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About Face: American Ex-POWs Turned Away by the United States Government, after Denial of Reparations, What Does the Future Hold

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Board Games: Germany’s Monopoly* on the Two-Tier System of Corporate Governance and Why the Post-Enron United States Would Benefit From Its Adoption

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In the wake of the recent corporate scandals such as Enron and WorldCom, investors have lost faith in the stability of the American securities markets. Consequently, stock prices have rapidly declined over the past year and investors have lost billions of dollars. Corporations

* Other countries, such as Austria, Holland, and Indonesia also have a form of two-tier board, sometimes referred to as a “compound” board or a “split” board.

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3. Alan Reynolds, More Beltway Madness, NATIONAL REVIEW ONLINE, Aug. 6, 2002 at http://nationalreview.com/nrof_comment/comment-reynolds080602.asp (stating
are currently experiencing difficulty finding willing investors because potential investors fear that any corporation could be the next Enron.\(^4\) In the midst of this paranoia, the business world seems to be looking for an answer to the following question: "How can we prevent this from happening again, and at the same time, assure investors that the market is safe?"\(^5\) One way of improving the corporate system is to improve the structure of corporate governance.

Rather than starting from scratch, legislators should look to the corporate governance structures of other countries.\(^6\) The basic corporate form, that of a company with perpetual existence and limited liability for its owners, is common to many countries, yet each country has approached the problems faced by corporate America differently.

Germany, for example, has a corporate structure that separates those who manage the business of the corporation from those who oversee the management. This governance structure ensures more accountability for managers of the corporation's business. The idea of separating management from those who oversee management is an appealing one; therefore, U.S. legislators should look to the corporate structure of Germany for guidance in improving the American system.\(^7\)

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4. Ulick, supra note 1 (quoting Patrick Boyle, trader at Credit Suisse First Boston, as saying "No one wants to be the next Enron"); Holden Lewis, Investors' Fear of Enron Sequel Helps Mortgage Shoppers, CBS MARKET WATCH at http://www.bankrate.com/cbsmw/news/mtga/20020221a.asp?prodtype=mtg (stating "Definitely, there is an impact from the Enron crisis and the fear in equity markets that it has created") (last visited Jan. 14, 2003).

5. See Bruce A. Hiler et al., Criminalizing Business Judgment Could Stagnate U.S. Economy, ANDREWS ENRON LITIG. REP., Sept. 3, 2002 (stating that "the collapse of Enron has resulted in an avalanche of reform proposals from all corners of Washington . . . Congress has at least forty new proposals pending before it, regulators have proposed dozens of rule changes, and even the White House has offered its own 'Ten Point Plan' of proposed reforms").

6. The comparative method of problem-solving is not an uncommon approach, but rather one frequently used in the United States:

American lawyers are natural comparativists. American lawyers, judges and legislators look to other jurisdictions for solutions to similar problems . . . the American legal system is accustomed to the use of the comparative method: (i) as a model, (ii) to gain perspective; (iii) as a means to harmonize the laws between jurisdictions; or (iv) as part of a plan of unification of the law.


7. Although a stagnant economy such as Germany's can be a result of a poor system of corporate governance, see Matthew Senechal, Comment, Reforming the Japanese Commercial Code: A Step Towards an American-Style Executive Officer System in Japan?, 12 PAC. RIM L. & POL'Y J. 535, 535 (2003) (implying that a country's form of corporate governance can transform an economy), Germany's stagnant economy has been attributed to other factors, such as rising unemployment, tax increases, and the threat of war. German Economy Stagnant, CNN BUSINESS, at
Section I of this comment will explain some of the events that have created the need for corporate governance reform in the United States. Sections II and III will examine the basic structures of corporate governance in the United States and in Germany. Section IV will then examine some of the attempts to reform corporate governance structure in the United States. Finally, Section V will advocate the adoption of a modified two-tier system of corporate governance in the United States and explain why Germany’s major problems with the two-tier structure could be avoided if the system were implemented in the United States.

I. Events Creating the Need for Internal Corporate Governance Reform

The United States has experienced a recent explosion of corporate collapses, many caused by false or misleading financial statements and executive misconduct. The chairman and CEO of the investment banking firm of Goldman Sachs recently remarked “I cannot think of a time when business overall has been held in less repute.” Some of the most notable recent collapses have involved Enron, WorldCom, Adelphia, Tyco, and Global Crossing.

A. Enron

Enron was an “old line” energy company that reinvented itself in the 1990’s as an energy trading company whose primary business was trading in assorted energy mediums. The corporation used accounting strategies to misconstrue its financial situation. It created “special purpose entities” (SPEs) which financed Enron’s activities, shifted debt from Enron’s books, and hid Enron’s credit risk. These SPEs were used in many different ways to disguise risk and debt, and to create the appearance of liquidity and profitability. Some of Enron’s SPEs were


11. Id.

12. Id.

managed by Andrew Fastow, the chief financial officer (CFO) of Enron.\textsuperscript{14}

In October of 2001, after Enron’s auditor reviewed one of the SPEs and decided that the accounting had been incorrect, Enron announced it was taking a $544 million after-tax charge against earnings, and recognized that in prior transactions it had improperly recorded $1.2 billion in notes receivable transactions.\textsuperscript{15} The next month, Enron announced a re-statement of earnings and an increase in debt for the years 1997 to 2000.\textsuperscript{16} Earnings were reduced by $28 million for 1997, $133 million for 1998, $153 million for 1999, and $91 million for the year 2000.\textsuperscript{17} Reported debt was increased by $711 million for 1997, $561 million for 1998, $685 million for 1999, and $628 million for the year 2000.\textsuperscript{18} The restatements of earnings and increased debt caused a collapse in Enron’s ability to trade in the energy markets.\textsuperscript{19} Stock that had been selling between $80 and $90 per share during the year 2000 became worthless, and as a result, Enron filed for bankruptcy in December of 2001.\textsuperscript{20}

\textbf{B. WorldCom}

WorldCom announced in June, 2002, that it had overstated earnings by over $3.8 billion in the five previous quarters.\textsuperscript{21} This overstatement was in part due to a strategy of treating operating costs as capital investments.\textsuperscript{22} In addition to the restatement of earnings, WorldCom also announced that it would eliminate twenty percent of its work force.\textsuperscript{23} WorldCom’s market capitalization fell from over $115 billion to less than $1 billion.\textsuperscript{24}

\begin{itemize}
\item 2003).
\item \textsuperscript{14} Ruder, \textit{supra} note 10.
\item \textsuperscript{15} \textit{Id.}
\item \textsuperscript{16} \textit{Id.}
\item \textsuperscript{17} \textit{Id.}
\item \textsuperscript{18} \textit{Id.}
\item \textsuperscript{19} Ruder, \textit{supra} note 10.
\item \textsuperscript{23} See \textit{id.}
\end{itemize}
C. Adelphia Communications

In the spring of 2002, Adelphia Communications admitted that it had guaranteed loans of $2.3 billion to family members of its controlling shareholders. In June, 2002, Adelphia filed for protection under Chapter 11 bankruptcy laws, causing its stock to fall from a high of nearly $28 per share to a low of $0.01 per share.

D. Tyco International

In 2002, the former CEO of Tyco International was indicted on charges of state sales tax evasion. The indictment, coupled with concerns about the use of corporate funds for the personal benefit of the CEO and general counsel of the corporation, caused Tyco International’s market capitalization to fall by $100 billion in 2002.

E. Global Crossing Ltd.

After Global Crossing Ltd. filed for bankruptcy, the former chairman and founder of the corporation was questioned regarding sales of over $700 million of his stock in the corporation in 1999. At the time of the sale, the stock had reached a high of $60 per share. However, by the end of 2001, the company filed for bankruptcy following allegations that the corporation’s revenues were inflated due to exchanges that were without economic substance.

II. Basic Corporate Governance in the United States

The American corporate governance structure is a one-tier system, also known as a unitary board system. The main participants in governance of American corporations are officers, directors, and shareholders. Although corporate law differs among the states, the general default structure of corporate governance features certain predominant characteristics present in corporations of every state.

26. See id.
28. See Alex Berenson, Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System, N.Y. TIMES, June 10, 2002 at C1.
29. See id.
31. See id.
A. The Board of Directors

The board of directors of an American corporation has primary responsibility for overseeing the business and affairs of the corporation.\(^{33}\) The board is ultimately responsible for safeguarding the well-being of the corporation.\(^{34}\) In the past, corporate governance norms required that boards of directors manage the business of the corporation. Today, however, the board does not have the ability or resources to manage the corporation.\(^{35}\) Today's boards are primarily monitoring boards, whose main function is to select, evaluate, fix the compensation of, and replace the senior executives.\(^{36}\) The board also monitors the conduct of the corporation's business activities to evaluate whether the business is managed properly.\(^{37}\) Whatever form the board takes, it continues to wield ultimate authority over, and responsibility for, decisions concerning the corporation.\(^{38}\)

B. The Officers

Responsibility for a corporation's day-to-day activities is often delegated to one or more officers who act as agents of the corporation, or more specifically, as agents of the board, which is the personification of the corporation.\(^{39}\) The corporate codes of the United States allow the corporation's directors to determine, either in the by-laws or through

33. See Del. Code Ann. tit. 8, § 141(a) (1999) [hereinafter DGCL] (stating that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may otherwise provided in this chapter or in its certificate of incorporation); Revised Model Bus. Corp. Act § 8.01(b) (1984) [hereinafter RMBCA] (stating that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its boards of directors . . .")

34. See DGCL, supra note 33, § 141(a); RMBCA, supra note 33, § 8.01(b).

35. Charles M. Nathan, Overkill, The Daily Deal, Sept. 14, 2002 at http://www.lw.com/resource/publications/_pdf/pub474.pdf (stating that "the board does not have the time, resources or skills to manage the modern corporation").

36. See RMBCA supra note 33, § 8.01(b) official cmt. (stating that "in most corporations . . . the role of the board of directors consists principally of the formulation of policy, the selection of the chief executive officer and other key officers, and the approval of major actions or transactions").

37. Melvin A. Eisenberg, Corporate Law and Social Norms, 99 Colum. L. Rev. 1253, 1278 (1999) (stating that until about twenty years ago, the dominant model of the board was that of a managing board, which was hopelessly unrealistic, because part-time directors cannot manage the business of, or even set business policy for, a complex enterprise).

38. DGCL, supra note 33, § 141(a); RMBCA, supra note 33, § 8.01(b).

39. Enno W. Ercklentz, Jr., Modern German Corporation Law Vol. 1 at 90 (Oceana Publ'ns 1979); see DGCL, supra note 33, § 142(a) (stating that officers have "such duties as stated in the by-laws or in a resolution of the board of directors . . ."); RMBCA, supra note 33, § 8.41 (stating that "[e]ach officer has the authority and shall perform duties set forth in the by-laws or . . . prescribed by the board of directors").
resolution, the number of officers the corporation will have and the titles of those officers.\textsuperscript{40} However, both the Delaware General Corporations Law (DGCL) and the Revised Model Business Corporation Act (RMBCA) require corporations to have at least one officer who functions as the corporation's "secretary."\textsuperscript{41}

While the board has the statutory authority to create its officers, give them appropriate titles, and delegate to them any combination of duties, few public corporations stray far from the standard model of governance. In this standard model, the chief executive officer (CEO), is the highest ranking officer and has the authority to bind the corporation in transactions entered into in the ordinary course of business. Most corporations are reluctant to adopt a model that greatly deviates from the standard because deviation results in uncertainty, which increases transaction costs.\textsuperscript{42} Furthermore, courts will sometimes adopt the presumption that the person titled president or CEO has the authority to bind the corporation, even if the board of directors did not delegate those particular powers to the person with that title.\textsuperscript{43} In the United States, the chairman of the board of directors (chairman) and the chief executive officer are often the same individual.

\section*{C. The Shareholders}

Although the shareholders are the owners of the corporation, they have a very limited role. Robert Thompson sums up the role of the shareholder in an American corporation in one sentence: "They can vote, sell, or sue."\textsuperscript{44} Shareholders have the power to elect and to remove directors\textsuperscript{45} and to vote on some fundamental changes to the corporation.\textsuperscript{46}

\textsuperscript{40} DGCL, \textit{supra} note 33, § 142(a) (stating that every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the by-laws or in a resolution of the board of directors); RMBCA, \textit{supra} note 33, § 8.40(a) (stating that a corporation has the offices described in its by-laws or designated by the board of directors).

\textsuperscript{41} DGCL, \textit{supra} note 33, § 142(a) (stating that one of the officers shall have the duty to record the proceedings of the meetings of the stockholders and directors); RMBCA, \textit{supra} note 33, § 8.40(c) (stating that the by-laws or board of directors must assign to one of the officers responsibility for preparing minutes of the directors' and shareholders' meetings and for maintaining and authenticating the records of the corporation required to be kept).


\textsuperscript{43} See Lee v. Jenkins Brothers, 268 F.2d 357 (2d Cir. 1959).


\textsuperscript{45} Shareholders may remove a director with or without cause, unless the articles of incorporation state that directors may only be removed for cause. In any case, the share-
Shareholders have the power to adopt, amend, and repeal the corporation's bylaws, but they do not have the power to initiate or compel action. Furthermore, their only control over managers is indirect: managers are appointed by the board of directors, and the shareholders elect the directors.

III. Basic Corporate Governance in Germany

The German legal system establishes two different forms of corporations. The first, the Gesellschaft mit beschränkter Haftung (GmbH) is similar to the American version of the close corporation. GmbHs are governed by the Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbH law). The second kind of corporation, the Aktiengesellschaft (AG), is similar to the American version of a publicly traded corporation and is governed by the Aktiengesetz (AktG). This comment will focus on the AG, which is most comparable to the American pub-
licly traded corporation.\textsuperscript{52}

The AG has a two-tier board system which consists of a \textit{Vorstand}\textsuperscript{53} (management board), and an \textit{Aufsichtsrat}\textsuperscript{54} (supervisory board).\textsuperscript{55} German corporate law draws a strict line between these two organs, requiring that membership in the two boards be mutually exclusive.\textsuperscript{56} Under German law, a member of the management board of a corporation is prohibited from also sitting on the supervisory board of the same corporation.\textsuperscript{57} This is the major difference between a unitary board, such as that of a United States corporation, and a two-tier board, such as that of a German corporation: in a unitary board, a member of the board of directors may also be an officer; in a two-tier board, a member of the supervisory board may \textit{not} sit as a member of the managing board, or vice versa.

There are two other major differences between the corporate governance in Germany and that of the United States. In Germany, labor has a function in the corporation's governance structure, a principle called codetermination.\textsuperscript{58} Additionally, German financial institutions play a much larger role in the governance of German corporations.\textsuperscript{59}

\section*{A. The Supervisory Board in German Corporate Governance}

The principle duty of the supervisory board is to appoint a \textit{Vorstand} (management board), and to oversee and monitor the \textit{Vorstand}'s man-

\footnotesize{}

\begin{itemize}
\item \textsuperscript{52} The proposal for a two-tiered board system does not apply to the United States close corporation. The close corporation is often run by only a handful of people, who often serve as majority shareholders, officers, and executives. Consequently it is necessary for each person to wear many different hats, and would be impractical to mandate strict separation between the members of the board and executives.
\item \textsuperscript{53} Aktiengesetz § 76(1) [hereinafter AktG] (Germany's stock corporation law), available in translation in \textsc{Hannes Schneider \\& Martin Heidenhain, The German Stock Corporation Act} (2d. ed. 2000).
\item \textsuperscript{54} AktG, supra note 53, § 90.
\item \textsuperscript{55} The two-tier system of corporate governance has been in place in Germany for over 130 years, since 1870. \textit{See} Manuel Rene' Theisen \\& Wolfgang Salzberger, Germany's "\textit{Aufsichtsrat}" Board: Three Ideas for the "Two-Tier" Approach, Legamedia, Articles, Business, at http://www.legamedia.net/legamall/2002/02-02/0202_theissen-salzberger_aufsichtsrat_e.php (last visited Jan. 14, 2003).
\item \textsuperscript{56} AktG, supra note 53, § 105.
\item \textsuperscript{57} \textit{Id.} (stating that a member of the supervisor board may not also be a member of the management board, a permanent deputy member of the management board, a registered authorized officer, or general manager of the company).
\item \textsuperscript{58} There have been 4 major codetermination laws enacted. Their general purpose is to ensure representation of employees of certain corporations on the supervisory boards of those corporations. For more information on codetermination, \textit{see infra} note 65.
\item \textsuperscript{59} \textit{See} Benjamin J. Richardson, \textit{Enlisting Institutional Investors in Environmental Regulation: Some Comparative and Theoretical Perspectives}, 28 N.C.J. INT'L L. \\& COM. REG. 247, 305 (2002) (stating that the German model of corporate governance views the existence of multiple financial relationships as offering superior avenues for investor influence).
\end{itemize}
Accordingly, the supervisory board does not have the authority to declare dividends, as does its United States counterpart.\textsuperscript{61}

In accordance with the supervisory board's power to oversee the management of the corporation, German corporate law requires that the management board report to the supervisory board on several important issues. These issues include the \textit{management board's} intended business policy and other fundamental matters regarding the future strategy of the company, the profitability of the company, the state of business, transactions which may have a material impact upon the profitability or liquidity of the company, and the occurrence of other significant developments.\textsuperscript{62}

Subject to exceptions, the supervisory board usually consists of three members.\textsuperscript{63} This number can be altered in the \textit{saltzing} (articles of incorporation), but must always be divisible by three, and cannot, in any event, exceed specified limits. These limits are related to the stated capital of the AG.\textsuperscript{64} However, if German codetermination laws apply, the composition of the supervisory board will be governed by the codetermination laws, rather than by the AktG.\textsuperscript{65}

\begin{itemize}
\item \textsuperscript{60} AktG, \textit{supra} note 53, § 84(1) (stating that the supervisory board shall appoint the members of the management board); \textit{id.} § 111(1) (stating that the supervisory board shall supervise the management of the company).
\item \textsuperscript{61} See DGCL, \textit{supra} note 33, § 170 (stating that the directors of every corporation may declare and pay dividends); RMBCA, \textit{supra} note 33, § 6.40 (stating that a board of directors may authorize distributions to its shareholders).
\item \textsuperscript{62} AktG, \textit{supra} note 53, § 90.
\item \textsuperscript{63} \textit{Id.} § 95.
\item \textsuperscript{64} \textit{Id.}
\item \textsuperscript{65} There are four main codetermination laws: The 1952 codetermination law does not impose any requirements as to size on its own, but merely provides that the supervisory board of any AG that falls within this law, and is not subject to an exemption from the law, must ensure that one third of the supervisory board shall consist of employee representatives. Therefore, the size of the supervisory board will be determined by the AktG because the '52 codetermination law does not impose its own numerical requirements. Betriebsverfassungsgesetz vom 11. Oktober 1952 (BGB\textit{I} S. 681), as amended by Gesetz vom. 14. December 1976 (BGB\textit{I} S. 3341) [hereinafter Codetermination Law of 1952]. The 1951 codetermination law primarily applies to AGs engaged in the coal, iron, or steel industries, and its application is limited to AGs with more than 1,000 employees. If this law applies, the supervisory board must consist of eleven members unless the articles provide for a larger number. Of the eleven members, five must be representatives of the stockholders, five representatives of the employees, and one is elected by the shareholders upon a motion of the other members of the supervisory board. Although the law allows the number of members to be increased by the articles, the proportion of members elected by shareholders to members elected by employees must remain the same, with election of the last member by stockholders upon motion of the other members of the supervisory board. Gesetz ueber die Mitbestimmung der Arbeitnehmer in den Aufsichtsraten und Vorstaenden der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie vom 21. Mai 1951 (BGB\textit{I} S. 347), as amended by Gesetz vom 6. September 1965 (BGB\textit{I} S. 1185) [hereinafter Codetermination Law of 1951]. The supplementary codetermination law applies to holding companies in the coal, iron and steel industries. This law dictates composition of supervisory boards of AGs which, although not themselves falling within the provisions
\end{itemize}
German codetermination laws govern the number of members on the supervisory board in qualifying AGs. These laws assign half of the supervisory board seats to representatives of labor under the principle of codetermination, allowing the shareholders to appoint the remaining members. In AGs that are not governed by codetermination laws, the AktG sets the number of supervisory board members depending on the amount of the corporation's stated capital. For example, the law states that the number of members for companies with a share capital of up to 1,500,000 euros shall be nine, of more than 1,500,000 euros shall be fifteen, and of more than 10,000,000 euros shall be twenty-one. Thus the supervisory board may consist of up to twenty-one members, but the number of members must always be divisible by three.

though not themselves falling within the provisions of the 1951 codetermination law, are deemed to dominate an enterprise which is subject to the 1951 law. If these conditions exist, the supplementary law might apply, depending on the gross turnover of the combined group involved and the proportion of that gross turnover which is attributable to sources in the coal, iron & steel industries. If the law applies, the supervisory board must consist of fifteen members, with seven elected by shareholders, seven by employees, and the last elected by shareholders upon a motion of the other members of the supervisory board. Under certain circumstances, the articles may dictate higher number of members, as long as the proportion of shareholder representatives to employee representatives stays the same, with the last member elected by shareholders upon a motion of the other members. Gesetz zur Ergänzung des Gesetzes über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie vom 7. August 1956 (BGBl. I S. 707), as amended by Gesetz vom 27. April 1967 (BGBl. I S. 505) [hereinafter Supplementary Codetermination Law]. The 1976 codetermination law applies to all AGs employing more than 2,000 workers and employees, which are not already covered by either the 1951 law or the supplementary law. AGs with less than 2,000 workers are unaffected by the 1976 law, but may still be subject to the 1951 law, supplementary law, or the 1952 law. Where the 1976 law applies, the size and composition of the supervisory board is determined by the number of persons regularly employed by the AG. An AG that regularly employs up to 10,000 people will have a supervisory board of twelve members, with half representing the shareholders, and half representing the employees. AGs with 10,000 - 20,000 employees will have sixteen members, and AGs with over 20,000 employees will have twenty members on the supervisory board. Whatever the number of members on the supervisory board, it must always retain the proportion of fifty percent representatives of the shareholders and fifty percent representatives of the employees. Some of the employee representatives must be union representatives. Thus, where there are six or eight employee representatives, two must be union representatives. Where there are ten employee representatives, three must be union representatives. Gesetz über die Mitbestimmung der Arbeitnehmer vom 4. Mai 1976 (BGB 1 S. 1153) [hereinafter Codetermination Law of 1976].

66. See id.
68. As of Jan. 20, 2003, 1 euro equaled 1.06428 United States dollars. At this conversion rate, 1,500,000 euros equals 1,596,394 United States dollars.
69. AktG, supra note 53, § 95.
70. Id.
B. The Management Board

The members of the management board of a German corporation direct the business of the AG on a day-to-day basis by managing the AG’s internal affairs and by representing it in the business world. Hierarchy among the members of the management board is prohibited by German corporate law; all members are theoretically equal and each is usually in charge of a defined area of the activities of the AG. However, the supervisory board may designate one person to act as the chairman of the management board, although he or she does not gain any additional powers. The management board bears the ultimate responsibility for the management of the corporation’s affairs, unlike the officers of a corporation in the United States. The management board is appointed through a resolution of the supervisory board. The supervisory board is authorized to appoint members of the management board, and the appointment may be renewed or the term of office extended, provided that the renewal or extension does not exceed five years. Management board appointments must be accomplished by a resolution of the supervisory board. Resolutions require a majority vote at a meeting of the supervisory board at which a quorum is present. The management board is also authorized to promulgate the by-laws of the corporation, which can only be accomplished through a unanimous vote of that board. In theory, the management board is somewhat dependant on the supervisory board. However, in reality, the supervisory board is also dependant on the management board for the flow of information.

C. The Shareholders

Unlike shareholders of American corporations, shareholders of

71. Id. § 76.
72. Id. § 78.
73. Id. § 84.
74. AktG, supra note 53, § 76(1) (stating that the management board shall have direct responsibility for the management of the company).
75. See DGCL, supra note 33, § 141(a) and RMBCA, supra note 33, § 8.01(b), stating that directors bear the ultimate responsibility for management of the corporation’s affairs.
76. AktG, supra note 53, § 84(1).
77. Id.
78. Id. § 108 (stating that the supervisory board shall decide by resolution and that the default quorum requirement is not less than one-half of the number of members).
79. Id. § 77(2).
80. See, e.g., Theisen & Salzberger, supra note 55, (stating that in the case of the Daimler/Chrysler merger in 1998, the supervisory board was informed only on the sixth of May, the same day the Wall Street Journal reported the potential merger, and one day before the merger was formally announced).
German corporations have the power to amend the articles of incorporation and to declare dividends. German shareholders also have the power to elect the members of the supervisory board, which then appoints the managerial board. Similarly, American shareholders elect the board of directors, which then appoints the officers of the corporation. However, private individual investors are less common in Germany than they are in the United States. The majority of German investors are financial institutions and large investment blocks.

IV. Reform Attempts in the United States

Although statutes addressing the subject of corporate governance in American corporations have traditionally been a product of state law, the post-Enron United States has suddenly become more amenable to federal legislation in this area. This shift might be a sign of the growing approval of the “race to the bottom” theory, spurred by recent corporate scandals. One example of new federal corporate legislation is the Sarbanes-Oxley Act of 2002, passed less than a year after Enron declared bankruptcy. Numerous federal bills have been proposed that contem-

82. Id. (stating that election of members of the supervisory board shall take place at the shareholders’ meeting); id. at § 84(1) (stating that the supervisory board shall appoint the members of the management board).
83. Id. § 101.
85. See NAT’L ASS’N OF CORPORATE DIR., REFORM SEASON: MORE THAN SOUND AND FURY, in 1318 PRACTISING LAW INST. CORPORATE LAW & PRACTICE COURSE HANDBOOK SERIES, 551, 557 (June-July 2002) [hereinafter NACD] (detailing post-Enron reform proposals made by President Bush and by Congress).
86. The race to the bottom theory contends that in an effort to entice large companies to incorporate in their state, legislators will make the laws of their state more management-friendly by systematically eliminating or reducing shareholder protections. Therefore, the only way to protect shareholder interests is to adopt federal minimum standards. See e.g., William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663 (1974); Donald E. Schwartz, A Case for Federal Chartering of Corporations, 31 BUS. LAW. 1125 (1976). Opponents of the race to the bottom theory argue that market forces will cause shareholders to chose to invest in those corporations incorporated in the state with the most shareholder-friendly laws, and that management-friendly corporations will suffer a decrease in stock price, causing corporations to eventually gravitate toward the states whose laws are more shareholder friendly. See e.g., Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. LEGAL STUD. 251 (1977). While these theories have existed for a long time, the recent outbreak of corporate bankruptcies seems to have created renewed interest in federalizing shareholder interests.
plate countless ways of preventing future collapses similar to that of Enron. Additionally, the NASDAQ Stock Market, Inc., and the New York Stock Exchange have also proposed their own guidelines for corporate governance reform, and the American Bar Association issued a Preliminary Report of the Task Force on Corporate Responsibility (ABA Report).

A. Sarbanes-Oxley Act

On January 23, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (Act). Some of the goals of the Sarbanes-Oxley Act include increasing accounting transparency of the corporate auditing system, increasing the independence of auditors and audit committees, codifying ethical standards for accountants and key executive officers, enhancing financial disclosure, preventing the profit-taking of corporate executives during pension plan blackout periods, and increasing the fines, civil and criminal liability for executives who fail to operate in a legal and ethical manner.

Because the Enron and WorldCom scandals brought to light serious deficiencies in corporate financial procedures, the Act focuses mainly on audits, accounting, and other financial matters. Although the Sarbanes-Oxley Act is very important to corporate governance reform because it is the first step toward federalized corporate governance standards, the Act does not directly address the problem of inside directors, and therefore, is inadequate to resolve the problems raised in this comment.

B. New York Stock Exchange Proposal


88. See NACD, supra note 85, at 558 (listing major reform bills, and stating that "[t]he spring legislative session of the current Congress could well go down in history as 'Enron season'").
89. ABA Report, supra note 22.
90. Sarbanes-Oxley Act, supra note 87. The Act is subdivided into eleven titles: public company accounting oversight board; auditor independence; corporate responsibility; enhanced financial disclosures; analyst conflicts of interest; commission resources and authority; studies and reports; corporate and criminal fraud accountability; white-collar crime penalty enhancements; corporate tax returns; and corporate fraud and accountability. Id § 1.
91. See Aldrich & Bonnefin, supra note 87.
92. Id.
(NYSE) to review its corporate governance listing standards. Subsequently, the New York Stock Exchange appointed a Corporate Accountability and Listing Standards Committee (Committee) which drafted proposals for corporate governance reform. These proposals will be codified in § 303A of the New York Stock Exchange's Listed Company Manual, and will apply to all companies listing common stock on that Exchange.

One rule recommended by the Committee requires that listed companies have a majority of independent directors. The Committee reasoned that "[e]ffective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest." The proposed rules define independent directors as those directors with no material relationship with the listed company. The proposed rules also require the independent directors to hold regularly scheduled executive sessions in the absence of management. This rule is designed to encourage independent directors to be more autonomous. However, the risk that directors will continue to passively agree with management cannot be eliminated.

94. NYSE Report, supra note 93, introduction.
95. Certain types of companies are exempted.
96. NYSE Report, supra note 93, introduction.
97. Id., recommendation.
98. Id. The Committee addresses the concept of director independence as follows:
   • No director qualifies as "independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).
   • In addition:
     - No director who is a former employee of the listed company can be "independent" until five years after the employment has ended.
     - No director who is, or in the past five years has been, affiliated with or employed by a (present or former) auditor of the company (or of an affiliate) can be "independent" until five years after the end of either the affiliation or the auditing relationship.
     - No director can be "independent" if he or she is, or in the past five years has been, part of an interlocking directorate in which an executive officer of the listed company serves on the compensation committee of another company that employs the director.
     - Directors with immediate family members in the foregoing categories must likewise be subject to the five-year "cooling-off" provisions for purposes of determining "independence."
99. Id. This rule was designed to promote open discussion among the non-management directors. NYSE Report, supra note 93, commentary.
100. Id., recommendation (requiring such sessions in an attempt to "empower non-management directors to serve as a more effective check on management").
unless the entire board is comprised of independent directors. Therefore, this proposal is also an insufficient attempt at corporate governance reform.

C. NASDAQ Proposal

Pursuant to the SEC Chairman’s request, NASDAQ also drafted a proposal addressing corporate governance reform.\textsuperscript{101} The proposal requires independent directors to comprise a majority of the board of directors, and mandates that these independent directors regularly convene executive sessions in the absence of inside directors or management.\textsuperscript{102} The proposal also limits the types of payments an independent director may accept.\textsuperscript{103} Directors are deemed not to be independent if any family member of the director is, or has been within the past three years, employed as an executive officer of the corporation or any of its affiliates.\textsuperscript{104} Furthermore, a director is not independent if, within the past three years, he or a member of his family not employed by the corporation has received any payments in excess of $60,000, other than for service on the board of directors.\textsuperscript{105} This prevents an executive from quitting his job as an officer to become an “independent” member of the board. Additionally, NASDAQ has listed as a “proposal under consideration,” a rule requiring continuing education for all directors.\textsuperscript{106}

D. Preliminary\textsuperscript{107} Report of the American Bar Association Task Force on Corporate Responsibility

In March of 2002, following the bankruptcy of Enron, the President of the American Bar Association appointed a task force to investigate corporate responsibility concerns.\textsuperscript{108} After conducting several formal

\begin{footnotes}
\item[102] \textit{Id.}
\item[103] \textit{Id.}
\item[104] \textit{Id.}
\item[105] \textit{Id.}
\item[106] NASDAQ Proposal, \textit{supra} note 101.
\item[107] The report is a \textit{preliminary} report – it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be considered as representing the policy of the American Bar Association. ABA Report, \textit{supra} note 22, cover page.
\item[108] The President of the American Bar Association charged the task force: The Task Force on Corporate Responsibility shall examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the
\end{footnotes}
and informal meetings, drawing on the collective personal experience of the members, the task force produced a preliminary report.\textsuperscript{109} The report begins by recognizing that most executives, directors, and advisors act honestly and in good faith, but sometimes they may "succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being."\textsuperscript{110} The report emphasizes the importance of oversight by independent members of the corporate governance system, such as outside directors, outside auditors, and outside counsel, to serve as a check on this temptation.\textsuperscript{111} Therefore, the report concludes that corporate responsibility and sound corporate governance rely upon the these independent participants, who must be empowered to act vigorously and in the best interests of the corporation.\textsuperscript{112} Furthermore, these independent participants must be genuinely dedicated to zealously executing their responsibilities.\textsuperscript{113}

The ABA Report recommends that a "substantial majority" of the members of the board of directors should be independent of management, both in fact and in appearance.\textsuperscript{114} Like the NASDAQ proposal, the ABA Report suggests that independent directors regularly hold executive sessions outside the presence of any senior corporate officer or director who is not independent.\textsuperscript{115} While the report does not define "independent," it states that the Task Force supports the concepts of independence advanced by the New York Stock Exchange Proposal.\textsuperscript{116} While each attempt at corporate governance reform is unique, most reflect a common theme: the pressing need to reform the corporate governance structure of American corporations—in particular, the need for the board of directors to have more autonomy.

framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust incorporate integrity and responsibility. The Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.

ABA Report, \textit{supra} note 22.

\begin{itemize}
  \item \textsuperscript{109} \textit{Id.}
  \item \textsuperscript{110} \textit{Id.}
  \item \textsuperscript{111} \textit{Id.}
  \item \textsuperscript{112} \textit{Id.}
  \item \textsuperscript{113} ABA Report, \textit{supra} note 22.
  \item \textsuperscript{114} \textit{Id.}
  \item \textsuperscript{115} \textit{Id.}
  \item \textsuperscript{116} \textit{See supra} text accompanying note 98.
\end{itemize}
V. Adoption of the German Two-Tier Board Structure in the United States

In corporations with a unitary board system, the board often complies with every decision management makes. Board members are often uninformed, uninvolved, or unassertive, and they fail to adequately monitor management of the corporation. This results in an entire board that may be too compliant and submissive to serve as an effective check on management. Alternatively, the directors may have a personal involvement with the officers, preventing the board of directors from acting as a genuine check on them.

The lack of separation between the board of directors and executives in American corporations has been a frequent target of criticism. Adoption of a default corporate governance structure similar to that of the German structure would have the potential to prevent corporate corruption by forcing a separation between those who manage the day-to-day affairs of the corporation and those who appoint and oversee the managers.

A. The Benefits of Adopting the German Model of Corporate Board Structure

In light of Enron, the proposals of the New York Stock Exchange and NASDAQ, and other recent proposals, the message is clear: “substantial changes are needed in corporate governance procedures in order to create an environment for monitoring of management that will be effective.” Individuals intimately familiar with the German corporate system attest to the fact that the “two-tier system does not display several of the problems now being discussed in the UK or US . . . .” The two-tier system would separate the functions of management and monitoring, increase the accountability of management, implement a system of checks and balances on the two governing bodies, allow for superior feedback on management decisions, and result in less opportunity for corruption to go unnoticed.

117. See Theisen & Salzberger, supra note 55.
118. There is already a distrust of corporate managers in the American system. See Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. PA. L. REV. 1, 49 (1987) (stating that the American Law Institute’s approach to corporate governance continues to reflect some distrust of corporate managers).
In the United States, it is common practice for the CEO of a corporation to also hold the position of chairman of the board of directors. This practice began as a way of promoting a CEO when he performed well, and soon evolved into a practice followed by two-thirds of U.S. corporations. Today, many CEOs demand to occupy the position of chairman of the board, believing that they will appear to have a lower status if they do not fill both positions. While the combination of these positions has the benefit of facilitating the CEO's job by making it faster and easier to obtain the board’s approval, and it serves as an incentive to attract well qualified applicants to the position of CEO, the practice creates several governance problems. It forms a concentration of power, dilutes supervision of management, and renders the rest of the board of directors effectively useless.

Adoption of the German two-tier board structure would remedy the problem of the executive director by forcing a separation between those who manage the day-to-day affairs of the corporation and those who appoint and oversee these managers, resulting in more detached and objective oversight. Adoption of the German corporate structure in the United States would have the desirable outcome of holding the officers of a corporation accountable to a separate and distinct governing body. A two-tier structure is necessary in order to have a true separation of the functions of managing and supervising.

The supervisory board would also act as a breakwater for corruption. The type of corruption experienced by Enron would be less likely to occur in a corporation with a two-tier board structure, because executives would not "set, mark, and report on their own exam papers." The independence of the German supervisory board would result in monitors that are more inclined and able to challenge the managers of the corporation. Institution of the German system would, in effect, impose a system of checks and balances on those responsible for managing the corporation.

Additionally, the division of power created through the two-tier structure helps in the mediation of conflicts, allows access to superior

121. In fact, Ken Lay was both CEO and chairman of the board of directors of Enron.
122. Pearlstein, supra note 2.
123. Id.
124. See Eisenberg, supra note 37 (stating that in order for a board of directors to have a monitoring board, as opposed to a managing board, the monitoring board must consist of at least a majority of directors who are independent of the senior executives).
126. See Pearlstein, supra note 2.
feedback from stakeholders, and enhances the integrity of firm governance. The German system of corporate governance would have the additional benefit of providing a long-term outlook without constricting deal making, entrepreneurial talents, or the ability of the management board to run the company.

The concept of separating managerial functions from supervisory functions is not a radical idea. The post-Enron United States considers separation of the management and monitoring functions to be a keystone of corporate governance reform. The New York Stock Exchange and NASDAQ proposals for reform both include requirements that independent directors comprise a majority of the board of directors. Similarly, the ABA Report and the Business Roundtable's Principles of Corporate Governance (Roundtable Principles) both recommend that the board of directors be comprised of a "substantial majority" of independent directors, suggesting that more than a simple majority should be required. CFO Magazine stated that the idea of separating the CEO and chairman roles is one idea that is most likely to be imported from European corporate practice. In fact, sixty-nine percent of the American corporate directors surveyed recently stated that they would support a move to separate the chairman and CEO roles. Bert Denton, president of the New York based investment firm Providence Capital Inc., is plan-

127. The term "stakeholders" refers to owners, debtors, and employees of the corporation.
129. Id. (stating that the presence of a second-level board holds a promise of improved oversight and monitoring of the company’s direction, performance, and top management).
130. See, e.g., Felton & Watson, supra note 2 (stating that the essential objective in corporate governance reform must be to reestablish the balance between management and the board so that the former runs the company while the latter contributes to its strategic and operational development and provides the oversight needed to satisfy shareholders).
131. NYSE Report, supra note 93; NASDAQ Proposals, supra note 101.
132. ABA Report, supra note 22.
134. See ABA Report, supra note 22; Roundtable Principles, supra note 133.
136. Id. (stating that U.S. executives are enamored with the idea of splitting the CEO and chairman roles. A combined sixty-nine percent of respondents in McKinsey & Co.’s 2002 Director Opinion Survey on Corporate Governance either very much support or somewhat support the move. However, to date, less than twenty percent of companies have actually adopted the practice, according to Bert Denton, president of the New York based investment firm Providence Capital Inc.).
ning a campaign to encourage American boards to switch to a nonexecutive chairman of the board.

While efforts like those of Mr. Denton are laudable, many firms will not adopt such measures until they are mandated by law. Furthermore, although a separation of the roles of the CEO and chairman is a good start, it is not sufficient without further reform. A two-tier structure, one in which the board is wholly independent of officers, is necessary in order to have a true separation of the functions of managing and supervising. Therefore, federal legislation implementing a two-tier board structure is both advantageous and necessary to achieve a more efficient corporate board structure in the United States.

B. The Biggest Problems Encountered in the German System of Corporate Governance Could be Avoided in the United States

The German system has often been criticized by American scholars and others for the extent to which large German banks control the corporate world. Another criticism of the German system has focused on the codetermination laws of that country. These problems could be avoided in the United States by selectively implementing only the board structure of German corporations, rather than the entire German corporate system.

1. American Banks Will Not Control the Corporate World Because They Are Prohibited From Doing So.

Prior to the Great Depression, banks played a large role in corporate governance—a role similar to that of German banks in German corporations. However, this relationship was often viewed critically

137. Id. (stating that although sixty-nine percent of directors surveyed supported a split of the chairman and CEO roles, less than twenty percent of companies have actually adopted the practice).

138. See Thomas J. Andre, Jr., Some Reflections on German Corporate Governance: A Glimpse at German Supervisory Boards, 70 TUL. L. REV. 1819, 1822 (1996) (stating that much of the criticism of the German system of corporate governance focuses on the fact that the supervisory boards of many large German companies are dominated by representatives of major German banks); see also Practical Law Company, Law Department UK, Corporate Governance, The German Two Tier Board, at http://lduk.practicallaw.com/scripts/article.asp?Article_ID=3237 (last visited Jan. 14, 2003) (stating that one of the structural flaws of the German system is that the appointment procedures are suspect because companies tend to have strong long term relationships with their banks, which is often reflected in the make-up of the supervisory boards. In fact, "[the chair is often a banker who dominates the supervisory board].")

139. See infra text accompanying note 151.

140. LESTER C. THUROW, HEAD TO HEAD, 135-36 (1992); see Corinne A. Franzen, Note, Increasing the Competitiveness of U.S. Corporations: Is Bank Monitoring the Answer?, 2 MINN. J. GLOBAL TRADE 271, 275 (stating that the Glass-Steagall Act was Con-
because of the potential for banks to manipulate certain companies. The Glass-Steagl Act separates commercial banks from investment banks, and prohibits commercial banks in the United States from entering into the securities business. Under the Glass-Steagl Act, a bank may not underwrite, distribute, sell, or deal in corporate securities, except on its own account. The Act also states that banks may not affiliate with any company engaged principally in underwriting securities. Commercial banks are prohibited from managing a company engaged primarily in the securities business, and investment banks may not accept deposits. Although there have been movements to repeal this act, and commercial banks have had some success in

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141. Examples of this manipulation include: bankers loaning money to customers to purchase equities sold by the bank’s own securities departments, often at inflated prices; banks purchasing overvalued stocks from their securities affiliates to place in customers’ trust accounts; and banks raising money for their customers by selling stock whose proceeds were used to pay off outstanding bank loans before a company failed. Franzen, supra note 140 (citing MICHAEL T. JACOBS, SHORT-TERM AMERICA 144 (1991)).


143. Id.

144. Id. Section 16 states: The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock; Provided, that the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe.

Id. § 16 (emphasis in original).

145. Id. Section 20 provides: “[N]o member bank shall be affiliated in any manner . . . with any corporation . . . or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities.” Id. § 20.

146. Id. Section 32 prohibits directors, officers, or employees of banks from simultaneously holding similar positions at firms “primarily engaged in the issue, flotation, underwriting, public sale or distribution . . . [of] securities.” Id. § 32.

147. Id. Section 21 prohibits: any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor . . . .


expanding their powers, the current law forbids the trespass of banks into the securities market.

2. The Two-Tier Board System Could Be Implemented in the United States Without Codetermination.

The codetermination laws of Germany may be the most controversial aspect of the German corporate system, and a cause of much unspoken frustration among German executives. These laws have been a major source of criticism, both in the United States and in Germany. Joachim Schwalbach, of Berlin’s Humboldt University, states that “[t]his is the only country in the world that thinks co-determination is the right way to make corporate decisions.”

However, Germany’s two-tier system of corporate governance could be implemented in the United States without codetermination, eliminating yet another major problem with the German system of corporate governance. Proof that a corporation with a two-tier system of corporate governance can function independently of codetermination is found in the fact that those AGs which do not qualify under one of Germany’s four codetermination laws are successfully governed under the two-tier system of corporate governance in the absence of codetermination laws.

VI. Conclusion

In the aftermath of numerous corporate scandals in the United States, Americans have been left searching for answers. The German model of corporate governance offers a practical answer. The two-tier system would provide American corporations with a better means of monitoring the actions taken by those who manage the day-to-day opera-

149. See Frank M. Tavelman, Note, American Banks or the Glass-Steagall Act—Which Will Go First?, 21 Sw. U. L. Rev. 1511, 1514-16 (1992) (listing the areas in which commercial banks have expanded their powers under the Glass-Steagall Act).
150. Benoit, supra note 120.
151. See Chantayan, supra note 84, at 450-51 (2002) (stating that one problem affecting a vibrant capital market in Germany is codetermination); Mark J. Roe, German Codetermination and German Securities Markets, 5 COLUM. J. EUR. L. 199, 201 (1999) (stating that the “codetermination structure fits poorly with diffuse ownership”); Gerald L. Neuman & Mark J. Roe, Convergence and Diversity in Private and Public Law, 5 COLUM. J. EUR. L. 181, 183 (discussing Freidrich Kubler’s belief that codetermination is one of the reasons why the German securities markets are weak).
152. Benoit, supra note 120 (quoting Joachim Schwalbach, head of the management institute at Humboldt University and one of Germany’s most virulent opponents of codetermination. The article also quotes a supervisory board member who states that “[a] lot of the criticism that is leveled at the board relates to co-determination . . . [b]ut I am skeptical that we will ever have a reform”).
tions of the corporation. Furthermore, while adopting the benefits of the German system, the United States could avoid those portions of the German system that are undesirable or would not mesh well with American corporate norms—those of codetermination and control by banking institutions. This modified German system is a sensible answer to the many questions raised by the recent wave of corporate corruption in the United States.