financial market law during the 1990s. Indeed, the KonTraG was designed to support policy goals of the Financial Promotion Laws\textsuperscript{55} and the government’s

\footnotesize{\textsuperscript{54} Such lawsuits are similar to derivative suits under American corporate law, with the significant difference that the minority shareholders and their counsel do not control the litigation as in the United States. Also, this reform did not extend to claims for breach of the fiduciary duty of care (\textit{i.e.}, some level of sanctionable negligence in carrying out directorial responsibilities) for fear of creating excessive litigation and risk aversion by managers and supervisory board members.


sustained policy initiatives seeking to establish a shareholder culture in Germany. The Financial Promotion Laws had created one level of legal infrastructure, including Germany’s first federal securities regulator (the BAWe) for the development of securitized finance, the spread of shareholding, and the diffusion of corporate ownership. The adoption of disclosure rules and the creation of a regulatory agency charged with rule making and enforcement in the realm of securities trading represented a convergence on the American SEC model of securities regulation. The KonTraG shared the fundamental normative commitments of the new framework of securities law to transparency, equal treatment of shareholders, and curbing the rent seeking of corporate insiders. The law’s provisions increasing the independence, autonomy, and activism of the supervisory board tracked the corporate governance debate as it had emerged in the Anglo-American economies since the 1980s. Likewise, its provision for greater flexibility in financing and incentive-based compensation drew from the governance theories of neoclassical economics and American financial and management practices that exercised considerable allure overseas during the decade. In short, whereas the Financial Promotion Laws improved transparency and accountability at the level of the markets, the KonTraG was intended to do the same at the level of the firm. This relationship between securities regulation and company law points to two levels of infrastructure necessary for the type of securitized finance that defines a modern financial system. One level is external to the firm, the other internal, and they must complement and reinforce one another.

The policy makers and interest groups that negotiated the KonTraG believed it was a necessary intermediate step in a broader structural reform of the German economy. It was necessary, but not sufficient. The reform of company law was necessary for the German corporation to become a vehicle for and recipient of the equity finance that the Financial Promotion Laws were intended to make available. Yet, even in concert with the Financial Promotion Laws, the KonTraG could not transform the tangled network of ownership that insulated corporate Germany from the demands of the financial markets and shareholders. Therefore, the project of financial modernization and economic (i.e., corporate) restructuring

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56 See Ziegler, 2000: 206-208 (discussing the privatization and flotation of Deutsche Telekom shares, the efforts of the Research Ministry to jump-start a market for venture capital, and the public-private effort spurring the development of the technology-intensive Neue Markt equity market in Frankfurt).
57 Many observers in Europe believe that the allure was especially powerful to German executives who envied the compensation packages of their American counterparts. To paraphrase one interviewee, the fondest wish of German executives is to be protected by German company law but paid like an American CEO.
begun under the CDU coalition (in part through instigation by the SPD) required further structural reforms of the structure of corporate ownership. The SPD pursued this agenda when it took control of the government under Gerhard Schröder. It enacted the most sweeping tax reform legislation in post-war German history in order to unwind the web of cross shareholdings that held “Germany Inc.” in place. In sum, all three sets of reforms (securities market, company law, and taxation) were necessary before genuine and effective corporate governance and financial system reform could become possible.\textsuperscript{58}

These reforms, however, left much of the core of company law’s normative framework was left untouched. The substance of the KonTraG reveals the oppositional forces working within the German political economy as its elites sought to accommodate the German model to a new era of finance and corporate organization. Neither codetermination, nor the substantive content of fiduciary duties were altered with respect to intra-firm relations.\textsuperscript{59} Fiduciary duties were strengthened only as they related to external relations in the financial services industry. Banks now owe a stricter duty of loyalty to their customers. Inside the corporation, directors’ fiduciary obligations remain essentially unchanged. As they approached the subject of company law reform, politicians knew that it would be impossible to institute a legal norm of shareholder primacy or any articulation of fiduciary duties that compromised codetermination was politically impossible. Such a norm would lead to one of two politically unacceptable results. One possibility would be the hollowing out of supervisory board codetermination by imposing on employee representatives a fiduciary duty to act in the best interests of shareholders, rather than their employee constituents. This would effectively repeal codetermination and leave it an empty institutional shell.

A second possibility would have been to define the obligations of supervisory board directors’ in terms of their respective constituency (\textit{i.e.}, shareholders, blue collar employees, white collar employees, and senior management). Shareholder representatives would owe stringent duties to shareholders, and employee representatives would have completely different

\textsuperscript{58} Pension reform constitutes the final component of the transformation of German finance and corporate governance. This process is only now beginning with a modest set of reforms encouraging the formation of private pensions. The most substantial political battles have yet to be fought over the funding of corporate pensions: the dominant form of private pensions (individual, company-level, or sectoral), the identity of their management (insurance companies, banks, mutual funds, and/or pension funds), and their form of governance (professional money management, managerial domination, or codetermined boards of trustees).

\textsuperscript{59} The German courts have inferred the existence of and elaborated upon fiduciary duties to shareholders, but law remains undeveloped and conceptions of corporate interest distinct from shareholder interest persist.
obligations. Although logically possible, this solution to the problem of fiduciary duties under codetermination poses both practical and theoretical problems. As a practical matter, this division of duties would undermine codetermination in large corporations. Codetermination is intended to produce consensual negotiations and decision-making, whereas divergent fiduciary duties would compel the opposing blocks of directors to vote against one another on important and contentious issues. Theoretically, fiduciary duties are conceived as a unified coherent whole.\textsuperscript{60} It is a bedrock principle of German company law that these obligations are owed not to shareholders or any other particularistic constituency but to the enterprise itself as an ongoing entity. This corporatist conception of obligation complements the institutional structure of codetermination, but does not support the norm of shareholder primacy or dichotomous conceptions of fiduciary duties.

The problem of fashioning an efficacious definition of fiduciary duties that could guide the conduct of intra-corporate affairs and provide a means of adjudicating corporate disputes indicates the persistent influence of codetermination on the development of company law. Codetermination—and labor politics generally—impose substantial constraints on the development of anything approximating Anglo-American shareholder capitalism. Aside from the issues surrounding fiduciary obligations, the abandonment of the proposed reduction in the size of the supervisory board provided the clearest example of the power of this constraint. The reduction of supervisory board size was supported by business and financial interests, as well as by economic theory, but was killed by unions (with justification) on the grounds that it constituted an indirect attack on their role in codetermination and corporate governance. Moreover, as codetermination is a structural remedy to the problem of employee representation, it precludes alternative structural arrangements designed to enhance shareholder interests and maximize shareholder value. Constraints imposed by courts on use of board committees comprised solely of shareholder representatives (\textit{i.e.}, outside directors) do not allow the board to focus on the interests of different constituencies in different contexts by restructuring itself into specialized units.

\textsuperscript{60} However, the Codetermination Case of 1979, in which the Federal Constitutional Court upheld the constitutionality of the Codetermination Act of 1976, recognizes—at least implicitly—the differing interests of employees and shareholders, and thus of their board representatives. The Court held that the Codetermination Act was not a taking of shareholder property or an abridgement of the basic right of free enterprise because shareholders retain the tie-breaking vote of the chair of the supervisory board and therefore remain in de facto and legal control of the corporation.
Given these impediments to fundamental reform of the supervisory board and fiduciary duties necessary for convergence on the American model, reform of the German stakeholder system strongly favors increased transparency. Theoretically, codetermination should discourage legal reforms that would mandate greater disclosure and transparency within the firm. Increased information flow to the supervisory board would strengthen both shareholders and employee representatives (and the unions). The KonTraG provides ambiguous evidence on this point. On the one hand, the law did significantly improve internal corporate transparency by increasing the supervisory board’s control over auditing and thus monitoring of management. On the other hand, the KonTraG linked this intra-firm transparency to audit functions that have been closely related to public financial reporting. This raises the possibility that the increased information flow to the board will not exceed that going into public disclosure and suffer from the familiar problems of opaque and distorted accounting. However, the basic shift in power and control effected by the KonTraG in favor of the supervisory board in auditing matters puts that body in a far stronger position to question auditors and managers about the firm’s finances. This suggests that codetermination has not constrained the development of internal transparency, monitoring, and accountability mechanisms to a significant degree.\footnote{The caveat must be added: the board may not use these new powers under the KonTraG for fear that labor will appropriate the gains from internal transparency, or a sufficiently large portion thereof that would render the effort and expense of monitoring futile. This empirical question can only be answered through additional detailed research at the firm level.}

The preclusion of shareholder primacy as a legal norm in a codetermined governance system and distaste for litigious enforcement mechanisms has prevented fiduciary law from developing along liberal lines. With the exception of the fiduciary relation between banks acting as securities brokers and their customers depositing shares, no articulations of fiduciary duties and shareholder primacy were made for fear of contradicting the norms and institutionalization of consensual governance represented by codetermination that require equal concern and consideration of shareholder and labor interests. A recent landmark decision by the Federal Supreme Court strengthened the fiduciary obligations of supervisory board members to defend the interests of shareholders against managing board members yet it could not endorse shareholder interests over those of employees.
Likewise, the KonTraG largely eschewed litigious mechanisms of governance and enforcement in favor of structural fixes. The minimal changes in the formal rights of shareholders and duties of directors contained in the KonTraG, and the law’s modest liberalization of litigation rules regarding suits against directors are peripheral matters compared to the provisions reforming the powers and role of the board. There are two principal reasons for this preference for structural reforms inside the governance structure of the firm. First, formal and enforceable rights give rise to a functional and predictable order of governance relations only where these rights describe and impose a hierarchical order of legal entitlements. In American law, this hierarchy is clearly fashioned by the norm of shareholder primacy and a corporate structure that provides no mechanism for employee representation. Codetermination creates an institutional structure and a corresponding normative understanding of corporate governance that legitimates multiple interests. As a result, adjudication of conflicts among these interests becomes exceedingly difficult, if not impossible. Conflicts must be negotiated internally within the firm rather than adjudicated externally in a court. In strengthening the board, the KonTraG inevitably strengthened both shareholders and employees. In a codetermined structure of representation, transparency favors both constituencies against managers and controlling shareholders.

Second, policy makers had sufficient experience with “predatory” lawsuits in Germany and enough information about the securities litigation industry in the United States to dissuade them from creating litigious mechanisms of corporate governance. Germany traditionally has had weak securities laws and procedural mechanisms that discouraged litigation. However, German company law contains a quirk that has created Germany’s own version of the litigation industry. The conduct of the annual general meeting of shareholders (the AGM) under German company law is subject to complex procedural rules and a failure to comply with them can provide the basis for an action to rescind a corporate decision and enjoin its execution. As a result, an active plaintiffs’ bar has developed to challenge important corporate decisions requiring shareholder approval on procedural grounds. These lawsuits are frequently without merit, but nonetheless threaten to delay critical corporate transactions and plans. Thus, just as in the case of many American securities suits, German company law actions are frequently brought

62 And even these structural remedies to governance problems of insider opportunism and managerial accountability were limited by codetermination as demonstrated by the debate over supervisory board size.
not because of their merit, but because of the leverage they exert on management to extract quick, but lucrative, settlements. Because German law provides for easier access to the courts in cases arising out the conduct of the AGM than in the trading of securities, lawsuits are frequently filed to enjoin the execution of important business decisions where time is of the essence (such as in the case of an urgent capital increase or corporate acquisition) where the leverage of the plaintiff’s attorney is maximized. Those who negotiated and drafted the KonTraG had no interest in expanding the opportunities for a type of legal practice they viewed as wasteful, extortionate, ineffective in the achievement of policy goals, and disruptive to the patterns of cooperation and negotiation favored and maintained by neo-corporatist institutional arrangements.

V. Unwinding Germany, Inc.? : The Mannesmann Takeover and Tax Reform

Taken in isolation, the KonTraG reforms appeared modest and unlikely to cause a substantial change in German corporate governance practice and policy. Several conjunctural developments following the passage of the KonTraG, however, threatened the interests of German elites in corporate governance: (1) Vodafone’s hostile takeover of Mannesmann, (2) major tax reforms designed to break up German cross-shareholdings, and (3) the negotiation of a EU Takeover Directive. In this context, the KonTraG’s elimination of takeover defenses provided by unequal share voting rights, voting caps, and cross-shareholding shifted the policy preferences—and fears—of German elites and the politics of corporate governance reform in Germany. Taken together, German economic and political elites believed that these developments would render domestic corporations asymmetrically vulnerable to takeover by better-protected firms from the United States and other European countries. The KonTraG reforms inadvertently mobilized political and economic elites against further liberalization of company and takeover law.

A. The Mannesmann Takeover

A sign of substantial change in German corporate governance arrived with Vodafone’s hostile takeover of Mannesmann.63 Mannesmann had been an established Düsseldorf-based metalworking and engineering firm, but made an extraordinarily successful transition to wireless telecommunications. The company also found itself suspended between the traditional structures
and practices and German corporate governance and the new rules of shareholder capitalism. Mannesmann had pursued shareholder value avidly. Its high share price financed a series of strategic acquisitions that turned it into one of Europe’s leading wireless telecommunications companies and an attractive investment for investors around the world. However, it had not adopted IAS or US-GAAP accounting standards, remained a diversified corporate group (Konzern), and it neither listed on either the New York or London stock exchanges nor made return on equity the central criteria for evaluating corporate strategy. By 1999, its stock market capitalization equaled 11.5% of the German blue-chip DAX index. Its shares were widely held, rather than locked up in cross-shareholdings, and foreign investors held 60% of its stock—and Anglo-American investors owned 40% and Anglo-American institutional investors held 19.2%. In November 1999, Vodafone, a smaller British wireless telecommunications corporation more thoroughly adapted to the demands of British and international capital markets, launched a successful cross-border hostile takeover bid for Mannesmann.

For the first time, a successful hostile takeover had been launched against a major German corporation by a foreign firm—and under German law no less. The Mannesmann takeover also revealed the surprising weakness of alleged defense mechanisms built into the German model of capitalism and corporate governance. First, relational finance provided no cover. The major German banks did not rise to the defense of the target company and at least tacitly supported the takeover. Mannesmann was also something of a special case. The universal banks did not have major equity holdings in Mannesmann, the company’s stock was unusually widely held for a German corporation, and Anglo-American investors held an unusually large percentage of its shares. This made Mannesmann atypically vulnerable to a tender offer bid. Second, supervisory board codetermination failed to create a block of directors capable of warding off Vodafone’s bid. Once the bid was made, there was little the directors

63 Höpner and Jackson (2001) provide an excellent detailed overview and analysis of the Mannesmann takeover and its implications for German corporate governance.
64 Id., p. 25.
65 Id., pp. 25-26 & Table 5.
66 Interview, Dr. Roland Köstler, Deutscher Gewerkschaftsbund (DGB-the German Federation of Trade Unions) and Hans Böckler Stiftung, former supervisory board member of Mannesmann, AG, Düsseldorf, July 18, 2000; cf. Höpner and Jackson, 2001: 44-45.
could do to prevent shareholders from tendering their shares because German law did not authorize takeover defenses, such as poison pills, common in the United States. 67

Notwithstanding the unprecedented nature of the Vodafone tender offer, the political and public response to the takeover bid was surprisingly muted. Chancellor Schröder issued a few critical comments regarding the incursion of Anglo-American capitalism into the Germany, but he was roundly criticized in many quarters—particularly in the business and foreign press—for interfering in a market transaction and he quickly withdrew from an active role in the matter. 68

Although Mannesmann’s management fought bitterly against the takeover, it did not want the government’s help to drive off Vodafone and sought to conduct its defense through available legal mechanisms and through lobbying shareholders. 69 There was little of the widespread public outcry or union militancy that accompanied the abortive ThyssenKrupp hostile takeover two years before or the near collapse of the Holzmann construction group. 70 Employee representatives on the supervisory board were primarily concerned with protecting the economic interests and job security of their constituents, not with the independence of the firm as an ongoing enterprise. Though IG Metall opposed the takeover, it did not call for mass demonstrations against it. 71 Moreover, CalPERS sided with Mannesmann’s management and IG Metall against the takeover on the ground that Vodafone’s anticipated debt levels and business strategy posed long-term risks to shareholders (concerns later proved correct after the crash of the telecommunications stocks in late-2000 and 2001). The CalPERS criticisms of the takeover blunted potential criticism of the power and influence of the foreign investors and investment funds that owned a substantial percentage of Mannesmann’s stock.

67 Indeed, in some important ways German law was more favorable to the hostile bidder than British law. German law allows the bidder to raise the price bid in a tender offer. The law in the United Kingdom, where Vodafone was based and incorporated, prohibited changing the terms of the bid once launched. Vodafone’s managers and strategists took advantage of German law by successively raising the bid price for Mannesmann shares, and certainly did not consider the legal defenses available under German company law insurmountable. Interview, Dr. Roland Köstler, Deutscher Gewerkschaftsbund (DGB-the German Federation of Trade Unions) and Hans Böckler Stiftung, former supervisory board member of Mannesmann, AG, Düsseldorf, July 18, 2000; cf. Höpner and Jackson, 2001: 44-45.

68 In fact, his half-hearted and unsuccessful intercession was seen as end of Germany, Inc. and beginning of era of takeovers and restructuring. Takeovers remained unpopular with the public, but opponents of takeovers and economic liberalization failed to mobilize politically around the issue.

69 For an account of the takeover battle, see Höpner and Jackson, 2001.

70 Cf. Ziegler, 2000 (discussing, inter alia, the ThyssenKrupp takeover attempt and eventual merger)

71 Interview, Dr. Roland Köstler, Deutscher Gewerkschaftsbund (DGB-the German Federation of Trade Unions) and Hans Böckler Stiftung, former supervisory board member of Mannesmann, AG, Düsseldorf, July 18, 2000
The public perception shifted, however, as it became clear that the Vodafone-Mannesmann deal was not the merger of equals as had been advertised. Mannesmann had been taken over by a British firm and the German operations were no longer directed from Düsseldorf. This represented something of a blow to German pride, a more serious blow to the economic heartland around Düsseldorf, and a looming threat to Germany’s corporate elite. No great economic benefit was seen in the takeover—certainly no benefit to Germany—and an innovative company that appeared to play by the new marketplace rules of shareholder value, high-tech innovation, and widely-held stock was seen as paying the price of its own existence for an economic order driven by speculative financial practices. These perceptions, along with suspicions of shareholder capitalism and its implications for German society and economic sovereignty, permeated the political elite as well. This resentment and fear festered in Germany even though no hostile takeovers occurred in Germany in the aftermath of the Mannesmann takeover.

B. Tax Reform and the Unwinding of Cross-Shareholdings

A web of cross-shareholdings traditionally provided the cement that kept “Germany Inc.” intact and made takeovers difficult to execute. These cross-shareholding arrangements, however, have been extremely resilient. Firms and financial institutions have refused to liquidate their stakes in other corporations so long as capital gains taxes were prohibitively high (over 50%). In light of these ownership networks, the rather modest reforms brought about by the KonTraG appeared to have little chance of affecting the practice or future politics of corporate governance in Germany. However, Vodafone’s hostile takeover of Mannesmann in late 2000 showed the German elites and electorate that the country’s firms were now exposed to tender offers from outside the country. Just a few months before, tax reform legislation had removed the structural impediments to unwinding protective cross-shareholdings and would ultimately increase this vulnerability.

72 Though the extent and intensity of anti-takeover attitudes among political elites is hard to determine without survey data, the shift in government policy on takeover law strongly indicates a substantial turn against neo-liberal corporate governance policies.

73 Cf. Jenkinson and Ljungqvist, 1999; Köke, 2000. These empirical studies found a more active market for control in Germany than commonly thought. Changes in control are made through the sale of control blocks, often with the assistance of banks. They also found, however, that the chances of a change in control and ultimate ownership is reduced by complex ownership structures (i.e., extensive cross-shareholdings). This finding raises the paradoxical possibility that in Germany, concentration of ownership facilitates takeovers while fragmentation of ownership may inhibit them.
The major tax reform law of July 2000 (*Steuerreform*) abolished capital gains taxes on the liquidation of cross-shareholdings. The Schröder government made a deliberate policy choice to invigorate German securities markets by increasing the proportion of shares traded (the free float of issued securities) and to induce the unwinding of ownership structures that shielded German corporations from pressures to restructure and adjust to changing economic conditions. Passed in July 2000, despite the evidence that Germany’s firms were increasingly vulnerable to takeover, this tax reform law promises to be the most important and radical corporate governance reform in German history.\(^74\) The legislation was animated entirely by corporate finance and governance concerns. The anticipated effects of the law were tax neutral. In the absence of the reduction in capital gains taxes, firms and financial institutions would simply have left the cross-shareholdings in place. No additional tax revenues would have been generated under the status quo ante. Conversely, the elimination of capital gains taxes on divestments would not deprive the government of revenues that would have been otherwise generated.

One of the most striking aspects of this dramatic policy shift is that it was pushed through a resistant legislative system by a Social Democratic government with business support over conservative opposition. Beginning with the KonTraG in 1998, the politics of corporate governance has been appropriated by the center-left coalition as part of an agenda of economic and legal modernization. Indeed, the tax reform agenda became a central piece of the Schröder government’s economic modernization agenda and required fierce political maneuvering to push the legislation through the Bundesrat, where CDU-CSU representatives of the Land governments held the majority. Only through shrewd bargaining and the promises of additional federal transfers to strapped Land governments secured the law’s passage. Economics did not drive the reform; politics did.

Having taken effect in January 2002, the tax reform law has already begun to set off a wave of corporate restructuring.\(^75\) The strength of organized labor and codetermination precludes the sort of takeover wave that the United States experienced in the 1980s, in which employees bore the brunt of adjustment costs. However, for the first time in German history,

\(^74\) See, *e.g.*, Holloway, 2001 (interview with international corporate governance Stephen Davis predicting that the 2000 tax reforms will transform German corporate governance and increase takeover activity).

\(^75\) However, for economic reasons this restructuring is unlikely to be immediate and comprehensive. The underdevelopment and relative illiquidity of Germany’s capital markets has constrained divestment of cross-shareholdings. See, *e.g.*, Bushrod, 2001(b). In the near term, the disposition of stakes will probably either follow
hostile takeovers became a realistic possibility and this looming threat altered the political terrain of corporate governance reform in Germany. The effects of this shift were felt both within domestic politics and in Brussels as the EU Parliament debated the long-awaited Takeover Directive.

VI. Backlash and the Spillover Effect: The EU Takeover Directive Debacle, the German Takeover Law, and the Limits of the Liberalism

A. The Reconstitution of German Interests and the KonTraG Reconsidered

The KonTraG was not a piece of nationalistic legislation. It was not drafted with an eye towards the defense of incumbent managers or the German model of neo-corporatism nor was it designed to reinforce the social market economy. Even though the political compromises that determined its final form removed those provisions that would most seriously destabilize the German model of corporate governance and political economic arrangements, the law was essentially neo-liberal in its conception and its proponents borrowed heavily from Anglo-American theories and practice in formulating the legislation. The tax reform legislation continued this liberalizing trend and reflected increasing political and economic pressures for the structural reform of established institutional arrangements.

In the context of a liberalized and more shareholder friendly company law, the new tax regime and the Mannesmann takeover increased the salience of the vulnerability of German firms to hostile takeovers. Contrary to numerous predictions in the popular press, the Mannesmann takeover had not been a watershed with respect to hostile takeovers in Germany. No other hostile takeovers by foreign firms occurred following the Vodafone-Mannesmann deal. However, the European Commission’s adoption of a draft EU Takeover Directive and its submission to the European Parliament for approval triggered fears of takeover vulnerability among German political and economic elites. With the submission of a proposed EU Takeover Directive to the European Parliament, conflicts over the desirability of hostile takeovers, the strategic advantages conferred by national law, and the interaction of the proposed EU directive and domestic law in reinforcing these advantages proved an explosive combination of political and economic factors. While the KonTraG eliminated anti-takeover defenses and created the legal infrastructure for a more vibrant market for shares, the tax reform law instituted incentives...
to unwind cross-shareholdings that provided *de facto* takeover protection. This conjuncture of factors led Germany’s political elites to oppose the Takeover Directive. The result was the first defeat of a major European Commission initiative in the European Parliament.

**B. The EU Takeover Directive**

The harmonization of company law has been a prominent item on the EU agenda for nearly thirty years. A common EU takeover code had been in negotiation for over a decade. The first formal incarnation of the recent Takeover Directive proposal dates back to 1989. The Commission presented a general framework for the draft Takeover Directive in 1996 and a further amended draft version in 1997. The Council unanimously adopted a common position on the draft Directive in June 2000 and Commission accepted that common position in July 2000. Sent to the European Parliament in September 2000, the Parliament approved the draft Directive—and fifteen amendments—in December 2000. The Commission and Parliament disagreed on a number of amendments drafted to allow greater managerial latitude in adopting defenses against hostile takeovers and greater consultation rights for employees of the target company. With less than a day to the expiration of a treaty-imposed deadline, the Commission and Parliament agreed to a common position on the Directive on June 6, 2001, and formally submitted the draft Directive for the required bare majority vote of approval by the European Parliament. This vote would constitute a watershed event in economic and corporate governance on the Continent, but it was not to be the major advance toward EU policymaking and market harmonization envisioned by its backers.

The draft Directive was the clearest and most far-reaching attempt to introduce Anglo-American concepts of shareholder value, and shareholder capitalism generally, into the European political economy. For this reason, the Directive became one of the most divisive pieces of

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76 The reforms were expected to increase the “free float” of German shares (the proportion of a firm’s shares actively traded on the market, as distinguished from shares held long-term by block holders or locked-up in cross-shareholdings). This would make controlling majorities of shares susceptible to tender offers in a much larger number of firms.


79 This indicates the novel politics and structural dynamics of efforts to reform European economies: the counterattack against a stringent piece of neo-liberal legislation, the Takeover Directive, combined an embrace of quintessential American anti-takeover defenses and an extension of codetermination rights.
legislation to ever come before the European Parliament, sparking fierce opposition and unusual alliances. The principles articulated in the Directive would have made takeovers much easier. By far the most controversial provision and the lightning rod of opposition, Article 9 of the draft imposed a requirement of “neutrality” on directors and senior managers in responding to a hostile takeover bid. This would have prohibited corporate boards and managers from adopting “poison pills” and other defensive measures without shareholder approval and would have prohibited the solicitation of shareholder approval in advance of a hostile bid. The fight over Article 9’s neutrality duties eclipsed the provisions of Articles 3 and 10 that required equal treatment of all the target corporation’s shareholders and mandatory bid rules compelling an offer for all outstanding shares of a publicly traded firm when the acquirer’s holdings exceeded a specified level. The controversy over board neutrality shifted the political debate from the improvement of European corporate governance and securities markets, which the equal treatment and mandatory bid requirements would have advanced, to one over the economic and social desirability of hostile takeovers. Further complicating the controversy, the draft Directive did not bar all takeover defenses. It contained no one-share, one-vote principle, as does the KonTraG, allowed the continued use of “golden shares” that confer voting control over corporations to the minority that holds them, and permits the sort of protective cross-shareholding that Germany’s tax reforms were designed to unwind. Thus, the Takeover Directive threatened to render German firms particularly vulnerable to takeover by corporations from countries allowing golden shares or poison pills. Despite the indications of deep-seated opposition in the European Parliament, the Council rejected a substantive amendment loosening the restrictions on defenses and agreed only to an extension of the phase-in period for the provision from four years to five. Nonetheless, by June of 2001 the majority of EU member

80 Article 9 provided:

Obligations of the board of the offeree company

Member States shall ensure that rules are in force requiring that:
(a) after receiving the information concerning the bid and until the result of the bid is made public, the board of the offeree company should abstain from any action which may result in the frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company, unless it has the prior authorization of the general meeting of the shareholders given for this purpose;
(b) the board of the offeree company shall draw up and make public a document setting out its opinion on the bid together with the reasons on which it is based.
state governments had approved the draft Directive, as had the European Commission. The political opposition that killed the Directive began in Germany.

C. German Takeover Politics Comes to the European Parliament

The direct and inherent threat posed by takeovers to vested economic interests triggered a shift in German politics against the Takeover Directive. German managers saw the directive as a threat to their own positions and that of German corporations generally. More broadly, the hostile takeover of Mannesmann by Vodafone of the United Kingdom had steeled opposition to takeovers across a broad swath of German interest groups and voters. The German industrial unions, a key pillar of support for the governing SPD, were adamantly opposed to the importation of Anglo-American forms of law, governance, and economic organization. Organized labor saw the Takeover Directive as a means of shifting both power and income from employees to shareholders, as had been the case in the United States and United Kingdom since the 1980s. However, German unions are far more politically and economically powerful than their American, British, and French counterparts. German managers and labor thus formed a potent coalition across class and ideological lines to oppose the Directive.

Opposition to the Takeover Directive was intensified by the sequence of domestic corporate governance reforms in Germany that had the effect of rendering German corporations particularly vulnerable to takeovers under the terms of the Directive. The KonTraG and tax reform legislation together had eliminated the principal defenses to hostile takeovers in Germany. In contrast, the Takeover Directive would have allowed both golden shares and cross-shareholding to shield those companies with such ownership structures. This left German firms asymmetrically vulnerable to takeover threats from firms based in France, Italy, and the Netherlands where golden shares are common, and from Italian firms within protective webs of cross-shareholdings and ownership “cascades.” Ironically, the draft Directive also would have

81 The managers of DaimlerChrysler, Volkswagen, BASF, and several German chemical companies reportedly led managerial opposition to the Takeover Directive. Volkswagen was a particularly effective lobbyist. See The Wall Street Journal Europe (Editorial), May 30, 2001; Simonian, 2001. Lower Saxony owns one fifth of VW shares, and politicians at the state (“Land”) level had no desire to see shareholder pressure induce job cuts or plant closures. They were even more opposed to legal changes that might make VW vulnerable to a takeover in a consolidating global automobile sector. In short, they did not want to see what happened in the American car industry (i.e., downsizing and Chrysler-style takeovers) repeat itself in Germany.


placed far more stringent restrictions on takeover defenses than any state in the United States.\textsuperscript{85} American firms, by far the world’s most savvy and experienced in merger and acquisition activities, have greater latitude under state corporate law to adopt poison pills and other defenses prohibited under the draft Directive. Thus, German firms would have been threatened with takeover by American firms with battle-tested financial and governance structures, hard won tacit knowledge of the offensive and defensive techniques of takeovers, and well-developed relations with financial institutions specialized in takeovers and related financial activities. The (remarkably belated) realization of how vulnerable German corporations might be to takeover by foreign firms under the draft Directive mobilized broad-based opposition and prompted the German government’s shift against the directive.

Mounting opposition and the weakening of the German government’s resolve in support of the Takeover Directive came as a shock to other European governments, especially those of Sweden (holding the EU presidency at the time) and the United Kingdom (the Directive’s biggest proponent). The German government had been a strong proponent of the measure.\textsuperscript{86} Chancellor Schröder’s tax reforms were deliberately designed to encourage takeovers and restructuring by lowering the tax barriers to corporate sales of cross shareholdings that protected German companies from hostile bids. In fact, the proposed German takeover law, then under consideration, was modeled on the draft Directive.\textsuperscript{87} Only a few weeks from completion of the political process, the German government shifted its position to oppose the Directive, generating accusations of betrayal from other EU governments.\textsuperscript{88} In the Commission, the Germans were pressed by other member state governments into signing on to the Conciliation Committee draft after being outvoted initially by 14-1. The opposition then moved to the European Parliament, which was then faced with a stark choice between a neo-liberal takeover framework and an outright rejection of the draft Directive and twelve years of work.

Following the conciliation procedure in late May and early June, the Germans continued to attack the draft Directive. German Christian Democrat Klaus-Heiner Lehne was both the rapporteur for the Directive in the European Parliament and the leader of the opposition to it.

\textsuperscript{85} Cf. The Economist (Global Agenda), June 6, 2001; Betts and Hargreaves, 2001.
\textsuperscript{87} In the wake of the German government’s opposition to the Takeover Directive, the draft domestic legislation was changed to allow prospective adoption of anti-takeover defenses. This shareholder consent would have been approved in a resolution voted on at any annual general meeting of the shareholder and would then operate indefinitely to authorize management and directors to adopt anti-takeover defenses. See Krause, 2001.
Lehne, hailing from the area near Mannesmann’s home base in Düsseldorf, argued that the draft Directive failed to address the remaining substantial differences among the company laws of different countries and that these variations would confer unfair advantages in an ensuing struggle for economic power through corporate control. Though the fear was significantly overstated, he also argued that German and other European corporations would be at a disadvantage against better-defended American firms in an international market for corporate control.\(^{89}\) While Lehne emphasized that the Takeover Directive would put German companies at a competitive disadvantage against other European and American companies, he framed his arguments in terms of a broader reallocation of corporate and economic power that would operate unequally across EU member states. These arguments resonated with a large number of European Parliament members.

The issues stressed by Lehne dominated the debate.\(^{90}\) First, the draft Directive permitted the continued deployment and use of “golden shares.” This share structure, common in France and the Netherlands, would give firms possessing it a strategic advantage in the market for control.\(^{91}\) Second, the fear of cross-national takeover threats from American firms and financial institutions raised by German representatives was reportedly widely shared across Europe. The opposition block used these two asymmetries to undermine support for the draft Directive in the European Parliament. Finally, the draft Directive was perceived as posing a direct threat to national sovereignty in a core area of political economic organization. Corporate governance in general, and company law in particular, links capital markets, labor relations, and the internal adjustment capacities and comparative advantages of national economies in a complex institutional framework. The Takeover Directive would have disrupted these complicated and
potentially contentious relationships and the distinctive balance of interests worked out by the member states during the post-war period. The potential disruptive effects of the Takeover Directive were particularly serious in neo-corporatist countries with board codetermination. The Directive’s neutrality requirement would impose a norm of shareholder supremacy in takeover situations when the interests of shareholders and employees come into sharpest conflict. 92 From the vantage point of organized labor, social democrats, and many Christian democrats, the neutrality provision was not neutral at all, but a decisive shift in the legal framework of corporate governance in favor of shareholder interests and neo-liberal shareholder capitalism. 93

In the European Parliament, only the liberals supported the Conciliation Committee compromise as a united block (the fifty-two MEPs affiliated with the Liberal, Democrat and Reform parties). 94 The two major parliamentary blocks, the Party of European Socialists (the Social Democrats with 181 members) and the European People's Party (the Christian Democratic block with 232 members), both split along national lines. By a tied vote of 273 to 273 (with 22 abstentions) the European Parliament rejected the draft Directive in the final form adopted by the Conciliation Committee. 95 A block of MEPs comprised of both Christian democrats and social democrats, largely from Germany, the Netherlands, Austria, Spain, and Italy embraced Lehne’s position. 96 In the end, the argument that there would be no “level playing field” in the market for corporate control at the European or international levels under the Takeover Directive carried the day. 97

92 Hence, Scandinavian countries such as Sweden, where corporatism is manifest at the national and sectoral levels and less evident within the firm, did not display the same levels of hostility towards the Takeover Directive as did Germany, the Netherlands, and Austria. These latter countries have well-developed institutional arrangements underpinning stable, long-term linkages between capital suppliers and industrial firms, and a more negotiated and consensual form of internal firm governance based on tripartite relations among management, capital, and employees.

93 Conversely, even in the United Kingdom, the source of the most unequivocal political support for the Takeover Directive, there were criticisms that the measure’s imposition of more uniform legal standards would weaken shareholder protections under British corporate governance rules and derogate from the country’s sovereignty. Tringham, 2000 (noting that opposition to the draft Directive increased in the UK in response to German and EU Parliament attempts to amend it to allow freer use of defensive measures).


96 Unfortunately, at the time of this writing, a breakdown of the voting in the European Parliament was not available.

97 The opponents were quite pointed in their comments attacking the Conciliation Committee’s draft as failing to address these concerns despite ample warning and outcry in the European Parliament. See Lehne, Klaus-Heiner (EPP-ED, D), “Takeover Agreement Rejected After Tied Vote,” Report on takeover bids - proposal for a 13th Council directive (Press Release), Doc.: A5-0237/2001 (Procedure: Codiscion procedure (3rd reading), Debate: July 3, 2001, Vote: July 4, 2001). MEPs also stressed their resentment of and opposition to the perceived heavy-handed and inflexible attitude often shown by Council and Commission in the conciliation process (and thereby flexed their own institutional muscles). Id.
D. Protective Convergence: The German Takeover Act

The backlash against neo-liberal takeover law reform also erupted within German domestic politics. The same interest group forces and political factions that mobilized against the EU Takeover Directive sought to protect German corporations against takeover threats by pushing for the passage of Germany’s first takeover law. The Schröder government made the same calculation in the domestic arena as it had on the European Commission: it backed a moderate reform of company law governing corporate takeovers of public companies. One week after the collapse of the EU Takeover Directive, the German Bundestag passed the Securities Acquisition and Takeover Act (the “Takeover Act”). The statute replaced the widely derided voluntary takeover “codex” that many public companies had endorsed and routinely ignored. The Finance Ministry, the government, and the Bundestag had long been at work on the statute as the means of incorporating the anticipated EU Takeover Directive into domestic law. In fact, the original text of the legislation followed that of the draft Directive on the assumption its passage was only a matter of time. The Mannesmann takeover and the mounting opposition to the draft EU Takeover Directive changed all this.

Compared with the politics and policy of corporate governance in the United States, state actors were far more involved in guiding and choreographing the policymaking process in Germany. What had been largely a bureaucratic and technical drafting exercise now became a highly politicized area of economic policy. The Mannesmann takeover amplified the demands for statutory regulation of takeover practices. Finally, the political failure of the EU Takeover Directive placed takeover law near the center of the domestic political agenda. The Schröder government once again appropriated the trappings of neo-corporatist negotiation and governance through policy making by commission. The government appointed a 19 member blue-ribbon commission comprised of business and finance leaders, securities market officials, union representatives, and leading legal academics. The commission format replicated the interest

98 For an English translation of the Takeover Act, see www.ashursts.com/pubs/briefings.htm.
100 Id.
101 Id.
102 According to Gerhard Cromme, former chief executive of ThyssenKrupp and later the chair of the government’s corporate governance code commission, “The takeover came as a shock and in Germany the word ‘hostile’ spelled rape, pillage, destruction (of assets) and large scale redundancies.” Betts, 2002.
103 See Bushrod, 2001a.
104 See Braude, 2000a.
group configuration of traditional corporatist bargaining but allowed the government to control the policy agenda and recommendations by selecting the group’s membership.

In May of 2000 the commission released a report recommending that the statute include a mandatory bid rule that would compel shareholders acquiring stakes in excess of 30% of a corporation’s stock to make a takeover bid to all remaining shareholders, a “squeezeout” provision allowing a compulsory buyout of minority shareholders, and for the first time, an explicit statutory provision authorizing managers to adopt takeover defenses approved by shareholders within the prior eighteen months. The commission also acknowledged the legacy of codetermination and organized labor relations by noting that the interests of workers as well as shareholders should be taken into account in responding to hostile bids. Yet it did not make any concrete suggestions as to how employee interests should be protected or incorporated into the takeover framework. Overall, many commentators viewed the report as sympathetic to takeovers.

The government pressed on with its effort to enact the law as the backlash against takeovers and the liberalization of company law gathered momentum. The opposition to takeovers across the political spectrum, from corporate managers backed by the CDU to the leaders of organized labor supported by the left-wing of the SPD, drove the government to accept expanded managerial powers to adopt takeover defenses. The domestic politics of takeover law ran parallel to the battle over the EU Directive. Managers seeking defenses against raiders and unions demanding protection for jobs and codetermination politically overran the large banks and shareholders groups seeking to facilitate takeovers and consolidated the victory they had won in the European Parliament. Managers won greater leeway to adopt takeover defenses and labor secured greater procedural and informational rights.

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105 Mandatory bid rules, widely mooted throughout Europe, is designed to distribute the control premium to all shareholders by requiring owners acquiring a control block (e.g., 30%) to them make an offer to the remaining shareholders on similar terms. This legal rule may encourage the development of tender offers as a means of changing corporate control, but discourage the traditional European mechanism for control transfers—the sale of controlling equity stakes by blockholders in exchange for a control premium.
106 See id.
107 Chancellor Schröder supported this balancing of interests obliquely by expressing concern that institutional investors behave “responsibly” in takeover situations and that acquirers commit themselves to developing the purchased firms. See id.
108 Braude, 2000b.
The German cabinet approved the Securities Acquisition and Takeover Act on July 11, 2001, one week after the rejection of the EU Takeover Directive. The Bundestag approved the legislation on November 15, 2001 and it came into effect on January 1, 2002. The Takeover Act covers public tender offers, takeover offers (offers to acquire 30% or more of a public firm’s voting stock), and mandatory offers for remaining shares once the offeror’s stake reaches the 30% control threshold. The Act incorporated most of the Takeover Commission’s recommendations. It imposes minimum bid requirements, a provision compelling a mandatory takeover bid once an acquirer’s voting stake reaches a 30% threshold, a squeezeout rule that allows a majority owning 95% or more of a corporation to buy out the remaining minority shareholders. The Takeover Act also extended the BAWe’s regulatory authority to corporate takeovers.

The Takeover Act contains a general “duty of neutrality” that prohibits the management board from taking any action that would prevent the success of the hostile bid. However, the statute expanded the latitude of management to deploy defensive tactics against a hostile takeover. Management may seek shareholder authorization to use specified defenses. These resolutions are valid for up to eighteen months, require a 75% supermajority vote, and the supervisory board must approve any deployment of these defenses. More importantly, the duty of neutrality “does not apply to acts that would also have been performed by a prudent manager of a company not affected by a take-over offer, the looking out for a competing offer, as well as acts approved by the supervisory board of the target company.” This provision grants the supervisory board potentially vast discretion to defend against takeover, similar to the reallocation of legal authority to the boards of American corporations during the 1980s. Yet the Act does not explicitly authorize a German equivalent of the poison pill defense common in American practice and the legal status of such mechanisms remains subject to some doubt.

111 For the text of the Act, see www.ashursts.com/pubs/briefings.htm. For overviews of the legislation, see Strelow and Wildberger, 2002; Osborne & Clarke, 2002; Rissel, 2002; Zehetmeier-Mueller and Ufland, 2002.
112 The warm welcome for the Takeover Act’s squeezeout provisions as a boon to MBO activity indicates the political and economic ambiguity of the law. See Hobday, 2001.
113 Securities Acquisition and Takeover Act, §§ 4-9.
114 “[T]he managing board of the target company may not perform any acts which might result in the success of the offer being prevented.” Securities Acquisition and Takeover Act, § 33.1.
115 Securities Acquisition and Takeover Act, § 33.2.
116 Id. § 33.1; see also Braude, 2001a.
117 Without activist courts to clarify the complex legal issues and ambiguous statutory rules, the application of the Act will be troublesome. In all likelihood, the courts will construe the Act’s requirement of 75% shareholder
Yet the Takeover Act does not alter the fiduciary obligations of directors to act in the shareholders’ best interests or introduce measures to increase the supervisory board’s independence from management. Given the conceptual and practical difficulties of relying on fiduciary duties to vindicate shareholder interests in a codetermined governance regime, the drafters of the law relied instead specific bidding procedures and disclosure requirements on takeovers. The details of takeover bids must be fully disclosed in a filing with the BAWe (similar to an SEC filing in the United States) and through publication, along with any plans the acquirer has for the firm following a change of control.\textsuperscript{118} The target’s management must respond with a public report assessing the adequacy of the offer and the bidder’s business strategy. In addition, the bid must remain open between four and ten weeks, with an additional two week “sweep up” period for dilatory shareholders to tender their shares. Far from recognizing shareholder primacy, the Takeover Act obliges both the offeror and the target’s management to disclose information to either the works council or directly to the employees concerning the terms of the offer and its implications for the firm and employees and their collective representation.\textsuperscript{119} Thus, the Act makes use of and may reinforce the institutions of works council codetermination even as it expanded the supervisory board’s power.

\textbf{VII. Conclusion}

The politics of German corporate governance reform and the spilling over of that politics into the EU illustrate political tensions inherent within the processes of economic reform. Interests, interest groups, and ideological commitments collide and constrain attempts to advance agendas of structural change. The KonTraG reforms resulted from a combination of entrepreneurial state actors and interest group politics. This combination mobilized a significant, though diffuse, populist resentment of concentrated financial capital and economic power and interest group alignments favoring more liberal economic policies in the area of corporate governance and company law. The populist element of the political agenda was used to place the issue of company law reform on the policy-making agenda, but then abandoned in the course of political compromise over the legislation. During these negotiations economic interests came

\textsuperscript{118} See id. §§ 11, 14.
to the fore and determined the final shape of the legislation. The legislation stripped the large German banks, the original targets of populist ire, of the mechanisms of leverage and corporate control that they were willing to abandon. Labor was able to block changes that threatened to weaken supervisory board codetermination. However, the liberal shift in German domestic policy represented by the KonTraG caused complications in European politics.

The genesis of the stunning defeat of the EU Takeover Directive, and the resulting setback for the European Commission’s capital market integration agenda and the cause of economic liberalism in the EU, resides in the tensions within German policy and politics that had been bubbling underneath the reform agendas of the country’s political parties. The irony of the battle over the Takeover Directive was that Germany did not switch its position on the Takeover Directive because it was hostile to economic modernization and liberalization. Rather, it was because domestic reforms had already liberalized the legal structure of corporate governance to a significant degree and other member states had not undertaken similar steps. Germany’s reforms during the late 1990s were highly coordinated. The EU takeover proposal dealt with the subject as if in a vacuum and failed to recognize and accommodate the broader systemic character of corporate governance reform at the national level. Accordingly, the Takeover Directive would have created undesirable—and indefensible—inequalities in the defense mechanisms available to the corporations of different member states. The European Commission refused to acknowledge or address this issue that was of paramount importance to domestic political and economic actors.

Without question, the German public and large segments of the economic and political elites were ambivalent about economic liberalism and are largely hostile to the very idea of takeovers. However, this ambivalence and hostility was not sufficient to block the string of substantial economic reforms of 1998 through 2000 that have incorporated Anglo-American legal structures and principles within German corporate governance conflicts to an unprecedented degree. However, once the implications of these reforms within the broader context of the European and global political economies became clearer, German politics reversed course and unleashed a backlash against the American model of corporate law and the market for

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119 See id. §§ 10.5, 11.2.6.2, 27. Labor is also entitled to two representatives on the BAWe’s thirteen-member “advisory board” on takeovers created pursuant to the Takeover Act, § 5.1.
corporate control. Ironically, this backlash took its final form in the legislative sanction of the very anti-takeover defenses commonly used in the United States.

Just as Baums and Bury in Germany had calculated in 1998 that they could mobilize both elite and populist support for liberalization in framing the KonTraG debate, Klaus-Heiner Lehne in the European Parliament and a cross-class coalition of Social Democrats and Christian Democrats in Germany during mid-2001 mobilized the same combination of popular and elite support in Germany and across Europe to oppose further liberalization. In the debates over the KonTraG, the EU Takeover Directive, and the German Takeover Law, advocates of legal change held out the specter of concentrated financial power as a threat to prosperity and a just socio-economic order. What the advocates of neo-liberalism in the EU did not count on adequately was that this sword of pseudo-populism and interest group politics would prove to be double edged.

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