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# The Legal Systems of Germany and USA Regarding Share- and Stakeholder Capitalism\*

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## ABSTRACT

*The legal form of the Modern Corporation inherent in the practiced Corporate Law in the US and UK and Germany have established and codified a working relationship between Corporate key players such as Managers/Directors and Shareholders by taking the conflicts among these players into consideration. E.g., the so called-Agency Theory. This paper analyses the Corporate legal framework and systems of US and Germany on a comparable basis together with pros and cons of Agency theory in the context of Shareholder versus Stakeholder Capitalism. Some policy conclusions are drawn for emerging countries to embolden their corporate legal structure,*

**Keywords:** *Shareholder capitalism, stakeholder capitalism, corporate governance, agency theory; stewardship theory; shareholder primacy model; director primacy model*

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## 1. INTRODUCTION

Corporate law performs an important role to create the structure of the corporate form as well as necessary corporate rules for supporting this structure, and to manage the conflicts of interest among corporate constituencies, including those between corporate ‘insiders,’ such as controlling shareholders and top managers, and ‘outsiders,’ such as minority shareholders or creditors. These conflicts all have the character of what economists refer to as ‘agency problems’ or ‘principal-agent’ problems. Thus, most corporate law theory today relies on agency theory and most corporate law scholarship is dominated by the agency theory in Anglo-Saxon legal system. The corporate structures in the US and the UK are characterized by the widely dispersed ownership and induce the agency theory. The agency theory is a cornerstone and a foundational theory of the corporate governance (Daily, Dalton, & Cannella, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Shleifer & Vishny, 1997; Lan and Heracleous, 2010, p. 294, 295). The codes of best practices in the Anglo-American system are mainly developed according to the agency theory. Thus, the theory explains the premise between self-interested management and weak, dispersed shareholders considered as the main corporate governance problem. To be noted, most firms outside the US and the UK have a dominant owner. Namely, the dominant stake of publicly listed companies in emerging economies are held by a dominant family or state (Berglof and Thadden, 1999; Claessens et al., 1999) and some of the publicly listed companies in the US, and UK have high concentrated ownership (Fan and Wong, 2005). High concentrated ownership could also cause principal-principal conflict, i.e., conflicts between majority shareholders who dominate the board, and minority shareholders (Young et al., 2008). Consequently, corporate governance problems in these circumstances should be solved differently from agency theory perspective (e.g., Lubatkin et al., 2005). At the national level, corporate governance in emerging countries started to become important through market-oriented economic reforms in the 1980s and 1990s with the implementation of the widespread privatization, liberalization of economies, as well as expanding market institutions, such as the stock markets. Nevertheless, due to weaknesses in their corporate governance systems of emerging countries seen in the

1997/1998 Asian crisis and few other crises in other emerging economies, corporate governance is also a concern at the international level due to its spill-over effects (Singh, 2003). Consequently, codes of corporate governance from the Anglo-Saxon system were adapted in a widespread manner. Whereas in Germany as well as in many other Continental European countries and Japan the definition of corporate governance explicitly mentions stakeholder value maximization, the Anglo-American system mostly focuses on generating a fair return for shareholders. The question of an overall goal for business should be analyzed in the context of these two most famous models, the shareholder and stakeholder approaches. Hence, we analyze the legal systems of Germany and USA regarding share- and stakeholder capitalism in following pages.

## **2. US MODEL-SHAREHOLDER CAPITALISM**

The US corporate legal system, as in Australia, Canada and the United Kingdom, is clearly a representative of shareholder capitalism. The US model is characterized by share ownership of individual, and increasingly institutional, investors not affiliated with the corporation, a well-developed legal framework defining the rights and responsibilities of three key players, namely, 1. Management, 2. Directors and 3. Shareholders. To be noted, there is a causal relationship between the importance of equity financing, the size of the capital market and the development of a corporate governance system. The US is both the world's largest capital market and the home of the world's most-developed system of proxy voting and shareholder activism by institutional investors. The US model, developed within the context of the free market economy, assumes the separation of ownership and control in most publicly-held corporations. This important legal distinction serves a valuable business and social purpose: investors contribute capital and maintain ownership in the enterprise, while generally avoiding legal liability for the acts of the corporation. Investors/Shareholders avoid legal liability by ceding to management the control of the corporation, and paying management for acting as their agent by undertaking the affairs of the corporation. The cost of this separation of ownership and control is defined as "agency costs". The interests of shareholders and management may not always coincide. Laws

governing corporations in countries using the US model attempt to reconcile this conflict in several ways.

To be noted, Dr. Demirörs analyzes from a financial and macro economist point of view the historical transformation of the “Modern Corporation” in the early 20th century for the two decades pre-and post-1980 in his article “Stock Market Capitalism: An Historical Perspective for The Two Decades Pre- and Post-1980” published also in this special publication. Within this context, in the following pages, we analyze the US corporate legal system regarding the legal theories of the corporation, legal models of corporate governance and legal analysis of the agency.

## **2.1 Legal Theories of the Corporation**

From a legal perspective, a corporation is a sui generis type of business organization, which has evolved from complex historical developments. Concession/fiction theory, contractual/aggregate theory, and realist/organic theory on the nature of the corporation have been proposed to explain this personification phenomenon. Table 1 outlines the key features of these theories. These treat the corporation, respectively, as an artificial entity created by the state, as an aggregate of persons bound by contracts, and as a real entity existing naturally (Millon, 1990; Phillips, 1994; Sc-hane, 1987). The contractual/aggregate theory underlies the “shareholder primacy” model of corporate governance with which agency theory is aligned, and it has also recently given rise to the “director primacy” model of corporate governance, challenging agency theory. (Lan and Heracleous, 2010, p. 295),

**Table 1: Legal Theories of the Corporation**

Key Ideas	Concession/Fiction Theory	Contractual/Aggregate Theory	Realist/Organic Theory
<b>Outline of theory</b>	Corporation is only a state-created reification and a legal fiction. It has no substantial reality, existing only in law.	Corporation is formed by voluntary private contracting among its human parts. It is the sum of its human constituents and nothing more; there is no distinct corporate entity.	Corporation is a real entity having a separate existence from its shareholders. It can will and act through the groups of individuals who are its organs, just as a natural person can will and act through his or hers.
<b>Time line of theoretical development</b>	Stage 1: First part of nineteenth century until 1880s  Stage 2: 1959–1970s Stage 3: 1990s–present	Stage 1: 1886–1890  Stage 2: 1979–present	Stage 1: 1897–1926  Stage 2: 1985–present
<b>Key supporters in legal literature</b>	Stage 1: Chief Justice Marshall, Associate Justices Washington and Story in <i>Dartmouth College v. Woodward</i> (1819)  Stage 2: Latham (1959), Nader, Green, & Seligman (1976)  Stage 3: Millon (1990)	Stage 1: Morawetz (1886), Beach (1891), Taylor (1902)  Stage 2: Hessen (1979), Fischel (1982), Kraakman (1984), Coffee (1999), Hansmann & Kraakman (2001)	Stage 1: Freund (1897), Laski (1916), Canfield (1917), Maitland (1927)  Stage 2: Horwitz (1985), Hager (1989), Phillips (1994), Mitchell (1995, 1999), Iwai (1999)

<b>Nature of the firm</b>	Firm is a fiction whose life and legal legitimacy derive from the state. In turn, the firm concedes to doing public good and subjects itself to state regulation.	Firm has no definite, independent existence; it is merely a collective term for contracts entered into by corporate constituents.	Firm is a naturally occurring being, a full-fledged subject of property ownership.
<b>Function of law</b>	Law creates corporation, and the charter determines its properties.	Law has little function beyond substantiation of contracts, and legal rules merely spell out what the human aggregates would have agreed to in the first place.	Law does not create corporations but merely recognizes and regulates their independent existence.
<b>State's regulatory interference</b>	Justified, since corporation is a legal creation whose existence derives from the state.	Not justified, since state should not have any interest in contracts between private individuals; disciplinary actions should be taken by the market rather than by the state.	Justified, since corporation is a social being that should operate under the law.
<b>Influence on legal model of the firm</b>	Communitarian model	<ul style="list-style-type: none"> <li>• Shareholder primacy model</li> <li>• Director primacy model</li> </ul>	Managerial model

Source: Lan and Heracleous (2010, p. 296).

## 2.2 Legal Models of Corporate Governance

The three legal views of the corporation summarized in Table 1 above give rise to four main legal models of corporate governance such as managerialism, the shareholder primacy model, the stakeholder/communitarian model, and the director primacy model outlined in Table 2 below.

**Table 2: Legal Models of Corporate Governance**

<b>Key Ideas</b>	<b>Managerialism</b>	<b>Shareholder Primacy Model</b>	<b>Stakeholder/ Communitarian Model</b>	<b>Director Primacy Model</b>
<b>Outline of model</b>	Management is the corporate strategic center in a bureaucratic hierarchy, acting as a rational, self-disciplined mechanism. It is composed of expert professionals carrying out the objective implementation of shareholders' wishes.	Shareholders are the main residual claimants of the firm's income stream and have ultimate control over the corporation. The sole purpose of management is to maximize shareholders' wealth, and it should only engage in activities that are financially beneficial to shareholders.	Non-Shareholder constituencies have stakes in the corporation that are as equally important as those of shareholders. Managers and directors should be sensitive to stakeholders' interests when making decisions.	The board of directors is a central, independent decision maker for the firm. It mediates competing interests among the various groups that bear residual risk and have residual claims over the firm, and it allocates team surpluses.
<b>Supporting legal theory</b>	Organic theory	Contractual theory	Concession theory	Contractual theory
<b>Key authors in legal literature</b>	Freund (1928), Landis (1938), Jaffe (1965)	Easterbrook & Fischel (1991), Coffee (1999)	Mitchell (1992a), Millon (1995, 2000)	Blair & Stout (1999), Bainbridge (2002a,b,c)
<b>Time line</b>	1928–1980s	1980s–present	1990–present	1999–present

<p><b>Purpose of corporate governance structure</b></p>	<p>To devise a structure that would confer an enormous range of discretion on management so as not to curb the creativity and flexibility needed for effectively running a corporation</p>	<p>To address the agency problem by devising a means of reducing agency costs and aligning the interests of managers and shareholders, and, consequently, to maximize shareholders' wealth</p>	<p>To devise a governance structure that takes into account and balances the diverse interests of the various corporate constituents</p>	<p>To maximize the sum of all risk-adjusted returns enjoyed by the groups that participate in team production through mediation and control of strategic decisions by board of directors</p>
<p><b>Position of shareholders</b></p>	<p>Passive; they have little understanding of the operations of the company and rely totally on the discretion of management; they'd rather sell their shares and walk than exercise their voting power</p>	<p>Powerful and supreme; as shareowners and main residual claimants, they have ultimate control over the corporation, and management is accountable to them</p>	<p>One class of corporate constituents that may exploit the interests of other constituents; shareholders are savvy investors who could manipulate the firm to their advantage</p>	<p>Willingly cede control of firm to the board for their own interests; shareholders are just one stakeholder within a broader coalition, which contributes to team production</p>
<p><b>Role of directors</b></p>	<p>Figureheads with little knowledge of the operations of the firm; rubber-stamping management proposals in most instances</p>	<p>Agents of shareholders serving a monitoring role to ensure that professional managers do not exploit corporate inputs and resources to the detriment of shareholders</p>	<p>With the help of management, balance the needs of all corporate constituents, including Non-Shareholder ones</p>	<p>Mediating hierarchs who balance competing claims of contributors to team production process, allocate team surpluses, and are legally in control of corporation's assets and key strategic decisions</p>



<b>Position of management</b>	Powerful; can exercise self-discipline and objective expertise	Self-interested group that will seek to maximize its own interests rather than shareholder interests	Assist the board to balance the needs of corporate constituents	One of the corporate participants who contribute to the success of the firm
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**Source:** Lan and Heracleous (2010, p. 298).

### 2.3. Legal Analysis of The Agency Theory

The different branches of science, such as economics, finance, law, management studies, sociology, psychology or ethics analyze the issue of corporate governance and various approaches according to the views on the nature and goals of a firm, as well as with the interpretation way of the corporate law (Jordi, 2010, p. 195; Zollo & Freeman, 2010, p. 191; Rajan & Zingales, 2001, p. 209; Segrestin & Hatchuel, 2011; Lan & Heracleous, 2010). A cornerstone and a foundational theory of the corporate governance is the agency theory (Daily, Dalton, & Cannella, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Shleifer & Vishny, 1997; Lan and Heracleous, 2010, p. 294, 295). Agency theory is based on economics and finance thinking (Fama, 1980; Fama & Jensen, 1983a,b; Jensen & Meckling, 1976), as well as determined codes of good practice in corporate governance, director training, and composition and procedures of corporate boards (Coffee, 1999; Hansmann & Kraakman, 2001; McCarthy & Puffer, 2008). Although corporate governance systems have long existed in the corporate world in US as evidenced by the work of Smith (1776) and Berle and Means (1932), in the 1970s the expression appeared in American law journals and has become widely discussed in the last two decades in US and UK (O’Sullivan, 2000). By the late 1990s corporate governance became increasingly a major issue in all other advanced economies as well as the developing countries due to privatization, pension deregulation, free capital movement or capitalism globalization, market integration, and corporate scandals (Becht et al., 2005).

The scholarship of Berle and Means can be counted among its early antecedents for this theory, and first empirically identified the strong sep-

aration of ownership by shareholders and control by managers in large U.S. firms in 1932. Berle and Means (1932) explained that, despite their benefits the structure of modern companies in the US, characterized by a separation of ownership and control, had engendered a situation where the true owners of companies, the shareholders, had little influence over the companies' management. Berle and Means expressed that "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear" (1932. p. 6). This situation formed the basis of the agency problem, since the shareholder as principals, struggles to control and monitor the activities of the managers as agents, where managers may not act in the best interest of owners due to differences in motivations. Jensen and Meckling (1976) then formulated how companies could survive this agency issue as well as focused on conflicts of interest between shareholders and managers and described the phenomenon of agency cost, consisting of monitoring costs, bonding costs, and residual losses that cannot be eliminated by contractual mechanisms. Since then, the agency theory has been dominating the corporate governance field, since agency theory perspective focuses on corporate governance as mechanisms to address the agency conflicts.

The agency theory reduces large corporations to two groups of participants i.e. managers as agent and shareholders as principal as well as defines their divergent interests clearly in the principal-agent relationship (Fama & Jensen, 1983b; Jensen & Meckling, 1976, Daily et al., 2003, p. 372). Consequently, corporate governance mechanisms restrict managers' own interests and make them pursue shareholders' interests. The agency problem is defined as agency conflicts arising from a divergence between agents' and principals' utility functions, creating the potential for mischief (Lan and Heracleous, 2010, p. 294). For the control- and self-interest-oriented assumptions of agency theory and cost (Davis, 2005; Ghoshal, 2005; Mizruchi, 1988) internal mechanisms of control over managers including appropriately structured board of directors, structure of salaries and external mechanisms including capital market and job market for managers are formulated. The board acts as a first-order agent of shareholders (Eisenhardt, 1989; Mizruchi, 1988), and main-

ly monitors managers to ensure that their interests do not diverge substantially from those of the shareholders and that they take actions maximizing principals' returns (Fama, 1980; Fama & Jensen, 1983a,b; Jensen & Meckling, 1976; Mizruchi, 1988). According to classical agency theory, it consists in control of managers' actions aimed at securing that their behaviours will be oriented towards maximizing the value for shareholders.

### **2.3.1. Critique of Agency Theory**

Brudney (1985) underlines the flaws of agency theory in explaining corporate governance mechanism that and argues: "Scattered stockholders lack the requisite information and institutional mechanisms either to bargain over the terms of management's employment, or to monitor and control management's activities. The "markets" for managers and for securities do not effectively implement investor constraints on management. Outside directors are insufficiently independent from management to serve as agents for stock-holders in selecting or controlling management, and too many factors, and possibly information imperfections, affect the price of stock for it to serve as mechanism for effective investor impact upon managerial performance.... realistic inquiry into the operation of institutional factors affecting corporate governance is required before accepting approaches which are based on the rhetoric of "contract" and agency costs and reject the need for "government intervention" (Brudney, 1985. p. 1403) Roe (1991) explains that legal and political factors in the US, at least in the 1930s, induced the initial separation of ownership and control; but not as an automatic response to the development of their firms. Such problems as unrealistic premises concerning managers' motivations and actions, ineffective recommendations inferred from the theory and dubious legal interpretations of agency theory and its applications to the issues of corporate governance are mainly criticized by some scholars (Segrestin & Hatchuel, 2011, pp. 487-488). They argue that premises of agency theory restrict its universality (Davis et al., 1997, p. 24) and the theory is one-sided (Mesjasz, 2007, p. 39), since it emphasizes just some economic factors, and not including (among other things) political factors, internal problems of governance or the roles of other stakeholders. For explaining managers' behavior, Davis et al. propose stewardship theory (1997, pp. 24-42), while Blair and Stout (1999a, 1999 b) draw

on team production theory in their analyses of legal aspects of corporate governance. It is further criticized that the agency theory is not only expensive, but also economically ineffective, since protecting mechanisms for shareholders' interests may interfere with realization of strategic decisions, may restrict collective actions, distort investment plans and ignore interests of other stakeholders, which may lead to decreasing their commitment to creation of economic value (Segrestin & Hatchuel, 2011, p. 487). Some scholars also explain some legal doubts related with ways of presenting relationships between shareholders and managers on the basis of agency theory and with primacy between shareholders who bear the risk and the other stakeholders involved in creation of value contribute their resources vital for the firm and bear risk arising from its activities. Stakeholder theory (Donaldson & Preston, 1995; Freeman & Evan, 1990), stakeholder-agency theory (Hil & Jones, 1992), years long debate between proponents of shareholders' primacy and the other stakeholders (Daily et al., 2003; Mamun et al., 2013; Freeman et al., 2004; Sundaram & Inkpen, 2004a, 2004b), social agency theory (Wiseman et al. 2012); and finally proposal for settling the argument on the basis of property rights theory (Blair, 2005; Asher et al., 2005; Grandori, 2005), could be mentioned in this context.

### **2.3.2. Rethinking of agency theory from a legal perspective**

Another critic concerns the ownership of a firm and is based on that from the legal point of view, shareholders are owners only of its shares, not of a firm, and therefore they should not be considered the only residual claimants. Furthermore, according to those critics the board of directors, which in turn acts as an autonomous fiduciary, gives the mandate to managers and thus they are agents of the board of directors, not shareholders'. Lan and Heracleous (2010, p. 295) explain this from the legal point of view so that a corporation is an independent legal person and have rights to control common property of its participants protected by states, thus corporation, not shareholders, is a principal as well as the board having authority to act on behalf and for the benefit of a beneficiary is an autonomous fiduciary, while according to traditional agency theory, board of directors acts as shareholders' first-order agent. According to the new view of Lan and Heracleous (2010) based on team production

theory (Alchian & Demsetz, 1972; Blair & Stout, 1999a; 1999b), the board of directors should act as a mediating hierarch with the objective of balancing interests of various groups substantially contributing to the process of team production, deciding on allocation of the surplus gained by the team, controlling corporate resources and strategic decisions. Two models of corporate governance, shareholder primacy model which supports agency theory, and director primacy model which demands revision of agency theory, have emerged in legal sciences, on the ground of contractual theory of the firm. (Lan & Heracleous, 2010, p. 295). Though shareholder primacy model became widespread in theory and in practice, the director primacy model became preferable in judicial precedents and corporate law.

### **2.3.3. The Shareholder Primacy Model and Classic Agency Theory**

The agency relationship is derived from the separation of ownership and control is defined as “a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent” (Jensen & Meckling, 1976, p. 308). According to shareholder primacy model based on contractual theory, a firm is a legal fiction, a bundle of contracts, (Alchian & Demsetz, 1972; Jensen & Meckling, 1976), and shareholders should have decisive authority as contractual principals. Managers as agents is accountable to shareholders and should aim maximization of wealth for shareholders (Fischel, 1982; Jensen & Meckling, 1976; Shleifer & Vishny, 1997). The divergence between shareholders’ as principals and managers as agents’ interests leads to the agency problem, as well as agency costs arising from the attempts to mitigate this problem (Jensen & Meckling, 1976; Wiseman & GomezMejia, 1998). In order to align their interests and to reduce agency costs proper mechanisms can be put in place to reward, monitor, and control agents’ behavior (Daily et al., 2003; Eisenhardt, 1989; Jensen & Meckling, 1976). The principle that management must conduct corporate affairs for the benefit of shareholders is legally formulated in *Dodge v. Ford Motor Co.* (1919) in which it was rejected Ford Motor’s rationale for deciding not to pay a special \$10 million dividend to shareholders, as it was intended to use the money to “employ still more men, to spread the benefits of this

industrial system to the greatest possible number, to help them build up their lives and their homes" (1919, p. 671). In this model a board of directors is appointed by shareholders as shareholders' first-order agent and controls managers on behalf of shareholders (Coffee, 1999; Easterbrook & Fischel, 1991; Eisenberg, 1976; Eisenhardt, 1989). Since the board of directors is viewed as shareholders' agent, in this relationship problems and costs of agency may emerge. E.g. board's independence from managers (Fama, 1980; Jensen & Meckling, 1976; Mizruchi, 1983), participation in ownership (Demsetz & Lehn, 1985; Fama & Jensen, 1983b; Jensen & Meckling, 1976), and corporate control market is being utilized (Fama & Jensen, 1983a; Fligstein, 1990; Jensen & Ruback, 1983) as a mechanism imposing discipline on directors and managers are proposed in order to minimize these effects.

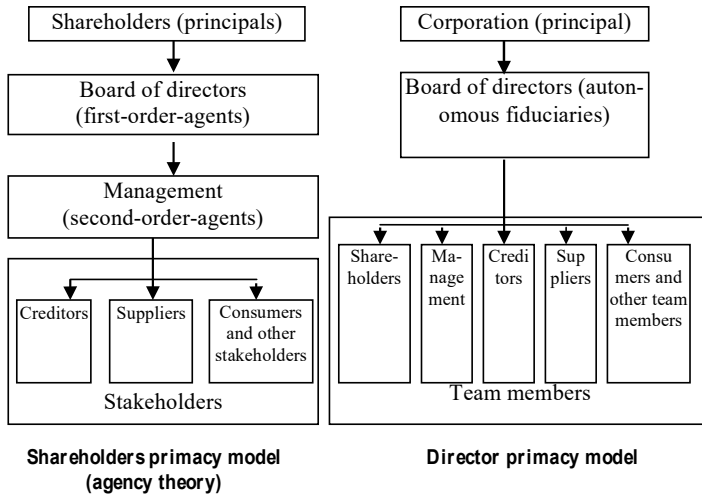
#### **2.3.4. The Director Primacy Model and Team Production**

According to director primacy model (Bainbridge 2002 a,b,c; Blair & Stout 2001a; Stout 2002, 2003) a firm is considered as production team carrying out complex production process, in which numerous parties such as employees, creditors, managers, and local government, are involved, and could not be distinguished clearly their particular contributions to its outcome (Blair & Stout, 1999). Thus shareholders are only one of the parties contributing to the final results and should not be the only residual claimants (Blair & Stout, 2001a), whereas other parties bring in assets vital for production process, specific for a firm, cannot be withdrawn and sold somewhere else for their full value (Blair & Stout, 1999). Therefore, the rights of the parties bringing in specific assets cannot be properly protected by the contracts, and thus they cannot provide appropriate stimuli for optimal commitment to the work of a team (Blair & Stout, 2001a: 419). For the solution of this problem the board of directors is placed on the top of structural hierarchy (Bainbridge 2002 a, c), as a mediator in possible arguments between the parties. In this model, such vital issues as employing and remunerating chief managers, fusions and takeovers, division of dividends, control over strategic decisions and securing are decided by the board of directors in the corporation's best interest, as well as related schemes for numerous managers' decisions provided by it. It would monitor commitment of particular parties to the production

process, remunerate properly for former involvement, motivate to future commitment and counteracting mutual opportunism in relationships between the parties involved. In this model, corporate governance is oriented towards creating a structure which would maximize the sum of returns adjusted to the risk of all the parties involved in a firm.

The peculiar character of legal relationship between directors and corporation which differs substantially from typical principal-agent relationships is underlined by proponents of director primacy model. Directors are legally obliged to act for the benefit of corporation, but are not subordinate to any of the stakeholders since their power is original and undelegated. Directors as autonomous fiduciaries role of the corporation take independently business decisions within the limits of justified risk, without persistently revision of shareholders though they are designated by shareholders. The board of directors has the legal right of control over managers' decisions and legally obligate as a fiduciary to review those decisions and ensure that they are in the best interests of the corporation (Lan and Heracleous 2010, p. 300). In the director primacy model, not just salary packages but also the values linked to their high status and the confidence given to directors motivate their actions. In this respect, the director primacy model keeps the stewardship theory, which assumes confidence, internal motivation, need for fulfillment, collectivism, self-control and high level of commitment. Nevertheless, confidence given to directors and managers, may be abused, so some governance mechanism is required – it is the legal system. Lan and Heracleous (2010, p. 302) compares shareholder primacy model and director primacy model in Table 3.

**Table 3:** Comparison of shareholder primacy and director primacy models



Source: Lan and Heracleous (2010, p. 302).

### 3. GERMAN MODEL-STAKEHOLDER CAPITALISM

The German corporate legal system, as in most European countries, is clearly not a representative of shareholder capitalism, but rather stakeholder capitalism, which does not mean that the managerial stakeholder theory characterizes the system, but rather that a literal multi-interest consideration does, which is mainly implemented by broad regulation ensuring the consideration of stakeholder interests. Neither is the management obliged to follow a kind of shareholder primacy rule, nor does the other legal framework ensure such primacy. According to the stakeholder approach, the corporate governance focuses not only the maximization of shareholder wealth, but also involves in the interest of other groups of stakeholders such as employees, customers, creditors and/or suppliers. (Dammann, 2003, p. 607; Von Werder et al., 2008, pp. 4, 8.)



### 3.1. Legal Background

In Germany the theory of the corporation as an autonomous unit and an entity independent from its members already existed at the beginning of the nineteenth century. The German legal scholar Gierke (1868) was one of the first developers of this theory. Nevertheless, the actual development of the stakeholder approach theory in Germany started with Rathenau (1917). The idea of Rathenau was to keep the shareholders out of the decision-making as much as possible and to empower the management to protect the corporation of its shareholders, since he was very skeptical about a strong influence of shareholders, in particular of speculative investors (Rathenau, 1917, p. 26, 27 f.). This is basically the complete opposite position to idea of Berle and Means which was to give the managers less discretion and freedom in making corporate decisions through giving the shareholders more power and establishing fiduciary duties of the managers to the shareholders of the corporation, and to protect the corporation of the powerful managers dealing in self-interest (Gelter, 2011, p. 678, 683 and 688).

The enactment of § 70 of German Stock Corporation Act in 1937 was seen as a strong stakeholder-oriented idea of business at the time and a main step towards a more explicit stakeholder capitalistic system although most of the vocabulary was obviously filled with Nazi ideology (Vagts, 1966, p. 23, 40). According to Art. 70 “The managing board is, on its own responsibility, to manage the corporation as the good of the enterprise and its retinue and the common weal of folk and realm demand.” (*“Der Vorstand hat unter eigener Verantwortung die Gesellschaft so zu leiten, wie das Wohl des Betriebs und seiner Gefolgschaft und der gemeine Nutzen von Volk und Reich es fordern.”*). But the management had immense power in corporate decision-making as a result of a lack of control mechanisms (Gelter, 2011, p. 689 f.). After World War II the concept of the interest of the enterprise (*“Unternehmensinteresse”*) evolving from § 70 German Stock Corporation Act (1937) guided principles for business (Gelter, 2011, p. 695), left the management with a lot of room in decision-making (Gelter, 2011, p. 696), thus the corporation was governed by multi-interest considerations instead of a prioritization of shareholder interest. The enactment of a new § 76 German Stock Corporation Act in 1965 („Der Vors-

tand hat unter eigener Verantwortung die Gesellschaft zu leiten.“ – „The Management shall have direct responsibility for the management of the company.“), which is still in place today, did not change the legal situation, although the wording of § 76 is completely different from the wording of § 70. The enactment of the Codetermination Act in 1976 further strengthened the stakeholder orientation in Germany in consideration of the worker participation right in the supervisory boards of big corporations. The German Constitutional Court confirmed its constitutionality and the stakeholder orientation in Germany and justified with a social aspect of the property of the shareholders (BVerfG March 1st 1979, BVerfGE 50, 290, 315 f.).

A new movement starting from the United States marked a new change in corporate law in the 1990s. From the 1990s onwards, the shareholder value concept gained more and more popularity and support in Germany through US legal scholarship, increased importance of institutional investors and capital markets in general and therefore increased pressure to meet the shareholder's demands of value creation in their favor, ergo considering the shareholder value. (Gelter, 2009, p. 641, 698.)

In 2002 the German Corporate Governance Code (Deutscher Corporate Governance Kodex, hereafter referred to as “DCGK”) has been published and introduced recommendations for standards of conduct for the management boards and the supervisory boards of listed company.. Furthermore, the DCGK recommends compliance with rules and provisions that are aimed to prevent the weaknesses of the corporate constitution in Germany, such as the lacking transparency of German management and the limited orientation of the interests of shareholders (Eisenhardt and Wackerbarth, 2011, para. 552.). The code, as a summary of mere recommendations, is technically not binding, yet has a legal basis. The DCGK attains normative force through section 161 of the German Stock Corporation Act, a legally binding provision of a parliamentary legislative proceeding. The code itself was, however, worked out by a governmental commission and therefore did not pass a legislative parliamentary procedure. Thus The code does not fit in the traditional German system of legal sources, wherefore the classifying of the code turns out to be difficult, especially in terms of enforcement. The DCGK will be referred to as

“soft law” since the provisions of the code can voluntarily be called in and non-compliance cannot be legally punished. Following the British model this phenomenon is captured by the concise formulation of “comply or explain”, which might be, however, deceptive, since the companies are not asked to explain, but to merely state if they complied with the code or not. Yet, No. 3.10 of the Code itself recommends to explain potential deviations from the code, so that the formulation “comply or explain” also fits the German model. The DCGK, as well, greatly contributed to the competitiveness of Germany on an international comparison. Before the adoption of the code, foreign investors experienced fears of contacts to German corporate law being faced with a comparatively small capital market, no comparable supervisory institutions as the SEC, 400 sections in the decisive law and a foreign language.

At the latest around 2000 the idea of the shareholder value was established in Germany (Groh, 2010, p. 2153, 2157 f.) and is now playing a legit role in the question for the right overall orientation because of progressive internationalization of national capital markets, the increased importance of such markets and institutional investors. After the collapse of Lehman Brothers in 2008 and the resulting financial crisis the topic of executive compensation was amongst the most controversial topics about time. With its Act on the Adequacy of the Management Board’s Compensation (Vorstandsvergütungsangemessenheitsgesetz, hereafter referred to as “VorstAG”) Germany took concrete steps towards systematic changes of the structures of executive compensation and encouraged companies to more efficient goal-setting and increased transparency being applicable to all tradable stocks (Mathieu, 2013, p. 582 f.).

Furthermore corporations are not primarily relying on bank financing anymore, but are rather making a move towards the capital markets. Still the costs of capital are relatively high in Germany at least partially due to a lack of focus on creating shareholder value. Thus this increased competition for investors puts pressure on German corporations to meet their demands and focus more on the creation of shareholder value. Nevertheless, still the block holding has not changed much and there are also no major changes on the most important elements of the German stakeholder oriented system, such as codetermination, foreseeable in the near fu-

ture. Therefore, it is highly unlikely that the stakeholder orientation will be completely dropped any time soon. Nonetheless corporations, and in this regard this means the management and also all the stakeholders, will have to focus more on the shareholder needs to not fall behind in the competition for investors.

### **3.2. The Characteristics of the System of German Corporate Governance**

The system of corporate governance in Germany has three characteristics which distinguish it from the United States' system: (1) concentrated ownership, (2) a dual-board structure (supervisory board and management board) and (3) worker representation on the supervisory board. (Vitols, 2005) Ownership and control are indeed concentrated in German firms. The main shareholders are, in order of importance, holding and industrial companies, individuals and families, banks and other institutional shareholders, and public authorities (Goergen et al., 2008 p.48). The German legal framework allows for dispersed ownership with concentrated voting power through a number of mechanisms such as (i) ownership pyramids, (ii) proxy votes, (iii) voting pacts, and (iv) dual class shares (Goergen et al., 2008 p.46). But Banks, wealthy individuals and families dominate the control structure of the German corporation which corresponds to that of an insider, bank-centred system of corporate governance. (Goergen et al., 2008 p. 50). Large shareholders and banks play, a two-tier board structure with labour participation on the supervisory board of large companies, the absence of hostile takeovers, and a legal framework based on statutory regulations deeply rooted in the German doctrine characterize the German system of corporate governance and play important role (Goergen et al., 2008 p.38).

#### **3.2.1. Banks' Involvement**

In addition to that another factor contributing to the strongly stakeholder oriented system in Germany might have been the traditional bank financing of German corporations instead of capital market financing (Kuhner, 2004, p. 2244, 247). Under German law commercial banks have a tremendous influence on corporate governance, whereas in the USA commercial banks are prohibited in having under their possession any equity

of the corporations. Historically, this has been due to the fact that bank loans have long been a favourite method of large corporations raising capital. In Germany the level of their influence over corporate governance's control extends beyond the traditional limitations between lender-creditor relationship (Emmons and Schmid, 1998). This relationship causes a different intervention rights to the banks in the interior management. Thus as a stakeholder the bank could even sometimes influence the management more than the shareholders of the company (Edwards and Fischer, 1994). Elston (1998) explain that the banks in Germany directly influence a corporation through associated voting rights and bank share ownership accrued from proxy votes and ownership, bank's representation on the Supervisory Board and share underwriting and bank lending. Provided that most shares are in the form of unregistered bearer shares and their holders normally deposit them with their banks, banks exercise proxy votes as main exercisers. The banks are allowed to cast the votes from these shares provided that the banks announce how they will vote on specific resolutions at the general meeting and the banks receive alternative instructions by the depositors. E.g. in the failed hostile bid for Feldmühle Nobel by the Flick brothers, Deutsche Bank supported resolution on imposed voting restrictions which passed with 55% of the shares voted, even though Deutsche Bank held only a direct share stake of about 8%; but the rest were proxy votes (Franks & Mayer 1998). Edwards and Nibler (2000) analyzed banks' proxy votes in a sample of 156 listed and unlisted German companies in 1992 and found that banks typically control more voting rights via proxy votes than via their own stakes. Especially the three largest banks such as Deutsche Bank, Dresdner Bank and Commerzbank have effective voting power via proxy votes (Goergen et al., 2008 p.47).

Since under German law proxy voting ("Depotstimmrecht") banks can get voting right from shares in trustee accounts of their customers, by collecting proxy votes the banks can significantly influence the decisions on the nominations and the remuneration of the Managing Board as well as the Supervisory Board. Thus the bank representatives can also play an active role as shareholders through attending shareholders' annual meetings, and representing on the Supervisory Board of the corporation. In Germany, almost half of the total issued shares are deposited in such

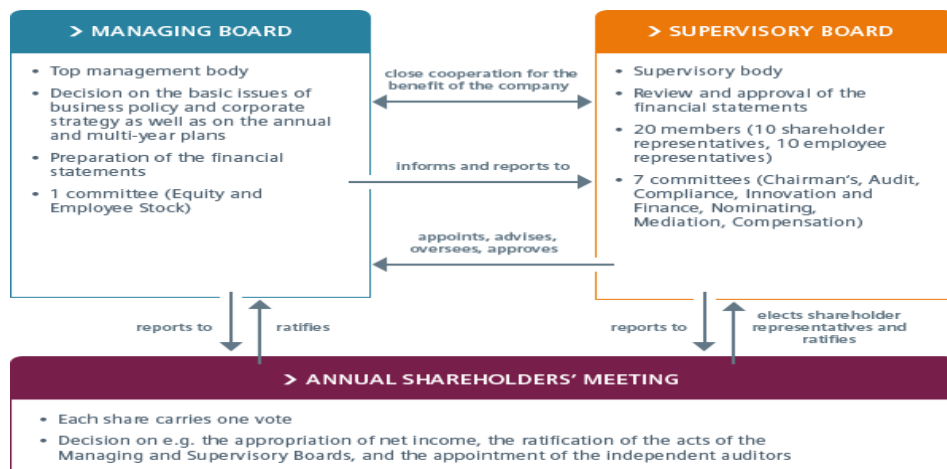
bank trustee accounts and the votes controlled overall (combining to the votes from direct ownership rights and the proxy votes) by banks in the largest 100 corporations in Germany is almost 36%. Nonetheless this in the top 10 corporations is much higher and could be over 50%.

To conclude, in Germany the banks obviously play a significant role as stakeholders and engage actively on the management and the operations of the corporations. This surpasses the traditional British-American corporation-creditor relationship and contrary to what is happening in the USA where the banks have no involvement affecting Managing and Supervisory board salaries.

### **3.2.2. Specific features: Two-tier system and co-determination**

Unlike the single-board system with sub-committees (i.e. the audit committee, remuneration committee, and the nomination committee) in the United States, large German companies are required by law to have a dual-board structure. The separation between a management board (“Vorstand”) and a supervisory board (“Aufsichtsrat”) could be considered as a specific feature of German corporate law. This two-tier board nages and represents the company. German board members, much like in the United States, are on average older, have long tenure, and are unlikely to have specific industry experience according to a study of Germany’s biggest listed firms by Russell Reynolds (The Economist, 2009). In contrast to the United States, where the average board size is between nine and ten members, German supervisory boards often have up to 20 members. When the management board is included, this number increases to around 30 members. Table 4 outlines Siemens’ two-tier board structure as a sample diagram of two-tiered structure.

**Table 4:** Sample Diagram of Two-Tiered Structure: Siemens' two-tier board structure



**Source:** Diagram referenced from the Siemens Global Website: Corporate Governance [http://www.siemens.com/investor/en/corporate\\_governance.htm](http://www.siemens.com/investor/en/corporate_governance.htm)

German corporate codetermination is in large parts based on the German Codetermination Act, which applies to companies with more than 2000 employees, the German One-Third Participation Act, which applies to companies with less than 2000 but more than 500 employees and the German Coal, Iron and Steel Codetermination Act. Even though the procedure differs in detail, all of those acts require the respective corporations to let employees participate in a supervisory body. According to the Codetermination Act one half of the supervisory board needs to be worker representatives whereas the other half needs to be shareholder representatives, resulting in parity on the board. The One-Third Participation Act obviously gives the worker representatives one-third of the supervisory board's seats, whereas the Coal, Iron and Steel Codetermination Act establishes parity on the board. In large German firms, co-determination requirements lead to a certain amount of board diversity. This is because of the requirement for employee and union representation, which leads to board members that tend to have a background different from that of shareholder representatives. In terms of an overall orientation the mere existence of such worker participation in a supervisory body shows a very clear stakeholder oriented system, even if the shareholders might

have a tiny little bit more influence in big corporations.

### 3.3. Comparison of the legal systems of Germany and USA regarding share- and stakeholder capitalism

**Table 5:** Comparative Table between Germany and USA regarding share- and stakeholder capitalism

<u>Categories</u>	<u>Germany</u>	<u>USA</u>
Shareholders	Arguably most important group of stakeholders; trend towards increased focus on creation of shareholder value.	“Shareholder primacy” All the modern American corporate Governance thought is based on this notion.
Stakeholders	Protected through a stakeholder friendly legal framework.	Under US Securities Law there is not any explicit obligation to consider Non-Shareholder interests. Stakeholders’ interests not really protected.
Management	(Two-tier Corporate Governance Structure): Broad discretion in terms of overall orientation.	(One-tier Corporate Governance Structure): Board has discretion in terms of overall orientation. Maximization of Shareholder value.
Social Responsibility of Corporations	No general duty; in the discretion of management.	No general duty, in the discretion of management. Recently creation of “Benefit Corporations”.
Role of the legislator	Sets legal framework responsible for stakeholder considerations. National corporate law.	US Securities Law deals with Federal issues (shareholders’ interests). Otherwise, each state law diversifies itself. Delaware law-most important state law for corporations.



Codetermination	Worker codetermination very extensive: almost parity on boards of big corporations	Worker codetermination not taken into account. No worker representatives on boards.
Role of Banks	Intervene directly in corporation's management.	Commercial banks are forbidden to intervene in corporation's management.

Source: Brandt and Georgiou (2016, p. 12).

## CONCLUSIONS

In conclusion, the United States and Germany both rely on corporate governance models to ensure that their businesses are operating smoothly. Each of these distinct models have been developed in a unique cultural, historical and technological context, and have been influenced by relevant national economic and social conditions, such as the financial markets and the banking sector, and by the government. German model uses a two-board structure, with a supervisory and managerial board to represent shareholders, while the United States has one board of directors for each publicly traded company. German companies focus on both shareholder and stakeholder interest, rather than just the shareholder value focus of the US and have similar board diversity. One of the overall goals of both countries' companies is to increase sustainability. The United States has many regulations enforcing sustainability, however, Germany has more of a voluntary approach which has shown to be successful. Both the United States and Germany have unique corporate governance structures and practices that will allow them to advance sustainability efforts in the future. Although the long-term success of these structures remains to be seen, both countries are well on their way to remaining two of the most influential business competitors in the world. Moreover, to be noted, emerging economies should focus on a well-developed legal framework defining the rights and responsibilities of three key players such as Managers, Directors and Shareholders and on the shareholder value as well as

on the good practice of corporate governance to attract more individual, and institutional investors and to develop their capital market.

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