The Structure of the Board of Directors: Boards and Governance Strategies in the US, the UK and Germany

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Abstract

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1. Board models like the one-tier board, as used in the US and the UK, or the two-tier board, as used in Germany, provide a basic governance structure that enables the use of specific governance strategies. It is the use of specific governance strategies, not the choice of a board model, which determines the role of the board in alleviating agency problems between owners and managers, controlling and non-controlling shareholders, and shareholder and stakeholder constituencies. Based on this finding, the choice of the suitable board model should be left to private parties.
2. The market for corporate control is known as a removal strategy that alleviates the agency problem between owners and managers of potential target companies. To achieve this effect, it must be ensured that takeover defenses are adopted in the interest of shareholders rather than as a means to shield the incumbent board from removal by the acquirer. The governance options include focusing the board structure through the allocation of decision-making power to independent directors (US) or to the supervisory board (Germany), and, as an alternative, reinstalling shareholder decision-making and thus removing the board from its coordination task (UK). Counter-intuitively, one might group US and German law together, despite differences in their basic board structures and despite the European Union's adoption of UK-style control shift regulation.
3. The three sample jurisdictions follow a similar pattern for securing fairness of related party transactions (RPTs). The UK relies on a structuring of the shareholder body, requiring ex-ante approval of the disinterested shareholders (MOM approval), a strategy that is also used in France but in a weaker form due to the possibility of ex-post authorization. In the US, the predominant choice seems to be structuring the board so as to leave the decision to independent directors, a strategy that Italy has, on one hand, sought to enhance with the obligatory involvement of a minority appointed director but, on the other hand, has weakened by allowing the board to override a recommendation of the independent directors. Germany also relies on board structuring in that it requires supervisory board approval of RPTs, but compared to the use of independent directors, the cooperation between the two boards provides a basis for manager-friendly results one would expect only from a jurisdiction that openly promotes board empowerment.
4. The most far-reaching advance of the corporate purpose debate relates to a further structuring of the board so as to provide employee representatives with a voice, as known from German co-determination. Proposals to reallocate a proportion of the appointment rights from shareholders to employees have not found their way into legal reform in the US or the UK. Out of the governance strategies discussed in this chapter, it is only employee co-determination that calls for a basic governance structure which solely a two-tier board model can provide.

Keywords: board models, corporate governance law, corporate purpose, directors' duties, director independence, related party transactions, shareholder approval, takeover law, employee co-determination.

JEL Classifications: G18, G30, G34, G38, K22

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***Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy,* European Company and Financial Law Review (ECFR) 2004, 135-168; also in VOC 1602-2004 – 400 YEARS OF COMPANY LAW (Ella Gepken-Jager, Gerard van Solinge & Levinus Timmerman eds., 2005), at 281-316; in Chinese: Company and Securities Law Review (Beijing, China) 1 (2005) 217-245 (translation: Ding Ding); European Corporate Governance Institute (ECGI), Law Working Paper No. 18/2004; SSRN: http://ssrn.com/abstract=487944.

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1. Introduction

The board of directors is the nucleus of internal corporate governance. The internationally predominant board model, as known from the US or the UK, reveals a one-tier structure. One-tier boards of large business corporations tend to comprise a considerable number of non-executive directors, often a majority or even a supermajority. In a two-tier structure, as found in continental European countries like Germany, non-executive directors are members of the supervisory board, while the management board is composed of executive directors. Thus, the two-tier model provides for a structural division of management and monitoring, while one-tier boards achieve such division through the appointment of non-executive directors and their membership on specific board committees.

This chapter continues our research on "Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy."[1] Some countries such as Germany oblige stock corporations by law to set up a supervisory board, while other countries allow for flexibility in board structuring.[2] In 2001, the EU introduced the Societas Europaea (European Stock Corporation) as a genuine supra-national corporate form. Businesses that incorporate as Societas Europaea are free to choose between the one-tier and two-tier board model. Around the same time, flexibility in board structures became a focus of legal reform in France and Italy, partly in addition to preexisting board model

[1] Klaus J. Hopt & Patrick C. Leyens, *Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France and Italy*, 1 EUR. COMPANY & FIN. L. REV. 135–68 (2004); also in VOC 1602-2004 – 400 YEARS OF COMPANY LAW 281–316 (Ella Gepken-Jager, Gerard van Solinge & Levinus Timmerman eds., 2005); in Chinese: 1 Company and Securities Law Review (Beijing, China) 217–45 (2005) (translation: Ding Ding); European Corporate Governance Institute (ECGI), Law Working Paper No. 18/2004; SSRN: http://ssrn.com/abstract=487944.

[2] Paul L. Davies & Klaus J. Hopt, *Corporate Boards in Europe – Accountability and Convergence*, 61 AM. J. COMP. L. 301 (2013).

choices.[3] As of today, board model choices have been made available in roughly half of the EU Member States.[4]

In our earlier research, we advanced a plea for more flexibility and leaving the choice of the suitable board model to private parties.[5] Our present chapter supports this plea. It shows that a board model only provides a basic structure to enable the use of specific corporate governance strategies. It is the use of these specific strategies, not the preexisting use of a board model, that determines the governance of agency relations between owners and managers, controlling and non-controlling shareholders, and shareholder and stakeholder constituencies. The most relevant strategies in this context relate to the well-known pairs of initiation or veto, and reward or trusteeship.[6] By using these strategies, the basic structure, as provided by a board model, is converted into a specific allocation of control rights. Under this allocation, the initiation of business decisions is often left to the board, while shareholders have a veto right with regard to some matters. Differentiated versions of the decision rights strategy or the trusteeship strategy aim to refine this initial allocation by further structuring the decision-making body.[7] The right of shareholders to veto a transaction can be entrusted to all shareholders, or only to those who are disinterested in the transaction at stake. Further, the trusteeship strategy can be employed to allocate control over specific matters to independent board members as a fraction of directors, thus excluding non-independent members from decision-making.

Throughout the chapter, we explore board structures with a view to the basic structure of the board, i.e. one-tier or two-tier. We show that techniques of structuring the

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[3] For a country-by-country analysis, *see* PAUL DAVIES, KLAUS J. HOPT, RICHARD NOWAK & GERARD VAN SOLINGE (EDS.), CORPORATE BOARDS IN EUROPEAN LAW: A COMPARATIVE ANALYSIS (2013).

[4] Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 23 (2011). For the country reports cited therein, *see* COMPARATIVE CORPORATE GOVERNANCE, A FUNCTIONAL AND INTERNATIONAL ANALYSIS (Andreas M. Fleckner & Klaus J. Hopt eds., 2013).

[5] Hopt & Leyens, *supra* note 1, at 163.

[6] John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 29, 32 (Reinier Kraakman et al. eds., 3d ed. 2017).

[7] PAUL DAVIES, INTRODUCTION TO COMPANY LAW 143, 145 (3d ed. 2020).

decision-making body can be employed, independent of the board model. The chapter focuses on boards of large business corporations with a stock exchange listing to secure cross-country comparability. Our three sample jurisdictions are the US,[8] the UK and Germany. France and Italy will be considered to round out the discussion of selected issues. In Section 2, we explore takeover defenses to explain basic board structures and techniques for structuring the board vis-à-vis excluding the board from decision making. Section 3 turns to related party transactions and shows how structuring either the board or the shareholder body can contribute to minority shareholder protection. In Section 4, we look at stakeholder constituencies, especially the allocation of decision rights to employees, with a view to exemplify a strategy that will prompt private parties to choose a two-tier board and whose statutory prescription limits board model choices. Section 5 sums up.

2. Boards and Markets: Control over Takeover Defenses

The board of directors operates within a system of corporate governance.[9] Governance systems can be roughly grouped according to whether the operation of the company by the board is determined by market forces (outsider control), or by mechanisms within the corporation and by its networks (insider control).[10] Given the traditionally greater extent of dispersed ownership in the US and UK, the governance systems of those countries serve as examples of powerful outsider control.[11] Conversely, the more concentrated ownership patterns in continental Europe, historically including Germany, imply a strong impact of insider control.[12] These differences influence

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[8] We focus on Delaware law unless otherwise specified.

[9] Ronald J. Gilson, *From Corporate Law to Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 3 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

[10] Reinhard H. Schmidt & Marc Tyrell, *Information Theory and the Role of Intermediaries in Corporate Governance*, *in* CORPORATE GOVERNANCE IN CONTEXT 481, 489 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda, & Harald Baum eds., 2005).

[11] Gur Aminadav & Elias Papaioannou, *Corporate Control around the World,* 75 J. FIN. 1191, 1211 (2020).

[12] On the change of ownership structures around the new millennium, *see infra* section 2.3 and notes 45 et seq. For accounts of the traditional structures, *cf.* Marco Becht & Ekkehart Böhmer, *Ownership*

the way the board of directors provides a basic structure for the operation of internal corporate governance vis-à-vis external market forces. In this section, we will look at the market for corporate control. As we will see, the role of the board is not determined by its basic structure, but by the allocation of decision rights with regard to defensive measures against hostile takeover bids.

2.1 Director Empowerment (US)

In the US, it is widely accepted that a functioning market for corporate control can serve as a highly effective corporate governance mechanism.[13] Directors who wish to retain their position are well advised to keep the stock price high in order to make hostile bids less likely, if not impossible. The market for corporate control thus serves as a removal strategy that aligns the interests of manager agents to those of shareholder principals.[14] Takeovers, however, are also a source of specific agency problems, which differ from those of other fundamental changes like mergers.[15] A takeover is executed via the market. This means that, to be effected, a takeover does not require consent of the general meeting. Instead, its success depends on whether a sufficient number of shareholders tender their shares. For a controlling shareholder, this setting does not materially differ from an ordinary sale transaction. Non-controlling shareholders, in contrast, are at risk of ending up as a minority that is vulnerable to exploitation by the successful acquirer. Accordingly, they face a pressure to tender, independent of whether the consideration offered by the bidder is fair or unfair.[16]

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and Voting Power in Germany, *in* THE CONTROL OF CORPORATE EUROPE 128 (Fabrizio Barca & Marco Becht eds., 2001); Reinhard H Schmidt, *Corporate Governance in Germany: An Economic Perspective*, *in* THE GERMAN FINANCIAL SYSTEM 386 (Jan Pieter Krahnen & Reinhard H. Schmidt eds., 2004).

[13] JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 10, 118 (2008) ("historically, the most effective corporate governance mechanism").

[14] Armour, Hansmann & Kraakman, *supra* note 6, at 37.

[15] Paul Davies, Klaus Hopt & Wolf-Georg Ringe, *Control Transactions*, *in* ANATOMY OF CORPORATE LAW, *supra* note 6, at 205, 207.

[16] Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911 (1987).

US corporate law seeks to solve the coordination problem of non-controlling shareholders by vesting the board with the power to negotiate favorable tender terms.[17] At the point a sale of a corporation is imminent, under the Revlon doctrine, the role of the board directors transforms from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders".[18] Their fiduciary duties shift from long-term corporate interest to short-term shareholder interest and the business judgment rule will be replaced with an enhanced scrutiny standard for judicial review. US boards, however, are not limited to the role of a passive auctioneer. They must actively take defensive measures to frustrate a bid if they reasonably think the tender terms are unfavorable.[19] It follows that, although the shareholders of the target company are the actual parties to the dealings, the board of directors of the target company takes control over the success of the takeover (director primacy).[20]

It is precisely this disjunction that explains, as we will explore further below, why some countries like the UK adopt specific control shift regulation to overcome imminent agency problems in takeovers.[21] Absent such regulation in the US, those problems must be dealt with by general corporate law. It is obvious that the power of the board to frustrate a bid comes at the risk of directors taking defensive measures to serve their own positional interests rather than those of shareholders. US courts react to this danger, since the landmark decision in Unocal,[22] by enhanced judicial scrutiny

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[17] Ronald J. Gilson & Alan Schwartz, *An Efficiency Analysis of Defensive Tactics*, 11 HARV. BUS. L. REV. (forthcoming 2020).

[18] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

[19] Emiliano M. Catan & Marcel Kahan, *The Law and Finance of Antitakeover Statutes*, 68 STAN. L. REV. 629, 637 (2016).

[20] Stephen M. Bainbridge, *Director Primacy*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 17 (Claire A. Hill & Brett H. McDonnell eds., 2012); STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 17 (2008).

[21] Afra Afsharipour, *Corporate Governance in Negotiated Takeovers: The Changing Comparative Landscape*, *in* RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE (Afra Afsharipour & Martin Gelter eds., 2021); Davies, Hopt & Ringe, *supra* note 15, at 211, 227; Matteo Gatti, *The Power to Decide on Takeovers: Directors or Shareholders, What Difference Does It Make?*, 20 FORDHAM J. CORP. FIN. L. 73 (2014).

[22] Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

of defensive measures.[23] To escape liability, directors must satisfy a fairness standard that in effect, under current case law, requires support of the decision by a majority of independent directors.

It follows that US law uses a technique of board structuring to channel the impact of the takeover market as a removal strategy. By requiring approval of independent directors, the law entrusts decision rights to a fraction of the members of the board. We will explore details of director independence with a view to minority shareholder protection in Section 3.[24] Generally, director independence is a governance strategy that builds on trusteeship. Trusteeship can be employed equally well in a one-tier board and two-tier board to focus board structuring. Thus, the independence requirement goes beyond a basic structural division of the management and the supervisory task, which is characteristic for the two-tier board.

Anecdotal evidence taken from the US Airgas case may help in understanding the difference between the basic structure, as provided by a board model, and techniques of structuring the board as a decision maker by using the trusteeship strategy.[25] In Airgas, the acquirer initiated a proxy fight that allowed her to install three new independent directors on the board. Upon taking independent advice, the new directors shared the view of the other directors that the acquirer's bid undervalued Airgas. The fact that the new directors served as non-executive directors does not explain why they felt prepared to oppose the acquirer to whom they owed their office. Similarly, the division of tasks between two boards will secure disinterested decision-making only if combined with governance strategies that specifically aim to foster an independent review of a takeover bid or any other business matter.

2.2 Shareholder Decision-Making (UK)

In the UK, it is well accepted, like in the US, that a functioning market for corporate control serves as a mechanism of aligning the interests of incumbent management to

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[23] Davies, Hopt & Ringe, *supra* note 15, at 211, 218; Afra Afsharipour & J. Travis Laster, *Enhanced Scrutiny on the Buy-Side*, 53 GEO. L. REV. 443, 458 (2019).

[24] *See infra* section 0.0.

[25] Air Products and Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

those of dispersed shareholders.[26] Contrary to the general corporate law approach chosen in the US, since 1968 the UK City Code on Takeovers and Mergers has provided a set of specific control shift rules.[27] The first of the two main components of the rules relates to the acquirer's obligation to launch a bid to all shareholders upon crossing the control threshold of 30 percent (mandatory bid), thus providing shareholders with an exit option at an early stage. The second relates to the duty of the target board to refrain from taking any measure that could frustrate the success of the bid (no-frustration rule).[28] While US law empowers the board of directors to serve as agents for shareholders, the UK no-frustration rule removes the board from decision-making by reinstalling shareholder decision-making over defensive measures (shareholder primacy).[29]

The no-frustration rule is thought to preclude directors from taking self-interested defensive measures. Removing directors from decision-making, however, deviates from the principle of delegated management, which counts as a core prerequisite for the functioning of a large business corporation.[30] The essential rationale of delegated management lies in enabling corporate decisions independent from the shareholder structure of the company and from changes in the shareholder base. Where shareholders are dispersed, delegated decision-making by the board mitigates the collective action problem pertaining to large groups. With a view to takeover defenses, the board of directors can be understood as an institution to save coordination costs between non-controlling shareholders. These costs re-emerge when the board is removed from its coordination tasks.

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[26] Paul Davies, *Control Shifts via Share Acquisition Contracts with Shareholders*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 9, at 532.

[27] PANEL ON TAKEOVERS AND MERGERS, CITY CODE ON TAKEOVERS AND MERGERS (12th ed. 2016).

[28] *Id.* at r. 9 and 21.

[29] Klaus J. Hopt, *Takeover Defenses in Europe: A Comparative, Theoretical and Policy Analysis,* 20 COLUM. J. EUR. L. 249, 254 (2014) (taking the clear position for the UK model and against the approaches taken by the US and Germany).

[30] John Armour, Henry Hansmann, Reinier Kraakman & Mariana Pargendler, *What is Corporate Law?*, *in* ANATOMY OF CORPORATE LAW, *supra* note 6, at 1, 11.

Disclosure can help overcome the information asymmetry between the target shareholders and the acquirer, but additional information will not eliminate the re-emerging costs.[31] The City Code obliges target boards to issue a reasoned fairness opinion that must include an assessment of the bid price by an independent advisor, normally an investment bank.[32] However, even such qualified disclosure will not fully resolve the pressure to tender problem of dispersed shareholders.

While the board of a target company serves as an active auctioneer and negotiator for shareholders under US law, the directors of a target company in the UK are precluded from intervention under the no-frustration rule. British control shift regulation must therefore include some form of third-party control over the fairness of the bid price. The City Code obliges the acquirer to set the consideration offered in a mandatory bid "at not less than the highest price paid by the offeror … for any interest in shares of that class during the 12 months prior to the announcement of that offer."[33] To understand the operation in practice, it should be noted that enforcement of these terms of fairness lies in the hands of the Takeover Panel. The powers of the Panel historically emanated from self-regulation. Despite its later statutory backing and a general trend toward fostered state control, the Panel still comprises some typical elements of self-regulation like public shaming of non-compliant parties.[34]

Although by different means, the approaches chosen in the US and the UK both seek to give effect to market forces by eliminating dangers of self-interested takeover defenses by the board of directors.[35] As a strategy, the empowerment of the board to take defensive measures in the US hinges on the general standard of duty for directors. Generally, standards derive their contours through ex-post review.[36] In contrast,

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[31] John Armour & Brian Cheffins, *Stock Market Prices and the Market for Corporate Control*, 2016 U. ILL. L. REV. 1010 (2016).

[32] CITY CODE ON TAKEOVERS AND MERGERS, *supra* note 27, at r. 3.1 (board of the offeree company) & r. 3.2. (offeror company).

[33] *Id.* at r. 9.5 (consideration to be offered).

[34] DAVID KERSHAW, PRINCIPLES OF TAKEOVER REGULATION 65, 112 (2016).

[35] *Id.* at 297. On experience with self-regulation in the UK, *cf.* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION 364 (2004).

[36] Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 571 (1992).

a rule-based approach as employed by the City Code relies on an ex-ante prescription of behavior.[37] Arguably, the removal of directors from decision making over takeover defenses has the advantage of saving shareholders from problems of risk aversion or, as highly relevant in regard to defenses, over-confidence of their directors.[38] In theory, either problem can be tackled by constraints, but carving out directors' duties through liability cases takes time and often does not sufficiently guide decision-making in complex settings.[39] Conversely, an ex-ante approach carries the danger of a gap in fairness control throughout the process of a takeover bid. Under the City Code, this gap is filled by oversight and sanctioning power of the UK Takeover Panel. The exercise of a continuing fairness control by a specialized supervisory body like the Takeover Panel is said to have advantages over ex-post judicial review, especially with regard to cases at the margin.[40] However, the highly specialized judiciary and bar of Delaware, together with the large body of case law, might help avoid typical shortfalls of ex-post decision-making like hindsight bias.[41]

Up to this point, the comparison made four points clear: firstly, a board model only provides a basic structure for the operation of specific governance strategies, in the example of takeovers, for the disciplining force of the market for corporate control. Secondly, the board model as such is not a proxy for the allocation of control rights to directors vis-à-vis shareholders. Thirdly, agency problems in takeovers can be tackled by focusing board structure through the allocation of control to independent directors, i.e. a fraction of the board members (US), or, conversely, by a removal of

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[37] John Armour & David Skeel, *Who Writes the Rules for Hostile Takeovers and Why? The Peculiar Divergence of the U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727 (2007).

[38] Michal Barzuza & Eric L. Talley, *Long-Term Bias*, COLUM. BUS. L. REV. 107 (2020). For a critical discussion, *see* Stephen M. Bainbridge, *Long-Term Bias and Director Primacy*, COLUM. BUS. L. REV. 801 (2020).

[39] Patrick C. Leyens & Michael G. Faure, *Directors & Officers Liability: Economic Analysis*, *in* DIRECTORS & OFFICERS (D&O) LIABILITY 769, 777 (Simon F. Deakin, Helmut Koziol & Olaf Riss eds., 2018).

[40] *See e.g.* CITY CODE ON TAKEOVERS AND MERGERS, *supra* note 27, at r. 9.5 ("The Panel should be consulted where there is more than one class of share capital involved.").

[41] Klaus J. Hopt, *Comparative Company Law*, *in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 1137, 1144 (Mathias Reimann & Reinhard Zimmermann eds., 2d ed. 2017).

the board from its coordination task through reinstalling shareholder decision making (UK). Fourth, the merits of possible solutions hinge on the credible threat of duty enforcement, which, as the debate stands, might be created equally well ex-ante through continuous monitoring by a specialized body (UK), or ex-post by specialized courts (US).

2.3 Supervisory Board Approval (Germany)

We now look into the handling of the same agency problem in a German two-tier board. Germany is one of the countries where stock corporations are obliged to set up a two-tier board.[42] This means that management and monitoring are divided between two separate bodies. Similar to other continental European countries, stock ownership was traditionally concentrated in Germany.[43] Cross-shareholdings and the strong role of banks created what was known as the "German Inc.", i.e. a particularly strong form of insider control. Decisions over control shifts were essentially made by small groups of individuals. Thus, market forces did not play a major role for corporate governance during that era.[44]

The new millennium marked a turning point.[45] The takeover of German Mannesmann by British Vodafone of 2000 was the largest cross-border acquisition in the history of the EU. Around that time, cross-shareholdings declined and banks sold large parts of their equity. Today, around 60 percent of the shares in the German top 30 listed stock corporations are held by institutional investors, more than half of which are

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[42] Aktiengesetz [Stock Corporation Act], sec. 23, para. 5, 76, 95. For a comparative overview, *cf.* Paul Davies, Klaus J. Hopt, Richard G. J. Nowak & Gerhard van Solinge, *Boards in Law and Practice: A Cross-Country Analysis in Europe, in* CORPORATE BOARDS IN EUROPEAN LAW: A COMPARATIVE ANALYSIS, *supra* note 3, at 3, 15.

[43] Marco Becht & Ekkehart Böhmer, *Ownership and Voting Power in Germany*, *in* THE CONTROL OF CORPORATE EUROPE 128 (Fabrizio Barca & Marco Becht eds., 2001).

[44] *Cf.* the references *supra* note 12.

[45] Klaus J. Hopt, *Law and Corporate Governance: Germany within Europe*, 27 J. APPLIED CORP. FIN. 15 (2015); Wolf-Georg Ringe, *Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG*, 63 AM. J. COMP. L. 493 (2015).

based abroad.[46] Institutional investors tend to own small bundles of less than 5 percent of the shares of a company. The rise of institutional investor ownership in Germany thus further contributes to the change in the ownership pattern.

The German two-tier board cannot be seen as a vehicle to serve the peculiarities of a national insider system anymore.[47] To be sure, two qualifications should be made: First, relics of the "German Inc." can still be found in some of the large business enterprises. Second, as we will see in Section 4, employee co-determination sustains elements of insider control.[48] These two qualifications in mind, the changes in ownership force management boards as well as supervisory boards to be aware of the market for corporate control in a way that compares to the US and the UK much better than it did earlier.

In 2004, the EU adopted the Directive on Takeover Bids.[49] After a struggle that lasted roughly 30 years, the EU decided to follow the approach chosen by the UK.[50] Generally, the EU Member States must provide for the mandatory bid on the side of the acquirer and the no-frustration rule on the side of the target.[51] The no-frustration rule, however, was considerably watered down by optional arrangements that many EU Members States used.[52] Under the German takeover statute, the most important

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[46] For some corporations, the percentages are considerably higher: Münchener Rück (87%), Bayer (86%), Allianz (83%) and BASF (56%). *Cf.* Ipreo/DIRK, Die Aktionärsstruktur des deutschen Leitindex DAX 30 (June 2018), at 7.

[47] Davies & Hopt, *supra* note 2, at 312. *Cf.* Paul L. Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?* 2 INT. COMP. CORP. L.J. 435 (2000) (providing an account of the German supervisory board at the time before the new millennium).

[48] *Cf.* the anecdotal examples *infra* notes 187, 188.

[49] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, OJ L 142, 30.4.2004, at 12.

[50] HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, REPORT ON ISSUES RELATED TO TAKEOVER BIDS (European Commission, 2002); the report is printed in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 825 (Guido Ferrarini, Klaus J. Hopt, Jaap Winter & Eddy Wymeersch eds., 2004).

[51] Klaus J. Hopt, *European Takeover Reform of 2012/2013 – Time to Re-examine the Mandatory Bid*, 15 EBOR 143 (2014) (taking sides for the mandatory bid, but pleading for reforms).

[52] European Commission, Application of Directive 2004/25/EC on takeover bids, Report, 28.6.2012, COM(2012) 347 fin. *See* Paul Davies, Edmund-Philipp Schuster & Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?*, *in* COMPANY LAW AND ECONOMIC PROTECTIONISM:

deviation from the UK comes from the power of the supervisory board to authorize defensive measures upon the management board's request.[53]

German takeover law thus does not mirror the approach chosen by the UK. It would be equally misguided to believe that entrusting the supervisory board with the right to authorize defensive measures resembles board empowerment in the US. It is true that the role of non-executive directors in a one-tier board and of supervisory directors in a two-tier board are similar.[54] Because both types of directors serve on a non-executive basis, they are mainly expected to secure due decision-making through giving or withholding their approval.[55] The German Stock Corporation Act codifies this expectation by limiting the supervisory board to vetoes, while reserving the right to initiate business decisions for the management board.[56] In practice, however, cooperation between the two boards will often lead to undamped implementation of defensive measures.[57]

German supervisory boards, it appears, are prone to support defensive measures against a hostile takeover, primarily due to two factors: first, case law carved out a duty to continuously consult with and proactively give advice to the management board which, in sum, results in cooperation between the two boards.[58] Second, co-determination legislation obliges large business corporations to give half of the supervisory board seats to employee representatives. We will explore details of employee co-determination in section IV with a view to stakeholder protection. To understand its impact on takeover defenses, it is important to recognize that one cannot

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NEW CHALLENGES TO EUROPEAN INTEGRATION 105, 148 (Ulf Bernitz & Wolf-Georg Ringe eds., 2010).

[53] Wertpapiererwerbs- und Übernahmegesetz [Securities Acquisition and Takeover Act], sec. 33, para. 1.

[54] Hopt & Leyens, *supra* note 1, at 160.

[55] STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, OUTSOURCING THE BOARD 45 (2018).

[56] Aktiengesetz, *supra* note 41, at sec. 111, para. 4.

[57] *See also infra* section 4.3.

[58] BGH, Judgment of 25.03.1991 – II ZR 188/89, BGHZ 114, 127, para. 10; BGH, Judgment of 04.07.1994 – II ZR 197/93, BGHZ 126, 340, para. 8. *See also infra* section 3.3; Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217 (2007) (explaining benefits of cooperation).

realistically expect employee representatives to easily accept the job losses that normally follow the acquisition of one business by another. Thus, employee representatives might team up with management or a controlling shareholder who wishes to frustrate the bid. The risk of being held liable for doing so appears to be negligible. As it stands, employee representatives widely act unconstrained in regard to furthering takeover defenses which run counter the interests of minority shareholders.

As we have seen, in theory, the approaches to takeover defenses differ considerably. The differences, however, do not result from the adoption of either a one-tier or a two-tier board. Rather, they follow from the use of specific governance strategies like the empowerment of independent directors as a fraction of the board (US), the complete removal of the board from decision making (UK), or the cooperation between two boards (Germany). It is not surprising that, connected to this, we find different modes of third-party control: ex-ante by the Takeover Panel as a specialized body (UK) or, at least in theory, ex-post by courts (US, Germany).[59]

The foregoing observations show a rather counterintuitive grouping of the sample jurisdictions. Germany, as an EU Member State, follows UK control shift regulation in that its takeover law foresees the no-frustration rule. In practice, however, the right of the supervisory board to approve a takeover defense better compares to board empowerment. Thus, it appears more adequate to group the US and Germany together. A major difference that we will explore in the next section relates to the structuring of the decision-making body by the use of the trusteeship strategy.

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[59] Bernard S. Black, Brian R. Cheffins & Michael D. Klausner, *Liability Risk for Outside Directors: A Cross-Border Analysis*, 11 EUR. FIN. MGMT. J. 153 (2005) (finding that dangers of out-of-pocket liability are similarly weak in common law countries like Australia, Canada, Britain, US, and civil law countries like France, Germany, and Japan).

3. Boards and Minority Shareholders: Independent Directors and Related Party Transactions

Boards of large listed corporations regularly comprise a certain proportion of independent directors everywhere.[60] The appointment of independent directors does not modify the legal concept of the unitary board according to which all (supervisory) directors, including independent ones, are vested with equal voting rights and powers. Rather, it focuses internal decision-making by making use of two different sets of incentives. Independent directors are believed to be primarily motivated by reputation, pride, and conscience (low-powered incentives).[61] Their incentives accordingly differ from those of their non-independent board colleagues, for whom constraints and rewards count as predominant incentives (high-powered incentives). The involvement of independent directors in board decision-making makes use of a governance strategy known as trusteeship. Independence from management serves to mitigate the agency conflicts between shareholders and management, and thus primarily evolved in dispersed ownership countries like the US and the UK.[62] In this section, we will not focus on independence from management, but rather on independence from a controlling shareholder. Director independence is primarily seen as a strategy to mitigate agency conflicts between minority and majority shareholders in countries with concentrated ownership like many of the continental EU Member States.[63] In all sample jurisdictions, the agency conflict between minority and majority shareholders becomes relevant following a change of control, and thus appears to be the next logical step following our analysis of board structures and defensive measures against

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[60] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1514 (2007); Hopt, *supra* note 4, at 35; Dan W. Puchniak & Kon Sik Kim, *Varieties of Independent Directors in Asia*, *in* INDEPENDENT DIRECTORS IN ASIA 89 (Dan W. Puchniak, Harald Baum & Luke Nottage eds., 2017).

[61] Armour, Hansmann & Kraakman, *in* ANATOMY OF CORPORATE LAW, *supra* note 6, at 35.

[62] Gordon, *supra* note 60, at 1514; BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED 8, 26 (2008).

[63] EU Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC), OJ EU L 52 of 25.2.2005, at 51, preamble no. 7.

takeovers in the previous section. Parallel to new developments in US case law, the amended EU Shareholder Rights Directive of 2017 moved related party transactions (RPTs) to the center of the debate.[64] The fundamental challenge of regulating RPTs relates to balancing the minority interest in setting the terms at arm's length against the controlling shareholder interest in wealth transfers or economies of cooperation, especially within groups of companies.[65] The legal regimes within the EU Member States use different tests to identify an RPT, but the typical choice is 5 percent of the company's value (in Germany, 1.5 percent).[66] The directive leaves it to the Member States to decide whether the fairness of RPTs should be secured by structuring the board and putting the decision in the hands of independent directors, or by using an alternative governance strategy.

3.1 Director Independence (US)

Boards of large US companies often comprise a considerably high proportion of independent directors, with many cases comprising up to a supermajority.[67] Companies listed on the NYSE must have a majority of independent directors.[68] To be independent under the NYSE Listing Rules, a director shall not have a material relationship with company.[69] However, to ensure that the controller's views prevail with regard

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[64] Article 9c Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement, OJ L 132, 20.5.2017, at 1.

[65] Luca Enriques & Tobias H. Tröger, *The Law and (Some) Finance of Related Party Transactions: An Introduction*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS 1 (Luca Enriques & Tobias H. Tröger eds., 2019).

[66] European Company Law Experts Group (ECLE), *Implementation of the SRD II Provisions on Related Party Transactions* (ECGI - Law Working Paper No. 543/2020), https://ssrn.com/abstract=3697257, at 19, 22. *See also* Andreas Engert & Tim Florstedt, *Which Related Party Transactions Should be Subject to Ex Ante Review? Evidence from Germany*, 20 J. CORP. L. STUD. 263 (2020) (showing pitfalls of the single factor test).

[67] Gordon, *supra* note 60, at 1473, 1481.

[68] NYSE Listed Company Manual (Nov. 25, 2019), sec. 303A.01.

[69] *Id.*

to corporate strategy, this rule does not apply to companies where half or more of the voting power is held by an individual or a company.[70] To balance out the interests of the majority against those of the controller, US law focuses board structuring not on the board in general, but rather on decision-making with regard to the specific RPT.[71] Driven by case law, the approval by independent directors became *the* paradigm for achieving transaction certainty.[72]

As a default rule, courts will review the terms of RPTs under the stringent "entire fairness test," which implies both procedural and substantive fairness.[73] The controller bears the burden of proving fairness. Litigation risks can be avoided, or at least substantially reduced by setting up a special committee composed of substantially independent directors. The committee must be vested *ab initio* with the task of negotiating the RPT and with the authority to say no if the terms are not favorable. The judicial standard remains entire fairness, but the burden of proof will be shifted to the party who challenges the substantive fairness of the transaction. In the MFW case of 2014, the Delaware Supreme Court went one step further.[74] The court held that the standard of review was the less stringent business judgment review if a controller's transaction received prior approval by an effectively functioning independent committee that is fully authorized, and, in addition, by the majority of the non-controlling

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[70] *Id.* at section 303A.00 (noting the exemption for controlled companies).

[71] To be disinterested, a director shall not benefit from the transaction at stake. In addition, the director shall not have ties to an interested individual or be otherwise controlled by that individual in a way that could compromise her ability to make objective decisions with respect to that individual. *Cf.* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 362 (Del. 1993).

[72] Zapata Corp. vs. Maldonado, 430 A.2d 779 (Del. 1981).

[73] Edward B. Rock, *MOM Approval in a World of Active Shareholders*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 105; Zohar Goshen & Assaf Hamdani, *Corporate Control, Dual Class, and the Limits of Judicial Review*, 120 COLUM. L. REV. 941 (2020) (conducting a critical assessment of the entire fairness test); Amir N. Licht, *Farewell to Fairness: Towards Retiring Delaware's Entire Fairness Review*, 44 Del. J. Corp. L. 1 (2020) (arguing that the entire fairness test should be retired).

[74] Kahn v. M&F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014) (concerning a controlling shareholder freezeout).

shareholders in a fully informed and uncoerced vote (minority of the majority approval, MOM).[75]

The US approach to RPTs does not prescribe the use of one specific governance strategy, but instead offers a choice between three options:[76] Firstly, if the board abstains from taking any measures to safeguard the interests of non-controlling shareholders, the success of the transaction will depend on the uncertain outcome of the entire fairness review by a court. Secondly, the use of the trusteeship strategy puts the fairness review into the hands of independent directors whose evaluation will often appear more foreseeable than that of a court.[77] Thirdly, the greatest degree of transaction certainty will be reached by using a combination of the trusteeship and the decision rights strategy, thus leaving the determination of the transaction terms to an independent committee and obtaining approval of unrelated shareholders prior to concluding the transaction. It follows that the choice between these options depends on how the board evaluates the risks of ex-post judicial review or, given the importance of the burden of proof, the risk of litigation.

The choice between these options is up to the board which, of course, will normally follow the wishes of the controller. The controller may well decide to stick to the trusteeship strategy and to independent director approval instead of seeking MOM approval although this means to dispense with the chance to mere business judgement review. The outcome of providing the MOM with a decision right can be highly uncertain and, since it must be announced to the shareholder public, the vote might also create opportunities for third parties to build up leverage with respect to the transaction through buying shares in the corporation.[78] It appears plausible to believe that, by numbers, the use of the trusteeship strategy will outweigh the use of the decision

[75] The *ab initio* requirement was recently clarified. *See* In re HomeFed Corporation Stockholder Litigation, C.A. 2019-0592-AGB (Del. Ch. July 13, 2020).

[76] Rock, *supra* note 73.

[77] For a counter-example, *see* Air Products and Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011), cf. *supra* note 25.

[78] Suneela Jain, Ethan Klingsberg & Neil Whoriskey, *Examining Data Points in Minority Buy-Outs: A Practitioners' Report*, 36 DEL. J. CORP. L. 939, 950 (2011).

rights strategy. It follows that director independence takes a predominant role for the governance of RPTs.

For trusteeship to be a viable strategy, two factors must be taken care of: firstly, it is essential to find the right proportion of independent directors.[79] Independence, per definition, requires a certain distance between the director and the corporation or, in other words, from the affairs that directors should actually monitor.[80] A supermajority of independent directors, it appears, reflects a somehow stern belief in the merits of decision-making by untainted agents who will often lack the necessary amount of inside knowledge. While this criticism gained special momentum through the monitoring failures of bank boards during the global financial market crisis of the years 2008 et seq., it might be less applicable for the case of RPTs.[81] Under US law, the assessment of an RPT by a special committee, at least de facto, will often replace third-party control by courts. Thus, it appears to be a coherent inference to demand a fully independent special committee.

Secondly, one might ask: "how independent are independent directors?"[82] If ownership is dispersed, independent directors owe their position to the nomination by the incumbent board, or, more precisely, to the chairperson. Conversely, if there is a controlling shareholder, the appointment of the independent director by majority vote reflects the choice of the controller. In both settings, independent directors face the difficult task of rigorously scrutinizing the performance of those to whom they owe their office. Against this background, it is difficult to see how they serve as natural agents of minority shareholders.[83] The US Airgas case, which we already touched

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[79] Lucian A. Bebchuk & Asssaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1297 (2017).

[80] Arnoud Boot & Johnathan R. Macey, *Monitoring, Corporate Performance: The Role of Objectivity, Proximity and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356 (2004).

[81] Klaus J. Hopt, *Corporate Governance of Banks and Other Financial Institutions After the Financial Crisis*, 13 J. CORP. L. STUD. 219 (2013). *Cf.* Harald Hau & Marcel Thum, *Subprime Crisis and Board (In-)Competence: Private v. Public Banks in Germany,* 24 ECON. POL. 701 (2009).

[82] Ronald W. Masulis & Emma Jincheng Zhang, *How Valuable are Independent Directors? Evidence from External Distractions*, 132 J. FIN. ECON. 226 (2020).

[83] Luca Enriques, *Related Party Transactions: Policy Options and Real-World Challenges (With a Critique of the European Commission Proposal),* 16 EBOR 1, 19 (2015); Lisa M. Fairfax, *The Elusive*

upon,[84] is often used to show that genuinely independent directors may feel prepared to oppose a controlling shareholder. However, one example can hardly dispel all doubts.

A nearby option would be to give minority shareholders a stronger say in the appointment and removal of independent directors.[85] So far, proposals did not find their way into US law reform.[86] The introduction of a so-called minority appointed director de facto would have enhanced the role of institutional investors who, despite their small shareholdings, already exercise considerably influence.[87]

Italy is one of the rather rare examples of a jurisdiction that provides for minority directors on the board, and requires their involvement in the approval of RPTs.[88] In an Italian listed corporation, at least one director must be elected from the minority slate.[89] Similar to the US approach, the board must set up a committee composed of independent directors whose vote will normally bind the board in its handling of the transaction.[90] However, a transaction that has not received approval of the independent directors can still be authorized with the vote of the majority of unrelated

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Quest for Director Independence, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, *supra* note 20, at 170.

[84] *See supra* Section 3.1, note 25.

[85] Alessio M. Pacces, *Procedural and Substantive Review of Related Party Transactions: The Case for Noncontrolling Shareholder-Dependent Directors*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 181.

[86] Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991).

[87] For more detail on institutional investors, *see infra* section 4.

[88] Guido Ferrarini, Gian Giacomo Peruzzo & Marta Roberti, *Corporate Boards in Italy*, *in* CORPORATE BOARDS IN EUROPEAN LAW: A COMPARATIVE ANALYSIS, *supra* note 3, at 367, 392; Giovanni Strampelli, *How to Enhance Directors' Independence at Controlled Companies,* 44 J. CORP. L. 103, 126 (2018); Corrrado Malberti & Emiliano Sironi, *The Mandatory Representation of Minority Shareholders on the Board of Directors of Italian Listed Corporations: An Empirical Analysis* (Bocconi Legal Studies Research Paper No. 18, 2007), https://ssrn.com/abstract=965398.

[89] Testo unico delle disposizioni in materia di intermediazione finanziaria [Consolidated Financial Services Act], art. 147-ter et seq.

[90] Art. 8 para. 1 Regulation Containing Provisions Relating to Transactions with Related Parties (Mar. 12, 2010), art. 8 para. 1 (currently under review). *Cf.* http://www.consob.it.

shareholders (whitewash).[91] Different from the US, MOM approval thus does not serve as a supplement to the obligatory approval by a fully authorized independent committee, but rather as an alternative to the procedural fairness that such independent committees otherwise provide. Accordingly, the vigor of minority protection is less articulated than it is under the US approach. Regarding the role of minority appointed directors, the prevailing view is that their presence on boards may be helpful in bringing matters of minority protection to the attention of the board, but the involvement of one minority appointed director will hardly prevent unfair RPTs.[92]
In sum, we saw that US law creates a nexus between the use of the trusteeship strategy through requiring independent director involvement and third-party control by courts. In Italy, the nexus between director independence and third-party control is less articulated due to the possibility of ex-post authorization of RPTs by the general meeting. Enforcement is entrusted to the financial market authority CONSOB, with the possible shortcoming that public enforcement tends to catch only the most flagrant cases.[93]

3.2 Shareholder Approval (UK)

In the UK, the practice of appointing independent board directors has been continuously fostered since the Cadbury Code of 1992, a soft law instrument similar to the City Code on Takeovers & Mergers.[94] The UK Corporate Governance Code of 2018, a successor of the Cadbury Code, recommends that at least half of the board should

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[91] *Id.* at art. 8 para. 2.

[92] Guido Ferrarini & Marilena Filippelli, *Independent Directors and Controlling Shareholders*, *in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 269 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

[93] Marcello Bianchi, Luca Enriques & Mateja Milic, *Enforcing Rules on Related Party Transactions in Italy: One Securities Regulators Challenge*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 477.

[94] Committee on the Financial Aspects of Corporate Governance (Cadbury-Report), December 1992; *cf.* Sir Adrian Cadbury, *The Response to the Report of the Committee on the Financial Aspects of Corporate Governance*, *in* PERSPECTIVES ON COMPANY LAW 23 (Fiona Macmillan Patfield ed. 1995).

be non-executive directors whom the board considers to be independent.[95] The chair should be filled with a non-executive independent director assuming that independence will be lost upon appointment, while in US corporations, the position of CEO and chairperson are often combined. Different from the NYSE Listing Rules, the UK Corporate Governance Code operates on a comply or explain basis. Under the UK Listing Rules, the annual financial report must include a statement as to whether the listed company has complied with all relevant provisions of the Code or in case of non-compliance, given reasons (comply or explain).[96] Although this approach allows deviations, it will hardly be an option for a large business corporation to ignore the Code's best practice standards.

There is no direct analogue to the Italian minority director, but the UK Listing Rules seek to give minority shareholders a more effective voice in companies with a premium listing that have a controlling shareholder. To be elected or re-elected, an independent director must be approved vis a dual voting process in an ordinary resolution of the shareholders, as well as by a separate ordinary resolution of the independent shareholders (dual voting).

To safeguard fairness of RPTs, the UK Listing Rules do not focus decision-making by the board, but rather by the shareholder body.[97] Companies with a premium listing must disclose transactions above a ratio of 5 percent to shareholders and obtain ex-ante approval from the unrelated shareholders, while excluding the controller from voting.[98] This approach to RPTs results in complete removal of the board from decision making, and thus counts as a strong form of MOM approval.

[95] FINANCIAL REPORTING COUNCIL, UK CORPORATE GOVERNANCE CODE (July 2018), Provision 11.

[96] FINANCIAL CONDUCT AUTHORITY, FCA HANDBOOK, r. 9.8.6(6) (Dec. 2019).

[97] Paul Davies, *Related Party Transactions: UK Model*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 361. For background information, *cf.* Brian R. Cheffins, *The Undermining of UK Corporate Governance,* 33 OXFORD J.L. STUD. 503, 505 (2013).

[98] FINANCIAL CONDUCT AUTHORITY, FCA HANDBOOK, r. 7.3.7(3) (Oct. 2012), r. 10.2.2, and r. 11.1.7(2–3) (July 2005).

MOM approval is also used in other countries as a primary technique to secure fair RPTs but often, as seen in France, although with important two deviations:[99] Firstly, the UK uses a rule-based approach by specifying a fixed percentage ratio that triggers the disclosure duty.[100] French law relies on a standard in that it leaves the distinction between routine transactions (no reporting duty) and non-routine transactions (duty to report) to the board.[101] Secondly, the UK requires ex-ante MOM approval. In contrast, France allows ex-post authorization which, as noted by observers, makes approval of RPTs an automatism.[102] In sum, French boards exercise considerable control over the treatment of transactions at the margin. The French approach can thus be seen as a weak form of MOM approval.

It is argued that the governance of RPTs by MOM approval follows the logic of a property right:[103] only those transactions that are acceptable to both sides, to the controller *and* to the unrelated shareholders will go forward. MOM approval creates bargaining power for minority shareholders that is disproportional to their stock ownership. This approach might not necessarily lead to fairer RPTs in comparison to a strategy that relies on board structuring. To name only three aspects of the ongoing discussion: firstly, non-controlling shareholders will often lack the capacity or the incentive to do the analytical work that is needed to distinguish between value-enhancing and value-destroying transactions. Secondly, small investors tend to favor exit over voice, and will thus fear the risk of a lock-in as a result of receiving non-public information that would preclude them from trading. Thirdly, there may also be a hold-up risk for the controlling shareholder due to the enhanced bargaining power of the minority.[104] With regard to the latter aspect, observers note that the more

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[99] Enriques & Tröger, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 1; ECLE, *supra* note 66, at 8, 30.

[100] Davies, *supra* note 97.

[101] CODE DE COMMERCE [COMMERCIAL CODE], art. L225-39.

[102] Genevieve Helleringer, *Related Party Transactions in France: A Critical Assessment*, *in* THE LAW AND FINANCE OF RELATED PARTY TRANSACTIONS, *supra* note 65, at 400.

[103] Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 402 (2003).

[104] Suneela Jain, Ethan Klingsberg & Neil Whoriskey, *Examining Data Points in Minority Buy-Outs: A Practitioners' Report*, 36 DEL. J. CORP. L. 939, 950 (2011).

specific EU squeeze-out rule has often motivated strategic investment in France and elsewhere.[105] This rule provides a controller who holds 90–95 percent with the right to acquire the shares of the minority against a compensation payment. Whether strategic investments are a realistic danger in regard to RPTs in general is still a point of discussion.[106] Building-up a blocking majority might require a considerably large amount of funds that, if used for a single investment, might severely limit the exit options.

In sum, it seems much less clear than might be expected that mandatory MOM approval, either ex-ante like in the UK or ex-post like in France, is needed for adequate minority protection. As it stands, it seems that the two alternative strategies, i.e. structuring the board (US) or structuring the shareholder body (UK, France), each have their strengths. To fully unfold, these strengths either need sophistication of courts in finding a suitable standard for the review of RPTs, or sophistication of the legislator or rule maker in setting a suitable threshold, preventing approval automatisms and white washing. These needs come in addition to the basic governance structure as provided equally well by one-tier and two-tier boards.

3.3 Supervisory Board Approval (Germany)

In Germany, the independence of supervisory board directors has been controversial since the beginning of the corporate governance movement.[107] In line with its counterpart in the UK, the German Corporate Governance Code operates on the basis of comply or explain.[108] The Code recommends giving half of the seats for shareholder representatives to independent directors but, in contrast with the approach taken in

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[105] Alain Pietrancosta, *"Going Private Transactions" in France*, Revue trimestrielle de droit financier (RTDF) N° 4 - 2013 / N° 1 - 2014 Colloque, at 65, 80.

[106] Rock, *supra* note 73 (assuming that the dangers are low). *See also* Pacces, *supra* note 85 (taking the opposite position).

[107] Deutscher Corporate Governance Kodex [German German Corporate Governance Code] (Dec. 16, 2019); *cf.* www.dcgk.de (providing a translation).

[108] Patrick C. Leyens, *Self-Commitments and the Binding Force of Self-Regulation with Respect to Third Parties, in* SELF-REGULATION IN PRIVATE LAW IN JAPAN AND GERMANY 157, 165 (Harald Baum, Moritz Bälz, Marc Dernauer eds., 2018).

the UK, does not mention ties to the controlling shareholder as a general obstacle to independence.[109] Instead, a controlled company with a supervisory board of more than six members should have at least two directors and a chairperson of the audit committee who are independent from the controlling shareholder.[110] It follows that a large supervisory board of 20 members, as obligatory under employee co-determination legislation, will have ten shareholder representatives members, of which two should be independent from the controlling shareholder plus ten workforce representatives.[111]

The arguably small proportion of two independent directors can be seen as compromise between the majority independence requirement under the UK Corporate Governance Code and the exclusion of the otherwise applicable majority independence rule for controlled companies under the NYSE Listing Rules.[112] However, it is clear that the two directors who are independent from the controlling shareholder will only be able to trump the votes of their non-independent colleagues if they team up with the employee representatives. For the reasons discussed with regard to takeover defenses, it can hardly be expected that employee representatives will serve as neutral referees with regard to RPTs when furthering the controller's interest promises better outcomes for their electoral body, or when doing so provides a concrete chance for bargaining on working conditions, salaries or similar matters.[113]

The cautiousness of the German Corporate Governance Code on the issue of independent directors is a result of mainly three path-dependencies: Firstly, as we have already seen, the traditional system of insider corporate control relied on ownership by powerful families, cross-holdings between corporations and monitoring by banks.[114] Secondly, German law provides for specialized rules that allow the deferral of surpluses within a group of companies, provided that controlling and controlled

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[109] Deutscher Corporate Governance Kodex, *supra* note 107, recommendation C.7.

[110] *Id.* at recommendation C.9 and C.10.

[111] On co-determined supervisory boards, *cf. infra* section 4.3.

[112] *See supra* sections 3.1 (US) and 3.2 (UK).

[113] *Cf. supra* section 2.3 (Germany).

[114] *See supra* section 2.3.

companies comply with a mandatory scheme of intra-group compensation.[115] Thirdly, as already touched upon, statutory employee co-determination obliges large corporations to give half of the supervisory board seats to employee representatives, which already limits the controller's influence.[116]

These observations probably also explain the intense discussions that forewent and probably determined the adoption of an optional design for RPTs by the amended EU Shareholder Rights Directive of 2017.[117] In its transposition of the directive, Germany did not make use of the option to adopt the UK approach to structuring the shareholder body through MOM approval. Instead, it focuses board structure, at first glance, in a way similar to the approach chosen in the US.[118] According to the amended German Stock Corporation Act, RPTs of 1.5 percent of the fixed assets and current assets must be approved by the supervisory board or one of its committees.[119] Supervisory board members who are parties to the transaction or might be conflicted as a consequence of their ties to a related party are excluded from voting.[120] In the case that the supervisory board withholds approval, the management board might, at least theoretically, still seek MOM approval of the general meeting. In contrast with the Italian example, MOM approval cannot be used as a cleansing device, as it must be obtained *prior* to the transaction.[121]

The differences to the US approach become apparent at second glance. The powers of a special committee in a one-tier model are subject to a special authorization by the board. In the German two-tier model the supervisory board is vested with its own

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[115] Klaus J. Hopt, *Groups of Companies: A Comparative Study of the Economics, Law, and Regulation of Corporate Groups*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE, *supra* note 9, at 603; Tobias H. Tröger, *Corporate Groups: A Germans European Perspective*, *in* GERMAN AND NORDIC PERSPECTIVES ON COMPANY LAW AND CAPITAL MARKETS LAW 157, 176 (Holger Fleischer, Jesper Laus Hansen & Wolf-Georg Ringe eds., 2015).

[116] For further details of co-determination, *see infra* section 4.3.

[117] *See supra* note 64. For background information, *cf.* ECLE, *supra* note 66, at 10.

[118] ECLE, *supra* note 66, at 31.

[119] Aktiengesetz, *supra* note 41, at sec. 111b, para. 1. *Cf.* Engert & Florstedt, *supra* note 66 (discussing pitfalls of a single factor test).

[120] *Id.* at sec. 111b, para. 2.

[121] *Id.* at sec.111b, para 4. On Italian law, *cf. supra* section 3.1.

powers and does not depend on special authorization. These powers, however, do not extend to initiation, but only comprise a veto right. Unlike a fully authorized special committee of a US board, a German supervisory board is limited to vetoing an RPT while the task of negotiating the transaction terms firmly lies in the hands of the management board.

The major strength of the two-tier model, it is believed, lies in structuring the decision-making in a way that separates management from monitoring. The supervisory board provides for self-contained internal review as a second layer of the decision-making process.[122] In contrast, the outcome of negotiations conducted by a fully empowered US-style special committee are not subject to further internal review, and, as we have seen, external review by courts is restricted to cases where plaintiffs think they have a realistic chance of challenging the RPT, despite the shifted burden of proof.

On a closer look, the differences are less stark than they seem. Supervisory boards of companies with a controlling shareholder have never restricted themselves to a mere review of management decisions. As already noted, case law has enhanced the role of the supervisory board as an advisor to the management board.[123] Since its beginnings, the German Corporate Governance Code considers close cooperation between the two boards to be best practice.[124]

Especially major RPTs will normally be treated as an informal process between the management and the supervisory board. In the case of doubt, evaluations might be backed up by the opinion of an expert whose appointment will be consented between the boards rather than commanded by the supervisory board. In most cases, the outcome of this interaction between the boards will be a transaction that de facto already carries the approval of the supervisory board or of its special committee. Against this background, the treatment of an RPT arguably better compares to a decision that, in a one-tier model, is commissioned to the full board rather than to the operation of a US style special committee.

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[122] Marcus Lutter, *Comparative Corporate Governance: A German Perspective,* 2 INT. COMP. CORP. L.J. 423 (2000).

[123] *See supra* note 58.

[124] Deutscher Corporate Governance Kodex, *supra* note 107, principle 13.

In sum, RPTs of flagrant unfairness will likely be screened out in all sample jurisdictions. For cases on the margin, the viability of a strategy that relies on structuring the shareholder body by MOM approval (UK) hinges on whether problems of group decision-making can be overcome, while structuring the board (US, Germany) must secure a substantively independent fairness review. The German approach, which we saw at the end of this section, shows that subjecting approval of RPTs to a second board does not necessarily eliminate or alleviate agency problems. Arguably, the cooperation between the two boards in a German corporation provides a basis for manager-friendly results one would only expect from a jurisdiction that openly promotes board empowerment.

4. Boards and Stakeholders: Employee Voice on Boards

Boards of large business corporations need to orchestrate a number of interests to secure the success of the corporation. In the present section, we look at the board as an institution to secure the corporations' regard to non-shareholder interests, especially those of employees as stakeholders. Driven by the ESG[125] movement, stakeholder protection moved into the center of the debate on corporate governance reform. To understand the impact of the ESG movement, it is important to consider the strong increase of indirect equity ownership on both sides of the Atlantic. In many developed countries today, a high percentage of the stock of large business enterprises is no longer held by single private investors themselves, but rather through intermediaries. Institutional investors like investment and pension funds or insurance companies now dominate stock ownership and trading.[126] The investment guidelines of those entities often exclude a holding of stock in a corporation that does not show a sufficient ESG engagement. The role of institutional investors, especially their capacity and incentives to serve a monitoring task, is heavily debated.[127] While this

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[125] ESG is sometimes also referred to as EESG (employee, environmental, social, and governance).

[126] John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (ECGI - Law Working Paper 541/2020), https://ssrn.com/abstract=3678197.

[127] Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 864 (2013) (providing a critical

controversy goes on, some institutional investors openly pressure corporations to re-think their purpose. The best-known example is the letter to CEOs by *Larry Fink*, the head of BlackRock.[128] The proposals on how to make corporations more accountable to the public are multi-facetted and we will focus on some central points of the current debate.[129] Among existing legal strategies one of the most far-reaching proposals relates to reallocating a proportion of the appointment rights from shareholders to employees, with a view to give employees a voice on the board as known from German employee co-determination.

4.1 Shareholder Value (US)

US corporate law traditionally builds on the shareholder value approach.[130] Under the shareholder value approach, as phrased by Milton Friedman in 1970, "the social responsibility of business is to increase its profits." [131] As clear cut as this dictum might seem, its translation into legal duties has always proven to be troublesome.[132] Investors and markets can tend to favor short-term spending, especially on dividends, where an efficient use of corporate resources might require long-term decisions.

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account). For a more optimistic account, *cf.* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019).

[128] Larry Fink's 2021 letter to CEOs, BLACKROCK (Jan. 2021), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.

[129] Firstly, we discuss director's duties in the US, constituency statutes, corporate purpose clauses in the articles of the company, and benefit corporations (*see infra* section 4.1). Secondly, we turn to what is called (enlightened) stakeholder value in the UK and to enforcement by stakeholders (*see infra* section 4.2). Finally, we explore employee voice on board in its the most far-reaching form under German co-determination (*see infra* section 4.3).

[130] Armour, Hansmann, Kraakman & Pargendler, *in* ANATOMY OF CORPORATE LAW, *supra* note 30, at 22.

[131] Milton Friedman, *The Social Responsibility of Business is to Increase its Profits,* N.Y. TIMES MAG. (Sept. 13, 1970) ("[T]here is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.").

[132] For a more recent account of the economic rationale, *see* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value,* 2 J.L. FIN. ACCT. 247 (2017).

Furthering social goals, and, especially, providing extra benefits to employees can be in line with shareholder interests. For example, the business of some corporations strongly depends on idiosyncratic services of its personnel. The board is then well advised to provide benefits that might go (far) beyond statutory labor protection to motivate firm-specific investments of human capital.[133] Furthering stakeholder interests can thus be a necessary component of creating resilience.[134] While the long-term interests of shareholders and the interests of some stakeholders like employees or even of society at large might coincide, perfect alignment is implausible.[135] Accordingly, the ongoing debate on the corporate purpose needs to answer the narrower question of how the law should treat a spending of corporate resources when the interests of shareholders and stakeholders do not coincide under a long-term perspective.

Existing legal strategies relate to altering the terms of affiliation for shareholders under enhanced disclosure obligations of corporations or of institutional investors that serve as intermediaries for investors.[136] Other attempts aim to encourage board diversity, especially gender equality, by modifying the appointment rights of shareholders.[137] Recently, contenders for the Democratic presidential nomination went further

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[133] Erik G. Furubotn, *Codetermination and the Modern Theory of the Firm: A Property-Rights Analysis*, 61 J. BUS. 165, 170 (1988).

[134] Leo Strine, Kirby Smith & Reilly Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, IOWA L. REV. (forthcoming 2020), https://ssrn.com/abstract=3664021.

[135] Luca Enriques, Henry Hansmann, Reinier Kraakman & Marina Pargendler, *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, *in* ANATOMY OF CORPORATE LAW, *supra* note 6, at 79, 94.

[136] *Id.* (on corporate disclosure). Edward B. Rock, *For Whom is the Corporation Managed in 2020?: The Debate over Corporate Purpose* (ECGI - Law Working Paper No. 515/2020), https://ssrn.com/abstract=3589951. *See also* Paul L. Davies, *The UK Stewardship Code 2010-2020: From Saving the Company to Saving the Planet*, *in* FESTSCHRIFT FÜR KLAUS J. HOPT 131 (Stefan Grundmann, Hanno Merkt & Peter O. Mülbert eds., 2020) (on disclosure by institutional investors). On possible amendments of the company's articles in France *see infra* note 154.

[137] California seems to take the lead in furthering equality goals with a new bill filed with the Secretary of the State on September 30, 2020. *Cf.* Assemb. B. No. 979 (Ca. 2020) (an act to amend Section 301.3 of, and to add Sections 301.4 and 2115.6 to, the Corporations Code, relating to corporations).

and embraced the idea of strengthening corporate accountability by vesting employees of large corporations with the right to appoint up to 45 percent of the board members.[138] This option is known as employee co-determination, and marked a center point of the reform discussion in the 1980s.[139] The afresh proposals are loosely modeled on the German system of co-determination that we will explore further below.[140] As it stands, proposals of reallocating appointment rights to non-shareholder constituency groups, especially to employees, will not find their way into law reform in the US (or the UK).[141]

The US debate on the corporate purpose mainly focusses on setting standards of behavior which include the goal of social responsibility. In August 2019, the influential Business Roundtable (BRT) published its "Statement on the Purpose of a Corporation."[142] Signed by 181 CEOs of large US corporations, the statement mentions long term-value for shareholders as only one out of five commitments. These

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[138] Elisabeth Warren's "Accountable Capitalism Act," a one-pager published in 2018, proposed that employees of corporations with more than $1 billion in annual gross receipts are to elect 40% of the board directors. *Cf.* Elizabeth Warren, *Accountable Capitalism Act* (Aug. 2018), www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act%20One-Pager.pdf. Bernie Sanders's "Corporate Accountability and Democracy Plan" aimed at corporations that are publicly traded or have assets or revenues of at least $100 million and argued for an even higher proportion of 45% of the directors to be elected by employees. *Cf.* Bernie Sanders, Corporate Accountability and Democracy, https://berniesanders.com/issues/corporate-accountability-and-democracy/ (last visited: October 12, 2020).

[139] For a comparative account, *see* Klaus J. Hopt, *New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338 (1984).

[140] *See infra* section 4.3.

[141] Jens Damman & Horst Eidenmüller, *Codetermination: A Poor Fit for U.S. Corporations*, Col. Bus. L. Rev. 870 (2020); Leo E. Strine, Aneil Kovvali & Oluwatomi O. Williams, *Lifting Labor's Voice: A Principled Path Toward Greater Worker Voice And Power Within American Corporate Governance* (Faculty Scholarship at Penn Law 2021/2256), https://scholarship.law.upenn.edu/faculty_scholarship/2256, at 50 (arguing in favor of an introduction of co-determination and presenting far reaching proposals); Konstantinos Sergakis & Andreas Kokkinis, *A Flexible Model for Efficient Employee Participation in UK Companies*, 20 J. CORP. L. STUD. 453 (2020) (arguing for formal employee panels in a mere advisory role). For a state of the discussion in the UK, *cf. infra* section 4.2.

[142] Business Roundtable, *Statement on the Purpose of a Corporation* (Aug. 19, 2019), www.businessroundtable.org.

commitments include, inter alia, the interests of employees. Advocates of the ESG movement diagnosed a paradigm shift that will ultimately lead to a redefinition of the corporate purpose and eventually to material changes of directors' duties. However, a study conducted by Lucian Bebchuk and Roberto Tallarita in 2019 revealed that the vast majority of the CEOs signed the statement without obtaining approval of their boards, while, at the same time, the board approved corporate governance guidelines of their companies that continued to clearly reflect shareholder primacy.[143] These findings reinforce the view taken by many that the wording of the BRT Statement does not promise more than what one might call due regard to factors that must be considered by directors under a shareholder value approach anyways ("mere rethoric").[144]

It is clear that the Business Roundtable lacks authority for rewriting legal standards. For Delaware business corporations, it appears, "directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare."[145] Some Federal States like New York decided to adopt constituency statutes that would allow directors to consider the interests of employees and other stakeholders, to be sure, without creating a legal duty to any party, thus ultimately shielding directors from litigation by shareholders.[146]

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[143] Lucian Bebchuk & Roberto Tallarita, *"Stakeholder" Capitalism Seems Mostly for Show*, WALL ST. J. (Aug. 6, 2020), www.wsj.com/articles/stakeholder-capitalism-seems-mostly-for-show-11596755220; Lucian Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020).

[144] Luca Enriques, *The Business Roundtable CEOs Statement: Same Old, Same Old,* PROMARKET (Sept. 9, 2019), https://promarket.org/2019/09/09/the-business-roundtable-ceos-statement-same-old-same-old/; Luigi Zingales, *Don't Trust CEOs Who Say They Don't Care About Shareholder Value Anymore*, WASH. POST (Aug. 20, 2019), www.washingtonpost.com/opinions/2019/08/20/dont-trust-ceos-who-say-they-dont-care-about-shareholder-value-anymore/.

[145] Leo E. Strine, *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768 (2015). Strine was Delaware Chief Justice at the time the Business Roundtable published its statement.

[146] NY BUS. CORP. LAW, sec. 717(b). On the real effect of shielding managers, *see* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. REG. 119, 171 (1992).

Delaware declined such legal amendments in 1990. Like some other US Federal States, instead, Delaware introduced a so-called public benefit corporation (B-corporation) in 2010 whose charter may be amended to expand fiduciary duties to stakeholder interests.[147] From a US perspective, the B-corporation counts as a modification to the constraints strategy in that it provides legal protection to directors when they decide to promote non-shareholder interests.

In the EU, the discussion on introducing a social enterprise company might soon gain traction.[148] While in Germany law discussions are at an early stage,[149] Italy already introduced its Societá Benefit in 2015.[150] Contrary to the US Delaware, for Italy, a B-corporation arguably does not add much to the stakeholder approach as embodied in general company law.[151] The French counterpart (société à mission) was introduced in 2019.[152] Moreover, since 2019, French law allows for inclusion of a set of principles in the articles that the company is committed to and the furtherance of which it expects to devote resources to in the course of its business (raison d'être).[153]

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[147] Del. Gen. Corp. L. § 361. *Cf.* Michael B. Dorff, James Hicks & Steven Davidoff Solomon, *The Future or Fancy? An Empirical Study of Public Benefit Corporations,* HARV. BUS. L. REV. (forthcoming 2020).

[148] Holger Fleischer, *Corporate Purpose: A Management Concept and its Implications for Company Law* (ECGI - Law Working Paper No. 561/2021), https://ssrn.com/abstract=3770656 (presenting a comparative account of the corporate purpose discussion and of the developments in Europe); J. S. Liptrap, *The Social Enterprise Company in Europe: Policy and Theory*, 20 J. CORP. L. STUD. 495 (2020).

[149] Anne Sanders et al., *Entwurf eines Gesetzes für die Gesellschaft mit beschränkter Haftung in Verantwortungseigentum* (June 2020), www.gesellschaft-in-verantwortungseigentum.de/der-gesetzesentwurf/ (presenting a draft law on a German benefit corporation as published by a non-governmental expert group).

[150] Legge 28.12.2015, note 208, Disposizioni per la formazione del bilancio annuale e pluriennale dello Stato (legge di stabilitá 2016), Gazzetta Ufficiale, Serie Generale note 302, 30.12.2015, Suppl. Ordinario note 70/L.

[151] Gianluca Riolfo, *The New Italian Benefit Corporation*, 21 EUR. BUS. L. REV. 279, 295 (2020).

[152] CODE DE COMMERCE, *supra* note 101, at art. L210-10.

[153] CODE CIVILE [CIVIL CODE], art. 1835 ("Les statuts peuvent préciser une raison d'être, constituée des principes dont la société se dote et pour le respect desquels elle entend affecter des moyens dans la réalisation de son activité.").

The charter amendments of large French companies reveal a high degree of generality, lack quantifiable goals, and thus avoid the risk of being held accountable, or worse, liable for failure to achieve any of those goals.[154] It thus seems that the inclusion of purpose clauses which the board must respect does not change much in the business reality of a company.

To sum up the observations made up to this point, the board can be used as an institution to further stakeholder interests but, depending on the arrangements of the applicable law, only in a limited way. While directors of a Delaware business corporation arguably breach their duties when they spend corporate resources on matters that are outside the intersection with shareholder interests, the charter of a benefit corporation as available in Delaware, or, for example, in Italy and France, might oblige them to do so. As a result of the availability of either duty set, furthering of stakeholder interests that do not intersect with shareholder interests is left to investors' choice.[155]

4.2 Enlightened Shareholder Value (UK)

Similar to US law, English law traditionally follows a shareholder value approach.[156] As Bowen LJ phrased in 1883: "The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company."[157] Later, the reformed Companies Act of 2006 enshrined what is called enlightened shareholder value in its section 172: a director "must act in the

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[154] Alain Pietrancosta, *Intérêt social et raison d'être: Considérations sur deux dispositions clés de la loi PACTE amendant le droit commun des sociétés,* ANNALES DES MINES – RÉALITÉS INDUSTRIELLES, Nov. 2019, at 55, 58 (noting a number of examples, including Atos, Carrefour, Sanofi, Michelin, Sanofi and Total); Alain Viandier, *La raison d'être d'une société* (C. civ. Article 1835), BULLETIN RAPIDE DROIT DES AFFAIR, 10/2019, at 30.

[155] Eugene F. Fama, *Market Forces Already Address ESG Issues and the Issues Raised by Stakeholder Capitalism*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 9, 2020); *cf.* Eugene F. Fama & Kenneth French, *Disagreement, Tastes, and Asset Prices,* 83 J. FIN. ECON. 667 (2007) (illustrating a model in which investors also have "tastes" for assets as consumption goods).

[156] DAVIES, *supra* note 7, at 307.

[157] Hutton v. West Cork Railway Co. 23 Ch D 654 (1883).

way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole." The remainder of the section adds a list of matters to which directors must "have regard" to. These matters especially include the interests of the company's employees and, as it seems, the components of the list that may have strongly inspired the Statement by the US Business Roundtable of 2019.[158]

Following the prevailing view, the concept of enlightened shareholder value builds on the insight that without profits, a company will disappear and accordingly the success in achieving social goals must be seen as a derivative of making profits.[159] Some seem to believe the opposite, i.e. that the company's profits are a derivative of achieving the company's goals.[160] It is doubtful though that section 172 Companies Act will serve as a trajectory for redefining the corporate purpose, primarily for the following two reasons:[161] firstly, the statute creates a subjective framing by obliging a director to "act in the way he considers, in good faith." It is not clear how such subjective framing could contribute to judicial deference to directors, who use corporate resources for interests outside the intersection with shareholder value. In sum, the duty description, coupled with the list of interests that directors must give regard to, shows a degree of generality that arguably will rarely unfold constraining force.

Secondly, third parties, although their interests might form part of the list, do not have standing in court. Accordingly, they lack enforcement power at the outset, much alike under the constituency statutes in the US which, as we have seen, appear to shield managers from litigation.[162] This situation could change in the EU, which the UK, of course, is about to leave under terms currently negotiated. The EU wishes to adopt a

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[158] *See supra* note 142.

[159] DAVIES, *supra* note 7, at 333.

[160] COLIN MAYER, PROSPERITY 31 (2018). For the opposite position, *see* Bebchuk & Tallarita, *supra* note 143, at 96 note 13, and DAVIES, *supra* note 7, at 333. *Cf.* Colin Mayer, *Shareholderism Versus Stakeholderism – a Misconceived Contradiction. A Comment on "The Illusory Promise of Stakeholder Governance" by Lucian Bebchuk and Roberto Tallarita* (ECGI - Law Working Paper No. 522/2020), https://ssrn.com/abstract=3617847.

[161] Enriques, Hansmann, Kraakman & Pargendler, *supra* note 135, at 98.

[162] *See supra* note 146.

directive to foster sustainable corporate governance by 2021. It recently commissioned a study by Ernst & Young to sort out the possible ways of action.[163] The final report issued in July 2020 is controversially discussed due to presumed methodological weaknesses and highly questionable assumptions.[164] The study proposes to redefine directors' duties and to allow stakeholders to instigate legal proceedings against directors that fail to address the social risks and impacts.[165] The heroic assumption which underlies this proposal seems to be that stakeholders will take enforcement action only to pursue legitimate social goals. As known, litigation can also be used for blackmail, coercion, or simply as a means for political opposition against a market economy. Providing stakeholders that do not have a clear relationship to the company with legal standing could attract plaintiffs from inside *and* outside the country.[166] The report seems to dangerously underestimate the consequences of an increase of litigation risks that is impossible to insure against.[167] It would be mistaken to see the report as a blueprint for law reform, if not for its imprudence, simply for the reason that it fails to explain how the relevant stakeholder groups can be delineated and distinguished from the public.

Employees form an identifiable group, and they have a clear relationship to the company. This is why institutional representation of employees on the board of directors

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[163] Ernst & Young, *Study on Directors' Duties and Sustainable Corporate Governance* (July 2020). For a roadmap of future legislation in the EU, *cf.* European Commission, Sustainable Corporate Governance Initiative, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance.

[164] European Company Law Experts (ECLE), *Feedback Paper* (Sept. 28, 2020), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/feedback?p_id=8270916

[165] Ernst & Young, *supra* note 163, at 152.

[166] Mark J. Roe, Holger Spamann, Jesse M. Fried & Charles C. Y. Wang, *The European Commission's Sustainable Corporate Governance Report: A Critique* (October 14, 2020), https://ssrn.com/abstract=3711652, at 16.

[167] Paul Krüger Andersen et al., *Response to the Study on Directors' Duties and Sustainable Corporate Governance by Nordic Company Law Scholars* (Nordic & European Company Law Working Paper No. 20-12), https://ssrn.com/abstract=3709762, at 17 ("a recipe for disaster").

has been a topic of law reform in the UK several times similar to the US.[168] The proposals made by the British Bullock Commission in the late 1970s, however, did not gain momentum.[169] In 2016, Theresa May started her term as UK prime minister with a new advance but, upon strong opposition, quickly took her reform vision back.[170] As it stands, the UK uses disclosure duties to indirectly enhance the position of employees within the company. Since 2013, a detailed list of aspects must be addressed in the directors' report of companies with more than 250 employees working in the UK.[171] The 2018 version of the UK Corporate Governance Code takes the disclosure duties of companies with a premium listing one step further. It recommends adopting one out of the following options that can be seen as a mild form of board structuring: a director appointed from the workforce, a formal workforce advisory panel, or a designated non-executive director.[172] As we have seen, under the comply or explain approach, companies must disclose non-compliance with code recommendations and explain their reasons.[173]

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[168] Sergakis & Kokkinis, *supra* note 141.

[169] Report of the Committee of Inquiry on Industrial Democracy (Bullock Report), Cmnd 6706 (1977). *Cf.* Paul Davies*, The Bullock Report and Employee Participation in Corporate Planning in the UK*, 1 J. COMP. CORP. L. & SEC. REG. 245 (1978); Lord Wedderburn of Charlton, *The Legal Development of Corporate Responsibility: For Whom Will Corporate Managers Be Trustees?*, *in* CORPORATE GOVERNANCE AND DIRECTORS LIABILITIES 36 (Klaus J. Hopt & Gunther Teubner eds., 1985, reprint 2012).

[170] Dep't for Bus., Energy & Indus. Strategy, *Corporate Governance Reform, Green Paper* (Nov. 29, 2016), at 2, 34.

[171] The Companies (Miscellaneous Reporting) Regulations 2018, S.I. 2018 No. 860, Sch. 7, Part 4, reg. 11 (as amended). The directors' report "must contain a statement describing the action that has been taken during the financial year to introduce, maintain or develop arrangements that aim at (i) providing employees systematically with information on matters of concern to them as employees, (ii) consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests, (iii) encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means, and (iv) achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company."

[172] UK Corporate Governance Code (July 2018), provision 5.

[173] On comply or explain, *see supra* section 3.2.

To sum up, the recent upheavals in the corporate purpose debate have led to a considerable increase in proposals to use the board of directors as an institution to channel legal strategies which aim to promote social goals. Out of our sample jurisdictions the US and the UK, only the UK uses board structuring, and only on a comply or explain basis. Despite recurring reform debates, neither of the two samples vest employees with the right to appoint a board representative. The use of the appointment rights strategy thus remains the major difference to our third sample jurisdiction Germany, which we will discuss in the remainder of the chapter.

4.3 Employee Co-Determination (Germany)

Contrary to the US or the UK, German company law is known for its tradition of following a stakeholder approach that obliges directors to include the interests of constituencies other than shareholders into their business judgments. Interests of non-shareholder constituencies, however, may or even must stand back if necessary for reasons of economic viability.[174] The practical implications, arguably, will rarely differ from what is called enlightened shareholder value in the UK or what could be justified as long-term shareholder value in the US. The crucial difference does not concern directors' duties in general, but rather the process of internal decision-making by boards under employee codetermination.

German companies with over 500 employees must give one-third of the supervisory board seats to employee representatives.[175] Proponents argue that co-determination is a means of balancing out shareholder and stakeholder interests. In fact, the close involvement of employee representatives has often been useful to handle severe interest clashes that may occur in a restructuring or merger. The major controversy concerns the scheme known as half-parity codetermination, which applies to companies with 2,000 employees or more, and obliges to give half of the seats to employee

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[174] Patrick C. Leyens, *Corporate Social Responsibility: Developments, Challenges and Perspectives*, *in* GLOBALISATION OF CORPORATE SOCIAL RESPONSIBILITY AND ITS IMPACT ON CORPORATE GOVERNANCE 157, 162 (Jean J. du Plessis, Umakanth Varottil & Jeroen Veldman eds., 2018).

[175] Drittelbeteiligungsgesetz [One-third Co-determination Act], sec. 1, para. 1 & sec. 4, para. 1.

representatives.[176] Under this scheme, a company with 20,000 employees has to form a supervisory board of 20 directors. The chairperson, normally a shareholder representative, is vested with a casting vote to resolve deadlocks between the shareholder and employee benches.

The path-dependent reasons for the strong form of co-determination in Germany reach back to the rebuilding of the country's economy after World Wars I and II. It is true that within the EU, only 10 out of the 27 Member States do not provide a form of employee participation.[177] The institutional designs, however, differ strongly.[178] For example, in Austria, delegates are sent out by the workforce only.[179] In Germany, the employee bench is split up between workforce and worker unions, which can cause severe conflicts as representatives might be employed by competing companies or important suppliers.[180] The expectations that employees and unions set into their representatives are irreconcilable with a neutral role.[181] As other representatives of single constituencies, employee or union representatives will naturally and understandably tend to champion the interests of their electorate body, of course, only as far as compatible with their own individual interests.[182]

To avoid pitfalls of generalization, we should remember that two-tier board structures differ strongly between countries. The real-world impact of German co-determination is a result of at least three factors:[183] firstly, in addition to its veto right on business decisions, German supervisory boards are responsible for the selection and the

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[176] Mitbestimmungsgesetz [Co-determination Act], sec. 7, para. 1, no. 3.

[177] Belgium, Bulgaria, Cyprus, Estonia, Italy, Latvia, Lithuania, Malta, Romania, and the UK. *Cf.* S. Vitols, *The European Participation Index (EPI): A Tool for Cross-National Quantitative Comparison* (Oct. 2010), http://www.worker-participation.eu, at 6.

[178] Davies, Hopt, Nowak & van Solinge, *supra* note 3, at 72, 74.

[179] ARBEITSVERFASSUNGSGESETZ [LABOUR ORGANISATION ACT], sec. 110 (Austria).

[180] *See supra* note 176.

[181] Klaus J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe*, 14 INT. REV. L. ECON. 203, 206 (1994).

[182] Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 964 (1984).

[183] Otto Sandrock & Jean J. du Plessis, *The German System of Supervisory Codetermination by Employees*, *in* GERMAN CORPORATE GOVERNANCE IN INTERNATIONAL AND EUROPEAN CONTEXT 188, 196 (Jean J. du Plessis et al. eds., 3d ed. 2017).

removal of the members of the management board, and for enforcing liability claims of the company against the management board.[184] German supervisory boards further set the remuneration of management directors while shareholders only have a consultative vote.[185]

Secondly, the large proportion of 10 out of 20 parity votes vests the employee bench with considerable bargaining power and makes them a highly attractive coalition partner for the management board.[186] Due to the inherent antagonism between capital and labor the two fractions of the supervisory board will be unlikely to cooperate. The casting vote of the chairperson, in theory, could turn the table in favor of shareholders, but compromising employees might come at the cost of a severe disturbance of the cooperation within the supervisory board or with the management board. Evidence might be anecdotal, but well known cases show that labor will use its powers to force concessions.[187]

Thirdly, on the side of the supervisory board, a coalition of only one shareholder representative with the employee bench forms a majority, provided that employee representatives act unanimously, which they do, as known by other examples.[188] Representatives of controlling shareholders on supervisory boards thus find a basis for

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[184] Aktiengesetz, *supra* note 41, at secs. 84, 112. The duty to enforce liability claims was further carved out by case law. *Cf.* BGH, Judgment of 21.4.1997 – II ZR 175/95 (ARAG/Garmenbeck), BGHZ 135, 244. The case is discussed in MARCO VENTORUZZO ET AL., COMPARATIVE CORPORATE LAW 312 (2015).

[185] Aktiengesetz, *supra* note 41, at secs. 87, 87a, 120a. See also *infra* note 192.

[186] Katharina Pistor, *Co-Determination in Germany: A Socio-Political Model with Governance Externalities*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 163 (Margaret Blair & Mark Roe eds., 1999).

[187] For example, Herbert Diess, CEO and chairman of the management board of the Volkswagen group, received strong opposition by labor against his strategy to streamline production and to implement new technologies in the Volkswagen car division. It was only upon support by large block owners that he could stay in office. However, as a concession to labor, he had to turn down the management of the Volkswagen car division. *Cf.* FRANKFURTER ALLGEMEINE ZEITUNG, June 10, 2020, at 15, 22.

[188] Ferdinand Piëch, blockholder and supervisory board chairman of Volkswagen, was known for "instrumentalizing" the employee bench whenever needed for asserting his views within the supervisory board. One of those coalitions led to the appointment of Horst Neuman as a new management board director for human resources in 2005 against the will of the other shareholder representatives on the supervisory board. *Cf.* FRANKFURTER ALLGEMEINE ZEITUNG, May 2, 2006, at 17.

forming coalitions with employees on matters of common interest. The strongest example we discussed relates to the authorization of defensive measures against a hostile takeover that could further the interests of non-controlling shareholders but, simultaneously endanger job safety for employees.[189]

To take the example of rewards, experience shows that the mitigating effect of labor voice on exaggerated remuneration of managing directors was rather negligible in the past.[190] Still, by making use of an optional arrangement of the EU Shareholder Rights Directive of 2017, the German legislator chose to leave the task of setting the remuneration in the hands of the supervisory board, and provided shareholders with a mere consultative vote.[191] The decision to avoid a mandatory say-on-pay by shareholders – right or wrong – was also made because otherwise, the co-determined supervisory boards and therein labor and trade unions would have lost considerable influence. In 2009, law reform precluded the supervisory board from delegating remuneration decisions to one of its committees.[192] The well-intentioned motive was to prevent excessive remuneration packages. The real effect of reserving matters for plenary decision of the supervisory board, on a closer look, again gives greater say to employees and worker unions.[193]

Out of the governance strategies treated in this chapter, solely employee co-determination calls for a basic governance structure that, from the viewpoint of private

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[189] *Cf. supra* section 0.0.

[190] LUCIAN A. BEBCHUK & JESSE M. FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 121 (2004) (discussing the general problems of exaggerated remuneration).

[191] Aktiengesetz, *supra* note 41, at secs. 87, 87a, 120a as amended. *Cf.* Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie [Law on the Transposition of the Second Shareholder Rights Directive] (Dec. 12, 2019), BGBl. I 2019, 2637, Art. 1.

[192] Aktiengesetz, *supra* note 41, at sec. 107, para. 3 as amended. *Cf.* Gesetz zur Angemessenheit der Vorstandsvergütung [Law on the Adequateness of the Remuneration of Managing Directors] (July 31, 2009), BGBl. I 2009, 2509, Art. 1.

[193] Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 101 (2016) (showing how corporate governance reform is used to further external goals).

parties, only a two-tier board model can provide.[194] In a one-tier board, co-determination would provide employee representatives with the power (and the responsibility) for co-determining all business decisions. In fact, this option would be available for a Societas Europaea (European Company).[195] As far as is known, it has never been made use of by a large business enterprise.[196] In fact, the Hans Böckler Foundation, which is run by the German Trade Union Confederation, observes that private parties try to circumvent co-determination legislature.[197] Some choose a foreign corporate form. Others make use of a special scheme applicable to the Societas Europaea which allows to freeze the current level of co-determination, thus avoiding parity co-determination upon a further increase in the number of the company's employees.[198]

5. Summary

1. Board models like the one-tier board, as used in the US and the UK, or the two-tier board, as used in Germany, provide a basic governance structure that enables the use of specific governance strategies. It is the use of specific governance strategies, not the choice of a board model, which determines the role of the board in alleviating agency problems between owners and managers, controlling and non-controlling

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194 HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996) ("[T]here is no *legal* reason why large corporations are capital rather than labor cooperatives" (emphasis added)).

195 Article 38 Council Regulation (EC) No 2157/2001 of 8 October 2001 on the Statute for a European company (SE), OJ EC L 294 of 10.11.2001, at 1.

196 Horst Eidenmüller, Andreas Engert & Lars Hornuf, *Incorporating Under European law: The Societas Europaea as a Vehicle for Legal Arbitrage*, *in* THE LAW AND ECONOMICS OF CORPORATE GOVERNANCE 82, 88, 117 (Alessio M. Pacces ed. 2010); Martin Gelter & Mathias Siems, *Letting Companies Choose Between One-Tier and Two-Tier Board Models: An Empirical Analysis of European Jurisdictions* (Dec. 2, 2018) (unpublished manuscript) (on file with the authors).

197 *Cf. Böckler Impuls* (16/2020), www.boeckler.de/de/boeckler-impuls.htm; Sebastian Sick, *Erosion als Herausforderung für die Unternehmensmitbestimmung,* MITBESTIMMUNGSREPORT 58/2020 (April 2020), at 13; *Abschied von der Mitbestimmung*, HANDELSBLATT April 20, 2016, at 9.

198 Gesetz über die Beteiligung der Arbeitnehmer in einer Europäischen Gesellschaft [Law on the Partcipation of the Employees in a European Company] (22.12.2004), at sec. 21.

shareholders, and shareholder and stakeholder constituencies. Based on this finding, the choice of the suitable board model should be left to private parties.

2. The market for corporate control is known as a removal strategy that alleviates the agency problem between owners and managers of potential target companies. To achieve this effect, it must be ensured that takeover defenses are adopted in the interest of shareholders rather than to shield the incumbent board from removal by the acquirer. The governance options include focusing the board structure through the allocation of decision-making power to independent directors (US) or to the supervisory board (Germany), and, as an alternative, reinstalling shareholder decision-making and thus removing the board from its coordination task (UK). Counter-intuitively, one might group US and German law together, despite differences in their basic board structures and despite the European Union's adoption of UK-style control shift regulation.

3. The three sample jurisdictions follow a similar pattern for securing fairness of related party transactions (RPTs). The UK relies on a structuring of the shareholder body, requiring ex-ante approval of the disinterested shareholders (MOM approval), a strategy that is also used in France but in a weaker form due to the possibility of ex-post authorization. In the US, the predominant choice seems to be structuring the board so as to leave the decision to independent directors, a strategy that Italy has, on one hand, sought to enhance with the obligatory involvement of a minority appointed director but, on the other hand, has weakened by allowing the board to override a recommendation of the independent directors. Germany also relies on board structuring in that it requires supervisory board approval of RPTs, but compared to the use of independent directors, the cooperation between the two boards provides a basis for manager-friendly results one would expect only from a jurisdiction that openly promotes board empowerment.

4. The most far-reaching advance of the corporate purpose debate relates to a further structuring of the board so as to provide employee representatives with a voice, as known from German co-determination. Proposals to reallocate a proportion of the appointment rights from shareholders to employees have not found their way into legal reform in the US or the UK. Out of the governance strategies discussed in this

chapter, it is only employee co-determination that calls for a basic governance structure which solely a two-tier board model can provide.

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