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Mergers and Acquisitions in Germany

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Mergers and Acquisitions in Germany

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1. Introduction

On July 5, 2001, the European parliament threw out the proposed European takeover directive after more than 12 years of negotiations. The defeat of the directive means that, for the foreseeable future, individual country law remains preeminent in both domestic and cross-border transactions in Europe.

German members of the European parliament were pivotal in the vote on the takeover directive. The German government, along with opposition parties, business organizations, and organized labor all welcomed the decision. German chancellor Gerhard Schröder expressed satisfaction about the demise of the European takeover directive, stating "Now Germany can do what I'd proposed all along" (*Financial Times*, July 6, 2001, "Berlin glee greets demise of EU takeover directive"). The Schröder administration quickly drafted a national takeover law.

The Takeover Act, which entered into force on January 1, 2002, replaced the Takeover Code, which had been introduced in 1995 in a failed effort of self-regulation. Most significantly, the Takeover Act allows management to take defensive actions against unsolicited takeover bids on the condition that these actions are in the corporation's best interest. The law explicitly states that management may solicit competing bids in search of a "white knight." Also, the law gives shareholders the power to pre-approve defensive measures, which management may take at its own discretion within 18 months of such a shareholder resolution.

In the interim, the European Commission entrusted a group of experts with reviving the project of harmonizing takeover rules within the European Union. The *Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids*, dubbed "Winter Report" after the name of its chairman, Jaap Winter, was submitted to the Commission on January 10, 2002. The Winter group had two mandates. One mandate was to provide suggestions for creating a level playing field for cross-border mergers and acquisitions in

Europe. The other mandate was to come forth with recommendations for modernizing corporate law and corporate governance in Europe. At the time of writing of this chapter, the discussion of the report in academia and among policymakers was still underway. Much of the criticism has zeroed in on the proposed "one share, one vote" principle and, related to that, the suggested breakthrough rule (Berklof and Burkhart, 2002; Bebchuk and Hart, 2002). Under the breakthrough rule, upon acquiring 75 percent of the residual cash flow rights ("risk capital") of a corporation, a bidder would be able to gain full control over the corporation—regardless of the voting power this equity stake confers. The breakthrough rule would foil efforts of wealth-constrained founding families to retain control while their corporations expand—a subject to be discussed below.

National differences in corporate governance practices in Europe, such as board structures, shareholder structures, and labor participation rights, make it difficult to operate in the European cross-border mergers and acquisitions environment. Particularly thorny issues are "golden shares" and labor participation in corporate decision-making. Golden shares are equity stakes held by government authorities, mostly in industries that are of national interest, such as utilities (energy, telecom, water) and defense. Frequently, golden shares date back to the time when the companies in questions were privatized. Although golden shares might not fully insulate companies from takeover attempts, they render the government pivotal to the outcome. Not surprisingly, governments tend to favor "domestic solutions" over cross-border takeovers—an uneven playing field. What's more, companies that have issued golden shares tend to acquire aggressively, be it at home or abroad. First, the government stake expands the company's borrowing capacity through the implicit government guarantee on its debt as demonstrated by the steep borrowing of privatized European telecom providers in the late 1990s. Second, the diminished takeover threat lessens the penalty for squandering financial resources on over-expansion—the European telecom industry again being a case in point.

The widespread use of golden shares among its European neighbors was critical for Germany in causing the collapse of the proposed takeover directive in the European

parliament—a proposal that had been mute on this issue. In the meantime, the European Court of Justice on June 4, 2002, dealt a blow to the way the French and Portuguese governments at the time used golden shares to retain control over privatized companies, forcing these governments to rethink their practices. On the other hand, the court permitted a more restrained golden-shares practice employed by the Belgium government, as reported by the *Financial Times* (June 5, 2002, "Europe strikes a balance over golden shares").

Another area in which the harmonization efforts of the European Union were struggling is labor participation in company decisions. On October 8, 2001, after 31 years of negotiation, the European Union gave birth to the *Societas Europea*, or SE. The legislation, which is set to enter into force in 2004, allows companies that operate in more than one state of the European Union to establish as a single company under European Union law. The *Financial Times* (October 9, 2001, "EU establishes European company statute") quotes Frits Bolkestein, the internal market commissioner, saying that the SE would "enable companies to expand and restructure their cross-border operations without the costly and time-consuming red tape of having to set up a network of subsidiaries."

European harmonization efforts notwithstanding, to date, individual country law dominates in both domestic and cross-border mergers and acquisitions in Europe. This chapter reviews the social setting and the regulatory framework for mergers and acquisitions or, more generally, for the transfer of cash flow rights on complex assets in Germany. We also provide a survey on takeover barriers. We stay clear of issues in flux, such as the current discussion of the Winter report. Descriptive statistical information we provide only to the degree necessary for characterizing critical attributes of the merger and acquisition activity in Germany. The interested reader may find extensive statistical data at <http://www.mergers-and-acquisitions.de/>.

2. The Social Setting

For understanding the merger and acquisition activity in Germany, both in the opportunities they offer and the limits they are subject to, it is important to be familiar with the German way of doing business. Germany pursues a strongly consensus-oriented, egalitarian economic approach called *Soziale Marktwirtschaft*—a principle anchored in the country's constitution and shared by all quarters of society. This consensus-oriented business approach, which has been dubbed "Rhineland capitalism" in the financial press (most recently, *Financial Times*, July 10, 2002, "Collapse of Babcock unravels Germany's way of doing deals"), makes transactions in the market for corporate control particularly intricate. In mergers and acquisitions, third parties are at risk of being expropriated of unenforceable claims—be they pecuniary or non-pecuniary. Most importantly, transfers of residual cash flow rights might adversely affect labor if workers' claims are not fully protected by law—a prospect where contracts are incomplete (Gorton and Schmid, 2002). A bidder that disregards the deeply ingrained preferences of German society for consensus, risks the takeover attempt being frustrated by resistance from organized labor or overt opposition from the government.

Two case studies may serve to exemplify the idiosyncratic characteristics of the German social environment for transfers of residual cash flow rights on complex assets.[1] The first case relates the acquisitions of Hoesch (1991/92) and Thyssen (1997/98) by Krupp. The second case recounts the takeover of Mannesmann by Vodafone of the United Kingdom (1999/2000). In particular the Thyssen and Mannesmann takeovers left their marks, profoundly and possibly irreversibly changing the way the German takeover market functions.

The first episode bears the trademark of Gerhard Cromme, then CEO of the privately held company Friedr. Krupp GmbH, a venerable German steel and engineering company. In 1991, Cromme announced that Krupp controls a 24.9 percent equity interest in Hoesch AG, a publicly traded competitor. At the time, in Germany the disclosure threshold for equity stakes was 25 percent—a rule that allowed Krupp's share accumulation to go unnoticed. Cromme's

move embarrassed Deutsche Bank, a financial behemoth that, by tradition, has close ties (inclusive of equity stakes and non-executive director positions) to the German steel industry. Most significantly, Deutsche Bank orchestrated a rescue effort when Krupp went into financial distress in 1966. In utter disrespect, Cromme commissioned Credit Suisse for the secret share accumulation. Also, Cromme wittingly frustrated Deutsche Bank's restructuring efforts at Hoesch AG where Deutsche Bank—Hoesch's *Hausbank*—had just installed Karl Joseph Neukirchen as CEO. Initially Neukirchen resisted the idea of Hoesch being folded into Krupp, but succumbed. In December 1992, Krupp and Hoesch were merged into Fried. Krupp AG Hoesch-Krupp, a newly established publicly traded corporation.

The takeover succeeded despite a clause in Hoesch's articles of association that limited to 15 percent the fraction of votes that a block holder could cast at Hoesch shareholder meetings. Then again, such voting restrictions do not apply in ballots that require a (simple or qualified) majority of the voting *capital* represented at the shareholder meeting—a legal provision that is of critical importance in takeover decisions (Beinert, 2000, §§ 70, 314). Of course, the anecdote does not prove that voting restrictions or the far-reaching powers of German universal banks do not pose takeover barriers. At a minimum, the fact that the merger went through indicates that these two particularities of the German takeover market are not necessarily prohibitive—a finding consistent with Jenkinson and Ljungqvist (2001).

Even more daring than Cromme's assault on Hoesch AG was his 1997 takeover bid for Thyssen AG—a German steel and engineering group considerably larger than Fried. Krupp AG Hoesch-Krupp. According to the *Financial Times* (*FT 500 1998*, January 22, 1998), at the time, Thyssen was the 149th largest company in Europe while Krupp ranked 273rd—as measured by market capitalization. After Thyssen had rebuffed friendly advances in years past, Cromme enlisted Deutsche Bank for a hostile bid. Goldman Sachs of the United States devised the takeover plan under the telling code name *Hammer und Thor*.

Deutsche Morgan Grenfell and Dresdner Kleinwort Benson, London-based investment banking subsidiaries of the respective German universal banks, arranged financing.

On March 18, 1997, one day after rumors of an imminent takeover attempt had started circulating in the stock market, Krupp announced an unsolicited bid for Thyssen. Dieter Vogel, Thyssen's CEO, immediately denounced the offer. Possibly to the surprise of Krupp and Deutsche Bank, the German public was aghast. Soon Krupp and Deutsche Bank were to feel the wrath of the public, the political establishment, and organized labor.

Chancellor Helmut Kohl, whose administration rested on a coalition of the conservative Christian Democrats (CDU/CSU) and the moderately libertarian Free Democrats (FDP), on March 19 expressed his "deep concern" over the matter. Kohl appealed to Krupp and Thyssen to "live up to their social responsibilities" (*Die Welt*, "Kohl mahnt zur Vernunft," March 20, 1997). Johannes Rau, prime minister of a Social Democrat (SPD)-led administration in North Rhine-Westfalia—home state of both Krupp and Thyssen—moved quickly to broker talks between the two parties. Wolfgang Clement, the generally pro-business economics minister in the Rau administration, in addressing the state parliament, said he expected the talks to be conducted "with the will to end the confrontation and reach a co-operative solution" (*Financial Times*, online edition, March 20, 1997, "Mediators chosen for German steel talks"). As the pressure mounted, Krupp put the bid on hold, agreeing to an eight-day truce during which the parties were to negotiate a merger of their steel subsidiaries.

March 24 was the day that 30,000 infuriated steelworkers were expected to take to the streets in front of Deutsche Bank headquarters in Frankfurt. The night before, Krupp scrapped the takeover plan, pledging in writing that it would not make any further bid for Thyssen. At the same time, the two parties consented on holding talks on combining their steel interests (*Financial Times*, March 24, 2002, "Krupp drops bid for Thyssen"); the talks led up to a merger agreement on March 28.

In August, the public was taken by surprise when it learned that Krupp and Thyssen were holding talks about a full-fledged merger. The merger details were finalized in November and approved by the respective supervisory boards—that is, boards of non-executive directors—on January 22, 1998 (Thyssen), and February 5, 1998 (Krupp). Meanwhile, the public attention to the merger had all but died off.

The supervisory boards of Krupp and Thyssen approved the merger with thin majorities. Thyssen was subject to *Montan* codetermination, a regime of extensive labor representation on the supervisory board that dates back to the immediate postwar period. In *Montan* codetermination, which applies to an increasingly small, now single-digit number of companies in the coal and steel industries, labor and shareholder representatives each command the same number of votes; a so-called neutral member, who holds no interest in the corporation, casts a tie-breaking vote. All labor representatives on the Thyssen supervisory board voted against the merger, making the neutral member pivotal in the decision. Similarly, on the Krupp supervisory board, all labor representatives, except for the representative of middle management (*leitende Angestellte*), opposed the transaction. Note that the Krupp supervisory board, which was subject to equal representation under the 1976 Codetermination Act, was able to outvote labor regardless of the ballot cast by middle management. Under the 1976 Codetermination Act, which generally applies to corporations with more than 2,000 employees, there is no neutral member; rather, the chairman of the supervisory board can cast a second vote in a repeatedly tied ballot. Then again, there is generally strong reservation among shareholder representatives in using the tie-breaking vote—a manifestation of the German, consensus-oriented business model and a dominant strategy in a repeated game. It is worthy of note that the newly established, merged company, Thyssen-Krupp AG, is subject to the 1976 Codetermination Act, rather than *Montan* codetermination—a possible explanation of why the Thyssen workers resisted the merger so fiercely.

The roles played by Deutsche Bank and Dresdner Bank in this takeover battle remain controversial in Germany. When Krupp launched its takeover attempt on Thyssen, Wolfgang Röller, then ex-CEO of Dresdner Bank and chairman of its supervisory board, was a member of Thyssen's supervisory board. At the end of March 1997, when Röller's tenure at Thyssen ended, Bernhard Walter, a member of the Dresdner Bank management board—that is, the board of executive directors—succeeded him in this position. Even more delicate was the case of Ulrich Cartellieri, a member of the management board of Deutsche Bank and simultaneously a member of the Thyssen supervisory board. As a member of the Thyssen supervisory board, he had access to inside information that was potentially valuable to Krupp, a client of Deutsche Bank. As a member of the Deutsche Bank management board, he approved the takeover attempt. Cartellieri tried unsuccessfully to dispel accusations of a conflict of interest brought against him in the financial press; he retired from both board positions on May 20, 1997. The case highlights a general problem of financial conglomerates, universal banks in particular. What may be synergies to the universal bank may look like conflicts of interest in the eyes of the public or the financial regulator.

The Krupp-Thyssen takeover confirms and, at the same time, refutes the stereotypes the international financial press tends to associate with the German economic model of Rheinland capitalism. On one hand, public outrage and resistance from nearly all quarters of the political spectrum—save for a small libertarian faction—initially frustrated Krupp's unsolicited bid. On the other hand, the takeover eventually materialized. The takeover also highlights the intensely debated role of German universal banks in control changes. German universal banks maintain extensive networks of equity interests and board representation—a corporate structure dubbed "Deutschland AG" in the financial press (most recently, *Financial Times*, July 11, 2002, "Germany prefers failed bosses to quit quietly"). The banks have long been accused of insulating incumbent management from the disciplining forces of the market for corporate control (Wenger and Kaserer, 1998). In sharp contrast to this commonly held view, Jenkinson and Ljungqvist (2001) find that the German merger and acquisition

environment, not least because of the active role of German universal banks, is in fact more hostile than frequently portrayed. The authors find that hostile stakes in Germany play a role similar to hostile tender offers in the United Kingdom. Then again, Boehmer (2000) finds that concentrated ownership—a corollary to block trades—increases the chances of value-reducing takeovers in Germany.

The 1999/2000 takeover of Mannesmann AG by Vodafone AirTouch plc of the United Kingdom is the second episode that highlights important particularities of the German takeover market. At the time, Mannesmann AG was an engineering group that had diversified into wireless communication and fixed-line phone service, making communications its core business. Like Vodafone, which was a communications purebred, Mannesmann pursued a strategy of aggressive geographic expansion in its wireless business in an attempt to realize economies of scope. On October 1999, Mannesmann made a friendly bid for Orange plc, the third-largest wireless communications company in the United Kingdom. Vodafone, on the other hand, had just become the largest wireless communications company in the world after merging with AirTouch of the United States.

From the perspective of Vodafone, a takeover of Mannesmann appeared worthwhile for two reasons. First, Mannesmann would allow Vodafone to expand into Germany and, second, Mannesmann was a conglomerate, which presumably traded at a discount in the stock market. Indeed, after the takeover materialized, Vodafone quickly auctioned off the Mannesmann automotive and engineering subsidiaries. Although Mannesmann in September 1999 announced plans of splitting itself into telecommunications and engineering units with separate stock market listings, the restructuring was overdue. It is open to debate whether Mannesmann in a more competitive corporate control environment than Deutschland AG would have been long pressured to dispose of its non-core businesses, making the company a less attractive takeover target.

In October 1999, rumors that Vodafone was preparing a takeover of Mannesmann starting circulating in the stock market. On November 14, 1999, Chris Gent, CEO of Vodafone, traveled to Düsseldorf to present a takeover bid to the Mannesmann management board, offering 43.7 own shares per Mannesmann share. After the Mannesmann management rejected the offer, Vodafone on November 19 turned to the Mannesmann shareholders, offering 53.7 Vodafone shares per Mannesmann share. This bid granted the Mannesmann shareholders a 47.2 percent participation in Vodafone. Also, the offer implied a 68.8 percent takeover premium based on the share price implied in Mannesmann's bid for Orange and a whopping 84.4 percent takeover premium over the €144.8 Mannesmann share price at close on the day the news about the takeover talks with Orange hit the market. On November 28, the Mannesmann management board denounced the bid.

Meanwhile, German chancellor Gerhard Schröder, who was heading an SPD-led coalition government with the environmentalist party *Die Grünen* and who had campaigned on a pro-business platform akin to the one of UK prime minister Tony Blair, condemned the bid. On the day Vodafone announced the bettered offer to the Mannesmann shareholders, Schröder declared that hostile takeovers destroy the "culture" of the target company. He went on saying that hostile bidders underestimate "the virtue of co-determination" in German companies (*Financial Times*, online edition, November 20, 1999, "Schröder weighs into bid battle").

The matter came to a head in a meeting in Florence on November 21 between Tony Blair and Gerhard Schröder. There, the UK prime minister made it clear that shareholders, not the governments, ought to decide on takeover bids. Tony Blair was quoted saying that we "live in a European market today where European companies are taking over other European companies, are taking over British companies, and vice-versa…That's the European Market." On one hand, the German chancellor admitted that it "is, for the time being, only an affair between companies." Then again, Gerhard Schröder qualified: "I would put emphasis on there being no hostile takeovers." It is worthy of note that Mannesmann CEO Klaus Esser

spoke out publicly against government interference (*Financial Times*, November 22, 1999, "Blair enters telecoms battle").

On December 23, 1999, Vodafone formally submitted the announced (unconditional and unrestricted) tender offer; the deadline for tendering shares was set to February 7, 2000. At the time, the shares of Mannesmann were widely dispersed among small shareholders and institutional investors seeking portfolio investment; no single investor held a significant equity interest (*Hoppenstedt Aktienführer 2000*, Darmstadt: Verlag Hoppenstedt, November 1999). A possible reason for the dispersed shareholder structure was a clause in Mannesmann's charter that limited to 5 percent the fraction of votes a block holder could cast at shareholder meetings.

What followed was a highly controversial takeover battle. According to Beinert (2000, § 350), German corporate law demands that management shall take a neutral stance in a takeover. What's more, Mannesmann had signed the Takeover Code, which stipulates that management shall abstain from actions that are not in the shareholders' best interest. Specifically, after a takeover attempt has been launched, management may not take measures that might lead to exceptional price movements in its securities or the securities offered in exchange thereof. Then again, the German Takeover Code had no force of law, compliance being voluntary even for those companies that had signed on (Beinert, 2000, §§ 158, 163). At least twice, the Mannesmann management hovered on the brink of violating the neutrality principle of German corporate law and the Takeover Code in particular. On January 28, 2000, Mannesmann disclosed to the public plans of taking a stake in AOL Europe; two days later Mannesmann announced intentions of entering an Internet alliance with Vivendi of France. Neither business plan materialized.

Even more delicate than the defensive attempts of the Mannesmann management was the €15 million "appreciation award" for Mannesmann CEO Klaus Esser, made to him by the compensation committee of Mannesmann's supervisory board on February 4, one day after

Esser dropped his objections to the bid. Germany, in its corporate law, imposes strict fiduciary duties on management, rendering severance payments to the target's management ("golden parachutes") prone to prosecution and litigation (Beinert, 2000, § 345). In March 2000, the state prosecutor of North Rhine-Westfalia launched a criminal probe in this matter (*Financial Times*, August 22, 2002, "Esser sues over 18-month investigation").

In the end, the Mannesmann management board was defeated by the company's shareholders, which overwhelmingly chose to tender. To many, the Vodafone-Mannesmann takeover dealt a debilitating blow to Deutschland AG—a doomed economic concept that offers German corporations shelter from the chills of an unfettered market for corporate control. The *Financial Times*, on February 4, 2000, gave a telling description of the German post-Mannesmann takeover market, quoting an anonymous investment banker: "Germany's hitherto unbreachable corporate world has finally been broken and many are going to be licking their lips."

3. The Regulatory Framework

The regulatory framework for business combinations in Germany has seen significant revisions during the period 1990-2002. Four laws for the promotion of financial markets (*Finanzmarktförderungsgesetze*) have been passed under administrations of different political orientation in an attempt to increase the transparency and level the playing field in the market for corporate control. Also, a revised Reorganization Act (*Umwandlungsgesetz*) entered into force in 1995, significantly lowering the transaction costs of business combinations and restructuring. Then, there is the mentioned Takeover Act (*Unternehmensübernahmegesetz*), which became effective in 2002. The takeover law provides, for the first time, a legal framework for tender offers; the law applies to domestic as well as foreign bidders for publicly traded German corporations. Other legislation of import includes the antitrust law (*Gesetz gegen Wettbewerbsbeschränkungen*) and the corporate law (*Aktiengesetz*; *GmbH*

Gesetz). What follows is an overview of legal provisions that are most germane to the merger and acquisition activity in Germany. A more detailed analysis is Beinert (2000).

Antitrust supervision in Germany resides with the Federal Cartel Office (*Bundeskartellamt*, <http://www.bundeskartellamt.de>). Generally, all business combinations that have a measurable effect on the markets for goods and services are subject to German antitrust supervision, regardless of the respective companies' countries of origin. According to the Antitrust Act, there are four types of transactions by which an enterprise may establish a business combination—a term the Antitrust Act stretches considerably beyond its acceptation (Beinert, 2000, § 185). The first type of transactions that may establish a business combination is an enterprise acquiring the assets of another enterprise in whole or in substantial part. The second transaction type relates to an enterprise seizing direct or indirect control over an enterprise or parts thereof. Cases of decisive influence—the legal definition of control—includes contracts in which a company surrenders control (*Beherrschungsvertrag*) or its profit (*Gewinnabführungsvertrag*) to another company. The Stock Corporation Act legalizes such contracts if they are approved by a minimum of 75 percent of the voting capital represented at the shareholder meeting.[2] The third type of transaction relates to an enterprise raising its equity interest in another enterprise above the thresholds of 25 or 50 percent. Finally, the fourth type of business combination concerns transactions that enable an enterprise to exercise significant competitive influence over another enterprise.

The Federal Cartel Office must be notified of intended business combinations with German participation if the concerned enterprises in the latest completed fiscal year had sales (worldwide and consolidated) of more than €500 million or if at least one party had sales in Germany of more than €25 million. There are two exceptions to the notification requirement. The first exception pertains to a business combination where an acquirer is not legally part of a group of enterprises and, at the same time, billed worldwide sales of less than €10 million

during the latest completed fiscal year. The second exception applies to a business combination in a market that has existed for at least five years and had sales volumes of less than €15 million during the latest completed calendar year.

Upon notification of an intended business combination, the Federal Cartel Office must examine the case within one month's time. The Federal Cartel Office either moves on to an investigation (*Hauptprüfverfahren*) or the business combination may be consummated. If, during the investigation, the Federal Cartel Office does not disapprove of the intended business deal within four months of the original notification, the transaction may be executed.

The Federal Cartel Office must disapprove of a business combination if the transaction results in or strengthens a market-dominating position, unless the enterprises in question can demonstrate that the gain in market dominance is more than offset by an improvement of the competitive environment (Beinert, 2000, § 195). Then again, should the Federal Cartel Office indeed enjoin a business combination, the parties concerned may file a petition with the federal minister of economics (<http://www.bmwi.de>). The minister of economics may overturn the decision of the Federal Cartel Office if the intended business combination is in the country's economic or public interest (Beinert, 2000, § 197). As of June 2001, there were sixteen petitions on record for the postwar period, six of them having been granted (Bundeskartellamt, 2001, p. 14). Finally, the German Federal Cartel Office is incompetent in cases where European antitrust supervision applies.[3]

As mentioned, during the period 1990-2002, Germany passed four Acts on the Promotion of Financial Markets (*Finanzmarktförderungsgesetze*). The most significant of these four laws is the Second Act on the Promotion of Financial Markets from July 26, 1994. This law—by implementing the EC Insider Dealing Directive of November 13, 1989—created the Securities Trading Act (*Wertpapierhandelsgesetz*) and established the Federal Securities Supervisory Office (*Bundesaufsichtsamt für den Wertpapierhandel*); the

agency was folded into the newly established German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, <http://www.bafin.de>) in May 2002.

The Securities Trading Act applies to all companies that are headquartered in Germany and, at the same time, trade at a stock exchange—that is, not exclusively over the counter—in the European Union or the European Economic Area. The most significant provisions of the Securities Trading Act pertain to the disclosure of information on the corporation's shareholder structure—superseding similar provisions in the Stock Corporation Act—as well as to insider trading and ad hoc disclosure.

The German Stock Corporation Act stipulates that an investor, upon crossing the thresholds of 25 percent of the equity or 50 percent of the votes, shall notify the company, which in turn must disclose to the public the shareholder's identity and the threshold crossed. The investors do not have to disclose the actual sizes of the equity stakes, except in cases of cross-shareholdings in excess of 25 percent (Beinert, 2000, § 133). The disclosure standards specified in the Securities Trading Act of July 1994, on the other hand, stipulate that an investor shall notify the Financial Supervisory Authority upon arriving at the 5, 10, 25, 50, or 75 percent threshold levels of voting rights, be it from above or below. The information is then made available to the public on the Internet (<http://www.bafin.de>). There is an ongoing discussion about methodological issues in calculating these voting rights in complex shareholder structures, such as networks of cross-shareholdings and pyramids. There is also concern about the fact that investors do not have to notify the Financial Supervisory Authority of subsequent changes to their equity stakes so long as they do not cross a neighboring threshold. Following current methodology, the posted total of voting rights held in a given corporation by the investors on record might exceed 100 percent.

The Securities Trading Act of July 1994 has made insider trading a criminal offense in Germany. Pursuant to the Securities Trading Act, the former Securities Supervisory Office issued a code of conduct for institutions dealing in financial securities (Bundesaufsichtsamt

für den Wertpapierhandel, 1999). Most importantly, the former Securities Supervisory Office and Deutsche Börse AG—the corporation that operates the bourse in Frankfurt—released non-authoritative guidelines for insider trading and ad hoc disclosure (Bundesaufsichtsamt für den Wertpapierhandel and Deutsche Börse AG, 1998). The ad hoc disclosure rules stipulate than the corporation shall publish immediately all newly arriving, private information that has the potential of significantly affecting the prices of its securities—the intent being to create a level playing field in the marketplace and prevent insider trading. The guidelines specify that "complex decision-making processes, in particular those requiring approval of the supervisory board", are exempt from ad hoc disclosure—a clause that provides for clandestine preparations of merger and acquisition transactions. "Ad hoc disclosure does not apply until the final decision has been made, i.e., upon approval of the supervisory board."

Disclosure requirements for traded corporations beyond and above what is specified in the Securities Trading Act of July 1994 are detailed in the *FWB Rules and Regulations* of Deutsche Börse AG (<http://deutsche-boerse.com>). The disclosure rules vary by market segment, of which there is *Amtlicher Handel*, *Geregelter Markt*, and *Neuer Markt*; there is also an over-the-counter segment called *Freiverkehr*. The most liquid stocks are traded in *Amtlicher Handel*—*Geregelter Markt* being the second-tier market. *Neuer Markt* is a market segment for small to medium-sized companies that agree to adhere to international accounting and disclosure standards as specified in *Rules and Regulations Neuer Markt (FWB 9)*. Companies traded at *Neuer Markt* must publish quarterly—rather than just annual—financial reports and must host annual analyst meetings; they may choose between IAS (International Accounting Standards) and US-GAAP (Generally Accepted Accounting Principles) accounting standards.

Frequently, merger and acquisition transactions lead up to restructuring. The transaction costs of business restructuring in Germany were lowered significantly when on January 1, 1995, the revised Reorganization Act (*Umwandlungsgesetz*) went into force. The

law provides a general framework for reorganization, independent of the legal status of the businesses under consideration. Accompanying changes to the tax law, some of which have subsequently been reversed in response to abusive practices, allows companies to restructure at book value, avoiding asset write-ups and the ensuing capital gains taxation (Beinert, 2000, § 324). The Reorganization Act provides for four types of reorganization: mergers, breakups and various forms of spin-offs, transfers of assets, and changes of legal status. Most significant is the possibility to change the legal status at book value, a provision that allows for reorganizing public corporations into partnerships without invoking capital gains taxation (Beinert, 2000, § 325).

The revised Reorganization Act considerably constrains the power of dissenting shareholders in corporate restructuring when compared with the Stock Corporation Act. Corporate restructuring requires a qualified majority of at least 75 percent of the voting capital at the shareholder meeting—depending on the articles of association. The Stock Corporation Act generally allows shareholders to challenge in the court any resolutions passed at shareholder meetings—possibly blocking the execution of restructuring decisions for years. The Reorganization Act, which supersedes the Stock Corporation Act if invoked, allows shareholders that feel disadvantaged in the conversion of their interests to sue for cash compensation only—the restructuring decision being impervious (Beinert, 2000, § 322). Note that the Restructuring Act does not provide for squeeze-outs. In other words, the interests of dissenting shareholders can only be converted against their will, but not acquired (Beinert, 2000, § 342).

Effective July 14, 1995, Germany gave itself a Takeover Code (*Übernahmekodex*, <http://www.kodex.de>)—a code of conduct for bidders and targets in public tender offers. The Takeover Code was drafted and watched over by the *Börsensachverständigenkommission* at the Ministry of Finance—a case of self-regulation akin to the UK Takeover Panel.[4] Like the UK City Code, the German Takeover Code called for mandatory tender offers—bids that

investors are obligated to present to the residual shareholders upon obtaining control over the corporation.[5] Control was defined as manifest when an investor's equity interest conveys the majority of votes or, due to imperfect shareholder attendance, has represented 75 percent of the voting capital at all of the past three annual shareholder meetings. The code was last revised effective January 1, 1998.

It was in particular the mandatory tender offer stipulation that made corporations hesitant to sign the Takeover Code. This is because mandatory takeovers do not allow companies to hold significant equity interests in subcontractors as a means of protecting relation-specific investments (Kojima, 2000). Not surprisingly, four of the former 30 members of the German stock market index DAX (BMW, Hoechst, Viag, and Volkswagen) never signed on; as of February 1999, only 68 of the DAX 100 companies had submitted to the code. What's more, referring to the poor acceptance and to numerous counts of violation of the Takeover Code by the signatories, the *Börsensachverständigenkommission* concluded that the code failed to establish a "level playing field among the market participants." The commission recommended writing the code (in modified form) into law (Börsensachverständigenkommission beim Bundesministerium der Finanzen, 1999).

The German Takeover Act entered into force on January 1, 2002, rendering the Takeover Code ineffective. The law departs in two important ways from the Takeover Code. First, the Takeover Act (§ 29) associates control over the corporation with ownership of an equity interest that conveys 30 percent of the votes—a threshold significantly below what had been specified in the Takeover Code. It remains to be seen how this rule plays out in the German market for corporate control—a market that has so far been characterized by high shareholder concentration and control changes facilitated through block trades (Jenkinson and Ljungqvist, 2001; Köke, 2000). Second, whereas the Takeover Code reinforced the principle that the management of the target shall take a neutral stance in a takeover attempt—a

stipulation in existing corporate law (Beinert, 2000, § 350)—the Takeover Act (§ 33) explicitly allows for defensive measures.

Management may take defensive measures that are in the corporation's best interest. Such measures include the solicitation of (competing) bids—including the search for a "white knight"—and measures approved by the supervisory board. Moreover, the shareholders now have the power to authorize management with a qualified majority of 75 percent of the voting capital to take defensive measures at is own discretion within 18 months of the shareholder resolution. Note that the scope of defensive measures available to management is constrained by existing law—the fiduciary duties of the Stock Corporation Act in particular—and the explicit provision of the Takeover Act (§ 3) that management's actions be in the interest of the corporation.

Note that the Takeover Act (§ 33) rules illegal the bidder offering seductive severance payments (golden parachutes) to the management of the target company. The Takeover Act (§ 21) accommodates offers that are conditioned on the shareholder tendering a predetermined, minimum fraction of shares (restricted tender offers). The Takeover Act (§ 32) disallows offers that pertain to only a fraction of the outstanding equity (partial tender offers).

The introduction of the Takeover Act entailed only one change, albeit a significant one, to the Stock Corporation Act (§ 327). Shareholders can now pass a resolution that transfers the shares of the residual shareholders to an investor that holds at least 95 percent of the corporation's equity capital; the residual shareholders are compensated in cash. This squeeze-out clause is a significant improvement over existing corporate law—a topic to be discussed in the following section.

4. Barriers to Mergers and Acquisitions

Barriers to takeovers or, more generally, to transfers of residual cash flow rights on complex assets can be broken down into two categories. First, there are impediments that are systematic in that they are common to all corporations in Germany of a given type. Second, there are hurdles that companies may install at their discretion. Again, note that management may take measures to try to ward off a takeover attempt, be it imminent or not, but management has the duty to act in the corporation's best interest (Beinert, 2000, § 379). The permissive stance of the German Takeover Act toward defensive actions notwithstanding, because shareholders, creditors, and labor may be regarded as sufficiently protected by existing law, management may find itself at risk of being sued for serving its own interests when employing anti-takeover measures (Beinert, 2000, §§ 350, 379).

Barriers to transfers of residual cash flow rights that are systematic to public corporations in Germany originate predominantly from capital gains taxation, minority shareholder protection, qualified-majority rules, board entrenchment, and proxy voting. Defensive measures that companies might take to deter potential acquirers from launching a takeover attempt are shares whose registration is subject to the issuer's approval, voting restrictions, dual-class stock, stocks with multiple voting rights, cross-shareholdings, and pyramidal shareholder structures. In what follows we provide an overview on these two categories of barriers to control changes at German stock corporations.

The taxation of capital gains at the full corporate tax rate in the past was a major reason for German financial institutions, most importantly large insurers (Allianz AG and Munich Re) and large universal banks (Deutsche, Dresdner, and Commerzbank), to hold on to their equity stakes rather than selling them. The present value from deferring the realization of capital gains in order to avoid their taxation often outweighed the potential gain from reallocating the financial resources to projects with higher net present value before taxes. Effective January 1, 2002, divestitures of stakes held in other corporations are tax-exempt. It

is noteworthy that, shortly after the legislation was passed and before it had entered into force, there were isolated cases in which corporations sold off equity stakes, deferring through complex legal and financial arrangements the recording of the sale on their books past December 31, 2001.

German corporate law grants dissenting shareholders the right to fight in court decisions made at shareholder meetings. The initiation of legal proceedings by minority shareholders against amendments of the articles of association, equity issues or repurchases, and control or profit transfer agreements may block the inscription of these decisions on the commercial register for years. Before the introduction of a squeeze-out provision in the Stock Corporation Act (§ 327) effective January 1, 2002, the only way a block holder could get rid of small shareholders was to liquidate the corporation with a 75 percent majority and subsequently purchase the business (Beinert, 2000, § 342). The purchase of the business has to be made at arm's length and the assets have to be written up to the purchase price, invoking capital gains taxation. As discussed above, the revised Reorganization Act, although it does not allow for squeeze-outs, limits the power of dissenting shareholders in business reorganizations considerably.

Generally, decisions at shareholder meetings are made with the simple majority votes. For important decisions, in addition to the simple majority of votes, German corporate law requires a qualified majority of 75 percent of the voting *capital* represented at the meeting. Among the decisions that, by default, require a qualified majority of the voting capital are, according to Beinert (2000, § 367), amendments to the articles of association; removal of shareholder representatives from the supervisory board; control agreements and profit transfer agreements; and mergers. Furthermore, a qualified majority of the voting capital is required for the aforementioned 18-month authorization for anti-takeover measures. Besides, there are decisions for which the company may specify qualified-majority rules in the corporate charter—an option rarely exercised (Beinert, 2000, § 368). On the other hand, for some

decisions, German corporate law allows companies to abandon in their charter the qualified majority in favor of the simple majority of the voting capital represented at the shareholder meeting. Simple majorities of the voting capital may be adopted for decisions on the removal of shareholder representatives from the supervisory board, certain amendments to the corporate charter, and equity offerings with preemptive rights.

In Germany, members of corporate boards are legally entrenched. This holds for both the board of executive directors (management board) and the board of non-executive directors (supervisory board). The supervisory board oversees the management board, appoints the members, and, should the situation arise, removes them. The supervisory board consists of labor and shareholder representatives. The workforce elects the labor representatives. The shareholders elect at least two-thirds of the shareholder representatives, whereas the remainder, if the company's articles of association so determine, become members by virtue of owning an equity interest. The management board runs the day-to-day operations. The chairman or, synonymously, speaker of the management board is the company's chief executive officer. Neither the supervisory board nor the shareholders have authority to instruct the management board.

The composition of the supervisory board, and the balance of power between labor and shareholder representatives in particular, depends on the relevant codetermination regime. Among publicly traded corporations, only companies for whom the constitutional freedoms of faith and the free press are a business purpose are exempt from codetermination. For instance, the media company Springer AG has no labor participation in corporate decisions at the board level. Then, there is a handful of companies in the coal and steel industries that are subject to the 1951 *Montan* Codetermination Act. As mentioned, *Montan* codetermination determines equal representation of shareholder and labor representatives on the supervisory board; a so-called neutral member has a tie-breaking vote. For the remaining stock corporations, the 1976 Codetermination Act applies if they have more than 2,000 employees; otherwise, the Stock Corporation Act is relevant. The 1976 Codetermination Act calls for

equal representation on the supervisory board. The chairman, who is generally a shareholder representative, can cast a tie-breaking vote in a repeatedly tied ballot. The Stock Corporation Act, on the other hand, calls for a labor representative in only a third of the supervisory board seats. When equal representation applies, be it in the 1951 or the 1976 version, there is also a labor representative (*Arbeitsdirektor*) on the management board.[6]

For traded corporations, the supervisory board has to meet twice per half calendar year. The supervisory board has far-reaching information rights. The corporate charter defines the areas in which management board decisions are subject to supervisory board approval. Supervisory board vetoes to management decisions can be overturned by a majority of 75 percent of the votes at the shareholder meeting. At any time, the supervisory board can call for an extraordinary shareholder meeting if deemed in the company's interest.

The members of the management board are usually appointed for the legal maximum of five years, reappointment being permissible. During their tenure, members of the management board cannot be removed from the post, except for cause. Cause exists, according to the Stock Corporation Act, in cases of incompetence or acute negligence, or when shareholders cast a vote of no confidence "for reasons that are not manifestly arbitrary" (Beinert, 2000, § 55). In consequence, German management boards enjoy a fair amount of independence—a significant hurdle for an unwelcome bidder that tries to seize control over the corporation.

The members of the supervisory board usually serve for five years—the maximum tenure allowed by law. All labor representatives are elected at the same time. Staggered terms, which spread attrition evenly over time, are possible for the shareholder representatives if provided for in the articles of association. Then again, corporations in Germany rarely opt for staggered terms to avoid the ordeal of electing (some) shareholder representatives at every annual meeting (Beinert, 2000, § 373).

To an unwelcome bidder, attaining control over the supervisory board might prove a challenging task. For one thing, shareholders have no power of removing labor representatives. Also, a shareholder representative who is a member by virtue of owning an equity interest cannot be removed from the post, except by the actual owner of the equity interest should the supervisory board member in question be a stand-in. Only supervisory board members that have been elected at the annual meeting can be voted out of office, by default with a qualified majority of 75 percent should the corporate charter not specify a different majority rule.

Proxy voting has long been one of the most hotly debated corporate control issues in Germany. Proxy voting originates from the fact that in Germany shares are predominantly bearer shares. Usually, small shareholders leave their shares in the bank that keeps their brokerage accounts. The bank, which knows the identity of its brokerage clients, typically solicits permission for voting on their behalf. Many shareholders grant this permission and go along with the pre-announced voting behavior of the bank, rather than attending the shareholder meetings in person or giving the bank legally binding voting instructions. Not surprisingly, the large universal banks, which have the most extensive branch networks, garner most of the small shareholder's votes. It is thus not unusual that, at the annual meeting of a public corporation with a dispersed shareholder structure, the large universal banks taken together control the majority of votes. In fact, there have been instances when, as a group, the three largest universal banks at the time (Deutsche, Dresdner, and Commerzbank) cast the majority of votes at their own annual meetings—all due to proxy voting.[7]

The degree to which proxy voting constitutes a takeover barrier is debatable. Although banks exercise substantial amounts of proxy votes at annual meetings, little is known about how much power these votes confer and, if they do confer power, how banks use this lever. On one hand, it can be argued that proxy voting is derived, rather than genuine, voting power. That is to say, small shareholders rarely give banks voting instructions because

the shareholders recognize that it is in their best interest to go along with the banks' announced voting behavior. The banks anticipate that, if they announced a voting behavior that suggested otherwise, the shareholders would issue voting instructions. In this case, then, proxy voting does not contain information that is not subsumed in the shareholder structure and, consequently, has no measurable impact of its own. On the other hand, it could be argued that proxy voting gives banks genuine voting power, simply because to the small shareholder the marginal cost of issuing voting instructions exceeds the marginal benefit, which gives rise to free riding. Again, proxy voting would then simply be the flip side of a dispersed shareholder structure, having no bearing of its own on the corporation. As the case may be, empirically, proxy voting seems immaterial for the conduct of the corporation and, as a result, may not constitute much of a takeover barrier. Gorton and Schmid (1998), who study the influence of proxy voting on the stock market valuation of the corporation, find no discernable impact. Jenkinson and Ljungqvist (2001), in a clinical study, find that banks in takeover battles do not always cast proxy votes in favor of the status quo. On one hand, Deutsche Bank drew on proxy votes in fending off an unsolicited bid of the Italian tire maker Pirelli SpA for its German competitor Continental AG in a bitter takeover battle that lasted from the initial Pirelli bid in September 1990 until March 1993. On the other hand, in the mentioned takeover of Hoesch by Krupp, Deutsche Bank, in spite of being Hoesch's *Hausbank*, cast the proxy votes in favor of the merger.

One of the most effective tools that a company can employ to discourage takeover attempts is to issue registered shares that can only be transferred upon approval of the corporation. By default, it is the management board that approves the inscription of this type of shares on the commercial register, called *vinkulierte Namensaktien*; the articles of association might bestow this right on the supervisory board or the annual shareholder meeting (Beinert, 2000, § 65). Only *vinkulierte Namensaktien* may convey the aforementioned statutory right on a supervisory seat. *Vinkulierte Namensaktien* are common in (and largely confined to) the insurance industry. Most recently, in the summer of 2002,

this type of share turned out to be pivotal in a wrestle over the control of a 40 percent equity stake in the aforementioned German media company Axel Springer AG. As reported by the *Financial Times* (August 27, 2002, "WAZ war of words with Springer escalates"), WAZ Gruppe—a secretive German media group—in the summer of 2002 deliberated the acquisition of a 40 percent stake in Springer AG from the insolvent media mogul Leo Kirch. Friede Springer, the widow of the company's founder, who—jointly with other member of the Springer family—controls just over 50 percent of Springer AG, vowed to veto the inscription of the shares on the register should the transaction come about. As reported by the *Financial Times* (September 4, 2002, "Kirch attempt to sell Springer stake halted"), Munich's civil court ruled on September 3, 2002, that Leo Kirch could not transfer his 40 percent stake without the consent of Axel Springer AG. In response to the court decision, WAZ Gruppe withdrew its interest. Meanwhile, Leo Kirch defaulted on a €720 loan from Deutsche Bank, for which he had pledged the Springer interest as collateral. On October 8, 2002, Deutsche Bank held an auction in which it acquired Kirch's equity stake. On the following day, Deutsche Bank traded a 10.4 percent block to Friede Springer, who now is the sole majority shareholder of Springer AG. Deutsche Bank retained the remaining 29.9 percent equity interest in Springer, a position just short of the mandatory takeover threshold laid down in the German Takeover Act.

In the past, German corporations could resort to voting restrictions as a means of discouraging takeover attempts. Voting restrictions limit the voting power of block holders to a certain percentage of the corporation's total voting stock. The Third Act on the Promotion of Financial Markets (*Drittes Finanzmarktförderungsgesetz*), introduced in 1998, prohibits the introduction of voting restrictions for public corporations and rules that voting restrictions, where they existed, would be ineffective as of June 1, 2000. Note that voting restrictions do not apply where corporate law or the articles of association call for a (simple or qualified) majority of the voting capital represented at the shareholder meeting, rather than a majority of the votes (Beinert, 2000, § 70).

The legislation that outlaws voting restrictions for traded stock corporations exempts Volkswagen AG, which has a 20 percent limit on the fraction of votes a shareholder can cast. The control structure of Volkswagen is governed by the Volkswagen Act, a law that legalized the privatization of Volkswagen in 1960 and was last revised in 1970.[8] The Volkswagen voting restriction preserves the voting power of the State of Lower Saxony—the state that harbors the Volkswagen headquarters. As of year-end 2001, the State of Lower Saxony owned 13.7 percent of the Volkswagen voting stock. (Another 9.8 percent of the voting stock was in the hands of Volkswagen-Beteiligungsgesellschaft mbH, a 100 percent subsidiary of Volkswagen AG.) The degree to which the equity interest of the State of Lower Saxony, along with the voting restriction, serves as a barrier to a control change at Volkswagen can be read from the remarkable spread between the share prices of Volkswagen's voting and nonvoting stocks. Over the period 1997-2001, based on the share price of the last trading day of the year, the premium of voting over nonvoting stock hovered between 30 percent (1999) and 76 percent (2000). Note that over the same period, the cash dividend on nonvoting shares exceeded the cash dividend on voting shares by between 4.6 and 8.2 percent (Volkswagen AG, Annual Report 2001, <http://www.volkswagen-ir.de>). Arbitrageurs in years past have established long-short portfolios in Volkswagen stock, hoping that the special control structure of Volkswagen might crumble under legal pressure from the European Union, paving the way for converting Volkswagen's nonvoting stock into voting stock. Indeed, in the wake of the mentioned ruling of the European Court of Justice on golden shares on June 4, 2002, the Volkswagen governance structure has come under scrutiny (*Financial Times*, June 20, 2002, "EU says examining 10 golden share cases including VW").

German corporate law allows corporations to issue half of the stock as nonvoting stock. This provision allows founding families to remain in control even as the companies grow beyond the point where wealth constraints force the families' interests below the 75 percent level—the level of voting stock ownership that delivers exclusive control. Well-known examples of corporations with a 50 percent fraction of nonvoting stock are

BMW AG—controlled by the Quandt family—and Porsche AG—controlled by the Porsche and Piëch families.

Schmid (2002) argues that, due to the qualified-majority rules written into German corporate law, dual-class stock might enhance social welfare if founding families enjoy large private control benefits. Nenova (2001) and Dyck and Zingales (2001) find that private control benefits are indeed significant in Germany. To illustrate the point, assume there is a wealthy individual, possibly an entrepreneurial competitor, who enjoys benefits from controlling an interest of 25 percent plus one vote in a corporation where the founding family's stake has dropped below the 75 percent level due to a binding wealth constraint. At a minimum, the intruder can thwart all motions at shareholder meetings that require—by law or corporate charter—a qualified majority of the represented voting capital; ironically, these decisions are the most critical ones for the performance of the corporation. If the loss of exclusive control weighs more heavily on the family than the gain in control weighs on the intruder, society finds itself worse off. As Schmid shows, the founding family has no capacity to ward off an intruder. If the family were sufficiently wealthy to control at least 75 percent of the votes, the situation would not arise in the first place. Also, paying off potential intruders for dispensing of the equity interest or not acquiring it in the first place is not an option. "Greenmailing" would only increase the incentive for copycat investors. Also, if financed with company funds, greenmailing is in violation of German corporate law (Beinert, 2000, § 341). Taken together, nonvoting stock might be a welfare-enhancing countermeasure where qualified-majority rules are mandatory. Not surprisingly, nonvoting stock is found almost exclusively with corporations that are controlled by the founding families.

Another possible departure from single-class stock is shares with multiple votes. Then again, German corporate law no longer allows the issuance of multiple-vote stock. Multiple votes, where they exist, will phase out on June 1, 2003, barring an opposing resolution of the shareholders (Beinert, 2001, s 70).[9]

A further barrier to control changes in Germany is cross-shareholdings. Plain vanilla cross-shareholding pertains to cases where two companies own stock in each other. If the mutual equity stakes exceed 25 percent, certain restrictions apply when it comes to exercising the votes at the annual shareholder meeting (Beinert, 2000, § 382). More sophisticated cross-shareholding might involve complex networks of inter-corporate stock ownership. The most extensive network of cross-ownership in Germany is centered on two financial institutions: Allianz AG and Munich Re. It should be noted that Allianz AG is the most powerful financial institution in Germany as measured by market capitalization and the size and reach of its equity stakes, eclipsing Deutsche Bank. The Allianz network comprises mainly domestic financial institutions, but also stretches into the domestic nonfinancial sector and the financial sectors of neighboring European countries (*Hoppenstedt Aktienführer 2002*, Darmstadt: Verlag Hoppenstedt, November 2001). Clearly, networks of cross-shareholdings are difficult to crack for outsiders and, hence, are highly effective takeover barriers. Then again, it is difficult to gauge the degree to which cross-shareholding is indeed motivated by anti-takeover considerations. First, cross-shareholdings might simply serve as a call option on a possible future merger. For instance, Allianz in the past has used some of its stakes to forge mergers in the banking and insurance industries. Second, cross-shareholding might serve as a means of bonding where contracts are incomplete, keeping the parties in question sufficiently vulnerable to uncooperative behavior.

Attempts of management to engineer the corporation's shareholder structure are limited by the legal provision that seasoned offerings generally be endowed with preemptive rights. This stipulation holds both for shareholder pre-approved offerings (*authorisiertes Kapital*), which are at the discretion of management, and immediate seasoned offerings. In consequence, existing shareholders generally cannot be excluded from seasoned equity issues. Then again, exclusion of preemptive rights, both for immediate and pre-approved seasoned offerings, are possible if three legal requirements are met (Beinert, 2000, § 363). First, shareholders authorize the share issue and the added-on exclusion of preemptive rights with a

qualified majority of 75 percent of the represented voting capital. Second, management submits to the shareholders in writing the reasons for the exclusion of preemptive rights. Third, the exclusion of the preemptive rights is in the corporation's best interest. Then again, Beinert (2000, § 365) argues that, from a legal perspective, only in special circumstances would an exclusion of preemptive rights be justifiably in the company's best interest. In particular, so the argument goes, engineering of the corporation's shareholder structure is likely to violate management's fiduciary duties toward the company.

One of the boldest moves in crafting an indulgent shareholder structure was undertaken in September 2000 by the management of Commerzbank, the fourth largest German universal bank. The barely disguised objective of this endeavor was to ward off a looming takeover attempt. At the time, Commerzbank's largest shareholder was CoBRa Beteiligungsgesellschaft, which was led by Hansgeorg Hofmann, a corporate raider. CoBRa had accumulated an equity interest of 17 percent with the intent of auctioning off the stake to the highest bidder in a future takeover battle for Commerzbank—a case of merger arbitrage. Commerzbank's strategy was to issue shares—exclusive of preemptive rights—to two companies with which it had existing cross-shareholding relations: Assicurazioni Generali of Italy and Banco Santander Central Hispano (BSCH) of Spain. The intent of the transactions was to dilute CoBRa's stake and the free float.

On September 1, 2000, Commerzbank announced that Generali agreed to raise its stake from 5.1 percent to 9.9 percent. At the same time, Mediobanca, the secretive Italian investment bank, agreed to notch up its holdings in Commerzbank to 2 percent (*Financial Times*, October 17, 2000, "Commerzbank builds cross-shareholdings"). The Generali transaction had a cash component of €600 million; another €360 million involved a transfer to Commerzbank of part of Generali's 1.8 percent stake in BSCH (*Financial Times*, September 4, 2000, "Generali lifts German stake"). The Generali transaction strengthened existing cross-shareholdings with both Generali and BSCH. For one thing, in 1998, Commerzbank

had acquired about 1.5 percent of Generali, according to an officious AMB Generali Holding AG document (Schöllkopf, 2002). What's more, Commerzbank's stake in BSCH rose to 2.3 percent while, at the same time, BSCH owned about 5 percent in Commerzbank (*Financial Times*, October 17, 2000, "Commerzbank builds cross-shareholdings").

The intended share issue to BSCH did not materialize. The talks ran into obstacles and failed in October 2000. The two banks could not agree on the value of CC Bank, a German subsidiary of BSCH that Commerzbank was supposed to acquire as part of the transaction (*Financial Times*, October 24, 2000, "Commerzbank and BSCH end stake talks").

According to an official Commerzbank investor relations document, (<http://www.commerzbank.com/aktionaere/vortrag/charts_010510.pdf>), as of March 31, 2001, Commerzbank had cross-shareholdings with four financial institutions. These financial companies were Assicurazioni Generali (1.4 percent owned by Commerzbank and 9.9 percent owned in Commerzbank), BSCH (2.4 and 4.8 percent), Banca Commerciale Italiana (2.5 and 0.8 percent), and Mediobanca (1.8 and 1.1 percent). As the odds of cracking the network for possible Commerzbank acquirers grew longer, the interest for CoBRa's stake waned. In early April of 2002, CoBRa threw in the towel.

Related to cross-shareholdings are pyramidal shareholder structures. Pyramids are multiple layers of financial holding shells that are sandwiched between an investor and a company the investor wishes to control. The financial holding shells, which are often times obscure and privately held, frequently have two or three owners—typically banks or insurance companies. For matters of illustration, suppose an investor owns 25 percent plus one vote in a financial holding shell, which in turn holds a similar stake in another holding shell, while this shell holds a similar stake in a target company. The investor at the bottom of the pyramid effectively holds a blocking minority interest in the company at the top of the pyramid, although the investor (indirectly) owns only 1.5625 percent of the top layer’s voting stock. The apotheosis of an shareholder pyramid is the former Mercedes-Automobil-Holding

AG, which held a blocking minority in Daimler-Benz AG and was controlled by two layers of financial holding shells. At the bottom of the pyramid was a myriad of banks and insurance companies, as well as nonfinancial companies with close ties to the automobile industry. The pyramid, which is described in Franks and Mayer (2001), was established as an anti-takeover device in the aftermath of the first oil-price shock when OPEC countries started taking stakes in large public German corporations. In 1993, Mercedes-Automobil-Holding AG was dissolved. Franks and Mayer find little evidence that pyramid structures can be used for control purposes.

To summarize, German corporations hide behind a host of takeover barriers, some of which are in place by virtue of law whereas others are optional to the corporation. Some of these impediments have been removed during Germany's ongoing effort to modernize financial markets and corporate governance, among them shares with multiple votes and voting restrictions. Most of the mentioned barriers to transfers of cash flow rights on corporations have not been established or made available with the intent of fending off unsolicited takeover bids. Rather, these impediments to takeovers are artifacts of a historically grown financial system that is inevitably highly path-dependent. Judging takeover barriers in isolation might lead to erroneous conclusions, as the case of dual-class stock in the presence of qualified majorities and private control benefits illustrates.

5. Conclusion

In the late 20th century, Germany made great strides toward establishing sophisticated financial markets. Between 1990 and 2002, the federal legislature passed four laws for the promotion of financial markets (*Finanzmarktförderungsgesetze*). These laws increased the incentive of corporations to disclose critical information to investors, improved the transparency in financial markets, and extended the range of financial transactions available to corporations and investors. As a result, the import of financial markets in the savings and investment process of the German economy increased.

It is fair to say that the financial modernization process in Germany was spurred by the tremendous wealth creation of U.S. financial markets during the latest bull market. The U.S. bull market, which began in the summer of 1982 and ended in the spring of 2001, culminated in torrid merger and acquisition activity during the period 1993-2001 (Gaughan, 2002). The ensuing collapse of the U.S. stock market—and the Nasdaq in particular—ended the fifth merger wave recorded in the United States. Ironically, Germany, which had gone long ways in creating competitive financial markets modeled after the United States, was caught in the eye of the hurricane. The percentage declines from the peaks in March 2000 to the latest troughs in October 2002 of the German *Neuer Markt* Nemax 50 and Nemax All Share indexes were considerably steeper than the percentage drops of their U.S. counterparts, the Nasdaq 100 and the Nasdaq Composite indexes. While the U.S. indexes declined by 82 and 78 percent, respectively, the German indexes fell by a respective 97 and 96 percent. Unable to stem the loss in investor confidence, Deutsche Börse AG on September 26, 2002, announced to close *Neuer Markt*.[10] Then again, because the allocation of financial and real resources—and, consequently, the merger and acquisition activity—in Germany does not rely as much on financial markets as in the United States, the collapse of the stock market may prove less disruptive for the real economy in Germany.

In order to understand the causes and the consequences of mergers and acquisitions, it is necessary to turn to the history of merger waves. Although it is not fully understood why mergers and acquisitions happen in waves, the five periods of elevated merger and acquisition activity the United States experienced during the 20th century seem to teach two lessons. First, merger waves tend to fall into the late stages of an economic expansion and a booming stock market. Second, merger waves prompt (and are sometimes terminated by) regulatory changes (Gaughan, 2002).

A key factor in causing the ebbing of the latest merger wave in the United States is the elimination of pooling of interests as an accounting practice in business combinations.

FASB (Financial Accounting Standards Board, <http://www.fasb.org>) voted on the matter on April 21, 2000. The ruling has entered into force on July 1, 2001 (FASB Statement 141). Pooling of interests—called merger accounting in the United Kingdom—has its origin in the "merger of equals" concept. In pooling of interests, companies are combined at book value. The counterpart to pooling-of-interests accounting is purchase accounting—called acquisition accounting in the United Kingdom. Simply put, in purchase accounting a purchaser needs to be identified, and the difference between the price the purchaser pays in the acquisition and the book value of the acquired company are put on the acquirer's books—the "goodwill" position. Goodwill is then written off linearly over time; the maximum amortization period tolerated by FASB varied by industry. Although goodwill amortization has no cash flow implications and hence has no impact on the company's intrinsic value, management tends to dislike amortization of goodwill because it depresses reported net income and reported earnings per share.[11]

Under pressure from both Main Street and Wall Street—and here in particular from investment banks—FASB on June 1, 2001, ruled that goodwill in purchase accounting need only be written off as the assets in question are impaired (FASB Statement 142, effective as of July 1, 2001). Ironically, this rule dealt a crippling blow to the balance sheets of companies that had gone on acquisition sprees during the late 1990s. For instance, in 2002, AOL Time Warner saw itself writing down goodwill in the neighborhood of $50 billion. Although a goodwill write-off does not subtract from the company's cash flow, it might nonetheless bear on the stock market valuation. This is because, by admitting to impairment of acquired assets, management discloses to the market a downward revision in cash flow expectations.

The change in accounting practice in the United States—the elimination of pooling of interests and the marking down of impaired goodwill—has profound implications for the merger and acquisition activity in Germany as an increasing number of German companies

choose to adopt US-GAAP accounting standards. The new accounting method makes it more difficult for companies to obscure declines in the values of acquired assets compared with the previous purchase accounting practice with standardized, linear goodwill amortization or the discontinued pooling-of-interests accounting concept.

It is too early to assess the implications of the bust in the German stock market in the allocation of financial and real resources in Germany. On one hand, the 68 percent drop of the German stock market between March 2000 and the latest trough in October 2002 was accompanied by a decline in the merger and acquisition volume from €478 billion in 2000 to €163 billion in 2001, the lowest level since 1999.[12] On the other hand, while the transactions dropped by volume, by number they increased by 10 percent to a new all-time high of 2,173 (<http://www.mergers-and-acquisitions.de>).[13] Possibly, because the allocation of financial and real resources in Germany does not rely as heavily on financial markets as in the United States, there might be less spillover from boom and bust in financial markets into the real economy. For instance, in 2000, the ratio of stock market capitalization to GDP in Germany ran at only 67 percent (World Federation of Exchanges, <http://www.world-exchanges.org>), while it equaled 150 percent in the United States and averaged 89 percent across the European Union (European Central Bank, 2001). On the other hand, a lesser role of financial markets in asset allocation leads to less public information on asset prices and, consequently, misallocation of resources might be less discernable.

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[1] Emmons and Schmid (1998) offer a systematic description of the social environment in Germany for reallocation of claims on residual cash flow.

[2] The Stock Corporation Act distinguishes between votes and voting capital. For decisions of critical import to the corporation, such as control or profit transfer agreements, the Stock Corporation Act calls for a (qualified) majority of the voting capital, rather than just a (simple) majority of the votes. The difference is critical in cases where there are voting restrictions or shares with multiple votes—to be discussed below.

[3] European antitrust supervision rests on Council Regulation (EEC) No. 4064/89 from December 21, 1989, as amended by Council Regulation (EC) No. 1310/97 of June 30, 1997.

[4] *FWB Rules and Regulations* of Deutsche Börse AG (<http://deutsche-boerse.com>) has made the adherence to the Takeover Code a precondition for the listing at *Neuer Markt* or the inclusion in the stock market indexes DAX—the most popular German stock market index—and its mid-cap and small-cap siblings (MDAX, SDAX). Incumbents were "grandfathered."

[5] Rule 9 of the UK City Code stipulates that an investor shall make a tender offer to the residual shareholders once his equity interest reaches 30 percent of the corporation's voting rights (<http://www.thetakeoverpanel.org.uk>).

[6] Gorton and Schmid (2002) offer a detailed description of the German board system and an analysis of the influence of various degrees of codetermination on the performance of the corporation.

[7] The German Antitrust Commission (*Monopolkommission*, <http://www.monopolkommission.de>) investigated the influence of banks on the German corporate sector in its 1976/77 report *Fortschreitende Konzentration bei Großunternehmen*, Baden-Baden: Nomos, 1978, compiling the first extensive set of proxy voting data.

[8] Prior to the 1970 revision of the Volkswagen Act, the voting restriction at Volkswagen was 2 percent.

[9] Volkswagen AG is exempt from this legal provision (Beinert, 2000, § 70). Currently, Volkswagen has no stock with multiple votes outstanding (*Hoppenstedt Aktienführer 2002*, Darmstadt: Verlag Hoppenstedt, November 2001).

[10] The Nemax 50, Nemax All Share, Nasdaq 100, and Nasdaq Composite indexes had their all-time highs on March 10, 2000; they had their respective latest troughs on October 9, 2002 (Nasdaq Composite), October 8, 2002 (Xetra Nemax All Share), and October 7, 2002. The percentage declines were calculated from daily values at close.

[11] Weston, Johnson, Kwang, and Siu (2000, Chap. 3) present a textbook exposition of the accounting implications of goodwill write-offs.

[12] The most widely used German stock market index, DAX, which comprises 30 corporations, reached an all-time high on March 7, 2000, at 8064.97 before declining to its latest trough on October 9, 2002, at 2597.88 (Xetra DAX, daily values at close).

[13] The previous all-time high was 2,172 transactions, established in 1991—a year in which the merger and acquisitions activity in Germany was fuelled by the German reunification (<http://www.mergers-and-acquisitions.de>).

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