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DEUTSCHE TELEKOM, GERMAN CORPORATE GOVERNANCE, AND THE TRANSITION COSTS OF CAPITALISM

Jeffrey N. Gordon*

THE TRANSACTION

In November 1996, Deutsche Telekom AG, the government-owned German telephone company, sold common stock representing approximately 25 percent of the company in a global stock offering that raised approximately DM 20 billion ($13 billion), the largest equity offering ever in Europe.[1] In selling off this equity stake, the German government (i.e., the Federal Republic) had a number of motives. First, the sale was an important step in converting a government-run telephone monopoly into a nimble competitor in the emerging European and world telecommunications market. In anticipation of a fully competitive European telecommunications regime in 1998, Deutsche Telekom ("DT") had been separated from Deutsche Bundespost — Germany's postal, telephone, and telegraph authority — as a private law stock corporation owned 100 percent by the government.[2] Sale of the initial 25

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* Professor of Law and Co-Director, Center for Law and Economic Studies, Columbia University. This paper was prepared for the Conference on Cross-border Views of Corporate Governance sponsored by the Columbia Law School Sloan Project on Corporate Governance and the L'Ecole Polytechnique Federale (Zurich), March 1997. The author would like to thank David Blass and Christopher Kirkham for research assistance, Mark Roe for innumerable conversations on German corporate governance, David Charny and Katharina Pistor for comments and suggestions, and the Sloan Foundation for financial support. © 1998 Jeffrey N. Gordon.

[1] DEUTSCHE TELEKOM AG, Prospectus for the Offering of 85,000,000 Ordinary Shares in the form of American Depositary Shares 104, Nov. 17, 1996 (hereinafter, the "Prospectus").

[2] The process of restructuring began in 1989 with legislation that separated the three main activities of the Bundespost, telecommunications, postal services, and financial services into distinct

percent tranche was the first stage of an eventual privatization of the entire company. At the time of the offering, DT's outstanding debt was approximately DM 110 billion ($73 billion),[3] and a significant objective of the sale was to recapitalize the company. During the 15 months following October 1996, approximately DM 16 billion of debt comes due, bearing an average interest of 6.6 percent, that management intends to replace with the new equity.

Second, the sale was part of an effort to establish an entrepreneurial culture at DT. This means downsizing the workforce, from 230,000 at year-end 1994 to a targeted 170,000 by 2000 (through traditional German means of attrition and early retirement rather than layoffs), and reorganizing the business on functional lines. In addition, approximately 3.3 percent of the offering, nearly one percent of the company's equity, was sold to employees under various preferential arrangements designed to "increase employee identification"[4] with the company, a particular challenge since nearly half the workforce are tenured civil service employees whose salaries and benefits are set by government regulation.

Further, a major objective of the offering was to promote a "shareholding" culture among German citizens. There is apparently widespread sentiment among political actors that the system of bank-centered finance is hindering

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businesses. Gesetz zur Neustrukturierung des Post- und Fernmeldewesens und der Deutschen Bundespost [Law on Restructuring the Postal and Telecommunications Services and the Federal Postal System] (PostStruktG), v. 8.6.1989 (BGBl. IS.1026) (F.R.G.) ("Post Reform I"). In 1994, the second reform act made all three private stock corporations. Gesetz zur Neuordnung des Postwesens und der Telekommunikation Postneuordungsgesetz, 27.6. 1994 (BGB1. I S. 2325) ("Post Reform II"), and contemplated their privatization.

[3] As one sardonic banker stated, this amount of debt is greater than the public debt of Turkey.

[4] Prospectus, *supra* note 1, at 103. *See* Hans-Willi Hefekäuser, Die *Deutsche Telekom AG — Von der öffentlich-rechtlichen zur privatrechtlichen Zielsetzung in Unternehmen der öffentlichen Hand, 25,* ZEITSDRIFT FÜR UNTERNEHMENS UND GESETTSCHAFTSRECHT 385 (David Blass trans., 1996) (on file with author).

German economic development and thus the desire to develop stock market channels for equity finance. Initial public offerings are rare in Germany (only 10 in all of 1994), and the stock markets are famously illiquid[5] and volatile.[6] Among other things, this makes it difficult to imitate the U.S. pattern of high-tech development in which venture capital specialists nurture a startup with an eye toward a lucrative exit via an initial public offering. Banks are not seen as very effective in performing the venture capital role, so a shareholder culture might make possible alternative modes of finance for potential sources of innovation and growth.

Moreover, the grossbanken, in particular, have lost credibility as monitors of managerial performance. The failures have been spectacular: Daimler-Benz, in which Deutsche Bank supported the company's costly move into extensive unrelated diversification in the late 1980s (just at the time when the U.S. takeover market was at high boil in the effort to undo prior decades of unrelated diversification); Metelgesellschaft, which showed a glaring failure to monitor the financial risks of commodities trading, presumably an area in which a bank would have some special sensitivity; the collapse of the real estate empire of Jurgen Schneider, in which escalating bad loans suggested in-group bank myopia; and Klockner-Humboldt-Deutz, in which a longstanding accounting fraud remained hidden from a Deutsche Bank-led restructuring of the firm

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[5] In 1994, just three companies — Deutsche Bank AG, Daimler-Benz, and Siemens AG — accounted for a third of the trading volume in German public markets; the top six firms accounted for almost 50%. Peter Gumbel, *Cracking the German Market: The Hard Sell: Getting Germans to Invest in Stocks*, WALL ST. J., Aug. 4, 1995, at A4.

[6] Over the period 1975-95, the approximate ratio of average annual nominal returns to risk (standard deviation) on German equity markets was 8.6%/18%. *See* Charles Olivier, *Unlocking Germany's $200 Billion Corporate Pension Pot*, EUROMONEY, June 1996, at A5; *Euromoney Survey, Guide to Germany 1996, Equities*, EUROMONEY, June 1996, at A4, Table 4. By contrast, German investors can earn a nominal yield of 7-8% on a portfolio of government bonds and local mortgage bonds, with risk below 6%. Olivier, *supra*.

only two years earlier.[7] Apart from these highly visible events, there also have been a number of academic studies that challenge the efficacy of bank monitoring. Thus, the development of a shareholding culture carries with it some idea of injecting new voices in the monitoring of German management and, even more important, shifting the focus of finance and governance away from creditor claims to equity claims.

This paper argues that the Telekom offering does not take the idea of a shareholding culture very far. The key idea is that finance and governance are jointly determined, and that so long as the capital structures of German firms are heavily leveraged (about which there may be factual uncertainty), bank monitoring of managerial performance with a creditor twist will persist. However, the previous success of German "stakeholder capitalism," as opposed to Anglo-American "shareholder capitalism," raises questions about the introduction of a shareholding culture. Perhaps a shareholding culture is a second best solution to a more fundamental problem of an inflexible labor regime within which firms must maximize; a superior solution would find a satisfactory way to address the transition costs of labor market change. Even without change to a shareholding culture, or resolution of even harder issues of political economy, however, it is possible to pursue a modest corporate governance reform agenda that would use the threat of shareholder damage proceedings to elicit more diligent monitoring from the banks.

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[7] Some of these failures are described with particular vigor in Ekkehard Wenger & Christoph Kaserer, *The German System of Corporate Governance — A Model Which Should Not Be Imitated* 4-16 (Conference on Comparative Corporate Governance, Center for Law and Economics, Columbia Law School, 1997) *in* COMPETITION AND CONVERGENCE IN FINANCIAL MARKETS: THE GERMAN AND ANGLO-AMERICAN MODELS (Stanley W. Black & Mathias Moersch eds., forthcoming 1998).

DEUTSCHE TELEKOM AND THE SHAREHOLDING CULTURE — AN INTRODUCTION

In many respects the Deutsche Telekom offering was a great success on the road to widespread public ownership of securities in Germany. Although the transaction was a "global offering," two-thirds was eventually allocated to German investors and institutions, approximately 40 percent of the total going to retail purchasers. More than three million retail investors signed up to get information on the issue, making the offering several times oversubscribed.

Nevertheless, the Deutsche Telekom offering seems an unlikely preparation for a shareholding culture. Indeed, it may undermine one, both because it replicates public shareholder passivity and sets unrealistic standards for stability of value. The DT initial public offering is, of course, only a partial privatization; the government holds 74 percent, making it the dominant shareholder. Under the German Stock Corporation Law of 1965,[8] a 50 percent holder has the power to elect all the shareholder representatives of the supervisory board[9] and controls the disposition of all other routine matters that come before the shareholders meeting,[10] including ratification of the acts of the management board and the supervisory board.[11] A 75 percent holder has distinctive powers, including the right to recall a member of the supervisory board[12] and to amend the articles.[13] Many of these powers are subject to alternative specification in the articles including capped voting rights,[14] but the DT Articles do not provide for any such limitation.

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[8] Aktiengesetz, 1965 BGB1. I 1089, amended by 1994 BGB1. I 4 8 ("AktG").

[9] *Id.* at §§ 101, 119.

[10] *Id.* at § 119.

[11] *Id.* at § 120(1), (2).

[12] *Id.* at § 103(1).

[13] *Id.* at § 179(1), (2).

[14] *Id.* at § 134(1).

Many aspects of the transaction assure that the government will remain the dominant holder for a substantial period of time, and that management is substantially entrenched.[15] The privatization legislation restricted the government from further public stock sales until 2000 to give DT priority on public market access. Under pressure to meet the Maastricht budgetary criteria for economic and monetary union, the government subsequently decided to sell off a 25 percent stake in DT to the state development loan agency, Kreditanstalt für Wiederaufbau, which will eventually place the shares with "strategic investors," including potential international business partners, but not until 2000.[16] Even after this sale, issuance by DT of all of the remaining authorized but unissued shares would still leave the government a 44 percent holder. Supervisory board members were elected upon DT's formation in 1995; their five-year terms will extend until 2000. The government also agreed to give the management board a veto over its sale of shares to "strategic investors."[17] Moreover, the availability of a DM 0.50 per share discount for German retail investors was conditioned on a purchase through a bank account, making it likely that "public" share ownership has been folded into the bank's proxy voting system. Thus, certainly in the near term, DT is unlikely to present the occasion for significant public shareholder involvement in serious governance or control questions.

The offer has a number of unusual features designed to encourage and sustain widespread public ownership. First, the economics have been shaped in a way that will minimize, at least in the near term, the volatility often

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[15] The government's shares are held by the Federal Institute, which appears to comprise the administrative apparatus of the Post Ministry.

[16] Ralph Atkins, *Bonn in Deal to Sell 25% Stake in Telekom*, FIN. TIMES (LONDON), June 27, 1997, at 2. The first part of this disposition, amounting to a 13% block of DT, took place in December 1997 and January 1998, at a sale price of $5.5 billion. *KfW Pays DM10bn for 13% Stake*, FIN. TIMES (LONDON), Jan. 6, 1998, at 22.

[17] Prospectus, *supra* note 1, at 18.

associated with equity ownership. In connection with the offering, DT announced that it expected to pay a two percent dividend in 1997 and a four percent dividend measured against the offering price in 1998,[18] a somewhat remarkable undertaking for a company in the midst of a fundamental business change. A substantial part of DT's business is the monopoly provision of public fixed-link voice telephony, which will be regulated by a new administrative agency, the Regulatory Authority for Telecommunications and Post (the "Regulatory Authority").[19] A prospective shareholder could well find in these arrangements an implicit promise that the Regulatory Authority will set a rate structure so as to permit payment of a regular dividend regardless of the profitability of DT's other business activities.

The offer also contains special incentives for widespread share ownership, a DM 0.50 discount for share purchases up to 300 shares and a special 1/10 share bonus for shares continuously held for three years after the initial public offering (up to 30 bonus shares). This presumably is based on the experience of the Volkswagen privatization in the 1960s, in which public investors bought shares at a discount and promptly resold them.

Finally, the stock exchange was pressured to give DT disproportionate weighting in the DAX-30, which will help support the price and liquidity of the offering.[20]

In any event, the offering has been sold and the stock has been trading continually at a premium over the market price, in the DM 30's to low 40's. But this is hardly the stuff of which high-tech IPO's are constructed.

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[18] Prospectus, *supra* note 1, at 15-16.

[19] Telekommunikationsgesetz ("TKG") S 66, v. 1.8.1996 (BGBl. I S.1120).

[20] Laura Covill, *Telekom Rules OK*, EUROMONEY, Dec. 6 1996, at 33. The Stock Exchange Committee was persuaded to weigh the full amount of DT's capital, not just the public float.

THE BANKS' ROLE IN GERMAN CORPORATE GOVERNANCE — SOME INITIAL QUESTIONS

From an American perspective, the distinctive feature of German corporate governance is the role of the leading German banks, which have representatives on supervisory boards of most large publicly traded German firms, often as Chair.[21] This can be heralded as a potentially valuable mechanism for the monitoring of managerial performance[22] or questioned as the interference by risk-averse creditors with the interests of risk-taking equity claimants.[23] An important basis for the banks' governance power is said to be control over the overwhelming majority of votes cast at the shareholders meeting. For example, in 1992, the banks cast an average of 84 percent of all votes at shareholders meetings of the 24 largest firms with a substantial public float.[24] The banks' direct holdings are substantial but rarely controlling; similarly, bank-managed mutual funds add only a relatively small amount to the banks' position. So the most significant source of the banks' voting strength is said to be discretionary authority over customers' shares on deposit,[25] which raises the question as to whether the banks are exploiting the rational apathy of public shareholders.

This story seems to be missing a crucial piece of information: a more detailed account of the actual owners of the shares on deposit with the banks. Looking to the simple percentage of bank votes may overstate bank influence because that percentage reflects the mechanics of voting

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[21] *See* Mark J. Roe, *Some Differences in Corporate Structures in Germany, Japan and the United States*, 102 YALE L.J. 1927, 1938-41 (1993).

[22] *Id.* at 1979-80.

[23] Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 90-96 (1995).

[24] THEODOR BAUMS, CORPORATE GOVERNANCE SYSTEMS IN EUROPE — DIFFERENCES AND TENDENCIES OF CONVERGENCE Table 3 (Crafoord Lecture, Univ. of Lund/Sweeden Working Paper 1996) (on file with author).

[25] Roe, *supra* note 21, at 1938.

shares that are issued in bearer form. In order to vote, a shareholder must either deposit the shares with the company or give a proxy to a "credit institution," a professional shareholders agent, or a shareholders association.[26] Deposit of the shares with the company would sacrifice the anonymity that apparently is an attraction of bearer shares, so the deposit with a bank seems almost a mechanical necessity. The real question is the degree of discretion that the bank has over the shares that are voted by proxy.

The data on share ownership is fragmentary. Because shares are issued in bearer form, a company itself will not necessarily have a good sense of its owners, much less the public. Although the Securities Dealing Act requires disclosure of five percent blocks,[27] this can be evaded through private holding companies in which no party owns a majority of the stock.[28] Share ownership by households is concentrated among a narrow group, only six percent as opposed to 20 percent in the United States which suggests holdings of relatively large blocks. More important, a very large percentage of the stock of "public" corporations is held through cross-holdings, and the estimates of their significance range from 27 to 52 percent of the gross market capitalization.[29] The sheer arithmetic suggests that in many

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[26] *See* Deutsche Telekom AG, Articles of Incorporation § 19(1): "Eligible to participate in and to exercise their voting rights at the shareholders' meeting shall be those shareholders who deposit . . . their shares at a cash office of the Corporation, with a German notary, [or] at a financial institution operating collective security deposits. . . ." An interesting aside: in response to a request for a copy of the articles, a DT official and one of its law firms said the articles were "confidential." Whatever the German practice, they were attached as an exhibit to the U.S. Registration Statement for the offering of American Depositary Shares.

[27] Wertpapierhandelsgesetz, Zweites Finanzmarktforderungsgesetz [Second Financial Markets Promotion Act], 1994 Bundesgesetzblatt, Teil I (BGBl. I) 1749 (F.R.G.), at § 21 ("WpHG").

[28] *See* Wenger & Kaserer, *supra* note 7, at 22-24.

[29] *Id.* at 24. For explorations of the disclosure rules and estimates of ownership, see Marco Becht & Ekkhart Böhmer, *Transparency of Ownership and Control in Germany* (European Corporate Governance

cases a significant percentage of the votes cast by the bank must be of large blocks held by sophisticated investors. As to these shares, the bank's exercise of nominal discretion is surely limited by the shareholders' knowing acquiescence in the bank's decisions. A significant shareholder displeased by a bank's strategy could revoke the proxy and vote independently at the sacrifice of anonymity or deposit the shares with another bank.

In other words, depending on the distribution of share ownership, the banks' apparent discretion might be significantly limited. Large blockholders would have the sophistication to monitor the bank's behavior and the capacity to insist on bank voting that served shareholder interests. Thus, insofar as the banks' influence depends on shareholder voting, at least in some cases, the bank might feel more constrained to pursue shareholder interests than might initially appear. Further data would clarify this question.

GOVERNANCE AND FINANCE

Bank monitoring of managerial performance raises three kinds of potential objections, of which only two are curable. One curable objection is that banks have been incompetent at the job, at least recently, perhaps because of insufficient attention or resources devoted to the task. Perhaps the problem is that senior officials at Deutsche Bank serve on or chair too many supervisory boards to do an effective job, or that the banks' tradition of generalist monitoring needs to shift to industry-specific skills. Another curable objection is the problem of self-dealing; that the bank wants to maximize the value of its relationship with the firm and so may use its influence to increase interest charges and fees at the expense of equity holders.

Network Working Paper, Oct. 1997) (available at www.ecgn.ulb.ac.be, hardcopy on file with author); Peter O. Mülbert, *Banks' Equity Holdings in Non-Financial Firms and Corporate Governance — The Case of German Universal Banks* (Working Paper, Aug. 1997) (on file with author).

The third objection, incurable if true, is that the banks are structurally unsuited as monitors because of the inherent conflicts between the monitoring of credit and equity claims. Creditors and equity holders will have different attitudes toward risk, since the creditors' claim is capped on the upside (at full repayment) and the equity holders claim is capped on the downside (by limited liability).[30] The managers have similar attitudes toward risk as the creditors, but for different reasons. Creditors are risk neutral (because they can assemble portfolios of loans), but they resist risk because it may lower their expected return.[31] Managers are risk averse (because their entire human capital investment may be tied up in a particular firm) and so may resist risk even if it raises their expected return. The similarity of attitude promotes an unholy alliance between the banks and the managers against the shareholders that undermines the firm's ability to maximize equity values.[32]

But the force of this objection depends upon the capital structure of the firm. Bank monitoring may be problematic for a firm with a small amount of debt in the capital structure, but it may be the ideal arrangement for a highly leveraged firm. The shareholder/creditor conflict is, of course, symmetric. In a highly leveraged firm without creditor monitoring, shareholders would optimally pursue a number of strategies that opportunistically shift value from creditors to shareholders, in particular, asset substitution into riskier projects. This is captured in the finance literature by likening equity to an option held by shareholders to buy back the firm upon full repayment of the debt, or, in the alternative, likening equity to a put option held by shareholders to sell the firm to debtholders at the face amount of the debt. In the first scenario, the

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[30] John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1499 (1990).

[31] *Id.* at 1501.

[32] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 328 (1976) *See generally* Coffee, *supra* note 30.

shareholders gain value by increasing the volatility of returns through riskier projects or increasing leverage. In the second scenario, the shareholders gain value by drawing cash out of the firm through dividend payments. In the vicinity of insolvency, as the shareholder call option moves out of the money, the shareholders may gain value through the selection of risky negative net present value projects.[33] Thus, shareholder opportunism is controlled by designating the banks as monitors, sustained by an implicit understanding that the bank will exercise its voting power to protect creditor interests. In the case of the highly leveraged firm, the creditors are residual claimants and thus, not surprisingly, exercise voting control.

One important question regarding the "fit" of bank monitoring for German firms is the nature of firm capital structures. The commonly repeated stylized "fact" about German corporate finance is the heavy debt. This seems consistent with the disparity between the total stock market capitalization and GNP in Germany relative to other OECD countries where equity plays a more important role. For instance, stock market capitalization is 17 percent of GDP in Germany, while it is 132 percent of GDP in Great Britain.[34] On the other hand, German firms allegedly accumulate huge retained earnings that would certainly reduce leverage in the capital structure.[35]

Thus, conditions of governance and finance are jointly determined. There also may be a strong element of path dependency. If background social, political, and economic conditions produce a strong tendency to a characteristic

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[33] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613, 17 DEL. J. CORP. L. 1099, *1155 n.55 (Del. Ch. 1991).

[34] *See* Baums, *supra* note 24, at Table 2. *See also Euromoney Survey, supra* note 6, at Table 1 (For 1995, 23.9% for Germany, 130.7% for Great Britain). These comparisons may, however, reflect the relatively small number of German firms that are publicly traded more than the debt-equity ratio throughout German business.

[35] JEREMY EDWARDS & KLAUS FISCHER, BANKS, FINANCE AND INVESTMENT IN GERMANY (1994).

financial form, then legal arrangements and customs will develop that reinforce the existing pattern. Assume that at some imaginary moment German firms were heavily capitalized with debt, leading to a characteristic pattern of bank monitoring. Subsequent equity investment would pay a penalty because of the creditor focus of monitoring, so new capital will tend to come in as debt capital, which reinforces the governance case for bank monitoring. Alternatively, even if equity increases as a percentage of firm capitalization, the prior debt-protective governance mechanism may persist, despite the equity penalty.

DEUTSCHE TELEKOM AND THE SHAREHOLDING CULTURE — A RECONSIDERATION

This bring us back to Deutsche Telekom and the German government's ostensible desire to use this partial privatization as the springboard for the establishment of a shareholding culture. The questions, of course, are why change? Why foster a strategy of equity finance that will undoubtedly roil the harmony of reasonably well working governance arrangements? What's so great about shareholder wealth maximization anyway?

Seen from an economic perspective, the goal of a system of corporate governance is to maximize the economic value of the firm, as measured by the total of economic returns for all possible residual claimants. For instance, the goal is to maximize the sum of the returns for shareholders, debt claimants, and workers. The ultimate defense of the assignment in the Anglo-American system of exclusive governance rights to the stockholders rests on the empirically contestable fact that this is how to maximize the size of the economic pie.

For a long time the German experience suggested that it wasn't necessarily the case. While returns to equity investment in German firms have been significantly lower than in the United States over the last 15 years, increases

in labor productivity have been significantly higher.[36] Although precise comparisons of the sum of the returns are quantitatively difficult, there is much suggestion of equivalence: the growth rate of per capita GDP in Germany exceeded the U.S. growth rate over a 40 year period, to the point of GDP equality in absolute terms.[37] Now, however, at least some believe that significant gains depend upon a different economic culture, of entrepreneurial risk-taking induced by high-powered incentives like the equity rewards under a regime of shareholder wealth maximization.[38] As discussed above, the partial privatization of Deutsche Telekom hardly provides such a model; the public float is less than 20 percent of the outstanding debt. Nevertheless, as an example of the fund-raising potential of the Germany equity markets, it is a significant moment. This is not a statement about the competence of managerial monitors, but a transitional moment in a debate about corporate objectives.

GERMAN CORPORATE GOVERNANCE AND THE TRANSITION COSTS OF CAPITALISM

Seen from afar, it appears that the effort to convert the German system of corporate governance and finance is a decidedly second best approach to a deep problem of adjusting to a changing competitive environment. The U.S.'s success in mastering the "New Economic Order" has been based on flexible markets in products, corporate

[36] *See Le Defi Americain, again*, ECONOMIST, July 13, 1996, at 21-22. For example, the average return on equity for German firms in 1994 was 7.4%, half the average return for U.S. firms; the return on capital for German firms between 1974-93 was only 7%, compared with 9% in the United States. Average labor productivity in German firms, however, increased at an annual 1.8% since 1979, twice the American rate of increase. *Id.*

[37] *Stakeholder Capitalism: Unhappy Families*, ECONOMIST, Feb. 10, 1996, at 23-24.

[38] *Id.* at 25.

control, and labor.[39] At this point, the most significant difference between the United States and Germany is with respect to labor markets, not control markets. In other words, there may be nothing seriously wrong with the German system of governance and finance, but rather with the surrounding set of social institutions within which it must pursue maximizing behavior.

Governments can pursue different strategies in addressing the transition costs of capitalism.[40] One possibility is a protectivist strategy that seeks to impede the transition in question, through trade barriers, for example, or capital market controls.[41] Another is a frankly transitional strategy that looks to measures such as grandfathering, retraining, and incentives for early retirement.[42] A third is simply to let the costs fall where they may, subject to background conditions of social insurance.[43] The structure of the German labor regime seems highly protectivist, one that will resist change in staffing and compensation patterns. It also seems that the existence of national bargaining will undermine the possible advantages of changes in corporate governance and finance at the firm level. Or perhaps the goal is to use new pressure for firm specific adjustments, deriving from shareholder culture, as a way of modifying the national bargaining structure. In any event, the fundamental issue is a basic question of political economy in which a governance change is not the key event.

This is borne out by the tortured history of the failed hostile takeover attempt of Thyssen AG by Fried. Krupp AG Hoesch-Krupp ("Krupp") in the spring of 1997 and the eventual combination of the two companies. Massive labor

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[39] *See* Jeffrey N. Gordon, *Employees, Pension Funds, and the New Economic Order*, 97 COLUM. L. REV. 1519 (1997).

[40] *See* Jeffrey N. Gordon, *Employee Stock Ownership as a Transitional Device: The Case of the Airline Industry, in* THE HANDBOOK OF AIRLINE ECONOMICS 575, 576 (Darryl Jenkins ed., 1995).

[41] *Id.*

[42] *Id.*

[43] *Id.*

and political opposition, rather than managerialist manipulation of a failed corporate governance system, was the key barrier to the hostile bid, and shaped the eventual merger.[44] Krupp initiated the struggle with a cash tender offer to Thyssen shareholders at a 25 percent market premium. Thyssen management of course objected (particularly to the conflicting role of Deutsche Bank, whose investment banking subsidiary advised Krupp, while one of the Bank's management board members sat on the Thyssen supervisory board). The most effective resistance, however, was waged by the union leadership, goaded in part by the Thyssen CEO's assertions that the takeover would lead to heavy layoffs (at a time of 11 percent unemployment). Labeling the hostile bid as a "Wild West" tactic, the union leadership organized demonstrations of as many as 30,000 workers, and particularly focused them against Deutsche Bank — a politically vulnerable target. In response to the ensuing political pressure, Krupp called off the hostile bid. Eventually, the firms entered into a "friendly" merger, brokered in part by political leaders, in two stages: first, a consolidation of their steel operations, and then an overall merger of the two firms. But the critical element in putting together these transactions was reducing the level of job loss, not maximizing the value to shareholders. If the outcome represents a "failure" (certainly contestable), it is not principally a failure of the German corporate governance system.

A MODEST GOVERNANCE REFORM AGENDA

Even if the major questions of political economy remain unresolved, there seems room for a modest governance

[44] The account here is based on press reports, especially from the European Wall Street Journal. *See* Matt Marshall, *Thyssen, Krupp Opt for 2 CEOs, Removing Barrier in Merger Talks*, WALL ST. J. (EUROPE), Jan. 12, 1998, at 3; Thomas Kamm & Matt Marshall, *The Next Wave: Global Forces Push European Companies into Merger Frenzy*, WALL ST. J. (EUROPE), Apr. 4, 1997, at 1; Kristi Bahrenburg, *Takeover Flop Dims German Shares' Sheen*, WALL ST. J. (EUROPE), Apr. 2, 1997, at 12.

reform agenda that will contribute value in regimes of stakeholder maximization as well as shareholder maximization. Many failures at the supervisory board level involve no conflict between creditors and shareholders, just a failure of diligence. In this regard increasing the power of shareholders to call to account supervisory board members and managing board members would be valuable. Although German corporate law does not permit a shareholder derivative suit, it does allow a 10 percent holder to demand that the company pursue a claim for damages against such board members for "violation of their duties,"[45] including the obligation to "employ the diligence of an orderly and conscientious manager."[46] Such liability, however, may be extinguished by shareholder ratification.[47] On the other hand, if no damages are recovered, the shareholder is liable for both the defendant's and the corporation's costs,[48] a significant risk for someone who has no voice in the litigation and will recover only a pro rata share. Ten percent is a very high threshold, especially in a large public firm, that could be lowered, and the "loser pays" rule could be eliminated altogether. Similarly, the requirement of five percent share ownership or a DM 1 million stake as a condition for presenting a resolution at the shareholders' meeting[49] seems like an overly stringent barrier.

It also seems possible to enhance the quality of the supervisory board without major upheaval, through changes in custom over the selection process. One possible evolutionary path is for the supervisory board, under pressure from foreign capital investment, to move more in the direction of an American-style board, especially in the attitude of directors. The question is whether more energetic engagement by shareholder directors fits well with a codetermined board.

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[45] AktG § 117(2).

[46] *Id.* at § 93(1).

[47] *Id.* at §§ 93(4), 117 & 147.

[48] *Id.* at § 147(4).

[49] *Id.* at § 122(2).