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### **The German Corporate Governance System and the German “Mitbestimmung” – An Overview**

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**Abstract:** Corporate governance is not universal. Due to external and internal factors, corporate governance can differ from country to country. In this paper the German corporate governance system, the typical example of a two-tier board system, is presented. The major institutions of the German system and their functioning are described and explained. Since Germany has a very sophisticated system of employee participation and co-determination, this paper outlines how “Mitbestimmung” affects the corporate governance of German firms. Finally, the German corporate governance system is critically evaluated. Current problems and recent reforms as well as future developments are briefly addressed.

**Key Words:** German Corporate Governance, Vorstand (Management Board), Aufsichtsrat (Supervisory Board), Hauptversammlung (Shareholders’ Meeting), Reforms of Corporate Governance, Employee Participation, Co-determination, Mitbestimmung, Works Councils

**Background:** To most non-Germans, the German corporate governance system seems to be very complicated. The objective of this paper is to provide a brief overview of the German corporate governance system, with a particular emphasis on German “Mitbestimmung”. The regulations and practices outlined in this contribution are not only relevant for German firms, but also for foreign firms investing in Germany or dealing with German firms. Thus, this paper is mainly targeted at readers who are interested in becoming familiar with the current corporate governance system in Germany. Readers interested in deeper insights find suggestions for further reading at the end of the contribution (pp. 19-22).

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# **The German Corporate Governance System and the German “Mitbestimmung” – An Overview**

## **1 The German Corporate Governance System**

### **1.1 Introduction**

Firms are embedded in their environments – whether historically, culturally, socially, institutionally, demographically, technologically, economically, politically or legally. Despite this apparent embeddedness, there has been a long debate in the (international) management literature on how far management should be considered as being universal or country-specific. Furthermore, in the academic literature as well as in popular writings, there has been a long debate on whether management practices and systems are converging or diverging.

In management areas that are influenced by legal factors, such as corporate governance, it is particularly evident that management differs from one legal system to another. While there have been numerous attempts to further harmonize legislation in zones of high economic integration like the European Union, we are (still?) far away from having common legislation. Several systems of corporate governance (still?) exist in the world of management.

Depending on its legal form, a firm has to comply with specific regulations. When putting emphasis on the public company (for instance the “public limited company” – plc – in the UK, the “société anonyme” – S.A. – in France, the “Aktiengesellschaft” – AG – in Germany), one can differentiate so-called “one-tier board models” and so-called “two-tier board models”. The German corporate governance system is the typical example of a “two-tier board system”. The functioning of the German corporate governance system shall be explained in this section of the paper. First, a general overview of the German system will be provided. This will be followed by chapters on the different institutions within the German corporate governance system.

## 1.2 General Overview of the German Corporate Governance System

The governance of the German “Aktiengesellschaft” is not in the hands of one board, but in the hands of two boards, one of them being the “Vorstand”, the other one being the “Aufsichtsrat”. The “Vorstand” is the board which represents the firm (outside perspective) and which manages the firm (inside perspective). It can best be translated as “management board”. The “Aufsichtsrat” is the board which supervises the “Vorstand” of the firm. In the English speaking literature the “Aufsichtsrat” is called “supervisory board”.

In Germany, we find a strict separation of the two boards. Within one firm, members of one board cannot be members of the other board at the same time. Members of the “Vorstand” are internal to the firm, whereas members of the “Aufsichtsrat” are external to the firm. Regardless of size and listing, the organizational and personal separation of management and control is mandatory for German stock corporations. In addition to the “Vorstand” and the “Aufsichtsrat”, there is the general assembly of the firm’s owners, the shareholders’ meeting. This institution is labelled “Hauptversammlung” in Germany.

Germany’s corporate governance system has traditionally relied upon statutory regulations, especially upon the German Stock Corporations Act (“Aktiengesetz”). The “Aktiengesetz” is relevant for about 15,000 firms in Germany. Out of these 15,000 firms, about 1,000 are listed on the German stock exchange. Only recently, non-statutory rules, such as the German Corporate Governance Code, became essential as a supplementing regime. Equally important are traditions and practices existing in Germany. The most noteworthy feature is that Germany’s system is traditionally stakeholder-oriented. Various stakeholders play an important role in German corporate governance. Networking with them and balancing their interests is therefore characteristic for German management.

After this general overview, the elements of the German system shall be explored in more detail.

### 1.3 The Three Bodies of the German “Aktiengesellschaft” (Stock Corporation)

#### 1.3.1 “Hauptversammlung” (Shareholders’ Meeting)

The general meeting of the firm’s shareholders is governed by articles 118-147 of the German “Aktiengesetz” and usually takes place once a year. Extraordinary shareholders’ meetings must be convened if required by 5% of the capital. Shareholders have several rights: they have the right to attend shareholders’ meetings where they have information rights and voting rights. They decide on profit distribution, on changes of the corporation’s charter, on the issuing of new shares and reductions of corporate capital. The shareholders’ approval is also necessary for affiliation and inter-company agreements as well as for mergers. Furthermore, the shareholders elect their representatives in the supervisory board and discharge members of the supervisory board as well as members of the management board for activities during the preceding year. Electing the auditor upon proposal of the supervisory board is another important right of the shareholders’ meeting.

Who are typical shareholders of a German “Aktiengesellschaft”? To answer this question three major features of the German system will be outlined. A first characteristic consists in cross-shareholdings. It frequently happens that firm A owns shares of firm B, while firm B owns shares of firm A. For instance, the reinsurance company Münchener Rück (Munich Re Group) holds a 12% stake in the financial group Allianz, while Allianz has 12% of the voting rights at Münchener Rück. Münchener Rück also directly and indirectly holds an 18% stake in HypoVereinsbank that vice versa owns a stake of 13%. A second characteristic of the German system is the importance of banks as investors. Banks, in particular universal banks, not only provide loans and investment banking services, they also own shares in companies from other industries. For instance, Deutsche Bank has stakes in DaimlerChrysler (10%), Linde (10%) and Philipp Holzmann (20%). This leads to a third characteristic of the German corporate governance system: German firms often have concentrated shareholder structures. In other words, many firms have (some) shareholders who own a considerably high proportion of their shares and who have a decisive influence on the firm. While these features are still typical for the German corporate governance system, they are becoming less extensive. During the last years for instance, many German companies reduced their cross-shareholdings caving in to the raising pressure of (international) investors.

### 1.3.2 “Vorstand” (Management Board)

As already stated above, the management board represents and manages the firm. Articles 76-94 of the German Stock Corporations Act provide regulations concerning the “Vorstand”. The members of the management board are appointed by the supervisory board. Firms whose share capital is below 3 million Euro can have one individual at the top. From a share capital of 3 million Euro onwards, the management board is composed of at least two individuals. However, most German firms which are listed on the stock exchange have larger boards. Usually, the “Vorstand” of a German stock corporation comprises between three and eight top-managers. The members of the management board can be designated for a period of up to five years, but the German Corporate Governance Code suggests granting shorter periods of appointment. The members of the management board can serve for more than one period which is common in Germany. The salary of top-managers within the management board is defined by the supervisory board; the salary shall correspond to the performance of the top-manager as well as to the situation and performance of the firm.

In most German firms, the members of the “Vorstand” have fields of specialization - either a functional specialization, a business area/product line specialization, a regional specialization or a combination of these specializations. However, despite such specializations, decisions have to be taken by the board and cannot be taken by single board members. Thus, the final responsibilities are at board level, not at the level of individuals. This is the consequence of the so-called “Kollegialprinzip”, which means that the members of the management board are collectively accountable for their actions. Some decisions and transactions of the management board are subject to approval by the supervisory board. The management board also has to regularly inform the supervisory board about the situation and performance of the firm as well as about transactions of major scope. The “Kollegialprinzip” should, however, not be misunderstood as a centralization of all decisions at the level of the management board. It is evident that the management board can transfer some decisions to managers at lower ranks. Individuals holding a general commercial power of procuration can act in the firm’s name vis-à-vis outsiders.

Although the “Vorstand” is conceived as a collective board, most German firms either have a chairman of the board (“Vorstandsvorsitzender”) elected by the supervisory board or have a spokesman of the board (“Vorstandssprecher”) designated by the management board members themselves. The role of a chairman or the position of a spokesman of the board does not provide the top-manager in question with a

hierarchically higher position. For instance, a member of the “Vorstand” is by no means entitled to appoint or to dismiss fellow members or give orders to them. However, the chairman or the spokesman of the board can have additional functions and competencies, such as preparing and directing board meetings, acting as a bridge between the management board and the supervisory board or representing the firm in the public.

Despite the possibilities to install a chairman or a spokesman of the board, German law conceives the management board as a collective board. Empirical studies on current management practice, however, found that many firms have one dominant person within the management board. For instance, Jürgen Schrempp of DaimlerChrysler and Josef Ackermann of Deutsche Bank seem to shape their companies’ strategies, structure and systems (slightly or considerably) more than their colleagues in the management board. This is why some authors, like Michael Oesterle, argue that German management practice apparently favours an Anglo-Saxon CEO-model instead of the “Kollegialprinzip” which is required by law.

### 1.3.3 “Aufsichtsrat” (Supervisory Board)

The third body of the German “Aktiengesellschaft” is the supervisory board which is governed by articles 95-116 of the German Stock Corporations Act. The members of the “Aufsichtsrat” are elected by the shareholders for a period of up to four years. However, according to German law not all members of the “Aufsichtsrat” are delegates of the owners. Depending on various factors, such as the size and the activity of the firm, up to 50% of the members of the “Aufsichtsrat” can be delegates from the staff. In this way, employees have formalized participation rights which result from a complex system of employee participation and co-determination (“Mitbestimmung”). This is typical of the German corporate governance system and will be explained in the section 2 of this paper. Due to co-determination the influence of the shareholders within the supervisory board is restricted.

Taken together, the shareholders’ representatives and the employees’ representatives form the supervisory board. The supervisory board of a German stock corporation can have up to 21 members. The members of the supervisory board elect a chairman who is usually a representative of the shareholders. The chairman of the supervisory board has a double vote in case of deadlocks. Unless stated otherwise in specific charters, decisions of the supervisory board are taken by simple majority. The supervisory board of a German stock corporation meets at least

four times a year. It can create committees for covering specific topics, like compensation or audit committees. Specific tasks and decisions can be transferred to these committees.

Which groups of individuals are members of the German “Aufsichtsrat”? There are several categories frequently represented in German supervisory boards. First, in many firms, former members of the management board, especially former chairmen of the management board, are elected to the “Aufsichtsrat”. For instance, Gerhard Cromme, the former chairman, is now heading ThyssenKrupp’s supervisory board. The same is true for Bayer where Manfred Schneider switched from the management board to the supervisory board. A second category are (ex-)managers from other firms, not only in the case of cross-shareholdings. The example of Bayer illustrates this very well: within Bayer’s supervisory board we find, for instance, Heinrich von Pierer from Siemens or Jürgen Weber, chairman of the supervisory board of Lufthansa. A third category of members of the supervisory board are representatives of financial institutions. Sticking to the example of Bayer, Paul Achleitner, member of the Allianz management board, and Josef Ackermann, spokesman of the Deutsche Bank management board, are among the members of the supervisory board. Fourth, academics, experts and politicians serve on some German supervisory boards. In Bayer’s supervisory board Ernst-Ludwig Winnacker, professor in bio-chemistry, has a vote. Fifth, given the rules and practices of co-determination, labour representatives and union representatives are members of supervisory boards in Germany. As far as unions are concerned, in Bayer’s board, Hubertus Schmoldt from IG Bergbau, Chemie, Energie (union of the mining, chemical and energy industries) is one of the representatives. In Germany, no individual can be a member of more than ten supervisory boards.

The members of the “Aufsichtsrat” appoint the members of the “Vorstand” and, as stated above, they also have the right to elect the chairman of the management board, the so-called “Vorstandsvorsitzenden”. Furthermore, the members of the “Aufsichtsrat” supervise the decisions of the management board, their activities and their strategies. The members of the “Aufsichtsrat” decide upon removal of members of the management board and they are responsible for taking legal action on behalf of the firm against the members of the management board in case of misconduct. While the “Aufsichtsrat” is not involved in management, it nevertheless has a considerable indirect influence on management, since specific types of decisions, activities and transactions are subject to its approval. Finally, the members of the supervisory board are consulting the management board in identifying opportunities and avoiding threats and risks.

It is self-evident that the “Aufsichtsrat” cannot control all activities of the firm. Whereas its duty is to control the management board, the management board has to supervise all activities at lower ranks within the firm, for instance by establishing management accounting and auditing systems. Strictly speaking, the “Aufsichtsrat” does not control the firm, but it does control the top-managers who are running the firm.

Empirical studies show that the role of the “Aufsichtsrat” varies from one firm to another. In some firms, the “Aufsichtsrat” is active, in other firms rather passive. In some firms, the “Aufsichtsrat” tries to intervene in strategic decisions, while in other firms it tends to get involved in day-to-day operations. In some firms, relationships between the members of the “Aufsichtsrat” and the “Vorstand” are rather task-oriented, whereas in other cases personal relationships prevail.

German “Mitbestimmung” as one central pillar of corporate governance will be outlined in the next section of this paper.

## **2 “Mitbestimmung” in the German Corporate Governance System**

### **2.1 Introduction**

Participation and co-determination of employees have an influence on the decision-making power of management. The regulations and practices are not only relevant for German firms, but also for foreign firms investing in Germany. In addition, understanding the German “Mitbestimmung” helps to understand the strategies, structures and systems of German firms competing in the world markets.

The German system of employee participation and co-determination has a long tradition. Already in 1848, when the National Assembly met in Frankfurt’s Paulskirche, demands for participation rights were raised by German workers. But it was only in 1920 that participation rights were granted to workers by the Works Council Act. Two years later, in 1922, an act on the representation of works council members in the supervisory board was introduced. Trade unions, the Catholic Church and the Protestant Church played a considerable role in promoting workers’ rights.

## 2.2 General Overview of “Mitbestimmung” in Germany

The current system of participation and co-determination originated after World War II and was further developed in subsequent years, especially during the 1970's/80's and at the beginning of the new century. Within German firms, participation and co-determination can be found at two levels (see also figure 1):

- first, at site level where works councils (“Betriebsräte”) and executive committees (“Sprecherausschüsse”) are an integral part of the decision-making system,
- second, at firm level where labour representatives are members of the supervisory board and a labour director (“Arbeitsdirektor”) for the management board can be nominated by the employee side.

Thus, it becomes evident that employee participation and co-determination is a decisive element of the German corporate governance system, known for its immanent stakeholder-orientation. After this general overview, the functioning of participation and co-determination will be explained in more detail.

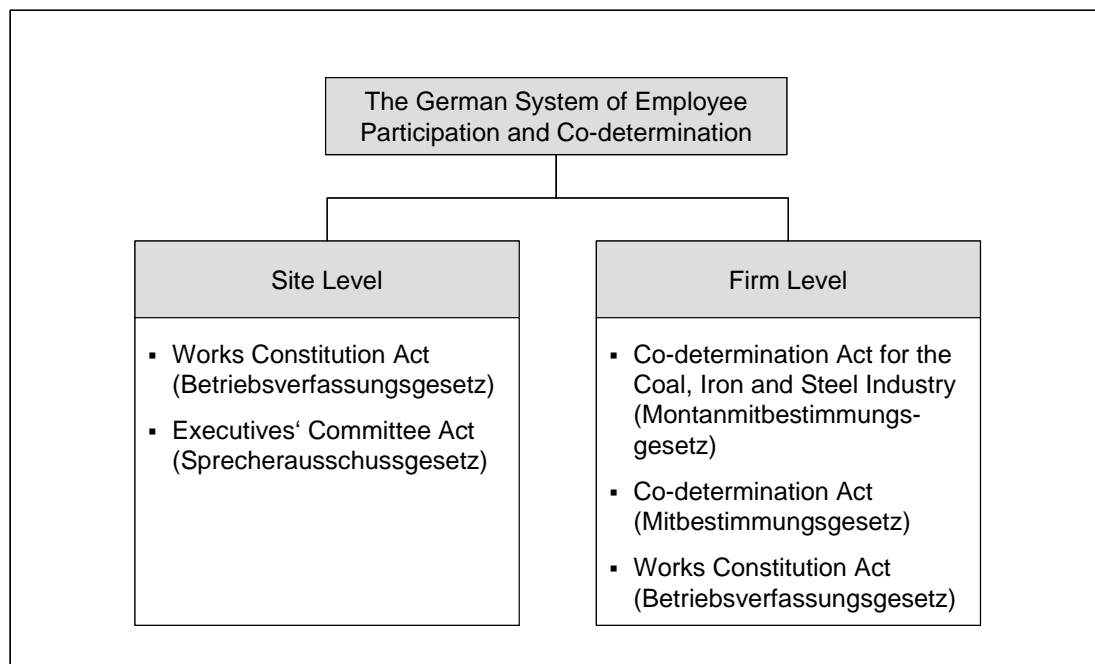


Figure 1: Employee Participation and Co-determination in Germany – An Overview

## 2.3 Participation and Co-determination at Site Level

Participation and co-determination at site level is governed by the Works Constitution Act (“Betriebsverfassungsgesetz”). It should be noted that “site” does not only refer to production sites but to all company locations. For instance, distribution centres, call centres and outlets are equally governed by the Works Constitution Act. The “Betriebsverfassungsgesetz” was passed in 1952 and considerably modified in 1972 and 2001. In addition, the Executives’ Committee Act (“Sprecherausschussgesetz”) was introduced in 1989.

### 2.3.1 Works Councils

As soon as a site operating in the private sector has at least five employees, works councils can be established on employees’ request. The members of the works councils are elected for a period of four years. They shall ensure that employees’ interests are adequately taken into account. Employers and executives are neither eligible for works councils nor are they represented by works councils.

The influence of works councils depends on the decisions in question, so that different participation rights can be distinguished: information, consulting and hearing rights ensure employees’ participation, while powers of veto, initiation and sanctioning rights as well as genuine co-determination rights increase the works councils’ possibilities of involvement. For instance, management has to inform the works council on the planning of human resource capacities for the future. In case of lay-offs the works council is granted consulting rights and the planning of new buildings is subject to discussions with management. Furthermore, works councils need to approve pay scale groupings and re-groupings. There are also some important fields of genuine co-determination: together with the employer and with executives, works councils are deciding on new working hours, on fixing performance-related remuneration, on the installation of devices monitoring the employees’ behaviour and performance or on the assignment of company-owned accommodation.

The size of the works council depends on the size of the site. In sites of up to 20 employees, there is one representative. From 21 employees onwards, works councils have 3 members. Sites with 51 employees and more can elect 5 representatives for their works council. If the number of employees surpasses 100 employees, works councils have 7 members. The number of members of the works council further

increases with the size of the site. For instance, sites with more than 7,000 employees have 35 representatives in the works council. Current practice shows that works councils in German firms are still dominated by individuals who are members of trade unions. This, in fact, enables unions to exert a considerable influence on site level.

The German Works Constitution Act ensures that participation and co-determination is facilitated and that those individuals engaging in works councils are protected. For instance, elections for the works council take place during working hours. The costs of elections are borne by the employer. It is nearly impossible for a firm to lay off members of the works council. In addition, members of the works council must be released from their regular work duties in order to be able to fulfil their function. The Works Constitution Act even provides that, in sites with more than 200 employees, a specific number of members devote all their time to issues of participation and co-determination. German law also grants members of the work council the right to attend training courses in order to obtain the knowledge required. Aiming at taking the interest of special groups of employees into account, the Works Constitution Act introduced youth delegations and representatives of disabled employees in the works council. To bridge the gap between the employees and the works council, works meetings (“Betriebsversammlungen”) are organized.

An additional institution concerned with business issues is formed in sites having at least 100 employees. It is called the “Wirtschaftsausschuss” (“economic/business committee”). This committee comprises between 3 and 7 members who have to be employees of the site and who are designated by the works council. The “Wirtschaftsausschuss” has no decision rights, but discusses business issues such as rationalisations of workflow, production plans or plant closings with the employer. Later on, the “Wirtschaftsausschuss” informs the works council.

### 2.3.2 Executives’ Committees

For a long time, executives in the sense of “Leitende Angestellte” have not been legally represented in the German system of participation and co-determination. However, in some industries, like for example the banking industry, the number of executives has risen considerably over the last decades. The Executives’ Committee Act (“Sprecherausschussgesetz”) was introduced in order to institutionally represent the executives’ interests as well. There is a complex definition of executives in the

German Works Constitution Act requiring rights of hiring and laying-off employees, holding powers of procuration or decision-making competencies with wider scope.

Executives' committees can be elected in all sites having at least 10 executives. Their elections take place at the same time as elections of works councils. Their members are assigned for four years. In sites of up to 20 executives, there is one representative. From 21 executives onwards, the executives' committees have 3 members, above 100 executives we find 5 members and above 300 executives 7 members can be elected. In contrast to works councils, executives' committees have no rights of genuine co-determination. Their role is restricted to participation rights, such as information and consulting rights in fields where executives' interests are concerned.

While works councils and executives' committees are organized at site level, i.e. the level of the single site (in the sense of a specific factory or a specific branch), the following forms of participation and co-determination refer to firm level.

#### **2.4 Participation and Co-determination at Firm Level**

Participation and co-determination at firm level is governed by several acts – the Co-determination Act for the Coal, Iron and Steel Industry (“Montanmitbestimmungsgesetz”) from 1951, the Co-determination Act from 1976 (“Mitbestimmungsgesetz”) and the Works Constitution Act (“Betriebsverfassungsgesetz”). These acts have been modified in subsequent years, but still hold the constituent elements which had been introduced decades ago. This part of German legislation grants the right to German employees to have their own representatives in supervisory boards and, in some cases, even in management boards. As stated above, supervisory boards have far-reaching influence in Germany. While they are not directly involved in management, they supervise management and have indirect power, for instance via their competence to approve or reject specific transactions. Figure 2 provides an overview of relevant legislation and their consequences for co-determination at firm level.

	<b>Co-determination Act for the Coal, Iron and Steel Industry</b>	<b>Co-determination Act</b>	<b>Works Constitution Act</b>
<b>Preconditions</b>	<ul style="list-style-type: none"> <li>Public companies</li> <li>Active in the coal, iron and steel industry</li> <li>More than 1,000 employees</li> </ul>	<ul style="list-style-type: none"> <li>Public limited companies, limited liabilities companies, co-operative companies</li> <li>Not active in the coal, iron and steel industry</li> <li>More than 2,000 employees</li> </ul>	<ul style="list-style-type: none"> <li>Public limited companies, limited companies, co-operative companies</li> <li>Between 500 and 2,000 employees</li> </ul>
<b>Affected Firms*</b>	<ul style="list-style-type: none"> <li>45 firms</li> <li>In total: 300,000 employees</li> </ul>	<ul style="list-style-type: none"> <li>700 firms</li> <li>In total: 5 million employees</li> </ul>	<ul style="list-style-type: none"> <li>3,500 firms</li> <li>In total: 1 million employees</li> </ul>
<b>Scope of Co-determination</b>	<ul style="list-style-type: none"> <li>Supervisory board: equal representation of employees and shareholders as well as one neutral member</li> <li>Management board: labour director for human resources</li> </ul>	<ul style="list-style-type: none"> <li>Supervisory board: equal representation of employees and shareholders</li> <li>Management board: labour director</li> </ul>	<ul style="list-style-type: none"> <li>Supervisory board: one third representation of employees</li> <li>Management board: no employees' representative</li> </ul>
<b>Decreasing scope of co-determination</b>		<b>Increasing number of affected firms</b>	

\* Approx. numbers (beginning of the 21st century).

Figure 2: German Co-determination at Firm Level

#### 2.4.1 Co-determination Act for the Coal, Iron and Steel Industry

The strongest form of co-determination at firm level is applicable in the coal, iron and steel industry. All public companies in these industries having more than 1,000 employees are governed by the Co-determination Act for the Coal, Iron and Steel Industry ("Montanmitbestimmungsgesetz"). In the supervisory board of these companies, shareholders and labour representatives have an equal number of seats. Additionally, there is a neutral member in the supervisory board who shall prevent votings from ending in a tie. Depending on the nominal capital of the firm, there are in total 11 (below 25 million Euros nominal capital), 15 (from 10 to 25 million Euros nominal capital) or 21 (above 25 million Euros nominal capital) members serving on the supervisory board.

While the shareholders' representatives are elected by the general meeting, employees' representatives are nominated by the works council after consultations with trade unions. The general meeting has to formally approve the decision of the works council.

The members of management boards of German firms are usually designated by the supervisory board. However, the Co-determination Act for the Coal, Iron and Steel

Industry provides for the appointment of a labour director (“Arbeitsdirektor”) as a full member of the management board. The labour director is responsible for issues of human resources, including organization of work, performance (evaluation), remuneration, training, labour and social law as well as safety. The shareholder side has to accept the nomination of the employee side.

#### 2.4.2 Co-determination Act

Whereas the Co-determination Act for the Coal, Iron and Steel Industry only applies to a relatively low number of about 45 firms employing altogether about 300,000 people, the Co-determination Act (“Mitbestimmungsgesetz”) has a broader scope. It is relevant for all companies with more than 2,000 employees which are not active in the coal, iron and steel industry and which have one of the following legal forms: “Aktiengesellschaften” (stock corporations), “Gesellschaften mit beschränkter Haftung” (limited liability companies) and “Genossenschaften” (co-operative companies). About 700 German firms with a total of more than 5 million employees are governed by the Co-determination Act.

The supervisory board of companies affected by the Co-determination Act consists of an equal number of representatives from the shareholder and employee side. In firms up to a size of 10,000 employees the supervisory board is composed of 12 members. For firms which have between 10,001 and 20,000 employees the supervisory board usually counts 16 members. Finally, firms whose number of employees surpasses 20,000, generally have 20 seats in their supervisory board. The seats of the labour side are partly reserved for the trade unions: boards with 12 or 16 members include two representatives from trade unions as labour representatives. If the board size reaches 20 members, unions can nominate three representatives.

As it is the case for companies ruled by the Co-determination Act for the Coal, Iron and Steel Industry, shareholders’ representatives for the supervisory board are elected during the general meeting. Employees’ representatives, however, are either directly elected by the staff (in firms up to 8,000 employees) or they are elected indirectly by delegates (in firms with more than 8,000 employees). German law requires that employees as well as executives are represented on the supervisory board. The chairman and the vice chairman of the supervisory board have to be elected by a two-third majority. If in the first ballot a two-third majority is not reached, the shareholders’ representatives can appoint the chairman and the employees’ representatives the vice chairman. This rule is crucial: if any vote in the supervisory

board results in a tie and makes a second round necessary, the chairman of the supervisory board has a casting vote and is thus able to determine the decision in favour of the shareholder side.

Similar to the Co-determination Act for the Coal, Iron and Steel Industry, the Co-determination Act grants the employee side the right to appoint a labour director as a full member of the management board. Legally, labour directors are not bound to issues concerning human resources, but in common practice they are in charge of this field.

### 2.4.3 Works Constitution Act

The weakest form of employee representation in the German system – but still a comparatively important co-determination in the international context – is regulated by the Works Constitution Act (“Betriebsverfassungsgesetz”). This act has to be applied by all limited companies (“Aktiengesellschaften”, “GmbHs”) and by some special legal forms such as co-operative companies (“Genossenschaften”), if they have less than 2,000, but more than 500 employees. The act is far-reaching since many firms in the German economy are mid-sized firms. According to estimates it governs about 3,500 firms with a total of about one million employees. The comparably low number of affected employees can be partly explained by the smaller size of the firms being subject to the Works Constitution Act. Furthermore, some medium-sized companies try to avoid co-determination at firm level by creating holding structures including small subsidiaries. This avoids surpassing the relevant threshold of 500 employees.

In firms governed by the Works Constitution Act two thirds of the seats in the supervisory board are reserved for shareholders’ representatives, while one third of the seats has to be granted to employees’ representatives. As usual, shareholders elect their representatives during the general meeting. Employees directly vote to determine their representatives. In most cases, works councils propose lists of candidates. Unlike the Co-determination Act, the Works Constitution Act does not require any union members on the supervisory board. It is up to the employees to decide whether one or several of the seats shall be granted to (a) union representative(s). The Works Constitution Act has no influence on the composition of the management board. All members are appointed by the supervisory board.

### **3 Evaluation and Reforms of the German Corporate Governance System**

In most Western countries corporate governance has been a heavily discussed topic during the last decade. This is partly due to severe crises or even bankruptcies of some stock corporations, like Enron or Worldcom in the U.S., Parmalat in Italy or Swissair in Switzerland. Germany has also seen some spectacular examples of companies which got into severe difficulties, such as the Kirch Group, Intershop or EM.TV. Other German companies were taken over under circumstances which have been subject to investigation by jurisdiction, like Mannesmann. Companies in difficulties always foster the question whether there are structural problems in the system of corporate governance. What are major problems of corporate governance in Germany?

The members of the management board are often accused of not acting on behalf and to the benefit of the shareholders. It is sometimes stated that executives rather maximize their own interests, like their salary, their career opportunities or their prestige. The typical agency problem – shareholders as principals and top-managers as agents – arises. While there is some criticism against management boards, the supervisory boards are even criticized more frequently. It is argued that the members of the supervisory board often fail to identify problems which already exist or which can be foreseen. Furthermore, some members of the supervisory board are said not to be competent or not to devote enough time to their activities. It is also criticized that some members of supervisory boards are not truly independent in making-up their decisions, for instance due to personal relationships with members of the management board.

Not only the German corporate governance system as such, but also the German “Mitbestimmung” is heavily discussed. Ideally, works councils and employee representatives in the supervisory board shall work together with employers and management in a spirit of mutual trust and co-operation. While having diverging sub-interests, they shall have a co-aligned overall objective – the future competitiveness of the firm. If firms succeed in translating a co-operative philosophy into management practice, they can make participation and co-determination a distinctive feature of their corporate culture – a corporate culture which can be a resource in the sense of the resource-based view of strategic management. Employee participation and co-determination in companies cannot only be interpreted as logic consequence of individuals’ participation rights in democratic societies; they can also be explained economically: participation and co-determination can foster employees’ motivation, enhance employees’ identification with their firm and lead towards long-term

relationships between both parties. While involving employees may slow down the decision-making process, it may facilitate implementation of decisions. Instead of having colliding views during periods of implementation, potential discrepancies between employees and employer may be identified and resolved at early stages.

Participation and co-determination are, however, a double-edged sword. One important criticism is that the German system is costly – at least at short sight. For instance, organizing elections for works councils, releasing members of the works council from normal duties, negotiating with works councils or organizing complex meetings of the supervisory board is not free of cost. In addition, decisions may be slowed down. Another criticism is that employees' representatives may not be competent in areas they are involved in. Representatives in the supervisory board have to evaluate strategies of top-management, identify risks in the environment and decide upon mergers and acquisitions. Thus, it can be questioned whether all representatives have the background and knowledge to fulfil these tasks. Furthermore, German management practice shows that unions still exert a decisive influence. It seems that, in some cases, unions rather try to reach their own goals and objectives instead of being true partners for the employees in a specific firm. The most important question for many experts is whether the extent of the German "Mitbestimmung" can be justified. While there is a consensus in German society that the partnership of employers and employees can be fruitful, there are doubts whether the scope of participation and co-determination which has been reached in Germany is reasonable. A final criticism which should be raised lies in the national orientation of participation and co-determination practice. Employees' representatives in German works councils and supervisory boards are often not considering the world-wide situation of the firm, but rather concentrating on local or national interests.

Over the past years, Germany has started to reform several elements of its corporate governance system. First, there is new legislation in Germany. The Stock Corporations Act has been modified, including norms on a more intense interplay between the management board and the supervisory board. In addition, a new act which shall improve supervision and transparency in corporations was enforced; it is called "Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)". For instance, according to this act the management board has the duty to inform the supervisory board regularly about short-term, medium-term and long-term planning. Another act, the "Transparenz- und Publizitätsgesetz (TransPuG)", aims at better disclosure of information. The German "Mitbestimmung" was subject to reforms in 2001, when the Works Constitution Act was amended. Thereby, participation and co-determination rights at site-level were adapted to structural changes and the

thresholds for the number of work council members per site were altered. Second, codes of conduct have been developed in Germany. The Frankfurt initiative around Theodor Baums and the Berlin initiative around Axel von Werder are typical examples. The basic reasoning behind these initiatives is to make sure (or to enhance the chances) that management boards and supervisory boards fulfil their responsibilities. Furthermore, the German minister of justice appointed a commission chaired by Gerhard Cromme to work out the so-called German Corporate Governance Code. Its purpose is to present the German corporate governance system to interested parties in a clear-cut and understandable way. The German Corporate Governance Code also includes concrete recommendations and suggestions which go beyond applicable law and thus contribute to the improvement of the German corporate governance system. Since 2002 publicly listed companies have to publish declarations of conformity (“Entsprechenserklärungen”) once a year conforming their compliance with the German Corporate Governance Code or expressing deviations.

The German Corporate Governance Code does not address the German “Mitbestimmung” and criticism on the German co-determination and participation rights is constantly restated. In an era of internationalization and (sometimes even globalization) the role of industrial relations is changing. For instance, the establishment of European works councils currently enforced by European Union legislation is a severe challenge for the German participation and co-determination system. Although European Union legislation only grants information and hearing rights (and no genuine co-determination rights) to European Works Councils, new institutional forms of co-operation across countries have to be developed by employees’ representatives. At the level of supervisory boards, changes in management practice should be implemented as well. Currently, employees’ representatives are, in most firms, only employees from the home country. In firms in which a considerable percentage of turnover and profit stems from abroad and which employ more than 50% of their staff in foreign markets, this may not be appropriate anymore. Thus, given the internationalization of firms, the employee side may also think about internationalizing the supervisory board.

It should be kept in mind that the stock corporation (“Aktiengesellschaft”) is not the prevailing legal form in Germany. While the emphasis in the academic literature as well as in popular writings is often on public companies, small- and mid-sized firms are essential for the German economy, for instance in terms of employment, innovation and tax contribution. In most cases, corporate governance of these small- and mid-sized firms is less restricted by law. Individual owners and managers, their

values, attitudes, decisions, behaviour and actions become even more crucial than in the case of stock corporations. Regardless of size and legal form, corporate governance is always a question of individual ethics.

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