INDEPENDENCE IN THE ERA OF SHAREHOLDER ACTIVISM

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Abstract: *In this Article, I analyze the requirement of directors' independence from controlling shareholders in German corporations. I, firstly, present the regulatory framework in the US and in Germany, with a special focus on the provisions of German Corporate Governance Code. Then, I provide an overview of shareholder activism in Germany the last two decades, in order to highlight the increasing influencing power of minority shareholders, such as hedge funds. Using empirical evidence from activist campaigns in the US, I show that ownership structure and directors' perception about the degree of collaboration between institutional investors and hedge fund activists create a dependence relationship between directors and shareholders with a minority equity stake. I conclude that the concept of independence from controlling shareholder should be revised from DCGK-Committee in order to capture control by minority shareholders.*

TABLE OF CONTENTS

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INTRODUCTION

The rise of institutional investors and the financial scandals of 1990s and 2008-2010 have stimulated a number of regulatory initiatives with the objective of enhancing monitoring of a corporation's management. Monitoring mechanisms mitigate agency costs arisen out of the separation of ownership and control in public companies. Agency theory and efficient capital markets theory have been the theoretical background for the introduction of independent directors in the board of directors of US corporations.

EU regulators, in their attempt to ameliorate corporate governance of EU corporations, and, thus, to enhance their competitiveness in an environment of international capital markets, have recommended the introduction of independent directors (EU Reccomendation 2005/162/EC). Since 2005, one of the most controversial debates among corporate governance scholars in Germany is the necessity and feasibility of requiring independent directors in German corporations. The main argument in favor of such a requirement is the attraction of international investors. The main counterargument is the dualistic nature of the board of directors in German corporations, where there is already a corporate body, the Aufsichtsrat, responsible for monitoring the management body, the Vorstand.

Since 2009 the independence requirement for supervisory board members has been introduced in the German legal regime through the German Corporate Governance Code. Initially, the independence concept was limited to the management. Since 2012 it has been extended to *anyone with a substantial influence on the management of corporate affairs.* The latter category refers traditionally to controlling shareholders.

Nowadays, the assumption of the classical Berle and Means model concerning shareholders' rational apathy has been contested. The reason is the rise of shareholder activism, meaning the active engagement of shareholders (hedge funds and/ or institutional investors) in corporate affairs. This new reality poses new challenges for corporate governance not only in US, but also in German corporations. Shareholder activists are minority shareholders who, through their collaboration with other shareholders, can monitor and affect the management of corporate affairs. In order to provoke operational and financial changes, they initiate corporate governance changes, especially with respect to the composition of the board of directors.

The last two decades a number of empirical studies focus on the means that shareholder activists employ in order to influence corporate affairs. They build equity stakes around 5%, they run campaigns in order to alert other shareholders about incidents of mismanagement and, thus, secure their support with respect to shareholder proposals they might make against current management. Lately, there is evidence that directors, being aware of this strategy, prefer to conclude settlement agreements with shareholder activists in order to avoid their removal and the consequential reputational costs.

Based on the empirical evidence about the degree of collaboration between shareholder activists and institutional investors and the effect of this collaboration on directors'

perception about activists' power to remove them, I propose a revision of the concept of controlling influence of a shareholder. Shareholders' influence on directors, or, in other words, directors' dependence on shareholders is not exclusively a matter of majority shareholding. More than ever, it is a matter of power dynamic between shareholders and directors. Therefore, regulators shall not attribute the status of independence to directors that are captured by agreements with shareholder activists.

The purpose of this Article is not to highlight independence as the ideal solution to corporate governance problems, but to demonstrate how "fluid" it is. The weaknesses of the concept of independent directors must be acknowledged, so that we can develop more efficient boards of directors.

The Article consists of two parts. Part I includes a presentation of the existing legal framework with regard to independent directors. Starting with the functions that boards of directors serve in general, I describe the economic factors that caused the introduction of the independence requirement for directors. Such a requirement was first introduced in the US and incorporated in US case law, in securities regulation and stock exchanges' listing requirements. The internationalization of capital markets led to the adoption of the independence requirement in European jurisdictions.

This Article focuses on the German jurisdiction due to material idiosyncratic differences of German and US corporations, especially relating to ownership structure and the dualistic form of the board of directors. I analyze the legal rules and the "soft law" sources that have introduced the independence requirement. Among them, German Corporate Governance Code contains the only explicit provision about the independence of supervisory board members. In this context, I make the distinction between lack of independence and conflicts of interests. Then, I present the relationships with corporate constituencies that might jeopardize the independence status of a supervisory board member. From this point, I look into the challenging points of independence from controlling shareholders that have not yet been explored by regulators and legal scholars.

Part II aims to present, firstly, empirical evidence on shareholder activism in Germany. For many years, shareholder activists were targeting mainly US firms, with the few activist incidents in Europe being concentrated in the UK. German corporations were perceived as immune to shareholder activists' attempts because of the peculiarities of their board structure. But this is not the reality anymore.

Most shareholder activists' objective in Germany is changes in the composition of supervisory boards. Using empirical evidence from activist campaigns in the US, I want to show how exposed supervisory board members in Germany are to shareholder activists' demands. An indicator of the controlling influence that activists have on directors is the conclusion of settlement agreements in order to terminate anti-management campaigns. Out of empirical studies on the terms of these agreements, I come to the conclusion that two factors are determinant for the existence of a

dependence relationship between shareholder activists and directors: ownership structure and the degree of collaboration between institutional investors and hedge fund activists.

Based on the aforementioned evidence, I make some regulatory proposals with respect to disclosure requirements imposed to minority shareholders and the concept of independence from shareholders with controlling influence in the context of the German Corporate Governance Code. In support of these proposals, I present a qualitative analysis of the responses of market participants to the public consultation for the revision of the Code in 2020.

I. LEGAL FRAMEWORK

Boards of directors constitute one of the main corporate constituencies. They undertake the management of corporate affairs as a central body consisting of a small number of members. This is a substantial characteristic of modern corporations with a broad shareholders' base. The separation of ownership and control has given rise to agency costs that corporate legal rules aim to minimize. Such a legal rule is the requirement for directors' independence. In this Part, I present the legal rules relating to directors' independence focusing on two jurisdictions, the US and the German one. The US is the jurisdiction where independence requirements were first introduced, while Germany's corporations are distinct for their board structure.

A. Independent Directors

Among the three functions that boards of directors undertake, monitoring has become the most important one. Monitoring function can be exercised efficiently only under the condition that the monitored cannot influence negatively the monitoring body's scrutiny. Such a negative influence can be exercised in case there are dependence relationship between directors and managers or shareholders who influence managers. Therefore, any independence requirement aims at detecting and excluding such dependence relationships.

1. The Role of Board of Directors

Each board of directors has a three-fold role: management, monitoring and advising[1]. Even though the balance among these roles deviates from time to time[2] and from jurisdiction to jurisdiction[3], the main role of the board of directors is monitoring the managers.

[1] Stephen M. Bainbridge & M. Todd Henderson, *Boards-R-Us: Reconceptualizing Corporate Boards*, 66 STANFORD LAW REVIEW, 1060-1062 (2014).
[2] STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS (Oxford University Press. 2016).
[3] See about the function of the dual board of directors in Germany and Japan: Lynne L Dallas, *Proposals for reform of corporate boards of directors: The dual board and board ombudsperson*, 54 WASHINGTON & LEE LAW REVIEW, 137-146 (1997).

The monitoring function is more profound in Germany than in the US because of the dualistic form of the board of directors[4]. More concretely, in Germany there are two separate corporate bodies with two distinct functions, the management board (MB) and the supervisory body (SB). The MB is responsible for developing the corporate strategy[5], running the everyday operations of the corporation[6] and representing it in its transactions with third parties[7]. The SB is mainly responsible for monitoring the MB[8].

Its monitoring function is two-folded: it involves supervision and consultancy towards the MB[9]. SB's suggestions to MB are not binding. Exceptionally, SB has binding decision-making power with regard to severe transactions that have a substantial impact in the form and the operations of the corporation[10]. Part of the SB's monitoring role is the power to appoint and remove members of the Vostand[11], as well as the prerogative to raise claims against the MB for mismanagement in the name of the corporation[12].

In the US, the DGCL and the Model Business Act provide that "the business and affairs of every corporation (…) shall be managed by or under the direction of a board of directors" (§141(a) DGCL, 8.01 Model Act). In praxis, because of the complexity of the modern corporations the everyday management of corporate affairs is conducted by managers based on the broad corporate policy set by the board of directors[13].

2. Rationale behind Independent Directors

Independent directors were firstly introduced in the US. During the 1950s, the board of directors' main role was advising rather than monitoring managers. The reason for the board's passivity towards management is two-folded: firstly, the composition of the board out of insiders and outsiders as representatives of stakeholders with different economic interests, and secondly, the role of the management as the central planner[14].

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[4] Markus S. Rieder & Daniel Holzmann, *Brennpunkte der Aufsichtsratsregulierung in Deutschland und den USA*, AG 570, 571 (2010).
[5] §76 (1) AktG. Hüffer/Koch/*Koch*, 13. Aufl. 2018, AktG § 76, Rn. 8-10, MüKoAktG/*Spindler*, 5. Aufl. 2019, AktG § 76 Rn. 14-20, Spindler/Stilz/*Fleischer*, 4. Aufl. 2019, AktG § 76 Rn. 4-20.
[6] §77 (1) AktG. Hüffer/Koch/*Koch*, ibid, § 77, Rn. 3-5, MüKoAktG/*Spindler*, ibid, § 77 Rn. 5-8, Spindler/Stilz/*Fleischer*, ibid, § 77 Rn. 3-7.
[7] §78 (1) AktG. Hüffer/Koch/*Koch*, ibid, § 78, Rn. 3, MüKoAktG/*Spindler*, ibid, § 78 Rn. 5-25, Spindler/Stilz/*Fleischer*, ibid, § 78 Rn. 4-8.
[8] §111 (1) AktG. Hüffer/Koch/*Koch*, ibid, § 111, Rn. 2-4, MüKoAktG/*Spindler*, ibid, § 111 Rn. 12, Spindler/Stilz/*Fleischer*, ibid, § 111 Rn. 6-33.
[9] Lutter/Krieger/Verse/*Lutter/Kriege/Verse*, Rechte und Pflichten des Aufsichtsrats, 6. Aufl. 2014, § 3 Die allgemeine Überwachung durch den Aufsichtsrat, Rn. 63-108, Spindler/Stilz/*Spindler*, ibid, § 111 Rn. 10-12.
[10] Lutter/Krieger/Verse, ibid, Rn. 112-136, Holger Fleischer, *Gestaltungsgrenzen für Zustimmungsvorbehalte des Aufsichtsrats nach § 111 Abs. 4 S. 2 AktG*, BB 835(2013);Franz Jürgen Säcker & Christian Rehm, *Grenzen der Mitwirkung des Aufsichtsrats an unternehmerischen Entscheidungen in der Aktiengesellschaft*, DB 2814, 2818 (2008).
[11] §84 AktG.
[12] §112 AktG.
[13] ANDREAS CAHN & DAVID C. DONALD, COMPARATIVE COMPANY LAW: TEXT AND CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 349-364 (Cambridge University Press 2 ed. 2018).
[14] Jeffrey N. Gordon, *The rise of independent directors in the United States, 1950-2005: Of shareholder value and stock market prices*, 59 STANFORD LAW REVIEW, 1511-1514 (2007).

That decade can be characterized as the decade when *managerial capitalism* was established[15].

During the 1970s, scandals, such as the Penn Central collapse and the Watergate, showed up the inefficiency of the existing monitoring mechanisms and they gave rise to concerns relating corporate social responsibility. These factors led to the reconceptualization of the board of directors as a monitoring rather than a passive advisory corporate body[16]. Management elites seemed to accept the enhancement of directors' monitoring role aiming to forestall more stringent measures against them[17].

The 1980s is characterized by the takeover movement that "gave emphasis on shareholder value as the ultimate corporate objective"[18]. Under the pressure of hostile takeovers, managers showed a preference towards a "board-centered" monitoring mechanism over the external monitoring power of the market for corporate control. The superiority of independent board of directors was established during the 1990s[19]. Market participants started perceiving hostile takeovers as too costly and with low probability of success due to judicial acceptance of anti-takeover defense measures taken by target firms' management. Independent directors were seen as responsible for aligning managerial performance with the ultimate corporate objective of maximizing shareholders' wealth[20].

3. Legal Provisions about Independent Directors

i. US regime

In the US, the legal regime regarding independent directors consists of provisions enfolded in state law[21], in federal securities law and in stock exchanges regulations.

Delaware law does not require companies to have independent boards of directors. Case law is responsible for the embeddedness of the concept of independence in the DGCL provisions about corporate transactions with "interested directors" (§144 DGCL). In that sense, Delaware courts seem to interpret independence as the lack of "beholdedness"[22]. Delaware courts have attempted to interpret independence prompted

[15] See Alfred D. Chandler, *The Emergence of Managerial Capitalism*, 58 BUSINESS HISTORY REVIEW (1984).
[16] See William O Douglas, *Directors who do not direct*, 47 HARVARD LAW REVIEW (1933);Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUMBIA LAW REVIEW (1989).
[17] Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 THE BUSINESS LAWYER (1978);Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA LAW REVIEW (2010);Urska Velikonja, *The political economy of board independence*, 92 NORTH CAROLINA LAW REVIEW (2013).
[18] Gordon, supra note 14, at 1520-1526.
[19] Gordon, supra note 14, at 1526-1535.
[20] See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, *in* CORPORATE ETHICS AND CORPORATE GOVERNANCE (Walther Ch Zimmerli, et al. eds., 2007).
[21] On the level of state law, I am going to focus on the DGCL provisions.
[22] See Aronson v. Lewis 473 A.2d 805 (1984): "*There must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person"* (emphasis added).

by three kinds of cases: self-dealing transactions, derivative suits and take-over offers[23]. Therefore, the judicial interpretation is more context-oriented. That means that the courts examine the conditions of each specific case and they affirm the independence of directors in cases where they conclude that directors' decisions are made on corporate merits rather than extraneous considerations or influences[24].

On federal level, two pieces of legislation require independence of the boards of directors. These are the Sarbanes-Oxley Act (SOX) of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Sarbanes-Oxley was introduced as a reaction to the audit scandals of Enron and Worldcom and set higher standards of independence for the audit committees[25]. More specifically, the audit committees must consist entirely of independent directors. Under Sarbanes-Oxley, directors are qualified as independent when they do not receive direct or indirect compensation from the corporations on whose board they sit or from affiliated persons of the corporation or its subsidiaries[26]. Sarbanes-Oxley offers the regulatory framework for the listing requirements that national securities exchanges and associations are obliged to set.

Dodd-Frank was introduced in the aftermath of the financial crisis. Because one of the main causes of the financial crisis was managerial excessive risk-taking[27], higher standards of independence for the compensation committees were introduced[28]. Moreover, Dodd-Frank provides for the creation of risk-management committees consisting of independent directors and at least one expert in risk-management[29].

Based on the aforementioned pieces of federal legislations, stock exchange listing requirements have demanded a majority of independent directors[30] and specified independence criteria that all listed corporations shall comply with in addition to the independence definition of SOX[31]. The criteria refer to financial or/ and familial relationship between directors and managers of the respective corporation. Therefore, independence according to federal securities and stock exchanges regulation is defined as having "outsider" status, as an absence of ties to those in control of the corporation[32].

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[23] Usha Rodrigues, *The Fetishization of Independence*, JOURNAL OF CORPORATION LAW, 465-484 (2007).
[24] See Aronson v. Lewis 473 A.2d 805 (1984): *"Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences".*
[25] See Eric M Fogel & Andrew M Geier, *Strangers in the house: Rethinking Sarbanes-Oxley and the independent board of directors*, 32 DEL. J. CORP. L. (2007).
[26] Sarbanes-Oxley Act, Public Law 107-204 (July 30, 2002), 116 Stat. 745, Sec 301 (3).
[27] John C. Coffee, *What Went Wrong? An Initial Inquiry Into the Causes of the 2008 Financial Crisis*, 9 JOURNAL OF CORPORATE LAW STUDIES, 16-18 (2009). See OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009),
[28] §952 Dodd-Frank Act, H. R. 4173.
[29] §165 (h) Dodd-Frank Act, H. R. 4173.
[30] §303A.01 NYSE Listed Companies Manual, §5605 (b)(1) NASDAQ Equity Rules.
[31] §303A.02 (b) NYSE Listed Companies Manual, §5605 (a)(2) NASDAQ Equity Rules.
[32] Rodrigues supra note 23, at 450.

ii. German regime

In Germany, until 2009 there was no provision in the Aktiengesetz (Stock Corporation Act) about independence of MB or SB members. The first provision was introduced through BilMoG requiring the presence of an independent financial expert in the SB of financial institutions. Nonetheless, the independence requirement was removed from §100, par. 5 AktG[33] and replaced by the requirement of "familiarity with the sector"[34]. Despite the lack of a positive requirement of independence for SB members[35], Aktiengesetz provides in §100, par. 2[36] and §105[37] a number of impediments to membership in SB. These impediments reflect mainly situations of lacking independence from MB, so that we can draw out of them the *principle of independence* as a general principle of corporate law[38]. This principle is breached, whenever an SB member is involved in a relationship of "beholdedness" (Befangenheit) that jeopardizes the fulfillment of its monitoring duties[39].

The deficit of a positive legal requirement of independence was covered through the German Corporate Governance Code (DCGK). In the first version of DCGK (2002), § 5.4.2 highlighted the assurance of independent advice and supervision of the MB by the SB as one of the main corporate governance goals. In order to achieve this goal, DCGK-Committee introduced a limitation of the number of MB members that could sit in the SB and the prohibition of having directorial or advisory positions in competitive corporations[40]. These provisions were supplemented by the requirement of an adequate number ("ausreichende Zahl") of independent SB members and the initial definition of independence[41].

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[33] MüKoAktG/Habersack, supra note 5, §100, Rn. 4, 68, Schmidt/Lutter/ *Drygala*, AktG, 3. Aufl. 2015, § 100 AktG, Rn. 45-53.

[34] Hüffer/Koch/*Koch*, supra note 5, §100, Rn. 25a-26, MüKoAktG/*Habersack*, supra note 5, §100, Rn. 72-73, 79.

[35] MüKoAktG/*Habersack*, supra note 5, §100, Rn. 83, Spindler/Stilz/*Spindler*, supra note 5, § 100 Rn. 39-41.

[36] Hüffer/Koch/*Koch*, supra note 5, §100, Rn. 9-18, MüKoAktG/*Habersack*, supra note 5, §100, Rn. 21-48, Schmidt/Lutter/ *Drygala*, AktG, 3. Aufl. 2015, § 100 AktG, Rn. 4-23.

[37] Hüffer/Koch/Koch, supra note 5, §105, Rn. 1-10, MüKoAktG/*Habersack*, supra note 5, §105, Rn. 1-21.

[38] Katja Langenbucher, *Zentrale Akteure der Corporate Governance: Zusammensetzung des Aufsichtsrats*, 41 ZGR 314, 323-325 (2012).

[39] See the definition of independence in Regierungsentwurf eines Gesetzes zur Modernisierung des Bilanzrechts (Bilanzrechtsmodernisierungsgesetz – BilMoG), BT-Drs. 16/10067, p. 101: "*Ein Aufsichtsratsmitglied ist unabhängig, wenn es in keiner unmittelbaren oder mittelbaren geschäftlichen, finanziellen oder persönlichen Beziehung zur Gesellschaft oder deren Vorstand steht, die die Besorgnis einer Befangenheit begründet, die der Wahrnehmung der Aufsichtsfunktion entgegensteht*." (emphasis added).

[40] Christian Bender & Hendrik Vater, *Lückenhaft und unverbindlich–Der Deutsche Corporate Governance Kodex lässt auch nach der Überarbeitung wichtige Kernprobleme der Unternehmensüberwachung ungelöst*, 42 DSTR 1807(2003).

[41] Philipp Jaspers, *Voraussetzungen und Rechtsfolgen der Unabhängigkeit eines Aufsichtsratsmitgliedes nach dem BilMoG*, AG 607(2009);Jan Lieder, *Das unabhängige Aufsichtsratsmitglied*, NZG 569, 570-572 (2005).

The amendment of § 5.4.2 was the result of German regulator's compliance with EU Recommendation 2005/162/EC[42] and, more specifically, with articles 4 ("Number of independent directors") and 13 ("Independence"). DCGK provisions deviate from the respective EU Recommendation regarding the definition of independence. On EU level, independence is determined as independence from the corporation and its management (a) as well as independence from its controlling shareholder (b). DCGK-Committee justified this deviation referring to functional differences of the monistic and dualistic system that make unnecessary the requirement of independence from the controlling shareholder in German corporations. This was also the prevailing position among legal scholars and market participants[43].

After 2012, the provision was revised in order to comply with the EU Recommendation in all respects, especially the non-attribution of the status of independence to a director with "personal or business relationship (…) with a controlling shareholder"[44]. This amendment has signaled a regulatory shift from the prevailing doctrine about the presence of representatives of the controlling shareholder in the SB. According to this doctrine, the legislator has constructed the SB as a *shareholders' committee,* so that shareholders' representation in the SB is legitimate and proportional to the equity stake of each shareholder[45].

In the previous version of DCGK (2017), instead of an adequate, an appropriate number ("angemessene Zahl") of independent directors was required for the SB[46]. Out of this amendment, we can come to the conclusion that the German regulator wanted to "nudge" corporations to increase the number of independent SB members[47]. Nonetheless, because the estimation of the appropriateness falls under the discretionary power of the SB, the amendment was not expected to cause any significant change in corporate practice.

In the current version, DCGK structure has been fundamentally altered. Instead of provisions, DCGK consists of principles complemented by recommendations ("shall"-rules) and suggestions ("should"-rules)[48]. Besides structural changes, there have been changes with regard to independence requirements. §5.4.2 has been replaced by Recommendations B.7-B.16. From now and on, independence refers solely to SB

[42] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).
[43] Michael Hoffmann-Becking, *Unabhängigkeit im Aufsichtsrat*, 21 NZG 801, 805 (2014).
[44] Jan Hupka, *Die Unabhängigkeit des Aufsichtsrats nach dem DCGK 2012*, DER AUFSICHTSRAT 128(2012);Axel v. Werder & Jeny Bartz, *Die aktuellen Änderungen des Deutschen Corporate Governance Kodex*, DB 769(2017);Hans-Ulrich Wilsing & Klaus von der Linden, *Unabhängigkeit, Interessenkonflikte und Vergütung von Aufsichtsratsmitgliedern – Gedanken zur Kodexnovelle 2012*, DSTR 1391, 1391-1392 (2012).
[45] MüKoAktG/*Habersack*, supra note 5, §100, Rn. 83, Hoffmann-Becking, supra note 43, at 806.
[46] Klaus Hopt, J. & Patrick Leyens, C., *Der Deutsche Corporate Governance Kodex 2020*, 48 ZGR, 958-959 (2019).
[47] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, DCGK-Kommentar, 7. Auflage 2018, Rn. 1390-1391.
[48] Compliance with recommendations is subject to the comply-or-explain principle. That means that corporations may depart from recommendations, but they should explain such departures. On the contrary, any departures from suggestions do not need explanation (Präambel DCGK 2017).

members who are shareholder representatives, while employee representatives are deemed independent (Rec. B.7). DCGK-Committee adopted the prevailing opinion that employee representatives fall out of the scope of §5.4.2 DCGK, despite the employment agreement they have concluded with the corporation[49].

In accordance with Annex II of the EU-Recommendation, DCGK includes a list of criteria describing default situations of lacking independence (Rec. B.8). The SB has discretionary power to judge, if in a specific case the criteria of non-independence are met. In an affirmative case, the SB can attribute the status of independence under the condition of justifying such a deviation from DCGK default provisions in the Corporate Governance Statement (Rec. B.9). Additionally, independence requirement has been extended to the chair of the Prüfungsauschuss[50], while for the chair of the Compensation Committee only independence from the corporation is demanded (Rec. B.10).

DCGK is a "soft law" source[51] whose provisions complement the provisions of AktG[52]. The way DCGK provisions are integrated in the corporate legal framework is through §161 AktG. According to this, all corporations should publish a statement regarding compliance with the DGCK-provisions and, in case of non-compliance, they should explain any deviation (comply-or-explain principle)[53].

B. Independence and Conflicts of Interests

Out of the EU-Recommendation and DCGK provisions, it is obvious that there is no positive definition for independence. Independence is associated with the lack of conflicting interests[54]. Nonetheless, it is not accurate to identify the lack of independence with the presence of conflicting interests. A conflict of interests exists

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[49] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1384-1385;Theodor Baums, Unabhängige Aufsichtsratsmitglieder, 180 ZHR, 703-705 (2016);Kai Hasselbach & Janis Jakobs, Die Unabhängigkeit von Aufsichtsratsmitgliedern, BB 643, 649-650 (2013);Martin Klein, Die Änderungen des Deutschen Corporate Governance Kodex 2012 aus Sicht der Unternehmenspraxis, AG 805, 807-808 (2012). See also Recommendation 2005/162/EC, Annex II, par. 1 (b): "…*except when the non-executive or supervisory director does not belong to senior management and has been elected to the (supervisory) board in the context of a system of workers' representation recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment"*.The explicit adoption of the prevailing opinion by DCGK-Committee has been welcomed by labor unions in the public consultation for 2020 DCGK revision.

[50] I have chosen to use the term Prüfungsausschuss instead of the English term "audit committee" because of the different scope of their responsibilities. Audit committees' scope of responsibilities is broader including the establishment and supervision of internal controls and risk management mechanisms as well as the preparation of financial statements. Prüfungsausschuss's responsibilities are limited to the supervision of the audit procedure, the efficiency of internal control systems, risk-management systems and the compliance (§5.3.2 (1) DCGK). That is why DCGK-Committee removed the term "audit committee" from the text of the DCGK 2015. Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer* supra note 47, Rn. 1291-1292.

[51] Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 THE AMERICAN JOURNAL OF COMPARATIVE LAW, 11-16 (2011).

[52] Rieder & Holzmann, supra note 4, at 571.

[53] Hüffer/Koch/*Koch*, supra note 5 § 161, Rn. 1-33.

[54] Recital 7 Recommendation 2005/162/EC: *„Independence should be understood as the absence of any material conflict of interest (…)"*.

whenever a person faces the dilemma to satisfy interests of different nature or source. Differences shall be such, that satisfaction of one interest might decrease or vanish the probability of satisfying the others. A director might be exposed to such a conflict of interests because of her capacity as agent[55].

1. Enterprise's best interests

More concretely, directors are considered to be "fiduciaries"[56], meaning that they must act in accordance and in order to promote the interests of principals whose assets they are appointed to manage. Concerning the interests that directors should serve, there are two doctrines: *shareholder theory* and *stakeholder theory*. According to shareholder theory[57], which has prevailed in the US[58], directors' actions should be oriented towards shareholders' wealth maximization[59]. In pursuing this purpose, they are not obliged to take into consideration the interests of the rest of the corporation's stakeholders, meaning creditors, employees, consumers, suppliers, etc.

On the other side, according to stakeholder theory[60], an enterprise's interest (Unternehmensinteresse) consists of the interests of multiple stakeholders with whom the corporation has transactions. The prevailing opinion in Germany is that directors are allowed to take into consideration the interests of the corporation's multiple stakeholders[61] without being obliged to prioritize the interests of a specific corporate constituency[62]. Thus, directors have broad discretionary power to rank stakeholders' adversarial interests in a specific case. The only limit set to their discretionary power is the sustainability of the long-term value of the corporation[63].

DCGK 2009 introduced the concept of "*company's best interest"* in its foreword. According to this, both MB and SB have the obligation to *"ensure the continued existence of the company and its sustainable value creation in line with the principles*

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[55] Jens Koch, *Begriff und Rechtsfolgen von Interessenkonflikten und Unabhängigkeit im Aktienrecht*, 43 ZGR, 698-700 (2014).
[56] For an economic analysis of fiduciary duties see: María Gutiérrez, *An Economic Analysis of Corporate Directors' Fiduciary Duties*, 34 THE RAND JOURNAL OF ECONOMICS (2003). From the perspective of the Incomplete Contracts Theory see: Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 THE UNIVERSITY OF TORONTO LAW JOURNAL (1993). From the perspective of Critical Resource Theory see: D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, VANDERBILT LAW REVIEW (2002).
[57] Spindler/Stilz/*Fleischer*, supra note 5, § 76 Rn. 29-42f.
[58] MüKoAktG/*Spindler* supra note 5, § 76 Rn. 75-80. See also Katharine V. Jackson, *Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis*, HASTINGS BUSINESS LAW JOURNAL (2011).
[59] MüKoAktG/*Spindler* supra note 5, § 76 Rn. 74, ADOLF A. BERLE & C. GARDINER, THE MODERN CORPORATION PRIVATE PROPERTY (Commerce Clearing House. 1932);M. FRIEDMAN, CAPITALISM AND FREEDOM (University of Chicago Press. 1962).
[60] See Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications*, 20 (1995);J. Kaler, *Evaluating Stakeholder Theory*, 69 JOURNAL OF BUSINESS ETHICS (2006);Margaret M. Blair & Lynn A. Stout, *Team Production Theory of Corporate Law, A*, VIRGINIA LAW REVIEW (1999).
[61] For the MB: Spindler/Stilz/*Fleischer*, supra note 5, § 76 Rn. 22-28, for the SB: Spindler/Stilz/*Spindler*, supra note 5, § 116 Rn. 24-36.
[62] Hüffer/Koch/*Koch*, supra note 5, § 76, Rn. 28-34.
[63] MüKoAktG/*Spindler*, supra note 5, § 76 Rn. 72-73.

of the social market economy"[64]. Based on this provision, we can safely conclude that DCGK-Committee has opted-in for stakeholder theory. This conclusion is enhanced by the following DCGK revisions. The revision of 2017 established the concept of *"the reputable person"* (Leitbild des Ehrbaren Kaufmanns)[65] as a reference point for directors' behavior. Their behavior shall be lawful, but also *"ethically sound and responsible".* In DCGK 2020, we can find the clearest expression of stakeholder theory in German legal regime. In the context of defining *"the enterprise's best interests"* the regulator refers to specific stakeholders' interests that should be taken into consideration[66]. Nonetheless, the regulator does not go as far as classifying the different stakeholders' interests.

To secure the orientation of managerial behavior towards pursuit of the enterprise's best interests, jurisdictions impose two fiduciary duties to directors: the duty of loyalty (Treuepflicht[67]) and the duty of care (Sorgfaltspflicht[68]). In AktG, there are no special provisions about the duty of loyalty. Such a duty derives from individual rules, such as the prohibition of competition (§88 AktG), the personal qualifications of members of the supervisory board (§100, par. 2, sent. 1, no. 2 and 3 AktG), the incompatibility of management and supervisory board membership (§105 AktG) and the exclusion of voting rights (§136 AktG)[69]. Besides these special provisions, the duty of loyalty derives from the organic position and the contractual relationship SB and MB members have with the corporation[70]. DCGK explicitly provides for the duty of SB members to promote the enterprise's best interests (Principle 11).

To fulfill their duty of loyalty, SB members should promote corporate interests by avoiding situations of conflicting interests, and, in case that such situations arise, by prioritizing the enterprise's interest over other conflicting interests[71]. They should take into consideration the enterprise's best interests, especially when they approve

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[64] Official translation of DCGK 2015 found in: https://www.dcgk.de/en/code/archive.html.

[65] The addition of this provision has been criticized by legal scholarship as a mere formal declaration without some profound regulatory meaning (See Holger Fleischer, *Ehrbarer Kaufmann – Grundsätze der Geschäftsmoral – Reputationsmanagement: Zur „Moralisierung" des Vorstandsrechts und ihren Grenzen*, DB 2015(2017);Hans-Ulrich Wilsing & Klaus von der Linden, *Compliance-Management, Investorengespräche, Unabhängigkeit und ein moralischer Imperativ – Gedanken zur Kodexnovelle 2017*, DSTR 1046(2017).)

[66] Foreword DCGK 2020: *"The Code highlights the obligation of Management Boards and Supervisory Boards – in line with the principles of the social market economy – to take into account the interests of the shareholders, the enterprise's employees and the other groups related to the enterprise (stakeholders) to ensure the continued existence of the enterprise and its sustainable value creation (the enterprise's best interests)"* (emphasis added).

[67] Hüffer/Koch/*Koch*, supra note 5, § 84, Rn. 10-11; §116 Rn. 7-8, MüKoAktG/*Spindler*, supra note 5, § 93 Rn. 125-129; MüKoAktG/*Habersack*, supra note 5, §116 Rn. 46-70, Spindler/Stilz/*Fleischer*, supra note 5, § 93 Rn. 113-175; Spindler/Stilz/*Spindler*, supra note 5, §116 Rn. 74-123.

[68] Hüffer/Koch/*Koch*, supra note 5, § 93, Rn. 6-27; §116 Rn. 2-4a, MüKoAktG/*Spindler*, supra note 5, § 93 Rn. 25-124; MüKoAktG/*Habersack*, supra note 5, §116 Rn. 16-45, Spindler/Stilz/*Fleischer*, supra note 5, § 93 Rn. 14-112; Spindler/Stilz/*Spindler*, supra note 5, §116 Rn. 8-72.

[69] Hans Diekmann & Dermot Fleischmann, *Umgang mit Interessenkonflikten in Aufsichtsrat und Vorstand der Aktiengesellschaft*, AG 141, 141 (2013).

[70] See Holger Fleischer, *Zur organschaftlichen Treuepflicht der Geschäftsleiter im Aktien- und GmbH-Recht*, WM 1045(2003).

[71] Großkomm AktG/*Hopt/Roth*, §93 Rn. 227, 229.

corporate decisions (§111, par. 4, sent. 2 AktG), when they appoint MB members (§84, par. 1 AktG) and when they address proposals to the general meeting (§171 AktG). Nonetheless, the duty of loyalty is less strict for SB members because of the part-time nature of their tasks[72].

2. Conflicting interests

Sources of interests, that are adversarial to an enterprise's best interests, are the directors per se (conflicts of interests, *Interessenkonflikte*)[73] or third parties with whom directors have fiduciary relationships (conflicts of duties, *Pflichtenkollisionen*)[74]. Direct interests of directors conflict with the enterprise's best interests in two cases: a) in case a director participates in both sides of a transaction under its capacity as director of a corporation and as the counterparty (Eigengeschäfte der Aufsichtsrats-mitglieder)[75], and b) in case a director takes advantage of a business opportunity in which the corporation has an interest[76]. These two forms of conflicts of interests have been acknowledged by DCGK-Committte (Principle 19).

Indirect interests are served from directors, especially when a director is a SB member of more than one corporations, or a SB member of one corporation and a MB member of another corporation[77]. In both situations, SB members act as agents for the interests of different principals, bearing the duty to promote the best interests of different enterprises[78]. The interests of different enterprises are not necessarily irreconcilable. They come into conflict, when enterprises are engaged in the same industry, so they are competitors, or when they are counterparties with mutually exclusive interests. Particularly directors of German corporations were exposed to indirect interests. The reason is that, traditionally, the majority of SB members were former or current MB

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[72] MüKoAktG/*Habersack*, supra note 5, §116 Rn. 47.

[73] Günther H. Roth & Ulrike Wörle, *Die Unabhängigkeit des Aufsichtsrats Recht und Wirklichkeit*, 33 ZGR, 614-616 (2004).

[74] Lutter/Krieger/Verse, supra note 9, § 12 Rechte und Pflichten der einzelnen Aufsichtsratsmitglieder; Vergütung, Rn. 896.

[75] Lutter/Krieger/Verse, supra note 74, Rn. 904-906. See also Hans-Joachim Fleck, *Richter am Bundesgerichtshof a.D., Karlsruhe: Eigengeschäfte eines Aufsichtsratsmitglieds*, *in* FESTSCHRIFT FÜR THEODOR HEINSIUS ZUM 65. GEBURTSTAG AM 25. SEPTEMBER 1991 (Friedrich Kübler ed. 1991).

[76] MüKoGmbHG/*Fleischer*, 3. Aufl. 2019, GmbHG § 43 Rn. 175-191; Lutter/Krieger/Verse, supra note 74, Rn. 907-925. For the doctrine of business opportunities in US case law see: Guth v. Loft, Inc. - 5 A.2d 503 (Del. 1939). For the doctrine in Germany see Mathias Habersack, *Geschäftschancen im Recht der verbundenen Aktiengesellschaften*, *in* FESTSCHRIFT FÜR MICHAEL HOFFMANN-BECKING ZUM 70. GEBURTSTAG (Gerd Krieger, et al. eds., 2013). For a comparative analysis of the doctrine see: Martin Gelter & Genevieve Helleringer, *Opportunity Makes a Thief: Corporate Opportunities as Legal Transplant and Convergence in Corporate Law*, BERKELEY BUSINESS LAW JOURNAL (2018).

[77] Roth & Wörle, supra note 73, at 611-614. See also Peter Ulmer, *Aufsichtsratsmandat und Interessenkollision*, NJW 1603(1980).

[78] BGH NJW 1980, 1629: *„Die Spaltung einer Person mit kollidierenden Pflichten in solchem Verhalten weisen, die nur dem einen, nicht aber zugleich dem anderen Verantwortungsbereich zugeordnet werden könnten, ist, wenn tatsächlich beide Bereiche betroffen sind, nicht möglich. Interessenkollisionen sind, wenn ein SBsmitglied zwei Gesellschaften angehört, auch grundsätzlich nicht in dem Sinne entlastend, daß die Pflichterfüllung gegenüber der einen die Pflichtverletzung gegenüber der anderen Gesellschaft rechtfertigen könnte".*

members of the same or other corporations as well as of financial institutions with which the corporation had financial transactions[79].

With regard to the nature of conflicting interests, they might be of personal or business nature. Personal interests are pursued in the context of familial and, in general, social relationships. In these cases, directors feel the moral obligation to pursue the interests of persons[80] they have developed social ties with. Business interests are associated with wealth maximization of the interest-bearer[81]. This distinction is also adopted by DCGK in the context of defining independence (*"…wenn es in einer persönlichen oder einer geschäftlichen Beziehung…"*).

To determine the range of familial relationships that jeopardize a director's status of independence, we refer to the list of "persons closely associated" as defined in article 3, par. 1, no. 26 of Market Abuse Regulation[82]. The SB has discretionary power to evaluate, if in a particular case the existing familial ties render a director "beholden" to her relatives or not[83]. On the other side, we should take into consideration that a lack of independence can be affirmed even in cases where there are no familial ties but mere friendship or close social ties[84].

3. Independence – Conflicting Interests – Duty of loyalty

The distinction between lack of independence, conflicting interests and breaches of the duty of loyalty depends on the point in time that we have to evaluate the presence of a conflict of interests. *Scholderer*[85] has developed a three-levels theory of conflicts of interests, illustrating conflicts as three types of harm for the enterprise's best interests. On the first level, it is the lack of independence. Such a lack can be affirmed, when there is "abstract imperilment of the corporate interest". In this context, we employ an ex ante evaluation of the probability, conflicting interests to arise in the future[86]. On the second level, it is the ascertainment of present conflicts of interests in concreto. In this case, a breach of the duty of loyalty is potential. On the third level, it is the actual breach of the duty of loyalty. Such a breach exists, when the director prioritizes other interests over corporate interest and that can trigger director's liability.

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[79] Roth & Wörle, supra note 73, at 584-587.
[80] Familial ties exist only between natural persons.
[81] Markus Stephanblome, *Der Unabhängigkeitsbegriff des Deutschen Corporate Governance Kodex*, NZG 445, 446-447 (2013).
[82] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC.
[83] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1382.
[84] For the US jurisdiction see Beam ex rel. Martha Stewart Living v. Stewart, 833 A.2d 961, 978 (Del. Ch. 2003), Oracle Corp. Derivative Litig., 824 A.2d 917, 938-39 (Del. Ch. 2003); for the German jurisdiction see Stephanblome, supra note 84, at 447; Klein, supra note 49, at 811.
[85] Frank Scholderer, *Unabhängigkeit und Interessenkonflikte der Aufsichtsratsmitglieder - Systematik, Kodexänderungen, Konsequenzen*, NZG 168, 171-172 (2012).
[86] Koch, supra note 55, at 728.

The aforementioned hierarchy is depicted also in DCGK provisions. In Recommendation C.7 DCGK independence is defined as the lack of personal or business relationships (…) that *may cause* a substantial and not merely temporary conflict of interests. Here, the lack of independence is described as a source of potential conflicts of interests[87] and, thus, is conceptually broader than present conflicts of interests. Relationships that can generate potential conflicts of interests shall be disclosed in SB' proposals for the election of SB candidates to shareholders' general meeting (Recommendation C.13 DCGK)[88].

In order to confine the range of relationships out of which conflicting interests might arise, German regulator sets a high threshold for the nature of potential conflicts. Conflicts must be *substantial and not merely temporary*.

To assess the existence of substantiality criterion[89], the SB should examine all the aspects of the relationship connecting a candidate member and the company or the controlling shareholder. In case of a business relationship, among other elements to be examined, the financial impact of the relationship on both the candidate member and the company/ controlling shareholder is of crucial importance. Subjective aspects, such as the economic position and parties' market power, as well as objective aspects, such as the expected value of transactions and performance contingent clauses, should be taken into consideration.

Besides the financial impact, the duration of the relationship is an additional element to be considered, in order to estimate the potential of future conflicts of interests. The more permanent the relationship, the more beholden is the candidate member perceived[90]. The SB has to forecast both financial impact and duration of the existing relationship in a horizon of approximately three years[91].

It is not clear, if the regulator's will was to align the scope of Recommendation C.7 and C.13 DCGK. Therefore, we must accept that the SB has discretionary power to apply the measure of *the objectively judging shareholder*[92] in accordance with substantiality and permanence criteria[93].

With respect to these criteria, the definition of conflicting interests is conceptually broader than that of lack of independence, because even minor or temporary conflicts can cause a potential breach of the duty of loyalty. This kind of conflicts are regulated

[87] Hasselbach & Jakobs, supra note 49 at 645.
[88] Kremer/ Bachmann/ Lutter/ v. Werder/ *Kremer*, supra note 47, Rn. 1363, Thomas Kremer & Axel v. Werder, *Unabhängigkeit von Aufsichtsratsmitgliedern: Konzept, Kriterien und Kandidateninformationen*, AG 340, 347 (2013).
[89] Kremer/ Bachmann/ Lutter/ v. Werder/ *Kremer*, id., Rn. 1387, Kremer & v. Werder, id., at 345-346.
[90] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, id., Rn. 1389, Kremer & v. Werder, id., at 345.
[91] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, id., Rn. 1388, Kremer & v. Werder, id., at 346.
[92] Recommendation C.13: *„Die Empfehlung zur Offenlegung beschränkt sich auf solche Umstände, die nach der Einschätzung des Aufsichtsrats ein objektiv urteilender Aktionär für seine Wahlentscheidung als maßgebend ansehen würde"* (emphasis added).
[93] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1361, Kremer & v. Werder, supra note 88, at 347.

in Principle 19. Each SB member shall inform the SB chair about any conflicts of interests (Recommendation E.1, sent. 1 DCGK) and the SB shall inform shareholders respectively (Recommendation E.1, sent. 2 DCGK). In the latter case, the announcement shall take place after the SB has taken measures to address the conflicts. SB members would have the obligation to disclose any conflicts of interests, even if that was not provided in DCGK. This obligation derives from the general duty of loyalty[94].

The rationale behind transparency requirements is the prevention[95] of potential breaches of the duty of loyalty. This rationale determines the range of information to be disclosed. Especially concerning disclosure towards the SB, there is no obligation to disclose conflicts of interests that are already known to the SB or they cannot have a substantial impact on decisions made by the SB[96]. The latter is the case with regard to potential conflicts of interests. While potential conflicts of interests shall be disclosed by SB candidate members before their appointment (Recommendation C.13 DCGK), only actual conflicts of interests shall be disclosed by current SB members of the SB Recommendation E.1 DCGK)[97].

4. Legal Consequences for Conflicting Interests

After disclosure has taken place, the SB has discretionary power to take further preventative measures in order to comply with its duty to pursue the enterprise's best interests[98]. The first measure to be taken is exclusion from voting procedures[99]. The legal basis for such an exclusion is §34 BGB[100]. The application of this article is contested on two bases: 1) Exclusion is legitimate under the condition that the decision to be made refers to conclusion of a transaction or arrangement of a legal conflict between the legal person and its member. This is the case when the SB has to decide about filing a motion to remove one of its members (§103, par. 3 AktG)[101]. The broad interpretation of § 34 BGB in order to be applicable in cases of conflicting interests is not justified[102]. 2) Exclusion finds its limits in SB's collective liability[103]. That means that all SB members are held liable for decisions the SB has made as a collective corporate body. In order to avoid liability of the interested director for decisions whose outcome could not influence, we must accept that she is entitled to be present at the SB meetings. Exceptionally, in cases of substantial conflicts of interests, such as takeover

[94] Großkomm AktG/*Hopt/Roth*, §93 Rn. 164; Koch, supra note 55, at 723.
[95] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1462, 1463.
[96] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, id., Rn. 1465, 1466.
[97] Diekmann & Fleischmann, supra note 69, at 145; Hoffmann-Becking, supra note 43, at 807, 808; Koch, supra note 55, at 724, 725.
[98] Lutter/Krieger/Verse, supra note 74, Rn. 897-903.
[99] Diekmann & Fleischmann, supra note 69, at 146-147.
[100] Klaus J. Hopt, *Interessenwahrung und Interessenkonflikte im Aktien-, Bank- und Berufsrecht - Zur Dogmatik des modernen Geschäftsbesorgungsrechts*, 33 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT, 32 (2004).
[101] Hüffer/Koch/*Koch*, supra note 5, § 103, Rn. 12, MüKoAktG/*Habersack*, supra note 5, § 103 Rn. 35, Spindler/Stilz/*Spindler*, supra note 5, § 103 Rn. 30.
[102] Diekmann & Fleischmann, supra note 69, at 146.
[103] MüKoAktG/*Habersack*, supra note 5, §116 Rn. 38.

offers, a SB member can be deprived of its participation right as ultima ratio and in accordance with *proportionality principle*. In this case, the SB member should be informed about the result of the voting procedure.

Material or long-term conflicts of interests justify the strictest measure of terminating interested director's mandate (Recommendation E.1, sent. 3 DCGK). This provision can be perceived as an ex post application of the independence requirement. Because of its rationale, termination is legitimate only in cases that an existing conflict of interests has a substantial impact on SB's monitoring function and cannot be otherwise eradicated[104]. In practice, termination takes place in the form of resignation. If the termination does not take place by the interested director's volition, the SB can respond through filing an application for judicial removal of the director (§103, par. 3 AktG).

A lack of response from the side of the SB can deprive it from the privilege of *business judgment rule*[105]. This rule immunizes SB members from liability when they exercise their decision-making power with regard to specific corporate affairs (*unternehmerische Entscheidungen*)[106]. One of the conditions for the implementation of the rule is SB's acts to be guided by the enterprise's best interests (*Wohl der Gesellschaft*). This is not the case when decisions are made with the participation of directors who are subject to conflicts of interests[107].

Concerning disclosure to shareholders' general meeting, the underlying rationale is allowing shareholders to make informed decisions about the ratification of the current SB's acts[108]. Moreover, disclosed information about past conflicts of interests can be taken into consideration for the reelection of SB members[109]. Therefore, shareholders' decisions on the aforementioned topics, without any disclosure having taken place despite the existence of conflicting interests, are contestable on the grounds of incomplete information (§243, par. 4 AktG)[110].

The range of information to be disclosed should be determined based on the addressees. In contrast to case law[111], legal scholars[112] are of the opinion that disclosure of core elements of the conflicts and the measures taken is sufficient without any further details to be needed. The means of disclosure is SB's report to shareholders' general meeting (Berichterstattung, §172, par. 2 AktG)[113]. Breaches of the disclosure requirement can

[104] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1480, 1481.
[105] Scholderer, supra note 85, at 175.
[106] Spindler/Stilz/*Spindler*, supra note 5, § 116 Rn. 43.
[107] Spindler/Stilz/*Spindler*, supra note 5, § 116 Rn. 47.
[108] BGH, Urteil vom 16. 2. 2009 - II ZR 185/07 (OLG Frankfurt a.M.), NZG 2009, at 345.
[109] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1477.
[110] Scholderer, supra note 85, at 174-175.
[111] OLG Frankfurt a. M., Urt. v. 5. 7. 2011 − 5 U 104/10, NZG 2011, at 1030.
[112] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1476. For the opposite opinion see: Scholderer, supra note 85, at 175.
[113] Hoffmann-Becking, supra note 43, at 808; Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1478.

render decisions made by shareholders' meeting void on the legal basis of misinformation.

C. Independence from…

1. Company and its Governing Bodies

The choice of the word "Gesellschaft" and not "Unternehmen"[114] makes clear that independence is meant from the particular corporation in which someone is SB member. Therefore, even if a SB member of the mother company has a business relationship with one of its subsidiaries, this member will be deemed independent in the absence of other indicators of lacking independence[115].

Independence from the company covers solely the existence of direct or indirect business relationships between a SB member and the company. Such business relationships are established through conclusion of a contract or agreement to provide advisory or other professional services[116]. The responsibilities that SB members undertake in the context of these contracts differ qualitatively and/ or quantitatively from their supervising and advisory duties. More specifically, such contracts are concluded, when a member obtains financial, legal or technical expertise in a field critical for the operations of the corporation, where specific solutions are needed[117].

Another form of dependence from the company is questionable: share ownership. There are German scholars who support the argument that share ownership can be perceived as a form of dependence from the company, because each one of the shareholders has the financial obligation to contribute to the company's capital and, as an exchange, they bear financial claims towards the company[118]. In support of this argument, §6.3 DCGK[119] is called upon, which provided transparency requirements for SB members that owned shares representing more than 1% of outstanding shares[120]. The opinion of

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114 Like in Recommendation C.13 DCGK: "*Der Aufsichtsrat soll bei seinen Wahlvorschlägen an die Hauptversammlung die persönlichen und die geschäftlichen Beziehungen eines jeden Kandidaten zum Unternehmen, den Organen der Gesellschaft und einem wesentlich an der Gesellschaft beteiligten Aktionär offenlegen*". Both words, Gesellschaft and Unternehmen, are translated inaccurately in the official English translation of DCGK as company.

115 Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1378.

116 These kinds of contracts shall be concluded after SB's approval according to §114 (1) AktG and Recommendation E.3 DCGK.

117 Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1483, 1484, Hüffer/Koch/*Koch*, supra note 5, § 114, Rn. 6-7, MüKoAktG/*Habersack*, supra note 5, § 114 Rn. 22-27, Spindler/Stilz/ *Spindler*, supra note 5, §114 Rn. 16-20.

118 Jenny Bartz & Axel v. Werder, *Unabhängigkeit von Kandidaten für den Aufsichtsrat - Empirische Befunde zur tatsächlichen Anwendung der Kodexempfehlungen zur Beziehungstransparenz*, NZG 841, 843 (2014).

119 Tobias de Raet, *Die Angaben bei den Wahlvorschlägen zum Aufsichtsrat gem. Ziff. 5.4.1 Abs. 4–6 des Deutschen Corporate Governance Kodex*, AG 488, 493 (2013).

120 This provision was removed at the revision of DCGK in 2017. The removal of the provision was justified on the grounds that the new Market Abuse Regulation provides sufficient transparency requirements with regard to directors' dealings (article 19 MAR) that supplement the quite stringent provisions about disclosure of share ownership from the threshold of 3% and above (§§33 ff. WpHG). Of course, companies can on a voluntary basis disclose information about share ownership of SB members (Kremer/ Bachmann/ Lutter/*Bachmann*, supra note 47, Rn. 1615-1616).

the author is that, irrespective of the removal of §6.3 DCGK, the financial nature of the relationship established through share ownership justifies taking it into consideration when assessing the independence of a SB member from the company. The condition of the "material and non-temporary" conflicts of interest can limit the range of share ownership cases that are indeed hazardous for a member's independence.

Concerning independence from governing bodies, these are the MB and the SB. There are no provisions of the AktG that demand independence of the SB from the MB, but we can come to this conclusion based on the monitoring function of the SB[121]. Monitoring the MB aims at minimizing agency costs[122] caused by the separation between ownership and control of the firm[123]. This is the case especially in jurisdictions where companies have dispersed shareholders' base. US corporations were traditionally perceived as the representative example of such companies[124]. According to DCGK, shareholder structure should be taken into consideration, when the SB determines the appropriate number of independent members[125]. So, the more dispersed the shareholders' base, the larger the number of required SB members independent from the MB.

Besides the lack of personal and business relationships to members of the MB (interest-related dependence), independence of a SB member is jeopardized in case of previously serving in the MB of the same corporation (personal dependence)[126]. In such a case, it is highly improbable that, under her current capacity as SB member, the former managing director will challenge corporate policy[127], as it was determined with her contribution[128]. That is why §100, par. 2, no. 4 AktG and Recommendation C.7, sent. 3, no. 1 DCGK establish a two-year[129] cooling-off period for the transition from the MB to the SB. This barrier can be surpassed through nomination by shareholders

[121] Tim Florstedt, *Die Unabhängigkeit des Aufsichtsratsmitglieds vom kontrollierenden Aktionär*, ZIP 337(2013);Birgit Reese & Christian Ronge, *Kunde, Lieferant und Kreditgeber als unabhängige Mitglieder des Aufsichtsrats - Überlegungen zu Ziff. 5.4.2 DCGK bei Doppelfunktionen*, AG 417, 419 (2014).

[122] See John Armour, et al., *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (Reinier Kraakman, et al. eds., 2017).

[123] See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 THE JOURNAL OF LAW AND ECONOMICS (1983).

[124] See John C Coffee Jr, *The rise of dispersed ownership: The roles of law and the state in the separation of ownership and control*, 111 YALE LAW JOURNAL 1(2001).

[125] Recommendation C.6: *„The Supervisory Board shall include what it considers to be an appropriate number of independent members, thereby taking into account the shareholder structure* "(underlined by the author).

[126] Roth & Wörle, supra note 73, at 574.

[127] Axel v. Werder & Bernd J. Wieczorek, *Anforderungen an Aufsichtsratsmitglieder und ihre Nominierung*, DB 297, 299 (2007).

[128] Christian Bender & Hendrik Vater, *Lückenhaft und unverbindlich - Der Deutsche Corporate Governance Kodex lässt auch nach der Überarbeitung wichtige Kernprobleme der Unternehmensüberwachung ungelöst*, DStR 1807, 1807-1808 (2003).

[129] The respective cooling-off period according to EU Recommendation 2005/162/EC is five years (Annex II, par. 1 (a)).

holding more than 25% of voting rights, but, even in this case, Recommendation C.11 DCGK limits the SB membership of former MB members to two seats.

The other governing body in German corporations is the SB. Apparently, what DCGK means by independence from the SB is the lack of personal and business relationships to individual SB members[130]. Besides interest-related dependence, personal and mental dependence can hinder the efficient operation of the SB as a monitoring corporate body.

By personal dependence, we refer to long-term SB membership. The longer the membership in the SB, the less vigilant the "checks and balances" applied with regard to internal affairs of the SB. What is more, long-term membership is associated with higher probability of ingroup biases[131]. Ingroup biases, developed in the context of collective decision-making processes, cause members of a collegial body to adhere to consensual decisions without critically challenging proposals made by other members of the body. This kind of dependence had been acknowledged by the EU regulator[132] since 2005 but had not been adopted by DCGK-Committee. In the meantime, German scholars' proposal to limiting the development of ingroup biases is a maximum SB term of 10 years[133]. At the 2020 revision, DCGK-Committee adopted the EU Recommendation and sets a maximum limit of 12 years to attribute someone the status of independence (Recommendation C7, sent. 3, no. 4 DCGK).

According to Recommendation C.1, sent. 4 and 5 DCGK, the SB is required to publish information concerning the implementation of its composition policy and the names of its members that are perceived as independent. Nonetheless, we can draw more information about the existence of relationships of dependence from the company and its governing bodies upon SB's election proposals to shareholders' general meeting (Recommendation C.13 DCGK). Based on the empirical findings of *Bartz* and *v. Werder*[134], most dependence relationships exist between SB members and the company in the form of business transactions. On the other side, dependence relationships with the MB and the SB constitute the minority and are equivalently of both personal and business nature.

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[130] Raet, supra note 119, at 494.

[131] See in general for ingroup biases: Donald C Langevoort, *Organized illusions: A behavioral theory of why corporations mislead stock market investors (and cause other social harms)*, 146 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 135-139 (1997);Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASHINGTON UNIVERSITY LAW QUARTERLY 821, 860-865 (2004). See specifically for the impact of ingroup biases on boards of directors: Page, *Unconscious Bias and the Limits of Director Independence*, UNIVERSITY OF ILLINOIS LAW REVIEW 237, 249-253 (2009);JULIA REDENIUS-HÖVERMANN, VERHALTEN IM UNTERNEHMENSRECHT: ÜBER DIE REALVERHALTENSORIENTIERTE FORTENTWICKLUNG DES UNTERNEHMENSRECHTS ANHAND AUSGEWÄHLTER ANWENDUNGSBEISPIELE 34-38 § 237 (Mohr Siebeck. 2019).

[132] EU Recommendation 2005/162/EC, Annex II, par. 1 (h).

[133] Julia Redenius-Hövermann & Hendrik Schmidt, *Unabhängigkeit von Aufsichtsratsmitgliedern - Überlegungen zur Einordnung und Definition des Unabhängigkeitsbegriffs*, 18 ZEITSCHRIFT FÜR CORPORATE GOVERNANCE 218, 222 (2018).

[134] Bartz & v. Werder, supra note 118, at 846.

2. Controlling Shareholders

The empirical study of *Bartz* and *v. Werder* shows that, following dependence relationships with the company, most of non-independent SB members have business relationships with controlling shareholders[135]. Before 2012, the only types of independence DCGK was requiring was independence from the company and the management body. DCGK-Committee did not adopt the EU Recommendation[136] about the qualification of a controlling shareholder or her representatives as non-independent directors. The aversion of the German regulator to adopt the requirement of independence from a controlling shareholder is depicted in the opinion letters of German scholars as a response to the public consultation relating to the Report of the High Level Group of Company Law Experts on a modern Regulatory Framework for Company Law in Europe[137] and the revision of DCGK in 2012[138].

The main reason against introducing the requirement of independence from controlling shareholders seems to be the ownership structure of German corporations. Several empirical studies during 1990s[139] have corroborated the presence of blockholders in German corporations. The presence of a blockholder can have positive effects on the minimization of managerial agency costs[140]. Blockholders have economic incentives to monitor directors[141], but, by doing so and given the rational apathy of minority

[135] Bartz & v. Werder, id.

[136] EU Recommendation 2005/162/EC, Annex II, par. 1 (d).

[137] Arbeitsgruppe Europäisches Gesellschaftsrecht, *Zur Entwicklung des Europäischen Gesellschaftsrechts: Stellungnahme der Arbeitsgruppe Europäisches Gesellschaftsrecht (Group of German Experts on Corporate Law) zum Report of the High Level Group of Company Law Experts on a modern Regulatory Framework for Company Law in Europe*, ZIP 863(2003);Deutscher Anwaltverein, *Stellungnahme zum Aktionsplan der EU-Kommission zur Modernisierung des Gesellschaftsrechts und Verbesserung der Corporate Governance in der Europäischen Union*, NZG 1008, 1010-1011 (2003);Mathias Habersack, *Europäisches Gesellschaftsrecht im Wandel - Bemerkungen zum Aktionsplan der EG-Kommission betreffend die Modernisierung des Gesellschaftsrechts und die Verbesserung der Corporate Governance in der Europäischen Union*, see id. at 1, 5 (2004).

[138] DAV-Handelsrechtsausschuss, *Stellungnahme zu den Änderungsvorschlägen der Regierungskommission Deutscher Corporate Governance Kodex vom 1. 2. 2012*, see id. at 335, 337 (2012);Mathias Habersack, Thesen zum Gutachten von Prof. Dr.Mathias Habersack, München 56 (2012).

[139] See Marco Becht & Ekkehart Boehmer, *Ownership and voting power in Germany*, *in* THE CONTROL OF CORPORATE EUROPE (Fabrizio Barca & Marco Becht eds., 2001);Marco Becht & Ekkehart Boehmer, *Voting control in German corporations*, 23 INTERNATIONAL REVIEW OF LAW AND ECONOMICS (2003);Jeremy Edwards & Marcus Nibler, *Corporate governance in Germany: the role of banks and ownership concentration*, 15 ECONOMIC POLICY (2000);Julian Franks & Colin Mayer, *Ownership and control of German corporations*, 14 THE REVIEW OF FINANCIAL STUDIES (2001);Jens F Koke, *New evidence on ownership structures in Germany*, CENTRE FOR EUROPEAN ECONOMIC RESEARCH WORKING PAPER (1999);Rafael La Porta, et al., *Corporate ownership around the world*, 54 THE JOURNAL OF FINANCE (1999);Christoph Van der Elst, *The equity markets, ownership structures and control: Towards an international harmonisation*, *in* CAPITAL MARKETS AND COMPANY LAW (2003).

[140] See Luca Enriques, et al., *The Basic Governance Structure: Minority Shareholders and Non-Shareholder Constituencies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 79, (Reinier Kraakman, et al. eds., 2017).

[141] Michael C. Jensen & William H. Meckling, *Theory of the firm: Managerial behavior, agency costs and ownership structure*, 3 JOURNAL OF FINANCIAL ECONOMICS, 10-12 (1976).

shareholders, they can expropriate corporate assets[142] or extract private benefits[143] from the corporation at the expense of other shareholders.

With the aim to protect minority shareholders[144] from agency costs associated with controlling shareholders[145], the German legislator developed *Konzernrecht*, a bundle of legal rules (§§15-19, 291-328) regulating the relationship between controlled and controlling company as members of a corporate group[146]. German scholars support that the level of protection that Konzernrecht rules offer to minority shareholders renders unnecessary the introduction of the independence requirement from controlling shareholders[147].

Nonetheless, in 2012, DCGK-Committee, in alignment with article 13, par. 1 of the EU Recommendation, has added the requirement of independence from controlling shareholders. Despite the introduction of such a requirement, the Committee did not define the concept of controlling shareholder.

Only in Recommendation C.13, sent. 3 DCGK can someone find the definition of "shareholders with material interest" ("wesentlicher Beteiligter") in the context of the requirement to publish affiliations of candidate SB members with shareholders[148]. DCGK does not distinct between the concept of "controlling shareholder" and that of "shareholder with material interest". It is worth mentioning that the historical interpretation of Recommendation C.7 does not support the analogical implementation of the 10% threshold of Recommendation C.13, sent. 3 DCGK, because such a threshold was proposed but removed from the final version of DCGK in 2012[149].

In literature there are three opinions expressed with regard to the threshold needed, so that a shareholder is perceived as controlling with respect to the independence requirement. According to the first opinion, which prevails in literature[150], in order for a shareholder to be characterized as controlling the criteria of §17 AktG must be met. Based on §17, par. 2 AktG the critical element is *majority shareholding.* Majority shareholding is associated with a majority of voting rights (§16, par. 1 AktG) and, thus,

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[142] Lucian A Bebchuk & Assaf Hamdani, *The agency costs of controlling shareholders*, UNPUBLISHED WORKING PAPER, HARVARD LAW SCHOOL AND TEL AVIV UNIVERSITY, 8-40 (2018).
[143] Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 787-804 (2003);Alexander Dyck & Luigi Zingales, *Private benefits of control: An international comparison*, 59 THE JOURNAL OF FINANCE, 541-544 (2004).
[144] Hüffer/Koch/*Koch*, supra note 5, § 15, Rn. 3, Spindler/Stilz/*Schall*, supra note 5, Vorbemerkung zu den §§15ff. Rn. 27.
[145] See John Armour, et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 30, (Reinier Kraakman, et al. eds., 2017).
[146] Cahn & Donald, supra note 13, at 682-687.
[147] Stephanblome, supra note 84, at 448.
[148] Hoffmann-Becking, supra note 43, at 806; Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1360.
[149] Klein, supra note 49, at 807.
[150] Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1380, Nikolaos Paschos & Sebastian Goslar, Unabhängigkeit von Aufsichtsratsmitgliedern nach den neuesten Änderungen des Deutschen Corporate Governance Kodex 1363 (NZG 2012).

the ability to determine the outcome of decisions made by the shareholders' general meeting, especially the ones relating to composition of the SB and the MB[151].

Majority of voting rights can be achieved either by one blockholder or by a group of coordinating minority shareholders. The percentage of outstanding shares that a shareholder must possess in order to secure majority in the voting process depends on the participation rate of other shareholders[152]. A percentage of less than 50% can ensure *controlling influence* in a company, if the rest of shareholders have an insignificant stake in corporation's capital. In case there is no shareholder that can exercise controlling influence exclusively through her own voting rights, coordination with other non-controlling shareholders must be secured through fiduciary or voting agreements[153].

According to the second opinion, the definition of control can be found in §29 WpÜG. Based on this definition a percentage of 30% of voting rights confers control over the company and obliges the possessor to make a takeover bid to all shareholders[154]. The reason why German scholars[155] reject this interpretation is the different regulatory purposes of §29 WpÜG and Recommendation C.7 DCGK. The requirement of mandatory bids aims at protecting minority shareholders from collective action problems[156], while the requirement of independence from controlling shareholders aims at protecting both minority shareholders and creditors from ownership agency costs. The first requirement is triggered by even a temporary overleap of the 30% threshold[157], while lack of independence arises from continuous and established exercise of controlling influence[158].

According to the third opinion, which is the most appropriate in the author's opinion, the criteria of §290 HGB concerning controlling influence of a mother company on its subsidiaries should also be applied with respect to Recommendation C.7 DCGK. The reasons for such an analogous implementation of §290 HGB are two. Firstly, this interpretation aligns with the definition of controlling shareholder according to article 1, case (d) of Annex II of the EU Recommendation. The Annex refers to article 1, par. 1 of Council Directive 83/349/EEC which has been replaced by article 22, par. 1 of Directive 2013/34[159]. According to this article, control is associated with majority of

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[151] Emmerich/Habersack/*Emmerich*, 9. Aufl. 2019, AktG § 17 Rn. 5-8, MüKoAktG/*Bayer*, supra note 5, § 17 Rn. 25-27.
[152] Hüffer/Koch/ *Koch*, supra note 5, § 17, Rn. 9, MüKoAktG/*Bayer*, id., § 17 Rn. 35-36.
[153] Emmerich/Habersack/*Emmerich*, supra note 151, AktG § 17 Rn. 18-19, MüKoAktG/*Bayer*, supra note 5, AktG § 17 Rn. 38-39.
[154] Article 5, par. 1 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.
[155] Klein, supra note 49, at 807; Kremer/ Bachmann/ Lutter/ *v. Werder/ Kremer*, supra note 47, Rn. 1380, Paschos & Goslar, supra note 150, at 1362-1363.
[156] Cahn & Donald, supra note 13, at 886-887.
[157] Angerer/Geibel/Süßmann/*Süßmann*, 3. Aufl. 2017, WpÜG § 29 Rn. 21.
[158] Emmerich/Habersack/*Emmerich*, supra note 151, AktG § 17 Rn. 11-13.
[159] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of

voting rights and/or the rights to appoint or remove the majority of the members of governing bodies[160]. Secondly, the fact that the criteria of §290 HGB have been transferred from the EU Directive 2013/34 allows international investors to evaluate the independence of SB members based on the common EU framework standards[161].

The advantage of the first and the third opinion is that they do not set a specific rigid numerical threshold to determine the existence of controlling influence. Nonetheless, from the aforementioned articles it is clear that a shareholder with an equity stake of less than 10% cannot be considered as controlling shareholder[162].

II. ECONOMIC FRAMEWORK

In the second half, I will present the challenges that the rise of shareholder activism poses for the independence requirement. More specifically, I am going to present the conditions and means which shareholders might take advantage of to exercise controlling influence on directors.

A. Who are Shareholder Activists?

As shareholder activists we define shareholders who decide to get engaged[163] in the management of corporate affairs by initiating changes in financial or operating performance, in corporate governance or the economic structure of a company[164]. There are different classes of shareholders that have undertaken an active corporate governance role. The differences refer to economic incentives and regulatory boundaries to exercise activism, business models and operating strategy, target companies and activism means.

1. Institutional Investors

Since 1980s the main actors were institutional investors, meaning financial institutions, such as mutual funds, public and private pension funds, insurance companies and banks. During 1980s public pension funds and the mutual fund "TIAA-CREF" in the US initiated shareholder proposals under the Rule 14a-8 pursuing corporate governance changes[165]. The most common objectives were the repeal of antitakeover amendments,

undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC.

[160] This is the reason why *Paschos* and *Goslar* claim that the implementation of the criteria of either §17 AktG or §290 HGB.

[161] Stephanblome, supra note 81, at 448-449.

[162] Paschos & Goslar, supra note 150, at 1363.

[163] For the difference between shareholder activism and shareholder engagement see S. Alvaro, et al., *Institutional investors, corporate governance and stewardship codes - Problems and Perspectives*, 19 CONSOB LEGAL PAPERS, 6 (2019).

[164] Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the US*, 19 JOUNAL OF APPLIED CORPORATE FINANCE 55, 55 (2007).

[165] M. Kahan & E. B. Rock, *Hedge funds in corporate governance and corporate control*, 155 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1042 (2007).

the adoption of cumulative voting and greater board independence[166]. Empirical studies have shown that shareholders proposals by institutional investors were receiving more support than proposals submitted by individual shareholders[167] Other mutual funds were limited to voting in favor of other shareholders' proposals or to having a "no-vote" policy against management's proposals[168].

During 1990s traditional investors changed their strategy to private negotiations with management. In Germany, communication with the board of directors was the dominant strategy of institutional investors whose objectives referred more to financial performance of the company rather than corporate governance issues[169]. There are very few empirical data about the success of such negotiations[170], but there is an increasing trend of preference towards behind-the-scenes negotiations[171]. Nonetheless, their efficacy can be expected to be limited, if it is not combined with a threat to go public in case of disagreement between the institutional investor and the management[172].

Going public means initiating a proxy contest against management. In order to ensure success in such a contest, activist shareholders must have accumulated a majority blockholding or they must have established cooperation with other shareholders[173]. Furthermore, they must be willing to incur particularly high costs[174].

Traditional institutional investors face regulatory constraints with regard to the stake of equity that they can own in a company. First of all, mutual funds are subject to enhanced disclosure requirements[175]. As a result, the market will be aware of any accumulation of voting power. Second, both in the US[176] and in Germany[177] must comply with diversification criteria. More concretely, a mutual fund shall not invest in more than 10% of the outstanding shares of a specific issuer and any investment in a specific issuer

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[166] Alexander Bassen, *Einflussnahme institutioneller Anleger auf Corporate Governance und Unternehmensführung - Ergebnisse einer empirischen Untersuchung*, 14, 433 (2002);Gillan & Starks, JOUNAL OF APPLIED CORPORATE FINANCE, 57 (2007).

[167] See Cynthia J. Campbell, et al., *Current Perspectives on Shareholder Proposals: Lessons from the 1997 Proxy Season*, 28 FINANCIAL MANAGEMENT (1999);Lilli A. Gordon & John Pound, *Information, Ownership Structure, and Shareholder Voting: Evidence from Shareholder-Sponsored Corporate Governance Proposals*, 48 THE JOURNAL OF FINANCE (1993).

[168] Frank S. Partnoy & Randall S. Thomas, *Gap Filling, Hedge Funds and Financial Innovation*, VANDERBILT UNIVERSITY LAW SCHOOL LAW AND ECONOMICS, WORKING PAPER NO. 06-21/ UNIVERSITY OF SAN DIEGO SCHOOL OF LAW, LEGAL STUDIES RESEARCH PAPER NO. 07-72, 10 (2006).

[169] Max Steiger, *Institutionelle Investoren und Corporate Governance: Eine empirische Analyse*, ZEW-DOKUMENTATION, NO. 98-05, 24-27 (1998).

[170] See Willard T. Carleton, et al., *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 THE JOURNAL OF FINANCE (1998).

[171] J. A. McCahery, et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 JOURNAL OF FINANCE, 2913 (2016).

[172] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1044 (2007).

[173] L. A. Bebchuk & M. Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CALIFORNIA LAW REVIEW, 1073-1074 (1990).

[174] According to Gantchev an activist campaign ending in a proxy fight has average costs of §10,71 million. See Nickolay Gantchev, *The costs of shareholder activism: Evidence from a sequential decision model*, 107 JOURNAL OF FINANCIAL ECONOMICS 610(2013).

[175] Investment Company Act, Section 30, par. (e), case (2).

[176] Investment Company Act, Section 5, par. (b), case (1).

[177] §60 Abs. 1, 62 Abs. 2 Satz 1 InvG.

shall not surpass the threshold of 5% of the value of the fund's assets. Thirdly, open-ended mutual funds are subject to liquidity requirements, because they must be in the financial position to redeem shares at shareholders' request at short notice[178].

The most important constraint for institutional investor activism is the potential conflict of interests. Besides investing in a company's equity, traditional institutional investors have usually additional business relationships with the company. For example, a mutual fund might belong in the same group of companies as a bank that has lent to the company[179]. Such interconnections between a mutual fund and an investee company make the former one refrain from contesting the management of the latter one under the fear of losing revenue from business transactions with the company[180].

Despite the aforementioned regulatory boundaries, nowadays institutional investors have the economic incentives to monitor the management of their investee companies[181]. These are mainly the Big Three, Black Rock, State Street Global Investors and Vanguard[182]. Currently, they own 70-80% of the entire U.S. capital market[183] and are among the top 15 DAX investors[184]. The way that they have established such a market power is by managing index funds.

The level of diversification they achieve through indexing does not exclude their economic incentive to engage in corporate governance[185]. The marginal benefit they get from investing in the amelioration of the corporate governance mechanisms of the investee companies are higher than the marginal costs. In other words, they enjoy the benefits of creating economies of scale[186]. The reason is that corporate governance problems are common among companies and they do not demand acquiring company-specific knowledge which is more costly[187].

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[178] 17 CFR § 270.2a-7.

[179] Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law Symposium: Institutional Investor Activism in the 21st Century: Responses to a Changing Landscape*, BOSTON UNIVERSITY LAW REVIEW, 1172-1186 (2019). For examples in the German market see Klaus Ulrich Schmolke, *Institutionelle Anleger und Corporate Governance, Traditionelle institutionelle Investoren vs. Hedgefonds*, 2007 ZGR, 721-722 (2007).

[180] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1054-1056 (2007).

[181] See B. S. Black, *Agents Watching Agents - the Promise of Institutional Investor Voice*, 39 UCLA LAW REVIEW (1992).

[182] See Lucian A Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 BOSTON UNIVERSITY LAW REVIEW (2019);Jill E. Fisch, et al., *The New Titans of Wall Street, A Theoretical Framework for Passive Investors*, 168 UNIVERSITY OF PENNSYLVANIA LAW REVIEW (2020).

[183] Eric A. Posner, et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 81 ANTITRUST LAW JOURNAL (2017).

[184] IHS Markit/DIRK, 'Who Owns the German DAX?' (2019), available at https://cdn.ihs.com/www/pdf/0519/DAX-Study-DIRK.pdf.

[185] This argument is supported by Dorothy S. Lund, *The Case against Passive Shareholder Voting*, JOURNAL OF CORPORATION LAW (2017).

[186] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1048 (2007);Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders be Shareholders*, 18-39 NYU LAW AND ECONOMICS RESEARCH PAPER, 13-31 (2019).

[187] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1043 (2007).

This can be verified by empirical data on the characteristics of the companies targeted by institutional investors and their objectives. More specifically, institutional investors invest in companies with good corporate governance structure. This fact suggests that they perceive corporate governance mechanisms as means to minimize monitoring costs[188].

Under these economic circumstances the largest institutional investors are willing to engage in corporate governance affairs and the rest are "pushed" to do so in order to remain competitive[189]. These economic incentives have been complemented by regulatory initiatives in the form of soft law codes of conduct[190] or even legal rules[191]. Institutional investors are required to engage in corporate affairs and disclose to regulatory authorities the respective engaging activities ranging from the exercise of their voting rights to direct communication with the board of directors.

2. Private Equity Funds and Hedge Funds

Institutional investors have an ex post strategy, meaning they initiate corporate governance changes after they have already invested in a company. On the contrary, private equity and hedge fund managers make an investment in a company with the aim to initiate corporate governance changes[192]. They have similar performance-based compensation schemes and investors' base, but they differ in their business models and objectives[193].

More specifically, both investor types are considerably less regulated than traditional institutional investors. For example, they tie fund manager compensation with performance. They charge a fee of 1-2% of the assets under management and a fee of 20% of the absolute returns[194]. That means that, unlike institutional investors' performance, alternative investors' performance is not evaluated relatively to a benchmark[195]. This compensation scheme incentivizes managers to increase the value of the investee companies.

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[188] See Brian J. Bushee, et al., *Institutional Investor Preferences for Corporate Governance Mechanisms*, 26 JOURNAL OF MANAGEMENT ACCOUNTING RESEARCH (2014).
[189] Andreas G.F. Hoepner, et al., *Does an Asset Owner's Institutional Setting Influence its Decision to Sign the Principles of Responsible Investment?*, JOURNAL OF BUSINESS ETHICS, 14 (2019).
[190] In the UK: UK Stewardship Code 2020, in Germany: Wohlverhaltensregeln des BVI, and on international level: ICGN Global Stewardship Principles.
[191] Articles 3f-3h Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement (SRD II).
[192] Cheffins and Armour distinguish between the "defensive" activism of institutional investors and the "offensive" activism of hedge funds. Cheffins & Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 THE JOURNAL OF CORPORATION LAW, 56-57 (2011).
[193] For a comparison of private equity and hedge funds see Ann-Kristine Achleitner & Christoph Kaserer, *Private Equity and Hedge Funds: A Primer*, CEFS WORKING PAPER SERIES NO. 2005-03 (2005).
[194] Andrew Metrick & Ayako Yasuda, *The Economics of Private Equity Funds*, 23 THE REVIEW OF FINANCIAL STUDIES, 2310 (2010).
[195] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1051-1054 (2007).

Moreover, both private equity and hedge funds are not subject to diversification requirements. That means that they can invest in large equity stakes in one investee company or minority equity stakes in multiple companies[196]. The fact that they can invest in alternative financial instruments, such as derivatives[197], or that they can heavily rely on debt-financing[198] allows them to have large positions in companies. The low degree of regulating alternative funds' activities is the reason why their investors' base consists mainly of sophisticated investors, such as institutional investors.

Nevertheless, the differences between private equity and hedge funds refer to their objectives and their investment horizons. The objective of private equity funds is to initiate structural changes in private companies or public companies with the aim to take them private afterwards (PIPE transactions)[199]. Such structural changes require financial and industry expertise[200]. On the other side, hedge funds contribute to the investee companies their financial know-how.

Structural changes demand investments with longer horizons. That is why private equity's investment horizon is up to 10 years[201], while the initial lock-up period for hedge funds is up to 10 months[202]. A lock-up period is the period that a hedge funds' investors are not permitted to redeem their shares. In contrast to traditional institutional investors, hedge funds have the negotiation power to determine an initial lock-up period and their investors can opt-in it[203].

Hedge funds are known and sometimes accused[204] for their short-term investment horizons. Hedge funds' short-termism is due to the fact that their performance is evaluated by investors who can "exit" the fund on a periodic base. This business model drives hedge funds to adopt aggressive tactics to initiate corporate governance changes that will bear high returns in the short-term horizon. The realization of short-term returns can take place by initiating, on the first stage, changes that are perceived as positive by market participants, thus, leading to increases in firm value. On the second

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[196] Achleitner & Kaserer, CEFS WORKING PAPER SERIES NO. 2005-03, 6 (2005);Ann-Kristin Achleitner, et al., *Do Corporate Governance Motives Drive Hedge Fund and Private Equity Fund Activities?*, 16 EUROPEAN FINANCIAL MANAGEMENT, 816 (2010).

[197] See Henry T. C. Hu & Bernard Black, *Hedge Funds, Insiders and the Decoupling of Economic and Voting Ownership, Empty Voting and Hidden (Morphable) Ownership*, 13 JOURNAL OF CORPORATE FINANCE (2007);Jie Guo, et al., *The role of derivatives in hedge fund activism*, 18 QUANTITATIVE FINANCE (2018).

[198] Achleitner, et al., EUROPEAN FINANCIAL MANAGEMENT, (2010).

[199] See Mark Heesen, *The Slippery Slope of Hedge Fund Regulation*, VIEWPOINT: NVCA, VENTURE CAPITAL JOURNAL, 71 (2004).

[200] Achleitner, et al., EUROPEAN FINANCIAL MANAGEMENT, 809 (2010);Mark Mietzner & Denis Schweizer, *Hedge funds versus private equity funds as shareholder activists in Germany — differences in value creation*, 38 JOURNAL OF ECONOMICS AND FINANCE, 185 (2014).

[201] Achleitner, et al., EUROPEAN FINANCIAL MANAGEMENT, 808 (2010).

[202] Vikas Agarwal, et al., *Role of Managerial Incentives and Discretion in Hedge Fund Performance*, 64 THE JOURNAL OF FINANCE, 2231 (2009).

[203] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1063-1064 (2007).

[204] I. Anabtawi & L. Stout, *Fiduciary duties for activist shareholders*, 60 STANFORD LAW REVIEW, 1290-1292 (2008);Strine, *One Fundamental Corporate Governance Question we Face, Can Corporations be Managed for the Long-Term Unless their Powerful Elecorates also Act and Think Long Term*, 66 THE BUSINESS LAWYER, 10-19 (2010).

stage, hedge funds either exit the investee companies which has a negative signaling impact on firm value or they cause the dissolution, acquisition, merger of the investee company with another one.

For these reasons, short-termism can be proven detrimental for the investee company and its stakeholders. That is why the EU regulator has undertaken measures to promote long-termism in capital markets[205]. At the same time national regulators declare sustaining the long-term value of a company as one of the main objectives for running a business[206].

The different business models of private equity and hedge funds are reflected in the characteristics of the companies they target. Based on empirical studies[207], private equity funds prefer to invest in consumer goods companies in contrast to hedge funds that prefer pharmaceuticals and healthcare companies. This is why also hedge funds target firms with low R&D investments[208] which is an indication of managerial slack. In contrast private equity funds prefer more stable businesses.

B. Hedge Fund Activism

After having analyzed the identity and the differences between the various shareholder activists since 1980s, I will focus on hedge fund activists. By presenting the in more detail the characteristics of the firms they target and the strategies they employ to achieve their objectives, I aim to show the controlling influence they can exercise on target firms' management.

1. Target Firms

Empirical data show that hedge funds target small[209] "value" companies with good operating performance, but a low market-to-book value.

The fact that hedge funds target small- or mid-cap companies can be attributed to the investment needed to acquire, even a minority, stake in a large-cap company[210]. The investment that is needed in order to gain controlling influence in a large-cap company is much higher than the one needed in a small-cap company[211]. Also, the size of a

[205] Communication from the Commission to the european Parliament, the Council, the European Economic and Social Committe and the Committee of the Regions, *Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies* - COM/2012/0740 final (12 December 2012); Recitals 15, 19, 20, 22 SRD II.
[206] Principle A, The UK Corporate Governance Code (July 2018), Foreword, DCGK 2020.
[207] Achleitner, et al., EUROPEAN FINANCIAL MANAGEMENT, 819, 825 (2010).
[208] April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 THE JOURNAL OF FINANCE, 201 (2009). See also Alon Brav, et al., *How does hedge fund activism reshape corporate innovation?*, 130 JOURNAL OF FINANCIAL ECONOMICS (2018).
[209] For the US: Alon Brav, et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 THE JOURNAL OF FINANCE, 1766 (2008). For Germany: Wolfgang Bessler, et al., *The Returns to Hedge Fund Activism in Germany*, 21 EUROPEAN FINANCIAL MANAGEMENT, 123 (2015).
[210] W. W. Bratton, *Hedge funds and governance targets*, 95 GEORGETOWN LAW JOURNAL, 1388 (2007).
[211] Alon Brav, et al., *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 THE REVIEW OF FINANCIAL STUDIES, 2730 (2015).

company is inversely related to the degree of information disseminated about the company. The less the information disseminated, the more abnormal returns can hedge funds realize by taking advantage of information asymmetries and market inefficiencies[212]. In this process, hedge funds rely on investment analysts. That is why they prefer companies with high analysts' coverage[213].

Besides the size what drives hedge fund activism is the undervaluation of target companies. Companies are undervalued when despite a high operating performance[214], proxied by ROA (return on assets) and ROE (return on equity) they have low market-to-book ratio[215]. This inconsistency is an indication of market mispricing a company's shares. So, this kind of companies offer hedge funds the opportunity to realize abnormal returns by engaging in arbitrage[216].

With regard to the capital structure of target firms, most of them have high free cash flows[217] which are indicative of managerial agency problems[218]. Hedge funds aim to changes in the capital structure by promoting an agenda for increased cash distributions to shareholders either in the form of dividend payouts or in the form shares repurchases[219].

Another element of the capital structure that attracts hedge fund activists is the presence of institutional investors in the shareholders' base[220]. Their presence is crucial for the strategies that activists are going to employ to exercise control. Because hedge funds cannot invest in a majority stake in the investee company, in order to build negotiation power towards the target firm's management, they need the support of other shareholders.

With regard to corporate governance structure, targeted firms are the ones which are perceived as captured by their managers. That means that firms with high takeover

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[212] Ruth V. Aguilera, et al., *Gone Global: The International Diffusion of Hedge Fund Activism*, 5 (2019). Available at SSRN: https://ssrn.com/abstract=3402966 or http://dx.doi.org/10.2139/ssrn.3402966; Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 123 (2015);Jean Helwege, et al., *Why Do Firms Become Widely Held? An Analysis of the Dynamics of Corporate Ownership*, 62 THE JOURNAL OF FINANCE, 1012 (2007).

[213] Brav, et al., THE JOURNAL OF FINANCE, 1753 (2008).

[214] Nicole M. Boyson & Robert M. Mooradian, *Corporate governance and hedge fund activism*, 14 REVIEW OF DERIVATIVES RESEARCH, 180 (2011);Brav, et al., THE JOURNAL OF FINANCE, 1730 (2008).

[215] Brav, et al., THE JOURNAL OF FINANCE, 1754 (2008);Klein & Zur, THE JOURNAL OF FINANCE, 202 (2009).

[216] Andrew Carrothers, *The Impact of Hedge Fund Activism on Target Firm Performance, Executive Compensation and Executive Wealth*, 6 JOURNAL OF GOVERNANCE AND REGULATION/VOLUME, 19 (2017).

[217] Alon Brav, et al., *The Returns to Hedge Fund Activism*, 64 FINANCIAL ANALYSTS JOURNAL 45-61, 48 (2008).

[218] See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 THE AMERICAN ECONOMIC REVIEW (1986).

[219] Klein & Zur, THE JOURNAL OF FINANCE, 224 (2009);Mark Mietzner, et al., *Intra-Industry Effects of Shareholder Activism in Germany — Is There a Difference between Hedge Fund and Private Equity Investments?*, 63 SCHMALENBACH BUSINESS REVIEW, 154 (2011).

[220] Brav, et al., THE JOURNAL OF FINANCE, 1753 (2008);Michael P. Smith, *Shareholder Activism by Institutional Investors: Evidence from CalPERS*, 51 see id. at, 231 (1996).

defenses[221] or staggered boards[222] are more likely to be targeted by hedge fund activists. Both elements are indications of managerial entrenchment[223] and have a negative impact on share prices[224]. Such empirical findings support the hypothesis that shareholder activists can serve a monitoring role by suppressing managerial agency costs.

That is why they also prefer targeting firms in countries with strong shareholder rights[225]. According to *La Porta et al.* Germany is perceived as a jurisdiction with weak shareholder rights[226]. Shareholder rights are important for investors' protection and they are a factor that hedge fund activists take into consideration when they plan an intervention. The first reason is that there is a positive impact of shareholder rights on share prices[227], which makes an activist's intervention worthless. The second reason is that shareholder rights can be used as a means to introduce corporate governance changes[228].

Nonetheless, since 2000s there has been a clear trend of hedge fund activism towards German firms[229]. The first instances of shareholder activism in Germany can be attributed to a former "corporate raider"[230], Guy Wyser-Pratte, targeting companies like Rheinmetall AG[231] and KUKA AG[232]. His US-based fund, Wyser-Pratte Capital Management aimed at increasing the profitability of target firms without major changes in capital structure[233].

One example of shareholder activism in Germany, which attracted the public interest, is The Children's Investment Fund (TCI) activist intervention against the merger of Deutsche Börse (DB) and London Stock Exchange (LSE)[234]. TCI holding more than

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[221] Brav, et al., THE JOURNAL OF FINANCE, 1742 (2008);C. N. V. Krishnan, et al., *The second wave of hedge fund activism: The importance of reputation, clout, and expertise*, 40 JOURNAL OF CORPORATE FINANCE, 308-309 (2016).
[222] Re-Jin Guo, et al., *Undoing the powerful anti-takeover force of staggered boards*, 14 see id. at, 276 (2008).
[223] See Lucian Bebchuk, et al., *What Matters in Corporate Governance?*, 22 THE REVIEW OF FINANCIAL STUDIES (2008).
[224] See Paul Gompers, et al., *Corporate Governance and Equity Prices*, 118 THE QUARTERLY JOURNAL OF ECONOMICS (2003).
[225] Cheffins & Armour, THE JOURNAL OF CORPORATION LAW, 69-70 (2011).
[226] Rafael La Porta, et al., *Law and Finance*, 106 JOURNAL OF POLITICAL ECONOMY, 27 (1998).
[227] See Rafael La Porta, et al., *Investor Protection and Corporate Valuation*, 57 THE JOURNAL OF FINANCE (2002).
[228] Dionysia Katelouzou, *Worldwide Hedge Fund Activism: Dimensions and Legal Determinants*, UNIVERSITY OF PENNSYLVANIA JOURNAL OF BUSINESS LAW, 818-829 (2014).
[229] C. Thamm & D. Schiereck, *Shareholder Activism in Deutschland – Eine Bestandsaufnahme*, CORPORATE FINANCE, 18 (2014).
[230] Marco Becht, et al., *Hedge Fund Activism in Europe*, ECGI - FINANCE WORKING PAPER NO. 283/2010, 7 (2010).
[231] Matteo Erede, *Governing Corporations with Concentrated Ownership Structure, An Empirical Analysis of the Hedge Fund Activism in Italy and Germany*, ECFR, 377 (2013).
[232] Howard Gospel, et al., *New Investment Funds, Restructuring, and Labor Outcomes: A European Perspective*, 19 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, 283-285 (2011).
[233] Philipp Schüler, Shareholder Activism in Continental Europe (2016) Technische Universität Darmstadt).
[234] Kahan & Rock, UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 1035-1036 (2007).

5% stake in DB opposed DB' s bid favoring instead share repurchases. TCI, a UK-based hedge fund, was supported by Atticus Capital, a US-based hedge fund holding a 2% stake in DB. After having secured support by shareholders holding more than 35% of the outstanding shares, TCI managed to make DB refrain from its bid.

A more recent example is the activist campaign of Eliott Management Corporation (Eliott) towards Thyssenkrupp in 2017[235]. Eliott targeted Thyssenkrupp because of its operational inefficiencies proposing the removal of its CEO. After Eliott announced its joint activist campaign with Cevian Capital, Sweden's largest hedge fund, there was a 6% rise in Thyssenkrupp's share price. This was followed by a 17% rise, after the CEO' resignation and the division of Thyssenkrupp's maritime and industry solutions business lines.

Shareholder activism in Germany has some distinct characteristics, especially relating to target firms. The first deviation from US target firms is the ownership structure. German companies have been traditionally perceived as companies with controlling shareholders, banks and insurance companies. Even though blockholdings in German companies have been diffused[236], the investment of the Big Three in German capital market is so high that it allows them to monitor the management in the same way that controlling shareholders did. The presence of controlling shareholders had not prevented activist events[237] and is certainly not a deterring factor under the presence of institutional investors[238].

The second distinct characteristic of German corporations is the supervisory board. The supervisory board's function is to monitor the management board in order to mitigate managerial agency costs. It is comparable to the role of independent directors in US firms. If the main objective of hedge fund activists is to increase shareholder value of the investee companies through corporate governance changes, then the presence of effective corporate governance mechanisms would render unnecessary their intervention.

There are differences between different jurisdictions that depend also on the characteristics of target firms. Therefore, in Germany hedge funds target considerably large companies[239] and their main approach is private negotiations with management[240]. The reason that hedge funds do not target small- and mid-cap companies might lie in the fact that they are mostly family owned businesses[241] whose operating model does not fit hedge funds' business model. Even though the vast majority of activists targeting

[235] Aguilera, et al., 22 (2019).
[236] See above p.34.
[237] Erede, ECFR, 346-356 (2013);Kobi Kastiel, *Against All Odds, Hedge Fund Activism in Controlled Companies*, COLUMBIA BUSINESS LAW REVIEW, 82-85 (2016).
[238] Marco Becht, et al., *Returns to Hedge Fund Activism: An International Study*, 30 THE REVIEW OF FINANCIAL STUDIES, 2936 (2017).
[239] Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 123 (2015).
[240] See Becht, et al., THE REVIEW OF FINANCIAL STUDIES, (2008).
[241] Julian Franks, et al., *Evolution of family capitalism: A comparative study of France, Germany, Italy and the UK*, (2008).

German companies are US-based funds[242], success rates are higher when companies are targeted by domestic funds[243]. That is an indication of the importance of the institutional environment for the outcome of activist interventions[244].

Empirical data on board independence of US and European target firms are "ambiguous"[245]. The more widespread is the adoption of the independence requirement in boards of directors, the more difficult is the establishment of causal relationship between hedge fund activism and independent directors[246]. Nonetheless, it has been proven that changes in board composition and, more specifically, the introduction of independent members or the activist representation in the target boards of directors are common objectives among shareholder activists[247].

It is worth mentioning that the relationship between the objective of increasing independent board members and the objective of board representation of activists is not very clear. Both objectives can be commingled in the form of nominations of independent directors by shareholder activists.

In Germany, where the equivalent of independent directors is the supervisory board, we can detect hedge fund activism patterns more clearly. Indeed, supervisory board changes are among hedge fund activists' main objectives[248]. The methodological problem arising in German companies is that we cannot clearly distinguish if this objective indicates the perception of activists about the efficacy of the monitoring role of supervisory board or their incentive to have their own representatives in the boardroom. The fact than in the German regime there is not such a requirement as the one about stating the purpose of owning more than 3% of a company's equity makes this distinction even more difficult[249].

[242] Becht, et al., THE REVIEW OF FINANCIAL STUDIES, 2938 (2017).
[243] Id. at, 2946-2948, 2960-2961.
[244] Andreas Engert, *Shareholder activism in Germany*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE-LAW WORKING PAPER, 7-8 (2019);Schaefer & Hertrich, IUP JOURNAL OF CORPORATE GOVERNANCE, 36-37 (2013). See also Igor Filatotchev, et al., *Corporate governance and national institutions: A review and emerging research agenda*, 30 ASIA PACIFIC JOURNAL OF MANAGEMENT (2013).
[245] Id. at, 2968.
[246] See Gillan & Starks, *A Survey of Shareholder Activism, Motivation and Empirical Evidence*, (2005).Available at SSRN: https://ssrn.com/abstract=663523.
[247] Marco Becht, et al., *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 22 THE REVIEW OF FINANCIAL STUDIES, 3112 (2008);Brav, et al., FINANCIAL ANALYSTS JOURNAL, 48 (2008);Gillan & Starks, JOUNAL OF APPLIED CORPORATE FINANCE, 63 (2007);Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, VIRGINIA LAW AND BUSINESS REVIEW, 26 (2012).
[248] Henry Schaefer & Christian Hertrich, *Shareholder Activism in Germany: An Empirical Study*, 12 IUP JOURNAL OF CORPORATE GOVERNANCE, 31 (2013).
[249] Thamm & Schiereck, CORPORATE FINANCE, 17 (2014).

2. Activist Strategies

It is widely accepted[250] that shareholder activists adopt a multi-stage approach of intervention in target firms. The evolution of their approach depends on the costs associated with each stage[251].

In the first stage, shareholder activists acquire shares or other financial instruments issued by the target firm[252]. When US activists accumulate more than 5% of equity stake and they want to participate actively in the corporate governance of the issuing company, they must file a Schedule 13D[253] with the SEC[254]. Otherwise, if they prefer a passive approach, they must file a schedule 13G. That is the point at time where shareholder activists go public and the dissemination of information relating to the activist's purpose triggers most of the times a positive market reaction[255]. Before this, shareholder activists might already have engaged in negotiations with management, which, nonetheless, escape publicity[256].

Hedge funds' equity stake depends on the activist approach, on the target firm and on the size of the fund. On average it ranges from 6% to 9%[257]. Especially in Germany it fluctuates from 5 to 10%[258], with the exception of a mean 21% of equity stake, when the largest shareholder in the target firm is a financial institution[259]. The voting rights associated with such an equity stake do not ensure a majority of votes, but, under conditions, even such a low equity stake can send signals of discontent to target management and, thus, influence, their response to activism[260]. The conditions refer to the rate of participation in the general shareholders' meeting and the potential alliances of activists with other shareholders.

With regard to the participation rate two elements are crucial: the free float shares and the voting turnout in different jurisdictions. The larger the free float, the more expected is rational apathy from the side of dispersed shareholders. It has been evidenced that

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[250] Bratton, GEORGETOWN LAW JOURNAL, 1402-1405 (2007);Gantchev, JOURNAL OF FINANCIAL ECONOMICS, 611, 613 (2013).
[251] Gantchev, JOURNAL OF FINANCIAL ECONOMICS, 623-624 (2013).
[252] Boyson & Mooradian, REVIEW OF DERIVATIVES RESEARCH, 175-178 (2011);Brav, et al., THE JOURNAL OF FINANCE, 1745-1746 (2008). See also Alex Edmans, et al., *The Effect of Liquidity on Governance*, 26 THE REVIEW OF FINANCIAL STUDIES (2013).
[253] Section 12, par. 2 (1), Securities Exchange Act of 1934.
[254] See Lucian A Bebchuk, et al., *Pre-disclosure accumulations by activist investors: Evidence and policy*, 39 JOURNAL OF CORPORATION LAW (2013).
[255] Boyson & Mooradian, REVIEW OF DERIVATIVES RESEARCH, 185-189 (2011);Alon Brav, et al., *Recent Advances in Research on Hedge Fund Activism: Value Creation and Identification*, 7 ANNUAL REVIEW OF FINANCIAL ECONOMICS, 584-587 (2015).
[256] Gillan & Starks, JOUNAL OF APPLIED CORPORATE FINANCE, 64 (2007).
[257] Brav, et al., THE JOURNAL OF FINANCE, 124 (2008).
[258] Thamm & Schiereck, CORPORATE FINANCE, 22 (2014).
[259] Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 124 (2015).
[260] See Amy J. Hillman, et al., *What I Like About You: A Multilevel Study of Shareholder Discontent with Director Monitoring*, 22 ORGANIZATION SCIENCE (2011).

activists target firms with considerably large free float[261]. Empirical studies have shown that the participation rate in Germany is around 50%[262], but in companies with free float the attendance rate can drop to 10%[263].

With regard to potential alliances of shareholder activists with other shareholders, the former ones aim to gain support from minority shareholders with homogeneous preferences[264]. They do not refrain from targeting firms with majority blockholders[265], because of the arbitrage opportunities that offer companies with potential corporate governance problems, as the ones with concentrated ownership[266]. Nonetheless, when the largest shareholder is an individual family, as is often the case in Germany[267], shareholder activists might not have the financial incentive to intervene in these companies. The reason is that family owners have a large equity stake with a long-term investment horizon which incentivizes them to monitor the management[268]. Also, targeting a firm with family ownership might be costly for hedge fund activists because they will most probably face resistance to their attempts to change the status quo[269].

In general, activists prefer targeting firms with high institutional ownership[270]. Institutional owners can mitigate the costs of shareholders' coordination against management[271]. Empirical data show that shareholder proposals sponsored by institutional investors receive more support from the broad shareholders' base[272].

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[261] Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 107 (2015);Tilman H. Drerup, *Long-Term Effects of Hedge Fund Activism in Germany*, 17 (2014). Available at SSRN: https://ssrn.com/abstract=1718365;Mietzner, et al., SCHMALENBACH BUSINESS REVIEW, 166 (2011).

[262] Peter Cziraki, et al., *Shareholder Activism through Proxy Proposals: The European Perspective*, 16 EUROPEAN FINANCIAL MANAGEMENT, 748 (2010);A Comparative Analysis of the Legal Obstacles to Institutional Investor Activism in Europe and in the US. (2008).

[263] European Commission, *Annex to the Proposal for a Directive of the European Parliament and of the Council on the Exercise of Voting Rights by Shareholders of Companies Having Their Registered Office in a Member State and Whose Shares are Admitted to Trading on a Regulated Market and Amending Directive 2004/109/EC – Impact Assessment* (2006).

[264] Tanja Artiga González & Paul Calluzzo, *Clustered shareholder activism*, 27 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, 213 (2019).

[265] Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 121 (2015).

[266] See Michael J. Barclay & Clifford G. Holderness, *Private benefits from control of public corporations*, 25 JOURNAL OF FINANCIAL ECONOMICS (1989);Dyck & Zingales, THE JOURNAL OF FINANCE, (2004).

[267] Achleitner, et al., EUROPEAN FINANCIAL MANAGEMENT, 811-812 (2010).

[268] See Christian Andres, *Large shareholders and firm performance—An empirical examination of founding-family ownership*, 14 JOURNAL OF CORPORATE FINANCE (2008).

[269] Bessler, et al., EUROPEAN FINANCIAL MANAGEMENT, 123, 139-140 (2015);Kastiel, COLUMBIA BUSINESS LAW REVIEW, 74-75 (2016).

[270] See above footnote 220.

[271] Ian R. Appel, et al., *Passive investors, not passive owners*, 121 JOURNAL OF FINANCIAL ECONOMICS, 127 (2016).

[272] John M. Bizjak & Christopher J. Marquette, *Are Shareholder Proposals All Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills*, 33 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS (1998);Jonathan M. Karpoff, et al., *Corporate governance and shareholder initiatives: Empirical evidence*, 42 JOURNAL OF FINANCIAL ECONOMICS (1996);Smith, THE JOURNAL OF FINANCE, (1996).

Nonetheless, the interests of institutional investors, on the one side, and hedge fund activists, on the other side, might deviate with respect to investment horizons[273]. More specifically, traditional institutional investors have longer investment horizons in comparison to hedge funds[274]. The different investment horizons are not necessarily incompatible. If the changes initiated by activists keep creating shareholder value after their exit, institutional investors benefit from shareholder activism[275].

Another category of shareholders that makes firms attractive for shareholder activism is other hedge funds. It has been evidenced that the success rate increases with the number of hedge funds that have invested in a target company[276]. Hedge funds do not face differences with respect to investment horizons[277], so they have the highest degree of homogeneous preferences. This degree makes unnecessary the coordination of their actions. The potential of non-coordinating shareholders joining forces against management has been one of the most effective activist strategies and is known as wolf pack activism[278] or clustered activism[279].

If shareholders coordinate and their equity stake in sum surpasses the threshold of 30%, they have the regulatory obligation to make a mandatory bid (article 30, par. 2 WpÜG), because "acting in concert" bears the suspicion of coordinated exercise of control[280]. Also, even if their equity stakes do not add up to 30%, but only 5%, they would have the obligation to file a 13D Schedule as a group. This disclosure would give a signal to other shareholders about the arbitrage opportunity in the target firm[281].

That is why shareholder activists avoid communicating with other shareholders and they rely on the potential threat that can pose the numerical concentration of

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[273] M. Goranova & L. V. Ryan, *Shareholder Activism: A Multidisciplinary Review*, 40 JOURNAL OF MANAGEMENT, 1249 (2014).
[274] McCahery, et al., JOURNAL OF FINANCE, 2911 (2016).
[275] Lucian A. Bebchuk, et al., *The Long-Term Effects of Hedge Funds Activism*, COLUMBIA LAW REVIEW, 1130-1135 (2015).
[276] Mietzner & Schweizer, JOURNAL OF ECONOMICS AND FINANCE, 192 (2014).
[277] IHY Chiu & D Katelouzou, *Making a case for regulating institutional shareholders' corporate governance roles*, 2018 JOURNAL OF BUSINESS LAW, 72 (2018);Gantchev, JOURNAL OF FINANCIAL ECONOMICS, 624 (2013).
[278] Becht, et al., THE REVIEW OF FINANCIAL STUDIES, 2940-2943 (2017);Brav, et al., THE JOURNAL OF FINANCE, 1745-1746 (2008);Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, JOURNAL OF CORPORATION LAW, 689-692 (2006);J. C. Coffee & D. Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS OF CORPORATE GOVERNANCE, 562-568 (2016);L. E. Strine, *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE LAW JOURNAL, 1895-1899 (2017);Thamm & Schiereck, CORPORATE FINANCE, 25 (2014).
[279] Artiga González & Calluzzo, CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW, 214-215 (2019).
[280] Katelouzou, UNIVERSITY OF PENNSYLVANIA JOURNAL OF BUSINESS LAW, 26-28 (2014);Ana Taleska, *Shareholder Proponents as Control Acquirers: A British, German and Italian Perspective on the Regulation of Collective Shareholder Activism via Takeover Rules*, 19 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 812 (2018).
[281] John C. Coffee, *The Agency Costs of Activism: Information Leakage, Thwarted Majorities, and the Public Morality*, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (ECGI) - LAW WORKING PAPER NO. 373/2017, 32 (2017).Available at SSRN: https://ssrn.com/abstract=3058319;McCahery, et al., JOURNAL OF FINANCE, 2921 (2016).

institutional investors and hedge fund activists in a company. US case law has been ambiguous with respect to the formation of a group among shareholders[282]. Nonetheless, in Sotheby's case[283], where Sotheby's was targeted by three hedge funds, Third Point LLC, Trian Fund Management, L.P., and Marcato Capital Management LLC, Vice Chancellor Parsons accepted the "objective reasonable possibility" of a control block between the hedge funds acting with "conscious parallelism"[284][285].

Under these conditions, shareholder activists attempt, in the first stage, to communicate with target management, in order to present them their agenda about the needed changes in capital structure, operations and/ or corporate governance[286]. The management has two options: either it negotiates with the activists and they end up adopting their proposals[287] with or without compromises or it resists[288]. Management's response will depend on its expectation about the probability of activists' success in a potential proxy fight[289].

Academic literature distinguishes between aggressive and non-aggressive activist campaigns. As non-aggressive are characterized the private negotiations with the management and as aggressive the initiation or the threat of initiating a proxy fight[290]. In general, empirical data verify that non-aggressive interventions are more successful than aggressive[291]. Nonetheless, in case of hostile managerial response aggressive activist strategies bear successful outcomes[292].

In each stage, the negotiation power of the parties plays the most important role. The negotiating power of the management relies on the inside business information they own under their capacity as managers. Traditionally, the voting outcome of contested

[282] Coffee & Palia, ANNALS OF CORPORATE GOVERNANCE, 568-550 (2016).

[283] Third Point LLC v. Ruprecht, No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

[284] Yucaipa American Alliance Fund II, LP v. Riggio, 1 A.3d 310 (Del. Ch. 2010).

[285] See Carmen XW Lu, *Unpacking Wolf Packs*, 125 YALE LAW JOURNAL (2015);Bernard S. Sharfman, *The Tension between Hedge Fund Activism and Corporate Law*, JOURNAL OF LAW, ECONOMICS & POLICY (2016).

[286] Bratton, GEORGETOWN LAW JOURNAL, 1402-1403 (2007);Brav, et al., THE JOURNAL OF FINANCE, 1743, 1745 (2008);Majed R. Muhtaseb & Karampreet K. Grover, *Hedge fund activism: Cases, analysis and corporate governance*, 9 INTERNATIONAL JOURNAL OF DISCLOSURE AND GOVERNANCE, 278-280 (2012).

[287] See Carleton, et al., THE JOURNAL OF FINANCE, (1998).

[288] For the factors affecting management's resistance decision: Nicole M Boyson & Pegaret Pichler, *Hostile Resistance to Hedge Fund Activism*, 32 THE REVIEW OF FINANCIAL STUDIES, 786-791 (2018).

[289] Bonnie G. Buchanan, et al., *Shareholder Proposal Rules and Practice: Evidence from a Comparison of the United States and United Kingdom*, 49 AMERICAN BUSINESS LAW JOURNAL, 764, 767 (2012);Krishnan, et al., JOURNAL OF CORPORATE FINANCE, 310-312 (2016).

[290] Katelouzou, VIRGINIA LAW AND BUSINESS REVIEW, 21-22 (2012).

[291] Brav, et al., THE JOURNAL OF FINANCE, 1744 (2008).

[292] Boyson & Pichler, THE REVIEW OF FINANCIAL STUDIES, 791-801 (2018).

agenda was in favor of the management[293]. This seems to have changed in the era of shareholder activism[294].

The fact that shareholder activists target a specific company can have a signaling function for the management. Activists target a firm when they feel confident that they can achieve their goals. This signal can lead managers perceive a higher probability of activist's success that the actual one[295]. This weight depends on the publicity that shareholder activism receives[296] (availability heuristic[297]) as well the successful past performance of the activist hedge[298] (representativeness heuristic[299]). Sophisticated activists can take advantage of these heuristics. Indeed, the threat of going public is widely used by activists either as a threat on the first stage or as an aggressive response on the second stage[300].

All the aforementioned factors have resulted in a decrease in the number of aggressive activist campaigns. Most activists prefer, economically speaking, private negotiations and the positive impact of activism on firm performance seems to put management under pressure to not oppose activists, but to indulge in negotiations with activists.

3. Activists' controlling influence

Negotiations result in settlement agreements with specific terms about the activist's proposals. One of the most important aims of shareholder activists is board representation[301] after a change in the board structure. There has been empirically evidenced that shareholder activists time their intervention based on the directors' election period[302]. That is why directorial terms are determinant factors for the initiation

[293] Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VIRGINIA LAW REVIEW, 682-687 (2007).
[294] See Y. Ertimur, et al., *Board of directors' responsiveness to shareholders: Evidence from shareholder proposals*, 16 JOURNAL OF CORPORATE FINANCE 53(2010);Gillan & Starks, JOUNAL OF APPLIED CORPORATE FINANCE, (2007);Luc Renneboog & Peter G. Szilagyi, *The role of shareholder proposals in corporate governance*, 17 JOURNAL OF CORPORATE FINANCE (2011).
[295] John C Coffee Jr, et al., *Activist directors and agency costs: What happens when an activist director goes on the board*, 104 CORNELL LAW REVIEW, 10-13 (2018).
[296] Kate Sikavica & Amy Hillman, *Towards a Behavioral Theory of Corporate Ownership and Shareholder Activism*, 2008 ACADEMY OF MANAGEMENT PROCEEDINGS, 4 (2008).
[297] Daniel Kahneman & Amos Tversky, *Availability: A heuristic for judging frequency and probability*, 5 COGNITIVE PSYCHOLOGY, 207-232 (1973).
[298] C.N.V. Krishnan, et al., *The Second Wave of Hedge Fund Activism, The Importance of Reputation, Clout and Experience*, 27, 33 (2016).Available at SSRN: https://ssrn.com/abstract=2589992.
[299] Daniel Kahneman & Amos Tversky, *Subjective probability: A judgment of representativeness*, 3 COGNITIVE PSYCHOLOGY, 430-454 (1972).
[300] Kastiel, COLUMBIA BUSINESS LAW REVIEW, 75 (2016). See also Travis L. Johnson & Nathan Swem, *Reputation and Investor Activism: A Structural Approach*, JOURNAL OF FINANCIAL ECONOMICS (2019).Available at SSRN: https://ssrn.com/abstract=3347501.
[301] Boyson & Mooradian, REVIEW OF DERIVATIVES RESEARCH, 178 (2011);Brav, et al., THE JOURNAL OF FINANCE, 1743, 1745 (2008);Klein & Zur, THE JOURNAL OF FINANCE, 197-198, 211-214 (2009);Thamm & Schiereck, CORPORATE FINANCE, 26-27 (2014).
[302] Thamm & Schiereck, CORPORATE FINANCE, 23 (2014).

of shareholder activism[303]. The longer a director's term, the less flexible it is to gain board representation.

The objective of board representation can serve two purposes. On the one side, the adoption of activists' proposals about capital structure or operations in an agreement will always be incomplete[304]. The shareholder activist, as the one party of the agreement, will want to be able to evaluate the fulfillment of management's obligations. This monitoring might have a temporary nature and a specific objective, but it might take time. As a result, the best way to ensure the activist's monitoring ability is to allow their representation in the board of directors. On the other side, the objective of board representation can give shareholder activists access to business information. This information can be used by activists either to refine their agenda[305], to engage in insider trading or to share it selectively with other investors as an exchange for supporting their interventions[306].

In both case scenarios, it is shareholder activists who nominate specific directors that the target management accepts in the context of a compromise. The right of nomination of board directors is not foreign in legal systems. Especially in jurisdictions with companies with controlling shareholders, such as Italy[307], the law attributes minority shareholders the right to nominate elect their own representatives on the board of directors. In Germany, the certificate of incorporation can attribute such a right to specific shareholders (Entsendungsrecht)[308]. Directors elected this way are not perceived as non-independent[309].

The case of directors appointed by shareholder activists, the activist directors, is similar to the aforementioned case. The only difference is that in this case the right is attributed by a contractual arrangement between the activist and the management[310]. As a default we can analogically accept that activist directors are independent from the shareholder

[303] Engert, EUROPEAN CORPORATE GOVERNANCE INSTITUTE-LAW WORKING PAPER, 21 (2019).
[304] Lucian A. Bebchuk, et al., *Dancing with Activists*, NBER WORKING PAPER NO. W26171, 14-17 (2019).
[305] A. Hamdani & S. Hannes, *The Future of Shareholder Activism*, 99 BOSTON UNIVERSITY LAW REVIEW, 996 (2019).
[306] See Coffee Jr, et al., CORNELL LAW REVIEW, (2018).
[307] Erede, ECFR, 350-354 (2013);Taleska, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 825-827 (2018).
[308] Hüffer/Koch/*Koch*, supra note 5, §101, Rn. 9-12, MüKoAktG/*Habersack*, supra note 5, §101, Rn. 30-60, Spindler/Stilz/*Spindler*, supra note 5, § 101 Rn. 49-81.
[309] Julia Redenius-Hövermann & Hendrik Schmidt, *Zur Unabhängigkeit von Aufsichtsratsmitgliedern - Überlegungen zur Einordnung und Definition des Unabhängigkeitsbegriffs*, ILF WORKING PAPER SERIES NO. 154/2018, 5 (2018).
[310] Activist Insight (in association with Schulte Roth & Zabel), *Shareholder Activism in 2019*, 6, 10 (January 2020). It is worth mentioning that most of the board seats won by shareholder activists in Europe have been won through contested vote, in contrast to the US, where most seats have been won through settlements. In 2019 shareholders activists have won half the board seats in European companies that they had won in 2018. So, there is a profound decrease in the board representation of shareholder activists in Europe.

that has appointed them. The exception is the case where the director is a hedge fund employee[311] or there is a golden leash agreement with the shareholder activist.

A golden leash agreement is a special compensation scheme agreed between a shareholder activist and a director. Their purpose is to align the director's incentives with those of the nominating hedge fund[312]. Stock-appreciation based terms make attractive serving in the board of a target firm[313]. On the negative side, the capture of a fraction of directors by such arrangements might promote shareholder value in the short-term, but at the expense of the long-term value of the company[314]. Also, the fact that the compensation is paid not by the company, but by a shareholder poses challenges for the fiduciary duties[315] and the independence[316] of the nominee director. This is why US firms have started adopting anti-activist terms in their articles of association[317] in the same way they had adopted anti-takeover defenses during 1980s.

Activist directors are appointed by minority shareholder activists holding less than 10% of the equity stake as result of compromise with target management. The negotiation power that shareholder activists have developed can be so high that the management is captured by them despite their low stake in the company. This is reflected in "standstill terms" included in the agreements[318]. Bound by these terms, shareholder activists are restricted to accumulate shares of the target firm after the completion of the agreement. In this way the contracting management attempts to secure its position in the target firm after the activist campaign has ended[319]. Their purpose is not always achieved as activist interventions are correlated with high CEOs'[320] and board chairs'[321].

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311 Coffee, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (ECGI) - LAW WORKING PAPER NO. 373/2017, 11 (2017).

312 G. H. Shill, *The Golden Leash and the Fiduciary Duty of Loyalty*, 64 UCLA LAW REVIEW, 1268-1271 (2017).

313 Gregory H. Shill, see id. at.

314 Anna L. Christie, *The new hedge fund activism: activist directors and the market for corporate quasi-control*, 19 JOURNAL OF CORPORATE LAW STUDIES, 30 (2019);J. C. Coffee, *Shareholder Activism and Ethics: Are Shareholder Bonuses Incentive or Bribes*, 29 THE CLS BLUE SKY BLOG (2013).

315 M. D. Cain, et al., *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 670 (2016).

316 Gregory H. Shill, *The Independent Board as Shield*, U IOWA LEGAL STUDIES RESEARCH PAPER NO. 2019-26, 27-29 (2020).Available at SSRN: https://ssrn.com/abstract=3454619.

317 Cain, et al., UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 671-678 (2016).

318 Bebchuk, et al., NBER WORKING PAPER NO. w26171, 6 (2019);Coffee, EUROPEAN CORPORATE GOVERNANCE INSTITUTE (ECGI) - LAW WORKING PAPER NO. 373/2017, 16 (2017).

319 Coffee Jr, et al., CORNELL LAW REVIEW, 395 (2018).

320 See D. DelGuercio, et al., *Do boards pay attention when institutional investor activists "just vote no"?*, 90 JOURNAL OF FINANCIAL ECONOMICS 84(2008);Yi Lin Wu, *The impact of public opinion on board structure changes, director career progression, and CEO turnover: evidence from CalPERS' corporate governance program*, 10 JOURNAL OF CORPORATE FINANCE (2004);Caroline Zhu, *The Preventive Effect of Hedge Fund Activism*, (2013).Available at SSRN: https://ssrn.com/abstract=2369533.

321 Bebchuk, et al., NBER WORKING PAPER NO. w26171, 30-31 (2019);Vyacheslav Fos & Margarita Tsoutsoura, *Shareholder democracy in play: Career consequences of proxy contests*, 114 JOURNAL OF FINANCIAL ECONOMICS, 321 (2014);Ian D. Gow, et al., *Consequences to Directors of Shareholder Activism*, HARVARD BUSINESS SCHOOL WORKING PAPER, NO. 14-071, 15 (2014).

The conclusion of an agreement with a shareholder activist and specific terms that ensure activists board representation at the exchange of standstill provisions can be an indication of management's capture by a shareholder activist. The activist does not need to have a high equity stake to align management's behavior with her incentives. Activists' power to exert influence does not rest in their equity stake but in their ability to initiate corporate governance changes at a low cost and with a positive market reaction. That is why the traditional perception of control must be revised. It must be disentangled by the element of equity stake and it must become more flexible in order to take into consideration the dynamic relationship that can be developed between shareholders and management under the prominent role of shareholder activists in corporate governance.

All in all, shareholder activists can exert controlling influence on the target company by concluding agreement with its management under the threat of a proxy fight. Directors that have business relationships with shareholders having controlling influence cannot be perceived as independent directors. Golden leash agreements establish a relationship of dependence between shareholder activists and activist directors. For all the above reasons, directors appointed by a shareholder activist in the context of a negotiated agreement between the activist and the target management cannot be perceived as independent, irrespective of the activist's equity stake.

On the regulatory level, the conditions created under the presence of shareholder activists call upon a revision and refinement of the definition of independence. This seems to be the view of market participants. With a qualitative analysis of the opinion letters of market participants in the context of the public consultation for the 2020 version of DCGK, I found out the following positions with respect to the independence requirements. The vast majority[322] welcomed the clarification that the independence requirement refers to the shareholders' representatives in the supervisory board. Especially labor unions were really satisfied with this addition that was already accepted by academics.

With regard to the independence requirement from controlling shareholders, several market participants refrained from opining about it. Most of the respondents seem to set the controlling influence threshold at 10% (Glass Lewis, Fidelity International). Some respondents, mainly foreign asset owners and managers, expressed their opinion about a lower threshold at 1-5% (1% advocated from Legal & General Investment Management, 3% from Pensions & Investment Research Consultants (PIRC), 5% from BMO Global Asset Management, Allianz Global Investors). Such an equity stake represents the usual stake of a shareholder activist.

A regulatory initiative of lowering the threshold of control must be complemented by a legal provision similar to the one about 13D filling in the US. In other words, it is highly suggested the introduction in the German legal regime of a disclosure requirement with

[322] Arbeitskreises deutscher Aufsichtsrat e.V. (AdAR), Deutscher Gewerkschaftsbund.

respect to the purpose of accumulating 3% or more of the outstanding shares of a company. Such a requirement will promote more transparency of shareholder activism in Germany and, thus, more informative market reactions to activist interventions.

CONCLUSIONS

Both institutional investors and hedge funds aim to increases in the shareholder value of the companies they invest in. These increases are achieved through corporate governance changes, among which changes in board structure and composition are the main objectives of shareholder activists. In most cases, activists seek either increases in the number of independent board members or their board representation. In both case scenarios, activists want to have a say on the identity of the appointed directors. They achieve this through settlement agreements they conclude with target management.

In the beginning, managers of targeted firms were hostile towards shareholders who attempted to change the status quo. They could afford such a hostile response because the risk of their removal by shareholders was minimal. With shareholder activists gaining reputation thanks to positive market reactions towards activist campaigns, the power dynamic between shareholder activists and target management changed. This evolution was exacerbated by the degree of collaboration between hedge fund activists and institutional investors. The collaboration between then cannot be easily characterized as "acting in concert". Therefore, even though they do not exert de jure control, their negotiating power is such, that we can talk about hedge fund activists' controlling influence on target management.

The fact that hedge fund activists own minority equity stakes renders necessary a revision of the concept of independence, as it is defined in the German Corporate Governance Code. The definition must be disentangled from the equity stake that a shareholder holds. On the contrary, qualitative criteria, such as the nature of agreements between shareholders and the management, must be taken into consideration, in order to evaluate the potential of controlling influence. This seems to be the opinion of large asset managers and owners, such as Allianz GI and LGIM.