

## Articles

### The German Supervisory Board on Its Way to Professionalism

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#### Abstract

The paper shows how the efficiency of the German supervisory board has been significantly improved in the last decade. These legal changes made the supervisory board climb to a higher position of power. In particular, the supervisory board is now significantly involved in the decision-making process on a company's overall strategic concept and on management decisions of fundamental importance. This emphasizes the future-oriented monitoring obligation of the supervisory board, which gained much more importance in the last decade. Furthermore, the new provisions increased the flow of information from the management board to the supervisory board, and they facilitated the monitoring efficiency of every single supervisory board member. In addition, several important changes improved the cooperation of supervisory board and auditors. The most recent changes strengthened the supervisory board's responsibility with regard to internal control and risk management.

The vast majority of those changes in the German supervisory board system are very welcome. However, the current regime of German codetermination as well as the excessive size of the supervisory board has to be changed. Under the important developments on the European level, the time has come to act now in this direction. The advocated concept of codetermination by consensus provides a solid basis for more flexibility in the rigid German corporate governance system. It is also desirable to further limit the size of the supervisory board to no more than twelve members. Finally, the efficiency of the corporate governance system would be improved by allowing enterprises to choose between a one-tier and a two-tier board system.

#### A. Introduction

The history of the German supervisory board<sup>1</sup> is a history of its reformation.<sup>2</sup> There is no doubt, however, that the last decade marks the heyday of reform endeavors with a

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<sup>1</sup> For an early English-language source as to the German supervisory board and its role compared to the American unitary board system, see, Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*,

particular focus on the supervisory board.<sup>3</sup> The familiar quotation of the “corporate law reform in permanency”<sup>4</sup> is resounded throughout the land. In this regard, the paper shows on the one hand how the efficiency of the German supervisory board has been significantly improved in the last decade. On the other hand, this paper addresses some major critical points of today’s supervisory board system.

The reformation of the supervisory board was accomplished through several legislative steps, beginning with the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (Law on Control and Transparency of Enterprises) as of 1998<sup>5</sup> and the *Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität* (Law on Transparency and Disclosure) as of 2002<sup>6</sup>. Furthermore, the German Corporate Governance Code (GCGC) as of 2002 including its most important amendments in 2005 and 2007, in particular, refined the German corporate governance system with a specific emphasis on the independence of supervisory board members<sup>7</sup> and the creation of supervisory board committees<sup>8</sup>. Both developments are evidence for the current tendency of the one-tier and the two-tier system to converge. Recently in 2009, the reform process continued with enactments of the *Gesetz zur Modernisierung des Bilanzrechts* (Accounting Law Reform

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80 HARVARD LAW REVIEW (HARV. L. REV.) 23, 50-53, 61-62 (1966). For a modern overview, see, Klaus J. Hopt, *The German Two-Tier Board: Experience, Theories, Reforms*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH 227-258 (Klaus J. Hopt et al. eds., 1998); 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 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW (ECFR), 135, 141-146 (2004); Udo C. Brändle & Jürgen Noll, *The Power of Monitoring*, 5 GERMAN LAW JOURNAL (GLJ) 1349, 1353-1360 (2004). For a broader comparison, see, e.g., Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE LAW JOURNAL (YALE L. J.) 1927-1997 (1993); John W. Coiffi, *Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany*, 7 GLJ 533-561 (2006).

<sup>2</sup> See, RUDOLF WIETHÖLTER, INTERESSEN UND ORGANISATION DER AKTIENGESELLSCHAFT IM DEUTSCHEN UND AMERIKANISCHEN RECHT 35 (1961); KARSTEN SCHMIDT, GESELLSCHAFTSRECHT 761 (4<sup>th</sup> ed., 2002); JAN LIEDER, DER AUFSICHTSRAT IM WANDEL DER ZEIT 35 (2006). For an early comparison of German corporation law institutions with the American corporate law practice *Id. Vagts*, 23-89. See also, Detlev F. Vagts, *The European System*, 27 BUSINESS LAWYER (BUS. LAW.), 165-171 (Special Issue, February 1972); Don Berger, *Shareholder Rights under the German Stock Corporation Law of 1965*, 38 FORDHAM LAW REVIEW (FORDHAM L. REV.), 687-742 (1970). With regard to the theoretical foundation of German corporate law, see, Thomas Raiser, *The Theory of Enterprise Law in the Federal Republic of Germany*, 36 AMERICAN JOURNAL OF COMPARATIVE LAW (AM. J. COMP. L.), 111-129 (1988).

<sup>3</sup> See, Marcus Lutter, *Professionalisierung des Aufsichtsrats*, 62 DER BETRIEB (DB) 775 (2009); *Id.* LIEDER, 35.

<sup>4</sup> Wolfgang Zöllner, *Aktienrechtsreform in Permanenz – Was wird aus den Rechten des Aktionärs?*, 39 DIE AKTIENGESELLSCHAFT (AG) 336 (1994); Ulrich Seibert, *Aktienrechtsreform in Permanenz?*, 47 AG 417 (2002).

<sup>5</sup> See, section B of this paper.

<sup>6</sup> See, section C of this paper.

<sup>7</sup> See, section D of this paper.

<sup>8</sup> See, section E of this paper.

Act)<sup>9</sup> and the *Gesetz zur Angemessenheit der Vorstandsvergütung* (Act on Adequacy of Executive Compensation)<sup>10</sup>. The latter legislation is an early reaction to issues of the latest financial crisis.

Overall, these legal changes made the supervisory board climb to a higher position of power. In particular, the supervisory board is now significantly involved in the decision-making process on a company's overall strategic concept and on management decisions of fundamental importance. This development emphasizes the future-oriented monitoring obligation of the supervisory board, which gained much more importance in the last decade. By the same token, these changes strengthened the supervisory board's capability to monitor the management board more efficiently. Furthermore, the new provisions increased the flow of information from the management board to the supervisory board, and they facilitated the monitoring efficiency of every single supervisory board member.

However, today's supervisory board system is, by no means at all, free from any deficiencies. To the contrary, there are still a number of shortcomings of the German supervisory board system. This paper addresses some major critical points of the current system including the standards of German codetermination<sup>11</sup> and the excessive size of the supervisory board<sup>12</sup>. I will advocate a fundamental change of the current status quo of German codetermination<sup>13</sup> and a limitation of board size to no more than 12 members<sup>14</sup>. In addition, this paper supports the idea of allowing enterprises to choose between a one-tier and a two-tier board system<sup>15</sup>.

## **B. Law on Control and Transparency of Enterprises**

The overall starting point for the current reform endeavors was the enactment of the Law on Control and Transparency of Enterprises as of 27 April 1998.<sup>16</sup> This law was not enacted

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<sup>9</sup> See, section F of this paper.

<sup>10</sup> See, section E.IV of this paper.

<sup>11</sup> See, section G.II of this paper.

<sup>12</sup> See, section G.III of this paper.

<sup>13</sup> See, section G.IV of this paper.

<sup>14</sup> See, section G.III of this paper.

<sup>15</sup> See, section H of this paper.

<sup>16</sup> Bundesgesetzblatt 1998 I, 786. As to the political background of this Act, see, John W. Cioffi, *Restructuring 'Germany, Inc.': The Corporate Governance Debate and the Politics of Company Law Reform*, 24 LAW & POLICY 355-402 (2002); Cioffi (note 1), 551-554.

in order to change the corporate governance system of the Germany stock corporation fundamentally, but rather to improve more or less important details of control mechanisms that were already in place. In this regard, the reform did not only focus on the supervisory board, but also on the management board, shareholders' meeting, and auditors. This approach was absolutely convincing, because only an improvement of every individual controlling sub-system and of the cooperation between those sub-systems made the corporate governance system more efficient.<sup>17</sup>

Accordingly, the Law on Control and Transparency of Enterprises advanced the corporate risk management by requiring the management board to set up a risk management system (Section 91(2) German Stock Corporation Act<sup>18</sup>). Furthermore, the law of 1998 improved the flow of information from the management board to the supervisory board, in particular with regard to information on corporate planning (Section 90(1)). Concerning its organization, the new law obligated the supervisory board to meet more often (Section 110(3)), and to inform the shareholders' meeting of publicly held companies with regard to which committees the supervisory board has established and how often the supervisory board and its committees have actually met (Section 171(2)). Finally, the law of 1998 improved the cooperation of the supervisory board and the auditors.

### *I. Risk Management System*

With regard to the management board, the newly created Section 91(2) requires the management board to take appropriate action in order to detect detrimental developments as soon as possible if they may endanger the survival of the company. In particular, the management board is obligated to establish a risk management system. Background and reason for the new duty were occurrences at Metallgesellschaft AG that broke down because of incautious use of derivatives and other risk-hazardous financial instruments.<sup>19</sup> Under Section 91(2), risk management has become a major task of the management board. This is consistent with empirical studies stating that companies being aware of business-related risks are run more prosperously.<sup>20</sup>

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<sup>17</sup> See, *Begründung zum Regierungsentwurf eines Gesetzes zur Kontrolle und Transparenz im Unternehmensbereich* (Official Explanatory Statement), Bundestagsdrucksache 13/9712, 11 (1998).

<sup>18</sup> All of the following sections are from the *Aktiengesetz – AktG* (German Stock Corporation Act) unless otherwise indicated.

<sup>19</sup> See, e.g., MARCO ALBERS, CORPORATE GOVERNANCE IN AKTIENGESELLSCHAFTEN 276 (2002); LIEDER, (note 2), 516.

<sup>20</sup> Thomas Kless, *Beherrschung der Unternehmensrisiken: Aufgaben und Prozesse eines Risikomanagements*, 36 DEUTSCHES STEUERRECHT (DSTR) 93 (1998).

The new law has an impact not only on the management board, but also on the supervisory board and the auditor.<sup>21</sup> Under German Commercial Code (GCC) Section 317(4)<sup>22</sup>, the auditor is obligated to monitor and assess the efficiency of the established risk management system. Under GCC Section 321(4), they are required to report on the efficiency of the risk management system in the auditor's report, in fact, in a separate part of that report. Furthermore, the auditor's report has to address the issue whether the established risk management system can be developed further. These provisions focus on the company's auditor, but they also show indirectly that the supervisory board has the duty to monitor the risk management system.<sup>23</sup>

Accordingly, the German system provides three layers of risk management.<sup>24</sup> The management board is responsible for creating a risk management system on the first level. On the second level, the supervisory board is required to monitor and assess the established system. On the third level, auditors support the supervisory board with its monitoring duty and they report on the efficiency and possible improvements of the risk management system. As a result, the members of the supervisory board have become more sensitive and more conscious for the monitoring of risky business decisions, and the supervisory board, thereby, makes a contribution to risk precaution.<sup>25</sup> This weakens the predominant position of the management board with regard to matters of risk management, and strengthens the supervisory board's responsibility on that issue.<sup>26</sup>

## *II. Improved Flow of Information from the Management Board to the Supervisory Board*

In addition, the law of 1998 improved the flow of information from the management board to the supervisory board. Under the amended Section 90(1), the management board is required to inform the supervisory board on all issues important to the company with

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<sup>21</sup> Manuel René Theisen, *Risikomanagement als Herausforderung für die Corporate Governance*, 58 BETRIEBSBERATER (BB) 1426, 1427 (2003); Bruno Kropff, *Zur Information des Aufsichtsrats über das interne Überwachungssystem*, 6 NEUE ZEITSCHRIFT FÜR GESELLSCHAFTSRECHT (NZG) 346 (2003).

<sup>22</sup> *Handelsgesetzbuch*, Reichsgesetzblatt 1897, 219.

<sup>23</sup> Anne-Kathrin Pahlke, *Risikomanagement nach KonTraG – Überwachungspflichten und Haftungsrisiken für den Aufsichtsrat*, 55 NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 1680, 1684-1685 (2002); Peter Hommelhoff & Daniela Mattheus, *Corporate Governance nach dem KonTraG*, 43 AG 249, 251 (1998); Peter Hommelhoff, *Die neue Position des Abschlussprüfers im Kraftfeld der aktienrechtlichen Organisationsverfassung (Teil II)*, 53 BB 2625, 2626 (1998).

<sup>24</sup> See, generally, LIEDER (note 2), 519-520.

<sup>25</sup> ALEXANDER LENZ, WERTORIENTIERTE RISIKOFRÜHERKENNUNG UND IHRE ÜBERWACHUNG DURCH DEN AUFSICHTSRAT 48 (2004).

<sup>26</sup> THIES LENTFER, DIE ÜBERWACHUNG DES RISIKOMANAGEMENTSYSTEMS GEMÄß §91 ABS. 2 AKTG DURCH DEN AUFSICHTSRAT 62 (2005).

regard to corporate planning. The new obligation emphasizes the responsibility of the supervisory board to monitor issues of corporate planning more carefully. The particular value of Section 90(1) is that the supervisory board participates increasingly in the company's decision-making process, especially with regard to the overall strategic concept of the firm. In this regard, the new provision emphasizes the future-oriented monitoring obligation of the supervisory board which gained a lot more importance in the last decade.<sup>27</sup> In particular, knowledge on corporate planning data provides the supervisory board with an insight into the prospective business policy of the company, and it improves its competence to promptly detect and prevent corporate malfeasance. Finally, the increased supply of information strengthens the advisory function of the supervisory board, because a better-informed supervisory board is significantly more capable to advise the management board on fundamental issues of a corporation's strategy.<sup>28</sup>

### *III. Organizational Improvements*

With regard to its organization, the new law obligated the supervisory board to meet more often. In addition, the supervisory board is required to inform the shareholders' meeting of publicly held companies with regard to the issues, which committees of the supervisory board have been established and how often the supervisory board and its committees have actually met.

The newly established Section 110(3) as of 1998—which required the supervisory board of publicly held companies to meet twice in a semi-annual period, the one of privately held companies only once—had primarily symbolic value. The provision emphasized the importance of meetings in order to improve the efficiency of the supervisory board. However, as long as the monitoring capability of the supervisory board lacked refinement, it was hardly meaningful to force the supervisory board to meet more often.<sup>29</sup> To increase the meeting frequency does not automatically lead to a supervisory board working more efficiently because a violation of Section 110(3) does not have any legal consequences.<sup>30</sup>

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<sup>27</sup> See, Official Explanatory Statement, (note 17), 15; Lutter (note 3), 775; Ulrich Seibert, *Kontrolle und Transparenz im Unternehmensbereich (KonTraG) – Der Referenten-Entwurf zur Aktienrechtsnovelle*, 51 WERTPAPIERMITTEILUNGEN (WM) 1, 2 (1997).

<sup>28</sup> LIEDER (note 2), 514.

<sup>29</sup> Theodor Baums, *Der Aufsichtsrat – Aufgaben und Reformfragen*, 16 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 11, 17 (1995); Marcus Lutter, *Professionalisierung der Aufsichtsräte*, 48 NJW 1133 (1995).

<sup>30</sup> LIEDER (note 2), 508.

Conversely, the amendment of Section 171(2) shows promise. Under this so-called “incentive rule”<sup>31</sup>, the supervisory board is obligated to inform the shareholders’ meeting of publicly held companies with regard to the issues, which committees it has established and how often the supervisory board and its committees have actually met. Thereby, the reporting obligation raises the informational level of the stockholders, and, thus, makes the monitoring process of the supervisory board more transparent. Furthermore, the provision incentivizes the supervisory board to meet more often and to establish an appropriate number of committees in order to demonstrate to the shareholders’ meeting, in particular to institutional investors, that it takes its monitoring obligations seriously.<sup>32</sup> If a supervisory board of a large public firm consists of twenty members, it will hardly be able to explain that it did not establish even a single committee. On the other hand, if the supervisory board consists of only three or six members, it is frequently not necessary to establish committees at all, because the supervisory board is small enough to reach decisions rapidly, and to facilitate an unconcealed exchange of ideas.<sup>33</sup> This example shows that the concept of an incentive rule is convincing. Which committees the supervisory board establishes and how often it and its committees actually meet, depends on the size, structure, industry and any other particularity of a given company, as well as on the size and structure of the supervisory board including the applicable standard of codetermination<sup>34</sup>. In any case, anecdotal evidence indicates that Section 171(2) seems to fulfill its function in practice.<sup>35</sup>

#### *IV. Cooperation of Supervisory Board and Auditor*

Finally, several new provisions of the 1998 amendment of the German corporate law improved the cooperation of the supervisory board and the auditor. The main intention of the legal changes was to overcome corporate malfeasance and to ensure that the auditor serves again as “principal supporter of the supervisory board”.<sup>36</sup> Although the legal changes as of 1998 have been minor ones, applied as a whole, they led to significant improvements in the corporate governance system. In particular, they reduced informational asymmetry between the management board and the supervisory board, as the supervisory board, under the new law, receives more and better accounting- and auditing-related information from the auditor. Moreover, the new provisions mitigated the

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<sup>31</sup> Hommelhoff & Mattheus, (note 23), 250; see also, LIEDER (note 2), 548, 622-624.

<sup>32</sup> See, Official Explanatory Statement (note 17), 23.

<sup>33</sup> See, LIEDER (note 2), 548-549.

<sup>34</sup> Regarding German codetermination see, section G of this paper.

<sup>35</sup> See, Lutter (note 3), 775.

<sup>36</sup> Hommelhoff & Mattheus, (note 23), 251-252; Seibert (note 27), 5.

distance between the supervisory board and the auditors, and they increased the independence of auditors from the management board.

Due to the 1998 legal change, the supervisory board is responsible for the audit assignment with the auditors (Section 111(2)). In Addition, the supervisory board is the direct recipient of the auditor's report (Section 321(5) GCC). Furthermore, every member of the supervisory board, as a rule, receives a copy of the auditor's report (Section 170(3)). Finally, the responsible auditor is required to participate in the supervisory board's deliberations on the annual financial statements and reports on the essential results of its audit (Section 171(1)).

### 1. Supervisory Board's Responsibility as to Audit Assignment

The newly established responsibility of the supervisory board to make the audit assignment improves the independence of the auditor *vis-à-vis* the management board, and it strengthens the flow of information from the auditor to the supervisory board. Under the former legal situation, the management board was assigned to make the audit assignment including the audit's focal points and the auditor's compensation (Section 318(1) GCC as of 1985). Since the auditor had an interest to audit the company in the following years as well, she needed to get the audit assignment from the management board whose conduct she was supposed to monitor. As a result, the auditor occasionally lost her independence *vis-à-vis* the management board, and she did not appropriately provide the supervisory board with audit-specific information.<sup>37</sup> This changed a great deal under the amended law, which made the supervisory board responsible for making the audit assignment. Thereby, auditors have become much more independent.<sup>38</sup> In addition, the supervisory board now receives more and better information on the company's accounting and auditing, and it cooperates with the auditor more intensively.<sup>39</sup> Finally, the supervisory board can now require the auditor to focus particularly on specific accounting issues what seems crucial with regard to the supervisory board's monitoring obligation towards the management board's accounting.

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<sup>37</sup> Heinrich Götz, *Die Überwachung der Aktiengesellschaft im Lichte jüngerer Unternehmenskrisen*, 40 AG 337, 340-341 (1995); Rainer Funke, *Aktienrechtsreform 1997: Aufsichtsrat und Abschlussprüfer*, 17 ZIP 1602, 1603 (1996).

<sup>38</sup> Hommelhoff & Mattheus (note 23), 257; Manuel René Theisen, *Vergabe und Konkretisierung des WP-Prüfungsauftrags durch den Aufsichtsrat*, 52 DB 341, 346 (1999).

<sup>39</sup> See, Official Explanatory Statement (note 17), 16; see also Dietrich Dörner, *Ändert das KonTraG die Anforderungen an den Abschlussprüfer?*, 51 DB 1, 5 (1998).



## 2. Supervisory Board as Direct Recipient of the Auditor's Report

Since the supervisory board, under the new law, receives the auditor's report directly from the auditor, the management board is no longer able to falsify the content of those reports. Under the former legal situation, the management board received the auditor's report (Section 321(3) GCC as of 1985). It was common practice that the auditor firstly sent a draft to the management board, before both discussed the content of the report with each other.<sup>40</sup> Only after this final discussion, the auditor sent an ultimate version of the auditor's report to the management board. Many times, critical passages of that report had been removed at the instance of the management board in order to make sure that the supervisory board did not ask bothersome questions. The auditor frequently complied with such kind of requests, because she had an interest to audit the company in the next years again. As a result, the management board gained control over the auditor what significantly interfered with the audit assignment that was focusing on the legality and regularity of the management board's accounting.<sup>41</sup> Therefore, the newly established Section 321(5) GCC requires the auditor to directly deliver her report to the supervisory board in lieu of the management board. Moreover, under the new legal situation, both the management board and the supervisory board have to make sure that the management board does not influence the auditing process and the auditor's report in a manner that would interfere with the *ratio legis* of Section 321(5) GCC.<sup>42</sup>

## 3. Individual Receiving the Auditor's Report

Since every member of the supervisory board, as a rule, receives a copy of the auditor's report, the level of information of the supervisory board members has increased with the result that they are able to monitor the management board more efficiently. Under the former law, only in a few corporations all of the members of the supervisory board received the auditor's report. In most cases, the report was handed out at the beginning of the supervisory board meeting and was collected immediately afterwards ("table

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<sup>40</sup> See, Peter Hommelhoff, *Störungen im Recht der Aufsichtsrats-Überwachung*, in *CORPORATE GOVERNANCE*, 1, 15-16 (Arnold Picot ed., 1995), compared to *Id.* Dörner, 5.

<sup>41</sup> See, LIEDER (note 2), 528; Hommelhoff (note 23), 2628.

<sup>42</sup> See, Holger Altmeyen, *Der Prüfungsausschuss – Arbeitsteilung im Aufsichtsrat*, 33 *ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR)* 390, 407 (2004); Hommelhoff (note 23), 2628; LIEDER (note 2), 529-30 compared to Dörner (note 39), 5-6; Dietrich Dörner, *Zusammenarbeit von Aufsichtsrat und Wirtschaftsprüfer im Lichte des KonTraG – Schlüssel zur Verbesserung der Corporate Governance –*, 53 *DB* 101, 104-105 (2000); Christina Escher-Weingart, *Die gewandelte Rolle des Wirtschaftsprüfers als Partner des Aufsichtsrats nach den Vorschriften des KonTraG*, 2 *NZG* 909, 918 (1999); Karl-Heinz Forster, *Das Zusammenspiel von Aufsichtsrat und Abschlussprüfer nach dem KonTraG*, 44 *AG* 193, 197 (1999).

presentation”).<sup>43</sup> This practice was justified with regard to possible misuse of accounting information by employee representatives in codetermined supervisory boards.<sup>44</sup>

The revised Section 170(3) now ensures that every supervisory board member receives the information necessary to monitor the accounting of the company. On the other hand, the new provision still provides the opportunity for the supervisory board to decide whether the report should only be sent to the audit committee, rather than to every single supervisory board member. This exemption addresses the phenomenon that employee representatives in the supervisory board still view themselves as representatives of the personnel’s interest<sup>45</sup>. In this capacity, they still occasionally believe that they are authorized to forward confidential information from the boardroom to the workforce, even if they thereby infringe their legal obligation of secrecy under Section 116.<sup>46</sup> If there is a serious threat that confidential information would become publicly known, the supervisory board may opt for reporting to the audit committee only.

#### 4. Participation of the Auditor in the Supervisory Board’s Meeting

Finally, the mandatory participation of auditors in the supervisory board’s deliberations on the annual financial statements and reports, as well as the essential results of its audit, increased the level of information that the supervisory board held. This also made the supervisory board more sensitive and more conscious for issues of a company’s accounting and auditing.<sup>47</sup> Under Section 171(1) as of 1965, auditors were obligated to participate in the relevant meeting if and only if the supervisory board told them to do so. In fact, the supervisory board only infrequently asked the auditor to attend the meeting.<sup>48</sup> Therefore,

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<sup>43</sup> Katharina Pistor, *Codetermination: A Sociopolitical Model with Governance Externalities*, in EMPLOYEES AND CORPORATE GOVERNANCE, 163, 191 (Margaret M. Blair & Mark J. Roe eds., 1999); see also, Iren Schwegler, *Die Stellung des Wirtschaftsprüfers zu den Organen Hauptversammlung, Vorstand und Aufsichtsrat*, 50 BB 1683, 1686 (1995); LIEDER (note 2), 531.

<sup>44</sup> Pistor (note 43), 191; see also, Official Explanatory Statement (note 17), 22; Karl-Heinz Forster, *MG, Schneider, Balsam und die Folgen – was können Aufsichtsräte und Abschlussprüfer gemeinsam tun?*, 40 AG 1, 3 (1995); Götz (note 37), 343.

<sup>45</sup> See, in detail section G.II.3 of this paper.

<sup>46</sup> See, Official Explanatory Statement (note 17), 22; Forster (note 42), 197; Marcus Lutter, *Defizite für eine effiziente Aufsichtsratsstätigkeit und gesetzliche Möglichkeiten der Verbesserung*, 159 ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT (ZHR) 287, 300 (1995); see also Bundesarbeitsgericht (Federal Labor Court), 30 ZIP 2018-2022 (2009).

<sup>47</sup> See, LIEDER (note 2), 536.

<sup>48</sup> Lutter (note 46), 295; Thomas M.J. Möllers, *Professionalisierung des Aufsichtsrats: Zu einer differenzierten Verantwortung der einzelnen Aufsichtsratsmitglieder*, 16 ZIP 1725, 1729 (1995); Schwegler (note 43), 1684.

the new provision is convincing, as it increases the flow of information from the auditors to the supervisory board, and as it heightens the supervisory board members' sense of responsibility with regard to accounting and auditing.

### C. Law on Transparency and Disclosure

The Law on Transparency and Disclosure as of 19 July 2002<sup>49</sup> marks the second important amendment of the German stock corporation law in the last decade. In particular, the new law established the German Corporate Governance Code (GCGC)<sup>50</sup> and committed both the management board and the supervisory board to disclose whether they comply with the Code's recommendations or not (Section 161). Furthermore, the new provisions increased the flow of information from the management board to the supervisory board, they increased the future-oriented monitoring capability of the supervisory board, and they facilitated the monitoring efficiency of every single supervisory board member.

As a whole, the 2002 amendments were aimed at strengthening the supervisory board's position of power within the company, in particular *vis-à-vis* the management board. The supervisory board became more involved in the decision-making process with regard to a company's overall strategic concept and fundamental management decisions.<sup>51</sup> In particular, the supervisory board was obligated to establish a checklist with measures of fundamental importance to be taken by the management board that the supervisory board shall approve (Section 111(4)). With regard to the flow of information, now the management board has to point out deviations of the actual business development from previously formulated plans and targets, indicating the reasons therefore of follow-up reporting in Section 90(1). Furthermore, the GCGC characterizes the cooperation between management board and supervisory board as follow:

"3.1 The Management Board and Supervisory Board cooperate closely to the benefit of the enterprise.

"3.2 The Management Board coordinates the enterprise's strategic approach with the Supervisory Board and discusses the current state of strategy implementation with the Supervisory Board in regular intervals.

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<sup>49</sup> Bundesgesetzblatt I, 2681; as to the politics of this Act see, Cioffi (note 1), 555-556.

<sup>50</sup> German Corporate Governance Code as of 16 February 2002 (original version), available at: [http://www.corporate-governance-code.de/eng/download/DCG\\_K\\_E\\_old.pdf](http://www.corporate-governance-code.de/eng/download/DCG_K_E_old.pdf), last accessed 23 January 2010.

<sup>51</sup> See generally, Werner Gleißner, *Die strategische Positionierung im Urteil des Aufsichtsrats*, 6 DER AUFSICHTSRAT (AR) 39 (2009).

“5.1.1 The task of the Supervisory Board is to advise and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise.”

This explanation, as well as the subsequently detailed legal changes, shows that the supervisory board and the management board shall intensively interact in the German dual board system. As a result, this kind of involvement of the supervisory board in a company's decision-making process improves its efficiency of monitoring, because the supervisory board receives more and better monitoring-related information and it is able to detect and prevent corporate malfeasance more quickly and more efficiently. As a further result of the supervisory board's strengthened position of power, its members have become more sensitive and more conscious with regard to their monitoring duties.<sup>52</sup>

#### *I. Individual Rights of Supervisory Board Members*

In order to strengthen the sense of responsibility of each and every member of the supervisory board, all members are now entitled to request additional information from the management board that goes beyond the management board's regular reporting duties (Section 90(3)). The new provision makes clear that every supervisory board member is responsible for having all information necessary to monitor the management board appropriately.<sup>53</sup> In addition, Section 3.4 GCGC emphasizes that providing sufficient information to the supervisory board is the joint responsibility of both the management board and the supervisory board. A single supervisory board member is no longer able to excuse her lack of knowledge by referring to her inability to demand information from the management board on her own.<sup>54</sup>

Furthermore, under Section 110(2), every member of the supervisory board is now entitled to call for a meeting of the supervisory board. The new provision eliminated the objection that individual members are not able to do something on their own in order to detect and prevent corporate malfeasance.<sup>55</sup> This individual right also strengthens the sense of responsibility of supervisory board members.

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<sup>52</sup> See generally, LIEDER (note 2), 556.

<sup>53</sup> See, Eberhard Vetter, *Die Verantwortung und Haftung des überstimmten Aufsichtsratsmitglieds*, 57 DB 2623, 2625 (2004); Lutter (note 3), 775.

<sup>54</sup> LIEDER (note 2), 565.

<sup>55</sup> See, *Begründung des Regierungsentwurfs eines Gesetzes zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität* (Official Explanatory Statement), Bundestagsdrucksache 14/8769, 16 (2002); see also, Hans-Christoph Ihrig & Jens Wagner, *Die Reform geht weiter: Das Transparenz- und Publizitätsgesetz kommt*, 57 BB 789, 794 (2002); Ulrich Seibert, *Das "TransPuG" – Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu*

## *II. Mandatory Approval Rights of the Supervisory Board*

Under the 2002 amendment, the position of power of the supervisory board was strengthened, as the supervisory board is now obligated to establish a checklist with fundamental decisions to be taken by the management board that the supervisory board shall approve. Thereby, the supervisory board has become more involved in the decision-making process on a company's overall strategic concept and on fundamental management decisions.

The supervisory board's new obligation deals with an old problem.<sup>56</sup> Particularly after the enactment of the Codetermination Act of 1976, the bylaws of companies or the regulations of the management board changed with regard to decisions to be taken by the management board that must be approved by the supervisory board. The powers and responsibilities of the supervisory board were restricted in the way that even most important transactions no longer required the approval of the supervisory board.<sup>57</sup> This change in practice was aimed at preventing that employee representatives participated in the decision-making process of the company.<sup>58</sup> Bruno Kropff, one of the fathers of the German Stock Corporation Act of 1965, quoted a CEO of a large public firm with the words: A checklist for management decisions requiring approval by the supervisory board will only be possible "over his dead body".<sup>59</sup> This attitude led to a significant decline of the supervisory board's position of power, and it weakened its monitoring efficiency as well as the amount and quality of information provided by the management board.<sup>60</sup> The management board was able to decide on most important transactions and business measures without the approval of the supervisory board.

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*Transparenz und Publizität (Transparenz- und Publizitätsgesetz), – Diskussion im Gesetzgebungsverfahren und endgültige Fassung, 5 NZG 608, 610 (2002).*

<sup>56</sup> Regarding the history of and empirical data on approval rights, see, Jan Lieder, *Über den Nutzen der Rechtstatsachenforschung zur Verbesserung der Corporate Governance unter besonderer Berücksichtigung historischer Studien*, in *DIE AKTIENGESELLSCHAFT IM SPIEGEL DER RECHTSTATSACHENFORSCHUNG*, 79, 91-100 (Walter Bayer ed., 2007).

<sup>57</sup> Pistor (note 43), 184; BERTELSMANN-STIFTUNG & HANS-BÖCKLER-STIFTUNG, *MITBESTIMMUNG UND NEUE UNTERNEHMENSKULTUREN* 103 (1998); Lieder (note 56), 95-98.

<sup>58</sup> Wolfgang Schilling, *Die Überwachungsaufgabe des Aufsichtsrats – Besprechung der gleichnamigen Schrift von Johannes Semler*, 26 AG 341, 343 (1981); Maximilian Schiessl, *Deutsche Corporate Governance post Enron*, 47 AG 593, 597 (2002); Oliver Lange, *Zustimmungsvorbehaltspflicht und Kataloghaftung des Aufsichtsrats nach neuem Recht*, 41 DStR 376, 380 (2003).

<sup>59</sup> Bruno Kropff, *Zur Vinkulierung, zum Vollmachtstimmrecht und zur Unternehmensaufsicht im deutschen Recht*, in *REFORMBEDARF IM AKTIENRECHT*, 3, 20 (Johannes Semler et al. eds., 1994); as quoted in LIEDER (note 2), 580.

<sup>60</sup> See, Wolfgang Bernhard, *Aufsichtsrat – die schönste Nebensache der Welt? Defizite für eine effiziente Aufsichtsratsstätigkeit*, 159 ZHR 310, 313 (1995).

The 2002 amendment made a difference to the cooperation of the management board and the supervisory board, since Section 111(4) required the supervisory board to establish a checklist with fundamental business decisions to be taken by the management board that need approval by the supervisory board. The supervisory board's approval right is a powerful monitoring instrument, because the management board cannot implement any business decision requiring approval without the supervisory board having actually approved that decision.<sup>61</sup> Therefore, the management board and the supervisory board will cooperate closely with regard to any business decision that needs to be approved by the supervisory board. For that purpose, the management board will provide the supervisory board with all information necessary to decide on fundamental decisions on a well-informed basis. As a result, the supervisory board receives monitoring-related information in higher quality and quantity at an early stage of the decision-making process. Furthermore, this strengthens the supervisory board's capability to monitor the management board more efficiently, and it forces the management board to coordinate the strategic approach with the supervisory board.<sup>62</sup> As the management board and the supervisory board have to cooperate at an early stage in the decision-making process, the supervisory board is able to detect and prevent corporate malfeasance more quickly and more efficiently.<sup>63</sup> As a whole, the supervisory board becomes more involved in corporate planning, business development and risk management.<sup>64</sup>

The new provision is particularly striking, because the supervisory board has to make sure that all business decisions and transactions of fundamental importance need approval.<sup>65</sup> Those decisions include all measures, which fundamentally change the asset, financial or earning situation of the enterprise.<sup>66</sup> The supervisory board has to decide on which fundamental business measures require its approval bearing in mind size, structure, industry and other particularities of the company.<sup>67</sup>

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<sup>61</sup> As an exemption, the shareholders' meeting can substitute the supervisory board's approval with the vote of a majority whose aggregate holding equals or exceeds three-fourth of the share capital, Section 111(4).

<sup>62</sup> KATJA SCHÖNBERGER, DER ZUSTIMMUNGSVORBEHALT DES AUFSICHTSRATS BEI GESCHÄFTSFÜHRUNGSMAßNAHMEN DES VORSTANDS (§111 ABS. 4 S. 2-4 AKTG), 31 (2006); LIEDER (note 2), 581.

<sup>63</sup> See generally, Jan Lieder, *Zustimmungsvorbehalte des Aufsichtsrats nach neuer Rechtslage*, 57 DB 2251 (2004).

<sup>64</sup> Regarding risk management, see, section B.I of this paper.

<sup>65</sup> LIEDER (note 2), 584-587; Lieder (note 63), 2252-2253; SCHÖNBERGER (note 62), 187-190; Ihrig & Wagner (note 55), 794; Lange (note 58), 380; different opinion Klaus J. Hopt & Markus Roth, §111, in: GROßKOMMENTAR ZUM AKTIENGESETZ (Klaus J. Hopt & Herbert Wiedemann eds., 4<sup>th</sup> ed., 2005) margin numbers 608-618; Schiessl (note 58), 597.

<sup>66</sup> See, GCGC Section 3.3; see also Lieder (note 63), 2252-2253; UWE HÜFFER, AKTIENGESETZ §111 (8<sup>th</sup> ed., 2008) margin number 17; SCHÖNBERGER (note 62), 106-139.

<sup>67</sup> See, in more detail, SCHÖNBERGER (note 62), 106-139; Lieder (note 63), 2252-2255.

Not convincing is the argument that the corporate governance system could be damaged by the new provision due to an alleged upgrading of codetermination, since all fundamental business decisions now require approval by employee representatives.<sup>68</sup> This argument ignores that Section 111(4) does not only upgrade the legal position of labor representatives, but also the position of shareholder representatives. Besides that, the level of codetermination remains unchanged, *i.e.*, under the Codetermination Act of 1976, the representatives of the shareholders are still able to approve fundamental business measures against the employee representatives' wishes.<sup>69</sup> The legitimate core of this critique focuses rather on the detrimental impact that codetermination has on the German corporate governance system as a whole. The inconvenient truth is that German codetermination is not sustainable, because it interferes with the supervisory board's capability to monitor the management board more efficiently. Therefore, the current codetermination system has to be changed<sup>70</sup> in lieu of criticizing the persuasive concept of the supervisory board's mandatory approval rights.

### *III. Importance of the German Corporate Governance Code*

Due to the newly established Section 161, the supervisory board has become more responsible for a company's corporate governance system, as both the management board and the supervisory board have to disclose whether they comply with the recommendations of the GCGC or not on an annual basis. The GCGC catapulted the German corporate governance system into a new era, and it brought the responsibility of the supervisory board for good corporate governance to a whole new level.<sup>71</sup> However, it goes beyond the scope of this paper to go into the very details of the Code's legal nature,<sup>72</sup>

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<sup>68</sup> See, the critique of Hopt & Roth (note 65), Section 111, margin number 17; Schiessl (note 58), 597; Klaus J. Hopt, *Unternehmensführung, Unternehmenskontrolle, Modernisierung des Aktienrechts – Zum Bericht der Regierungskommission Corporate Governance*, in *CORPORATE GOVERNANCE*, 27, 60-61 (Peter Hommelhoff et al. eds., 2002).

<sup>69</sup> LIEDER (note 2), 586-587.

<sup>70</sup> See, in detail section G.IV of this paper.

<sup>71</sup> See, Peter Ulmer, *Der Deutsche Corporate Governance Kodex – ein neues Regulierungsinstrument für börsennotierte Aktiengesellschaften*, 166 ZHR 150, 152 (2002); Wolfgang Seidel, *Der Deutsche Corporate Governance Kodex – eine private oder doch eine staatliche Regelung?*, 25 ZIP 285, 289 (2004); Lutter (note 3), 775.

<sup>72</sup> See, *e.g.*, OLG München, 6 August 2008 – 7 U 5628/07 (MAN), 54 AG 294 (2009); HÜFFER (note 66), Section 161, margin number 3; Michael Kort, *Corporate Governance-Fragen der Größe und Zusammensetzung des Aufsichtsrats bei AG, GmbH und SE*, 53 AG 137, 137-138 (2008); Ulmer (note 71), 158-161; Christoph H. Seibt, *Deutscher Corporate Governance Kodex und Entsprechens-Erklärung (§161 AktG-E)*, 47 AG 249, 250-251 (2002).

its advantages and disadvantages<sup>73</sup> as well as empirical studies regarding the compliance with the Code's recommendations<sup>74</sup>.

In any event, the disclosure obligation forces both the management board and the supervisory board to think about the corporate governance of their enterprise and possible improvements at least once a year.<sup>75</sup> In this regard, Section 161 strengthens the sense of responsibility of both boards' members for issues of corporate governance. This is crucial since the Government Commission "German Corporate Governance Code" acts as a standing commission that reviews and refines the Code on an annual basis.<sup>76</sup> However, this was not the primary reason for establishing the GCGC; the Code's foreword reveals the ultimate goal: "The Code aims at making the German Corporate Governance system transparent and understandable. Its purpose is to promote the trust of international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations."

Furthermore, the Code emphasizes the value of the German supervisory board system and it develops that system significantly further. Again, the Code's foreword states, "In practice the dual board system, also established in other continental European countries, and the single-board system are converging because of the intensive interaction of the Management Board and the Supervisory Board in the dual-board system." Indeed, the above-mentioned Sections 3.1, 3.2 and 5.1.1 GCGC stand for the new approach that both boards cooperate closely, coordinate and decide jointly on the enterprise's strategic approach and on measures of fundamental importance to the enterprise. Generally, the recommendations concerning the supervisory board take the center stage of the Code.<sup>77</sup> For example, Section 3.4 GCGC substantiated the joint responsibility of both the

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<sup>73</sup> See, e.g., LIEDER (note 2), 595-603; see also Eberhard Vetter, *Der Deutsche Corporate Governance Kodex nur ein zahnlöser Tiger? – Zur Bedeutung von §161 AktG für Beschlüsse der Hauptversammlung*, 11 NZG 121 (2008).

<sup>74</sup> See, e.g., Axel von Werder & Till Talaulicar, *Kodex Report 2009: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex*, 62 DB 689 (2009); Wolfgang Becker et al., *Wie stehen mittelständische Unternehmen zur Corporate Governance? – Aktuelle empirische Erkenntnisse*, 4 ZEITSCHRIFT FÜR CORPORATE GOVERNANCE (ZCG) 5 (2009); Axel von Werder & Till Talaulicar, *Kodex Report 2008: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex*, 61 DB 825 (2008); Manuel René Theisen & Martin Raßhofer, *Wie gut ist "Gute Corporate Governance"? – Ein aktueller Praxistest*, 60 DB 1317 (2007); Axel von Werder & Till Talaulicar, *Kodex Report 2007: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex*, 60 DB 879 (2007); LIEDER (note 2), 604-605; Axel von Werder & Till Talaulicar, *Kodex Report 2006: Die Akzeptanz der Empfehlungen und Anregungen des Deutschen Corporate Governance Kodex*, 59 DB 849 (2006).

<sup>75</sup> Official Explanatory Statement (note 55), 21; see also, Schiessl (note 58), 594.

<sup>76</sup> See, Foreword GCGC; see also, Official Explanatory Statement (note 55), 10; Ulrich Seibert, *Im Brennpunkt: Der Deutsche Corporate Governance Kodex ist da*, 57 BB 581 (2002).

<sup>77</sup> See, Hopt & Roth (note 65), Section 95, margin number 25; Ulmer (note 71), 154-155.



management board and the supervisory board to provide sufficient information to the supervisory board. Moreover, the management board is required to inform the supervisory board “regularly, without delay and comprehensively, of all issues important to the enterprise with regard to planning, business development, risk situation, risk management and compliance.” In addition, the Code recommends to the supervisory board to specify the management board’s information and reporting duties in more detail. Today, almost all companies listed on the German stock exchange comply with this recommendation.<sup>78</sup>

#### **D. Independence of Supervisory Board Members**

A milestone on the supervisory board’s way to professionalism was the 2005 amendment of the GCGC requiring the supervisory board to consist of “an adequate number of independent members.”<sup>79</sup> The independence requirement aims at avoiding conflicts of interest that may interfere with the supervisory board members’ monitoring duty *vis-à-vis* the management board. Those conflicts of interests may not only arise out of a lack of distance towards the management board, but also out of a particular proximity towards rival businesses, financial institutions, and other business partners. Independent supervisory board members can be expected to monitor the business decision of the management board without those conflicts of interest, but rather consistent with the interests of the company’s shareholders. In particular, independent members are capable of challenging business decisions of the management board, and, thus, they protect the interest of shareholders.<sup>80</sup> Today, almost all companies listed on the German stock exchange comply with this recommendation.<sup>81</sup>

##### *I. Background*

The independence requirement for German supervisory board members have its seeds in the recommendation of the European Commission on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory)

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<sup>78</sup> See, v. Werder & Talaulicar (note 74), 691 table 3: 97%.

<sup>79</sup> See, section 5.4.2 GCGC as of 2 June 2005, available at: [http://www.corporate-governance-code.de/eng/download/E\\_CorGov\\_Endfassung2005.pdf](http://www.corporate-governance-code.de/eng/download/E_CorGov_Endfassung2005.pdf), last accessed 27 January 2010.

<sup>80</sup> See, 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 – A Plan to Move Forward" – COM (2003) 284 final, 21 May 2003, 12, available at: [http://ec.europa.eu/internal\\_market/company/docs/modern/governance-consult-responses\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/governance-consult-responses_en.pdf), last accessed 27 January 2010.

<sup>81</sup> See, v. Werder & Talaulicar (note 74), 693 table 5: 96, 1%.

board as of 15 February 2005.<sup>82</sup> Under Art. 4 of that recommendation, “a sufficient number of independent non-executive or supervisory directors should be elected to the (supervisory) board of companies to ensure that any material conflicts of interest involving directors will be properly dealt with”. If the supervisory board plays a role in the fields of nomination, remuneration and audit, there shall be nomination, remuneration and audit committees that shall consist of at least a majority of independent non-executive or supervisory directors. To be considered independent under Art. 13.1 of the recommendation, a (supervisory) director must be “free of 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 impair his judgement”.

## *II. Independence Standards, Especially Large Shareholders*

Under Section 5.4.2 GCGC, a supervisory board member is independent if she “has no business or personal relations with the company or its Management Board which cause a conflict of interests”. Accordingly, major creditors, such as banks, as well as major suppliers and major customers cannot be considered independent.<sup>83</sup> However, representatives of the controlling shareholder are not enfolded by Section 5.4.2 GCGC, because they do not have per se a business or personal relation with the company or its management board.<sup>84</sup>

Unlike the European Commission recommended in 2005, representatives of large shareholders can be considered to be independent under the German Corporate Governance Code. This is true, because such representatives may help to overcome the large public firm’s agency problem. They align the interests of shareholders and supervisory board members, and they strengthen a company’s commitment to a shareholder wealth maximizing strategy. On the other hand, the European Commission’s argument for refusing to consider majority shareholders as independent, *i.e.*, the protection of minority shareholders,<sup>85</sup> is not convincing, because the interests of minority

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<sup>82</sup> Recommendation 2005/162/EC of the European Commission on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board; available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:052:0051:0063:EN:PDF>, last accessed 22 January 2010.

<sup>83</sup> Jan Lieder, *Das unabhängige Aufsichtsratsmitglied – Zu den Änderungen des Deutschen Corporate Governance Kodex*, 8 NZG 569, 570-571 (2005).

<sup>84</sup> *Arbeitsgruppe Europäisches Gesellschaftsrecht* (Group of German Experts on Company Law), *Stellungnahme zum Aktionsplan der EU-Kommission zu Corporate Governance und Gesellschaftsrecht: Allgemeine Erwägungen, kurz- und mittelfristige Maßnahmen*, 24 ZIP 863, 869 (2003); Lieder (note 83), 571; see now also Hans Diekmann & Katja Bidmon, *Das “unabhängige” Aufsichtsratsmitglied nach dem BilMoG – insbesondere als Vertreter des Hauptaktionärs*, 12 NZG 1087, 1090-1091 (2009).

<sup>85</sup> See, Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe as of 4 November 2002, 59-60, 62-63, available at: [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf), last accessed 23 January 2010.

shareholders in German companies are sufficiently protected by the sophisticated German law of corporate groups.<sup>86</sup>

Furthermore, considering major shareholders to be dependent would overshoot the mark. The standards of independence as they are stipulated in the European Commission's 2005 recommendation have been elaborated in view of the one-tier system. The role model was the Combined Code in the UK.<sup>87</sup> It is convincing that a corporate governance system with a single management body (one-tier system) requires strong rules of independence in order to avoid conflicts of interests such as to impair the judgement of the board members. On the other hand, the institutional separation of the management board and the supervisory board, including the associated rules and standards is the main feature of the German two-tier system. This institutional separation of management and supervision leads per se to a higher level of independence of the supervisory board members in the German dual board system. In this regard, a stricter independence standard in a one-tier system is aimed at compensating for the lack of such an institutional separation of management and supervision like in a two-tier system. Therefore, the European standards on independence, to some extent, overshoot the mark concerning a two-tier system, such as the supervisory board system in Germany.<sup>88</sup> As a result, there is no need to transplant the European Commission's recommendation as to an alleged lack of independence of major shareholders into German law.

### *III. Limitation to an Adequate Number of Independent Board Members*

A further advantage of Section 5.4.2 GCGC is its limitation to "an adequate number" of independent board members. In particular, it is not recommended that the supervisory board consists of a majority or a super-majority of independent members.<sup>89</sup> A supervisory board consisting of three members complies with Section 5.4.2 GCGC even if only one board member can be considered independent.<sup>90</sup>

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<sup>86</sup> Mathias Habersack, *Der Aufsichtsrat im Visier der Kommission*, 168 ZHR 373, 377-378 (2004); Lieder (note 83), 571; see also, Diekmann & Bidmon (note 84), 1090.

<sup>87</sup> See, Silja Maul & Georg Lanfermann, *EU-Kommission nimmt Empfehlungen zu Corporate Governance an – Schaffung unabhängiger und transparenter Aufsichtsräte – Vergütung von Organmitgliedern*, 57 DB 2407, 2409 (2004); Lieder (note 83), 570.

<sup>88</sup> Lieder (note 83), 570; see also, Walter Bayer, *Aktuelle Entwicklungen im Europäischen Gesellschaftsrecht*, 59 BB 1, 7 (2004); Habersack (note 86), 375-379; Michael Hoffmann-Becking, *Organe: Strukturen und Verantwortlichkeiten, insbesondere im monistischen System*, 33 ZGR 355, 359-360 (2004).

<sup>89</sup> See, Gerald Spindler, *Empfehlungen der EU für den Aufsichtsrat und ihre deutsche Umsetzung im Corporate Governance Kodex*, 26 ZIP 2033, 2040 (2005).

<sup>90</sup> See, Lieder (note 83), 572.

This is consistent with empirical studies that could not find any persuasive evidence for the fact that firms with a majority of independent board members perform better than other companies do.<sup>91</sup> However, some studies indicate that a *reasonable* number of independent board members may improve the performance of the company.<sup>92</sup> This data is based on the fact that independent board members frequently lack firm- or industry-specific knowledge, skills and experience. Therefore, under its self-organization duty, the supervisory board is responsible for constituting itself with an appropriate mixture of independent and affiliated board members.<sup>93</sup> The non-independent members have to be chosen due to their knowledge, skills and experience that are valuable for the given supervisory board and company. As a result, companies are still able to keep in touch with major creditors, such as banks, as well as major suppliers and major customers by according them a supervisory board seat.

#### *IV. Change from Management Board to Supervisory Board*

##### 1. Recommendation: Change shall not be the Rule

In connection with increasing the independence standards of supervisory board members, Section 5.4.4 GCGC as of 2005 recommended, "It shall not be the rule for the former Management Board chairman [CEO] or a Management Board member to become Supervisory Board chairman or the chairman of a Supervisory Board committee." If such a change was intended, the supervisory board should present special grounds. A vast majority of all companies listed on the German stock exchange complied with this recommendation.<sup>94</sup>

Prior to the Code's 2005 amendment, former CEOs have been the chairman of the supervisory board in fifteen of the largest thirty companies listed at the German stock

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<sup>91</sup> See, Sanjai Bhagat & Bernard Black, *Independent Directors*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW*, 283 (Peter Newman ed., 1998); more empirical evidences as to the relation between firm performance and board composition is provided by Brändle & Noll (note 1), 1363-1365.

<sup>92</sup> *Id.* Bhagat & Black, 283; Eddy Wymeersch, *Corporate Governance Regeln in ausgewählten Rechtssystemen*, in *HANDBUCH CORPORATE GOVERNANCE*, 87, 94 (Peter Hommelhoff et al. eds., 2003).

<sup>93</sup> See generally, Peter Hommelhoff, *Der aktienrechtliche Organstreit – Vorüberlegungen zu den Organkompetenzen und ihrer gerichtlichen Durchsetzbarkeit*, 143 ZHR 288, 298-300 (1979); Peter Hommelhoff, *Die Autarkie des Aufsichtsrats – Besprechung der Entscheidung BGHZ 85, 293 "Hertie" –*, 12 ZGR 551, 561-562, 568-569 (1983); LIEDER (note 2), 625-627.

<sup>94</sup> See, v. Werder & Talaulicar (note 74), 828 table 5: 87%.

exchange (*Deutsche Börse – DAX30*).<sup>95</sup> At that time, CEOs became principally always supervisory board chairpersons.<sup>96</sup> This practice poses the inherent risk that former management board members try to conceal corporate malfeasance having its seeds in the time when they still served in the management board. Moreover, former management board members may oppose strategic reorientation and transformation of the company conducted by their successors.<sup>97</sup> Furthermore, they may frequently lack the necessary independence from the current management board members.<sup>98</sup> Therefore, it is convincing to recommend limiting the flow of personnel from the management board to the supervisory board.

However, it was also persuasive that Section 5.4.4 GCGC was designed as a rule that permitted exemptions in specific situations. If the company lacked appropriate alternative candidates who could become chairperson of the supervisory board, or if former management board members possess specific firm-related knowledge, skills and experience, this could provide special reasons for becoming supervisory board members.<sup>99</sup> In any event, the supervisory board had to present special grounds for deviating from the restrictive rule of Section 5.4.4 GCGC.

## 2. Cooling-Off Period

The enactment of the Act on Adequacy of Executive Compensation as of 31 July 2009<sup>100</sup> has changed this legal situation. This law is meant to be an answer to the latest financial

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<sup>95</sup> Christian Bender & Hendrik Vater, *Lückenhaft und unverbindlich – Der Deutsche Corporate Governance Kodex lässt auch nach der Überarbeitung wichtige Kernprobleme der Unternehmensüberwachung ungelöst*, 41 DStR 1807, 1808 (2003).

<sup>96</sup> Günther H. Roth & Ulrike Wörle, *Die Unabhängigkeit des Aufsichtsrats – Recht und Wirklichkeit*, 33 ZGR 565, 585 (2004); see also Gunnar Dieling, *Der Wechsel aus dem Vorstand in den Aufsichtsrat*, in *DIE AKTIENGESELLSCHAFT IM SPIEGEL DER RECHTSTATSACHENFORSCHUNG*, 111, 116-121 (Walter Bayer ed., 2007).

<sup>97</sup> Schiessl (note 58), 598; Bender & Vater (note 95), 1808; Roth & Wörle (note 96), 586; Lieder (note 83), 572-573.

<sup>98</sup> See, Carsten Peter Claussen & Norbert Bröcker, *Corporate-Governance-Grundsätze in Deutschland – nützliche Orientierungshilfe oder regulatorisches Übermaß*, 45 AG 481, 490 (2000).

<sup>99</sup> See, Michael Endres, *Organisation der Unternehmensleitung aus der Sicht der Praxis*, 163 ZHR 441, 456 (1999); Oliver Rode, *Der Wechsel des Vorstandsmitglieds in den Aufsichtsrat – eine gute Corporate Governance? Neuregelung in Ziff. 5.4.4 Deutscher Corporate Governance Kodex*, 61 BB 341, 342 (2006); Bender & Vater (note 95), 1808; see also, Martin Frühauf, *Geschäftsleitung in der Unternehmenspraxis*, 27 ZGR 407, 417 (1998); Albrecht Schäfer, *Der Prüfungsausschuss – Arbeitsteilung im Aufsichtsrat*, 33 ZGR 416, 417-418 (2004).

<sup>100</sup> Bundesgesetzblatt 2009 I, 2509; for this purpose see generally Ulrich Seibert, *Das VorstAG – Regelungen zur Angemessenheit der Vorstandsvergütung und zum Aufsichtsrat*, 63 WM 1489-1493 (2009); Holger Fleischer, *Das Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)*, 12 NZG 801-806 (2009); Gerald Spindler, *Vorstandsgehälter auf dem Prüfstand – das Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)*, 9 NEUE JURISTISCHE ONLINE-ZEITSCHRIFT (NJOZ) 3282-3291 (2009); Gregor Thüsing, *Das Gesetz zur Angemessenheit der*

crisis, in particular to provide for stricter compensation standards in order to align compensation of management board members with long-term value creation and to deter from excessive risk-taking. At the same time, the responsibility of the supervisory board to design executive pay should be improved. Furthermore, executive compensation should become more transparent as to investors and the public.<sup>101</sup>

In addition, and most importantly for the topic of this paper, the Act also contained some minor, but quite important changes as to the supervisory board system. Some of those changes will be illustrated below:

Under revised Section 107(3), issues regarding the compensation of management board members cannot longer be delegated altogether to a (compensation) committee, rather the supervisory board as a whole is now responsible for deciding on matters of executive compensation.<sup>102</sup> Furthermore, the amended Section 93(2) requires that directors' and officers' insurance contracts for management board members involve a retention (*Selbstbehalt*) of at least 10% of a possible damage, but not more than one and a half of the fixed annual income of the relevant board member.<sup>103</sup>

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*Vorstandsvergütung*, 54 AG 517-529 (2009); Judith C. Nikolay, *Die neuen Vorschriften zur Vorstandsvergütung*, 62 NJW 2640-2647 (2009); Klaus-Stefan Hohenstatt, *Das Gesetz zur Angemessenheit der Vorstandsvergütung*, 30 ZIP 1349-1358 (2009); Jürgen van Kann & Anjela Keiluweit, *Das neue Gesetz zur Angemessenheit der Vorstandsvergütung*, 47 DStR 1587-1592 (2009); Christian Bosse, *Das Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG)*, 64 BB 1650-1654 (2009); Stefan Lingemann, *Angemessenheit der Vorstandsvergütung*, 64 BB 1918-1924 (2009); Georg Annuß & Ingo Theusinger, *Das VorstAG – Praktische Hinweise zum Umgang mit dem neuen Recht*, 64 BB 2434-2442 (2009); Michael Hoffmann-Becking & Gerd Krieger, *Leitfaden zur Anwendung des Gesetzes zur Angemessenheit der Vorstandsvergütung (VorstAG)*, 12 NZG Beilage zu Heft 26/2009, 1-12 (2009); Björn Gaul & Alexandra Janz, *Das neue VorstAG – Veränderte Vorgaben auch für die Geschäftsführer und den Aufsichtsrat der GmbH*, 100 GMBH-RUNDSCHAU (GMBHR) 959-964 (2009); René Döring & Timon Grau, *Anwendbarkeit der Änderungen durch das VorstAG auf die paritätisch mitbestimmte GmbH*, 62 DB 2139-2142 (2009); Tobias Greven, *Die Bedeutung des VorstAG für die GmbH*, 64 BB 2154-2159 (2009); Peter Hanau, *Der (sehr vorsichtige) Entwurf eines Gesetzes zur Angemessenheit der Vorstandsvergütung*, 62 NJW 1652-1653 (2009); Jens Wagner & Jonas Wittgens, *Corporate Governance als dauernde Reformanstrengung: Der Entwurf des Gesetzes zur Angemessenheit der Vorstandsvergütung*, 64 BB 906-911 (2009).

<sup>101</sup> See, Gesetzentwurf der Fraktionen der CDU/CSU und SPD, Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG, Bundestagsdrucksache 16/12278, 1, 5 (2009); Beschlussempfehlung und Bericht des Rechtsausschusses, Bundestagsdrucksache 16/13433, 1, 12 (2009); for this purpose, see, Benedikt Hohaus & Christoph Weber, *Die Angemessenheit der Vorstandsvergütung gem. §87 AktG nach dem VorstAG*, 62 DB 1515-1520 (2009); Martin Diller, *Nachträgliche Herabsetzung von Vorstandsvergütungen und –ruhegeldern nach dem VorstAG*, 12 NZG 1006-1009 (2009); Jobst-Hubertus Bauer & Christian Arnold, *Festsetzung und Herabsetzung der Vorstandsvergütung nach dem VorstAG*, 54 AG 717-731 (2009); Klaus-Stefan Hohenstatt & Michael Kuhnke, *Vergütungsstruktur und variable Vergütungsmodelle für Vorstandsmitglieder nach dem VorstAG*, 30 ZIP 1981-1989 (2009).

<sup>102</sup> See also, section E. II of this paper.

<sup>103</sup> For details, see, Carola Olbrich & Daniel Kassing, *Der Selbstbehalt in der D&O Versicherung*, 64 BB 1659-1662 (2009); Jürgen van Kann, *Zwingender Selbstbehalt bei der D&O-Versicherung*, 12 NZG 1010-1013 (2009); Barbara

With regard to the change from the management to the supervisory board, under the amended Section 100(2), management board members may not become members of the supervisory board of a listed company within two years after the end of their appointment, unless they are appointed upon a motion presented by a minority whose aggregate holding equals or exceeds 25% of the share capital. The latter exemption aims at family-owned businesses and major shareholders that serve as management board members. They should have the continuing ability to administrate their economic interests, regardless of serving as management or supervisory board members.<sup>104</sup> According to a prominent official responsible for the new legislation in the German Ministry of Justice, the provision is not aimed at prohibiting the change from the management board to the supervisory board in general. Nevertheless, the both management board and the supervisory board shall ask themselves whether such a change might bear any conflict of interests.<sup>105</sup>

Still, the establishment of a cooling off period regarding the change from the management board to the supervisory board is not convincing. Allowedly, those changes may create a conflict of interests. On the other hand, however, a rigid fixed period of time cannot guarantee that any proximity of new supervisory board members to their former colleagues in the management board will be eliminated and cannot be restored afterwards. Conversely, within those two years, the former board member's knowledge about the firm and its particularities as well as management skills may fade and become obsolete. Overall, a cooling off period is inappropriate with regard to issues of independence of former management board members now serving in the supervisory board.<sup>106</sup> The future will show whether shareholders are able to make use of the exception

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Dauner-Lieb & Peter W. Tettinger, *Vorstandshaftung, D&O-Versicherung, Selbstbehalt*, 30 ZIP 1555-1557 (2009); Robert Koch, *Einführung eines obligatorischen Selbstbehalts in der D&O-Versicherung durch das VorstAG*, 54 AG 637-647 (2009); Björn Fiedler, *Der Pflichtselbstbehalt nach § 93 Abs. 2 Satz 3 AktG und seine Auswirkungen auf Vorstandshaftung und D&O Versicherung*, 63 MONATSSCHRIFT FÜR DEUTSCHES RECHT (MDR) 2009, 1077-1082 (2009); Einiko Franz, *Der gesetzliche Selbstbehalt in der D&O-Versicherung nach dem VorstAG – Wie weit geht das Einschussloch in der Schutzweste der Manager?*, 62 DB 2764-2773 (2009). Regarding the affiliated change of Section 3.8 GCGC, see, Andreas Hecker, *Die aktuellen Änderungen des Deutschen Corporate Governance Kodex im Überblick*, 64 BB 1654, 1655-1656 (2009); Thomas Strieder, *Erläuterungen der Änderungen des Deutschen Corporate Governance Kodex des Jahres 2009*, 11 FINANZBETRIEB (FB) 515-516 (2009).

<sup>104</sup> See, Seibert (note 100), 1492.

<sup>105</sup> Seibert (note 100), 1492.

<sup>106</sup> See, LIEDER (note 2), 719; see also, now, Martin Peltzer, *Trial and Error – Anmerkungen zu den Bemühungen des Gesetzgebers, die Arbeit des Aufsichtsrates zu verbessern*, 12 NZG 1041, 1043 (2009); Daniela Weber-Rey, *Änderungen des Deutschen Corporate Governance Kodex 2009*, 63 WM 2255, 2263 (2009); Patrick Velte, *Die Cooling Off-Periode*, 6 AR 160, 161 (2009); for a different view and a proposal to extend the cooling-off period to 5 years, see, Thomas M.J. Möllers & Dominique Christ, *Selbstprüfungsverbot und die zweijährige Cooling-off-Periode beim Wechsel eines Vorstandsmitglieds in den Aufsichtsrat nach dem VorstAG*, 30 ZIP 2278-2281 (2009). - Furthermore, empirical studies show that changes from the management board to the supervisory board do not lead to a significantly higher amount of executive compensation; see, Horst Entorf et al.,

to appoint former board members by a motion presented by a 25 % share capital minority. If this may not be accomplished, the only opportunity to use the knowledge, skills and experiences of former board members is to close adviser contracts with them.<sup>107</sup>

More convincing, however, is the Code's 2009 amendment, as Section 5.3.2 GCGC recommends the chairperson of the audit committee to be independent and not to be a former member of the management board of the listed company whose appointment ended less than two years ago. Generally, the Corporate Governance Code is able to deal more flexibly with issues of management board members becoming members of the supervisory board rather than any legal provision. Therefore, the Code is the appropriate place for the relevant regulation.

#### **E. Committees of the Supervisory Board**

The most recent amendments of the German stock corporation law and the Code's recommendations improved the efficiency of the supervisory board through enhanced requirements on supervisory board committees. Establishing committees improves the monitoring skills of the supervisory board, because committees can overcome the structural problems of large, codetermined supervisory boards. Unlike large boards, committees can principally reach decisions more rapidly, they can meet more often, and they can facilitate an unconcealed exchange of ideas.<sup>108</sup> Since several legislative attempts to limit the board size failed in the past few years—because employees' interest groups, such as workers unions, fought successfully for maintaining the status quo of German codetermination—committees may serve as a substitute for a smaller supervisory board.<sup>109</sup>

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*Aufsichtsratsverflechtungen und ihr Einfluss auf die Vorstandsbezüge von DAX-Unternehmen*, 79 ZEITSCHRIFT FÜR BETRIEBSWIRTSCHAFT (ZfB) 1113, 1131-1133 (2009).

<sup>107</sup> Oliver Rode, *Der Wechsel eines Vorstandsmitglieds in den Aufsichtsrat*, 61 BB 341, 343 (2006); Dieling (note 96), 125-126; Möllers & Christ (note 106), 2281.

<sup>108</sup> See, e.g., LIEDER (note 2), 752-753.

<sup>109</sup> See, LIEDER (note 2), 489-92, 510-512.



### *I. Background*

Until recently, the number of established committees of the supervisory boards in Germany was underdeveloped compared to other countries, in particular the US and the UK.<sup>110</sup> Even before the reform in 1998, commentators called for mandatory supervisory board committees.<sup>111</sup> Furthermore, the 61<sup>st</sup> German Legal Association's Biannual Meeting (*Deutscher Juristentag*) advocated this proposal. However, the reform of 1998 refused to make specific committees of the supervisory board mandatory. Although the legislature recognized that the supervisory board could improve its efficiency by establishing an increased number of committees, it emphasized that the supervisory board, under its self-organization duty,<sup>112</sup> should have the ultimate authority to decide on its own, which committees are necessary depending on the particularities of the given company.<sup>113</sup> In order to still incentivize the supervisory board to increase the number of committees, the above-mentioned provision of Section 171(2) requires that the supervisory board informs the shareholders' meeting of publicly held companies with regard to the issue which committees it has established and how often the supervisory board and its committees have actually met.<sup>114</sup>

### *II. Audit Committee*

Since its creation in 2002, Section 5.3.2 GCGC recommends, "The Supervisory Board shall set up an Audit Committee which, in particular, handles issues of accounting, risk management and compliance, 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." Nowadays, this recommendation is very well accepted among large publicly held companies, in fact, all of the thirty largest companies listed at the German stock exchange comply with Section 5.3.2 GCGC.<sup>115</sup> All of these companies also comply

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<sup>110</sup> See, KNUT BLEICHER ET AL., *UNTERNEHMUNGSVERFASSUNG UND SPITZENORGANISATION* 84-86 (1989); C. WOLFGANG VOGEL, *AKTIENRECHT UND AUFSICHTSRATSWIRKLICHKEIT* 183-197 (1980).

<sup>111</sup> See, e.g., Marcus Lutter, *Der Aufsichtsrat: Konstruktionsfehler, Inkompetenz seiner Mitglieder oder normales Risiko?*, 39 AG 176, 177 (1994); Lutter (note 29), 1134; Hans Peter Schreib, *Reform des Aufsichtsrats aus der Sicht der Aktionäre*, 48 BETRIEBSWIRTSCHAFTLICHE FORSCHUNG UND PRAXIS (BFuP) 285, 287 (1996).

<sup>112</sup> See, again, note 93.

<sup>113</sup> See, Official Explanatory Statement (note 17), 16, 23.

<sup>114</sup> See, section B. III of this paper.

<sup>115</sup> See, v. Werder & Talaulicar (note 74), 828 table 5; v. Werder & Talaulicar (note 74), 693 table 5; see, further, Fabian Ehlers & Nicolas Nohlen, *Unabhängiger Finanzexperte und Prüfungsausschuss nach dem Bilanzrechtsmodernisierungsgesetz*, in *GEDÄCHTNISCHRIFT FÜR MICHAEL GRUSON*, 107, 113-114 (Stephan Hutter & Theodor Baums eds., 2009).

with the 2005 established recommendation that the chairperson of the audit committee “shall have specialist knowledge and experience in the application of accounting principles and internal control processes” (financial expert, Section 5.3.2 GCGC).<sup>116</sup>

Besides the above-mentioned benefits of committees, further advantages of audit committees include, in particular, a more frequently and more intense cooperation of the supervisory board with the auditor. The members of audit committees receive more and better information regarding the competence and independence of auditors as well as regarding the company’s accounting and auditing. Since the audit committee is required to provide the supervisory board as a whole with the said information, audit committees improve the overall level of information of the supervisory board. Moreover, the close cooperation of supervisory board and auditor increases the independence of the auditor from the management board.<sup>117</sup>

The audit committee gains even more importance, as the Accounting Law Reform Act<sup>118</sup> has recently established a new provision in Section 107(3) making clear that the supervisory board can set up an audit committee, which monitors issues of accounting, internal control and risk management as well as auditing, in particular the impartiality of the auditor, auditing fees and further benefits that go beyond those fees.<sup>119</sup> In this regard, there is a close connection between the obligations of the audit committee and the new

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<sup>116</sup> Regarding the financial expert, see Georg Lanfermann & Victoria Röhrich, *Pflichten des Prüfungsausschusses nach dem BilMoG*, 64 BB 887, 888 (2009); Mathias Habersack, *Aufsichtsrat und Prüfungsausschuss nach dem BilMoG*, 53 AG 98, 103-104 (2008); Holger Erchinger & Winfried Melcher, *Zur Umsetzung der HGB-Modernisierung durch das BilMoG: Neuerungen im Hinblick auf die Abschlussprüfung und die Einrichtung eines Prüfungsausschusses*, 62 DB Beilage 5 zu Heft 23/2009, 91, 97-98 (2009); Ehlers & Nohlen (note 115), 115-122; Bruno Kropff, *Der unabhängige Finanzexperte in der Gesellschaftsverfassung*, in Festschrift für Karsten Schmidt, 1023-1040 (Georg Bitter et al. eds., 2009); Lieder (note 83), 573-574.

<sup>117</sup> LIEDER (note 2), 760-761.

<sup>118</sup> Bundesgesetzblatt 2009 I, 1102; for that purpose, see generally, Winfried Melcher & Daniela Mattheus, *Zur Umsetzung der HGB-Modernisierung durch das BilMoG: Neue Offenlegungsvorschriften zur Corporate Governance*, 62 DB Beilage 5 zu Heft 23/2009, 77-82 (2009); Karl-Heinz Withus, *Zur Umsetzung der HGB-Modernisierung durch das BilMoG: Wirksamkeitsüberwachung interner Kontroll- und Risikomanagementsysteme durch Aufsichtsorgane kapitalmarktorientierter Gesellschaften*, 62 DB Beilage 5 zu Heft 23/2009, 82-90 (2009); Erchinger & Melcher (note 116), 91-98; Götz Tobias Wiese & Philipp Lukas, *Das Bilanzrechtsmodernisierungsgesetz (BilMoG)*, 100 GMBHR 561-569 (2009); Carl Braun & Christoph Louven, *Neuregelungen des BilMoG für GmbH-Aufsichtsräte*, 100 GMBHR 965-970 (2009); particularly regarding the independence requirement, see, Philipp Jaspers, *Voraussetzungen und Rechtsfolgen der Unabhängigkeit eines Aufsichtsratsmitgliedes nach dem BilMoG*, 54 AG 607-615 (2009).

<sup>119</sup> See, generally, Lanfermann & Röhrich (note 116), 887; Habersack (note 116), 98; Erchinger & Melcher (note 116), 96-97.

reporting duty of the auditor under Section 171(1)<sup>120</sup>. Additionally, the supervisory board or the audit committee of capital markets oriented companies must consist of at least one independent financial expert (Sections 100(5) and 107(4)).<sup>121</sup>

Although the new provision is comparable with Section 5.3.2 GCGC, it has more legal authority, as it is implemented in the German Stock Corporation Act. Additionally, the new provision substantiates the previous legal situation and facilitates the flow of information from the auditor to the supervisory board and the audit committee, respectively. This may increase the pressure on supervisory board and audit committee members to comply with the now enhanced monitoring obligations<sup>122</sup>. Thereby, members of both the management board and the supervisory board as well as auditors may overall become more sensitive and more conscious for issues of accounting, auditing, internal control and risk management.

### III. Nomination Committee

The Code's 2007 amendment established a new Section 5.3.3 GCGC stating that the supervisory board shall set up a "nomination committee composed exclusively of shareholder representatives which proposes suitable candidates to the Supervisory Board for recommendation to the General Meeting." Today, all but one of the thirty largest companies listed at the German stock exchange comply with this recommendation.<sup>123</sup>

The main advantage of such a committee is that a smaller committee can deal with personal changes more quickly and more flexibly than the supervisory board as whole. Furthermore, the nomination committee is able to monitor the composition of the supervisory board on a continuous basis, it can prepare for any necessary personal changes, and it can provide for a sophisticated succession planning.<sup>124</sup> Overall, the

<sup>120</sup> See, section F. III of this paper. See, *Begründung zum Regierungsentwurf eines Gesetzes zur Modernisierung des Bilanzrechts (Bilanzrechtsmodernisierungsgesetz – BilMoG)*, Bundestagsdrucksache 16/10067, 103 (2009); Erchinger & Melcher (note 116), 97.

<sup>121</sup> Regarding the financial expert, see, again, note 116.

<sup>122</sup> See, generally, *Arbeitskreis Externe Unternehmensrechnung (AKEU) & Arbeitskreis Externe und Interne Überwachung der Unternehmen der Schmalenbach-Gesellschaft für Betriebswirtschaft e.V. (AKEIÜ), Anforderungen an die Überwachungsaufgaben von Aufsichtsrat und Prüfungsausschuss nach §107 Abs. 3 Satz 2 AktG i. d. F. des Bilanzrechtsmodernisierungsgesetzes*, 62 DB 1279, 1280-1282 (2009); Rolf Nonnenmacher, Klaus Pohle & Axel von Werder, *Aktuelle Anforderungen an Prüfungsausschüsse*, 62 DB 1447, 1450-1454 (2009).

<sup>123</sup> See, v. Werder & Talaulicar (note 74), 693 table 5.

<sup>124</sup> See, generally, Manuel M. Meder, *Der Nominierungsausschuss in der AG – Zur Änderung des Deutschen Corporate Governance Kodex 2007*, 28 ZIP 1538 (2007); LIEDER (note 2), 763.

recommendation may lead to a stronger autonomy of the supervisory board,<sup>125</sup> and makes it more independent from any possible detrimental exercise of influence by the management board.

#### *IV. Compensation Committee*

For the first time ever, compensation committees are legally addressed by the Act on Adequacy of Executive Compensation as of 31 July 2009.<sup>126</sup> According to Section 107(3), issues regarding the compensation of management board members cannot longer be delegated altogether to a (compensation) committee, rather the supervisory board as a whole is now responsible for deciding on matters of executive compensation.

Although this change does not seem to fit into the current development towards professionalism through creation of supervisory board committees, the new provision still improves the corporate governance system of the German stock corporation. Division of labor is the main purpose when the supervisory board delegates specific subjects, such as issues of auditing or nomination, to be handled by one or several committees. This idea, however, must step back with regard to executive compensation in order to improve the transparency of contracts with members of the management board including executive compensation.<sup>127</sup> In this regard, it is absolutely convincing that the new provision goes even beyond Section 4.2.2 GCGC adopted in June 2008<sup>128</sup>, under which “the full Supervisory Board shall resolve and regularly review the Management Board compensation system including the main contract elements”, and that with regard to “the proposal of the committee dealing with Management Board contracts” (compensation committee). Due to the Code’s 2009 amendment, Section 4.2.2 GCGC is now aligned with the new provisions of the Act on Adequacy of Executive Compensation, *i.e.*, “the full Supervisory Board determines the total compensation of the individual Management Board members (...).”

Under Section 107(3), the compensation committee’s scope of responsibility is now significantly diminished. This is convincing, however, with regard to the increase of transparency as to executive compensation. In addition, the new law may improve the awareness and responsibility of every single supervisory board member as to today’s socio-

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<sup>125</sup> Eberhard Vetter, *Die Änderungen des Deutschen Corporate Governance Kodex*, 60 DB 1963, 1967 (2007).

<sup>126</sup> See, note 100.

<sup>127</sup> See, *Gesetzentwurf* (note 101), 7.

<sup>128</sup> For details, see, Stefan Wehlte, *DCGK 2008: Anmerkungen zur jüngsten Revision der Standards für gute Unternehmensführung*, 3 ZCG 216-217 (2008).

political significance of those issues.<sup>129</sup> On the other hand, the supervisory board is still allowed to delegate detailed questions to the compensation committee, such as the negotiation on individual conditions of management board contracts.<sup>130</sup> This is meaningful, as it cannot be expected from a large codetermined supervisory board with, for instance, twenty members to negotiate efficiently with every individual management board member.<sup>131</sup> Nevertheless, the supervisory board as a whole must have sufficient knowledge about and it must ultimately resolve on all of the major issues of executive compensation. In this regard, the new law is persuasive, as it strikes a balance between a higher level of transparency as to executive compensation, and excessive demands of the supervisory board as a whole.<sup>132</sup>

## F. Accounting Law Reform Act

Besides the changes regarding the audit committee,<sup>133</sup> the Accounting Law Reform Act of 2009 improved the overall corporate governance system of the German stock corporation in several ways. The new law improved the monitoring function of the supervisory board and its audit committee as well as their responsibility as to accounting, auditing, internal control and risk management.

### I. Disclosure Report on Corporate Governance

To begin with, under the revised Section 161, both the management board and the supervisory board have not only to disclose whether they comply with the recommendations of the GCGC or not on an annual basis. Additionally, in case they do not, they have to explain why, *i.e.*, they have to give specific reasons for not complying with any recommendation.

The new obligation to explain non-compliance was already requested by the Government Commission "German Corporate Governance Code"<sup>134</sup> and legal scholarship<sup>135</sup> and is

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<sup>129</sup> See, Wehlte (note 128), 216-217; but, see also, Bauer & Arnold (note 101), 731.

<sup>130</sup> See also, Thüsing (note 100), 524; van Kann & Keiluweit (note 100), 1590; Hoffmann-Becking & Krieger (note 100), 9; Annuß & Theusinger (note 100), 2439.

<sup>131</sup> See, BDI et al., *Stellungnahme zum Entwurf eines Gesetzes zur Angemessenheit der Vorstandsvergütung (VorstAG)*, BT-Dr. 16/12278, 6 (2009), available at: [http://www.bdi-online.de/Dokumente/Stellungnahme\\_BDI\\_BDA\\_DAI\\_zum\\_VorstAG\\_endg.pdf](http://www.bdi-online.de/Dokumente/Stellungnahme_BDI_BDA_DAI_zum_VorstAG_endg.pdf), last accessed 23 January 2010.

<sup>132</sup> See also, Thüsing (note 100), 524.

<sup>133</sup> See, section E.II of this paper.

<sup>134</sup> BERICHT DER REGIERUNGSKOMMISSION CORPORATE GOVERNANCE margin number 10 (Theodor Baums ed., 2001).

absolutely convincing, because the legislative goal of the recommendations can only be accomplished if both the management board and the supervisory board are really looking into the current state of a company's corporate governance system and only choose not to comply with a recommendation if there is good cause. As a consequence, deviations without good reasons will be minimized, because it makes a difference whether a management board and a supervisory board can deviate from a recommendation with or without giving specific grounds. Now as they have to show good cause, the board members have to reflect on each single recommendation, with which they do not want to comply.<sup>136</sup> Furthermore, investors, creditors and the overall public have an interest to know why the company decided not to comply with a particular recommendation. With that knowledge, they can make a well-informed decision on whether to make an investment or to exit an investment. This information is relatively easy to access for the public, because under Section 161(2) the company has to permanently publish the report on its website.

### *II. Corporate Governance Statement*

Furthermore, since the enactment of the Accounting Law Reform Act in 2009, the disclosure obligation of Section 161 is supplemented by a Corporate Governance Statement. According to Section 289a GCC, publicly listed companies have to report on their corporate governance system either in their annual report or on their website. The relevant information include the disclosure report under Section 161, particularities of a company's corporate governance system that goes beyond legal obligations, and a description on the methods of operation of both the management board and the supervisory board as well as a description of both the composition and functioning of supervisory board committees. This information may further enhance the corporate governance system of the company and provide investors with investment-relevant information on a company's corporate governance system.

### *III. Report on Internal Control and Risk Management*

Finally, the Accounting Law Reform Act requires capital markets oriented companies to report on particular features of their internal control and risk management system in the management board's report on the business situation of the company (Sections 289(5) and 315(2) GCC). On the one hand, this provides the general public with information on the overall corporate governance system of the corporation. On the other hand, it facilitates

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<sup>135</sup> LIEDER (note 2), 593.

<sup>136</sup> Michael Kort, *Corporate Governance-Grundsätze als haftungsrechtlich relevante Verhaltensstandards?*, in Festschrift für Karsten Schmidt 945, 961 (Georg Bitter et al. eds., 2009).

interdependencies of accounting, auditing and risk management<sup>137</sup> and it provides the supervisory board, particularly the members of the audit committee, with valuable information on a company's current economic situation and a company's state of internal control and risk management.

Furthermore, under Section 171(1) the reporting obligations of the auditor *vis-à-vis* the supervisory board and the audit committee, respectively, have been improved, as the auditor now has a duty to report, in particular, on the major weaknesses of the internal control and risk management system with regard to the auditing process. Those enhanced reporting obligations may raise the awareness of supervisory board and committee members as to systemic weaknesses and a company's risk profile<sup>138</sup>, and it may make them more sensible for their supervisory obligations as to internal control and risk management. Furthermore, both the supervisory board and the audit committee now receive more and better information on the company's accounting and auditing, and they may cooperate with the auditor more intensively.

At the same time, the auditor is required to disclose any fact that may cause doubt about her impartiality, and she has to report on any benefit she receives in addition to her regular auditing fees (Section 171(2)). These new disclosure obligations lead to a higher level of transparency as to the cooperation between the supervisory board, its audit committee and the auditor. Additionally, the new law facilitates an auditor's independence *vis-à-vis* the management board. This is also true for Section 124(3). According to this provision, the audit committee is entitled to make a recommendation towards the supervisory board as a whole regarding the person who will be proposed towards the shareholders' meeting to be elected as an auditor.

#### *IV. Intermediate Result and Transition*

So far, this paper demonstrated how recent legislative developments significantly improved the German supervisory board system that is characterized by both a dichotomy of the supervisory board and the management board as well as conventional German codetermination. The above reviewed amendments of the German stock corporation law and the German Corporate Governance Code addressed issues of the said dichotomy. Those changes focused on the supervisory board as a body of the stock corporation that needs information and effectual means in order to monitor the management board efficiently. Conversely, until today, every legislative attempt to address any critical point of German codetermination failed, although the weaknesses of the current codetermination regime are today more than obvious. Therefore, the subsequent passages of this paper will

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<sup>137</sup> See, Melcher & Mattheus (note 118), 78.

<sup>138</sup> See, Withus (note 118), 83.

provide an argument for reforming German codetermination and for limiting the size of the supervisory board. Following, the remain of the paper will support the idea of allowing enterprises to choose between a one-tier and a two-tier board system.

### G. An Argument for Reforming German Codetermination

When the German laws of codetermination were enacted, there were several theories on the legitimacy of active participation of employees in the decision-making process of the company, such as moral approaches, democracy-theoretical approaches, sociopolitical approaches and sociophilosophical approaches.<sup>139</sup> Today, these theories are antiquated.<sup>140</sup> Nevertheless, codetermination has had a beneficial impact on the workers' conditions and industrial morale after World War II<sup>141</sup>, and today is still a primary structure characteristic of German corporate governance. Nowadays, German codetermination is still favored because it may improve the flow of information from the workforce to the management, and it may facilitate the participation of employees in the decision-making process inside the large firm that may have positive effects on the motivation of the workforce and may lead to more social peace<sup>142</sup>. The crucial point is the flow of information that goes either way. Firm-specific knowledge and expertise of employees may—bottom up—improve the decision-making process of the supervisory board. The satisfaction and motivation of the workforce is said to be improved by the information flow—top down—from the supervisory board to the employees, especially if the point is lay-offs or other measures that put pressure on the workforce.

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<sup>139</sup> See, in summary, MITBESTIMMUNG IM UNTERNEHMEN: BERICHT DER SACHVERSTÄNDIGENKOMMISSION ZUR AUSWERTUNG DER BISHERIGEN ERFAHRUNGEN BEI DER MITBESTIMMUNG (MITBESTIMMUNGSKOMMISSION) 18-21 (1970); Wolfgang Schilling, *Wirtschaftliche Mitbestimmung im Meinungsstreit*, 128 ZHR 217, 219-227 (1966). As to the evolution and development of German codetermination see, in general, Pistor (note 43), 165-175; see also, Vagts (note 1), 35-36, 65-78; Raiser (note 2), 117-122; Herbert Wiedemann, *Codetermination by Workers in German Enterprises*, 28 AM. J. COMP. L. 79-92 (1980); Gregory Jackson, *Contested Boundaries: Ambiguity and Creativity in the Evolution of German Codetermination*, in BEYOND CONTINUITY: INSTITUTIONAL CHANGE IN ADVANCED POLITICAL ECONOMICS 229-254 (Wolfgang Streeck & Kathleen Thelen eds., 2005). With regard to codetermination regimes in other countries and an explanation why those countries adopted systems of employee representation, see, Gregory Jackson, *Employee Representation in the Board Compared: A Fuzzy Sets Analysis of Corporate Governance, Unionism and Political Institutions*, 12 INDUSTRIELLE BEZIEHUNGEN 252-279 (2005).

<sup>140</sup> Christine Windbichler, *Arbeitnehmerinteressen im Unternehmen und gegenüber dem Unternehmen – Eine Zwischenbilanz*, 49 AG 190, 191 (2004); BERTELSMANN-STIFTUNG & HANS-BÖCKLER-STIFTUNG, MITBESTIMMUNG UND NEUE UNTERNEHMENSKULTUREN 7 (1998), compared to Thomas Raiser, *Bewährung des Mitbestimmungsgesetzes nach zwanzig Jahren?*, in FREUNDESGABE FÜR FRIEDRICH KÜBLER, 477, 491-492 (Heinz-Dieter Assmann et al. eds., 1997).

<sup>141</sup> Vagts (note 1), 76.

<sup>142</sup> See, Hopt & Leyens (note 1), 145; Klaus J. Hopt, *Gemeinsame Grundsätze der Corporate Governance in Europa?*, 29 ZGR 779, 801 (2000); Axel von Werder, *Überwachungseffizienz und Unternehmensmitbestimmung*, 49 AG 166, 168 (2004); Bernd Frick, Gerhard Speckbacher & Paul Wentges, *Arbeitnehmermitbestimmung und moderne Theorie der Unternehmung*, 69 ZfB 745, 750, 753 (1999); Windbichler (note 140), 190-191; see also anecdotal evidence from Vagts (note 1), 71-72.



*I. Empirical Evidence on German Codetermination*

However, there is little empirical evidence on the efficiency of German codetermination. The problem with studies on that subject is that the laws on codetermination principally apply to all companies depending on their size without any exception. Therefore, it is hard to make a comparison with companies without codetermination. Apart from that, the existing studies draw a heterogeneous picture.

Some studies show a significantly negative effect of German codetermination on share values. In particular, Gary Gorton and Frank A. Schmid find an average 31% stock market discount on firms with equal employee representation compared with one-third employee representation.<sup>143</sup> This finding supports the property rights theory, which argues that codetermination dilutes the property rights of shareholders, because they have to bear all the investment risk, whereas employee representatives participate in the decision-making process without bearing any economic risk for wrong decisions.<sup>144</sup> Approaching this issue differently, Mark J. Roe argues that there is a negative relation between codetermination on the one hand, and the development of capital markets and shareholder protection on the other hand.<sup>145</sup>

Other empirical research, such as the study of Larry Fauver and Michael E. Fuerst, arrive at the opposite result. On the basis of the participation theory and a team approach to management, they argue that codetermination increases the firm market value and make the corporate governance system of codetermined companies more effective because of an improved flow of information from the workforce to the supervisory board and positive effects on the motivation of the workforce.<sup>146</sup> A majority of other studies simply finds that there is no significantly positive effect of codetermination on share value.<sup>147</sup>

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<sup>143</sup> Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 JOURNAL OF THE EUROPEAN ECONOMIC ASSOCIATION (JEEA) 863-905 (2004); see further, Oliver Stettes, *Unternehmensmitbestimmung in Deutschland – Vorteil oder Ballast im Standortwettbewerb?*, 52 AG 611-618 (2007).

<sup>144</sup> See, Rüdiger von Rosen, *Kapitalmarkt und Mitbestimmung*, in Festschrift für Eberhard Schwark, 789, 793-794 (Stefan Grundmann et al. eds., 2009).

<sup>145</sup> Mark J. Roe, *German Co-Determination and German Securities Markets*, in COMPARATIVE CORPORATE GOVERNANCE, STATE OF THE ART AND EMERGING RESEARCH 361-372 (Klaus J. Hopt et al. eds., 1998); MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT (2003).

<sup>146</sup> Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, EFA 2004 Maastricht Meetings Paper No. 1171 (2004), available at: <http://ssrn.com/abstract=534422>, last accessed 23 January 2010; see also v. Rosen (note 144), 794.

<sup>147</sup> See, in summary, Dieter Sadowski, Joachim Junkes & Sabine Lindenthal, *Gesetzliche Mitbestimmung in Deutschland*, 30 ZGR 110, 126-132 (2001); Frick, Speckbacher & Wentges (note 142), 756-757; Martin Henssler, *Arbeitnehmermitbestimmung im deutschen Gesellschaftsrecht*, in UNTERNEHMENS-MITBESTIMMUNG DER ARBEITNEHMER IM RECHT DER EU-MITGLIEDSTAATEN, 133, 147-148 (Theodor Baums & Peter Ulmer eds., 2004).

To be clear, it is not the role of codetermination to enhance share value. The major benefit is to provide the board level with first-hand knowledge of employees. Although this may have a positive effect on share value, however, empirical evidence on the economic effects of codetermination is ambiguous. With regard to the theoretical background of empirical research on codetermination, the participation theory is not convincing, because the arguable benefits of codetermination are outweighed by some major weaknesses of the current codetermination regime, as I will show in the following sections by providing anecdotal evidence.<sup>148</sup> Furthermore, if the idea of codetermination was convincing, firms would adopt employee representation at the board level voluntarily. As Michael Jensen and William Meckling put it: "The fact that stockholders must be forced by law to accept codetermination is the best evidence we have that they are adversely affected by it".<sup>149</sup> Data from 1993 shows that only one firm out of Germany's 250 largest publicly held companies had established a codetermination regime that was not required by law. In addition, the majority shareholder of that firm was the state, so it is most likely that political forces rather than economical goals have been the reason for implementing this optional regime of employee representation in the said company.<sup>150</sup>

## *II. Disadvantages of German Codetermination*

### **1. Weak Factual Position of the Supervisory Board**

The most important downside of German codetermination is its detrimental effect on the monitoring ability of the supervisory board. As a result of codetermination, the management board and the shareholder representatives often join forces against the employee representatives in order to limit their influence on the decision-making process of the company. Overall, this development on the one hand weakens the factual position of the supervisory board, and on the other hand, it leads to a much stronger position of the management board.<sup>151</sup> This may explain why executives in Germany still cheer the active participation of employees in the decision-making process<sup>152</sup>. In the end, the supervisory

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<sup>148</sup> For an early discussion of the impact of codetermination on German corporate management, see, Vagts (note 1), 67-75.

<sup>149</sup> Michael Jensen & William Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 JOURNAL OF BUSINESS (J. BUS.) 469, 474 (1979).

<sup>150</sup> See, v. Rosen (note 144), 796.

<sup>151</sup> See, ELMAR GERUM, MITBESTIMMUNG UND CORPORATE GOVERNANCE 43 (1998); Raiser (note 140), 488; Joachim Jahn, *Nach dem Mannesmann-Urteil des BGH*, 27 ZIP 738, 745 (2006); Martin Peltzer, *Unternehmerische Mitbestimmung und gute Corporate Governance: Führt die Unvereinbarkeit zur Nachbesserungspflicht des Gesetzgebers?*, in FESTSCHRIFT FÜR KARSTEN SCHMIDT, 1243, 1253-1254 (Georg Bitter et al. eds., 2009).

<sup>152</sup> See, Wolfgang Bernhardt, *Deutsche (Unternehmens-)Mitbestimmung zwischen Wünschen und Wirklichkeit*, 59 BB 2480 (2004); see also, Vagts (note 1), 68.

board encounters difficulties with regard to its monitoring function in practice. Where the supervisory board maintains in an influential position, codetermination slows down the decision-making process, in particular as to internal controls.<sup>153</sup>

## 2. Poor Supply of Information

As a further result of codetermination, the supervisory board is principally reluctant to discuss confidential matters and controversial issues in order to limit the influence of employee representatives in the supervisory board and to prevent confidential information to be released to the public. Things changed for the better, when the German stock corporation law was reformed in recent years by the Law on Control and Transparency of Enterprises in 1998<sup>154</sup> as well as the Law on Transparency and Disclosure in 2002<sup>155</sup>. Nevertheless, the supervisory board to some extent still suffers from poor supply of information, because a number of employee representatives still believe that they are authorized to forward confidential information from the boardroom to the workforce, even if they infringe their legal obligation of secrecy. In practice, the management solves this problem by limiting the supply of information to the supervisory board in order to prevent indiscretion. Accordingly, the supervisory board lacks information and data that is needed for effectively monitoring the management board. A famous example for this practice was the way the merger of Daimler-Benz and Chrysler was prepared.<sup>156</sup> Daimler-Benz' management board and Chrysler's board of directors negotiated the largest trans-Atlantic merger deal ever. Daimler-Benz' supervisory board was called on to give approval of the merger not before the merger agreement was ready to be signed. Once more, this shows the weakness of the supervisory board concerning the participation in the decision-making process, even if it is a question of fundamental corporate change.

## 3. Conflict of Interests

Additionally, the participation of employees in the decision-making process of the company leads to more conflicts of interests, as employee representatives view themselves as representatives of the personnel's interests only. In particular, union-political objectives frequently collide with the interest of the monitored company. In this regard, the case of Frank Bsirske, chairman of the Trade Union for the Service Sector in

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<sup>153</sup> Hopt & Leyens (note 1), 165.

<sup>154</sup> See, *supra*, note 16.

<sup>155</sup> See, *supra*, note 49; see also Hopt & Leyens (note 1), 145.

<sup>156</sup> See, Hopt (note 142), 801; LIEDER (note 2), 662.

Germany (*ver.di*), gained notoriety<sup>157</sup>. In 2002, Bsirske called a strike at Lufthansa AG, although he served as vice chairman of the supervisory board of Lufthansa AG. This shows that only having codetermination in place is not an appropriate protection against expensive strikes.<sup>158</sup> Furthermore, it should be clear that employee representatives cannot be seen as independent board members, because they tend to protect the interests of their fellow workers rather than to serve in the interest of the company.<sup>159</sup>

Another example for the employee representatives' opinion that they only represent the personnel's interest was the voting behavior of the employee representatives in the infamous Mannesmann case.<sup>160</sup> When Mannesmann's supervisory board, including the chief executive of Deutsche Bank AG, Josef Ackermann, awarded rich bonuses to top executives at Mannesmann amid the takeover battle with Vodafone in 2000, the employee representatives abstained from voting, because in their opinion a different behavior could not have been explained to their fellow workers and they believed that this very decision did not touch the personnel's interests in the first place. As a result, codetermination *per se* cannot be seen as a safeguard against exorbitant bonuses and compensation.<sup>161</sup> Therefore, making all supervisory board members responsible for executive remuneration—as the Act on Adequacy of Executive Compensation as of 2009 did—does not necessarily lead to an overall lower compensation level. To the contrary, there is still the risk that employee representatives bargain in order to receive benefits in exchange for their approval to excessive remuneration of the management.

#### 4. Professionalism, Expertise and Codetermination

The recent development and changes in the laws concerning the German supervisory board have increased the responsibility of any supervisory board member as well as their risk of liability since the new legislation established increasingly demanding standards of care and expertise. Today, the supervisory board of capital market oriented companies must include a financial expert (Section 105(5)). Besides that, every supervisory board

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<sup>157</sup> See, Otto Ernst Kempfen, *Fernwirkungen von Arbeitskämpfen auf die Unternehmensmitbestimmung? (Der Fall Bsirske)*, in GEDÄCHTNISSCHRIFT FÜR MEINHARD HEINZE, 437-438 (Alfred Söllner et al. eds., 2005); Klaus J. Hopt, *Modernisierung der Unternehmensleitung und -kontrolle*, in FESTSCHRIFT FÜR HARM PETER WESTERMANN, 1039, 1046 (Lutz Aderhold et al. eds., 2008); Andy Ruzik, *Zum Streit über den Streik – Aufsichtsratsmandat und Gewerkschaftsführung im Arbeitskampf*, 7 NZG 455-459 (2004); for a different view, see, Thomas M.J. Möllers, *Gesellschaftsrechtliche Treuepflicht contra arbeitnehmerrechtliche Mitbestimmung*, 6 NZG 697-701 (2003).

<sup>158</sup> Hopt & Leyens (note 1), 165.

<sup>159</sup> For an earlier example from the 1950s, see, Vagts (note 1), 74-75.

<sup>160</sup> See, Peltzer (note 151), 1248-1250; Jahn (note 151), 745; Henssler (note 147), 152.

<sup>161</sup> See also, Hopt & Leyens (note 1), 165.

member should have a basic understanding of a corporation's financial affairs. Due to the lack of adequate candidates of the workforce and workers unions, the general standard of financial literacy is still at a minimum level.<sup>162</sup> In Germany, there is only a limited pool of financially well-educated and experienced employee representatives' candidates. In this regard, codetermination has also a detrimental effect on the expertise of board members, and, thus, hampers further ambitions towards professionalism.

### *III. Excessive Board Size*

Another—rather indirect—consequence of German codetermination is the excessive size of the supervisory board that in average consists of 13.25 members.<sup>163</sup> This is almost twice of the size of the average board of directors in the United States and the United Kingdom.<sup>164</sup> Furthermore, empirical evidence with regard to the European Company (SE) shows that some of Germany's most important publicly held companies reincorporated as European Companies and, thereby, decreasing the size of their supervisory boards.<sup>165</sup> Both Allianz SE and BASF SE decreased the board size from formerly 20 to 12 members. Additionally, both Max Boegl International SE and MAN Diesel SE reduced their supervisory board size by two members each.

This development is evident from an economic point of view, because smaller boards have several important advantages. They principally reach decisions more rapidly, they can meet more often, and they facilitate an unconcealed exchange of ideas.<sup>166</sup> Furthermore, the individual consciousness of responsibility of every supervisory board member is higher in smaller boards, because it is not possible to hide in an anonymous crowd.<sup>167</sup> Smaller boards may also be helpful to prevent conflicts of interests, because the more persons serve as supervisory board members, the higher the risk is that there is any conflict of interests that might derogate the efficiency of the supervisory board's monitoring function.<sup>168</sup> Accordingly, empirical evidence shows that there is a significantly negative

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<sup>162</sup> Hopt & Leyens (note 1), 145.

<sup>163</sup> Klaus J. Hopt, *Corporate Governance: Aufsichtsrat oder Markt*, in MAX HACHENBURG: DRITTE GEDÄCHTNISVORLESUNG 1998, 9, 29-30 (Peter Hommelhoff et al. eds., 1998); Hopt (note 1), 248.

<sup>164</sup> See, BERICHT (note 134), margin number 49; see further Carsten Berrar, *Zur Reform des AR nach den Vorschlägen der Regierungskommission "Corporate Governance"*, 4 NZG 1113, 1114 (2001).

<sup>165</sup> Horst Eidenmüller, Andreas Engert & Lars Hornuf, *Die Societas Europaea: Empirische Bestandsaufnahme und Entwicklungslinien einer neuen Rechtsform*, 53 AG 721, 728 (2008).

<sup>166</sup> LIEDER (note 2), 675.

<sup>167</sup> See, Hagen Lüderitz, *Effizienz als Maßstab für die Größe des Aufsichtsrats*, in FESTSCHRIFT FÜR ERNST STEINDORFF, 113, 120 (Jürgen F. Baur et al. eds., 1990).

<sup>168</sup> See, Lüderitz (note 167), 122-123; LIEDER (note 2), 677.

relation between board size and the performance measure Tobin's Q<sup>169</sup>. Establishing supervisory board committees may help to diminish the most detrimental effects of an excessive board size, but compared to a smaller board, committees are only the second best solution, because they often lead to an inappropriate information asymmetry between committee members and the other members of the supervisory board.

In the past, several legislative attempts<sup>170</sup> and reform proposals<sup>171</sup> to limit the board size failed, because employees' interest groups, such as workers unions, fought successfully for maintaining the status quo of German codetermination.<sup>172</sup> Nevertheless, a recently conducted opinion survey shows that 72.1% of the interrogated supervisory board members advocate to limit the size of the supervisory board to only 12 seats.<sup>173</sup> Therefore, the board size should be limited by the law, so that it does not consist of more than twelve members, regardless of the fact, whether the supervisory board is codetermined or not.

#### IV. Reform Proposals

These disadvantages of German codetermination can be avoided or at least mitigated by using an alternative approach that at the same time shares the above-mentioned benefits of the current codetermination regime. In recent literature, there are two major alternative approaches to German codetermination that are worth mentioning, in particular, the model of a consultation board (*Konsultationsrat*) and codetermination by consensus (*Konsensmodell*). Besides these proposals, there are other suggestions, such as the recommendation to limit codetermination in the way that employee representatives in

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<sup>169</sup> David Yermak, *Higher Market Valuation of Companies with a Smaller Board of Directors*, 40 JOURNAL OF FINANCIAL ECONOMICS (J. FIN. ECON.) 185-212 (1996); Theodore Eisenberg et al., *Larger Board Size and Decreasing Firm Value in Small Firms*, 48 J. FIN. ECON. 35-54 (1998).

<sup>170</sup> See, e.g., referent bill of the Law on Control and Transparency of Enterprises as of 1996, 17 ZIP 2193, 2196 (1996).

<sup>171</sup> See, e.g., Berrar (note 164), 1114; Marcus Lutter, *Vergleichende Corporate Governance – Die deutsche Sicht*, 30 ZGR 224, 236 (2001); Möllers (note 157), 701; v. Werder (note 142), 170; Henssler (note 147), 157; LIEDER (note 2), 674-679; Peltzer (note 106), 1047; see also Berlin Network of Corporate Governance, *12 Thesen zur Modernisierung der Mitbestimmung*, 49 AG 200, 201 (2004); *Arbeitskreis Externe und Interne Überwachung der Unternehmen der Schmalenbach-Gesellschaft für Betriebswirtschaft e.V. (AKEIÜ)*, *Best Practice der Mitbestimmung im Aufsichtsrat der Aktiengesellschaft*, 60 DB 177, 178 (2007); *Arbeitskreis "Unternehmerische Mitbestimmung"*, *Entwurf einer Regelung zur Mitbestimmungsvereinbarung sowie zur Größe des mitbestimmten Aufsichtsrats*, 30 ZIP 885, 886-887, 891 (2009).

<sup>172</sup> Dieter Schulte, *Reform des Aufsichtsrats aus Arbeitnehmersicht*, 48 BFUP 292, 304 (1996); see further, MARCO ALBERS, *CORPORATE GOVERNANCE IN AKTIENGESELLSCHAFTEN* 191 (2002); Hopt (note 163), 29; Hopt (note 142), 785.

<sup>173</sup> Arno Probst & Manuel René Theisen, *Businessverständnis der AR sowie erste Befragung zum BilMoG*, 6 AR 66, 68 (2009).

all codetermined companies fill only one-third of the supervisory board seats.<sup>174</sup> Others call for a ban of union members in supervisory boards<sup>175</sup> or for giving the voting right as to labor representatives not only to domestic employees, but also to the employees of foreign factories of the given enterprise<sup>176</sup>.

### 1. Consultation Board

The Berlin Network of Corporate Governance proposed in December 2003 the concept of a consultation board or *Konsultationsrat*.<sup>177</sup> That model, which could also be referred to as labor board or *Arbeitnehmerrat*, may prevent most of the discussed disadvantages of German codetermination and may still ensure that firm-specific information flow either way, *i.e.*, from the workforce to the supervisory board and from the supervisory board to the employees. The consultation board is not designed to replace the supervisory board or to be a committee of the supervisory board filled with labor representatives. It is rather to be seen as an independent third board besides the management board and the supervisory board. The main task of the consultation board would be to inform the executives and the supervisory board in the forefront of any important decision, especially if employees' interests are at stake. However, in order to avoid the above-mentioned negative effects of the current codetermination regime, the consultation board would not actively participate in the actual decision-making process of the company. The power to decide on major corporate issues on a day-to-day basis would vest solely in the executive board, monitored and supported by the supervisory board not consisting of any employee representatives.

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<sup>174</sup> AKEIÜ (note 171), 178; Michael Adams, *Das Ende der Mitbestimmung*, 27 ZIP 1561, 1567 (2006); Christoph H. Seibt, *Drittelbeteiligungsgesetz und Fortsetzung der Reform des Unternehmensmitbestimmungsrechts*, 21 NEUE ZEITSCHRIFT FÜR ARBEITSRECHT (NZA) 767, 775 (2004); Hermann Reichold, *Unternehmensmitbestimmung vor dem Hintergrund europäischer Entwicklungen*, 61 JURISTEN-ZEITUNG (JZ) 812, 818, 820 (2006); Holger Fleischer, *Der Einfluß der Societas Europaea auf die Dogmatik des deutschen Gesellschaftsrechts*, 204 ACP 502, 541-542 (2004); Henssler (note 147), 157; Peltzer (note 106), 1047.

<sup>175</sup> See, *e.g.*, AKEIÜ (note 171), 178-179; Reichold (note 174), 819; see further, Thomas Raiser, *Unternehmensmitbestimmung vor dem Hintergrund europarechtlicher Entwicklungen*, in VERHANDLUNGEN DES 66. DEUTSCHEN JURISTENTAGES, Vol. 1, B95-B101 (Ständige Deputation des Deutschen Juristentages ed., 2006).

<sup>176</sup> AKEIÜ (note 171), 179; Fleischer (note 174), 542-543; Peter Ulmer, *Paritätische Arbeitnehmermitbestimmung im Aufsichtsrat von Großunternehmen – noch zeitgemäß?*, 166 ZHR 271, 274 (2002); see also, *Arbeitskreis "Unternehmerische Mitbestimmung"* (note 171), 887, 894-895; Hans-Jürgen Hellwig & Casper Behme, *Zur Einbeziehung ausländischer Belegschaften in die deutsche Unternehmensmitbestimmung*, 30 ZIP 1791-1794 (2009).

<sup>177</sup> Berlin Network of Corporate Governance (note 171), 200-201; see also, Christian Kirchner, *Grundstrukturen eines neuen institutionellen Designs für die Arbeitnehmermitbestimmung auf der Unternehmensebene*, 49 AG 197, 198-200 (2004); v. Werder (note 142), 172; Franz Jürgen Säcker, *Rechtliche Anforderungen an die Qualifikation und Unabhängigkeit von Aufsichtsratsmitgliedern*, 49 AG 180, 185-186 (2004).

## 2. Codetermination by Consensus

Nowadays, the concept of codetermination by consensus or *Konsensmodell* has become particularly popular, as it is already in use on the European level to determine the codetermination standard of the board of a European Company (SE) and a European Cooperative Society (SCE) as well as with regard to border-crossing mergers within the European Union.<sup>178</sup> The main advantage of this concept is that the interest groups within a corporation, *i.e.*, shareholders, employees and the management can bargain for a codetermination model that fits best with regard to size, structure, industry and any other particularities of the given company. In this regard, the consensus model is particularly flexible and can provide solutions for any type of corporation. From a political point of view, another advantage of that concept is that the current codetermination regime could basically remain in place. Changing the current standards of codetermination would just be an option. True, this is the most crucial point of this very concept, because companies are not required to change their codetermination regime. In this regard, establishing a consultation board is more persuasive, as it changes the system fundamentally and, thereby, may prevent most of the weaknesses of the current regime and still ensure firm-specific information flow inside the company.

However, due to the current political environment and the remaining strength of German workers unions, it is unlikely that major changes, such as the establishment of a consultation board, will occur in the next few years. Nevertheless, the picture might change, as the existence of the SE and the forthcoming European Private Company (EPC) as well as the competition of legal forms in Europe will put more and more pressure on the current codetermination regime. In particular, UK-based private companies limited by shares—that are nowadays very popular in Germany<sup>179</sup>—are not subject to the German

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<sup>178</sup> See, in particular, *Arbeitskreis "Unternehmerische Mitbestimmung"* (note 171), 885-899; see further, Peter Hommelhoff, *Mitbestimmungsvereinbarungen im deutschen Recht – de lege ferenda*, 30 ZIP 1785-1787 (2009); Christoph Teichmann, *Verhandelte Mitbestimmung für Auslandsgesellschaften*, 30 ZIP 1787-1788 (2009); Martin Kraushaar, *Vom Anfang und dem Ende einer Verhandlung über die Unternehmensmitbestimmung aus Sicht der leitenden Angestellten*, 30 ZIP 1789-1791 (2009); Hellwig & Behme (note 176), 1791-1794; see also *AKEIÜ* (note 171), 177, 178; Raiser (note 175), B67-B68; Reichold (note 174), 816-818, 820; Windbichler (note 140), 195-196; Fleischer (note 174), 540-541; Christoph H. Seibt, *Privatrechtliche Mitbestimmungsvereinbarungen: Rechtliche Grundlagen und Praxishinweise*, 50 AG 413, 428-429 (2005); Henssler (note 147), 157; for a different view see, Roland Köstler, *Das trojanische Pferd der verhandelten Mitbestimmung*, 6 AR 137 (2009); against him see, Theodor Baums & Marcus Lutter, *Verhandlungen sind kein trojanisches Pferd*, 6 AR 153 (2009).

<sup>179</sup> Udo Kornblum, *Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrecht, Stand 1.1.2009*, 100 GMBHR 1056, 1063 (2009); Jan Lieder, *Die Haftung der Geschäftsführer und Gesellschafter von EU-Auslandsgesellschaften mit tatsächlichem Verwaltungssitz in Deutschland*, 15 DEUTSCHE ZEITSCHRIFT FÜR WIRTSCHAFTS- UND INSOLVENZRECHT (DZWIR) 399 (2005); André O. Westhoff, *Die Verbreitung der englischen Limited mit Verwaltungssitz in Deutschland*, 98 GMBHR 474-480 (2007).



laws of codetermination at all<sup>180</sup>. If there will be a change in the future, the model of codetermination by consensus will have the best chances to become the prospective German codetermination standard. In any event, that would be an important step in the right direction. With regard to safeguarding of labor interests, workers councils at the place of the production site are the most appropriate tool.<sup>181</sup> By the same token, the disadvantages connected with the current regime of codetermination would be prevented. The interest groups inside the corporation, however, are free to establish further instruments of codetermination as they see fit.

#### H. Choosing Between One-Tier and Two-Tier Board System

Until now, German codetermination hampers the further development of the current corporate governance system towards an opportunity of enterprises to choose between a one-tier and a two-tier board system. Modern research shows that both systems may function well under certain circumstances, but also that both models have strengths and weaknesses, which are inherent to each system.<sup>182</sup> Besides that, there is on the one hand no doubt about the fact that both systems converge, on the other hand the tendency to converge is influenced by the historical, societal and cultural environment of each system (path dependence). In order to make use of one board system due to its particular advantages, enterprises should have the option between those systems.

The corporate laws of France<sup>183</sup> and Italy<sup>184</sup> already enable enterprises to choose between a one-tier and a two-tier system. Evidence regarding the French option model shows that most corporations have implemented a one-tier board system. In particular, small and

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<sup>180</sup> Jan Lieder & René Kliebisch, *Nichts Neues im Internationalen Gesellschaftsrecht: Anwendbarkeit der Sitztheorie auf Gesellschaften aus Drittstaaten?*, 64 BB 338, 342-343 (2009); Cornelius Götze, Thomas Winzer & Christian Arnold, *Unternehmerische Mitbestimmung – Gestaltungsoptionen und Vermeidungsstrategien*, 30 ZIP 245, 248 (2009); Peter Mankowski, *Entwicklungen im Internationalen Privat- und Prozessrecht 2003/2004 (Teil 1)*, 50 RECHT DER INTERNATIONALEN WIRTSCHAFT (RIW) 481, 483 (2004); Daniel Zimmer, *Nach "Inspire Art": Grenzenlose Gestaltungsfreiheit für deutsche Unternehmen?*, 56 NJW 3585, 3589-3590 (2003); Eberhard Schwark, *Globalisierung, Europarecht und Unternehmensmitbestimmung im Konflikt*, 49 AG 173, 178 (2004).

<sup>181</sup> Patrick C. Leyens, *German Company Law: Recent Developments and Future Challenges*, 6 GLJ 1407, 1413 (2005).

<sup>182</sup> See already, Vagts (note 2), 165-171; see furthermore Hopt & Leyens (note 1), 139-156; Brändle & Noll (note 1), 1352-1360; Carsten Jungmann, *The Effectiveness of Corporate Governance in One-Tier and Two-Tier Board Systems*, 3 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW (ECFR) 426, 448-462 (2006); LIEDER (note 2), 636-640.

<sup>183</sup> Christoph Teichmann, *Corporate Governance in Europa*, 30 ZGR 645, 663-664 (2001); Hopt & Leyens (note 1), 156-158.

<sup>184</sup> Federico Ghezzi & Corrado Malberti, *The Two-Tier Model and the One-Tier Model of Corporate Governance in the Italian Reform of Corporate Law*, 5 ECFR 1 (2008); Hopt & Leyens (note 1), 158-160.

medium-sized companies strongly prefer this system. On the other hand, about 20% of the publicly held corporations listed on the stock exchange chose the dual board structure, in particular banks, insurance companies and corporations with an international focusing.<sup>185</sup> Similar tendencies can be discovered in Belgium.<sup>186</sup> Evidence from Italy shows that especially start-up firms are looking for a flexible and low-cost model that they may find by adopting the one-tier board system.<sup>187</sup> On the other hand, the dual board system has been adopted by corporations with shares widely distributed among the public, and by state-owned firms.<sup>188</sup>

To provide an option between the two systems was advocated by the High Level Group<sup>189</sup> and the Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union as of 2003<sup>190</sup> as well as by legal scholars<sup>191</sup> and practitioners<sup>192</sup>. In Addition, Art. 38 of the Statute for a European Company allows the SE to be structured comprising either both a management board and a supervisory board (two-tier model) or an integrated administrative board (one-tier model). Empirical research shows that a majority of SE incorporated in Germany<sup>193</sup> as well as incorporated throughout Europe<sup>194</sup>

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<sup>185</sup> Fleischer (note 174), 529; Teichmann (note 178), 664; Hopt (note 157), 1051.

<sup>186</sup> Teichmann (note 178), 664-665.

<sup>187</sup> Ghezzi & Malberti (note 184), 44.

<sup>188</sup> Ghezzi & Malberti (note 184), 45.

<sup>189</sup> High Level Group (note 85), 59.

<sup>190</sup> Communication of the Commission to the Council and the European Parliament "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" – COM (2003) 284 final, 21 May 2003, 15-16.

<sup>191</sup> *Arbeitsgruppe Europäisches Gesellschaftsrecht*, 24 ZIP 863, 869 (2003); Fleischer (note 174), 528; Jan von Hein, *Vom Vorstandsvorsitzenden zum CEO?*, 166 ZHR 464, 500-501 (2002); Hopt (note 142), 815; Hopt (note 157), 1051; Hopt & Leyens (note 1), 163-164; LIEDER (note 2), 643-645; Walter Bayer, *Empfehlen sich besondere Regelungen für börsennotierte und für geschlossene Gesellschaften?*, in VERHANDLUNGEN DES 67. DEUTSCHEN JURISTENTAGES, Vol. 1, E112-E113 (Ständige Deputation des Deutschen Juristentages ed., 2008); Theodor Baums, *Zur monistischen Verfassung der deutschen Aktiengesellschaft*, in GEDÄCHTNISSCHRIFT FÜR MICHAEL GRUSON, 1, 4-7, 32-33 (Stephan Hutter & Theodor Baums eds., 2009).

<sup>192</sup> DAV (German Lawyers' Association), *Stellungnahme zum Aktionsplan der EU-Kommission*, 6 NZG 1008, 1011 (2003); Karel van Hulle & Silja Maul, *Aktionsplan zur Modernisierung des Gesellschaftsrechts und Stärkung der Corporate Governance*, 33 ZGR 484, 493-494 (2004); Maximilian Schiessl, *Leistungs- und Kontrollstrukturen im internationalen Wettbewerb*, 167 ZHR 235, 250 (2003); Christoph H. Seibt, *Privatautonomie Mitbestimmungsvereinbarungen*, 50 AG 413, 429 (2005).

<sup>193</sup> Walter Bayer & Jessica Schmidt, *"Going European" continues*, 53 AG R31, R32 (2008); Eidenmüller, Engert & Hornuf (note 165), 728.

<sup>194</sup> Eidenmüller, Engert & Hornuf (note 165), 728.

opted for the one-tier system. It is not clear how this data has to be interpreted with regard to the purpose of using the SE in order to avoid employee codetermination as well as the particular flexibility and other advantages of the SE compared to the German stock corporation.<sup>195</sup> Nevertheless, all aspects considered together increase the pressure on the German dual board system to open up towards an option between those two models, although the 67<sup>th</sup> German Legal Association's Biannual Meeting in 2008 opposed this proposal<sup>196</sup>.

Overall, there is a tendency towards a one-tier board system with regard to small and medium-sized companies, whereas publicly held corporations listed on the stock exchange frequently implement a dual board system including a management board and a supervisory board. From an economic point of view, the option to choose between both models would help to structure corporate governance systems more efficiently, because enterprises could choose one of those board systems in accordance with their size, ownership structure, industry and other particularities. That would decrease transaction costs, and it may lead to a more efficient management and supervision.<sup>197</sup> At the same time, companies could make use of the particular strengths and avoid specific weaknesses of each system by choosing the model that fits best with their economic needs.

## I. Conclusions

This paper has shown how the efficiency of the German supervisory board has been significantly improved in the last decade. These legal changes made the supervisory board climb to a higher position of power. In particular, the supervisory board is now significantly involved in the decision-making process on a company's overall strategic concept and on management decisions of fundamental importance. This emphasizes the future-oriented monitoring obligation of the supervisory board, which gained much more importance in the last decade. For the same reason, it strengthened the supervisory board's capability to monitor the management board more efficiently. Furthermore, the new provisions increased the flow of information from the management board to the supervisory board, and they facilitated the monitoring efficiency of every single supervisory board member. In addition, several important changes improved the cooperation of supervisory board and auditors. This increased the level of information of the supervisory board and its members, and it made them more sensitive and more conscious for issues of a company's accounting

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<sup>195</sup> See *e.g.*, Baums (note 191), 4-6.

<sup>196</sup> Business Law Resolution No. 19 has been rejected, see VERHANDLUNGEN DES 67. DEUTSCHEN JURISTENTAGES, Vol. 2/2, N242 (Ständige Deputation des Deutschen Juristentages ed., 2009)

<sup>197</sup> See, Hopt (note 157), 1051.

and auditing. The most recent changes strengthened the supervisory board's responsibility with regard to internal control and risk management.

The vast majority of those changes in the German supervisory board system are very welcome. However, the current regime of German codetermination as well as the excessive size of the supervisory board has to be changed. Under the important developments on the European level, the time has come to act now in this direction. The advocated concept of codetermination by consensus provides a solid basis for more flexibility in the rigid German corporate governance system. It is also desirable to further limit the size of the supervisory board to no more than twelve members. Finally, the efficiency of the corporate governance system would be improved by allowing enterprises to choose between a one-tier and a two-tier board system.