EUROPEAN & INTERNATIONAL LAW

Recent Developments of Corporate Governance in the European Union and their Impact on the German Legal System

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A. Introduction

The collapses of several US-businesses like those of Enron and Worldcom and a number of scandals in the EU – in the recent past that of Parmalat – have strongly affected public confidence in the operation and governance of large entities trading their shares in organized capital markets. The European Commission reacted by issuing the *Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU* on 21 May 2003[1]. The *Action Plan* contains measures which the Commission wants to implement over the short term (until 2005), medium term (until 2008) and long term (until 2010). The key issues set up in the *Action Plan* concern corporate governance, capital maintenance, recapitalization as well as decreasing capital, groups of companies, international corporate restructuring and the introduction of a new legal form of incorporation. The fact that the big rating agencies have begun to rate the corporate governance performances of major companies[2], can well be seen as a further indicator that *good corporate governance* has an important concern for managers, shareholders and for policy makers. As part of the *Action Plan*, the Commission has recently launched consultations on board responsibilities and improving financial and corporate governance information[3], on direc-

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[1] Communication from the Commission to the Council and the European Parliament – Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to move forward, COM (2003) 284 final.

[2] *See* Habersack, 1 NZG 3 (2004).

[3] Consultation on board responsibilities and improving financial and corporate governance information, available at http://europa.eu.int/comm/internal_market/accounting/board/index_en.htm.

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tors' remuneration[4] and on the role of (independent) non-executive or supervisory directors[5]. In the light of these recent consultations and the results of the public consultation on the *Action Plan*[6], this Article offers an overview and assessment of the corporate governance measures planned at Community level.

B. Historical Context

The fact that proper and strict corporate governance principles are essential to the efficient functioning of capital markets has already been recognized by the *Financial Services Action Plan*[7] which was adopted by the Council in May 1999. Being the Commission's blueprint for the realization of a single financial market within the EU until 2005, it indicated that effective corporate governance was a vital premise to achieve this goal[8]. In November 2001, the Commission set up a *High Level Group of Company Law Experts* (HLG)[9] to provide independent advice on key priorities for modernizing European company law, including corporate governance. Subsequent to the collapse of Enron, the mandate of the HLG was extended in April 2002 in order to deal with those regulatory issues which had proved to be crucial to the Enron crisis. Therefore, the HLG also developed proposals concerning the role of non-executive board members and of members of the supervisory board, the remuneration of directors and their responsibility for financial information. In November 2002, the HLG released the final report on a modern regulatory framework for company law in Europe[10].

[4] Fostering an appropriate regime for the remuneration of directors. Consultation document of the Services of the Internal Market Directorate General, 23-02-2004, available at http://europa.eu.int/comm/internal_market/company/directors-remun/index_en.htm.

[5] Recommendation on the role of (independent) non-executive or supervisory directors. Consultation document of the Services of the Internal Market Directorate General 05-04-2004, available at http://europa.eu.int/comm/internal_market/company/docs/independence/2004-05-consultation_en.pdf.

[6] Synthesis of the responses to the Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union" – COM (2003) 284 final, available athttp://europa.eu.int/comm/internal_market/en/company/company/modern/index.htm.

[7] COM 1999 (232), avialable at http://europa.eu.int/comm/internal_market/en/finances/general/actionen.pdf.

[8] The suitability of corporate governance codes to achieve these goals is now doubted by Bernhardt, RIW 401, 402 (2004).

[9] *See* http://europa.eu.int/comm/internal_market/en/company/company/news/01-1237.htm.

[10] Available at http://europa.eu.int/comm/internal_market/en/company/company/modern/ (last visited 22 September 2004).

The HLG report was followed by the Commission's already mentioned *Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the EU* on 21 May 2003 and by the consultations that were published on 21 November 2003[11]. However, the measures proposed in the Action Plan and in the consultations are only notions which certainly will be modified or even dismissed or replaced to a wide extent in the course of the legislative process. On 14 May 2004, the OECD announced a revision of the OECD Principles of Corporate Governance[12]. Just recently, the European Corporate Governance Institute (ECGI) and the American Law Institute (ALI) started a transatlantic dialogue on corporate governance at a conference held on 12 July 2004 in Brussels[13].

C. The Content of the EU Projects on Corporate Governance

Many Member States have already taken the first steps to modernize their national company laws. For example, recent developments in the UK include a newly revised Combined Code[14] as well as the Higgs[15] and Smith[16] reports. In Germany, the federal government recently issued its so-called 10-Points-Plan and a draft of a law that addresses issues of "corporate integrity" in companies and the modernization of stock corporation law (UMAG).[17] In addition, Berlin has presented a proposed law on model proceedings concerning investors' actions for damages (KapMuG)[18]. For a long time already, and increasingly so in the last years, the European Commission felt that it had to react in order to facilitate the eventual creation of a coordinated system of corporate governance within the EU. The objective is not to develop a uniform European corporate governance code out of the vast amount of

[11] Available at http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/03/1581&format=HTML&aged=1&language=EN&guiLanguage=en (last visited 22 September 2004).

[12] *See* http://www.oecd.org/document/26/0,2340,en_2649_201185_23898906_1_1_1_1,00.html; concerning this revision and its impact on the corporate governance debate in the EU *see* Schneider, AG 2004, 429.

[13] *See* www.ecgi.org/tcgd/launch/flyer.htm.

[14] The combined code on corporate governance, available at http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf.

[15] Review of the role and effectiveness of non-executive directors, published January 2003.

[16] Audit Committees Combined Code Guidance, published January 2003.

[17] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, http://www.bmj.bund.de/media/archive/701.pdf.

[18] Gesetz über Musterverfahren zu Schadensersatzklagen von Kapitalanlegern, available at http://www.bundesgerichtshof.de/gesetzesmaterialien/KapMuG/005%20DiskE.pdf.

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existing corporate governance codes that have been adopted at national or international level[19]. Instead, the Commission considers it to be sufficient to establish some general principles and to harmonize the most important aspects of the national codes[20]. However, the Dutch Presidency has expressed its expectation of there being a European Corporate Governance Code[21] within the next five or ten years.

In the light of the above, in particular *seven* central elements of the Action Plan are examined in this paper. Part I covers the measures that seek to enhance corporate governance transparency. Parts II-V deal with the corporate governance measures regarding the board of directors. Part II focuses on the modernization of the structure of the board of directors and part III on directors' remuneration. Part IV deals with board committees and part V with the enhancement of directors' responsibilities. Parts VI and VII cover corporate governance elements that are intended to increase shareholders' voice such as enhancing the role of institutional investors (*infra*, VI) as well as increasing shareholders' rights (*infra*, VII). Finally, we will analyze the proposed structures of corporate governance coordination at EU level (*infra*, VIII).

I. Enhancing Corporate Governance Transparency

Both the *Action Plan* and the public consultation on board responsibilities propose that all companies listed in the EU should publish their corporate governance structures in the annual report[22]. This requirement could be imposed through a Directive covering a non-exhaustive list of key elements that need to be disclosed. As such possible elements, the *Action Plan* names:

- the operation of the shareholder meeting and its key powers
- the description of shareholder rights and how they can be exercised
- the composition and operation of the board and its committees
- the shareholders holding major holdings, their voting and control rights, key agreements and other direct and indirect relationships between these major shareholders and the company

[19] This caution is based on the recognition of distinct national traditions and company law cultures, *see*, e.g., Bernhardt, RIW 401 (2004); others expect the proposed recommendation to have positive effects on the harmonization process in spite of these differences, *see*, e.g., Schneider, AG 429, 430 (2004); *Becker*, GmbHR R 317 (2004).

[20] *See* http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf.

[21] *See* Becker, GmbHR R 317 (2004).

[22] *See* Van Hulle & Maul, ZGR 484, 490 (2004).

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- any material transaction with related parties
- the existence and nature of a risk management system[23]

According to the consultation on board responsibilities, the concrete content of the above information would eventually be published in a future "Corporate Governance Statement". The consultation proposes a requirement for the company to disclose whether or not it applies a corporate governance code and, if it does apply such a code, in which aspects it deviates from its provisions (so called comply-or-explain-method)[24]. Thereby, the company could illustrate its system of risk management, board committees, procedures for the appointment of board members and the operation of the shareholders' meeting and its key powers. Additionally, the consultation considers it to be helpful, if the statement contained a description of other elements of key importance for good corporate governance, in particular with respect to the independence and technical knowledge of the board members as well as the members of committees and, finally, regarding the existence and functioning of an internal control system[25].

As regards the consultation on board responsibilities, the European Commission differentiates between corporate governance structures that derive from binding laws and those that derive from non-binding laws[26]. Especially corporate governance elements regarding the structure and operation of the board and committees, the channels of information between executive and non-executive members of the board, the operation of the shareholders' meeting and the division of powers between the board and the shareholders' meeting generally derive from binding national laws. The European Commission believes that a merely descriptive statement exclusively providing information that is already contained in national statutes would lead to a pure repetition of the national provisions without bringing about any additional information. Instead, the Commission considers urging companies

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[23] Concerning risk management provisions in the German Code of Corporate Governance *see* Preußner, NZG 303 (2004).

[24] For the application of this principle in Germany, *see Bericht der Regierungskommission Corporate Governance – Unternehmensführung – Unternehmenskontrolle – Modernisierung des Aktienrechts*, 8, 14, edited by *Baums*, 2001 (German edition available at http://www.jura.uni-duesseldorf.de/dozenten/noack/Texte/cg/komplett.doc - last visited 24 September 2004); *see*, for a comment regarding the Higgs Report: http://www.financialdirector.co.uk/Comment/1135418; for the introduction of the principle into the Dutch Corporate Governance Code, *see* http://corpgov.nl/page/downloads/Conceptcode%20Engels%20DEFINITIEF.pdf (last visited 27 September 2004).

[25] *See* chapter 4 of the Consultation on board responsibilities, http://europa.eu.int/comm./internal_market/accounting/board/index_en.htm. (last visited 24 September 2004).

[26] *See* chapter 4 of the Consultation on board responsibilities, *supra*.

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to publish a statement which confirms the correspondence with those corporate governance elements that derive from binding national rules. In respect of non-binding laws regarding corporate governance elements – meaning national provisions which give the company a wide discretion in the installation and operation of corporate governance structures –, companies might be obliged to disclose those corporate governance elements in detail which differ from or go beyond the content of non-binding national provisions.[27] The general consensus concerning the principle of "enhanced corporate governance"[28] that emerged during the consultation process of the *Action Plan*[29] suggests that at least the core proposals of the European Commission concerning the corporate governance statement are widely accepted.

II. Modernizing the Structure of the Board of Directors

The modernization of the structure of the board of directors is a vital issue of the *Action Plan*. For that purpose the Commission seeks to adopt a *recommendation* promoting the role of independent non-executive or supervisory directors and the establishment of a number of specialized board committees until 2005[30]. The advantage of a recommendation is that – as it is not legally binding – the member states have great flexibility in transforming its provisions and adapting it to national characteristics. The disadvantage is that the Commission cannot enforce the transposition of the recommended legislative changes. Thus, it is questionable if all member states will in fact adopt the proposals made in the recommendation.

The Commission launched another public consultation on 5 May 2004[31] which stresses the need for an overall balance of executive or managing directors and non-executive or supervisory directors in the administrative, managing and supervisory bodies such that no individual or small group of individuals can dominate the decision making process[32]. This is of eminent importance with regard to the great dif-

[27] *Id*.

[28] *See* p. 24 Annex 1 of the Action Plan, available at http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf (last visited on 24 September 2004).

[29] *See* Synthesis of the responses to the Communication of the Commission to the Council and the European Parliament, chapter 3.1.1., available at http://europa.eu.int/comm/internal_market/en/company/company/modern/governance-consult-responses_en.pdf (last visited 24 September 2004).

[30] Both those measures were welcomed by the majority of respondents in the consultation procedure that followed the Action Plan, *see* Synthesis of the responses, p. 12.

[31] Recommendation on the role of (independent) non-executive or supervisory directors. Consultation document of the Services of the Internal Market Directorate General, *supra* footnote 5.

[32] *Id*. at 7.

ferences among the Member States. For example, in the German two-tier system, the managing board is responsible for managing the corporation[33], but at the same time it has to coordinate the firm's strategy with the supervisory board[34]. Therefore, the *Aktiengesetz* (German Stock Corporation Law) intends to split responsibilities between the two boards to better ensure a close cooperation to the benefit of the company. However, the two-tier system alone must fail in its attempt at ensuring good corporate governance if the members of the management board and of the supervisory board do not restrict themselves to the tasks assigned to them by law and manage the company in close linkage together[35].

Furthermore, the Commission recognizes that some decisions involve substantial conflicts of interests, e.g. with regard to directors' remuneration[36]. Such decisions must therefore be taken exclusively by non-executive directors in one-tier systems or members of the supervisory board in two-tier systems who are in the majority independent[37]. A definition of directors' independence is intended to be established at EU level[38] as a reaction to many respondents to the consultation on the Action Plan who pointed out the difficulties associated with defining and ensuring directors' independence in this matter[39]. However, this element of the recommendation has no effect on the German system. In German companies the remuneration of the members of the management board is already determined by the supervisory

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[33] § 76 I *Aktiengesetz*; No. 4.1.1 of the German Corporate Governance Code as amended on 21 May 2003 (GCGC); Hopt, *The German Two-Tier Board: Experience, Theories, Reforms*, *in* COMPARATIVE CORPORATE GOVERNANCE - THE STATE OF THE ART AND EMERGING RESEARCH 227 (Hopt et al., eds, 1998); Zumbansen, *Germany Inc. Eroding? - Board Structure, CEO and Rhenish Capitalism*, 3 GERMAN L. J. No. 6 (1 June 2002), available at http://www.germanlawjournal.com.

[34] §§ 90, 111 *Aktiengesetz*; No. 4.1.2 GCGC; Zumbansen, *supra* note 33; Theisen, *Empirical Evidence and Economic Comments on Board Structure in Germany*, *in* COMPARATIVE CORPORATE GOVERNANCE - THE STATE OF THE ART AND EMERGING RESEARCH 259 (Hopt et al., eds,1998).

[35] The BDI, the German Association of Industrialists, criticized that these innovations would lead to irresolvable restrictions both for small family-led businesses and groups. The structure of those companies would have to be remodeled in the whole of the EU, *see* Becker, GMBHR R 317 (2004).

[36] *See* Recommendation on the role of (independent) non-executive or supervisory directors, 2.6.2., p. 16, available at http://europa.eu.int/comm/internal_market/company/docs/independence/2004-05-consultation_en.pdf (last visited 24 September 2004).

[37] This proposal is criticized by Säcker, BB 1462, 1464 (2004) because it would eliminate the possibility for shareholders to control the management board's policy via the supervisory board.

[38] Recommendation on the role of (independent) non-executive or supervisory directors, p.12.

[39] Synthesis of the responses to the Communication of the Commission to the Council and the European Parliament, p. 13.

board[40]. In addition, at the proposal of the committee dealing with management board contracts the full supervisory board shall discuss and provide for a regular review of the structure of the management board remuneration system[41].

The proposed recommendation shall not set numeric limitations on the number of directorships that may be held by non-executive or supervisory directors in other listed companies, because the involvement required from a director may vary widely depending on the individual company. Also, directorships in unlisted companies or in other companies of the same group usually are not very time consuming. Instead, a general statement in which each director assures to apply the necessary time and attention to his duties might be sufficient[42]. A similar provision already exists in No. 5.4.3 of the German Corporate Governance Code (GCGC)[43], according to which every member of the supervisory board must take care that he has sufficient time to perform his mandate[44]. Moreover, a member of the supervisory board who also serves as a managing director in another company shall not accept more than four other supervisory board mandates.

Although the proposal for a recommendation acknowledges the need for non-executive or supervisory directors to be independent, it considers the inclusion of a general statement describing the general objective to be sufficient due to the absence of a universal understanding of what independence precisely entails[45]. A list

[40] *See* § 87 I *Aktiengesetz*. Certainly, problems are well known in Germany in this regard as well. *See* only the recent Mannesmann proceedings before the Regional Court (Landgericht) Düsseldorf. Hereto, e.g. Kolla, 5 GERMAN L. J. No. 7 (1 July 2004), and Rolshoven, 5 GERMAN L. J. No. 8 (1 August 2004), both available at http://www.germanlawjournal.com. *See* also the most recent proposal made by Professor Baums of the University of Frankfurt and Head of the Government Corporate Governance Commission (2000-2001), regarding the introduction of a mandatory disclosure of all management earnings. This proposal succeeds several weeks of dispute among policy makers, industrialists and scholars regarding the non-observance of the German Corporate Governance's recommendation to disclose management earnings; *see* http://www.forbes.com/associatedpress/feeds/ap/2004/08/25/ap1519364.html (last visited 27 September 2004).

[41] No. 4.2.2 GCGC.

[42] Recommendation on the role of (independent) non-executive or supervisory directors, p. 11.

[43] The compliance of Germany's leading listed companies with the provisions of the GCGC analyzed Oser, et al., BB 1121 (2004).

[44] *See* Schwark, *Corporate Governance: Vorstand und Aufsichtsrat*, *in* CORPORATE GOVERNANCE 108 (Hommelhoff et al., eds, 2002).

[45] Following draft is proposed: "A director is considered to be independent when he is free from any business, family or other relationship – with the company, its controlling shareholder or the management of either – that creates a conflict of interest such as to jeopardize exercise of his free judgment.", *id.* at 12.

of minimum criteria shall supplement this statement on a comply-or-explain-basis[46] such as

- not to be a managing or executive director of the company or an associated company and not having been in such a position for the previous five years,
- not to be an employee of the company or an associated company,
- not to be or to represent a controlling shareholder and
- not to have or to have had a significant business relationship with the company or an associated company within the last year[47].

These proposals go beyond what presently is provided in the GCGC. According to No. 5.5.1 and 5.5.3 GCGC all members of the supervisory board are bound by the company's best interests. No member of the supervisory board may pursue personal interests in his decisions or use business opportunities intended for the company for himself. Material conflicts of interest that are not merely temporary in respect of the person of a supervisory director shall result in the termination of his mandate. These provisions comply with the requirements for a general statement on the independence of supervisory directors. No. 5.5.2 GCGC only states that each supervisory director must inform the supervisory board of any conflict of interest which may result from a consultant or directorship function with clients or other business partners. It is obvious that this only insufficiently addresses the issue of possible conflicts of interests of board members.

III. Directors' Remuneration

One of the key elements of good corporate governance is the transparency of directors' remuneration[48]. According to the Action Plan, the Commission intends to publish a recommendation until 2005 on the installation of an appropriate regime of directors' remuneration in listed companies. The vast majority of respondents to the Action Plan were in favor of such measures[49]. To gain input from interested

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[46] *Id*. at 5.

[47] *Id*. at 12.

[48] *See* Maul & Lanfermann, BB 1861, 1866 (2004); Van Hulle & Maul, ZGR 484, 494 (2004); BENDER, HOW EXECUTIVE DIRECTORS' REMUNERATION IS DETERMINED IN TWO FTSE 350 UTILITIES, CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 206-17 (Vol. 11 2003); Yermack, *Remuneration, Retention, and Reputation Incentives for Outside Directors*, available at www.stern.nyu.edu/salomon/corporategovernance/S-CG-02-08.pdf (last visited 24 September 2004).

[49] Likewise Bernhardt, RIW 401, 404 (2004).

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parties, the Commission published a consultation document on directors' remuneration on 23 February 2004[50].

The consultation affirms that the amount and structure of directors' remuneration will be left to the sole responsibility of each individual company. The recommendation shall be refrained to imposing approval and disclosure requirements. Following the HLG final report and the Commission's Action Plan, the consultation paper proposes the approval of certain aspects of the company's remuneration policy like share-based schemes or performance criteria by the general meeting[51]. In addition, it imposes a number of substantial disclosure requirements[52] presumably to be published in the annual report like:

- information on the relative importance of the basic and performance related components of remuneration[53]
- details and justification regarding the performance criteria on which performance-related components of remuneration are based
- explanations of the reasons why non performance-related grants of shares or share options are provided, if any
- the main parameters and rationale for bonus schemes
- a description of pension funds granted
- a description of the company's policy on contracts, especially their duration, notice period and termination payments, and information on the company's remuneration policy setting process
- detailed disclosure of the remuneration of each individual director

Again, the Commission's proposals go beyond the existing provisions of the GCGC[54]. E.g. No. 4.2.3 GCGC provides that concerning the remuneration of the members of the management board the salient points of the compensation system and the concrete form of a stock options scheme or comparable instruments for components with long-term incentive effect and risk elements shall be published on the company's website in plainly understandable form and be detailed in the an-

[50] Available at http://europa.eu.int/comm/internal_market/company/docs/directors-remun/2004-consult_en.pdf (last visited 24 September 2004).

[51] Fostering an appropriate regime for the remuneration of directors, Consultation document of the Services of the Internal Market Directorate General, p. 12.

[52] *Id.* at 11.

[53] Frey, BB (2004), 1 postulates that the fix part of directors' remuneration should amount to at least 80 %.

[54] Concerning the provisions on directors' remuneration in the GCGC *see* Schwark, *Corporate Governance: Vorstand und Aufsichtsrat*, *in Corporate Governance*, 114 (Hommelhoff et al., eds, 2002).

nual report, including information on the value of stock options. The Chairman of the supervisory board shall outline the salient points of the compensation system and any changes thereto to the general meeting. In addition, in compliance with No. 4.2.4 GCGC the compensation of the members of the management board shall be reported in the notes of the consolidated accounts subdivided according to fixed, performance-related and long-term incentive components. These figures shall be individualized. According to § 192 II 3 *Aktiengesetz*, any stock-option rights for the managing directors must be authorized by the general meeting. Concerning the supervisory board members' remuneration, No. 5.4.5 GCG provides that their compensation is specified by resolution of the general meeting or in the by-laws of the association and shall be reported in the notes of the consolidated accounts, subdivided according to components. Last but not least, payments made by the enterprise to the members of the supervisory board or advantages extended for services provided individually shall be listed.

A comparison between the proposed European remuneration system and the German one shows their coherence in principle, but differences in detail. Especially the disclosure duties will be more extensive on the grounds of the recommendation. For example, the performance criteria on which performance-related components of remuneration are based shall not only have to be disclosed according to the rules of the GCGC. In addition, the GCGC needs to provide reasons and grounds of justification for this form of remuneration. This demand bears great resemblances to the rules governing the provision of non performance-related grants of shares or share options where an explanation rather than just its publication is demanded. Also, different from the practice in Germany, the value of stock-option plans shall have to be published in the financial statements. Besides, the elements of the remuneration of each individual director shall have to be disclosed in greater detail than it is currently done in Germany. E.g., companies shall have to disclose their pension plans for directors and the conditions of payments made in the case of a termination of the contract with a director.

These differences show that in the future German companies will have to disclose much more information concerning directors' remuneration than they currently do. This will on the one hand lead to greater transparency and control for shareholders and investors, but on the other hand restrict the directors' personal privacy connected with their income. The necessary changes of the GCGC will very likely trigger resistance of directors and their affiliated interest groups. However, this restriction of directors' privacy is the price one has to pay for the "enhanced corporate governance" which shall be established on a European level.

IV. Board Committees

The recommendation also provides for the establishment of nomination, remuneration and audit committees, defining their structure and role via minimum standards.

1. Nomination Committee

Though the Action Plan proposed to entrust the nomination of directors for appointment to a group mainly composed of executive directors, the Commission - now in accordance with many respondents to the consultation[55] - holds the view that a majority of independent non-executive directors should participate in the nomination committee in order to guarantee its independence[56]. The task of the nomination committee will be to ensure that the appointment and removal process of managing or executive directors is organized in an objective manner. It therefore shall identify and nominate board candidates to fill board vacancies as and when they arise that need to be approved by the supervisory board. It shall periodically assess the structure, size and composition of the one-tier or the two-tier board system and make recommendations to the supervisory board with regard to any changes. Besides, it shall regularly assess the skills, knowledge and experience of individual directors and report this to the supervisory board. Finally, it shall review the policy of the management board for selection and appointment of senior management. Doing so, the nomination committee shall consider proposals made by relevant parties, including management and shareholders[57]. It will have to make its terms of reference available by issuing statements in the annual report about its membership, the number of its meetings and attendance over the year and its main activities[58].

In German listed companies, the supervisory board appoints and dismisses the members of the management board. The supervisory board nevertheless has the choice to delegate preparations for the appointment of managing directors to a nomination committee that also determines the conditions of the employment contracts including compensation[59]. The Chairman of the supervisory board shall also

[55] Synthesis of the responses, p. 13.

[56] *See* Recommendation on the role of (independent) non-executive or supervisory directors., p. 14.

[57] *Id.* at 16.

[58] *Id*. at 15.

[59] No. 5.1.2 GCGC.

chair the nomination committee[60]. If Germany wants to comply with the recommended provisions, the GCGC will have to impose a duty to install a nomination committee. Its extensive tasks and competences, its operation and transparency will have to be established in the GCGC in accordance with the detailed provisions in the recommendation as described above. The assessment of the skills of individual directors and the publication of a statement in the annual report will be of special significance.

2. Remuneration Committee

According to the prospective recommendation, the remuneration committee must be composed exclusively of non-executive or supervisory directors the majority of which has to be independent. The committee should at least make proposals to the supervisory board on the remuneration policy for executive or managing directors, addressing both fixed and performance-related compensation as well as pension arrangements and termination payments. Furthermore, it shall make proposals on the individual remuneration to be attributed to executive or managing directors and on a standard form of contract for them. Also, the remuneration committee shall debate the general policy regarding the granting of stock options and review the information provided on this topic in the annual report and to the shareholders meeting. The transparency correlates to the one of the nomination committee, i.e. the remuneration committee also has to make a statement in the annual report[61].

German remuneration committees solely have the responsibility to discuss the structure of the management board compensation system and to deal with management board contracts[62]. The authority of the nomination committee as considered by the Commission shall be much more extensive. Although the competence to determine the managing directors' compensation rests with the supervisory board its proposal and audit rights will be reduced due to the installation of a remuneration committee. Especially the proposal on individual remuneration, stock option plans and the review of the company's stock option information would give the remuneration committee much greater power than it currently has according to the GCGC.

[60] No. 5.2 GCGC.

[61] Recommendation on the role of (independent) non-executive or supervisory directors., p. 17.

[62] No. 4.2.2 GCGC.

3. Audit Committee

Audit committees will serve an important function for selecting the external auditor for the appointment by the shareholders and monitoring his relationship with the company (external function) as well as in reviewing the accounting policies, monitoring the internal control and audit procedures and the company's risk management system (internal function)[63]. As public interest entities will be required by the proposed Directive on statutory audit[64] to set up audit committees[65], the dealing with audit committees in the proposed recommendation mainly serves as an interim tool of harmonization due to the inherent delay in the adoption procedure and as an instrument for providing explanatory and complementary provisions of the general principles envisaged by the proposed Directive[66].

The audit committee shall have to be composed exclusively of non-executive or supervisory directors the majority of which needs to be independent. The minimum function of the audit committee is to monitor the integrity of the financial information provided by the company, to review the internal control and risk management systems and to ensure the effectiveness of the internal audit function. Regarding the external auditor hired by the company, the audit committee shall make recommendations concerning his or her selection, his or her (re)appointment and removal. Furthermore, it shall monitor his or her independence, supervise the extent of non-audit services and review the effectiveness of the audit process.

The existence and tasks of audit committees in Germany widely correspond with the proposed EU-system, but nevertheless stay behind in detail. No. 5.3.2 GCGC provides that the supervisory board shall set up an audit committee which, in particular, handles issues of accounting and risk management, the necessary independence required of the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement. The GCGC will therefore have to include rules regarding the audit committee's objective to monitor the integrity of the financial information provided by the company and to review the extent of non-audit services and the effectiveness of the audit process.

[63] Concerning auditing provisions in corporate governance codes *see von Rosen*, Der Konzern, 325 ((2004)).

[64] Art 39. The full text of the proposed Directive is available at http://europa.eu.int/comm/internal_market/auditing/officialdocs_en.htm.

[65] Article 2 of the proposed Directive provides a definition of public interest entities. In general, this term covers companies that are of significant public relevance, i.e. because of the nature of their business, their size and the number of employees.

[66] Recommendation on the role of (independent) non-executive or supervisory directors, p. 9.

V. Enhancing Directors' Responsibility

According to the Action Plan, a Directive to be prepared before the End of 2005 shall confirm the collective responsibility and liability of directors for both financial and key non-financial information on EU-level. The public was invited to participate in this initiative by taking part in the consultation that was launched in April 2004[67]. One result of this consultation was that financial information comprises the information contained in the annual report. Key non-financial information covers e.g. the contents of the corporate governance statement, the company's risk management system, investment plans and strategies in technical, organisational and human resources areas. In Germany, the members of the management and supervisory board are in principle collectively responsible for the company's financial statements and non-financial information. Only under the conditions of §§ 93, 116 *Aktiengesetz*, the single director who gave wrong non-financial information can be made personally liable for damages resulting thereof[68].

The issues of directors' responsibility involve a number of tort and contract law aspects as well as procedural and company law rules that often differ among the legal systems of the Member States. For example, one important question is to what extent directors may rely on the work performed by other employees or co-directors. To answer this question one needs to take into account the national regulations and jurisprudence concerning due diligence[69]. It has yet to be decided whether or not the directors shall only be responsible towards the company or also towards all or some shareholders holding a certain percentage of the share capital or even all stakeholders, such as creditors and employees. In German law, a director is solely responsible towards the company for a breach of his duties (§§ 93 II 1, 116 *Aktiengesetz*). The shareholders cannot file a derivative suit, but only make a claim on the director in the name of the company[70]. If directors were made directly responsible towards the shareholders, a multiplicity of law suits could be expected. Surely, the low number of law suits filed by shareholders of German companies is

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[67] *Id*.

[68] *See* Hefermehl & Spindler, *in*: MÜNCHENER KOMMENTAR, AKTIENGESETZ, 70 § 93 (2004); K. Schmidt, Gesellschaftsrecht, § 28 II 4 (2002).

[69] BGHZ 129, 30, 34; OLG Köln NZG 2001, 135; OLG Hamburg AG 2001, 141, 144; OLG Köln AG 2000, 281, 284; OLG Düsseldorf AG 1997, 231, 235; OLG Hamm 1995, 512, 514.

[70] *See* § 93 II *Aktiengesetz*; BGH NJW 1976, 191; 1985, 1900; 1987, 1077; 1988, 413, 415; OLG Düsseldorf AG 1997, 231, 236; concerning the intended changes to the *Aktiengesetz* in order to change this situation *see* next section, regarding the UMAG.

less a result of especially strict liability rules in Germany than of the lack of possibilities to file derivative suits[71].

Due to the absence of class actions as in US-law or group litigations as in English law, Germany started to modernize its company law to enhance shareholder rights by facilitating law suits by a small number of shareholders and lowering costs of litigation[72]. In January 2004, the German *Bundestag* therefore adopted a law on the integrity in companies and the modernization of legal challenges (UMAG)[73]. The UMAG will enhance shareholder rights by allowing shareholders holding at least 1 % of the share capital or holding share capital of at least 100,000 € to file a claim for damages in their own name on behalf of the company against the directors of the management or the supervisory board, if the shareholders acquired the shares before they had knowledge of the breach of duty, if they asked the company to claim without success, if there is strong suspicion that the company suffered losses as a result of improbity or of a gross violation of the law or the by-laws and if the assertion does not conflict with the interests of the company[74].

Additionally, according to the law on model proceedings concerning investors' actions for damages (KapMuG) which was proposed in April 2004[75], in a claim for damages as a result of wrong or misleading capital information by the company, especially by one of its directors, the institutional or private investor has the right to apply for a decision at the court of appeals on a premise of the basis for the claim. The court of appeals (*Oberlandesgericht*) has to decide on this question, if investors in at least ten other pending proceedings also apply for such a decision within four

[71] POTTHOFF, ET AL., DAS AUFSICHTSRATSMITGLIED 518 (6th ed. 2003).

[72] Due to the German *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (KonTraG) available at http://www.ecgi.org/codes/country_documents/germany/gkontrag.pdf., the *Aktiengesetz* currently provides in § 147 (3) that shareholders holding at least 5 % of the share capital or holding share capital of at least 500,000 € may apply for the deployment of a special representative by the court. This rule had widely been regarded as being too restrictive, *see* Bayer, *Aktionärsrechte und Anlegerschutz*, *in* CORPORATE GOVERNANCE 156 (Hommelhoff, et al., eds, 2002); Ulmer, 163 ZHR 290 (1999); Lutter, ZGR 191, 210 (1998); Bayer, NJW 2609, 2616 (2000); Baums, Expert opinion for the 63rd DJT (German Meeting of Lawyers) 2000, F 126.

[73] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, available at http://www.bmj.bund.de/media/archive/701.pdf.

[74] *See* in detail Seibert & Schütz, ZIP 252 (2004); Diekmann & Leuering, NZG 249 (2004).

[75] *Gesetz über Musterverfahren zu Schadensersatzklagen von Kapitalanlegern*, available at http://www.bundesgerichtshof.de/gesetzesmaterialien/KapMuG/005%20DiskE.pdf.

months after the first application was published[76]. This provision ties up to Part 19 of the English Civil Procedure Rules that already allows group litigations.

Discharging directors' responsibilities is another issue under review. The Commission considers allowing directors to limit their responsibility by explicitly disclosing their disagreement with the content of documents[77]. Such a provision does not yet exist in German law. This innovation would presumably lead to a situation in which directors would rather publish an opposing statement to discharge their responsibility than work on reaching an agreement within the board. Thereby, the danger arises that the organs will not represent the company in a uniform and cohesive manner.

Furthermore, directors shall be made responsible for providing all relevant information to the auditors. This provision can adequately ensure that auditors are comprehensively informed which is the necessary basis for their scrutiny. Also, the Commission seeks to introduce a special investigation right until 2008 for shareholders who hold a certain percentage of the share capital. The threshold shall probably be set between 5 and 10 %. In Germany, a special investigation can only be initiated by the general meeting with the simple majority of votes, § 142 I *Aktiengesetz*. Besides, a wrongful trading rule is intended to be developed at a European level holding directors under certain conditions personally liable for the consequences of a company's failure. So far, a director of a German company is personally liable for the failure of the company only under the premises of §§ 93, 116 *Aktiengesetz*. Finally, directors' disqualification as a sanction for misleading financial or key non-financial information and other forms of misconduct is planned to be implemented. Such a sanction would be an improvement of the German company law, as the collapses of several US and European businesses due to wrong or misleading financial information have shown the need for strict sanctions in that respect[78].

VI. Institutional Investors

In the Action Plan, the Commission consequently announced its intention to put forward a proposal for a Directive on institutional investors until 2008. This Direc-

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[76] *See* in detail Hess & Michailidou, ZIP 1381 (2004).

[77] *See* question 2.3 of the consultation on board responsibilities, available at http://europa.eu.int /comm/internal_market/accounting/board/index_en.htm:

[78] *See* Hauschka, AG 461 (2004); Hopt, *Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron*, *in* 3 J. OF CORPORATE L. STUDIES 221, 268 (2003); Bratton, *Enron and the Dark Side of Shareholder Value,* 76 TULANE L. REV. 1275 (2003); Preußner, NZG 303 (2004).

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tive shall require institutional investors like insurance, pension funds or investment funds companies to disclose their investment and voting policies with respect to companies in which they invest. Moreover, they shall have to disclose to their beneficial holders at their request how these rights have been used. However, institutional investors will not be required to actually exercise their voting rights[79].

Until now, in German company law there do not exist any disclosure provisions regarding institutional investors. Yet as the role of institutional shareholders has widely been portrayed as an efficient disciplinary mechanism, especially in markets characterized by dispersed public share ownership[80], such an innovation has to be welcomed.

VII. Increasing Shareholder Rights

Shareholder rights shall be strengthened in order to facilitate shareholder information, communication and decision making. The Commission therefore plans to ensure effective access to information by all shareholders preferably through the use of electronic means, effective exercise of cross-border voting and full shareholders' democracy for companies listed in the EU. Although the Commission considers the existing provisions in the proposal for a Transparency Directive to be a significant and proportionate first step towards this direction, it wants to enhance the process by adopting a Directive until 2005 that enables shareholders to exercise their rights to pose questions, to vote and to participate in general meetings via electronic means. Furthermore, a study with respect to the effectiveness of a one-share-one-vote-system concerning the topic of shareholders' democracy shall be launched until 2010.

Until now, the participation of shareholders in general meetings and the casting of votes using electronic means is not allowed according to the German *Aktiengesetz*. The only electronic device that gives greater flexibility for general meetings is contained in § 118 II *Aktiengesetz*, whereby members of the supervisory board may take part in the general meeting via picture and sound programme transmission, if permitted by the by-laws of the company.

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[79] *See* Van Hulle & Maul, ZGR 484, 491 (2004).

[80] For a thorough analysis of the role of institutional shareholders in the UK *see* among others Davies, *Institutional Investors in the United Kingdom*, *in* INSTITUTIONAL INVESTORS AND CORPORATE GOVERNANCE (Baums et al., 1994); McCormack, *Institutional Shareholders and the Promotion of Good Corporate Governance*, *in*: *The Realm of Company Law* (Rider ed.)

VIII. Structures to Coordinate the National Corporate Governance Efforts

According to the Action Plan, until 2005 each Member State shall choose one of its various national corporate governance codes which its companies will be obliged to apply. The Commission acknowledges the need to coordinate and harmonize the future development of these national corporate governance codes which is concordant with the Commission's choice not to develop a single European code on corporate governance. The further harmonization shall be coordinated by a "European Corporate Governance Forum" that shall be set up by the Commission during a Corporate Governance Conference which will meet on 18 October 2004 in The Hague. This forum shall have a wide range of apparently twelve to eighteen participants including representatives from Member States, European regulators, issuers, investors, other market players and academics who shall meet on an annual basis[81].

D. Outlook

In the Action Plan, the Commission declared its will to establish a regime of sound corporate governance within the EU until 2010. For that purpose, a number of short, medium and long term measures were announced. A lot of these projects have already been embodied into existing Directive proposals (for example the requirement of audit committees in the Directive on statutory audit or the Transparency Directive) while others are currently under a consultation process (for example directors' remuneration, collective responsibility and the role of non-executive directors). Many of the proposed measures under development concentrate on enhancing transparency by imposing considerable and detailed disclosure requirements. This can undoubtedly increase good corporate governance, as a lack of transparency is one of the leading factors in the recent corporate scandals both in the US and in Europe.

EU companies will be subject to increased transparency requirements containing detailed information. In Germany, a number of changes will have to be made both to the *Aktiengesetz* and to the German Corporate Governance Code in order to conform the German system of corporate governance to the European one. However, there is a trade-off between the amount and quality of information published and the costs associated with providing such information. The Commission has to be cautious not to impose disclosure duties that lead to extensive communication costs, thereby hindering economic growth and competitiveness within the EU. This is of particular importance in the light of the tense economic situation that EU mar-

[81] *See* Becker, GmbHR R 317 (2004).

kets currently suffer and the European Union's aim to become the most competitive and most dynamic economic area in the world until 2010[82].

[82] *See* http://www.eu-kommission.de/pdf/dokumente/Binnenmarktstrategie%202003-2006.pdf.