GLOBALIZING TRUST?
TRANSFERRING ANGLO-AMERICAN MINORITY SHAREHOLDER PROTECTIONS TO CIVIL LAW GERMANY

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ABSTRACT

This paper critically examines the conventional view that the lack of fiduciary duty protections for corporate shareholders in civil law systems explains crucial differences in corporate structure and finance. It questions the thesis that the structure of civil law systems militates against the use of such residual doctrines. This thesis has been developed in a series of widely discussed articles by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (“LLS&V”) and is supported by their empirical study of investor protections in 49 countries. In their studies LLS&V have claimed that the weakness of minority shareholder protections, especially of fiduciary duty protections, explain why securities markets in civil law jurisdictions, such as Germany, France, and Italy have been relatively weak by comparison with common law jurisdictions. These findings have been widely cited. By comparing fiduciary duty protections in Germany and the U.S., with an eye to functional equivalents, this paper shows that neither a fairness deficit nor a literalism constraint can be attributed to civil law systems across the board. The paper shows that, contrary to what LLS&V’s data suggest, fiduciary duty protections are by now well-established in the German law of stock corporations.
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TABLE OF CONTENTS

I. INTRODUCTION.............................................................................................. 5

II. CAUSAL EXPLANATIONS FOR DIFFERENCES IN CORPORATE STRUCTURE AND FINANCE BETWEEN COMPARABLE NATIONAL ECONOMIES .................................................................................................... 10
A. Generally Recognized Differences Between Group I and Group II Countries .10
B. Three Causal Theories................................................................................. 13
   1. The Economic Theory of Corporate Structure and Finance .................... 13
   2. The Political Theory of Corporate Structure and Finance ........................ 14
   3. The Legal Theory of Corporate Structure and Finance ............................ 16

III. INVESTOR PROTECTION AND FIDUCIARY DUTIES IN GERMAN CORPORATE LAW .......................................................................................... 22
A. Formal versus Functional Equivalents......................................................... 22
B. The Codes of German Company Law ........................................................... 26
C. Directors and Shareholders......................................................................... 27
   1. Directors’ Duties and Liabilities in the Courts ......................................... 27
   2. What Causes of Action Do Shareholders Have? ..................................... 31
D. The Duty of Loyalty Among Shareholders as a Tool Against Minority Shareholder Expropriation and a Residual Doctrine of Equity ...................... 34

IV. LEGAL EXPROPRIATION AND JUDICIAL LITERALISM IN CIVIL LAW COURTS ........................................................................................................... 39
A. The Fairness Thesis..................................................................................... 40
B. The “Literalism Thesis” ............................................................................. 44

V. DOCTRINES OF EQUITY AND JUDICIAL DEVELOPMENT OF LAW IN
CIVIL LAW GERMANY ........................................................................................................ 51

VI. CONCLUSION ........................................................................................................... 56
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I. INTRODUCTION

Conventional wisdom has it that civil law systems are too rigid to accommodate fiduciary-duty like doctrines. Proponents of this view argue that fiduciary duty protections in common law courts significantly constrain expropriation of minority shareholders by managers and controlling shareholders. Fiduciary duty doctrine allows judges to sniff out subtle and shifting strategies of shareholder expropriation. In contrast, the comprehensive codification characteristic of civil law, on this view, gets in the way of more sophisticated forms of minority shareholder protection. Civil law judges are not supposed to go beyond the statutes and apply ‘smell tests’ or fairness opinions. Something inherent in civil law systems militates against the types of fiduciary duty protections that control agency costs in the U.S. system of corporate governance.

I show that this view is subject to question by describing the development of the doctrine of fiduciary duty in German corporate law. There is, by now, significant case law and a voluminous academic literature on duties of loyalty (Treuelpflicht) among shareholders of large publicly held corporations in Germany. German judges now universally

* Law clerk to the Honorable Thomas P. Griesa, United States District Court, Southern District of New York. I am grateful to Tom Heller, Michael Klausner, Bernard Black and Ron Gilson for discussing this paper with me. I’d like to thank Hanno Merkt, Patrick Leyens and Oliver Schroeder for their tremendous help in directing me to the German sources and for their comments. Daniel Halberstam, Erica Gorga, Jeff Gould, Kate Brown, and Mark West have read drafts and provided me with valuable comments.
recognize this residual doctrine – nowhere alluded to in the statute – as an important tool for minority shareholder protection.

In August of 2003, Der Spiegel reports, for example, that the German Supreme Court is poised to push this doctrine one step further in a highly publicized suit against the former CEO of Mannesmann and the current CEO of Deutsche Bank.\(^1\) The defendants allegedly engaged in a creatively structured payoff of senior Mannesmann management in order to overcome their opposition to the Vodafone merger. In this case the defense is arguing that management and their bankers did not violate any statutory provisions, while plaintiffs are arguing that defendants violated their fiduciary duties towards shareholders.

That fiduciary duties protecting minority shareholders exist in civil law systems, speaks to a broader thesis in contemporary corporate finance. In a series of widely discussed studies, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (LLS&V) claim to have empirically established that minority shareholder protections are stronger in common law than in civil law jurisdictions.\(^2\) They argue that superior investor protections account, at least in part, for the highly developed securities markets in common law countries such as the United States and the United Kingdom. Securities markets in civil law jurisdictions, such as Germany, France and Italy, have been relatively weak by comparison.

Legal systems, according to LLS&V, have a significant influence on the structure of corporate finance and, thereby, on the structure of large businesses organization. Minority shareholder protections explain the much greater prevalence of large publicly held corporations in the U.S. and the U.K. Broad public participation in equity markets sustains

\(^1\) Aktien-gegen Strafrecht, DER SPIEGEL, Aug. 24, 2003, at 54.
the U.S. Berle-Means type corporate structure, with its strong managers and widely dispersed shareholders. Such a corporate structure depends upon investors’ legal recourse against expropriation by management and by controlling shareholders – a feature that is weaker in civil law systems.

Among the legal mechanisms the authors regard as providing significant investor protection in common law jurisdictions are fiduciary duties owed by management to minority shareholders. In contrast, the absence of fiduciary duty type protections in civil law jurisdictions, LLS&V argue, is a critical deficit that helps explain the reluctance of minority shareholders to buy shares.

LLS&V’s claim that fiduciary duty protections in common law courts matter to corporate and financial market structure are being widely cited.

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3 La Porta, et al. (2000), supra note 2, 9. See also, Simon Johnson, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, Tunneling, 90 Amer. Econ. Rev. 22 (2000).
4 Id.
5 See, e.g., Bernard Black, The Core Institutions that Support Strong Securities Markets 55 Bus. Law. 1565, 1594 (2000) (“Common law courts have greater latitude to develop and apply vague fiduciary principles to the many guises in which self-dealing can occur.”); Edward B. Rock, Saints and Sinner: How Does Delaware Corporate Law Work? 44 UCLA L. Rev. 1009 (2xxx) (“Corporate law can be divided into two alternative and rather incompatible models. on one side there is the civil code, Germanic approach, which, with some significant parody, can be described as ‘anything not explicitly is permitted is prohibited.’ The second approach is the ‘enabling’ approach that characterizes Delaware law: Anything not explicitly prohibited is permitted, and the law mainly serves to save transaction costs by providing low-cost standard form contracts. Tracking this difference in character is a difference in judicial role: In Germany, the free-ranging, fact-specific, fiduciary analysis of Delaware is absent and utterly foreign to the corporate law sensibility.”); York Shnorbus, Tracking Stock in Germany: Is German Corporate Law Flexible Enough to Adopt American Financial Innovations?, 22 U. Pa. J. Int’l Econ. L. 541 (2001); Scott Mitnick, Note, Cross-Border Mergers and Acquisitions in Europe: Reforming Barriers to Takeovers, 2001 Colum. Bus. L. Rev. 683, 710 (“In the U.S. and the U.K., minority shareholders are protected from ex post expropriation by well-defined fiduciary duties; however, fiduciary duties differ throughout Europe. in Germany, there is no real tradition of fiduciary duties, and little opportunity for shareholders to enforce them through litigation.”); Kon Sik Kim & Joongi Kim, Revamping Fiduciary Duties in Korea: Does Law Matter in Corporate Governance? (working paper) http://www.ciaonet.org/conf/cip001/cip01k.pdf (2002), 4 (last visited October 17, 2002) (holding that “the most important concept in terms of legal protections (of investors)
Within the context of the international corporate governance debate the claim has potentially significant policy implications. It suggests, for example, that government intervention take the form of discretionary judicial enforcement of private law rights, rather than that of administrative regulation, enforcement and oversight by a centralized state agency.\(^6\)

In this paper I critically examine LLS&V’s thesis, that the lack of fiduciary duty protection in civil law systems, explains crucial differences in corporate structure and finance, and that there is something about civil law systems that militates against residual doctrines that give judges broad discretion to apply considerations of

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equity. By turning to German corporate law I show that LLS&V’s claims do not hold up.

In Part II I provide a rough sketch of three causal explanations for differences in corporate structure and finance between national economies. In comparing LLS&V’s legal explanation with two competing explanations for the differences in business organization between national economies with concentrated as opposed to dispersed shareholders, Part II also raises some questions as to the overall plausibility of LLS&V’s broader thesis.

Part III turns to the case of Germany to test the view that Germany lacks fiduciary duty protections. Part III shows that, in fact, there are a variety of functional equivalents to U.S. fiduciary duty protections in Germany law. Moreover, I identify and explicate a judicial doctrine of loyalty that is explicitly deployed as a residual principle for vindicating shareholders rights not specifically provided for in the code.

Part IV closely examines the conventional view that civil law systems suffer from a fairness deficit. I isolate two distinct claims in La Porta et al.’s articulation of this view. The first is the Fairness Thesis, which claims that in common law jurisdictions breach-of-loyalty actions significantly constrain the unjust expropriation of investors, and that civil law jurisdictions generally do not recognize such actions. The second is the Literalism Thesis, which claims that civil law courts are inflexible, and that the civil law’s rigid application of statutes thwarts investor protection. In light of what we learn from the case of Germany, a code exporting civil law system, I show that such a view is hard to maintain.

In Part V, I explore a well-entrenched German Civil Code doctrine of equity that has sometimes been cited as a legal source for the relatively recent duty of loyalty among shareholders of publicly held corporations: the doctrine of Treu und Glauben (BGB 242). The purpose of this discussion is not so much to establish the validity of such conceptual derivation, but rather to illustrate the significant role that
doctrines of judicial discretion have played, and continue to play, in the German civil law system.

Part VI concludes.

II. CAUSAL EXPLANATIONS FOR DIFFERENCES IN CORPORATE STRUCTURE AND FINANCE BETWEEN COMPARABLE NATIONAL ECONOMIES

In the following, I provide a rough sketch of how contemporary comparatists tend to explain the differences between corporate governance regimes in civil and common law systems. My account necessarily provides an incomplete picture and relies on stylized facts in its treatment of differing national systems of business organization and finance.

A. Generally Recognized Differences Between Group I and Group II Countries

LLS&V’s studies constitute an attempt to answer two related questions that have puzzled comparatists: Why do the United States and the United Kingdom have such highly developed securities markets, while other highly developed industrial nations like Germany, France and Japan do not? And why is the structure of corporate business entities so different in these two groups of countries?

In the United States and the UK, as LLS&V point out, the large publicly held Berle-Means corporation dominates. It has widely dispersed shareholders, who are largely passive, and strong managers, who exercise control over the deployment of corporate assets.

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7 Between July 1995 and June 1996, for example, Germany had 71 IPOs, France had 10, and the U.S. had 803. La Porta, et al., Legal Determinants, supra note __, 1137. See also, John C. Coffee, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 YALE L.J. 1, 55-56 (2001).

8 In 1994 France had 8 listed firms per million in population, Italy 4, Germany 5, compared to 36 in the U.K., 30 in the U.S. and 128 in Israel. La Porta et al., Legal Determinants, supra note __, 1137 (citing ENERGY MARKET FACT BOOK & WORLD DEVELOPMENT REPORT, 1996).

Globalizing Trust?

concentrated. Large block-holdings dominate in this second group of countries, with banks and other corporations holding significant blocks of shares. Especially in Germany publicly held corporations are rare and many of the very large companies are privately held.

Countries in which concentrated ownership of corporations prevails are sometimes distinguished as bank-centered systems. In such systems corporations are thought to rely on large financial intermediaries to finance their projects and to monitor management. In Japan, for example, the industry group or Kereitsu typically has a special relationship with a lead bank, which takes the primary role in putting together a syndicate to finance the Keiretsu’s ventures. In Germany, companies fostered special relationships with private commercial banks or Haushanken. Bismark curtailed the securities markets after scandals in the 1890’s and promoted bank lending through low discount rates by the German Reichsbank. Commercial banks thus played a significant role in German industrialization, and the German system is frequently called a bank-driven system. In contrast, the U.S. and the UK, where corporations get a significant chunk of their funding directly from private investors on the nation’s securities markets, are referred to as securities market based systems.

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11 Roe, supra note 10, 1927ff. This view has been somewhat revised. Large German corporations finance their projects through withheld earnings or by borrowing on international financial markets.


13 Richard Tilly, Banking Institutions in Historical Perspective: Germany, Great Britain and the United States in the Nineteenth and Early Twentieth Century, 145 ZEITSCHRIFT Fuer DIE GESAMTE STAATESWISSENSCHAFT [J. INSTITUTIONAL & THEORETICAL ECON.] 189-209 (1989); ALFRED CHANDLER, SCALE AND SCOPE.

14 Ronald Dore, STOCK MARKET CAPITALISM: WELFARE CAPITALISM. JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS 3 (2000). This distinction has received several qualifications, but is still helpful. For example, it is recognized that large German corporations finance many or most of their projects through retained earnings and
Each system of financing brings with it different monitoring structures. These have been much discussed in the literature. But there is still significant disagreement as to their operation and efficacy. Banks are thought to exercise oversight and control in bank-centered systems through a variety of mechanisms. Securities markets are thought to discipline managers in securities market based systems. Investor protection takes on great significance in market-based systems. Without protection against expropriation of their residual earnings fewer investors would invest, and equity markets would lose in efficiency.

Three competing explanations for these differences between systems with concentrated and dispersed ownership are readily distinguishable in the literature: (1) the economic explanation, (2) the political explanation, and (3) the legal explanation. Each gives a different causal explanation for the structural differences.

Cutting across these three explanations is also a difference in emphasis between those who stress efficiency and those who stress the path dependency of the structurally differential development of industrial organization in different national economies.

usually do not return to the equity markets for refinancing. Moreover, lending to U.S. corporations as a percentage of funds raised apparently no longer differs dramatically from lending in bank-centered systems.


16 Roe, supra note 10, 1927-1954.

17 F. ALLEN & D. GALE, COMPARING FINANCIAL SYSTEMS (2000). But see, La Porta et al., Investor Protection, supra note 2, 18 (arguing that “the classification of financial systems into bank and market centered is neither straightforward nor particularly fruitful”).

18 Bernard Black, The Core Institutions That Support Strong Securities Markets, 55 BUS. LAW. 1565, 1565-6 (2000) (“[T]here are two essential prerequisites for strong public securities markets. A country’s laws and related institutions must give minority shareholders: (i) good information about the value of a company’s business; and (ii) confidence that the company’s insiders (its managers and controlling shareholders) won’t cheat investors out of most or all of the value of their investment.”).
B. Three Causal Theories

1. The Economic Theory of Corporate Structure and Finance

The economic explanation tends to favor an evolutionary paradigm. Such observers frequently argue backwards from the success or persistence of a particular institutional structure to the efficiency factors that explain their evolution into such a structure.\(^\text{19}\) Depending on how the economic winds were blowing, this has sometimes rendered the Japanese “cooperative system” (before the crash of the early 1990s),\(^\text{20}\) and sometimes the U.S. “competitive system,” the end of history for corporate law.\(^\text{21}\) In favor of the U.S. Berle-Means type corporation it has been argued that liquid and deep securities markets were essential to financing the large industrial projects of mass production that characterized the development of the U.S. economy.\(^\text{22}\) But the very capital-intensive projects in German and Japan, for example, were financed by different mechanisms.\(^\text{23}\) One current argument in favor of

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\(^{20}\) For a favorable, but not messianic, view of the Japanese system, see RONALD J. GILSON AND MARK J. ROE, UNDERSTANDING THE JAPANESE KEIRETSU: OVERLAPS BETWEEN CORPORATE GOVERNANCE AND INDUSTRIAL ORGANIZATION (1993). But see, La Porta, et al., Investor Protection, supra note 2, 17 (stating that “In the 1980’s, when the Japanese economy could do no wrong, bank-centered governance was widely regarded as superior because, as Aoki and Patrick (1993) and Porter (1992) argue, far-sighted banks enable firms to focus on long term investment decisions …. [and] banks replace the expensive and disruptive takeovers with more surgical bank intervention …. In the 1090s, as the Japanese economy collapsed, the pendulum swung the other way. Kang and Stulz (1998) show that, far from being the promoters of rational investment, Japanese banks perpetrate soft budget constraints, overlending to declining firms that require radical reorganization. And according to Weinstein and Yafeh (1998) and Morck and Nakamure (1999), Japanese banks, instead of facilitating governance, collude with enterprise managers to deter external threats to their control and to collect rents on bank loans.”).


\(^{23}\) For example, as Coffee points out, the German Kaiser established an extremely favorable credit system for private banks, which effectively gave them unlimited credit through their ability to borrow from the German Central Bank. John C. Coffee, The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of
the adaptive advantages of the U.S. system to the current economic environment is that deep and liquid securities markets are required for the quick and inexpensive financing of capital-intensive high-technology ventures in an increasingly competitive global market.\(^{24}\) Defenders of the evolutionary economic approach argue that the globalization of national economies will force convergence of corporate structure, because national businesses exposed to international competition will need to tap into the international equity markets to lower their cost of capital and remain competitive.\(^{25}\) John Coffee, for example, believes that “as markets globalize and corporations having very different governance systems are compelled to compete head to head (in product, labor, and capital markets), a Darwinian struggle becomes likely, out of which, in theory, the most efficient [corporate] form should emerge dominant.”\(^{26}\) Assuming that there is a best corporate governance practice, some argue along these lines that governance structures of corporations around the world are converging on those of the U.S. Berle-Means corporations.\(^{27}\)

2. The Political Theory of Corporate Structure and Finance

The political theory of corporate structure and finance claims that capital markets in both the U.S. and Europe were significantly shaped by political forces. Mark Roe argues that the U.S. Berle-Means corporation is not the norm, as the economic evolutionists suggest, but the exception. The separation of ownership from control in U.S. corporations is, according to Roe, the result of government intervention in the financial

\(^{24}\) See, e.g., Hansmann & Kraakman, supra, note 20, 439; Ronald J. Gilson & Bernard S. Black, Does Venture Capital Require an Active Stock Market? 11 Journal of Applied Corporate Finance 37, 37 (1999) (arguing that "venture capital can flourish especially -- and perhaps only-- if the venture capitalist can exit from a successful portfolio company through an initial public offering (IPO), which requires an active stock market.").

\(^{25}\) Id..

\(^{26}\) The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 YALE L.J. 1, 3 (2001).

\(^{27}\) Hansmann and Kraakman, supra note 21.
markets on behalf of populist demands: “In the nineteenth century America systematically destroyed strong financial institutions,” because American voters historically tended to be intolerant of big government.28

Through an historical analysis of U.S. legislation on banking, mutual funds and insurance, Roe shows how the power of large banks and other large financial institutions in the United States were the object of a hostile populism from the 1890s to the 1980s.29 Congress responded by repeatedly breaking up large banks and thwarting their capacity to grow into large financial intermediaries.30 Congress prevented U.S. banks from functioning as universal banks in stark contrast with the German system, for example, where the large commercial banks are savings and loan institutions as well as investment banks. Through a variety of federal and state regulations investment companies (diversification requirements), pension funds (proxy rules), and insurance companies were also prevented from controlling the boards of publicly held corporations in the United States. In contrast, the three largest commercial banks in Germany frequently own enough shares to constitute a majority at the shareholder meeting. In addition, they control the proxy machinery. According to Roe, the fragmentation of financial intermediaries in the U.S. was the result of government intervention. The absence of large financial intermediaries forced corporations to seek out other sources of corporate finance and turn to the equity markets.31

30 The Glass-Steagal Act prohibiting universal banking in the U.S. provides just one example.
31 Id.
In Germany, Japan and France Roe similarly finds political forces at work that have had significant historical impact on the development of national financial systems. The German institution of co-determination, for example, which requires that large corporations fill half the seats on their supervisory board with employee representatives, originated in a postwar power-sharing arrangement between capital and labor in the coal and steel industry that was subsequently expanded to other industries. The so-called Montanmitbestimmung was to safeguard against another collusion between capital and right-wing militarists in commandeering industries essential to war production. In a thesis that some regard as too reductive Roe has also argued that the commitment to social democracy in Germany, France and Japan explains why large corporations in these countries are still generally privately held or owned by large blockholders.

3. The Legal Theory of Corporate Structure and Finance

Finally, LLS&V provide a legal explanation for differences between Group 1 (U.S. & U.K.) and Group 2 (Germany, France, Japan) countries. They argue that legal investor protections have a significant, if not determining, impact on the development of corporate and financial structures in a national economy. Superior investor protections account, at least in part, for the highly developed securities markets in common law countries such as the United States and the United Kingdom. Securities markets in civil law jurisdictions, such as Germany, France and Italy, have been relatively weak by comparison. This, in turn, is explained by insufficient legal protection of shareholders in civil law systems.

LLS&V thereby empirically challenge the standard Coasian approach that has prevailed in Delaware Corporate Law. Law and economics scholars have argued that regulation is largely superfluous (or

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33 Roe, Political Preconditions, supra note 28, 541 ("shareholders’ core problems in the public firm cannot be readily resolved in a strong social democracy").
worse) to achieving an efficient system of corporate finance, so long as contractual arrangements between sophisticated issuers and sophisticated investors are enforced by the courts.\footnote{EASTERBROOK & FISHEL; La Porta et al., \textit{Investor Protection}, supra note 2, 7.} Contradicting such assessment, LLS&V challenge the Coasian theory with empirical evidence that shows that “law matters.” Legal systems, according to their data set, have a significant influence on the structure of corporate finance and, thereby, on the structure of large businesses organization. Minority shareholder protections explain the much greater prevalence of large publicly held corporations in the U.S. and the U.K. Broad public participation in equity markets sustains the U.S. Berle-Means type corporate structure, with its strong managers and widely dispersed shareholders. Such a corporate structure depends upon investors’ legal recourse against expropriation by management – a feature largely absent in civil law systems.

LLS&V’s thesis puts forward specific conclusions about the relation between investor protections and the structure of corporations and financial markets within a country. It also includes a generalization across national economies explaining why some countries have better investor protections than others.

The more specific conclusions are that legal protections for small investors, and more particularly, for minority shareholders, are strongest in countries with widely dispersed shareholders. In contrast, countries such as Germany, France and Japan, where ownership tends to be more concentrated, have comparatively weak investor protections.\footnote{La Porta et al., \textit{Investor Protection}, supra note 2, 14 (“countries with poor investor protection typically exhibit more concentrated control of firms than do countries with good investor protection”); La Porta et al., \textit{Law and Finance}, supra note 2, 1116.}

LLS&V’s more general thesis is that legal differences in investor protection are due to more fundamental differences between common law and civil law systems. They claim that their data show that the
strength of investor protections depends, in part, on whether a jurisdiction has a common law or a civil law system.\textsuperscript{36}

The tension between these two theses emerges when one reflects on the practical implications of each. If specific legal rules mattered, that would counsel countries seeking to develop their securities markets to augment their legal investor protections and thereby reap the benefits that such equity markets offer. In contrast, if investor protection primarily depended on the legal system, we would be much more pessimistic about the success of such an approach.\textsuperscript{37}

LLS&V adopt the following explanation for their empirical findings that legal investor protections are critical to vibrant securities markets. Control rights (as opposed to the dividend or cash flow rights) acquire significant value in a legal environment where expropriation of shareholders is feasible on a substantial scale as a result of poor investor protections. Under such circumstances, the private benefits of control become the most important share of a firm’s value. This is so for several reasons: Ownership concentration is better able to take advantage of the private benefits of control than dispersed ownership; expropriation requires secrecy; the entrepreneur’s family may need to retain control of the firm because their reputation is needed to raise capital; dispersion of control among many investors means giving up the “private benefits” premium in a takeover, rendering dispersed ownership inherently unstable.\textsuperscript{38} LLS&V conclude that “the evidence has proved to be broadly consistent with the proposition that the legal environment shapes the value of the private benefits of control and thereby determines the equilibrium ownership structures.”\textsuperscript{39}

\textsuperscript{36} Id.
\textsuperscript{37} Katharina Pistor & Chenggang Xu develop this tension and draws precisely such a conclusion in \textit{Fiduciary Duty in Transitional Civil Law Jurisdictions}, (working paper), 1, 36 (arguing that “[in] Anglo-American law, fiduciary duty is the core legal concept to address conflicts of interest of directors/managers and shareholders,” but “may not be easily transplantable either to civil law systems or to transition economies.”).
\textsuperscript{38} La Porta et al., \textit{Investor Protection}, supra note 2, 13-14.
\textsuperscript{39} Id. 15.
In their study, which they publish and discuss in their articles *Law and Finance* (1998) and *Investor Protection and Corporate Governance* (2000), LLS&V conducted an inventory of the laws governing investor protection in forty-nine countries. They surveyed investor protection through shareholder and creditor rights, creating a composite index of shareholder rights and creditor rights they took to be the most significant. These measures were weighted, additionally, according to the quality of law enforcement in each jurisdiction, in order to create a data set that quantified differences in legal protections of investors in each country. LLS&V found significant differences among four types of legal systems, which they distinguish as the common-law system, the French civil law system, the German civil law system, and the Scandinavian system. Investor protection in countries that had adopted the French civil law system was least effective. Overall, civil law systems were found to have inferior investor protections than common law systems in the area of both shareholder and creditor rights.  

More specifically civil law systems had inferior minority shareholder protections, while, at the same time, they intervened more heavily in the private/economic sphere.

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<th>Common Law (18 countries)</th>
<th>French Civil Law (21 countries)</th>
<th>German Civil Law (6 countries)</th>
<th>Scandinavian Civil Law (4 countries)</th>
<th>World Average (49 countries)</th>
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<td>Antidirector Rights</td>
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*We leave the issue of creditor rights aside for the purposes of this paper.*
LLS&V’s index of anti-director rights purported to measure the level of protection offered in each country in six different categories of investor protection:

1) proxy voting by mail;
2) the absence of any requirement that shareholders deposit their shares prior to the general shareholders’ meeting in order to vote them;
3) cumulative voting or proportional representation;
4) the ability of shareholders to sue their directors or otherwise challenge in court the decisions reached at shareholders meetings;\(^{41}\)
5) the ability of ten percent or less of the shareholders to call an extraordinary shareholders’ meetings; and
6) shareholders’ pre-emptive rights to new issues.\(^{42}\)

While the U.S. ranks 5 out of 6, with 6 being the highest level of legal shareholder protection, Germany ranked 1 out of 6. I focus on the German case in examining more closely some of LLS&V’s results.

LLS&V place a great deal of emphasis on the “anti-director rights” they identify as the central factor distinguishing common-law from civil-law systems. But as John Coffee points out, these “strike many legal commentators as only tangentially related to effective legal protection for minority shareholders.”\(^{43}\) Coffee concludes that, while not unimportant, such rights were “only partial and sometimes easily outflanked safeguards.”\(^{44}\) So, for example, ratification under Delaware Law seems to undermine the efficacy of shareholders’ ability to take directors to court for duty of loyalty breaches. The Delaware ratification

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\(^{41}\) I here summarize what LLS&V call “Oppressed minorities mechanism[s]”, viz. company or commercial law that “grants minority shareholders either a judicial venue to challenge the decisions of management or of the assembly or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, asset dispositions, and changes in the articles of incorporation.” La Porta, *Law and Finance, supra* note 2, 1124.

\(^{42}\) La Porta, *Law and Finance, supra* note2, 1123.

\(^{43}\) 111 YALE L.J.1, 8 (2001)

\(^{44}\) 111 YALE L.J. 1, 82 n6.
procedure, which allows “disinterested shareholders” or non-conflicted board members to ratify conflicted directors’ transactions, shields even duty of loyalty violations from court review.  

Another example is proxy rights. While shareholders are able to vote by proxy in the U.S., thereby in principle encouraging broad participation by dispersed shareholders, there are significant draw-backs to the U.S. system, since the proxy machinery is controlled by management and shareholders are prevented by the SEC’s proxy rules from organizing and solving their collective action problems.

While only one of six factors in their anti-director index, LLS&V place special explanatory emphasis on the ability of shareholders in common law countries to bring suits against the corporation for violation of fiduciary duties. To be sure, the constraints placed on directors by the law of fiduciary duty are generally regarded as critical structural elements of the U.S. law of corporations. But the standards according to which courts police managements’ efforts to shield themselves from the disciplining power of the market for firms and to expropriate minorities during takeovers may make the greatest difference. These rules, however, could also be understood as rules that define a market for firms. When looked at this way, it is possible to ask whether more rigid rules, such as the proposed European mandatory bid rule (which serves the same purpose), would not better serve the purpose to stabilize such markets more quickly for those eager to benefit from the efficiency gains and greater transparency of management failures that such markets inherently produce.


46 A better measure of the protection of dispersed shareholders, according to Coffee, is whether “the dispersed shareholders have the capacity to block an incoming control seeker from acquiring control without paying a control premium.” 111 YALE L.J. 1, 82 n.6.

47 La Porta, Investor Protection, supra note 2, 9.

48 Conversation with Michael Klausner.
III. INVESTOR PROTECTION AND FIDUCIARY DUTIES IN GERMAN CORPORATE LAW

A. Formal versus Functional Equivalents

LLS&V largely focus on formally equivalent shareholder protections in different countries. They begin with rules that work a particular result within the U.S. institutional context in a particular manner (e.g., anti-director rights), and then search for similar rules in other countries.49 But such a “dry taxonomy” fails to appreciate both the path dependency of national governance institutions as well as their functional adaptivity.50

National economies differ in their starting points, which are determined by historical accident or political decision, and develop different governance rules as a result of path dependence.51 When institutions are added to a system in order to increase efficiency, they typically will be designed to increase the efficiency of existing institutions, which they must complement. While there has been considerable cross-fertilization in governance structures between Germany and the United States it is therefore unlikely that institutional solutions take precisely the same form.

One example of a functional equivalent is the once proposed European “mandatory bid” rule.52 Everyone agrees that minority shareholder protection is necessary for the development of a nation’s security markets. In the context of takeovers, such protection can be

49 The U.S. ends up with the highest score in the category of anti-director rights, whereas Germany ends up with the lowest score. La Porta et al., Law and Finance, supra note 2, 1130-31.
50 Ronald J. Gilson, Globalizing Corporate Governance: Convergence of Form or Function, 7-9, Working Paper, May (2000).
52 Gilson, supra note 50, 13.
achieved in different ways. In the U.S. the strict enforcement of fiduciary duty rules against self-dealing prevents management from compromising minority shareholder interests. The European Takeover Directive – though not enacted in this form – instead proposed a rule that would force acquirers to make a mandatory bid to all shareholders once they acquired a certain percentage of a company’s shares. Both rules function to prevent management and majority shareholders from stealing their share of the control premium from minority shareholders. But formally they have little in common. The U.S. rule constrains the actions of the target company’s management, whereas the proposed European rule was to constrain the actions of the acquirer.

Any treatment of fiduciary duties in German corporate law must, therefore, look to functional equivalents. It must disaggregate the senses in which the term is used and identify the purposes of the governance structure. It must further examine whether such purposes are indeed realized by existing rules.

As we shall see, German board members have specific duties towards the corporation and its shareholders. Such duties are provided for in the Stock Company Act and in a variety of other codes, such as, for example, the accounting requirements of the Commercial Code (HGB) and the protections of the Merger Code (Uebernahmegesetz).

Because shares of public corporations are much more concentrated in Germany, the threat of minority shareholder expropriation comes not so much from management, but from majority or influential shareholders, working in concert with management. Duties of loyalty thus appear in the case law in the form of a residual doctrine developed by judges. The duty of loyalty among shareholders (Treuepflicht) functions as a residual principle for

53 Henze, supra note ___, 489 (citing the ITT-Decision’s rationale for extending the duty of loyalty among shareholders (“Zudem verlangt auch hier insbesondere die fuer eine Gesellschaftermehrheit bestehende Moglichkeit, durch Einflussnahme auf die Geschaeftsfuerung die gesellschaftsbezogenen Interessen der Mitgesellschafter zu beeintraechtigen, als Gegengewicht die gesellschaftsrechtliche Pflicht auf diese interess en Ruecksicht zu nehmen.”)).
vindicating shareholders rights not specifically provided for in the code. This doctrine is intended to provide minority shareholder protection, insofar as such protection is not provided for by other means.

Shareholders also have certain statutory rights they can assert in court.

Practicing attorneys believe that, taken together, these protections address many of the same problems that U.S. corporate law addresses, albeit in a different manner.

As I will show, the example of Germany does not bear out LLS&V’s generalization that civil law countries lack a “residual concept” or doctrine that can confer discretionary authority on judges to protect investors.\(^5^4\) In a series of decisions, the German Supreme Court (BGH) has begun to enforce a fiduciary duty among shareholders of publicly owned companies.\(^5^5\) A significant legal literature has developed expounding the implications of the decisional law.\(^5^6\) Judge Henze, of the

\(^5^4\) The “general duty of loyalty is a residual concept that can include factual situations that no one has foreseen and categorized.” CLARK, CORPORATE LAW (1986), 141. Pistor & Xu, 2, (citing Clark and arguing that such residual concepts are virtually impossible to transplant to civil law jurisdictions).

\(^5^5\) “ITT”-Decision, BGHZ 65, 15, 18 (1976) (holding that fiduciary duty existed in the limited partnership (GmbH), because of the ability of a majority to prejudice the rights of a minority); “Linotype”-Decision, BGHZ 85, 350, 358, 360 (1988) (overturning “AUDI”-Decision and extending duty of loyalty recognized within partnerships to corporations); “Girms”-Decision, (xxxx find BGHZ cite) BGH, Urt v. 20. 3. 1995 – II ZR 205/94, ZIP 1995, 899 (z. V. in BGHZ bestimmt) (recognizing duty of loyalty among shareholders of a public corporation); Hartwig Henze, *Die Treuepflicht im Aktienrecht*, BETRIEBS-BERATER (BB), 51, 10, 489ff (July 3, 1996). [I here use the German citation format for cases and journal articles, because there is no point to blue-booking such citations. Should the reader wish to follow up on the citations, s/he will be hopelessly lost without the proper German citation format. The key to deciphering German legal citations is given by ______].

Supreme Court (BGH) writes that “[t]he duty of loyalty, the content of which consists in placing limits on the legal rights shareholders’ can exercise against the corporation, is today generally accepted as emanating from a doctrine of fiduciary duty in company law.”

How can a fiduciary duty among shareholders -- that limits shareholders’ legal rights -- curb management misbehavior? This question can only be answered once we understand the context of structural safeguards in German corporate law within which this fiduciary duty functions. In other words, I suggest that the German concept of fiduciary duty among shareholders is a functional equivalent of the U.S. doctrine, not a formal legal equivalent.

The German residual concept of loyalty [Treuepflicht] in corporate law focuses on constraining unduly influential shareholders. It thus only partially overlaps with the American concept of fiduciary duty.

The function of constraining management has been addressed in both structural and procedural features of the German system. One well-known structural feature of the German system is the two-tiered board system.

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57 Henze, supra note ___, 494.
58 Henze, supra note ___, 489 (citing the ITT-Decision’s rationale for extending the duty of loyalty among shareholders (“Zudem verlangt auch hier insbesondere die fuer eine Gesellschaftermehrheit bestehende Moglichkeit, durch Einflussnahme auf die Geschaeftsfuhrung die gesellschaftsbezogenen Interessen der Mitgesellschafter zu beeintraechtigen, als Gegengewicht die gesellschaftsrechtliche Pflicht auf diese interess en Ruecksicht zu nehmen.”)).
The German theory of the enterprise [Unternehmensbegriff] and of the legally defined “interest” of the enterprise [Unternehmensinteresse] are also frequently regarded as partial functional equivalents of the American fiduciary duty.\(^{59}\) (The doctrine of Unternehmensinteresse comprises what LLS&V refer to as the business purpose test.) As Guenther Teubner points out, the legally defined Unternehmensinteresse imposes constraints on management in response to the issues that arise from the separation of ownership and control in German business organization. The constraints are to be found both in the code, but also in the judicial and academic interpretation and development of the code that influences the application of German corporate law in the Courts.\(^{60}\)

\textit{B. The Codes of German Company Law}

Company law, the law of unions or associations to carry out commercial or industrial enterprises,\(^{61}\) falls under the German Law of Associations (Gesellschaftsrecht). The law of associations is conceptualized variously as the law of private cooperation, or the law of private associations for the pursuit of a common interest.\(^{62}\) There are many different legal forms for the organization of business enterprises in Germany. Just as the Partnership Codes, Limited Liability Company Codes and Corporations Codes are separately codified by the several states, German law does not systematize the law of associations within one code.

Rather the different legal forms of association are to be found either in separate codes, or are provided for within other codes.

The private limited liability company, or \textit{GmBH}, is provided for in a separate law (GmBHG) and the large joint stock company or \textit{AG} is


\(^{60}\) \textit{Id.}, 155.

\(^{61}\) BLACK’S LAW DICTIONARY.

\(^{62}\) KARSTEN SCHMIDT, \textit{GESELLSCHAFTSRECHT} 3 (1997).
provided for in the Stock Corporation Act of 1965 (AktG 1965). The GmBH is the most widely used legal form of the limited liability company, which accommodates small, medium-sized, as well as large business and industrial enterprises. It was first introduced by an Act of 1892, later amended in 1898. The Commercial Code (HGB) initially regulated the publicly held joint stock company, but in 1937 the Stock Company Act of 1937 was passed. Usually, only the largest industrial enterprises incorporate as an AG. While many AGs are publicly held and traded on the stock exchanges, some of are still closely held. Both the GmBH and the AG have independent legal personality.

--See Table 1--

**C. Directors and Shareholders**

1. **Directors’ Duties and Liabilities in the Courts**

   German corporate law clearly establishes fiduciary duties on the part of managers to the corporation. Section 93 AktG sets forth directors’ liability for duty of care violations, as well as for other illegal acts that overlap with those actionable as duty of loyalty violations under U.S. state law. As is characteristic not just of civil law codes, but also of codes such as the U.S. Securities Act of 1933, § 93 provides a specific list of acts that are proscribed, unless performed in such a manner as specifically permitted by the code. Directors incur personal liability

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63 HORN, et al., supra note 150, 240.
64 § 93(1) (“Die Vorstandsmitglieder haben bei ihrer Geschäftsführung die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters anzuwenden.”). Interestingly, the duty of confidentiality is given a very prominent place equal to that of the duty of care: “Über vertrauliche Angaben und Geheimnisse der Gesellschaft, namentlich Betriebs- oder Geschäftsgeheimnisse, die ihnen durch ihre Tätigkeit im Vorstand bekanntgeworden sind, haben sie Stillschweigen zu bewahren.” § 93(1).
65 § 93 AktG. Directors’ liability under § 93, however, appears to be directed at protecting creditors.
66 §93(3) (“Die Vorstandsmitglieder sind namentlich zum Ersatz verpflichtet, wenn entgegen diesem Gesetz . . .”). Section 5 of the 1933 Act, which start out categorically prohibiting the sale of all securities unless accompanied by a prospectus in § 5(a), and then creates numerous exceptions, provides a good example of this feature of codification in U.S. law.
for distributing dividends, repurchasing and distributing shares, disposing of corporate assets, conferring benefits on Supervisory Board members, or guaranteeing loans in violation of the express provisions of the statute. This approach contrasts sharply with the way in which the Delaware statute provides default rules that can be contracted around, and then relies on non-negotiable duty of loyalty principles to provide investors with recourse in court where directors abuse their control over corporate assets.

More generally, the primary duties of the Board of Directors of the Joint Stock Corporation are specified in §§ 76 – 78, § 88 and §§ 90-93 of the AktG. Section 76(1) AktG provides that directors are solely responsible for managing the day-to-day business affairs of the company. They do so jointly by unanimous vote or majority vote as specified in the statute. Section 77 AktG provides that the directors are responsible for managing the legal affairs of the corporation. Section 91(1) provides that the directors are responsibility for “keeping the books” and managing accounts. Section 88 prohibits directors from competing with the corporations’ business, from which requirement only the Supervisory Board can exempt directors in specific cases.

The duty of care articulated in § 93 has some bite in German corporate law in that there is no business judgment rule that automatically shields directors’ business decisions from judicial scrutiny. Moreover, the statute provides that defendant directors have the burden of proof. As we shall see, there are, however, other significant procedural hurdles to holding directors liable for fiduciary duty violations in a court of law.

\[\text{globalizing trust?}\]
Under the U.S. doctrine, the directors are considered the agents of the corporation. The corporation, however, is viewed as a nexus of contracts, with shareholders as the owners of the corporation and as the ultimate principals. While formally the directors owe fiduciary duty only towards the corporation, and a suit for a directors’ violation of fiduciary duty belongs to the corporation, individual shareholders can initiate such a suit “derivatively” on behalf of the corporation. Notwithstanding the fact that individual shareholders face significant procedural hurdles when suing on behalf of the corporation, they are not automatically barred from initiating such a suit. Individual shareholders can also file a class-action suit on behalf of other shareholders. They can seek injunctions or declaratory relief. Generally speaking U.S. investor protections, whether under fiduciary duty law, state and federal fraud provisions, the disclosure requirements of § 11 and § 12 of the 1933 Act, rely heavily on private suits to discipline managements.

In German law, suits by individual shareholders are contemplated under the Stock Corporation Act of 1965 only under very specific circumstances. Individual shareholders do not have a cause of action under § 93 for duty of care violations on the part of board members (Vorstandsmitglieder), nor do they have a cause of action under § 116 for duty of care violations on the part of the Supervisory Board members (Aufsichtsrat). Instead the Supervisory Board is charged with initiating suit on behalf of the corporation against Directors (Vorstand), and vice versa, the Board of Directors is charged with initiating suit on behalf of the corporation against members of the Supervisory Board.

As is well known, German corporate law relies on a two-tiered board structure to address many of the agency problems that arise in German corporate finance. The Supervisory Council was originally made

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71 Shareholders must first make a demand on the directors to sustain the suit, or else plead futility of demand. CLARK, CORPORATE LAW, 634.
72 § 112 AktG.
73 § 78(1) AktG.
up only of shareholder representatives, but since Co-Determination it also represents the interests of the employees of publicly held corporations with over 500 employees and of employees of corporations engaged in the mining, iron, or steel industry. Composed of outsiders, the Supervisory Council is intended to serve the function of a watchdog for the interests of shareholders and other stakeholders. In support of this watchdog function, the Stock Company Act thus places the responsibility for initiating suit against management into the hands of the Aufsichtsrat.

Two important qualifications are necessary. If the Supervisory Board balks, and the board of directors is equally unwilling to file suit against one of its own, a majority of the shareholders voting in favor of a suit, or a minority that comprises at least 5% of the share capital or a minority that owns at least 1 million Euro of shares, can appeal to a court pursuant to § 147 AktG for permission to file suit. The court will then assess whether such action is warranted. Section 147 AktG thus provides for a safeguard where the Aufsichtsrat is unwilling to file suit. There are, however, significant shortcomings with the shareholder suit under §147 that are connected with fee provisions. In Germany, as in most civil law countries, losers bear the cost of the entire lawsuit. Contingency fees are not allowed. So the plaintiff cannot share the risks of the lawsuit with attorneys. While the corporation is the plaintiff and the benefits of the suit accrue to the corporation, shareholders who force a suit and lose, bear the cost of the legal fees for both sides.

The second qualification is that Section 93(4) also gives individual creditors (but not shareholders) the right to sue for gross violations of managements’ duty of care and the “list” of actions prohibited in § 93 (3). This can be explained by the much greater

75 Zivilprozessordnung (ZPO) § § 91, 92.
76 § 147 AktG (stating an exception to the German rule that the party of the lawsuit bears the costs of the suit).
significance of debt in German corporate finance, and the importance that German limited liability law placed on creditor protections right from the beginning.

While management has duties of loyalty and care towards the corporation, these are generally not capable of being enforced by shareholders in the courts. LLS&V are right insofar as shareholders have limited access to the courts under German corporate law. This does not, however, mean that courts are somehow incapable of making fiduciary duty type assessments where the code does provide a cause of action against management or other shareholders. Nor does it prove that fiduciary duty as a residual concept of fairness is absent in German corporate law, or that directors have no legally enforceable duties towards the corporation that prevent expropriation.

2. What Causes of Action Do Shareholders Have?

Suits by shareholders are only contemplated under specific circumstances in the German Stock Corporation Code. As in the United States, direct suits by shareholders seeking to enforce the fiduciary duties of management are not contemplated in German law. In contrast to the U.S. system, however, shareholders in Germany additionally lack a general right to initiate suits on behalf of the corporation derivatively (or through a so-called action pro socio as it is referred to in the German literature). The Stock Corporation Act (AktG) provides individual shareholders with the following causes of action.

If the board refuses to act, the “Substitution Claim” [Ersatzanspruch], which we have already discussed, can be brought by shareholders holding 5% of shares (or shares valued at 1 million Euro) in the name of the corporation. The shareholders here stand in for the board. The corporation is the named plaintiff. Section 148 AktG then requires the court to appoint a representative of the corporation to

77 SCHMIDT, supra note ___, 651.
78 Raiser, supra note ___, 3.
79 § 117.
Globalizing Trust?

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prosecute the claim. The substantive claims that can be brought in this way, however, are limited: (1) claims against promoters; (2) claims against directors (§93) or members of the supervisory board (§ 116) for violation of their duties; (3) claims to recuperate damages on behalf of the corporation from persons who have illegitimately influenced management to act to the detriment of the corporation pursuant to § 117 (This latter provision is not much in use -- see below). 81

The most important statutory claim individual shareholders can assert is the “Challenge” or “Voidance” suit [Anfechtungs- und Nichtigkeitsklage], which permits shareholders to have a court declare a shareholder resolution void, including shareholder resolutions approving year-end financial statements (§ 256), the investment or distribution of profits (§ 254), capital increases (§ 255). 82 In order to challenge a resolution in court, the shareholder must (1) have attended the meeting and raised his objections to the resolution at the time of the meeting, or (2) must show that he was somehow illegitimately excluded from the meeting, whether through procedural shenanigans, such as lack of notice, change of meeting times, etc. 83 A Challenge Suit must be brought within a month of the shareholder resolution. 84 The corporation, but not the managers or the majority shareholder, are named as defendants. 85 A shareholder resolution can be challenged in case it violates the statute or the charter. 86 It can also be challenged – and this is more apposite for our present interests -- where any shareholder uses the vote to achieve an “unequal advantage” [Sondervorteil] for herself or a third party “to the detriment of the corporation or the other shareholders.” 87

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80 § 147 AktG
81 WOLFGANG ZOELLNER, KOELNER KOMMENTAR ZUM AKTIENGESETZ, VOL. 1 (1973) § 147 (1526).
82 §P 241-277. See also, SCHMIDT, supra note __, 648f.
83 § 245(1)-(2) AktG
84 § 246 AktG.
85 § 246 AktG.
86 § 243 AktG.
87 § 243 AktG.
Damages suits are available to shareholders only exceptionally pursuant to § 117 AktG and in certain cases where parent companies take advantage of subsidiaries. Section 17 grants a shareholder the right to sue a person who has intentionally instigated a board member or a supervisory board member to act to the detriment of the corporation or particular shareholders. A shareholder can only recover for damages she sustains independently of damages to the corporation. But she can’t sue for drops in stock price or other damages she individually sustains as a consequence of damage to the corporation as a whole. (That suit belongs to the corporation and the board asserts it under § 117.) The provision sounds primarily in tort and has been underutilized. It does, however, sound promising as the basis for shareholder suits against board members, according to one commentary.

Traditionally, the German law of joint stock corporations rejected shareholder suits that went beyond the claims described above and explicitly contemplated by the statute. Since the “Holzmueller” Decision, however, the BGB has been willing to entertain additional claims for injunctive, declaratory and damage relief where the board intrudes on shareholder democracy. And in the Linotype Case the BGH recognized a shareholder suit to stop a parent company from stripping a subsidiary of a major corporate opportunity by voiding a shareholder resolution that ratified the decision, citing a violation of the duty of loyalty among shareholders. The development of such fiduciary duty type judicial inquiries is now a vibrant issue in the German legal community and in the courts.

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88 §§ 309(IV), 319(V), 317(IV), 323(I). See also, Raiser, supra note ___, 3.
89 WOLFGANG ZOELLNER, KOELNER KOMMENTAR ZUM AKTIENGESETZ, VOL. 2 (Dec. 1999), § 117 (667).
90 Id., § 117 (660).
91 Raiser, supra note ___, 3.
92 BGHZ 83, 122ff (date). See also, Raiser, supra note ___, 4. In the U.S., the Blasius, Unitrin, and Apple Bankcorp line of cases addresses management interference with the shareholder vote. These are not straightforward fiduciary duty cases, but also shift the burden to prove valid exercise of their business judgment onto management in the face of a shareholder suit.
D. The Duty of Loyalty Among Shareholders as a Tool Against Minority Shareholder Expropriation and a Residual Doctrine of Equity

In the by now voluminous debate about fiduciary duty in German corporate law, scholars (including judges) cite a line of cases repudiating the AUDI/NSU decision that Johnson, La Porta, Lopez-de-Silanes and Shleifer rely on in their article on Tunneling as evidence that fiduciary duties are not recognized in the German law of publicly held stock corporations.

In their Tunneling article, in contrast, Johnson et al. cite the AUDI/NSU case (1976) as an example for the lack of fiduciary duties on the part of controlling shareholders in the German system. In the AUDI/NSU case the controlling shareholder of AUDI, which was Volkswagen (75% of all shares), bought up a small equity stake of a minority shareholder of Audi for DM 145 per share. The price was based on a valuation provided by VW. Two weeks later, VW bought up a very large (14%) stake in AUDI by the British-Israeli Bank for DM 220 per share. The German BGH held at the time that VW, the controlling shareholder, did not owe any duty of good faith or loyalty to the minority shareholder.

In order to understand the development of the case law on fiduciary duty in German corporate law, we need to pause and briefly turn to conceptual foundations.

In agency law, the doctrine of fiduciary duty specifies the duties of the agent to his or her principal. The agent is charged with carrying out the principal’s purposes and has discretion in doing so. Fiduciary duty binds the agent and places constraints on the capacity of the agent.

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93 Supra note 3.
96 Johnson, et al., supra note ___, 25.
to harm the principal. The basic principle of fiduciary duty is that when acting within the scope of the agency relationship, the agent must at all times act in solely in the interest and for the benefit of the principal.\footnote{General Automotive Manufacturing Co. v. Singer, 19 Wisc.2d 528 (1963) (agent has “fiduciary duty to act solely for the benefit of the principal”).} Fiduciary duty in corporate law, though giving rise to different specific responsibilities, is still conceived on the model of the principal-agent relationship. The principal-agent relationship, in turn, is a relationship between individual A and individual B. This is the kind of relationship that Brandeis described as the paradigmatic focus of the common law – a focus, which he, however, viewed as inadequate to the demands of complex modern society.\footnote{International News Service v. Associated Press, 248 U.S. 215, 262-63 (1918 (Brandeis, J., dissenting).}

In contrast, German civil law conceives of loyalty (\textit{Treue}) in civil associations according to a different paradigm. Here loyalty is to the company or group. \textit{Treuepflicht} is a reciprocal obligation among the members of a group. As one scholar put it, “[t]he root of the such loyalty formation is membership (in an association), by which membership the shareholder legally subordinates himself to an indeterminate influence (of the group).”\footnote{Zoellner, ZHR 161, 235, 237 (1998); see also, Lutter, ZIP (1998) (“Grundlage ist die Mitgliedschaft in der Gesellschaft als allseitiges Rechtverhaeltnis.”).}

\textit{Treuepflicht}, moreover, conceived of as a personal relation (or \textit{Bindung}) among members of a group. It makes sense to speak of a relation of loyalty between partners or between family members who own a close corporation. Duties of loyalty among members of civil partnerships (\textit{Personengesellschaften}) have accordingly long been recognized in the German law of partnership. \textit{Treuepflicht} among shareholders is therefore sometimes justified by reference to § 705 of the Civil Code (BGB), which provides for reciprocal obligations among partners who “bind themselves mutually to promote the attainment of a common object in the manner specified by the (partnership) contract.” Such foundation seems inapposite, however, when applied to widely
dispersed shareholders. Shareholders in the large public corporations are not expected to participate in management, but to be passive, neither exerting themselves on behalf of the corporation, nor having the duty to refrain from competing with its activities. It is thus easy to see why, given the foundation of the concept of loyalty in the idea of an “interpersonal cooperative working community” (*personenbezogene Arbeitsgemeinschaft*) in the words of one judge, no duty of loyalty was recognized among shareholders of an AG. The AUDI/NSU decision was based on precisely this view. And such understanding was also the reason for the failure to provide for a duty on the part of shareholders to promote the ends of the corporation in the AktG of 1965 to mirror the provision of such duty in BGB § 705 with regard to the civil partnership. Nevertheless, fiduciary duties in German company law— including, more recently, in the law of public corporations -- are conceived of in terms of membership relations. Loyalty, therefore, does not run from director to shareholder, but from shareholder to shareholder.

While the duty of loyalty was not initially accepted among shareholders of an AG, it was more readily extended to shareholders of a GmBH. In the ITT decision (1976), reached only eight months prior to the AUDI/NSU decision, the BGH affirmed that the duty of loyalty among shareholders within a limited liability company (GmBH). The court explained that the duty of the controlling shareholder to refrain from prejudicing the interests of the minority arose out of a corresponding ability of the controlling shareholder to exert its control on management.

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102 *Id.*, 489.

103 Henze, *supra*, note ___, 489.
In 1988, the BGH overruled the AUDI decision in Linotype (1988). Linotype recognized the duty of loyalty (Treu pflicht) among shareholders of a publicly held corporation (AG). In the Linotype case, a limited liability company, Linotype, tried to merge one of its subsidiaries, the D. Stempel AG, into itself. D. Stempel was a publicly held corporation, but Linotype was not. Instead of using the statutory merger procedure, which, at the time, required the assent of all shareholders, Linotype liquidated the subsidiary and transferred the subsidiaries assets and operations to itself. Linotype held 96% of the shares of D. Stempel, and minority shareholders held 4%. One of the minority shareholders of D. Stempel brought suit, challenging the resolution to liquidate the company and complaining that Linotype had abused its voting privileges.

The BGH held, for the first time, that a duty of loyalty obtained between shareholders of a publicly held corporation. Linotype, as a shareholder of D. Stempel, had violated the duty it had towards the other shareholders. The court also held that the burden of proof did not necessarily rest with plaintiffs. While the court reaffirmed its refusal to engage in substantive review of resolutions to liquidate a company, it did remand to the court below to seek further clarification regarding the alleged transfer of assets in anticipation of the liquidation. (Presumably the burden to prove the legitimacy of the transaction now rested with the defendant parent company, Linotype.).

In the Linotype decision -- and in several other decisions that affirmed and circumscribed the duty of loyalty among shareholders of a publicly held corporation (AG) -- the BGH suggested that it would no longer look to the legal form of a business company to determine

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104 BGHZ 103, 184, 194. The decision has generated a large body of commentary. See, e.g., Kort, ZIP 1990; Lutter, ZHR 153 (1989) 446; Hueffner, FS Steindorff 1990, 59.
106 § 369(II) AktG.
107 §243 AktG.
whether such duties obtained. (In the past, could only provide the basis for a claim in the case of partnerships or limited liability companies.)

Citing Linotype the BGH went even further in the Girmes decision. In Girmes, the BGH announced what seemed like an odd duty of loyalty to those familiar with the common law doctrine: a duty of loyalty among shareholders, including that of a minority shareholder to the majority. In Girmes, a minority shareholder was able to muster sufficient votes to block a financial reorganization of a publicly held corporation (AG) that was on the verge of bankruptcy. The reorganization required a recapitalization that denied existing shareholders subscription rights and reduced their equity in the company. When the reorganization was blocked, however, management declared bankruptcy and the company’s shares, which had been valued at around $43 at the time the reorganization was announced, became worthless. Plaintiff shareholder, who had voted in favor of the reorganization, brought a suit for damages against the shareholder who had blocked the reorganization plan.

The BGH held that minority shareholders had a duty of loyalty -- just as majority shareholders did -- to use their (legal) ability to influence the corporation with proper regard to the interests of the other shareholders. The Court declared that the minority shareholder had violated such duty by convincing other shareholders to permit him to vote their shares in the action to block reorganization. The minority shareholder was, therefore, held liable for the resulting damages to the corporation.

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110 Id.
111 Id., 1740.
112 Id., 1739.
113 Id., 1740.
E. The Protection of Minorities in the Law of Groups [Konzernrecht]

As Klaus Hopt and others have pointed out, the real difficulties of extending the doctrine of loyalty among shareholders to the law of joint stock corporations and of addressing conflicts of loyalties arises in the context of the law of groups of corporations.\textsuperscript{114} German law was quick to recognize the special relationships between parent companies and subsidiaries and dedicates a separate chapter of the AktG to the law of conglomerates or Konzernrecht. While German law was concerned with the rights of subsidiaries (and their shareholders), it did “acknowledg[e] the economic reality of the group and giv[e] preference to the interest of the group beyond the interest of the single members.”\textsuperscript{115} Scholars are now reconsidering that approach and are considering how the recently established doctrine of loyalty in joint stock corporation law should be integrated with and relied upon to revise the law of company groups.\textsuperscript{116}

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<Section on Konzernrecht to be completed>

IV. LEGAL EXPROPRIATION AND JUDICIAL LITERALISM IN CIVIL LAW COURTS

In their explanation of the observed legal systems, LLS&V put forward two basic arguments, which I will call the Fairness Thesis and the Literalism Thesis.

The Fairness Thesis consists of two propositions. The first holds that the doctrine of fiduciary duty in common law courts significantly constrains managers and controlling shareholders. This is largely assumed by LLS&V, though it is not an uncontroversial assumption. The second part of the Fairness Thesis is the empirical claim that civil


\textsuperscript{115} Hopt, \textit{supra note ___}, 311.

\textsuperscript{116} \textit{See, e.g.}, Zoellner, \textit{supra note ___}.
law systems have no law corresponding to the common law of fiduciary
duty. As we have seen by looking at German case law and legal writing,
this view needs to be significantly amended.

The Literalism Thesis refers to the assumptions about the rigidity
of the common law and holds that civil law judges are literalists. The
civil law system’s codification of private law binds the civil law judge
and renders their decisions inherently inflexible. Civil law courts are
therefore incapable of innovating, developing a case law that uses the
law creatively, and administering complex, fact-specific standards such
as the common law doctrine of fiduciary duty.

A. The Fairness Thesis

In the article on Tunneling Johnson et al. have laid out their
arguments about fiduciary duty in greater detail.\footnote{Supra note 3.}
Tunneling refers to
“the transfer of resources out of a company to its controlling shareholder
(who is typically also a top manager).”\footnote{Johnson, et al., supra note 3, 25.}
Tunneling therefore covers
what U.S. law would call fiduciary duty violations or outright fraud or
theft.\footnote{Interestingly, LLS&V do not interrogate the distinction between fraud and outright
theft on the one hand, and violations of fiduciary duty on the other. They simply
conclude that outright theft or fraud “is illegal everywhere,” upon which it drops out in
their This presumably closes the issue. However, the relation between the fraud and
fiduciary duty violation in different legal systems might make a significant different in
drawing conclusions about investor protection. If what constitutes fraud, for example,
is defined more broadly in civil law countries, and some of what is actionable only as a
fiduciary duty in common law countries, is actionable only as criminal fraud in civil
law countries, then such protection would escape the radar of LLS&V’s comparison of
investor protections. Indeed, this suggestion is not pure speculation, as civil law
systems use criminal sanctions to cover a broader range of actions than common law
countries. Cite.} Tunneling is achieved through self-dealing transactions by
directors (favoring themselves and/or the controlling shareholders), or
the expropriation of corporate opportunities. The paper focuses on
“asset sales, contracts such as transfer pricing advantageous to the
controlling shareholder, excessive executive compensation, loan
guarantees, expropriation of corporate opportunities.”120 It concludes that substantial tunneling takes place in developed countries, that much of it is legal,121 and that there are “some potential differences between civil- and common-law countries in how courts approach tunneling cases.”122

Legality (of tunneling) is defined in the paper as meaning “consistent with both the statutes and the basic principles followed by judges.”123 The paper focuses on “how the courts allow tunneling,”124 but does not discuss statute in any detail. Based on evidence from what the authors take to be representative cases of tunneling from the civil law jurisdictions of France, Italy and Germany, the authors claim to have established that:

“[i]n civil-law countries, the expropriation of minority shareholders by the controlling shareholder in a transaction with a plausible business purpose is often seen as consistent with directors’ duties, especially if the controlling shareholder is another firm in the group. Self-dealing transactions are assessed in light of their conformity with statutes, and not on the basis of their fairness to minorities. In contrast, fairness to minority shareholders as a broad principle going beyond statutes is central to the analysis of self-dealing transactions by common-law courts, and the burden of proof in such cases is favorable to outside shareholders.125

Before we go any further, it is worth pointing out the following problem with JLL&S’s argument. If fiduciary duty is judicially developed doctrine that cannot be found in the statutes, and if LLS&V believe that German law is thoroughly code based, then looking for a functional equivalent to the American doctrine in civil law without thinking about

120 Johnson, et al., supra note 3, 23.
121 Id., 26.
122 Id., 26.
123 Id., 26.
124 Id., 26.
125 Id., 23.
126 Id., at 26.
how the different provisions of the civil law might work together systematically to produce similar results seems like a fools journey.

Another way of putting my criticism of the methodology deployed by JLL&S is to emphasize the importance of looking for functional equivalents in comparative law. It is trivially true that civil law assesses self-dealing in light of statutes, rather than in light of fairness – if by “fairness” we narrowly mean the formal “fairness analysis” deployed by U.S. common law courts to adjudicate breach of loyalty violations. JLL&S contrast the fairness analysis done by U.S. courts with the business judgment analysis done by civil law courts. But some clarity is here required as to the use of these terms. There may be no formal equivalent in civil law to the common law fairness inquiry into conflicted directors’ transactions. But there are, as we have seen, functional equivalents to breach of loyalty actions. Such functional equivalents make use of a civil law business purpose test. The civil law reliance on business purpose, therefore, does at least to some extent protect shareholders from tunneling and contributes to “fairness” in the broader evaluative sense of the term.

In U.S. corporate law, the significance of the “business purpose” concept has been largely eviscerated and carries no punch. The

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127 See, e.g., A.P. Smith Mfg. Co. v. Barlow, 13 N.J. 145, 98 A.2d 581, *appeal dismissed*, 346 U.S. 861 (1953) (holding that directors’ donation of corporate funds to Princeton University did not need to be directly related to an immediate business purpose); Shlensky v. Wrigley, 95 Ill.App.2d 173, 237 N.E.2d 776 (1968) (dismissing minority shareholders’ complaint against director/controlling shareholder of Wrigley field that directors’ refusal to install lights, “not because of interest in the welfare of the corporation but because of his personal opinions ‘that baseball is a ‘daytime sport’ and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood,’ constituted mismanagement, waste of corporate assets, and failure to pursue the interests of the corporation.”). *But see*, Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919) (holding that Henry Ford’s refusal to pay dividends to minority shareholder Dodge brothers and instead to reinvest profits solely for the humanitarian end of spreading wealth to workers constituted a violation of the business purpose of the corporation, which “is organized and carried on primarily for the profit of the stockholders.”). *See also* the corporate control cases on business purpose.
business judgment rule and the rather insignificant business purpose test are not the same, though they are related. Where, for example, shareholders have complained that corporate directors have spent corporate resources without a business purpose, courts have typically responded that what is or is not a business purpose is largely a matter of discretion left to the directors of a corporation and thus falls under the business judgment rule.\textsuperscript{128} An argument about business purpose is thus not one likely to be won by a complaining shareholder.\textsuperscript{129} Proof that directors’ actions on behalf of the corporation did not constitute a valid exercise of their “business judgment” falls on plaintiffs, turning the business judgment rule into a shield against court review and directors’ personal liability in most cases that do not constitute violations of directors’ duty of loyalty.

The authors themselves point out in an aside that transactions usually protected by the business judgment rule, such as empire building and other benefits to insiders, decisions on executive compensation and most takeover defenses are “[n]ot surprisingly…the areas where the abuse of minority shareholders in the United States is perceived to be significant.”\textsuperscript{130} There is nothing fair to minority shareholders about such abuses in the broader evaluative sense of the term “fair”, but this alone will not subject them to a fairness analysis as a fiduciary duty violation.

To conclude, therefore, that courts in civil-law countries may accommodate more tunneling than courts in common-law countries in part because of “a narrower application of the duty of loyalty largely to transactions with no business purpose,”\textsuperscript{131} is potentially misleading.

\textsuperscript{129} The business judgment rule thus functions as a strong defense against shareholder suits. It does so doubly, because the decision whether or not to maintain a derivative suit, which provides a significant venue for minority shareholders’ access to justice, is itself subject to the business judgment rule and the fairness inquiry by a court that would be entertained at trial can itself be addressed procedurally by the board, by setting up an independent board to decide whether or not the corporation should entertain the suit.
\textsuperscript{130} Johnson, et al., \textit{supra} note 3, 23.
\textsuperscript{131} Id., at 24.
GLOBALIZING TRUST? 44

unless we also understand what the concept of business purpose entails in the particular civil law jurisdiction. The appropriate question to ask is, therefore, whether or not the business purpose test serves a real disciplining function in civil law systems.\textsuperscript{132}

A separate question pertains to JLL&S’s interpretation of the case law. As we have seen, there are significant oversights in their presentation. LLS&V do not examine the code for possible functional equivalents to fiduciary duty analysis. In order to engage in a proper comparative legal analysis, however, we should interrogate the German code for statutes that authorize a fiduciary type judicial intervention on behalf of shareholders.

\textbf{B. The “Literalism Thesis”}

According to John Coffee, the tendency of civil law countries to disrupt markets might plausibly be explained, at least in part, by certain features of the civil law system. Coffee produces two distinct arguments to back up this thesis.

The first argument suggests that the comprehensive codification of the private law in civil law countries tends “to crowd out the possibility for local variation, experimentation, or adjustments to changed circumstances.”\textsuperscript{133} This conclusion is drawn from the following

\textsuperscript{132} Johnson et al. make a mess of this simple question. I challenge the reader to interpret the following sentence: “The duty of care may allow a transaction that benefits insiders at the expense of outside shareholders unless the latter can show that it does not have a legitimate business purpose and that its sole intent is expropriation.” \textit{Id.}, at 23.

\textsuperscript{133} Coffee, \textit{supra} note 26, 62. (citing ARTHUR VON MEHREN, THE CIVIL LAW SYSTEM (1957), JOHN MERRYMAN, THE CIVIL LAW TRADITION (1969)). See also, MIRJAN DAMASKA, THE FACES OF JUSTICE AND STATE AUTHORITY (1986) (emphasizing the difference between a civil law “hierarchical” judiciary, charged with implementing state policy and a common law “coordinate judiciary” which sees itself as an independent branch of government charged with dispute resolution.), and Klaus J. Hopt, \textit{Self-Dealing and use of Corporate Opportunity and Information: Regulating Directors’ Conflicts of Interest}, in HOPT &GUNTER TEUBNER, CORPORATE GOVERNANCE AND DIRECTORS’ LIABILITIES, 295-96 (1985): “From a comparative law point of view it is interesting to see that some jurisdictions, particularly in the United States and Great Britain, have a highly developed doctrine of corporate opportunity and a very rich case material, while others
two premises. First, the civil law’s codification of private law introduces “bright-line and prophylactic rules” into private law, “that leave less room for flexibility or innovation.”\textsuperscript{134} A second premise states that the civil law’s practice of systematizing legal rules in a code is driven by “an effort to eliminate all gaps in the law [thereby] to minimize opportunities for judicial discretion.”\textsuperscript{135} LLS&V also rely on these propositions, as we shall.

Coffee’s second argument is that “the civil law is inherently interventionist and ‘policy-implementing,’” as opposed to the common law system’s “dispute resolution” approach.\textsuperscript{136} The heavy hand of civil law governments is somehow inscribed into its very law. Coffee does not tell us how to make this connection. He does suggest, however, that civil law systems are centralizing and contrast with “the ease and thoroughness with which [the common law] accepted private ordering mechanisms for commercial disputes.”\textsuperscript{137} We might supplement Coffee’s argument by recalling that the codification in France and in Germany were efforts to create equal rights and obligations throughout what had previously been multiple, dispersed jurisdictions with different laws. Germany and France did so to unify their nations, and, in the view of some scholars, to make what were previously opaque local structures like Germany have just a few cases or like France do not even know the doctrine. Indeed, a recent French doctor thesis found out that there was just one case ad there the court considered the use of the corporate opportunity by the director to be perfectly legal. The reasons for this discrepancy are complex and speculations about them are going right to the roots of comparative law...The reasons are probably to be found in a socio-legal mix of conditions which are different in the various countries. One of the main reasons is certainly the development of the idea of trust in Anglo-Saxon law and its application to corporations. Its lack in continental laws is a major handicap for German, French and other corporation laws to get a grip at the specific problems of modern public corporations. Another reason may be the different emphasis on statutory or case law. The legislator may think more of how to solve the big problems and may tend to neglect or overlook more detailed ones, while the courts will answer the problems brought before them.”

\textsuperscript{134} Coffee, \textit{supra} note 26, 62.

\textsuperscript{135} \textit{Id.}

\textsuperscript{136} \textit{Id.}

\textsuperscript{137} \textit{Id.}
GLOBALIZING TRUST?

transparent and surveyable to a centralized state bureaucracy. In Germany, for example, the Civil Code (BGB), which was over 20 years in the making and introduced in 1900, replaced a confusing and fragmented array of different legal systems. The German Civil Code “completed the unification of the modern German State . . . . putting an end to the existing fragmentation of the legal system.”

Citing an earlier paper by Coffee (as well as an article by Johnson, La Porta, Lopez-de-Silanes and Andrei Shleifer), LLS&V build on this view in their explanation of the civil law deficit in investor protection.

The “judicial” explanation of why common law protects investors better than civil law has been most recently articulated by Coffee (2000) and Johnson et al. (2000b). Legal rules in common law systems are usually made by judges, based on precedents and inspired by general principles such as fiduciary duty or fairness. Judges are expected to rule on new situations by applying these general principles even when specific conduct has not yet been described or prohibited in the statutes. In the area of investor expropriation, also known as self-dealing, the judges apply what Coffee calls a ‘smell test’, and try to sniff out whether even unprecedented conduct by the insiders is unfair to outside investors. The expansion of legal precedents to additional violations of fiduciary duty, and the fear of such expansion, limit the expropriation by the insiders in common law countries. In contrast, laws in civil law systems are made by legislatures, and judges are not supposed to go beyond the statutes and apply ‘smell tests’ or fairness opinions. As a consequence, a corporate insider who finds a way not explicitly forbidden by the statutes to expropriate outside investors can proceed without fear of an adverse judicial ruling. moreover, in civil law countries courts do not intervene in self-dealing transactions as long as these have a plausible business purpose. The vague

138 See, e.g., JAMES SCOTT, SEEING LIKE A STATE (1998).
139 B.S. MARKENSINIS, THE GERMAN LAW OF OBLIGATIONS, VOL. II, 21-22 (1997) (noting that “Voltaire’s quip, that in his time in France one changed one’s law as often as, when traveling, a man changed his horse, thus applied to Germany as well.”).
140 Id., 21.
GLOBALIZING TRUST?

fiduciary duty principles of the common law are more protective of investors than the bright line rules of the civil law, which can often be circumvented by sufficiently imaginative insiders.\textsuperscript{141}

In LLS&V’s view, the civil law is rigid and deploys bright-line rules that limit judicial discretion. Bound by such fixed rules civil law judges are unable to intervene on behalf of shareholders.\textsuperscript{142} Presumably this is because the rule created by legislatures is too removed from the concrete realities of corporate transactions to get a grip on the critical differences between a merely efficient transaction that must be tolerated by the minority and an unfair expropriation that will be redressed.\textsuperscript{143} Alternatively, the nature of such conflicts might be too case specific and indeterminate for the formulation of any general rule. (Why this is so for the corporate law of fiduciary duty, but not for, say, employment law, is not self-evident.) On this view, expert courts such as Delaware’s Chancery are needed, because its judges can develop the knowledge and experience to “sniff out” fiduciary violations.

LLS&V similarly suggest that civil law judges lack the imagination of common law judges and are strapped to their code. Where common law judges “are expected to rule on new situations by applying . . . general principles even when specific conduct has not yet been described or prohibited in the statutes,” civil law judges are

\textsuperscript{141}LLS&V (2000), supra note 2, 9 (citing J. Coffee, Privatization and Corporate Governance: The Lessons From Securities Market Failure, Working Paper No. 158, Columbia Law School, New York (citing S. Johnson, R. La Porta, F. Lopez-de-Silanez & A. Shleifer, Tunneling, 90 AMER. ECON. REV. 22 (2000)). Note, however, that they immediately qualify this claim: “The judicial perspective on the differences is fascinating and possibly correct, but it is incomplete. It requires a further assumption that the judges have an inclination to protect the outside investors rather than the insiders. In principle, it is easy to imagine that the judges would use their discretion in common law countries to narrow the interpretation of fiduciary duty and to sanction expropriation rather than prohibit it.”

\textsuperscript{142}La Porta et al., supra note 3, 9. Note how this view is in tension with the proposition that civil law countries tend to interfere with the market.
moreover strapped to the past. They lack the capacity to innovate or to integrate social change and new experience into the law.

In the *Tunneling* article JLL&S try to back up the loose references to civil law literalism in LLS&V’s other writings. JLL&S purport to find a differences in “the ways in which the courts apply [the law] that matter for real outcomes, including the extent of tunneling.” JLL&S argue that civil law systems are institutionally hampered in the application of doctrines of fiduciary duty, because the system of codification and the role of norm application that is accorded to civil law judges prevent the exercise of discretion and the development of a case-based approach.

Adjudication in civil law courts, the argument runs, rigidly follows “formal statutory rules that are consistent with legal certainty” even though such “legal certainty may invite insiders to structure unfair transactions creatively so as to conform to the letter of the law.” On this odd reading, all civil law judges are literalists. In contrast, adjudication of investor protection in common law courts is much more flexible and can address “situations that no one has foreseen and categorized,” as it is guided by a standard of fairness. The fiduciary duty of loyalty is gives judges considerable discretion and allows for a continuous evolution of the law. Johnson et al. conclude that “[p]recisely because the common-law notion of fiduciary duty is associated with a high level of judicial discretion to assess the terms of transactions and to make rules, it is at odds with the civil-law emphasis on legal certainty.”

143 See, e.g., the court’s view in Weinberger v. UOP, 457 A.2d 701 (Del.Sup. 1983) (en banc) (holding that minorities have only appraisal rights, but cannot block a squeeze out.).
144 *Id.*, at 26.
145 *Id.*, at 23.
146 *Id.*, at 24.
147 *Id.*, at 24.
As an example of the rigidity of the civil law, Johnson et al. cite the French case of *SARL Peronnet* (1999).\(^{148}\) This case presents a classic case of self-dealing, in which directors appropriate a corporate opportunity to themselves in violation of what U.S. lawyers would commonly recognize as a violation of the duty of loyalty. The Peronnet family controlled SARL Peronnet and provided some of the corporation’s board members. In a suspect transaction the Peronnet family established an entirely independent company called SCI, solely owned by the Peronnet family. SCI bought land, took out a loan to build a warehouse, and then leased both to SARL Peronnet and used the proceeds to pay off the loan. The plaintiff (a corporation called SAICO) was a minority shareholder in SARL Peronnet and sued, arguing that the Peronnet family had expropriated a corporate opportunity from SARL.

According to JLL&S, the court refused to examine the substantive merits of the transaction, but instead applied a “business interest test.” It concluded that the decision by Peronnet to pay SCI for the warehouse lease was not against the interests of the company. This was so for two reasons: (1) SARL Peronnet expanded during this period, and (2) the expansion of SARL Peronnet had benefited the minority shareholder SAICO as well. According to JLL&S, the court blindly looked only towards whether or not the shareholders suffered an actual loss, rather than to the actual fairness of the deal, measured by comparing it with an arms-length transaction or ratification by an independent board.\(^{149}\)

Johnson et al. thus take fiduciary duty as a prime example of the genius of the common law, its flexibility, and its ability to adapt to the changing needs and practices of society. To this they contrast the

\(^{148}\) *Id.*

\(^{149}\) JLL&S conclude that the court held that “as long as [the minority shareholders] have not suffered an actual loss, the business judgment rule protected the Peronnet family.” 24. This, is of course, highly misleading, as the business judgment rule as it is understood in the U.S. is in fact much more rigid and does not usually inquire into business purpose at all, and certainly does not look at whether a transaction generated a profit or a loss.
rigidities of codification, for which “ideally, the rules should all be contained in a major enactment which the judges are dutifully and obediently to apply.”¹⁵⁰ The sketch thrown up with such quick strokes is inherently implausible. For one, it uncritically cites the ideological self-presentations of the two legal systems. We know at least since legal realism that common law judges are not immune to excessive formalism that is blind to social consequence, as well as the deployment of bright-line rules that disregard the cases before them.¹⁵¹ At the same time, those who championed codification of the civil law in order that the judiciary be prevented from taking over the legislative function, had to acknowledge that “even if it keeps on changing and adding to private law, the legislature can no more regulate everything in this sphere than it can in other areas of lawmaking.”¹⁵²

As the German case shows, LLS&V deploy these assumptions about the differences between the civil law and the common law system uncritically. While there are significant differences between the civil law and the common law, the standard characterization of these differences in the comparative corporate governance needs to be qualified.

¹⁵¹ Morton Horwitz shows how the lasting influence of the legal realists in U.S. law was their critique of the 19th Century “categorical mind” of common law judges: “Late nineteenth-century legal formalism represented the crystallization of a ‘legalistic’ mindset that had emerged in seventeenth- and eighteenth-century English constitutional thought and was further elaborated in liberal political theory and post-revolutionary American legal thought. It was marked by a series of basic dichotomies: between means and ends, procedure and substance, processes and consequences. In a world of conflicting ends, it aspired to create a system of processes and principles that could be shared even in the absence of agreed-upon ends. Law played a crucial role in this system of thought. If legal concepts could be neutral, they could then be used to decide disputes without resort to the substantive merits of a case.” MORTON HORWITZ, TRANSFORMATION OF AMERICAN LAW, VOL. II, 16 (1992).
¹⁵² HORN, et al., supra note 150, 12.
V. DOCTRINES OF EQUITY AND JUDICIAL DEVELOPMENT OF LAW IN CIVIL LAW GERMANY

There is indeed a quality to the German legal analysis of cases and law that differs sharply from the U.S. and U.K. decisional law. German legal scholars are very concerned with consistency in the conceptual foundations of their legal analyses. The conceptual foundations of legal analysis provide a systematic and consistent elaboration of the code. Such discussion reaches metaphysical dimensions from the viewpoint of the common law scholar.

In the debate about duties of loyalty in the law of stock corporations, for example, the problem for scholars is that no such principle is announced in the Stock Corporation Act of 1965. In order to justify setting limits to legal tunneling by majority shareholders, the German legal community is, therefore, engaged in soul-searching about the proper legal and conceptual foundations of loyalty in the body of statutes. This concern has generated an entire literature that includes both judicial and academic writings. This literature about the conceptual foundations of loyalty in corporate law has no counterpart in the elaboration of the rights against control persons in the recent legal literature in the U.S. It is not primarily a pragmatic search for the proper level of monitoring or the efficiencies of a particular rule. These concerns are addressed as well. But the debate about conceptual foundations is entirely different and is driven by a desire to maintain the consistency of the code and the clarity of the model conceptions that it deploys.

A different relation of legal theory and practice is also suggested by the fact that the academic elaboration of conceptual foundations does

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154 Id.
155 See footnote ___ and accompanying text.
not proceed separately from judicial decisions. German judges engage in “detailed consideration of the views of contemporary (and past) academic writers dealing with the subject before the court.”\textsuperscript{157} Frequently courts will adopt the “dominant opinion” (\textit{herrschende Meinung}) reflected in the academic literature. This proximity between the courts and the academic systematization of the law shows the significance of the elaboration of conceptual foundations. One example we will turn to below is the close cooperation between academic writers and courts in the development of the principle of good faith (\textit{Treu und Glauben}), set forth in § 242 of the Civil Code (BGB), into a doctrine of equity and judicial discretion.\textsuperscript{158}

The emphasis in a typical decision of the \textit{BGH} is on the legal arguments. Cases by the \textit{BGH} usually have much briefer presentations of the facts than U.S. cases.\textsuperscript{159} The facts of the case (\textit{Tatbestand}) are as one commentator puts it:

[n]ever as detailed as in English (or American) judgments, the court not being obliged to indulge in the kind of detailed consideration of material which is necessary in the Common Law in order to decide whether the case before it is covered by an earlier authority or whether, on the contrary, the present facts are materially different and thus justify distinguishing it from earlier precedents.\textsuperscript{160}

The judge does not necessarily have less discretion than a U.S. judge. It could be that the discretion simply expresses itself differently in the typical German and U.S. decision, depending on a variety of factors, including the area of law (as we shall see in the case of § 242). If an abstract principle is to yield decisions in particular instances, it is clear that the abstraction will not significantly constrain the outcome.

\textsuperscript{157} MARKESINIS II, 10.
\textsuperscript{158} \textit{Id.} See also, B.S. MARKESINIS, W. LORENZ & G. DANNEMANN, THE GERMAN LAW OF OBLIGATIONS, VOL. I, 511-12 (1997) [hereinafter MARKESINIS I].
\textsuperscript{159} MARKESINIS II, 9.
\textsuperscript{160} \textit{Id.}. 
Midlevel theorizing is more likely to do so. Or as the legal realists were apt to say: “general principles do not decide concrete cases.” For example, “[t]he wording of the text [of § 242 BGB] – ‘The debtor is obliged to perform in such a manner as good faith requires, regard being had to general practice’ – gives no clue as to why such a general . . . statement could have been of such importance to German law, justifying a voluminous tome [in Staudinger’s Commentary on the Civil Code].”

In other words, all this is to say that the German legal system is not unfamiliar with judge made law, or with the application of principles that grant judges broad discretion to fill gaps in the law or reach equitable decision that run counter to a literalist reading of statutory entitlements. Very much like their common law counterparts, German jurists and judges discuss the significance of cases for the interpretation of statute and for the development of law. Introducing a critique of “Code positivism” somewhat analogous to the legal realist critique of “Classical Legal Thought,” the German scholars of Interest-Jurisprudence (Interessenjurisprudenz) established what every German jurist now accepts: that there are necessarily “true gaps” in the conceptual systematization of legal rules in the codes, and that these gaps require supplementation and development by judges. As one introduction to the German commercial law explains, “the German lawyer today needs to be almost as familiar with the wealth of judicial decisions as the common [law] lawyer,” in order “to understand the law as it actually operates.” Just as the American law student identifies lines of cases, the student of German law will learn of the decisional law, or staendige Rechtsprechung, of the BGH court. Such lines of decision do not exactly establish precedent in the manner in which the common

162 MARKESINIS I, 511.
164 Id..
GLOBALIZING TRUST? 54

law doctrine of *stare decisis* does, but lower courts will generally be reluctant to depart from the *staendige Rechtsprechung* of the BGH.\(^{165}\)

While “statute and custom are...technically the only true sources of law,”\(^{166}\) the German legal system is, therefore, not unfamiliar with judge made law or with the application of standards or principles that grant judges broad discretion to fill gaps in the law or render equitable decisions that run counter to a literalist reading of statutory entitlements. The prime example for such a principle is that of *Treu und Glauben* (§ 242 BGB).\(^{167}\)

A whole body of law has developed surrounding § 242 of the Civil Code (BGB), which provides for loyalty and good faith (*Treu und Glauben*) in the discharge of any legal obligation: “The debtor is obliged to perform in such a manner as good faith requires, regard being paid to general practice.” *Treu und Glauben* is part of the *Law of Obligation*. It was intended originally “to make people conscious of the true content of the obligation,’ and was “confined to regulating the manner and method of the duty to perform.”\(^{168}\) While it is still applied to the interpretation of performance, § 242 has been elaborated into a master principal (“super control norm”) for the entire Civil Code and for large parts of German law that are not comprised within the Civil Code.\(^{169}\) Deployed as a basic principle of law, it provides “a general requirement of good faith, a ‘principle of legal ethics’, which dominates the entire legal system.”\(^{170}\) Section 242 of the Civil Code has, in this way, served as “a vehicle for the judicial development of private law”\(^{171}\) and as a means for accommodating the law on the books to the requirements of law in practice. Moreover, it functions, in part, to justify

\(^{165}\) MARKESINIS II, 10-11.

\(^{166}\) Id., 11.

\(^{167}\) There are also others, such as BGB § 826 (principle of negligence) & § 823 (principle of compensation for intentional harm). See MARKESINIS I, 512 and MARKESINIS II, 12.

\(^{168}\) I PROTOKOLLE ZUM BGB, 303.

\(^{169}\) HORN, et al., supra, note 150, 135.

\(^{170}\) HORN, et al. supra, note 150, 135.

\(^{171}\) Id., 136.
the value judgments of the judge. The very large body of decisional law that has developed under § 242 is compared by legal scholars to the case law within the common law systems.

In a famous decision during the period of hyperinflation between 1919 and 1923, § 242 was deployed to reconstruct mortgage contracts, so as to revalue them in terms of the value of the currency at the initiation of the mortgage.\textsuperscript{172} In other cases, during that period, § 242 was used to establish a doctrine of contract law called “collapse of the foundation of the transaction.”\textsuperscript{173} Because it was increasingly impossible for contracting parties to honor the principle of \textit{pacta sunt servanda} during the period of hyperinflation, the courts finally declared that in cases where “the underlying basis of the transaction” had collapsed that the failure of implied conditions permitted a rewriting of the contract. In the revaluation decisions, the Court showed itself willing to intervene in the markets and adjust the contract according to a conception of fairness. This did not mean that Courts would simply reallocate the risks of contract.\textsuperscript{174}

Section 242 is part of the \textit{Law of Obligation} and as such its operation is not confined to contract. Contract is simply one among many possible legal relationships, which are subject to the \textit{Law of Obligation}. Section 242 serves as a constraint on the unconscionable misuse of a legal right. It authorizes the judge to interfere on behalf of a debtor – understood broadly as one who is legally bound to fulfill an obligation or perform a service or a contract – where a literal reading of the law would impose an inequitable result. In this way it is also viewed as a possible legal basis for the duty of loyalty among shareholders of a stock corporation.\textsuperscript{175}

\begin{enumerate}
\item[\textsuperscript{172}] RGZ 107, 78, 86.
\item[\textsuperscript{173}] HORN, et al., \textit{supra} note 150, 141.
\item[\textsuperscript{174}] MARKENSINIS I, 540.
\end{enumerate}
VI. Conclusion

During the period of strong economic growth and booming stock markets in the 1990s, nations around the world, and especially the western industrial nations on the Continent, have scrambled to develop their own equity and derivative markets. They have naturally looked to U.S. regulations for guidance. The agency-cost model that has governed corporate law theory in the academy was quickly picked up as the intellectual ground on which this debate about potential legal transfers was discussed. The peculiar structure of U.S. state corporate law and its focus on fiduciary duty that was grand-fathered into the federal securities laws has, accordingly, been widely touted as the *sine qua non* of efficient corporate finance. Rafael la Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (who are not legal scholars themselves) correctly picked up on this majority position among legal academics. LLS&V claimed to find empirical support for the conclusions that fiduciary duty protections were essential to vibrant stock markets and their seemingly bold claim that civil law countries were fundamentally incapable of accommodating such structures. If true, these conclusions would have far-reaching implications for what could be accomplished in the way of building stock markets without restructuring civil law judicial institutions and changing basic social and political commitments to what Continental Europeans view as their more humane and equitable brand of stakeholder capitalism.

By subjecting LLS&V’s thesis to careful criticism and examining the validity of their conclusions in light of the case of Germany, I have shown that their claims are questionable, or at least in need of significant qualification. As I have shown, German law has ample resources for innovation. Judicial discretion is a necessary part of the system, and principles of equity and judicial discretion are well developed in the German civil law. Similarly, a doctrine of fiduciary duty has long been a part of the German law of partnership, and has recently been expanded to provide minority shareholders additional protection and access to the
courts. To be sure, more needs to be said before we can assess the overall effects of investor protection in the German courts. Such assessment, however, requires greater attention to functional equivalencies.

Notably the general demand in response to the corporate scandals of the year 2002 has not been to strengthen state fiduciary duty laws – or at least not yet -- but to strengthen the criminal fraud provisions of the federal securities laws. Such criminal laws, however, are precisely the types of provisions that civil law countries already generally rely upon to a greater extent than we do.