Shareholder Protection in the USA and Germany - "Law and Finance" Revisited

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A. Introduction

Though Company Laws of the United States and Germany have much in common, they are opposite in many important ways. While the Anglo-Saxon Law derives from Common Law, German Law has its origin in the Civil Law.[1]

La Porta *et al*.[2] are not the only ones highlighting that the quality of shareholder protection varies across different jurisdictions depending on which legal system family the jurisdiction belongs. Pistor[3] and Siems[4] went a step further, highlighting that variations in market systems are explainable by more fundamental factors than law, like differences in the underlying ground rules.

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[1] U.C. Braendle & J. Noll 2004, *The Power of Monitoring,* 5 GERMAN L. J. 11 (2004), http://www.germanlawjournal.com/article.php?id=516.

[2] R. La Porta, F. Lopez-de-Silanes, A. Shleifer, & R. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter *Law and Finance*].

[3] K. Pistor, *Legal Ground Rules in Coordinated and Liberal Market Economies* 30, (ECGI Working Paper Series in Law, 2005).

[4] M. Siems, *Legal Origins: Law & Finance v. Comparative Law?*, (Duesseldorf Center for Bus. & Corp. L. Res. Paper Series No. 0023, 2006) [hereinafter *Legal Origins: Law & Finance v. Comparative Law?*].

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The thesis of La Porta *et al.* is clear: As "law matters" and Common Law countries are offering better shareholder protection than Civil Law countries, the latter should encourage changes towards an Anglo-Saxon approach. This contribution presents a criticism on this thesis.

The rest of the paper is organized as follows: in section B. I will summarize the differences between the main legal traditions, since they influence the shareholder protection of a jurisdiction. Section C. introduces the *law matters* thesis of LaPorta *et al.* (hereafter: LLSV) and highlights its importance in economic as well as legal literature. The results of their *Law and Finance* article emphasize the better shareholder protection of Common Law countries. The existing criticism on and the impact of the article is reviewed. In section D. I reconsider the index for Germany and the United States, two typical representatives of their legal families. By scrutinising the legal provisions of the two countries I will illustrate the weaknesses and pitfalls of the LLSV index.

Germany would score much better on the index if one bothers analyzing the German company law. Moreover, I am pointing out inconsistencies in the judgment of the USA and Germany. After this exercise the differences between Common and Civil Law in terms of shareholder protection seem to be far less significant than LLSV propose, if at all, which will be part of the implications in section E. Pertinent changes after 1998 (introduction of laws concerning transparency and a German corporate governance code) lead to the conclusion that given the present state of shareholder protection under German law the LLSV assessment is actually far less correct than it was 1998.This should be considered in the ongoing Corporate Governance discussion.

B. Legal Traditions

I. Civil Law

Civil or *Civilian* Law is the legal tradition that forms the basis of law in many countries of the world. This is especially true in Continental Europe, but it is also the case in Japan, South Korea, Taiwan, Latin America, and most former colonies of Continental European countries. Civil Law was originally characterized by one common legal system in much of Europe, but with the development of nationalism in the 17th century and the French Revolution, it became fractured into separate national laws such as in France, Germany and Switzerland. Because Germany was a rising power in the late 19th century when many Asian nations were developing, the German Civil Code has been the basis for the legal systems of Japan and South Korea. Moreover, the German Civil Code was introduced in China in the later years of the Qing Dynasty and therefore is also in place in Taiwan. Today, there are three

major bodies of law that modern Civil Commercial Laws originate from: French, German and Scandinavian.[5]

II. Common Law

The *Common Law* developed in the 12th century under the auspices of the adversarial system in historical England from judicial decisions that were based in tradition, custom, and precedent. It applied to all people and displaced the Anglo-Saxon regional laws of communities and great land owners. The form of reasoning used in Common Law is known as casuistry or case-based reasoning. It is notable for the inclusion of extensive non-statutory law reflecting a consensus of centuries of judgements by working lawyers. Although Common Law exhibits features of Customary Law, parts of the laws have been codified since the 20th and 21st century. Therefore it may be unwritten or written in statutes or codes. The Common Law, as applied in civil cases, was devised as a means of compensating someone for torts, including both intentional torts and negligence and for developing the body of law recognizing and regulating contracts. The Common Law forms a major part of the law of many countries, especially those that were British territories or colonies. Today the legal systems of England, Wales, Ireland, the United States (execept Louisiana), Canada, Australia, New Zealand, Southern Africa (in parts), India, Malaysia, Singapore and Hong Kong are affected by this legal tradition.

Historically, the difference between Civil and Common Law is that Common Law was developed by custom, beginning before there were any written laws and continuing to be applied by courts after the introduction written laws. Civil Law, on the other hand, developed out of the Roman Law of Justinian's *Corpus Juris Civilis* proceeding from broad legal principles and the interpretation of doctrinal writings rather than the application of facts to legal fictions.[6]

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[5] D. MUELLER, THE CORPORATION – INVESTMENT, MERGERS, AND GROWTH 140 (2003).

[6] A.N. Hatzis, *Having the Cake and Eating it too: Efficient Penalty Clauses in Common and Civil Contract Law*, 22 INT'L REV. OF L. & ECON. 381 (2003).

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C. Law and Finance

I. The Theory of La Porta et al.

The allocation of countries to the legal families strongly influences the design of shareholder protection. A team of economists, Rafael LaPorta, Florencio Lopez-de Silanes, Andrei Shleifer and Robert Vishy (hereinafter LLSV), attempted in a series of articles[7] to prove that Common Law countries offer good shareholder protection, whereas Civil Law countries fall far behind. In their well-known *Law and Finance* (1998) article they conclude that the environments favourable to shareholders are provided by Common Law countries, characterised by a dispersed ownership structure. Those offer the best shareholder protection, whereas Civil Law countries (especially French Civil Law) perform badly.

For their study LLSV take the "mean ownership" and regress it against a variety of legal distinctions to see whether there is a correlation between ownership concentration and those legal issues. Mean ownership means the percentage of the stock of the ten largest non-financial corporations in a country held by the three largest shareholders. This should highlight the extent to which investors are willing to make investments in corporations that are not large enough to carry a significant share of control.[8]

Law and Finance investigates 49 countries,[9] according to their legal families, referring to shareholder and creditor protection as well as law enforcement. Only countries with more than five corporations in 1993 (excluding those in public

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[7] *Law and Finance*, *supra* note 3; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, & R. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter *Legal Determinants of External Finance*]; R. LaPorta, F. Lopez-De-Silanes, A. Shleifer, & R. Vishny, *The Quality of Government*, 15 J. L. ECON. & ORG. 222 (1999) [hereinafter *The Quality of Government*]; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, & R. Vishny, *Investor Protection and Corporate Governance*, 58 JO. FIN. ECON. 13 (2000) [hereinafter *Investor Protection and Corporate Governance*]; R. La Porta, F. Lopez-de-Silanes, A. Shleifer, & R. Vishny, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147 (2002) [hereinafter *Investor Protection and Corporate Valuation*].

[8] M.J. Roe, *Political Preconditions to Separating Ownership from Corporate Control*, 53 STAN. L. REV. 539 (2000); D. Vagts, *Comparative Company Law – The New Wave*, *in* FESTSCHRIFT FÜR JEAN NICOLAS DRUEY 596 (R. Schweizer, H. Burkert, & U. Gasser eds., 2002)

[9] The sample consists of 18 Common Law countries, 21 French Civil Law, 6 German Civil Law and 4 Scandinavian Civil Law countries.

ownership) were included in their study. The article has been and is still cited frequently and usually uncritically, in legal as well as in economic journals.[10]

In the article, the "law matters" idea is stressed with an index regarding the shareholder protection. For the compliance with certain *ex-ante* determined criteria points are assigned to the legal system of a country. If the respective legal system fails to comply, zero points are assigned. Scoring more points means better shareholder protection. The following criteria were consulted for the judgement of the shareholder protection:[11]

- One Share – One Vote.[12]
- Proxy by mail allowed.
- Shares not blocked before Meeting.
- Cumulative Voting/Proportional Representation.
- Oppressed Minority.[13]
- Pre-emptive Right to New Issues.[14]
- The Percentage of Share Capital to Call an Extraordinary Shareholder Meeting has to be less or equal to 10% of the votes.

The score of a jurisdiction highlights the "Antidirector Rights" of a country.

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[10] The 357 citations in the Social Science Citation Index through May 2005 highlight the impact of this article (compared to only 23 citations of Jean Tirole's "Corporate Governance" article in Econometrica since 2001 and 58 citations of Hart and Moore's "Foundation of Incomplete Contracts" since 1999).

[11] *Law and Finance*, *supra* note 3, at 1127.

[12] The measure for this criterion is very strict. If the law allows non-voting stocks and/or multiple voting the criterion is not fulfilled.

[13] The company law or Commercial Code has to grant minority shareholders either a judicial venue to challenge the decision 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 or changes in the articles of incorporation. *Law and Finance*, *supra* note 3, at 1122.

[14] Only a majority of shareholders can waive this right.

II. Results of "Law and Finance"

Concerning shareholder protection the United States, judged according to Delaware Law, achieved five out of the seven points (criteria 2, 3, 4, 5, and 7) and therefore shares the first rank with other Common Law countries such as Canada, India, South Africa and the UK. Germany, however, with a score of 1 is ranked towards the end, pooled with many other Civil Law countries. Belgium, without getting any points at all, finds itself at the bottom of the list. Table 1 summarizes the results for the United States and Germany.

	USA	GER
One Share – One Vote	0	0
Proxy Voting	1	0
Shares not Blocked before Meeting	1	0
Cumulative Voting/ Proportional Representation	1	0
Oppressed Minority	1	0
Preemptive Right to New Issues	0	0
Percentage of Share Capital to Call an Extraordinary Shareholder Meeting	1	1
Score (Antidirector Rights)	5	1

Table 1: Results of USA and Germany according to LLSV

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On average the 18 Common Law countries of the study score 4 points. The six German Civil Law countries[15] and the 21 French Civil Law countries achieve an average of 2.33 points. The four Scandinavian Civil Law countries perform slightly better with an average score of 3 points.

Regarding legal enforcement German Civil Law countries perform best, followed by Common Law countries. French Civil Law countries are ranked last in their study.[16] Moreover, LaPorta et al.[17] illustrate that richer countries possess a better method of legal enforcement.

III. Impact and Criticism

The LLSV article *Law and Finance* has gained much importance because of the *law matters* theory. In several other articles, LLSV's index is used to prove the correlation of shareholder protection and capital markets,[18] dividends,[19] evaluation of companies,[20] efficient allocation of capital,[21] company size,[22] etc. To put it another way, one can say that *Law and Finance* is a standard reference in comparative corporate and financial law.[23]

The article met with some criticism, especially in Civil Law countries. Some minor comments (most of them working papers) on specific criteria for Germany came

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[15] In addition to Germany, Austria and Switzerland as well Japan, South Korea and Taiwan

[16] Concerning the quality of accounting, Scandinavia is top, Common Law perform quite well, statistically significant ahead of German Civil Law countries. Again, the French family has the weakest quality of accounting.

[17] *Law and Finance*, *supra* note 2, at 1140.

[18] *Legal Determinants of External Finance*, *supra* note 7.

[19] *Investor Protection and Corporate Governance*, *supra* note 7.

[20] *Investor Protection and Corporate Valuation*, *supra* note 7.

[21] J. Wurgler, *Financial Markets and the Allocation of Capital* (Yale Int'l Center for Fin., Working Paper No. 99-08, 1999)

[22] T. Beck, A. Demirgüc- Kunt, V. Maksimovic, *Financial and Legal Institutions and Firm Size* (World Bank Policy Research, Working Paper No. 2997, 2003).

[23] S. Cools, *The Real Difference in Corporate Law between the United States and Continental Europe: Distribution of Powers* (Harv. L. & Econ. Discussion Paper No. 490, 2004).

from Vagts arguing against the relevance of some criteria.[24] Siems criticises the methodology (numerical comparative law) of La Porta et al. as a whole[25] and brings forward some well-established principles of comparative law.
Baums and Scott, however, criticize the simplicity of the judgement (zero or one).[26] Coffee thinks that "by no means is it here implied that these rights are unimportant, but only that they supply partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium."[27]

Cools argues that the differences in shareholder protection are overvalued by LLSV whereas other important aspects of company laws and their differences are not taken into consideration at all.[28] Furthermore, he highlights the fundamental distinction of Common and Civil Law concerning the allocation of power in corporations.[29] According to him this is the very reason for different ownership structures.

In fact it seems questionable whether seven criteria are sufficient to judge shareholder protection. Moreover, the restriction to zero and one is problematic if we think about borderline cases. This is a major pitfall as countries use different notations for the criteria, but different national measures may lead to the same outcome. In addition, one has to take the different board structures into consideration. Anglo-Saxon countries are characterized by one-tier board systems with a board of directors, whereas Civil Law countries are characterized with a two-tier board systems, which strictly separate management and supervisory boards.[30] Different board systems illustrate different allocation of power within corporations.

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[24] Vagts, *supra* note 8, at 596.

[25] He is referring to a 2004 article of theirs where they nevertheless used the same methodology in terms of security law. *See* M. Siems 2005, *What Does not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*, INT'L CO. AND COM. L. REV. 300 (2005) [hereinafter *What Does not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*].

[26] T. Baums & K. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany* (Stan. L. Sch., Working Paper No. 272, 2003).

[27] J. Coffee,*The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control* (Center for L. & Econ. Stud., Columbia L. Sch., Working Paper No. 182, 2001).

[28] Cools, *supra* note 23.

[29] *Id*.

[30] Breandle & Noll, *supra* note 1.

Pistor went a step further illustrating that variations in market systems are explainable by more fundamental factors than law, like differences in the underlying ground rules.[31] Siems also followed this path and illustrates the importance of politics, culture, religion, and geography.[32]

Marco Pagano and Paolo Volpin extend the indicator constructed by LLSV (1998) to an interval between 1993 and 2001, relying on the answers on questionnaires sent to legal experts and business practitioners around the world.[33] Their dataset includes 47 of the original 49 LLSV countries. It turns out that the answers of the independent legal experts differ from the LLSV data for five countries, Germany included.

D. The LLSV Index Reconsidered – Germany and USA

In the following section I want to reconsider the seven criteria of anti-director rights by analysing the legal provisions of the two company laws. I will try to illustrate the weaknesses and pitfalls of the LLSV index by looking for alternatives within company law if a criterion is not directly met. This is necessary as some legal provisions in Germany are not obvious at first sight. Furthermore, the legal families differ in the design of their boards which also has to be taken into consideration.

I. One Share – One Vote

The principle of one share – one vote assigns the same exertion of influence for all shareholders according to their stake in the company. LLSV grant one point for a legal system if the Company Law or Commercial Code of the country requires that ordinary shares carry one vote per share or when law prohibits the existence of both multiple-voting and nonvoting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares owned, and zero otherwise.[34] Neither Germany nor the United States meet this criterion.

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[31] Pistor, *supra* note 3.

[32] *Legal Origins: Law & Finance v. Comparative Law?*, *supra* note 4.

[33] M. Pagano & P. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005 (2005).

[34] *Law and Finance*, *supra* note 2, at 1122.

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Generally, United States' shareholders are assigned one vote per each share. But in many States – including Delaware – shares with multiple voting as well as fractional voting are allowed. In Germany the voting rights are in accordance with the nominal value of the share. Nevertheless the possibility of nonvoting preference shares exists.[35] As long as the owner of those shares receives her preference dividend, the voting right rests. Moreover, restrictions to a maximum number of votes as well as graduations of votes are allowed (§ 5 preamble to AktG and mainly in § 134 para 2 AktG).[36] According to § 12 para 2 AktG multiple voting is prohibited.[37]

Although I therefore agree to the evaluation of LLSV,[38] the feasibility of such a regulation is questionable. One share – one vote is in the meantime without reflection incorporated in most Corporate Governance Codes[39] all over the world. But Khatchaturyan points out that one share – one vote is a sub-optimal voting mechanism in a world of specific investments.[40] As different modes of finance have different costs, the level of asset specificity determines the mode of finance. Ownership and ex-post residual decision-making should be allocated to the party making the most specific investment. The latter would economize on the information asymmetries and high agency cost of monitoring on the one hand and extend them adequate incentives to perform on the other hand. One share – one vote, however, implies that high and low agency cost factors get equal ex-post voting rights. This in turn increases information asymmetries and agency costs of monitoring, while reducing the incentives of high agency cost factors, thus including further costs to the firm and affecting its value.

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[35] Aktiengesetz 1965 [AktG] [Company Law], § 12, para. 1 AktG [hereinafter AktG].

[36] Note that until 1998 maximum voting rights were not limited to non-listed companies.

[37] The law has changed in Germany after the enactment of a law for more control and transparency in companies ("Gesetz zur Kontrolle und Transparenz im Unternehmensbereich" (KonTraG)). Five years after this law all multiple voting rights of company expired, except a qualified majority of 75% of the share capital voted for it in an annual general meeting.

[38] Zero points for both countries.

[39] Those codes were established in many countries to restore investor confidence after the financial scandals of Enron, WorldCom and Parmalat (to mention the most prominent ones).

[40] A. Khatchaturyan, *The Economics of Corporate Governance Regulation in the EU* (University of Siena, Working Paper 2004).

Concerning takeovers, even parts of LLSV claim that deviations from the rule are necessary to extract the highest value from the bidder.[41] It is therefore incomprehensible that the Economist[42] refers to Europe's unfair voting rights because of deviations from one share – one vote.

II. Proxy Voting

Proxy voting allows for voting without personal attendance or representation in a general meeting. According to LLSV a point is assigned if the Company Law or Commercial Code allows shareholders to mail their proxy vote to the firm.[43] A point was assigned to the United States, but not to Germany.

But what makes proxy voting such an important issue in shareholder protection? The idea of proxy voting is to give the shareholder with voting power the opportunity to give a proxy for certain polls to a deputy, the latter often being a member of the management. Advantages to being able to vote without attending the general meeting include saving of time, money and effort. This seems to be important because recent years were characterized by abuse - as the shareholders often only served as a rubberstamp for the managements.[44]

Weak points of shareholder proposals are premises for the submission on the one hand and the multitude of possible proposal-disclaimers from the corporations on the other hand.[45] In the U.S. this is of special importance for the nomination of board members.

For the German Company Law proxy voting *per se* is alien.[46] Nevertheless we should think of similar instruments fulfilling the same purpose, saving time, money

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[41] A. Shleifer & R. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986) [hereinafter *Large Shareholders and Corporate Control*]; A. Shleifer & R. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7 (1988) [*Value Maximization and the Acquisition Process*].

[42] *What shareholder democracy? Europe's unfair voting rights*, THE ECONOMIST, Mar. 23, 2005.

[43] *Law and Finance*, *supra* note 2, at 1127.

[44] The financial scandals at the beginning of the 21st century made this issue even more relevant.

[45] Securities Exchange Commission (SEC) Rule 14a-8 (i) 1-13, for download at http://www.sec.gov/about/forms/reg14a.pdf.

[46] Although the German *Bundestag* adopted a new law (Namensaktiengesetz 2000 (NaStraG)), which allows shareholders to authorize company representatives to exercise their voting rights at Annual General Meetings.

and effort. Obvious is the depositary proxy votes practices of banks. Proxy voting by banks is available after the assignment of legitimation to a bank.[47] This is a legal disposition of the voting rights without transferring the ownership. The bank receives the right to exercise the vote either on behalf of the owner[48] if she gives clear instructions, or on its own behalf if these instructions are missing[49]. In the latter case, banks are not obliged to disclose the owner of the shares.

Therefore the result is the same for both Germany and the United States. Shareholders are able to exercise their votes without attending the general meeting. A disadvantage in Germany could be abusive behaviour of banks in cases of missing instructions. Although § 128 para 2 AktG requires that banks vote in the best interest of the shareholders,[50] banks maximize their own interests which may not align with those of the shareholders.[51] But although voting by banks may therefore bring about conflicts of interests, voting by management (US-style) does the same.

Nevertheless, as proxy votes of banks in Germany fulfil the same purpose as proxy voting in the United States, namely saving of time, money and effort for the election of the board of directors, LLSV should have assigned a point to Germany for this criterion.

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[47] AktG, *supra* note 35, at § 135 para. 7.

[48] AktG, *supra* note 35, at § 135 para. 4.

[49] AktG, *supra* note 35, at § 135 para. 5.

[50] H. SCHMIDT & J. DRUKARCZYK, CORPORATE GOVERNANCE IN GERMANY 24 (1997).

[51] MUELLER, *supra* note 5, at 130.

III. Deposit of Shares Prior to a General Meeting

Concerning this antidirector right LLSV assigns a point if the Company Law or Commercial Code does not allow firms to require that shareholders deposit their shares prior to a general shareholders meeting, thus preventing them from selling those shares for a number of days, and zero otherwise.[52] The United States scored again, whereas Germany still waits for its first point.

Within the United States shares are not deposited before general meetings. Since 1991 American corporations only offer registered shares. Germany allows both bearer and registered shares. Nevertheless, companies in the United States are allowed to determine a record date. Only shareholders being registered at this date (shareholders of record) are allowed to vote at the general meeting. The record day is decided by the board of directors; if the board does not fix a date, the day prior to the convening of the general meeting depicts the effective date.[53] This is problematic for the buyer of shares after this deadline. The new shareholder is then not allowed to vote due to a missing registration. This problem can be overcome with a letter of attorney for the successor. Nevertheless, the record date highlights certain restrictions for the selling of shares, an aspect not mentioned by LLSV.

In Germany the deposit of shares is not mandatory.[54] Generally, the ownership of bearer shares or the entry in the register of shareholders for registered shares is sufficient. The deposit is permitted by law[55] and by all means customary for larger corporations. The background of such a regulation is the legitimation for a general meeting, especially if bearer shares are issued.[56]

The existence of both, bearer and registered shares in Germany may be the very reason why the deposit of shares is not forbidden by law, whereas corporations in the United States only issue registered shares and therefore deposition is useless. In

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[52] *Law and Finance*, *supra* note 2, at 1122.

[53] REVISED MODEL BUS. CORP. ACT § 7.05(d) (1984) [hereinafter RMBCA].

[54] The option to require the deposit of shares has only recently (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts 2005 (UMAG)) been replaced by the option of the requirement to ask for a registration for the general meeting.

[55] AktG, *supra* note 35, at § 123 para. 3.

[56] J. PICHLER & E. WENINGER, AKTIENRECHT IN DER MANAGERPRAXIS 1 (2002).

systems with registered shares, a deposit would not make sense, as the identification of the shareholders is easily discoverable. On the other hand owners of bearer shares are anonymous and want to remain so. To ensure that only the owner of the share is exercising her voting right, a deposit seems to be inevitable – especially for larger corporations.

The evaluation of LLSV for Germany is acceptable for this criterion. Nevertheless, the criterion itself is not accurate. Due to the existence of bearer shares in Germany, a deposit is indispensable to ensure a frictionless general meeting of larger corporations. Without deposit it would not be possible to monitor the right usage of the voting rights. This is overseen by LLSV.

IV. Cumulative Voting and Proportional Representation

LLSV assigns a point here if the Company Law or Commercial Code allows shareholders to cast all their votes for one candidate standing for election to the board of directors (cumulative voting) or if the Company Law or Commercial Code allows a mechanism of proportional representation in the board by which minority interests may name a proportional number of directors to the board, zero otherwise.[57] The United States' score increases to three points, Germany is still waiting for the first point.

Cumulative voting is a common practice in the United States to elect the members of the board of directors. The idea behind it is to secure a representation of minority shareholders in the board of directors. Interestingly enough, cumulative voting is not mandatory in all States. It is only mandatory in nine States, where opposing regulations in the articles of incorporation are ineffective. In many other States, Delaware amongst others, cumulative voting does not apply if it is excluded from the articles (opt-out election). In some States cumulative voting is only allowed if the articles allow for it specifically (opt-in election).[58] Cumulative voting is in general regulated within the articles of incorporation.

According to LLSV a point is justified if the Law provides for the possibility – not an obligation – to introduce cumulative voting in corporations. Looking at the other criteria this perception is astonishing. For the previous criterion it was necessary to

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[57] *Law and Finance*, *supra* note 2, at 1122.

[58] H. MERKT, US-AMERIKANISCHES GESELLSCHAFTSRECHT 294 (1991). According to § 7.28 RMBCA it is up to the corporation to allow for cumulative voting in their articles or prohibit it specifically.

prohibit the deposit, the facultative possibility of deposit was not allowed. Now it is not obligatory to have cumulative voting, the possibility alone suffices for a point. In other words, the United States would not have scored here if the criterion would have been as strictly implemented as the rest of them.

Contrary to the United States, Germany does not allow the shareholder meeting for a direct election of the managing board. Instead, the supervisory board – elected by the shareholder meeting – in turn vote for the managing board.[59] Cumulative voting is an unknown election rule in Germany. Nevertheless, the articles of incorporation can allow for the delegation of supervisory members by certain shareholders up to one third of all custodians.[60] In my opinion such a regulation fulfils the requirements of cumulative voting as soon as the German election of a supervisory board is equated with the United States' vote for the board of directors.

If the different board structures are crucial to the criteria, the whole index has to be reconsidered. An objective evaluation regarding the better shareholder protection cannot be made without taking the legal framework of the different forms of corporations into consideration. In addition to Germany, Civil Law countries such as Austria, Denmark, Finland, Sweden and the Netherlands rely on this dual board structure with managing and supervisory board .[61] All of these countries do not score for this criterion.

If we take this criterion of LLSV literally, the evaluation of Germany is justifiable. The shareholder meeting can only elect the supervisory board, which in turn elects the managing board. This differs structurally from the one-tier board of directors system in the United States. The only chance for Germany to score would be a fundamental change of the company structures or a direct election of both managing and supervisory bard by the general meeting method as we know it from Civil Law countries such as China or Hungary.[62] But as German regulations result in the same protection (but with different means) as the United States, this criterion also seems to be inappropriate.

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[59] AktG, *supra* note 35, at § 101 para. 1, § 84 para. 1.

[60] AktG, *supra* note 35, at § 101 para. 2.

[61] Braendle & Noll, *supra* note 1.

[62] U.C. Braendle, T. Gasser, & J. Noll, *Corporate Governance in China – Is Economic Growth Potential Hindered by guanxi?*, 110:4 BUS. & SOC'Y REV. 389 (2005).

V. Minority Rights

If the law provides for mechanisms such as shareholder claims or compensation rights for minority shareholders in case of changes in the company structure, the respective country scores. In other words, a point is assigned if the Company Law or Commercial Code grants minority shareholders either a) a judicial venue to challenge the decisions of management or of the assembly, or b) 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 article of incorporation .[63] Minority shareholders are holding less or equal to 10% of the stakes in a company. Again LLSV assigns one point to the United States and Germany still does not score.

Shareholder claims serve as an instrument to control the management .[64] Single shareholders can take legal measures either due to the derived right in the name of the corporation (derivative suit) or from her own rights, if her rights are directly infringed upon (direct suit). Class suits should also be mentioned, where a single shareholder brings a claim acting for a group of persons whose rights have been impinged. The derivative suit in particular is tied to several requisites which aggravate a claim.[65] First, the shareholder has to call upon the board to lodge a claim. According to the business judgement rule the claim is normally settled if the board disapproves the decision. The business judgement rule therefore limits the application of derivative suits.

In Germany the single shareholder cannot file suit in the name of the company. However, § 147 AktG allows minorities (> 10% of share capital) to pursue a claim for damages for the corporation in their right. This instrument within the German Company Law differs from the American derivative suit in the requirement for 10% of the share capital.[66] Direct and class suits are unknown to the German Law. Under certain conditions a shareholder can directly sue managing and supervisory board members according to § 117 AktG. The shareholders can appeal against

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[63] *Law and Finance*, *supra* note 2, at 1122.

[64] M. BECKER, VERWALTUNGSKONTROLLE DURCH GESELLSCHAFTERRECHTE: EINE VERGLEICHENDE STUDIE NACH DEUTSCHEM VERBANDSRECHT UND DEM AMERIKANISCHEN RECHT DER CORPORATION 113 (1997).

[65] S. ELSING & M. VAN ALSTINE, US-AMERIKANISCHES HANDELS- UND WIRTSCHAFTSRECHT 245 (1999).

[66] It should nevertheless be mentioned that recent reforms in Germany (UMAG) have made it possible that under certain circumstances a minority of 1% of share capital may gain the right to sue the management (§ 148 AktG as amended by UMAG).

resolutions passed at the general meeting in case of some breaches.[67] Such an action can be brought in by each shareholder at any time.

The right to sell ownership of the company in the United States includes the pricing of the stake in the company at court and redemption. Shareholders are entitled to such rights when the corporation objects to certain fundamental changes such as mergers, asset dispositions and changes in the articles of incorporation. The requirements differ from State to State. Delaware Law for example does not grant this right for the sale of assets. In Germany, shareholders are entitled to such a right under certain circumstances. Demergers and commutations spanning legal forms are worth being mentioned as examples.

Even if not all mechanisms proposed by LLSV are totally fulfilled by Germany, we would nevertheless assign a point to the legal system. The § 147 AktG allocates to the shareholder an equivalent to the derivative suit. As LLSV themselves define a minority with less or equal 10% of the share capital, they use the same definition as German Company Law. Interestingly enough, the requirements for derivative suits are much stiffer than a claim under to § 147 AktG. In addition, German Company Law allows shareholders to appeal resolutions made at the annual meeting. The very different regulations of the different States cause doubt about the validity of this criterion.

VI. Pre-emptive Right to New Issues

A country scores when the Company Law or Commercial Code grants existing shareholders the opportunity to buy new issues of stock, and this right can be waived only by a shareholders' vote.[68] Neither the United States nor Germany scored with this criterion.

Existing membership rights are affected when a company issues new shares. With a preemptive right to new issues proportional to the previous stake, shareholders are protected, as they do not have to accept an unintended shrinkage of their membership rights. LLSV apply mandatory rules here (contrary to the option concerning cumulative voting).

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[67] AktG, *supra* note 35, at § 243.

[68] *Law and Finance*, *supra* note 2, at 1123.

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According to § 102 (b) (3) Delaware General Corporation Law the articles of incorporation have to provide explicitly for such preemptive rights. This opt-in regulation can also be found in § 6.30 (a) R.M.B.C.A. Some States like New York rely on an opt-out regulation. In other words, here the shareholder in general is protected by preemptive rights, but these can be excluded from the articles of incorporation. As Delaware Law provides for no mandatory preemptive rights, the United States did not score here.

In Germany, according to § 186 AktG, each shareholder is granted the opportunity to buy new issues of stock according to the previous stakes held. Seventy five percent (75%) of the share capital can exclude these rights in the general meeting. As the right can only be waived by a shareholders' vote, Germany definitively fulfils this criterion and should get a point here.

As Austria and Germany have almost the same Company Law it is very surprising that Austria, with an identical legal regulation concerning preemptive rights (§ 153 Austrian Company Law), scores for this criterion whereas Germany did not. It is worth mentioning that we find these regulations in both, Germany and Austria since 1965. This highlights the weaknesses of this index and questions the quotability of "Law and Finance."

VII. Call for Extraordinary Shareholder Meeting

This criterion depends on the minimum percentage of share capital required to call for an extraordinary general meeting. A point is assigned if the percentage is less or equal to 10%. Both, the United States and Germany score here.

In Germany § 122 AktG highlights that 5% of the share capital are entitled to call for a general meeting if some formal requirements are met. This percentage can be decreased in the articles of incorporation. An increase is forbidden.[69]

Nevertheless, it is surprising that the United States scored here. According to § 211 (d) Delaware General Corporation Law an extraordinary shareholder meeting can be called either by the board of directors or by other persons authorized in the articles of incorporation or bylaws.[70] Shareholders of firms incorporated in Delaware might de deprived of calling up a general meeting. In other US States,

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[69] AktG, *supra* note 35, at § 122 para. 1.

[70] BUNGERT, GESELLSCHAFTSRECHT IN DEN USA 19 (1994).

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10% of the share capital may be sufficient but the percentage can be increased. According to § 7.02 R.M.B.C.A the rate can even be increased to 25%. LLSV therefore takes the most favourable case but ignore the fact that minorities have little power to call a general meeting. Regarding this, the point for the United States seems unjustified.

E. Implications and Conclusion

Given this, an objective comparison of legal systems is a challenging task. The LLSV criteria seem appropriate to provide protection for minority shareholders. Nevertheless, they do not consider the deviation of theory and practice. Due to the difficult implementation of some instruments they do not even serve shareholder protection in the way they were intended to do so.

Furthermore, the design of some criteria is very much US-oriented.[71] Different legal systems provide different methods of shareholder protection, which are hardly recognized in the evaluation of LLSV. Proxy votes of banks, the deposit of shares and cumulative voting in Germany illustrate where LLSV sticks to US-oriented criteria without giving Civil Law countries the opportunity to meet the goal of the criterion with other means.

The formulation of the different criteria seems strange. In some parts it is sufficient to score if company laws provide for an option for a right, in other parts rights have to be mandatory to acquire a point. It is obvious that this framework benefits Common Law countries. Although using Delaware Law as a reference point, in some of the criteria (e.g. call for extraordinary general meeting) the US can only score by taking laws of other states.

Two essential factors were not taken into consideration when choosing the criteria. On the one hand the different ownership structures (dispersed vs concentrated ownership[72] on the other hand the different allocation of power within corporations. In the United States the board of directors and the executives are in power whereas in Germany (larger) shareholders possess more influence. This can

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[71] *What Does not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology*, *supra* note 25.

[72] Anglo-Saxon countries like the US and UK are characterised by dispersed ownership, i.e. many shareholders only own smaller stakes in the company. Concentrated ownership, on the other hand, means that companies are owned and controlled by a few large shareholders. Many Continental European countries are representatives for the latter.

be traced back to the mandatory character of the Company Law.[73] Delaware's Corporation Code gives leeway to the board, as almost no obligatory rules for shareholder protection exist. The German Company Law however does not offer many possibilities to amend regulations for the disadvantage of shareholders.

In addition, binary evaluation of legal systems according to "0 or 1" is a very simplified method of judging the extent of shareholder protection. It is a system without gradation or weighting. Reconsidering the criteria of the LLSV index, Germany performs much better than in the original study. Without doubt I would assign a point for the preemptive right to new issues, as Germany definitively fulfils the requirements. Austria, with the identical regulation in its Company Law scores, whereas Germany misses out.

[73] Cools, *supra* note 23.

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	USA	GER
One Share – One Vote	0	0
Proxy Voting	1	1
Shares not Blocked before Meeting	1	0
Cumulative Voting/ Proportional Representation	1	0
Oppressed Minority	1	1
Preemptive Right to New Issues	0	1
Percentage of Share Capital to Call an Extraordinary Shareholder Meeting	0	1
New Score (Antidirector Rights)	4	4

Table 2: Evaluation after reconsidering the LLSV index

In addition, proxy votes of banks in Germany fulfil the same purpose as proxy voting in the United States, namely saving time, money and effort for the election of the board of directors. Germany should also score regarding minority rights. The § 147 AktG allocates to the shareholder an equivalent to derivative suits. In addition, German Company Law allows for reasons to appeal resolutions made at the annual meeting, a protection we do not find in the United States. Therefore the requirements of shareholder protection are met in this criterion.

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All in all, four points could easily be assigned to Germany. The United States would certainly loose their last point concerning call for extraordinary general meeting. Table 2 illustrates the new results after re-evaluation.

Taking this into consideration I conclude that the difference between Common and Civil Law in terms of shareholder protection is far less significant than LaPorta et al. proposes, if at all. Given the analysis, it will be interesting to see such a study for other countries as well. However, the blindfold citation of "Law and Finance" – which seems very common the moment - can and does implicate wrong political-economic measures and should therefore be avoided.