Takeovers vs. Institutions in Corporate Governance in Germany

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I. Introduction

The corporate governance Systems in the U.K. and in Germany differ markedly. German large firms have a two-board structure, they are subject to employee codetermination, their managements are not confronted with public hostile takeover bids, and banks play a major role in corporate governance, through equity stakes, through proxies given to them by small investors, and through bankers' positions on the supervisory boards of these firms. One of the main issues of corporate governance in large firms, the problem of shareholders' passivity in monitoring management in Berle-Means type corporations, is thus addressed by an institutional Provision, the role of the banks, rather than by a market-oriented Solution as we find it in the U.K. with its "market for corporate control" through the threat of hostile takeovers. These two different approaches to corporate governance have been compared several times recently, and it was argued that a bank-based or institutional Solution has clear advantages and should be preferred. Cosh, *Hughes* and *Singh*,[1] for example, argue at the conclusion of their discussion of takeovers and short-termism in the U.K. that

> "the institutional shareholder [in the UK] should take a much more active and vigorous part in the internal governance of corporations. . . . In order for such a proposal to be effective both in disciplining inefficient managements and promoting long-term investments, far reaching changes in the internal workings and behaviour of the financial institutions would be required. The financial institutions would need to pool their resources together, set up specialised departments for promoting investment and innovations - in other words behave like German banks."

The following remarks seek to continue this discussion from the German perspective. The article will first attempt to evaluate the monitoring potential of our domestic bank or institution-oriented corporate governance system and then, in a further part, compare it with that of a market-oriented Solution. It will be argued that both Systems focus on different problems and have specific advantages and drawbacks, and that there are still quite a few puzzles to be solved until all pros and cons of each of these monitoring devices can be assessed. The perception that both Systems focus on different problems suggests combining institutional monitoring with a "market for corporate control" rather than considering them to be contrasting and incompatible approaches.

The article is organized as follows. Section II will describe the legal structure of the large corporation in Germany in more detail. Section III explains why a "market for corporate control" by the threat of public hostile takeover bids does not exist in Germany. Section IV then shows how corporate governance in publicly held corporations with small investors is organized instead, and deals with the role of banks in corporate governance in these firms. Section V of the article then will try to compare the monitoring potential of a market-oriented and our bank or institution-oriented corporate governance System. Concluding remarks follow.

II. The Structure of the Large Corporation

1. Legal forms of firms and distribution of ownership

In Germany firms can be organized and run either by a sole proprietor, a partnership[2] or by a corporation. The most important forms of corporations are the private Company with limited liability[3] and the stock corporation.[4] The following remarks will only deal with the publicly held stock corporations, the stock of which is either owned by scattered individuals or by institutions. While only focussing on these publicly owned corporations we have to keep in mind that although we are speaking of a small number of firms, they are also Germany's largest firms: In 1990 there were about 2 million firms in Germany; of these about 430,000 were private companies with limited liability and less than 2,700 were stock corporations.[5] Of the latter only 551 are quoted on a stock exchange,[6] and of these 551 about 80 are widely held and traded.[7] However, most of these corporations with widely distributed ownership are among the 100 largest firms in Germany[8].

2. The three "organs" of the stock corporation

To understand corporate governance in these large stock corporations, the impediments to hostile takeovers (cf. Section ill.) as well as the role of the banks in this respect (cf. Section IV.), it is necessary to mention some special features of German corporate law.

First, the two-tier or dual *boards* System, which was established in 1870. It consists of a management board and a separate supervisory board. Management is appointed, mostly for five year terms, and is dismissed by the supervisory board.[9] The management runs the day-to-day business of the firm independently and can only be recalled for cause. Complete power rests with neither the management nor the supervisory board. A more detailled picture would show a complex structure of balance of powers between these two Organs. The powers of the shareholders' meetings are restrained to basic decisions such as changes of the Statutes, approval of the annual Statements of accounts, distribution of (half of) the annual balance-sheet profits, election of (half the) members of the supervisory board, consent to some specific structural changes as mergers, issuance of new stock and the like.

Second, the *codetermination system*[10] involves members of the supervisory board that are neither elected nor appointed by the shareholders. In firms with more than 2,000 employees, half of the members of the supervisory board are elected by the shareholders and the other half by the employees (blue and white collar as well as lower-ranking management) and labor Unions. Hence, the members of the supervisory board and the management board are considered to be agents of all stakeholders in the firm rather than of the shareholders only.[11]

Third, the *voting process.* There is no proxy system with proxies for the management. In the shareholder meetings shares are either voted by the shareholders themselves or - in the case of smaller shareholdings - by institutions, mainly banks, which act as custodians for the shares. This voting power of a few banks, sometimes not more than three or four, each with a large block of votes, gets their representatives on the supervisory boards (alongside the representatives of the employees and trade Unions). This will be described in more detail in Section IV.

III. Impediments to Hostile Takeovers

1. Specific structural features of German corporate law

To date, no public hostile takeover bid has been successful in Germany. One actual case is still pending - although a bid in its technical sense has not yet been launched - the struggle between the two tyre makers Continental AG and Pirelli of Italy. The attempt of the French Company AGF to take over the insurer AMB has recently been settled by an agreement. What are the reasons for this pattern which obviously is so different from the Anglo-American corporate world?

To start with, these recent cases may indicate an ongoing change which will probably be reinforced by the further internationalisation of markets and changes of the economic and regulatory environment in the E.C. Apart from that, the fact that public hostile takeovers did not occur until now does not mean that there are no hostile takeovers at all. The management of Hoesch AG, the shares of which were recently taken over by Krupp, would probably have liked to hinder this shift of control if there had been a chance to do so. Resistance to a hostile takeover is not always possible, as will be shown later, and will become particularly difficult for an incumbent management if it loses the support of one or even several depot banks. That means that in such cases these institutions will still play an important if not a decisive role, and that means in turn that these cases cannot - in terms of our differentiation between inside monitoring by institutions versus outside control by a takeover market - be attributed clearly to the latter. Hence it is justified to exclude such "private" hostile takeover activities which are accompanied or supported by the depot institutions and focus on public hostile takeover bids only.
We need not speculate about different corporate cultures here to explain why this technique to gain control even against the will of the incumbent management is not used in corporate Germany so far. There are quite a few more tangible and concrete arguments which explain this pattern as a result of specific structural features of German Company law as well as of the conditions of corporate finance and other peculiarities. The following remarks will try to describe some of these impediments to hostile takeovers in more detail.

aa) First remember the comparably small number of potential targets: There are less than 100 listed stock corporations with widely distributed shares.[12] The continued concentration of equity holdings in families or small groups of shareholders can to a large extent be explained by the relative importance of debt (bank) rather than equity financing.[13]

As to the large corporations with widely distributed stock, the shares in these firms are normally not voted by the shareholders themselves but by *depot banks as proxy holders.* Hence these few large banks play a key role in this respect. Until recently the majority of these banks firmly opposed public hostile takeovers ("blunders of American capitalism") and supported managements in protecting firms and themselves against possible attempts by amending the Statutes through antitakeover provisions. Is this attitude likely to change if the banks' competitors from abroad finance hostile takeover bids in the future? Only if the benefits from supporting a hostile takeover bid outweigh the disadvantages that our large banks still fear from their corporate clientele if they were to support such an attack. In this context, it should be mentioned that the Großbanken (large banks) themselves are also (or were at least until recently, before the cross-holding alliance between Dresdner and Allianz) large corporations with widely dispersed shareholders; hence, their managements have no interest in being exposed to a hostile takeover, either. On the other hand, the banks as depot institutions have been increasingly criticised in the literature as well as in the media. Not least because of this criticism two of the three Großbanken recently abstained from voting in the Conti case where the issue was whether they, as the proxy holders of their clients, were to abolish an antitakeover Provision in the company's statute.

bb) A second structural impediment to hostile takeovers is the *two-boards structure.* The representatives of the shareholders on the supervisory boards (half the members of this board) can be recalled before the expiration of their office term (usually five years) only with a supermajority of 75 % of the votes cast. The members of the management boards can, by resolution of the supervisory board, be recalled prematurely only for cause, although a recall without cause is valid until nullified by a court. However, if someone has succeeded in acquiring the majority, the board members will usually submit to the development.

cc) A further impediment for takeovers financed by means of the assets of the target (LBO's) are the *strict capital protection rules* of German corporate law which prohibit these financial techniques. By the same token, repurchases of shares as an antitakeover device are also prohibited.

dd) *Antitrust law,* the *Ia w of groups of companies* and *labour law* specialties can render takeovers difficult. If a bidder is a group of companies or is going to be such a group by virtue of its acquisition it will be subject to the rules of the law of groups of companies which provide for the protection of minority shareholders and creditors of subsidiaries. Shutting down plants or laying off employees can be a cumbersome and costly undertaking.

2. Statutory antitakeover provisons; preventive actions

Apart from these and other structural impediments some specific statutory antitakeover provisions and preventive actions are possible and can be observed. For the purpose of this article it should suffice to mention the most common or sweeping ones rather than to display the whole palette.

aa) In 1990 the Statutes of 23 of the large stock corporations with widely distributed shares provided for *caps on voting rights.*[14] In such a case a shareholder cannot vote more than (usually) five percent of the stock irrespective of the number of voting shares held by him. Since 1990 several firms have eliminated this Provision. In the long run a firm with a controlling shareholder will have to come to terms with a major shareholder despite a voting limit if the latter is not to block everything, since the voting cap affects only the voting right and not the other rights of a shareholder.[15] Apart from that, this Provision can be overcome by help of “friends” who vote together with the shareholder that seeks the control. That is the main issue in the Conti-Pirelli case.

bb) A much more effective means of preventing takeovers are *registered shares.* It is contended in the literature that about one third of the German stock corporations, among them 47 companies listed on stock exchanges, are equipped with this device.[16] In such a case the management board has broad discretion whether or not to register an acquirer.[17] The acquirer's rights as a shareholder depend on registration.

cc) *Crossownerships* between two firms up to a stake of 25 % of the other firm's stock can be organized by the managements of these firms. The shareholders' consent is not necessary. A famous example which was recently reported by the financial press is the interlock between Dresdner Bank and Allianz, the largest European insurer. This example shows, however, that such an alliance cannot be entered into by management without an underlying business rationale other than to provide a defense against takeovers, and the acquisition of a stake of, say, 15 % of the stock of another large firm has to make sense in other respects, and has to be approved by the supervisory board and explained to the shareholders and the public.

dd) Another model which avoids these drawbacks which can be found in practice consists of several large firms setting up a *joint subsidiary* which acquires small blocks of shares of the participating firms and acts as a "white knight" in the event of a hostile takeover bid.[18]

There are other devices such as staggered boards, the issuance of preference shares without voting rights and so forth which need not be explained here fully to show that hostile takeovers face cultural and structural impediments as well as obstacles set up for the purpose of obstructing the acquisition of a controlling block of shares.

This takes us back to our question of how, if not by the threat of takeovers, management in these firms is monitored. Theoretically there are several instruments and devices which could serve to align the interests of the management with those of the stockholders, employees and creditors of the firm:

- Monitoring of the management by the supervisory board;

  Pressure from the various factor markets (product, capital, labor) as far as these are competitive;

  Competition in the market for managers;

- Incentives in contracts with the compensation of managers tied to their Performance;

- Monitoring by creditors;

  The threat of bankruptcy and the resultant loss of prestige and reputation; and

  Legal rules under which managers must act with loyalty and care with respect to the firm and its various stakeholders.

To be sure, not all of these devices are thought of as aiming at the same goal; the liability rules, for example, are more concerned with misbehaviour such as self-interested conduct by management, rather than with monitoring managerial efficiency.

Our focus here is not on all of these devices but only on the attempt of the German system to overcome the problems of shareholders' passivity in monitoring management in Berle-Means type corporations by an institutional arrangement rather than a market-oriented solution (i.e., through the "market for corporate control" or the threat of hostile takeovers). This institutional solution consists of financial intermediaries (universal banks) which act as proxy holders for small investors. The banks are better informed than small investors and have the advantage of economies of scale when monitoring the management. Hence, the "agency costs" due to asymmetric information and collection action problems of small shareholders in Berle-Means type corporations can perhaps be reduced by inserting these institutions. But new questions arise: What incentives do these institutions have to monitor corporate activities? Do they really act on behalf of the shareholders? And how is their Performance? Does “internal monitoring” by institutions have limitations which a market Solution does not have? Are there other interests which distract or deter them from pursuing their clients' - the small shareholders' - interests? Are the "controllers" themselves "controlled"? Before these questions can be addressed, the system and practice of the depot banks should first be described for the benefit of the foreign reader.[19]

IV. Banks as Institutional Monitors

1. The instruments

a) Proxy held by banks

The typical large German firm with dispersed shareholders finds its shares in voting blocks which are voted by a few banks and which, if aggregated, comprise up to 30 % or more of all votes.[20] This voting power, which helps place representatives of the banks on the supervisory board,[21] comes from different sources: from directly owned stock,[22] from investment companies controlled by banks,[23] or from voting the shares held by banks as custodians for their clients.

Since the Separation of commercial banks and securities firms is unknown in German banking law, banks are allowed to trade stock. They may also offer their customers custodial or depository Services for those shares, administer them (e.g., collect dividends), and vote them at shareholder meetings. Shares of German publicly-held corporations are predominantly bearer shares; smaller shares are mostly part of a single global document. A shareholder who wants to hold actual stock certificates will have to pay additionally for them. This drives stock into institutions.

Banks need a special written power of authority to vote the deposited shares. There is no ceiling or cap limiting the exercise of the voting rights by banks to a certain percentage of the firm's stock capital. The power of authority for the bank, or proxy, cannot be given for more than fifteen months, and it is revocable at any time. Before a shareholder meeting, banks have to recommend to their customers how to vote, and must ask for special instructions. As a practical matter, special instructions are extremely rare.[24] If the shareholder does not give the bank special instructions, the bank is to vote according to its recommendations. Generally, banks can vote their customers' stock on any matter. In its own shareholder meeting,[25] however, a bank may only vote stock if it receives explicit instructions from its shareholders.[26]

Banks do not charge extra fees for voting their clients' stock. There is only a basic fee for their depot (custodial) Service.

bb) There are several older empirical studies on banks as proxy holders.[27] The most recent ones were published by *Gottschalk*[28] and by *Böhm*.[29] Gottschalk selected those companies from the list of the 100 largest firms in 1984 where more than 50 % of their stock was either widely held or owned by banks. These 32 companies, with a (nominal) equity capital of DM 29.5 billion, represented about a quarter of the nominal capital of all German stock corporations. Among them were seven of the ten largest[30] firms of the Federal Republic. Böhm extends this study on a smaller sample of firms.[31]

Unlike *Böhm, Gottschalk's* study adds up the voting power of the banks' own shares, their depot shares, and shares held by investment companies, which are bank subsidiaries. His study shows the following results:
on average, banks represented more than four-fifths (82.67 %) of all votes present in the meetings. With one exception, they represented at least a majority (more than 50 %) of those votes present. Consequently, they were able to elect the members of the supervisory board elected by the shareholders (as opposed to those elected by the employees). Changes of the Statutes of the corporation could not be effected against their votes. In 22 or two-thirds of the firms, the banks voted more than three-fourths of the stock present and thereby could change the Statutes. No other shareholder could block these decisions. Note that most of these corporations (by the votes of these very banks) have adopted provisions in their Statutes to the effect that no one shareholder may vote more than (typically) 5 % of all shares of the com pany.[32] This rule, however, does not apply to banks in their capacity as proxy holders voting for different clients.

The breakdown in *Gottschalk's* study shows that the voting rights are highly concentrated in the three largest private banks (Deutsche Bank, Dresdner Bank, and Commerzbank). Together these three banks voted on average approximately 45 % of the stock that was represented at the general meetings of the 32 companies.[33] In almost half of these cases (15 firms), they together held the majority; in a further one-third (10 firms) they had a blocking minority. In individual cases, one or another of the big banks dominates; in most cases the votes are distributed roughly equally among them, or the other two banks together have about the same number of votes as their competitor.[34]

The extent of coordinated behaviour of these banks in the voting process[35] has not yet been empirically determined. A government commission in its report of 1978, noted that "the banks mostly vote in the same sense".[36]

b) Banks as Shareholders

aa) A second source of influence of banks in corporate affairs is their position as stockholders for their own account. According to German banking law, credit institutions may acquire and hold stock in nonbank firms for their own account; there are no rules which forbid or limit such holdings to a certain percentage of the firm's capital. There are only caps or limits with respect to the bank's capital to protect the depositors and creditors of the bank: a single participation in one firm may not exceed 50 % of the capital of the bank.[37] Further, investments of a bank in stockholdings and other illiquid assets may not exceed its own capital.[38]
The Second EC Banking Directive lowers these limits: In the future no single holding may exceed 15 %, nor all holdings together 60 % of the capital of the bank.[39] Additionally, the recent draft of an EC directive concerning large credits limits each single "credit" (including participations on own account) to 25 % of the capital of the bank.[40] Practically, however, these new rules will not mean significant changes for German banks and their equity holdings.

bb) By the end of 1989 German credit institutions directly and through subsidiaries held 4.69 % of all shares of domestic stock corporations[41] (this number includes subsidiaries of banks, such as corporations that own bank premises, etc.). For the issue of “banks and corporate control” this number alone is not very informative. It does not tell us whether or in which banks these holdings are concentrated; in how many cases these holdings are mere portfolio investments rather than controlling blocks of shares; whether they are acquired only for short term, for placement or trading purposes, or as a long-term investment; or what the structure of the remaining shares is (i.e., whether they are widely dispersed or concentrated).

In his recent study *Böhm* analysed the shareholdings of banks in the 100 largest industrial firms (measured by turnover). In 1986 12 credit institutions held participations in 22 of these firms.[42] The list shows that the holdings on own account have little relation to the blocks of shares voted by banks in the name of their clients. Second, the size of the holdings is not distributed equally; they rank from about 5 % (holdings of all banks in one firm) up to more than 50 % (holding of a single bank in one firm). Third, the holdings are rather stable over time. This impression is confirmed when we compare recent with older data.[43]

c) Interlocking directorates

aa) Influence on management, its decisions, its appointment and dismissal is not exercised directly by the shareholders but by the supervisory board. Therefore, seats on the supervisory board are crucial for every shareholder or institution that wants to have a say in corporate governance, obtain relevant information, etc. Banks influence or strengthen their influence on firms by appointing members to the supervisory board of the companies. One can find bank managers and other professionals on these boards who are appointed to multiple boards with the votes of the same institution, but such “informal” relationships between a bank and these professional supervisory board members are difficult to identify; however, interlocks with firms by board members of the bank must be disclosed.[44]

Members of the managing board or the supervisory board of a bank can be members of the supervisory board of a firm, be it as a consequence of the credit relationship. That does not mean that management does not also try to influence the selection of its supervisors to a certain extent. As mentioned earlier, the members of the supervisory board are - except of those elected by the employees - elected by the shareholders. A single person may not be a member of more than ten boards at the same time. This rule, however, does not restrain the institution which he or she represents. There is no rule in German law that prohibits Service on boards of competing firms. Direct cross-interlocks (the member of the supervisory board of Company A sitting on the management board of Company B and vice versa) are forbidden.

As mentioned above, the supervisory board appoints the members of the managing board and may dismiss them though only for cause. It is reponsible for monitoring the management, although practically it acts as an advisory committee rather than as a monitoring panel[45] except in times of financial distress of the firm. To accomplish its duties, the board has the right to receive comprehensive information. The management must report to it periodically on all important questions, and the supervisory board may always ask the management for reports. The supervisory board reviews the annual reports and balance sheets of the firm. The board may require management to obtain its prior approval before entering into certain important transactions, such as obtaining (or granting) loans above a specific amount. Board members must treat Company information confidentially.
The chair of the supervisory board has a particularly influential position.[46] He prepares the meetings of the board - which are less frequent than, for example, board meetings in the U.S.[47] - proposes the agenda, and stays in steady contact with the management. The management has to brief the chair immediately on all important occasions. If there is a stalemate in a vote on a board under a codetermination regime (a rare event), the chairman breaks the tie.

bb) Comprehensive data on personal links between firms and banks in Germany do not exist. Various studies have been done at different times in different sectors.[48]

Let us have another look at the list of the 100 largest firms which has been provided by *Böhm*.[49] 92 of these firms had a supervisory board (numbers as of 1986); banks were represented on 75 (= 81 %) of these boards. They held more than 10 % of all seats and more than 20 % of the seats of the shareholders' side of the board. On average they had more than 2 representatives on each board. The three Großbanken held more than 61 % of all banks' seats; the Deutsche Bank alone held 54 seats in 44 of these largest firms. The key position as president of the supervisory board was held by banks' representatives in 1986 in 20 of the 92 firms.

Although these numbers, which refer only to direct personal links between a bank and the large firms, do not give us the whole picture of the potential influence which can be exerted by banks through the supervisory boards, it is safe to say that there is a significant potential for banks to get information, give advice and monitor management in most of these large firms. But do banks really exert their influence and, if so, to what extent and with what results? If these questions cannot be answered satisfactorily, can we at least say something about the incentives and disincentives to monitor or behave in a way which might be advantageous for the bank, but disadvantageous for the other shareholders, among them the bank's clients?

2. Control, incentives and disincentives to monitor

a) "Control" can mean various grades on a scale that starts with the right of a shareholder or a bank to information, which in turn causes management to refrain from certain actions, and ends with the power to recall the incumbent management. In the following we consider (aa) control by means of better access to information; (bb) influence by giving advice to management on an ongoing basis; (cc) influence by appointing the members of the management board; and (dd) interim and ex post monitoring. There are certainly other ways for a bank to exert control, especially if it is also a lender to the firm (scrutinizing of the borrower before granting or extending a credit; monitoring during the credit relationship; pressure of the claim to fixed payments irrespective of the unsteady flow of returns to the borrowing firm; threat of bankruptcy), and these means are perhaps even more important for monitoring management than the instruments described here if one looks at the extent and importance of credit finance for German firms.[50] Although the means and devices available to a bank as a creditor do not stand in the center of our interest here, we also have to consider in the following the extent to which the bank's role as custodians is either reinforced or hampered by their other role as (major) creditors of the firm.

aa) *Information* about somebody may influence that person's behaviour if the person is aware of it. As mentioned above, the management board must report to the supervisory board on a continuing basis. Hence information about the firm and its management, so far as it is given to the supervisory board at all, is almost always immediately available to at least one bank on the supervisory board. Thus, information about the plans and the quality of the firm's management can be disclosed to these institutions without the need to make this information public - information which the banks perhaps would not get otherwise.

However, it is doubtful whether this argument is valid. Remember the rather infrequent meetings of the supervisory board. A poll of banks done by *Fischer* shows that a bank does not expect to get any better or more thorough information from its representatives on the board than it already has as the firm's creditor.[51] In addition, members of the supervisory board must keep confidential the information they get in that capacity.[52] Board members are normally well aware of this because the breach of this duty is a criminal offence.[53]

In all, it does not seem very likely that the information which a bank gets from its position on the supervisory board puts a tighter rein on management than would be the case without board membership.

bb) Bank representatives on supervisory boards have specialized knowledge, particularly in the field of finance. Very often they have an office back in their bank with special facilities, such as the help of an assistant, to support them in their work as a board member. The large banks have departments specialized in corporate finance, analyzing the financial markets as well as the financial needs of their client firms. This information, too, is available to the representatives of these banks. Thus, these representatives can provide the respective firms *with specialized advice, financial knowledge and informa tion.*

Banks may not be able to run industrial firms themselves, but from the activities of their representatives on supervisory boards they know the manager market quite well. They should at least be able, by the exercise of their stock voting rights, to appoint the right people to the supervisory board, which in turn can provide management with information and experience in other fields.[54] A poll done by Bleicher shows that nine of ten board members in his sample believe that the actual influence of their advice on management is "strong."[55] This belief, of course, does not mean that this is in fact the case, especially given the rather infrequent Sessions of the supervisory board, although there is some evidence that there are informal contacts between the board and management between the sessions.[56] Certainly one also must make a distinction between the chairman of the supervisory board and the members of certain subcommittees on the one hand, and the "regular" members on the other.

cc) Where advice cannot be given because of institutional impediments (infrequent Sessions, for instance), and where the supervisory board cannot monitor the management (see subsection (dd), below), the more important is the question of whether the supervisory board is capable of *sorting out managers from the beginning* who appear capable of doing a good job - because of the pattern of their behavior in the past, their career and previous success - even if their efforts cannot be observed on an ongoing basis. This seems, indeed, to be the most important task of the Supervisor-y board, and banks seem to play some role in this respect.

It has already been mentioned that the members of the management board are appointed by the supervisory board and that - in large German corporations - one half of the members of the supervisory board is elected by the shareholders. That means that in our sample[57] all banks together determine who sits on the shareholders' side of the supervisory board, even if there are no personal interlocks. Furthermore, if there is an open conflict between shareholders' and employees' representatives on the board, the shareholders could push their management candidate through, because of the tie-braking vote of the chairperson.[58] That means that banks have a decisive influence on who gets into the management boardroom even though the members of the supervisory board are legally independent and may - should a conflict arise - act independently. To the extent one bank dominates the shareholders' meeting, is represented on the nominating committee of the supervisory board or holds the position of chairperson, its influence will be greater accordingly.[59]

In their roles as creditors, shareholders, proxyholders and their representation on many supervisory boards, banks should know the market for managers quite well. Nevertheless, bankers' influence on the appointment of managers could be detrimental if only one institution, with perhaps doubtful knowledge about the firm's particular sector, had to decide. But that seems not to be the case. If we keep in mind that the three big banks often have similar voting holdings or that two of them can outweigh the other, that the members of the supervisory board are not bound to follow the instructions of the shareholders, and that the shareholders' representatives would think long and hard before they pushed a candidate through against the vote of the employees, then it becomes clear that a candidate for the management board has to pass several tests of qualification and approval and is not simply appointed by one dominating institution.

dd) With regard to monitoring management, it is useful to differentiate between interim and ex post monitoring.
Interim *monitoring* can occur especially in cases where the management must ask the supervisory board for its consent, like, for instance, if the management plans to shut down a plant, enter into a loan agreement and so forth. Another case where the supervisory board is likely to interfere is where the firm is in financial distress. Apart from these cases, "interim monitoring" activities seem to be limited.[60]

But the supervisory board may be able to measure the performance of the management by its results at the end of certain periods (i). If so, there may be incentive for management to perform well even if it is not monitored continuously, if management can be recalled in the case of disappointing results (ii). At first sight, *expost monitoring* in this sense does not seem to be directly related to the role that banks in particular have in corporate governance, and could theoretically occur without them. There is, however, a link between the ex post monitoring role of the supervisory board and the existence of depot institutions. It becomes evident when one considers the difference between a board system with outside directors on the board who are there because of the influence of the managing directors, the chairman or the CEO on one side and a two-tier system on the other where you have "outside" supervisory board members who are appointed by large influential institutions in the shareholder meetings rather than by the incumbent management. The readiness of the supervisory board members to act and, if necessary, even to dismiss or not to prolong the contracts of the members of the management board should be stronger because of the independence guaranteed through the existence and role of influential institutions in the shareholder meetings.

(i) How does the supervisoty board measure the Performance of the incumbent management? According to German law management must prepare and publish the firm's balance sheet and profit and loss Statement annually. Both are reviewed by independent public accountants who are responsible to the supervisory board and report to it. There are additional obligatory interim reports that are provided to the supervisory board only. The supervisory board can then put further questions to the management, compare the results of the firm with past results as well as with those of the firm's competitors (to the extent that such information can be obtained) and thus get at least a partial picture of the Performance or mistakes of the incumbent management as a whole and perhaps also of individual members of the management board. To the extent to which this information is disclosed to the internal supervisory board only and not to the capital market, this "institutional" Solution may have an advantage over the market if it also provides for appropriate reactions (see subsection (ii), below).

The Observation that this internal monitoring system relies very much on comparisons with previous results, plans and the results of the industry competitors hints at a limitation of such an internal monitoring system which will be examined later, in the context of and the comparison with, takeovers. A potential outside bidder may have information about, say, a new technology which the board of a specific firm does not have. Is "outside" governance by (hostile) takeovers which forces a firm to react to technological changes before the competitive process on the product markets will do so a necessary Supplement to an internal monitoring system which fails in such cases?[61]

(ii) Can boards react, and do they really react, if they observe bad Performance? If so, this can be anticipated by management and give it an incentive to try harder.

A member of the management board can be recalled only for cause before the expiration date of his or her term.[62] For this reason, as well as because of the attendant bad Publicity, such recalls occur only in cases of criminal offences, etc.
Practically, there is the more subtle threat of not renewing the contract after its expiration (a manager's term may not last longer than five years; at that point, the supervisory board must explicitly decide whether or not to renew it).[63] *Poensgen* and *Lukas* have published an interesting empirical study in which they show that there is significant involuntary "fluctuation" of management board members not only in cases of very serious problems or the financial distress of the firm,[64] but also in "lighter" cases in which the supervisory board was not content with the Performance of individual managers or with the management board as a whole.[65] To be sure, the fact that there is significant involuntary fluctuation does not by itself say anything about the monitoring "performance" of the supervisory boards. Did they react too late, did they dismiss the right people, on what signals did they react, and are there certain directions in which their incentives might drive management? This issue certainly deserves further research, and until such studies are made it seems difficult to maintain that one corporate governance system or the other shows better results and should be preferred.

To get closer to an answer to this question we also need to take into consideration the incentives and disincentives for institutions like banks for corporate control. The following sections try to address this.

b) Incentives for control

Why do banks get involved in corporate governance, act as proxy holders and hold positions on supervisory boards?

aa) Banks are compensated through *fees for their custodial Services.* But that alone does not explain why banks vote their own and their clients' stock, appoint their managers to the supervisory boards of other firms, and spend money to support their monitoring work. Banks could (as owners of stock) free-ride, and their customers could redeposit their stock with institutions that promised no monitoring but also no expenses.
As to the latter, such services are not offered in the market. Banks could easily drive such competing institutions out of the market by cross-subsidizing their depot business. Further, investment companies that are subsidiaries of banks will not try to dilute the position of their parent banks.

bb) There may be other incentives or advantages that accrue to banks from their governance activities. First, they can try to *protect their own equity investment.* As our overview has shown, banks hold, besides their position as proxy holders of their clients, equity stakes that rank from stakes as small as 1 % of a firm's stock up to more than 50 %.[66] The right to vote their clients' stock (at low additional costs) gives banks leverage to protect or strengthen their own investment without making capital infusion. For instance, if a bank holds an equity position of 12 % of a firm's stock and commands another 15 % through its clients' deposited shares, it has a blocking position against the issuance of new stock and the elimination of shareholders' preemptive rights[67] that it would not have as a 12 % owner alone.

cc) Secondly, banks can try to *protect their other (credit) investment in the firm.*
Creditors face the problem of "asymmetric information", both before the conclusion of a loan contract and thereafter. It is often argued that an equity stake of a bank in the borrowing firm will improve the information for the bank, and reduce the problem of asymmetric information.[68] That is doubtful. Typically, a shareholder will not receive earlier or better information than would a creditor bank (although, to be sure, a small creditor and a majority shareholder with immediate access to the management should not be compared). Even if the bank is represented on the firm's board, this will

normally not provide the bank with better or earlier information than it already has as creditor.[69]

If these positions do not provide the bank with better information, they may nonetheless help to exclude or minimize risks for the bank during the course of a credit relationship and thus lower the agency costs associated with debt.

There is no doubt that a bank can improve its position as creditor in certain aspects if it is equity owner or votes stock of the firm for its clients at the same time. A creditor commanding 51 % of the votes in the shareholders' meeting of this borrower can choose who manages the firm. Perhaps the creditor is not capable of electing the best managers, but at least they will choose people who implicitly promise not to harm the interests of the creditor by engaging in risky projects, distribution of assets to shareholders, etc., without the bank's approval. As the threshold at which the bank's own equity investment is able to command a majority will be normally too high, the addition of the depot shares of the bank's clients seems to be a perfect arrangement to get the necessary leverage on the management to protect the bank's own (equity as well as) credit investment. Certainly, this power usually has to be shared with other banks, but as creditors of the firm they have, at least to a large extent, parallel interests with regard to the management.

If this is so, we can expect that credit finance for these firms plays a more important role (in terms of availability and costs of credit finance as well as higher leverage) than it does for firms in an environment in which banks do not have a comparable Position, and, as mentioned above, this indeed seems to be the case[70].

dd) Another incentive for a bank to acquire and vote stock can be to Capture *all or at least a part of the firm's financial business.* In his study on "housebank relationships", however, *Fischer* concludes that exclusive relationships between banks and firms are rather the exception today. They still can be found between small firms and banks. But publicly-held corporations with widely distributed stock (which to a large extent is, as shown, voted by the banks) may have five to ten "primary" banking relationships and a number of additional connections to other banks.[71]

Regrettably, the study does not analyze the question whether there are syndicates rather than exclusive business relationships with a single bank, as has always been contended in the literature, especially for the fee-based business like underwriting,[72] and whether these syndicates reflect the shares of their members in the shareholders' meeting. Certainly, a management board will think long and hard before it chooses to give a considerable part of its financial business, such as raising capital through issuance of bonds or shares, to the competitors of those banks represented in its shareholders' meeting if the latter offer the same services on roughly the same conditions.

c) Disincentives

Are there also disincentives to banks in engaging in corporate control activities?

aa) A bank which is an institutional shareholder and offers other (financial) services at the same time could be eager *to* gef *into or keep up* a *business relationship* and therefore refrain from being a nuisance to management at least as long as things run comparably well.[73] This depends on questions that differ in each individual case: what position do the offering banks and other banks have regarding management and can management independently decide to prefer a competitor or an "outside" bank?

bb) Another disincentive could come from *implicit* management *coalitions.* The large banks themselves are generally corporations with widely distributed ownership.[74] That could lead to the same "sympathetic" understanding of how corporate governance should function, or even to certain "arrangements". The most simple way would be to have cross-interlocks (manager A sits on the supervisory board of Company B and vice versa). That, however, is forbidden.[75] In the past, banks have helped managements of other large firms, whose stock they vote, to protect their own and the other managers' interests against takeovers, by changing the Statutes of the respective corporations.[76] This may have been done to protect the banks' position as proxy holders and thereby the banks' own equity investments, or to protect or promote such banks' business relationships rather than to do the management of these firms a favour. But for whatever reasons, protection against hostile takeovers as a means of management control does not mean protection against control altogether if there are other "institutional" devices of control.

A last remark on disincentives to monitor should be made with respect to the banks themselves. As our statistics prove, managements of these banks can punish each other to a certain extent because they hold and vote roughly the similar amounts of proxies for voting shares in the other banks.[77] Hence there seems to be a strong disincentive at work in monitoring and controlling the other banks' managements. Instead of a control through this method and through the other monitoring devices mentioned earlier,[78] monitoring of bank management may occur through state supervision (i.e., the central bank and the banking supervisory authority) and the media.

3. Drawbacks

As we analyze institutions which represent small investors in shareholder meetings and on boards and act as corporate monitors in the shareholders' place, we should ask three questions: What are their incentives; are there conflicts of interests or other drawbacks, and how, in turn, are these institutions monitored themselves? So far I have only tried to describe the role of banks in corporate governance, their instruments, incentives, and disincentives. This may be accepted as a Substitute for the more precise measurements of their Performance which our economists still owe us. The following part will deal briefly with the question of whether there are drawbacks connected with this governance system (other than those already mentioned as possible disincentives). "Drawbacks" means disadvantages for the shareholders as well as for the respective firms. They may result from conflicts of interests on the part of the depot banks. Or there may be disadvantages for the shareholders that are clients of the depot banks if these institutions, which are thought to control management on behalf of their clients, remain uncontrolled themselves.

The following remarks on drawbacks will, however, not deal with the political debate. The role and "power" of German banks, especially the Großbanken, have been discussed for decades. This section also does not deal with the possible risks for the banks and their depositors (which is not presently an issue, and for which prudent regulation should be capable of providing),[79] the impacts on the German stock market, the question of the "equity capital shortage" of German firms,[80] the abuse of confidential information, the role of the banks in the concentration process,[81] or other antitrust questions - issues which normally dominate the discussion about bank-firm relationships.[82]

a) Large voting right holdings of a bank and its representation on the supervisory board may drive management into an *exclusive business relationship* with this bank. This can be advantageous to the firm (through the commitment of the bank as a source of finance and lowered risks because of better possibilities to monitor and control management and the resulting easier and cheaper access to credit finance).[83] On the other hand, such a Situation may be exploited by a controlling bank to the detriment of "its" firm. When we look at the distribution of votes among several institutions,[84] however, such an "exploitation" by one offeror does not seem very likely. Even if this were proved empirically, it would be difficult to weigh up the advantages and drawbacks of such "stable" business relationships.[85] - As there are several large banks represented in the general meetings, the question rather is whether these banks share at least a part of the respective firm's business. Such an oligopolistic behaviour is often contended in the literature for the fee-based underwriting and floating business.[86] As to the lending business, "exploitation" through the imposition of interest rates above the market price seems unlikely. Admittedly, asking for the market price may still be advantageous for banks which have better information or better means to monitor their borrower than an "outside" lender. To the extent to which a firm pays more than under competitive circumstances, these premiums can be considered to be agency fees paid by the shareholders to the bank for its Service of monitoring management.

b) Another charge in this context is that institutional proxy holders who are also creditors *may not support* a profitable, innovative (and - perhaps - more risky) policy aimed at *maximizing shareholder value.* Or, to put it differently, banks may influence investment decisions of the firm to protect an already existing credit relationship, and they may prefer projects which need (higher) external (credit) finance rather than preferring projects with a comparatively higher net present value for the firm (rather than the banks) and which are of greater benefit for the shareholders.[87] Banks may indeed have this preference if they are not themselves shareholders. And if the assertions of the managerialists are correct that corporate managers do not pursue profit maximization, but rather size or growth maximization,[88] then there seems to be an implicit agreement between managers and depot banks on a mutually favourable pattern at the expense of the shareholders.89 On the other hand, debt is always looked at as a device to discipline management.[90] So why should management yield to its alleged incentives for growth maximization with the help of credit finance? Here we simply need a more systematic analysis of the relation between the financing patterns of large firms and the underlying interests.

c) A related issue concerns the *dividend policy* of firms. Management may prefer to retain earnings rather than distribute them as they accrue since this provides a way to conceal fluctuations in future earnings and thereby to reduce management's accountability for losses. And retained earnings give management the means to achieve growth maximization without being monitored by outside financiers, even at the expense of the shareholders (i.e., through "free cash flow").[91] It is contended in the literature that banks support this restrictive dividend policy of managements either because they want to get at least a share of the firm's financial business[92] or - and that seems to be the main argument - in order to protect their credit investments.[93] On the other hand, retaining dividends means that managements become increasingly independent and "emancipated" from external finance the larger the internal funds grow. But perhaps banks tend to neglect this long-term development in order to protect their present interests. Furthermore, there are limits to the "emancipation" of managements because of the role which banks play in their function as proxies in shareholder meetings and on supervisory boards. Here again one would like to see more theoretical and empirical studies on this point, with reference to the tax and other cost issues which affect a firm's dividend policy.

d) Even if there is no abuse there is, as our summary has shown, certainly a potential for it because of conflicts of interests. There is a longstanding discussion about how abuse can effectively be avoided without destroying the advantage of having an institutional arrangement which overcomes shareholders passivity and serves as a professional monitor. It is not necessary to go into this discussion here in detail; suffice it to say that the existing rules and provisions against potential abuse seem not to be sufficient and could and should be amended.[94] Another problem which can only be mentioned here is how the efforts and the Performance of these institutions which monitor managements on behalf of small investors can themselves be measured and controlled. By installing an institution to solve the "principal-agent" problem on the level of the corporation, we get a new "principal-agent" problem on the level of the intermediary. Do we have similar problems (i.e., asymmetric information, collective action, etc.) on this second stage too, and how can these be solved?[95]

Although these questions concerning the monitoring Performance of the depot institutions as agents of the shareholders remain unanswered, in the following a first attempt is made to compare this institutional Solution with a market Solution, more specifically, with the threat of hostile takeovers. This threat has often been claimed in the literature to align adequately the interests of shareholders and managers, and to address the problem of managerial inefficiency. Would such a Solution avoid the problems which are connected with the institutional Solution, such as conflicts of interests, lack of control, etc.; would it even show better results, or are there other imperfections and drawbacks connected with this Solution? The following section will try to address these questions.

V. Market and Institutional Monitoring - a Comparison

A comparison between market and institutional monitoring Systems has to start with several caveats.

First, such a comparison is necessarily narrowsighted in that it picks out only one instrument from among several which are meant to cope with managerial inefficiency, self-dealing and related Problems, and which are meant to Supplement each other within a given legal System. If, for instance, the takeover market cannot deal with individual instances of management selfdealing but the institutional control of managers perhaps can, there may be, in a system which relies on market rather than on institutional control of managers, supplementary instruments available which may be even more capable of dealing with this specific problem.

Secondly, such a comparison is of limited value because the possible policy consequences seem to be very limited. Even if such a comparison could provide us with reliable results at this time and show us the advantages and disadvantages of both Systems, that would not necessarily mean that the other system could be adopted and implanted into a completely different environment. For example, since there are specific structural impediments to takeovers in German corporate law, as was shown earlier,[96] the threat of takeovers would presumably show different results than in a system which is more responsive to this incentive. On the other hand, it does not seem very likely that public policy and regulators in the Anglo-American countries would permit banks to play a role similar to that in Germany, even if banks had more and better incentives to monitor management on behalf of small shareholders than other institutions (such as pension funds).

Thirdly, the following comparison cannot deal with all aspects, all pros and cons of (hostile) takeovers on one hand[97] and the influence of banks on firms on the other.[98] The focus has to be and will be limited on the potential of these monitoring Systems for monitoring management efficiently.

1. Divergence of interests of shareholders and managers

A good starting point for a comparison is Professor *Eisenberg's* list of cases in which the interests of shareholders and managers diverge.[99] Eisenberg differentiates between "shirking," "traditional conflicts of interests" and "positional conflicts." If efforts of an agent cannot be observed, and his Performance not be controlled, he has no disincentive to work at a slack pace and to avoid the effort and discomfort involved in adapting to changed circumstances ("shirking"). "Traditional conflicts of interest" means the potential interest of agents in diverting the principal's assets to their own use through unfair self-dealing. The third potential divergence of interests are "positional conflicts": the interest of top corporate managers in maintaining and enhancing their position even at the shareholders' expense. Positional conflicts may occur in a great variety of ways: among other measures, managers can make it particularly difficult to monitor their performance, impose high barriers to their own removal, seek to increase corporate size or "free cash flow" in order to maximize their power, prestige and salary rather than to maximize the firm's value. How do both hostile takeovers and institutional monitoring through banks cope with these Problems?

a) To start with, neither device is aimed at prohibiting or lessening problems like shirking and self-dealings if these are problems at all. Most top managements will certainly refrain from *shirking* because their self-esteem is tied to work and accomplishment, and the selection process on the management market as well as the mutual control among agents[100] tends to exclude this pattern.

b) Also, most top managers will probably refrain from *unfair self-dealing* because they have internalized the rules of social morality.[101] The takeover market likely has very little impact on such traditional conflicts of interest. A hostile takeover bid does not succeed unless it includes a premium that is significantly above the market price.[102] A hostile bidder must also pay large fees to advisors such as lawyers, investment bankers and others. Hence, a takeover bid would not be economically justified if the bidder's only aim is to end unfair self-dealing by managers.[103] That means that other legal provisions must deal with this particular conflict of interest, and the same is true for a system which relies on institutions like banks rather than on takeovers as a monitoring device. If a supervisory board finds out about unfair self-dealing of management, that does not happen just because banks have representatives on the board.

c) Much more interesting are the effects of takeovers and institutional control on *positional conflicts.* It seems clear that takeover activity is, among several other factors like synergy gains etc., also motivated by the inefficiency of the target's management.[104] Here the first question is whether the "outside" bidder has information about the inefficiency of incumbent management, such as whether the stock price of a firm is lower than that of industry peers because of inefficient management. An "inside" monitor like a bank may have an informational advantage in this respect. The next question then is whether and under which circumstances an outside bidder and an inside institutional monitor will react when they observe inefficiency. Putting to the side for the moment other factors such as synergy gains, etc., the bidder will only act if a takeover and replacement of incumbent management will produce sufficient gains to justify the huge premium and out-of-pocket transaction costs required - something that does not seem very likely if management is not excessively inefficient.[105] An "inside" monitor who is represented on the supervisory board can act without incurring these costs. The problem here, however, is that an institutional monitor with personal business interests in the firm has incentive not to act in cases in which "inefficiency" of the management, such as seeking to increase corporate size or maximize cash and other resources at the disadvantage of the firm and its shareholders, is favourable to the monitor.[106] Hence it is not very likely that initiatives for restructuring, disposing of underperforming subsidiaries, or splitting up a conglomerate will come from banks' representatives as long as the firm is not in financial distress.[107]

2. Ex ante, interim and ex post monitoring

A further difference is remarkable. Institutional and market control by threat of hostile takeover differ also in that control by management replaces by way of a takeover is merely *expost control* whereas institutional control is not. To be sure, the idea of control by the threat of replacement is thought to give management incentive in advance to try harder. But it works differently from the ex *ante, interim* and ex *post monitoring* by an inside institutional monitor. Firstly, as *Eisenberg* has pointed out, the threat of takeover will not affect the behaviour of managers who do not realize they are inefficient, and do their best as they see it: they are already doing all they can.[108] Especially in such cases a system should be preferred which does not react only after the firm has incurred considerable losses. Identifying competent managers from the beginning, gathering information continuously and familiarity with the qualifications of management could avoid this.

3. Turnover vs. "relational" monitoring

The notion that the governance system which we are examining is based on a long-term relationship between a few depot institutions and the respective firms reveals another contrast to a system in which no "intermediaries" stand between management and institutional or private shareholders, shareholders who themselves are not active in corporate governance except by "voting with their feet," especially in the case of a takeover. Private shareholders, like institutional shareholders, may have short "shareholding horizons." That may be because they have to sell their shares, in the case of an individual, for purposes of private needs for liquidity or, in the case of, say, a pension fund, because it has to make disbursements to pensioners. Or shares may be sold because the investor or fund manager believes he has identified a mispriced share, or because the shareholder is offered a higher price than the actual market price by a bidder. Short shareholding horizons and a high turnover in a firm's shares make it difficult for the Company to establish meaningful relationships and two-way communications with its shareholders. Short term investments in a firm's stock do not only make it difficult for shareholders to influence a company's affairs, leaving the takeover mechanism as the major corrective device to align the interests of management with those of constantly changing shareholders. It may even lead to the question of extent to which shareholders who own stock only for a comparably short period of time should be given influence and say in corporate affairs at all by those who formulate the Charter, by-laws and applicable regulations of the corporation. In a system where proxies are given to "professional" institutions which remain the same over time irrespective of the turnover in the underlying shares, long-term relationships and two-way communications between management and such interested and responsive proxyholders can be established, and there may be more willingness to give more information and to concede more rights and influence to shareholders represented by such institutions. Of course, the question arises again of whether and to what extent such stable relationships between management and professional proxyholders with own business or equity interests in the firm are favourable or detrimental to the small investors because of the conflicts of interests or the lack of control in the relationship between these intermediaries and the shareholders, as mentioned above.

4. Long-term vs. short-term

How do managers behave in a system without stable long-term relationships with their shareholders and the threat of a hostile takeover above their heads? Do they, in order to satisfy the greediness of the investors and to keep the stock prices high, slash expenditures which pay off only in the long-term? That has frequently been contended in the literature as well as in the political debate, and Anglo-American scientists and policy-makers apparently become increasingly concerned about the short-term issue.[109]
Research and development expenditures of firms in various nations are compared, and specific institutional features like quarterly reports, interim dividends, or the investment policy of pension funds and other institutional investors are blamed for forcing managements to take short term views. Hostile takeovers are said to contribute to this, too. The plans of the EC Commission to abolish caps on shareholder voting rights and dual class voting ("Höchststimmrechte" and "Mehrfachstimmrechte") under the Fifth EC directive has been strongly opposed by German industry, especially on the grounds that (hostile) takeover activity would lead to short-termism and have negative impacts on resource allocation and the German economy as a whole. Is a bank-oriented corporate governance system (without hostile takeovers) advantageous in this respect?
As to hostile takeovers, the debate among economists seems to date to be unsettled. In one Version investors are short-sighted and behave myopically to sacrifice long-term benefits for immediate profits. As a consequence, firms that engage in long-term planning and make substantial investments in research and development (R & D) are supposedly undervalued by the market and become takeover targets. [110] *Shleifer* and *Vishny* have argued that the short time horizon of arbitrage investors, who focus on short-term assets because they are relatively less expensive to arbitrage, may result in market underpricing of a corporation's equity. This phenomenon in turn is said to impose a short time horizon on managers, who thus avoid long-term investments that depress share prices over the short term and make the corporation vulnerable to a hostile takeover.[111] *Stein* has developed a formal model in which the threat of takeovers encourages myopic behaviour on the part of managers. A central prediction of this model is that firms that construct

barriers to takeovers are able to increase profitable long-term investments such as research and development (R & D).[112] There is, however, empirical evidence that firms actually decrease R & D intensity after the introduction of shark repellents, thus failing to support this prediction. These findings suggest that takeover impediments may even reduce incentives to engage in long-term investments.[113] Furthermore, there is evidence that the market responds positively to announcements of increases in R & D and other capital investment expenditures[114] which, on the other hand, does not mean that there informational asymmetries between the markets and firms with respect to such expenditures may not still remain, such as instances where management does not want to communicate commercially sensitive information to the market. And it may well be that managers, in order to avoid undervalued stock which might lure hostile bidders, shift from profitable long-term investment to short-term projects - although this hardly seems to be a good defence against unwanted bids.[115]

As this debate cannot be continued from the outside, would it be possible at least to establish that the corporate governance structure in German large firms supports long-term views of management? Although to my knowledge there are no empirical data available with respect to these large firms, my guess certainly is that management in these firms are encouraged to maintain a focus on the long term: firstly, managers in these firms are usually elected for five years, and can be recalled prior to the expiration of their term only for cause.[116] Secondly, the equity holdings of banks as well as the amount of proxies which are given to them remain rather stable over time irrespective of the fact that the underlying stock is traded. That means that the monitoring institutions remain the same over time. Thus, long-term projects can be discussed and explained to them, and this discussion is a dialogue rather than merely giving a “Signal” to an anonymous market which will “mirror” it by pricing the firms value. On the other side, we must also take into account the incentives of banks as creditors. Banks might, as creditors, prefer projects which are comparatively less profitable.’ [17]

In short, there is no clearcut answer to our question as to whether the elements of the governance Systems discussed here favour rather than discourage long-term investments with higher net present values.

5. Adaptability to change

a) It has already been mentioned that in order to assess the efforts and results of the management an internal monitoring system must rely on a comparison of actual results with the results of the firm for former periods, the firm's plans and the results of the firm's competitors within the same industry. This hints at a limitation of such an internal monitoring system where "outside governance" may have an advantage: a potential outside bidder may have information about, say, a new technology which management and the supervisory board of a firm do not have and which is not yet in use within the industry. Is outside governance by (hostile) takeovers which forces a firm to adapt and react to technological changes a necessary Supplement to an internal monitoring system which fails in such cases?

In this respect one should differentiate between the mere dissemination of information on one side and the reluctance of the incumbent management and supervisory board on the other. Hostile takeovers are not necessary to disseminate new information about, e. g., new value - increasing technologies. Information can be sold to the firm or shared with it in other ways.

b) Management and the members of the supervisory board may, however, be reluctant to make changes that raise the market value of the firm even if the steps that have to be taken to raise the value are known. This may be because the required changes in a declining industry, such as layoffs, wage reductions, investment cutbacks, or divestitures, would harm the employees who are considered more important to the organization than shareholders or because members of the supervisory board fear the negative Publicity or problems with local authorities that would result from such unpopular decisions. In such cases, a hostile bidder could buy the firm and implement profit-increasing changes against the wishes of both the board and the top management of the target. More generally, takeovers could play a role in bringing about a necessary shift in a firm's policy and in replacing managers whom the supervisory board is unable or unwilling to force to take the necessary steps.

There is interesting empirical evidence especially for this role of hostile takeovers during the merger wave of the eighties in the U.S. *Morck, Shleifer* and *Vishny* examined the circumstances under which a company's poor Performance leads to an internal governance response - the incumbent board replacing management - as opposed to the external governance response of a hostile takeover. Tracking a sample of *454* of Fortune 500 companies over the period 1981 - **1985,** the authors concluded that an internal governance response is more likely when a Company performs poorly compared with industry competitors, but that hostile takeovers are predictable based on poor Performance of the entire industry. In cases in which whole industries (e. g., airlines, steel, or oil) were performing poorly corporate boards apparently were reluctant to take the necessary steps to increase the value of the firms by removing irresponsive managers. Instead, this function has been accomplished by hostile takeovers. Apparently takeover organizers have taken advantage of opportunities raised by the ineffectiveness of internal control devices. [118]

VI. **Concluding Remarks**

This overview and the thoughts expressed above may have shown that the German experience with its corporate governance system in large firms is both ambivalent enough and empirically unexplored to suggest great care in using it as a point of comparison for discussion of these issues or for making policy recommendations in other national contexts. It nevertheless seems safe to say that an institution-based or "relational" governance system and a market for corporate control focus on different problems for which the other system is less able to offer solutions. Hence they should be considered as supplementary rather than as mutually exclusive systems.[119] But this approach, which has also been adopted by the EC Commission in its proposals for a Fifth and Thirteenth Directive on Company law leads to new questions: can these two governance Systems really be combined, or will the development of a takeover market destroy the existing "relational" governance system or change it, and if so, with what results? The proposals of the EC Commission for the Fifth and Thirteenth Directives must be further discussed in this light.

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1 Cosh/Hughes/Singh (1990) p . . .

2 Unlimited partnership ("offene Handelsgesellschaft"); limited partnership ("Kommanditgesellschaft").

3 "Gesellschaft mit beschränkter Haftung" or "GmbH".

4 "Aktiengesellschaft".

5 Numbers as of Dec. 31, 1990: Gesellschaften mit beschränkter Haftung 433,731; Aktiengesellschaften and Kommanditgesellschaften auf Aktien 2,682. Source: Statistisches Bundesamt, oral information, and Statistisches Jahrbuch 1991 p. 141.

6 Source: Arbeitsgemeinschaft der Deutschen Wertpapierbörsen, Jahresbericht 1990, p. 157 (numbers of 1990); over-the-counter traded stock excluded).

7 More than 50 % widely held: about 80 companies; more than 75 % of stock widely held: 38 companies (Source: Saling, Aktienführer, 84. ed. 1991 [numbers as of Sept. 1990]; Commerzbank [ed.], Wer gehört zu wem?, A guide to capital links in German companies, 17. ed. 1991).

8 Cf. the list of the largest 100 firms (measured by their value-creating potential ["Wertschöpfung" = surplus or loss of the firm corrected by additional factors]) in: Bundestag-Drucksache 1 1/7582 pp. 176 ff. and the list of German firms and the structure of their ownership in: Commerzbank (ed.), Wer gehört zu wem (N. 7).

9 Cf. the detailed description by Conard (1984) and Meyer-Schatz (1988).

10 Cf. thereto Wiedemann (1980). Although the present codetermination laws came into force after the end of the Second World War, there is an older tradition of obligatory representation of employees on the supervisory boards.

11 In the German system employees are stakeholders in a firm not only in the regular and usual sense as Partners of long term (labour) contracts and relationships with the corporation but also because their pension capital is - unlike the practice in the Anglo-American countries - kept within the employing firm and serves as an important source of capital of the firm. "Codetermination" finds its legitimation in this specific structure.

12 Cf. IV. 1 .a), infra.

13 Cf. Hax (1990); Monatsberichte der Deutschen Bundesbank, Oct. 1991 pp. 22 seq. and N. 50, infra.

14 “Höchststimmrechte”; cf. Baums (1990).

15 In particular, changes of the Statutes mostly can be effected only if three quarters of the shares represented in the shareholder meeting agree irrespective of whether the present shares may not be voted because of a statutory cap on voting rights.

16 Lüttmann (1992) p. 158, 159.

17 Most recently thereto Landgericht Aachen in the ABM - AGF case; the suit of the French AGF to get its shares registered was dismissed (19.5.1992 Der Betrieb 1992, 1564).

18 Cf. Herdt (1991); Sünner (1991) pp. 469-475.

19 The following description is a slightly changed version of my article in 40 AmJCompL issue 3 (1992).

20 Cf. Table I (Appendix).

21 See c), infra.

22 See b), infra.

23 German banks may own investment companies and do so to a large extent. Data in Gottschalk (1988) p. 295, 296; data on the engagement of investment funds in corporate stock most recently in Mühlbradt (1992). Other than for banks (cf. N. 37, 38, infra), there is a 10 % ceiling on shares of a portfolio firm for investment companies (Gesetz über Kapitalanlagegesellschaften, § 8 a). Investment companies have to vote the shares in their portfolio personally and may not give a general proxy to another person or institution (Gesetz über Kapitalanlagegesellschaften, § 10 I). This Provision does not exclude, however, that an investment Company and its parent Company bank agree to vote in the same sense.

24 Only in 2-3 % of all cases; Immenga (1978) p. 103; Gottschalk (1988) p. 296.

25 Especially the large banks which act as proxyholders are (or until recently were) corporations with widely held shares themselves.

26 Cf. §§ 128, 135 Aktiengesetz (Stock Corporation Act).

27 Monopolkommission, Zweites Hauptgutachten 1976/77, Fortschreitende Konzentration bei Großunternehmen (1978) pp. 283 sqq.; Bericht der Studienkommission “Grundsatzfragen der Kreditwirtschaft (1979) pp. 111 seq. This commission concluded that in 1974/75 in 74 stock-exchange listed companies (with a nominal capital of at least DM 50 millions) 52,5 % of the present shares were voted by banks or investment companies as proxy holders and another 10,2 % as owners, Report p. 290-291.

28 Gottschalk (1988).

29 Böhm (1992).

30 Measured by their "Wertschöpfung" (= surplus or loss of the firm corrected by additional factors). The contribution of the largest 10 to the "Wertschöpfung" of all firms in the national economy was about 8 % in 1986.

31 Böhm (1992) p. 242.

32 Cf. N. 14, supra.

33 This corresponds with the data of the Bundesbank according to which by the end of 1988 the three Großbanken held 43 % of all depot shares in their custody; Die Aktiengesellschaft, AG-Report, p. 412 (1989).

34 See Table I in the appendix.

35 Cf., e.g., Immenga (1978) p. 103-104; Gottschalk (1988) p. 300.

36 Bericht der Studienkommission . . . (N. 27) p. 171.

37 §§ 13 (4), 19 (1) Nr. 6 Kreditwesengesetz (Banking Act).

38 § 12 Kreditwesengesetz.

39 Amtsblatt der EG Nr. L 386 (Dec. 30, 1989) Art. 12.

40 Korn. (91) 68 endg. (23/4/1991).

41 Source: Deutsche Bundesbank, written testimony for the hearing before the Committee for Economy of the Federal Parliament (Bundestagsausschuß für Wirtschaft. Anhörung vom 16. Mai 1990) of April 16, 1990 p. 9.

42 Cf. Table II (appendix).

43 Böhm (1992) pp. 231-238.

44 § 128 (2) (5) Aktiengesetz (Stock corporation Act).

45 Cf. in more detail 2., infra.

46 That corresponds with the self-assessment of their Position; Bleicher (1987) p. 58.

47 3-4 times per year; cf. Bleicher/Paul (1986) p. 273; Bleicher (1987) p. 41.

48 Cf. Bericht der Studienkommission (N. 27) pp. 122-126 and the tables on pp. 440-445 and on pp. 585-598; Immenga (1978) pp. 109-109; Informationen des Bundesverbandes deutscher Banken, Zur Diskussion um die "Macht der Banken" (1989) p. 20; Gottschalk

(1988) pp. 299 seq.; survey in Fischer (1990) pp. 148-149 with further references.

49 Böhm (1992) pp. 194-196 and pp. 257-263.

50 Banker's credits (of German banks) made up for (at least) 32 % of the balance sheet total of German firms in, 1987 (Source: Monatsbericht der Deutschen Bundesbank 1/1989 pp. 20, 22). Neuberger/Neumann (1991) even report an average of 40 % as compared to about 9 % in the U.S. and U.K., whereas C. Mayer (1990) p. 313 comes to other conclusions: "Rather strikingly, then, there is no support from these figures for the commonly held view that German banks contribute a substantial amount to the financing of their industry". (Note that these numbers cover all firms, not only our Sample).

51 Fischer (1990) pp. 80-81, 149; cf. also Poensgen (1980).

52 §§ 116, 93 (1) Aktiengesetz (Stock Corporation Act).

53 § 404 Aktiengesetz.

54 For empirical data on the composition of the supervisory board cf., e.g., the study of Gerum/Steinmann/Fees (1987).

55 Bleicher (1987) p. 57.

56 Bleicher (1987) pp. 54 sqq.

57 Cf. Table I, Appendix.

58 Cf. § 32 Mitbestimmungsgesetz (Codetermination Act).

59 On the role of the nominating committee (Vorstandsausschuss) and the nominating process, e. g., Brinkmann-Herz (1972).

60 Cf. Brinkmann-Herz (1972) pp. 81, 82.

61 Cf. V.5., infra.

62 § 84 (3) Aktiengesetz (Stock Corporation Act).

63 § 84 (1) Aktiengesetz.

64 Poensgen/Lukas (1982) pp. 187, 188.

65 Cf. same, pp. 183, 184, 188, 190.

66 Appendix Table II.

67 Cf. § 186 (3) Aktiengesetz (Stock Corporation Act).

68 Cable (1985); Pozdena (1987); (1990 a; b); McCauley/Zimmer (1989); Berglöf (1990).

69 Cf. N. 50 and accompanying text.

70 Cf. N. 450.

71 Fischer (1990) pp. 21-22; 102-103. Fischer looked at the credit relationships between banks and firms only. If the same is true for other Services, especially underwriting and floating new shares, is not clear.

72 Cf., e. g., Böhm (1992) pp. 154-155 with further references.

73 Cf. Böhm (1992) pp. 138-141.

74 Cf. Commerzbank (ed.), Wer gehört zu wem, A guide to capital links in German companies, 17. ed. 1991.

75 § 100 (2) (3.) Aktiengesetz (Stock Corporation Act).

76 See N. 14, supra, and accompanying text.

77 Appendix, table I.

78 Cf. p. [8], supra.

79 Overview and discussion in Baums (1992, 1992 a).

80 Cf. Hax (1990).

81 Cf. Eckstein (1980).

82 See most recently Böhm (1992).

83 Cf. the interesting study of Fischer (1990).

84 See Appendix, table I.

85 Cf. - for the credit relationship - Hellwig pp. 55 seq.

86 Cf. N. 72.

87 Böhm (1992) pp. 142,144.

88 Cf. Klein/Coffee (1990) pp. 161, 162 with further references.

89 Cf. Böhm (1992) pp. 142, 144.

90 See, e. g., Jensen (1989) p. 660.

91 Cf. Jensen, op. cit., p. 659.

92 Böhm (1992) pp. 139, 140.

93 Immenga (1978) p. 121; Böhm (1992) pp. 143, 144, 149 with further references.

94 Cf. the overviews in Körber (1989); Böhm (1992) pp. 157-167 and pp. 211-221; Köndgen (forthcoming).

95 For references on the theoretical discussion of the value of having agents watching other agents and how to solve the "control of controllers" problem, see Black (1992).

96 See III.1., supra.

97 A thorough overview has been given recently by Romano (1992).

98 Most recently thereto Böhm (1992).

99 Eisenberg (1989) pp. 1471-1474.

100 Cf. Varian (1990).

101 See also Eisenberg (1989) p. 1473.

102 Jensen (1988) pp. 22, 28.

103 Eisenberg (1989) p. 1498.

104 Jensen (1988) p. 28; a recent thorough overview is given by Romano (1992).

105 Eisenberg (1989) p. 1497; evidence on management turnovers after takeovers in Romano (1992) pp. 129, 130.

106 Cf. the discussion under IV., 2.c., supra.

107 Cf. also 5., infra.

108 Eisenberg (1989) p. 1498.

109 See the report in The Economist June 27, 1992, pp. 77-78.

110 Cf. Lipton/Rosenblum (1991) pp. 208-209 and pp. 213-214 with further references.

111 Shleifer/Vishny (1990).

112 Stein (1988).

113 Meulbroek et al. (1990); see also Gordon/Pound (1991); Romano (1992) p. 145 with further references.

114 Han/Martin/Kensinger (1990); see also Jensen (1988) pp. 26-27 and Marsh (1990) with further references.

115 Cf. Marsh (1990) p. 46.

116 See N. 62.

117 See IV.3.b), supra.

118 Morck/Shleifer/Vishny (1989).

119 Cf. also Gilson (1992).

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Appendix

Table I

Voting blocks of the banks at the shareholder meetings of the 100 largest firms in 1986*

Rank of Company in 1984		% of shares present at the meeting	% of shares voted by Deutsche Bank	Dresdner Bank	Commerz-bank	All 3 big banks	All banks
1	Siemens	60,64	17,84	10,74	4,14	32,52	79,83
2	Daimler Benz	81,02	41,80	18,78	1,07	61,66	69,34
	Mercedes-Holding	67,20	11,85	13,66	12,24	37,75	57,35
3	Volkswagen	50,13	2,94	3,70	1,33	7,98	19,53
5	Bayer	53,18	30,82	16,91	6,77	54,50	95,78
6	BASF	55,40	28,07	17,43	6,18	51,68	96,64
7	Hoechst	57,73	14,97	1692	31,60	63,48	98,34
9	VEBA	50,24	19,99	23,08	585	4792	98,18
11	Thyssen	68,48	9,24	11,45	11,93	32,62	53,11
12	Deutsche Bank	55,10	47,17	9,15	4,04	60,36	97,23
13	Mannesmann	50,63	20,49	20,33	9,71	50,53	95,40
18	M.A.N. (GHH)	64,10	6,97	9,48	13,72	30,17	52,85
21	Dresdner Bank	56,79	13,39	47,08	3,57	64,04	98,16
27	Allianz-Holding	66,20	9,91	11,14	2,35	23,41	60,08
28	Karstadt	77,60	37,03	8,81	33,02	78,86	87,27
29	Hoesch	45,39	15,31	15,63	16,73	47,67	92,39
34	Commerzbank	50,50	1630	9,92	34,58	60,81	96,77
35	Kaufhof	66,70	629	13,33	37,18	56,80	98,45
36	Klöckner-Werke	69,13	1730	3,78	3,55	24,63	53,00
37	KHD	72,40	44,22	3,82	1,50	49,54	6529
41	Metallg'schaft	90,55	16,42	48,85	0,35	65,62	75,95
44	Preussag	69,58	11,15	5,60	259	19,34	99,68
51	Degussa	70,94	688	33,03	1,89	41,79	67,09
52	Bayr.Vereinsbank	62,40	11,42	2,71	3,59	17,72	68,69
56	Continental	35,29	22,77	9,99	6,04	38,81	95,55
57	Bayr. Hypobank	67,90	586	7,05	1,20	14,11	92,09
59	Deutsche Babcock	67,13	7,58	9,67	529	22,54	97,01
67	Schering	46,60	2386	17,46	10,17	51,50	99,08
68	Linde	52,99	22,76	15,73	21,36	59,87	90,37
73	Ph. Holzmann	82,18	55,42	0,91	6,49	62,82	74,81
94	Strabag	83,02	6,80	19,15	1,37	27,32	95,24
96	Bergmann	99,12	3689	-		36,89	62,15
98	Hapag-Uoyd	84,50	48,15	47,82	0,39	96,36	99,50
on average		64,49	21,09	15,30	9,05	45,44	82,67

* Source: Gottschalk (1988) p. 298. The numbers for Siemens, Veba and Continental refer to the 1987 meeting. The list adds up the shares of banks held by them on own account, their proxy hddings and the shares held by investment companies which are subsidiaries of the respective banks.

Table II

(Source: Böhm [1992] p. 225, 226)

Stockholdings of banks
in the 100 largest industrial firms in 1986
(% of nominal capital)

Nr.	Rank (size of turnover)	Company	Nominal capital (Mill.DM)	Deutsche Bank	Dresdner Bank	Commerz-bank	Other banks	All banks together
1	1	Daimler Benz AG	2.116	28,5	1,6	1,6	3,2	34,9
2	8	Thyssen AG	1.565			> 5		> 5
3	12	Klöckner Werke AG	469,3	7,2	3,2	3,2	16,4	30
4	14	BMW AG	750		5-10			5-10
5	19	Metall-ges. AG	280	11,25	16,5		0,56	28,3
6	21	MAN AG	674,5			> 8,25		> 8,25
7	26	AEG AG	931,2	16	0,9	0,9	1,8	19,6
8	27	Degussa AG	284		>10			>10
9	32	Preussag AG	401,6				43	43
10	37	Ph. Holz-mann AG	90	35		7,55		42,55
11	41	VEW AG	1.000	6,3			10,46	16,76
12	43	MBB GmbH	600		5-10	> 0,3	5,0	10-15
13	46	Hochtief AG	200			>16,25	>25	>41,25
14	47	Dt. Babcock	250				> 5	> 5
15	49	Conti-nental AG	312,1	>10				>10
16	54	AGIV	80				44	44
17	58	Linde AG	237,7			>10		>10
18	80	Strabag AG	55,1				>50	>50
19	81	PWA AG	200				44	44
20	83	Bilf. u. Berger AG	70		>25			>25
21	91	Fichtel u. Sachs	128			35		35
22	99	Dyckerhoff u. Widmann AG	57	6,72		1,45	13	21,17