German and Asian Perspectives on Company Law

Edited by

HOLGER FLEISCHER, HIDEKI KANDA,
KON SIK KIM and PETER MÜLBERT

*Max-Planck-Institut
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Preface

This volume is based on presentations delivered at a conference held in May 2015 at the Max Planck Institute for Comparative and International Private Law in Hamburg. The symposium was organised to reinvigorate the scholarly exchange between company law academics in Germany, China, Japan and South Korea which can be traced back to the late 19th century. The organisers are convinced that this exchange will be very fruitful in solving the challenges for company and capital markets law in the 21st century. A follow-up conference has already taken place in Tokyo in March 2016.

We would like to thank all participants for their valuable and much appreciated contributions. Furthermore, we would also like to thank Jakob Hahn and Janina Jentz for their help in the editing process.

Hamburg, Tokyo, Seoul and Mainz
August 2016

Holger Fleischer
Hideki Kanda
Kon-Sik Kim
Peter Mülbert

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III. The Role of Shareholders

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Abbreviations

ADHGB	Allgemeines Deutsches Handelsgesetzbuch
AG	Aktiengesellschaft
AktG	Aktiengesetz
ALI	American Law Institute
ARUG	Gesetz zur Umsetzung der Aktionärsrechterichtlinie
Aufl.	Auflage
BAG	Bundesarbeitsgericht
BB	Betriebs-Berater
BEPS	Base erosion and profit shifting
BGB	Bürgerliches Gesetzbuch
BGH	Bundesgerichtshof
BGHSt	Entscheidungen des Bundesgerichtshofs in Strafsachen
BGHZ	Entscheidungen des Bundesgerichtshofs in Zivilsachen
BVI	Bundesverband Investment und Asset Management
CCZ	Corporate Compliance Zeitschrift
CEO	Chief Executive Officer
CGC	Corporate Governance Code
Cmnd	command papers 1956–1986
CMS	Controlling minority shareholders
CSR	Corporate Social Responsibility
CSRC	China Securities Regulatory Commission
DAX	Deutscher Aktienindex
DB	Der Betrieb
DGCK	Deutscher Corporate Governance Kodex
DGCL	Delaware General Corporation Law
DICJ	Deposit Insurance Corporation of Japan
DStR	Deutsches Steuerrecht
DT-AG	Deutsche Telekom AG
D&O	Directors and officers
EBOR	European Business Organization Law Review
ECFR	European Company and Financial Law Review
eG	eingetragene Genossenschaft
EU	European Union
EWIV	Europäische Wirtschaftliche Interessenvereinigung
FDI	Foreign direct investment
FIEA	Financial Instruments and Exchange Act
FRG	Federal Republic of Germany

FSA	Financial Services Agency
GAAP	United States Generally Accepted Accounting Principles
GbR	Gesellschaft bürgerlichen Rechts
GDP	Gross Domestic Product
GmbH	Gesellschaft mit beschränkter Haftung
GmbHG	Gesetz betreffend die Gesellschaften mit beschränkter Haftung
GmbHR	GmbH-Rundschau
HGB	Handelsgesetzbuch
HMC	Hyundai Motor Company
Hrsg.	Herausgeber
IFRS	International Financial Reporting Standards
JAL	Japan Air Lines
JASBA	Japan Audit and Supervisory Board Members Association
JCA	Japanese Company Act
JCGK	Japan Corporate Governance Code
JSC	Japan Stewardship Code
KAGB	Kapitalanlagegesetzbuch
KCC	Korean Commercial Code
KFTC	Korean Fair Trade Commission
KG	Kommanditgesellschaft
KGaA	Kommanditgesellschaft auf Aktien
KfW	Kreditanstalt für Wiederaufbau
KK	Kabushiki Kaisha
LAG	Landesarbeitsgericht
LG	Landgericht
LLC	Limited Liability Company
LLP	Limited Liability Partnership
M&A	Mergers & Acquisitions
MBC	Model Business Corporation Act
METI	Ministry of Economy, Trade and Industry
MitbestG	Mitbestimmungsgesetz
MNE	Multinational companies
MRFTA	Monopoly Regulation and Fair Trade Act
MOJ	Ministry of Justice
NaStraG	Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung
NJW	Neue juristische Wochenschrift
NJW-RR	Neue juristische Wochenschrift Rechtsprechungs-Report
NZG	Neue Zeitschrift für Gesellschaftsrecht
OCC	Ordinary Corporate Conduct
OECD	Organisation for Economic Co-operation and Development

OHG	Offene Handelsgesellschaft
OLG	Oberlandesgericht
PartG	Partnerschaftsgesellschaftsgesetz
PRC	People‘s Republic of China
RabelsZ	Rabels Zeitschrift für ausländisches und internationales Privatrecht
RCC	Resolution and Collection Corporation
RMB	Renminbi
ROE	Return on equity
ROHG	Reichsoberhandelsgericht
ROHGE	Entscheidungen des Reichsoberhandelsgerichts
SCE	Europäische Genossenschaft
SE	European Company
SEA	Securities and Exchange Act
SEC	Securities and Exchange Commission
SOEs	State-owned enterprises
SLC	Special Litigation Committees
SP	Steel Partners and its affiliates
SpruchG	Gesetz über gesellschaftsrechtliche Spruchverfahren
SR	Shareholder resolution
StGB	Strafgesetzbuch
TFEU	Treaty on the Functioning of the European Union
TSE	Tokyo Stock Exchange
UK	United Kingdom
UMAG	Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts
UmwG	Umwandlungsgesetz
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
VorstAG	Gesetz zur Angemessenheit der Vorstandsvergütung
VVaG	Versicherungsverein auf Gegenseitigkeit
WMF	Württembergische Metallwarenfabrik
WpHG	Wertpapierhandelsgesetz
WpÜG	Wertpapiererwerbs- und Übernahmegesetz
ZEuP	Zeitsdchrift für Europäisches Privatrecht
ZGR	Zeitschrift für Unternehmens- und Gesellschaftsrecht
ZHR	Zeitschrift für das gesamte Handels- und Wirtschaftsrecht
ZIP	Zeitschrift für Wirtschaftsrecht
ZJapanR	Zeitschrift für Japanisches Recht
ZPO	Zivilprozessordnung

Introduction

A Brief Guide to Japanese Company Law

Hideki Kanda

I. Introduction

1. Organization Forms

In Japan, aside from sole proprietorships, businesses can be organized in one of six organizational, or legal, forms – *kumiai* (partnership), *tokumeikumiai* (limited partnership), *gomeigaisha* (incorporated partnership), *goshigaisha* (incorporated limited partnership), *godogaisha* (incorporated limited liability company) and *kabushikigaisha* (stock company).

Among these six forms, only the first two – namely, *kumiai* and *tokumeikumiai* – enjoy single-tiered income taxation, by which income tax is not imposed at the "entity" level and individual investors report their proportional share of the profits earned by the entity in their personal tax returns. However, *kumiai* does not offer limited liability to their investors, and while *tokumeikumiai* offers limited liability to investors, if the number of investors is ten or more, a withholding tax is imposed, making the *tokumeikumiai* form costly. For these reasons, *kumiai* and *tokumeikumiai* are unpopular for large businesses in Japan. The other four forms all have "legal personality" (some of which provide investors with limited liability and others do not) and are subject to "double" income taxation. While *gomeigaisha*, *goshigaisha* and *godogaisha* (collectively called "person companies") are given flexibility under the Companies Act regarding their internal governance structure and related matters, they are unsuitable for raising a large amount of funds in capital markets. Thus, in Japanese practice, all major businesses take the *kabushikigaisha* (stock company) form, which is similar to a business corporation in the US, a public company in the UK, a German *Aktiengesellschaft*, and a French *société par action*.

As of the end of November 2014, there are about 3.4 million stock companies in Japan, but most of them are closely held companies, and the number of "large" companies (see below for definition) is estimated to be 9,000 to 10,000. There are about 3,600 publicly held companies listed on stock exchanges in Japan. As the largest stock exchange, Tokyo Stock Exchange ("TSE") has about 3,400 listed stock companies.

Table 1: Number of Companies as of the end of November 2014[1]

Stock companies	
(excluding special GmbH, see below)	
c: the amount of legal capital	
c < one million yen	116,713
one million yen ≤ c <10 million yen	566,299
10 million yen ≤ c < 100 million yen	1,049,174
100 million yen ≤ c < 1 billion yen	30,756
1 billion yen ≤ c	7,038
Total	1,769,980
Special GmbH[2]	1,642,039
Incorporated partnership *(gomeigaisha)*	17,887
Incorporated limited partnership *(goshigaisha)*	80,027
Incorporated limited liability company *(godogaisha)*	72,292
Total	3,582,225

2. Company Law

In Japan, the Companies Act of 2005 (effective from 1 May 2006) applies to *kabushikigaisha* (stock companies), *gomeigaisha*, *goshigaisha*, and *godogaisha*. The Companies Act provides for private law rules about stock companies and person companies. The Companies Act is a consolidation of the statutes that existed in 2005 in respect of company law rules governing stock companies and person companies in Japan. Until this consolidation, company law rules were codified primarily as part of the Commercial Code of 1899. Although Commercial Code is of German origin, many American rules for

[1] Source: Ministry of Justice.

[2] Before the Companies Act of 2005, these companies were the Japanese counterpart of German GmbH and governed by the Japanese GmbH Act of 1938. Under the Companies Act, which absorbed the Japanese GmbH Act, they are legally stock companies, but enjoy less stringent rules than other stock companies.

business corporations were transplanted after World War II. Today, the Companies Act also reflects numerous amendments to the Commercial Code made in the past decades, and represents the result of these historical developments in Japan. Thus, the Companies Act today exhibits its own, somewhat unique landscape.[3] In the following, this article will focus on stock companies.

3. *Securities Regulation*

The Financial Instruments and Exchange Act of 1948 ("FIEA") applies to large publicly held companies.[4] The name of the Act was changed to its present name by the amendments in 2006 (effective from 30 September 2007), prior to which it was called the Securities and Exchange Act ("SEA"). The SEA was modeled on the US Securities Act of 1933 and Securities Exchange Act of 1934, but again reflects the unique historical developments in Japan in the past decades. The Act, therefore, has its own characteristics, and the substance of the rules in the Act is not identical to that in the United States. Firms whose shares are listed on the TSE are subject to the Companies Act, the Financial Instruments and Exchange Act, and the rules of the TSE.

Sometimes the Companies Act and the FIEA regulate the same matters. For instance, both Acts require public companies to prepare financial statements and have them audited by professional auditors. In usual practice, as far as annual financial statements are concerned, companies prepare those documents and have them audited at the same time, so as to satisfy the requirements under both Acts.

The Companies Act is a private law, enforced by the courts and there is no administrative branch or agency of government that enforces rules under the Companies Act. As an exception, public registry offices are understood to enforce the rules applied to matters that must be registered, but this is not discussed in this article. In contrast, the FIEA has an administrative body of government, the Financial Services Agency ("FSA"), and an enforcement body, the Securities and Exchange Surveillance Commission. The FIEA is also enforced by the courts.

The FIEA and regulations under the FIEA have been amended several times in recent years. For instance, the disclosure rules under the FIEA were amended in March 2010. The current rules under the regulation called *kaiji*

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[3] For a comprehensive explanation in English of company law in Japan, see KAWAMOTO/KAWAGUCHI/KIHARA, Corporations and Partnerships in Japan (Alphen aan den Rijn 2012). The English translations of major Japanese statutes are available at <http://www.japaneselawtranslation.go.jp/?re=02>.

[4] A company whose securities are listed on a stock exchange, traded "over the counter" or with 500 or more registered shareholders is subject to the periodic reporting requirements of the FIEA. A company that has made a public offering is also subject to the same reporting requirements.

naikaku furei promulgated by the FSA impose enhanced disclosure regarding corporate governance on reporting companies (which include all listed firms). In particular, reporting companies are now required to provide disclosure of the annual amount of executive compensation for each individual where the annual amount is 100 million yen or more.[5] They also are now required to provide disclosure of the result of voting at the resolutions of the shareholders' meeting.

4. *Stock Exchange Rules*

In the past, the TSE has been active in providing rules concerning corporate governance for listed companies.[6] In particular, on 24 August 2009, the TSE introduced a rule concerning the issuance of new stock to third parties requiring increased disclosure and explanations as to why the firm is making such issuance.[7] Also, on 30 December 2009, the TSE adopted a new rule requiring all listed firms to have at least one "independent" director or statutory auditor, whose name must be provided to the TSE every year.[8] The definition of "independent" under the TSE rule is stricter than the definition of "outside" under the Companies Act. In the latter, outside means lack of an employment or family relationship, whereas in the former, independent also requires, in addition to being an outsider required under the Companies Act, lack of business or trade relationship.[9]

From 1 June 2015, the Corporate Governance Code ("CGC") promulgated by the TSE applies to all listed firms on the TSE.[10] Other stock exchanges follow the TSE. The CGC consists of 5 fundamental principles, 30 principles and 38 supplemental principles. For firms listed on the "main market" of the TSE (about 2,400 firms listed on the First Section and Second Section of the TSE), all of these principles apply as a "comply or explain" norm, requiring companies to explain any non-compliance. For smaller-size firms listed on markets other than the main market (which consist of two markets called Mothers and JASDAQ), only the fundamental principles carry this "comply or explain" requirement.

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[5] See Disclosure Rules of the Financial Services Agency *(kaiji naikaku furei)* (March 2010).

[6] See generally Tokyo Stock Exchange, Improvements to the TSE Listing System, <http://www.jpx.co.jp/equities/improvements/general/index.html>.

[7] See Art. 432 of the TSE Listing Rules (effective from 24 August 2009).

[8] See Art. 436 para. 2 of the TSE Listing Rules (effective from 30 December 2009, amended on 30 June 2010).

[9] See TSE Guidelines on Listing III-(3)-2 (*jojokanri-to ni kansuru*-guidelines) (effective from 30 December 2009).

[10] <http://www.jpx.co.jp/equities/listing/cg/index.html>.

II. Board Structure

In Japan "large" and "public" stock companies must choose from among three alternative board structures. All firms listed on stock exchanges fall within this category. A "large" stock company is defined under the Companies Act as a stock company having either legal capital in the amount of 500 million Yen or more, or total debt (according to its balance sheet) in the amount of 20 billion Yen or more (Art. 2 no. 6 Companies Act). A "public" stock company is defined under the Companies Act as a stock company other than one where the transfer of any shares is restricted in the company's charter by making any proposed transfer subject to the company's approval (Art. 2, no. 5 Companies Act).

Three alternatives are (i) two boards, (ii) one board and one committee, and (iii) one board and three committees. Until the amendments in 2014, the Companies Act permitted a choice between a two-board company and a one-board and three-committee company. The former *(kansayakukai secchi gaisha),* requires a board of directors and a board of statutory auditors, while the latter *(shimei iinkaito secchi gaisha),* has no statutory auditors and the board of directors is required to have three committees – a nominating committee, an audit committee and a compensation committee (Art. 400–Art. 417 Companies Act). This latter form was introduced by the amendments to the Commercial Code in 2002 (effective from 1 April 2003), and more than half of the members of each committee must be "outside" directors. For two-board companies, at least half of the members of the board of statutory auditors must be "outside" statutory auditors, but the board of directors does not have to have outside directors. In practice, the level of uptake shows that one-board and three-committee companies are not popular. Only 1.7% of the listed firms on the TSE as of 14 July 2014 are one-board and three-committee companies.[11]

A brief further note on two-board companies may be worthwhile, because statutory auditors are not well-known outside Japan. The Companies Act begins with the familiar position that shareholders are the owners of a stock company. A shareholders' meeting elects directors, and makes decisions about "fundamental changes" to the company, such as a merger, a sale of a substantial part or all the firm's assets, and any amendments to the firm's charter. For a two-board company, there must be at least three directors. Directors are elected at the shareholders' meeting, and form the board of directors. The board elects representative directors, the Japanese counterparts of US officers or executives. There must be at least one representative director. Representative directors and executive directors manage the company, running its day-to-day activities. The Companies Act requires that the board of

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[11] See TSE-Listed Companies White Paper on Corporate Governance 2015 (March 2015).

directors make important corporate decisions and supervise management. Each director, as a member of the board, owes a duty of care and loyalty to the company. The director's liability to the company may be enforced by shareholders through a derivative action. Shareholders have rights similar to those of other countries, such as the right to make proposals, the right to ask questions to directors and statutory auditors (although the Companies Act calls this the director's or auditor's "duty to explain"), and the right to examine the company's books and records.

A two-board company must have a *kansayaku*, often (somewhat misleadingly) translated as a statutory auditor.[12] Statutory auditors are elected at the shareholders' meeting, and do not have to be an accountant or other professional. A "large" company (see above for definition) must have at least three statutory auditors, and at least half of them must be "outside" statutory auditors. An auditor is "outside" where he or she does not, and in some cases did not in the past ten years, serve as a director or employee of the company or its parent or subsidiary (Art. 2 no. 16 Companies Act). In a large company, there must be at least one full-time auditor.

In addition, a large company must have an accounting auditor *(kaikeikansanin),* who must be a certified public accountant or certified auditing firm. An accounting auditor is elected at the shareholders' meeting, and is responsible for auditing the company's financial statements annually before they are submitted to the annual shareholders' meeting, where the audit opinion is also submitted. In contrast, a statutory auditor is responsible for overseeing the activities of management. This is understood to mean confirming the legality of management activities. The Companies Act requires collaboration between accounting auditors and statutory auditors, providing complex rules, the details of which are beyond the scope of this article.

A two-board company may elect an outside director, although this election is not mandatory. A director is "outside" where he or she is not, and in some cases was not in the past ten years, an executive director or employee of the company or its parent or subsidiary (Art. 2 no. 15 Companies Act).

There are two recent trends in this area. First, as noted below, the TSE today requires listed firms to have at least one "independent" director or auditor, and the TSE adopts a policy that encourages all listed firms to have independent directors.

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[12] The Japan Audit and Supervisory Board Members Association (JASBA) *(Nihon Kansayaku Kyokai)* recommends that *kansayaku* be translated into English as audit and supervisory board member and *kansayaku-kai* be translated as audit and supervisory board. See JASBA, New Recommended English Translation for *Kansayaku* and *Kansayaku-kai* (October 2012), available at <http://www.kansa.or.jp/en/ns121023.pdf>. I am sticking to the traditional translation in this article and am using "statutory auditor" and the "board of statutory auditors".

Second, the Companies Act was amended in 2014 (effective from 1 May 2015). The amendments introduced a new rule by which if reporting companies (to which the FIEA applies) are two-board companies, they must have an outside director as a comply or explain norm. Specifically, all two-board reporting companies without an outside director must explain why at the annual shareholder's meeting (Art. 327 para. 2 Companies Act). In addition, under the rule of the Ministry of Justice ("MOJ"), such explanation must be made in the annual business report *(jigyo hokoku),* and in the materials in connection with the election proposals of directors at the shareholders' meeting *(kabunushi-sokai sanko-shorui).* In this respect, it is interesting to note that the Legislative Council of the MOJ also made a strong request to stock exchanges that they encourage listed firms to have outside directors.[13]

Note also that the Corporate Governance Code mentioned above includes a principle (Principle 4.8 of the Code) providing that listed firms (on the main market, see above) must have at least two outside directors as a comply or explain norm.

The 2014 amendments to the Companies Act introduced a third option for structuring the board – the one-board and one-committee structure. Companies in this new type are called *"kansato-iinkai secchi geisha".* In such companies there are no statutory auditors and the majority of the committee members must be outside directors (Art. 399 para. 2–Art. 399 para. 14 Companies Act). This one-board and one-committee structure is intended to encourage listed firms with the two-board structure to move to that structure and thereby have outside directors.

III. Groups of Companies

There are few statutory rules governing groups of companies in Japan, and general company law rules apply to them. This is closer to the situation in the US, rather than in Germany.

One of the statutory rules governing groups of stock companies is the rule on mutual stock holding. If Company A holds 25% or more of Company B's shares, Company B is prohibited from voting on the share(s) in Company A that B owns. In practice, this rule seldom applies. In a typical "cross holding" situation, using the above hypothetical, Company B owns 100% to 1% of

[13] Legislative Council of the Ministry of Justice, Main Points for the Reform of Corporate Law (7 September 2012), available at <http://www.moj.go.jp/content/000102013.pdf> (in Japanese). On the date the bill was submitted to the Diet, the TSE made an announcement to that effect. See Tokyo Stock Exchange, Revisions to Listing Rules concerning Securing Highly Independent Outside Directors (29 November 2013), available at <http://www.tse.or.jp/rules/comment/b7gje600000186jz-att/131129_01e.pdf>.

Company A's shares, but Company A owns less than 25% of B's shares. Also, the situation where A owns B, B owns C, and C owns A is a popular, means of circumventing the voting restriction rule. In addition, with narrow exceptions, subsidiaries are prohibited from acquiring the shares of the parent company, a rule extending the regulation of share repurchase. Where subsidiaries hold the parent's shares as an exception, they do not have voting rights.

For accounting and disclosure purposes, as will be discussed later, the FIEA requires reporting companies (see above) to prepare and disclose financial statements on a consolidated basis four times a year. The Companies Act requires the same, but annually.

The 2014 amendments to the Companies Act introduced certain new rules. First, for public companies, a large-scale stock issuance that would create a controlling shareholding (that is, a majority holding of voting stocks) requires the approval of the shareholders' meeting (Art. 206 para. 2 Companies Act). The technical operation of this new rule is complicated and not discussed here.

Second, in parent-subsidiary situations, a so-called multi-layer shareholder derivative action was introduced under limited circumstances. Under the new regime, where a director of a subsidiary owes liability to the subsidiary, a shareholder of its 100% parent company (if he or she has one percent or more of the voting shares for six months or otherwise satisfies specified conditions) is given the right to sue the director of the subsidiary in the form of a derivative action (if the subsidiary is large enough to account for more than twenty percent of the parent's balance sheet or otherwise satisfies specified conditions) (Art. 847 para. 3 Companies Act).

IV. Recent Issues and Empirical Studies

1. Defensive Measures against Hostile Takeovers

The area of takeover defenses is complicated in respect to the law's coverage. The FIEA regulates tender offer processes, while most of the defense measures raise legal issues under the Companies Act, not the FIEA. In this sense, the distinction between the FIEA and the Companies Act roughly corresponds to that between the federal (and state) securities law and state corporate law in the United States. It is interesting to note that the validity of some of the defenses was challenged before the courts. In those cases the relevant issues were those under the Companies Act, not the FIEA.[14] In fact, the current tender offer regulation under the FIEA permits the target company to

[14] See generally K. OSUGI, Transplanting Poison Pills in Foreign Soil: Japan's Experiment, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London et al. 2008) 36.

adopt a defense action even after the commencement of a tender offer by a hostile bidder. Thus, as in Delaware, case law under the Companies Act shapes the landscape, although the substance of the case law is not identical between Delaware and Japan.

In a well-known case, in May 2007, Steel Partners, a US buy-out fund, commenced a hostile tender offer for all outstanding stocks of Bulldog Sauce, a Worchester sauce producer and a listed company on the TSE. Bulldog Sauce did not have any "pre-bid" defense plan. As a post-bid defense, the board of directors of Bulldog Sauce intended to issue stock warrants to all shareholders, including Steel Partners and its affiliates (collectively "SP"), with the condition that SP could not exercise the warrants. The warrants had a redemption feature, by which warrant holders other than SP would receive common stocks in exchange for turning the warrants into the company, whereas SP would receive cash. Thus, the scheme was structured as a scheme to dilute SP's voting right without imposing an economic loss on SP ("economic" does not include the value of the voting right). The Bulldog board introduced the proposal at the annual shareholders' meeting on 24 June 2007, and shareholders holding more than eighty percent of the total stocks approved the plan. SP sued to enjoin the issuance of the warrants. The Tokyo District Court held on 28 June 2007, that the scheme was valid. The decision was affirmed by the Tokyo High Court on 9 July 2007, and then by the Supreme Court on 7 August 2007. The relevant issues were decided under the Companies Act, and not the FIEA.[15]

Also, a number of public firms in Japan have one of the two types of "pre-bid" defense plans. Of the 3,414 firms listed on the TSE on 14 July 2014, 497 (14.6%) have pre-bid defense plans.[16]

Pre-bid defense plans take two forms. The first is a typical trust based scheme, where the firm issues stock warrants to a trust bank with designating shareholders as beneficiaries of the trust. A hostile bid triggers the defense plan, and the trust bank transfers the warrants to the shareholders. The warrants have a discriminatory feature and the bidder has no right to exercise them, as the terms and conditions of the warrants usually provide that the warrants cannot be exercised by shareholders who own twenty percent or

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[15] See C. J. MILHAUPT, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, 105 Columbia Law Review (2005) 2171. See also J.B. JACOBS, Implementing Japan's New Anti-takeover Defense Guidelines, Part II: The Role of Courts as Expositor and Monitor of the Rules of the Takeover Game, 3 University of Tokyo Journal of Law and Politics (2006) 102; H. KANDA, Takeover Defenses and the Role of Law: A Japanese Perspective, in: Tison et al. (eds.), Perspectives in Company Law and Financial Regulation (Cambridge 2009) 413.

[16] See TSE-Listed Companies White Paper on Corporate Governance 2015 (March 2015).

more of the firm's outstanding stocks.[17] This plan is not popular today. The second, more popular, plan is called the advance-warning plan. This plan varies from company to company but generally involves a mechanism of the board, sometimes with the approval of the shareholders' meeting, making a public announcement that if a shareholder attempts to increase its stake to twenty percent or more of the firm's outstanding stocks, that shareholder is first required to disclose and explain their intent for the shares in accordance with the details specified in the announcement. If the shareholder does not answer these questions or the target board thinks the shareholder's explanation is unsatisfactory, then a defense measure would be triggered. Typically, the defense measure involves issuing stock warrants to all shareholders; however, the shareholder having twenty percent or more cannot exercise the warrants, instead warrants are redeemed at a fair price at the option of the company. Thus, typically, a warrant issuance has the effect of "cashing out" the hostile bidder.[18]

Thus, the Companies Act is important for critical issues in the area of hostile takeovers and defenses, and the courts play an important role in applying the relevant rules under the Companies Act. The Tokyo Stock Exchange also plays an important role in shaping the landscape in this area, since such issues are not directly regulated by the FIEA, and thus there is no room for their enforcement by the FSA.

As noted above, beginning in 2005, some listed firms adopted pre-bid defense plans against hostile takeovers, in the form of advance warning defense plans noted above, and there is an empirical study showing a positive correlation between firms that adopted defense plans in 2005 and firms that showed poor economic performance.[19] The authors report that there is no such correlation for firms that adopted defense plans in 2006.[20] Causality is not entirely clear for firms that adopted defense plans in 2005: it is not certain whether the adoption of defense plans led to poor performance. It may be that firms with poor performance tend to expose themselves to hostile bids and thus introduced defense plans.

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[17] See KANDA, *supra* note 15, 419.

[18] Note, however, that after the report by the Corporate Value Study Group (at the Ministry of Economy, Trade and Industry on 30 June 2008) took a general position against paying compensation to hostile bidders for the economic loss they may suffer when the defense action is triggered, advance warning plans generally do not provide such payment.

[19] See S. HIROSE/T. FUJITA/N. YANAGAWA, *Baishuboeisaku no Gyosekijoho Koka – 2005 nen Donyu Jirei no Bunseki* [Information Effects of Performance by the Adoption of Takeover Defenses: An Analysis of Cases in 2005], Junkan shōji hōmu 1826 (2008) 4.

[20] See *id.*

2. Outside Directors

As was noted above, under the current Companies Act in Japan, outside directors are not required for "two-board companies", which is the most popular board structure among listed firms in Japan. In fact, 98.3% of the listed firms on the TSE as of 14 July 2014, are two-board companies, and the remaining 1.7% are "one-board and three-committee companies."[21]

The TSE-Listed Companies White Paper on Corporate Governance 2015 ("TSE White Paper") reports on all firms listed on the TSE as of 14 July 2014. As of that date, 1,814 are listed on the First Section, 545 are on the Second Section, 194 on Mothers and 861 on JASDAQ. Therefore, in total, 3,414 firms are listed on the TSE ("TSE-listed companies").[22]

The overall average number of directors per TSE-listed company was 7.50 persons. There are 7 companies that have more than 20 directors, and all of these companies have outside directors. On the other hand, 946 companies have up to 5 directors. In 11 companies (0.3% of two-board companies), the number of statutory auditors *(kansayaku)* exceeds the number of directors; 146 companies (4.3% of two-board companies) have equal numbers of directors and statutory auditors; and, in 425 companies (12.7% of two-board companies), the number of directors exceeds the number of statutory auditors by only one person.

Companies that have appointed outside directors accounted for 64.4% or nearly two-thirds of TSE-listed companies. Among two-board companies alone, the percentage is 63.8%.

Of the two-board companies, 25.9% (or 40.2% of two-board companies that appointed outside directors) have multiple outside directors. On the other hand, companies that appointed multiple "independent" directors accounted for only 12.0%.

The average number of outside directors per company was 1.1 for TSE-listed companies. For two-board companies, the average number of outside directors was 1.04, exceeding one for the first time. For one-board and three-committee companies, it was 4.7.

Of the 3,761 outside directors appointed by the 2,200 TSE-listed companies that appointed outside directors, the TSE was notified of 2,303 (61.2%) outside directors that were also independent directors.

Of all listed companies, 2,058 companies, or 60.3%, have at least two independent directors and/or statutory auditors. Where a company has multiple outside directors and/or statutory auditors who satisfy the independence criteria, it is at the company's discretion whether to notify the TSE of all of them

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[21] See TSE-Listed Companies White Paper on Corporate Governance 2015 (March 2015).

[22] The following text draws on the TSE-Listed Companies White Paper on Corporate Governance 2015 (March 2015).

or only of selected members who are considered appropriate. Therefore, compliance only requires a company to notify the TSE of only one of their independent directors or statutory auditors, but a significant number of companies have notified the TSE of multiple persons.

On aggregate, the TSE was notified of 7,526 independent directors and/or statutory auditors, of which 7,330 were in two-board companies, and 196 in one-board and three committee companies. The average number of independent directors and statutory auditors per listed company is 2.20 persons: 2.18 persons in two-board companies and 3.44 persons in one-board and three committee companies.

An analysis of the average number of independent directors or statutory auditors by market division reveals the greatest number of designations came from TSE First Section companies (average 2.62 persons), followed by Mothers (1.95 persons), the TSE Second Section (1.7 persons), and JASDAQ companies (1.7 persons).

Of the listed companies that have independent directors and/or statutory auditors, only 329 companies (9.6%) notified the TSE of outside directors, with 272 of those companies being two-board companies. On the other hand, 1,818 companies (53.1%) only notified the TSE of outside statutory auditors, while 1,267 companies (37.1%) notified them of at least one outside director and one outside statutory auditor.

Out of all independent directors and statutory auditors, 2,303 persons (30.6% of all independent directors and statutory auditors) are outside directors, and 5,223 persons (69.4%) are outside statutory auditors. Of the outside directors and statutory auditors reported to the TSE, 61.2% outside directors were independent, while independent statutory auditors accounted for 63.1%.

Whether outside directors play a positive role in corporate governance has been much debated, and several empirical studies on the subject have been conducted. As to whether there are correlations between having outside directors and firm performance, the results of those studies are split.[23]

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[23] Compare Y. MIWA/J. M. RAMSEYER, Who Appoints Them, What Do They Do? Evidence on Outside Directors from Japan, 14Journal of Economics and Management Strategy (2005) 299 with K. UCHIDA, *Torishimariyakukai Koseihenka no Ketteiyoin to Kigyo Performance eno Eikyo* [The Determinants of the Ratio of Outside Directors and Firm Performance], Securities Analysts Journal 50 (2012) 8; T. SAITO, *Nihon Kigyo niyoru Shagaitorishimariyaku no Donyu no Ketteiyoin to Sono Koka* [The Determinants and the Effects of Having Outside Directors in Japanese Firms], in: Miyajima (ed.), Corporate Governance in Japan – Toward Redesigning Corporate Governance and the Recovery of Competitiveness *(Nihon no Kigyo Tochi - Sono Saisekkei to Kyosoryoku no Kaifuku ni Mukete)* (Tokyo 2011) 181; H. MIYAJIMA/R. OGAWA, *Nihon Kigyo no Torishimariyakukaikosei no Henka o Ikani Rikaisuruka* [How to Understand the Change in the Composition of the Board of Directors in Japan], Junkan shōji hōmu 1973 (2012) 81.

It is interesting to note, however, that empirical studies in recent years have tried to examine the determinants of board composition, seeking to identify factors that may affect optimal board structure. The hypothesis is that more diversified firms with more branches need directors with different backgrounds and expertise, and firms requiring special knowledge and skills need a greater number of inside directors. While recent empirical studies concerning independent directors in the United States imply a situation consistent with this hypothesis, empirical studies concerning outside directors in Japan imply the opposite.[24]

3. Listing of Subsidiaries

While most listed firms on the TSE do not have parent companies, some of them do. The TSE White Paper 2015 reports that among TSE-listed companies, 629 companies have controlling shareholders, accounting for 18.4% of all listed companies. Of these, 61.8% (11.4% overall) have parent companies, with 83.5% (9.5% overall) being listed companies[25] while 38.2% (7% overall) have controlling shareholders other than a parent company. In terms of market division, 8.9% of TSE First Section companies have parent companies. This is relatively low compared to the high levels shown in the TSE Second Section 14.7%, Mothers 11.9%, and JASDAQ 14.4%. The same trend can be seen when looking at the total percentage of companies with controlling shareholders other than a parent company. In the TSE First Section, the percentage of companies with controlling shareholders is 12.7%, comparatively lower than the higher levels shown in the TSE Second Section 20.6%, Mothers 29.9%, and JASDAQ 26.6%.

Out of TSE-listed companies whose largest shareholder's ownership ratio is 50% or above, 293 companies do not have a parent company. By market division, they comprise 117 TSE First Section companies (6.4% of this market division), 56 TSE Second Section companies (11.7%), 28 Mothers companies (14.4%), and 92 JASDAQ companies (10.7%). This indicates that there are many companies with company founders and other individuals as controlling shareholders in the market divisions, other than the TSE First Section.

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[24] On this point, see T. FUJITA, Corporate Governance and the Rule of Soft Law, 5 UT Soft Law Review (2013) 9. For the studies in the United States, see, for example, J. S. LINCK/J. M. NETTER/T. YANG, The Determinants of Board Structure, 87 Journal of Financial Economics (2008) 308; K. LEHN/S. PATRO/M. ZHAO, Determinants of the Size and Structure of Corporate Boards: 1935–2000, 38 Financial Management (2009) 747; L. A. BEBCHUK/M. S. WEISBACH, The State of Corporate Governance Research, 23 Review of Financial Studies (2010) 939.

[25] The following text draws on the TSE-Listed Companies White Paper on Corporate Governance 2015 (March 2015).

TSE-listed companies that have controlling shareholders provided explanations on their guidelines for protecting minority shareholder interests.

Approaches to the specific descriptions are categorized into two types: (i) those that describe their policies for transaction conditions; and (ii) those that refer to their procedures for transactions with the controlling shareholders.

(i) 268 companies (or 42.6% of TSE-listed companies with controlling shareholders) described their policies for transaction conditions. They typically referred to policies that stipulate that transactions with the controlling shareholder are to be carried out in a fair and equitable manner, as in those with other business partners, taking into account the terms of such contacts and market prices, to prevent transactions that adversely affect minority shareholder interests (156 companies). Some companies stated that while they do not have business relationships with their controlling shareholders at the moment, they would adopt the above-mentioned policy for future transactions. Other companies referred to the control function of outside directors or statutory auditors, or putting the details of transactions up for internal approval and circulating the information internally. Furthermore, there were companies that stated that, as a matter of policy, they did not, in principle, conduct any transactions with their controlling shareholder in the first place.

(ii) 365 companies (58%) referred to procedures for transactions with the controlling shareholders. Specifically, the procedures described include: asking the opinion of independent directors or statutory auditors, other than those from the parent company to provide more objective decision-making in order to prevent any transaction that benefits the parent company but undermines the interests of minority shareholders; decisions being made in consultation with external specialists, when necessary, to ensure that the transaction terms in question are reasonable and appropriate; and, in contrast to ordinary transactions, requiring a resolution of the board, regardless of the transaction amount in question. As guidelines on protecting minority shareholder interests, some companies involve their own (not the parent company's) board in separate discussions and decisions on matters concerning the transaction, such as the appropriateness of the terms and making independent executive decisions. These companies are expected to provide greater detail demonstrating that directors under the parent companies' influence can make a fair decision. Other procedures include stipulating rules on internal procedures relating to decision-making on the transaction terms to ensure the appropriateness of transactions, and appropriate auditing by statutory auditors or the operations audit group, etc.

In addition to the above-mentioned approaches (i) and (ii), where a controlling shareholder assumes the role of director, company rules such as its code of ethics prohibit such a director from conducting conflict of interest transactions, which cause or may cause conflicts between the director's interests and the company's interests. There are certain companies that specifically include prohibition on unfairly favorable or unfavorable transactions compared with transactions with third parties, or transactions for the purpose of transferring profits, or losses or risks in their rules as policies to protect minority shareholders.

Finally, recent empirical studies tend to indicate that the economic performance of those listed subsidiaries is not consistently worse than other listed firms.[26]

4. Shareholder Activism

Whether shareholder activism plays a positive role in corporate governance is also a topic that has been much debated worldwide. There are empirical studies about the Japanese situation on this topic, and their implications seem somewhat unclear.[27]

In practice, many institutions have registered with the FSA as institutions implementing the Japanese Stewardship Code, which was promulgated in February 2014.[28] Many institutions also have internal policy guidelines on voting. Similarly, voting advisory institutions such as ISS and Glass Lewis also provide policy guidelines.[29]

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[26] See H. MIYAJIMA/K. NITTA/Z. SHISHIDO, *Oyako Jojo no Keizai Bunseki* [An Economic Analysis of Parent and Subsidiary Listings], in: Miyajima (ed.), *Nihon no Kigyo Tochi – Sono Saisekkei to Kyosoryoku no Kaifuku ni Mukete* [Corporate Governance in Japan – Toward Redesigning Corporate Governance and the Recovery of Competitiveness] (Tokyo 2011) 289.

[27] See Y. HAMAO/K. KUTSUNA/P. P. MATOS, US-Style Investor Activism in Japan: The First Ten Years, Marshall School of Business, Working Paper No. FBE 06-10 (2010). See also J. BUCHANAN/D. H. CHAI/S. DEAKIN, Hedge Fund Activism in Japan – The Limits of Shareholder Primacy (Cambridge 2012).

[28] <http://www.fsa.go.jp/status/stewardship/index.html/>.

[29] For ISS, see <http://www.issgovernance.com/file/policy/2016-asia-pacific-policy-updates.pdf> (in English) and <https://www.issgovernance.com/file/policy/2015japanvotingguidelines-japanese.pdf> (in Japanese). For Glass Lewis, see <http://www.glasslewis.com/assets/uploads/2015/12/2016_GUIDELINES_Japan.pdf> (in English).

A Guide to German Company Law for International Lawyers

Distinctive Features, Particularities, Idiosyncrasies*

Holger Fleischer

Legal comparativists know only too well how hard it is to break into a foreign jurisdiction. Much of what seems completely obvious to local jurists, remains shrouded in mystery for the external observer. This is particularly the case

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when dealing with circumstances not covered in a standard textbook: the practical significance of individual legal institutions, the interplay between legislation and case law or the unspoken preconceptions in legal thinking and methodology.[1] Alleviating these difficulties is not easy, even for a local expert: it is hard to overcome the imprinting of one's own legal education and to judge what is worth telling or explaining to a foreign lawyer. Assuming this risk with open eyes, the following presentation seeks to provide the foreign traveller with a short guide through the German company law neighbourhood.

I. Legal Sources and Types of Business Organisations in Germany

1. No Code Unique, no Comprehensive Company Code, no Unitary Capital Company

To get an overview of the corporate landscape in Germany is difficult for newcomers. The local legal horticulture needs getting used to and the garden of company law is not easily accessible. It is not constructed as a symmetrical *jardin à la française,* but rather presents itself as a thicket of wild growth.

With regard to the general organisation of legal material, German Private Law does not have a *Code unique*[2] at its disposal, i.e. no unity of civil and business law as found in the Italian *Codice civile,* the Dutch *Burgerlijk Wetboek* or the Brasilian *Código civil,* nor does it integrate civil and commercial companies into the law of obligations, as does the Suisse *Obligationenrecht.* Instead, there is a coexistence of a Civil Code and a Commercial Code which has been somewhat pretentiously characterised in the legal literature as a "system of dualistic full codification"[3].

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[1] See the contributions recently collected in Helland/Koch (eds.), Nordic and Germanic Legal Methods (Tübingen 2014).

[2] Explaining the concept of a 'code unique', P. SCHMIDT, catchword "Code Unique" in: Basedow et al. (eds.), Max Planck Encyclopedia of European Private Law, vol. I (Oxford 2012) 210 et seq.; E.A. KRAMER, Handelsgeschäfte – eine rechtsvergleichende Skizze zur rechtsgeschäftlichen Sonderbehandlung unternehmerischer Kontrahenten, in: Aicher/Koppensteiner (eds.), Beiträge zum Zivil- und Handelsrecht: Festschrift für Rolf Ostheim zum 65. Geburtstag (Vienna 1990) 306 et seq.; for a detailed account of the historical development of special commercial codes and the counter-movement of incorporating commercial law in a civil code W. MÜLLER-FREIENFELS, The Problem of Including Commercial Law and Family Law in a Civil Code, in: Stoljar (ed.), Problems of Codification (Canberra 1977) 95 et seq.; for a comparative overview over jurisdictions which separate or, by contrast, integrate civil and commercial law F. GALGANO, Diritto civile e diritto commerciale, in: Galgano/Ferrari (eds.), Atlante di diritto privato comparato (Bologna 1992) 35 et seq.

[3] C. M. SCHMITTHOFF, Das neue Recht des Welthandels, RabelsZ 28 (1964) 50: "System der dualistischen Vollkodifizierung".

German company law has a rugged landscape as well. There is no welcoming harbour or smooth mountain pass in the form of a comprehensive or coherent Company Code and no compilation of company laws comparable to the French *Code de commerce* of 2000[4] or the Belgian *Code des Sociétés* of 1999 to make company law at least more accessible.[5]

It comes therefore as no surprise that there is no General Part of company law, i.e. a set of common company law principles comparable to those codified in Arts. 1–124 of the Argentine *Ley de Sociedades Comerciales*[6], Arts. 1822–1844-7 of the French *Code civil*[7] or, at least partially, in Arts. 1–12 of the Polish Commercial Code. Thus, it was left to company law doctrine to develop a corpus of common principles from the scattered rules in the law of civil partnerships, the law of registered associations and various other legal sources.[8]

Regarding capital companies, Germany – as many other jurisdictions on the European continent, but in contrast to the unitary UK model[9] – provides for two distinct forms of business organisations: the stock corporation *(Aktiengesellschaft)* and the private limited liability company *(Gesellschaft mit*

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[4] For more details on the new *Code de commerce* "à droit constant" Y. GUYON, Le Nouveau code de commerce et le droit des sociétés, Revue des sociétés (2000) 647.

[5] Discussing the pros and cons of "codifications à droit constant" Y GUYON, Le Nouveau code de commerce et le droit des sociétés, Revue des sociétés 2000, 648: "The principle advantage is that it puts a collection in the hands of the users of the law, be they French or foreign, a that brings together, or at least attempts to bring together all of the relevant texts in one place. This makes it easier to gain a knowledge of the law while saving the time otherwise lost and reducing the risks associated with conducting legal research from a range of scattered texts […]. The main inconvenience is that it requires transposing the jurisprudence that interprets older texts into the articles of the new code." (author's translation).

[6] See A. V. VERÓN, Ley de Sociedades Comerciales comentada (Buenos Aires 2010) 1–336.

[7] Explaining these "règles communes à toutes les sociétés commerciales" P. MERLE, Sociétés commerciales (17th ed. Paris 2013) nos. 25 et seq.

[8] Trail blazing H. WIEDEMANN, Gesellschaftsrecht, vol. I (Munich 1980); K. SCHMIDT, Gesellschaftsrecht (1st ed. Cologne et al. 1986, 4th ed. Cologne et al. 2002).

[9] The pros and cons of both solutions have been discussed in Company Law Review Steering Group, The Strategic Framework, February 1999, paras. 5.2.25 et seq.: "The main advantage of a stand-alone small companies vehicle is said to be that it would be tailored more closely to the needs of those companies, unlike the existing Act. The legislation might be relatively concise and designed specifically for a limited class of users. On the other hand, the consequence of being tailored in this way is that legislation would not provide an integrated regime within which a company which ceased to satisfy the criteria could continue to operate." Earlier proposals to introduce a separate legal form for small companies received little support in the UK; see A New Form of Incorporation for Small Firms: a Consultative Document (Cmnd. 8171), 1981; summarising the discussion S. W. MAYSON/D. FRENCH/C. RYAN, Company Law (21th ed. Oxford 2013) 27 et seq.

beschränkter Haftung). Unlike the Spanish *Ley de Sociedades de Capital,* the German legislator has not yet envisaged merging the Stock Corporation Act *(*Aktiengesetz*)* and the Limited Liability Companies Act (*GmbH-Gesetz*) into one single Act.

2. Multitude of Company Law Acts

Given this lack of a comprehensive Company Code, lawyers and business people alike have had to grapple with various Acts scattered all over the field: The general commercial partnership (*offene Handelsgesellschaft,* OHG), the limited partnership (*Kommanditgesellschaft,* KG) and the silent partnership *(stille Gesellschaft)* are still to be found in the Commercial Code (*Handelsgesetzbuch,* HGB) whose tradition dates back to the General German Commercial Code (*Allgemeines Handelsgesetzbuch,* ADHGB) of 1861 and which was enacted on 1 January 1900 – together with the German Civil Code (*Bürgerliches Gesetzbuch,* BGB).

The cooperative (*eingetragene Genossenschaft,* eG) became the first business form codified outside the Commercial Code in the Cooperative Societies Act of 1889 (*Genossenschaftsgesetz,* GenG). Its intellectual father, HERMANN SCHULZE-DELITZSCH, had hoped in vain for an integration of this newly created business organisation into the ADHGB.[10]

Three years later, the German legislator 'invented'[11] the limited liability company (*Gesellschaft mit beschränkter Haftung,* GmbH) under a separate Act, the Limited Liability Companies Act of 1892 (*GmbH-Gesetz,* GmbHG). This turned out to be the final blow for the formal unity of German company law: Until then, most business organisations with the exception of the cooperative had found their lodgings safely within the Commercial Code.

The stock corporation (*Aktiengesellschaft,* AG), long rooted in the Commercial Code, was transplanted in 1937 to the newly formed Stock Corporation Act (*Aktiengesetz,* AktG). What appeared to be a shameful dismantling of the Commercial Code in those days is viewed more favourably today, with the Stock Corporation Act now operating as stand-alone codification.[12]

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[10] See W. SCHUBERT, Zur Entstehung der Genossenschaftsgesetze Preußens und des Norddeutschen Bundes (1863–1868), ZRG Germ. Abt. 105 (1988), 97, 102 et seq.

[11] For more on 'inventions' and 'discoveries' in German company law H. FLEISCHER, Juristische Entdeckungen im Gesellschaftsrecht, in: Bitter et al. (eds.), Festschrift für Karsten Schmidt zum 70. Geburtstag (Cologne 2009) 375.

[12] In this sense K. SCHMIDT, Die Zukunft der Kodifikationsidee (Heidelberg 1985) 50: "You could, for example, see the Stock Corporation Acts of 1937 and 1965 as a dismantling of the Commercial Code, but it arguably represents a greater understanding of the legal system to see these pieces of legislation themselves as codifications." (author's translation).

The civil partnership (*Gesellschaft bürgerlichen Rechts,* GbR), i.e. a non-registered, non-commercial partnership, has been governed by the German Civil Code since 1900.

For the sake of completeness, the range of business organisations in Germany also includes the registered and unregistered association (*rechtsfähiger und nichtrechtsfähiger Verein,* §§ 21 et seq. BGB), the partnership limited by shares (*Kommanditgesellschaft auf Aktien,* KGaA, §§ 278 et seq. AktG), the partnership for the liberal professions (*Partnerschaftsgesellschaft*) governed by a separate Act (*Partnerschaftsgesellschaftsgesetz,* PartG) and the mutual insurance association (*Versicherungsverein auf Gegenseitigkeit,* VVaG). In addition, there are supranational business organisations, i.e. the European Economic Interest Grouping (*Europäische Wirtschaftliche Interessenvereinigung,* EWIV), the European Company (*Europäische Aktiengesellschaft,* SE) and the European Cooperative (*Europäische Genossenschaft,* SCE).[13]

3. *No Single Dominant Organisational Form*

This multitude of business organisations, coupled with the permissibility of hybrid forms[14], comes second in Europe only to the complex ingenuity of the Principality of Liechtenstein.[15] The great variety is not confined to company law textbooks, but can also be found in daily business use. Unlike in the UK where the public and private "company" dominates the scene[16], the law and the life of business organisations in Germany are much more diverse. There is no one dominant organisational form, but different types of business organisations for different purposes. This is reflected in current statistics[17]:

a) *Statistical Data*

Types of business organisation	Status, 1 January 2014
Limited Liability Company *(Gesellschaft mit beschränkter Haftung, GmbH)*	1,127,620
Entrepreneurial Company *(Unternehmergesellschaft, UG)*	92,904

[13] See H. FLEISCHER, Supranational corporate forms in the European Union: Prolegomena to a theory on supranational forms of association, CMLR 47 (2010) 1671 et seq.

[14] For more details on hybrid business organisations in Germany *infra* I.4.

[15] For further detail on company law in Liechtenstein M. SCHAUER, Das neue liechtensteinische Stiftungsrecht, ZEuP 2010, 340 et seq., explaining that the Liechtenstein Company Law Code by 1926 already contained a General Part and specific provisions for 23 types of legal persons, bodies corporate and unincorporated associations.

[16] See L. C. B. GOWER/P. L. DAVIES, Principles of Modern Company Law (9th ed. London 2012) marg. no. 1.

[17] Figures taken from U. KORNBLUM, Bundesweite Rechtstatsachen zum Unternehmens- und Gesellschaftsrecht (Stand 1.1.2014), GmbHR 2014, 694 et seq.

Stock Corporation *(Aktiengesellschaft, AG)*	16,005
Partnership Limited by Shares *(Kommanditgesellschaft auf Aktien, KGaA)*	287
Commercial Partnership *(Offene Handelsgesellschaft, OHG)*	24,991
Limited Partnership *(Kommanditgesellschaft, KG)*	249,372
Civil Partnership *(Gesellschaft bürgerlichen Rechts, GbR, BGB-G)*	figures not available, not registered in the commercial register
European Company *(Europäische Aktiengesellschaft, SE)*	297
European Economic Interest Grouping *(Europäische Wirtschaftliche Interessenvereinigung, EWIV)*	274

b) Additional Explanations

While bare statistics are useful in forming an outline, some additional detail may help getting a more precise picture of German company law.

Private Limited Liability Company: The numbers listed above clearly show that the GmbH is by far the most popular business vehicle in Germany with more than 1 million units. Its popularity stems largely from three factors: its flexible organisational framework (§ 45 para. 1 GmbHG), the legal shield it provides against personal liability of shareholders (§ 13 para. 2 GmbHG), and the relatively low cost of its formation compared to the AG (§ 5 para. 1 GmbHG: 25,000 EUR; § 7 AktG: 50,000 EUR). In business practice, the German GmbH is most often used and treated as "incorporated partnership"[18] – a doctrinal concept also well-known in the US[19] and the UK[20]. According to statistical surveys, the bulk of GmbH companies is formed by a small number of shareholders who know each other well and often participate in the company's management.[21] Of these, two-member companies and single-member companies are most widespread.[22] The small number of share-

[18] Coining this term U. IMMENGA, Die personalistische Kapitalgesellschaft (Bad Homburg v.d.H. 1970) 17: "inkorporierte Personengesellschaft".

[19] See, e.g., R. A. KESSLER, The Statutory Requirement of a Board of Directors: A Corporate Anachronism, 27 U. Chi. L. Rev. (1960) 717: "incorporated partnership". Even more graphic E.R. LATTY, The Close Corporation and the New North Carolina Business Corporation Act, 34 N.C.L. Rev. (1956) 453: "incorporated hot dog stand".

[20] The leading case is: *Ebrahimi v. Westbourne Galleries* [1973] AC 360 [HL]: "quasi partnership".

[21] See F. WEDEMANN, Gesellschafterkonflikte in geschlossenen Kapitalgesellschaften (Tübingen 2013) 11 et seq., 24 (final result); most recently W. BAYER/T. HOFFMANN, Gesellschafterstrukturen deutscher GmbH, GmbHR 2014, 13 et seq.

[22] See W. BAYER/T. HOFFMANN, *supra* note 21, 12 et seq.

holders often correlates with the rather modest size of the GmbH, with the vast majority being small or medium-sized enterprises. Legally, the GmbH is an “all purpose vehicle”:[23] It can be used for commercial or non-profit purposes, it is particularly suitable for joint venture enterprises, it can serve as a subsidiary in a group of companies, and it can be employed by the state and municipalities as a legal vessel for public utilities as well as for private-public-partnerships.[24]

Entrepreneurial Company: A fairly recent company law innovation, the Entrepreneurial Company, has increasingly attracted those looking to found a business organisation. From its debut in 2008, it has grown to number almost 93,000 units today. Conceptually, the Entrepreneurial Company is a subtype of the GmbH, requiring only a minimum capital of one euro. Like the GmbH at the beginning of the 20th century,[25] the Entrepreneurial Company seems to have captured the spirit of the 21st century: In 2013, the Danish legislator chose to ‘copy’ the German concept by introducing a Danish version of the *Unternehmergesellschaft* (*ivaersaetterselskab,* IVS).[26] In 2012, Belgium introduced a private limited liability company “starter” (SPRL-S), which has been characterised in the legal literature as a “half sister” of the German *Unternehmergesellschaft.*[27] Finally, Italy joined their ranks by establishing a simplified version of its private limited liability company *(società a responsabilità limitata semplificata).*[28]

Stock Corporation: Compared to some neighbouring jurisdictions, the number of stock corporations in Germany is relatively low. Switzerland has 198,000 *Aktiengesellschaften* and 141,000 *Gesellschaften mit beschränkter Haftung;* in France, there are 114,000 *sociétés anonymes,* 128,000 *sociétés par actions simplifiées* and 178,000 *sociétés à responsabilité limitée;* Italy has 48,000 *società per azioni* and 1,300,000 *società a responsabilità limitata.* The small number of 16,000 stock corporations in Germany, of which 850 are

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[23] See § 1 GmbHG: “Companies with limited liability may be founded, in compliance with the provisions of this Act, for any statutorily permissible purpose by one or more persons.” (author’s translation).

[24] For a more detailed analysis of the manifold usages of the GmbH in business practice H. FLEISCHER, Münchener Kommentar zum GmbHG, 2nd ed. 2014, § 1 marg. nos. 17 et seq.

[25] For a detailed account of the triumphal march of the German GmbH around the world H. FLEISCHER, *supra* note 24, Einleitung, marg. nos. 210 et seq.

[26] See M. NEVILLE, The Regulation of Close Corporations in Danish Company Law in an International Regulatory Context, Nordic & European Company Law, LSN Research Paper Series, No. 14-02, July 2014, 11.

[27] See C. BROCAL, La création de la SPRL-S et sa demi-sœur allemande l’Unternehmergesellschaft (UG), une concurrence timide pour la ‘Limited’ anglaise?”, DAOR 95 (2010) 240.

[28] For an overview M. CIAN, S.r.l., s.r.l. semplificata, s.r.l. a capital ridotto. Una nuova geometria del Sistema o un Sistema disarticolato?, Rivista delle società 57 (2012), 1101.

listed on the stock exchange, indicates that it is employed primarily by "big business": Of the 100 biggest enterprises in Germany, 64 are organised as stock corporations and 5 as European Companies.[29] Some recent developments regarding shareholder structure are equally noteworthy: According to a well-known taxonomy, the German corporate governance system is often described as a 'blockholder system' with a controlling shareholder as the key player.[30] This description is gradually losing its accuracy, at least for listed companies. Certainly, there are still some major family- or foundation-controlled companies listed on the stock exchange, such as the carmaker BMW, the cosmetic company Beiersdorf, or the steel company Thyssen-Krupp backed by the mighty Krupp foundation. But dispersed ownership is becoming increasingly common. The free float of companies in the DAX 30, Germany's most important stock market index consisting of the 30 major companies trading on the Frankfurt Stock Exchange, has risen from 64.1% in 2001 to 89.6% in 2009.[31] Moreover, the network of cross shareholdings and personal connections known at home and abroad as "Deutschland AG" or "Germany Inc" has been largely dissolved during the last decade.[32] Today, foreign investors account for 55% of shareholdings in the DAX 30, compared to 36% in 2001.[33] The reasons for this development are manifold: Tax incentives for divestiture have played a role[34] as well as a reorientation of the banking sector[35] and the globalisation of financial markets.[36]

European Company: In contrast to many EU Member States, the European Company is becoming popular in this country. Germany actually hosts the greatest number of operating European Companies; half of them are registered locally. Among them are blue chip companies such as the insurer Allianz, the world's largest chemical company BASF, the sports company Puma, the car-

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[29] See Monopolkommission, 20. Hauptgutachten. Eine Wettbewerbsordnung für die Finanzmärkte, 2012/2013, marg. no. 435.

[30] See M. BECHT/E. BÖHMER, Ownership and Voting Power in Germany, in: Barca/Becht (eds.), The Control of Corporate Europe, 2001, 128; M. BECHT/E. BÖHMER, Voting control in German corporations, 23 Int'l Rev. L. & Econ. (2003) 1.

[31] See Bundeszentrale für Politische Bildung, Aktionärsstruktur von DAX-Unternehmen, 25 September 2010.

[32] See K. FEHRE et al., The Disappearing 'Deutschland AG' – an analysis of block holdings in German large caps, Problems and Perspectives in Management 9:4 (2011) 46.

[33] See "Der DAX geht fremd", Handelsblatt, 29 September 2013.

[34] See A. WEBER, An empirical analysis of the 2000 corporate tax reform in Germany: Effects on ownership and control in listed companies, 29 Int'l Rev. L. & Econ. (2009) 57; also S. RÜNGER, The Effect of Shareholder Taxation on Corporate Governance Structures (Paderborn 2014) 65 et seq.

[35] See A. WEBER, *supra* note 34, 65.

[36] For a thorough analysis W. RINGE, Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG, University of Oxford Legal Research Paper Series, No. 20/2014, June 2014.

maker Porsche or the multinational construction and engineering company Bilfinger. Recently, the energy giant E.ON and its competitor RWE have undergone the conversion to become European Companies. This exodus from the legal form of the Aktiengesellschaft may well be a response to the rigidities of the German Stock Corporation Act which will be dealt with later.[37]

4. Popularity of Hybrid Business Organisations

It is also worth noting is that hybrid business organisations enjoy great popularity in Germany. The most important illustration is the GmbH & Co. KG – a composite form of business enterprise where a GmbH acts as a general partner and natural persons as limited partners. Originally invented by creative lawyers to obtain tax advantages, this hybrid form was confirmed as being legal by the German Imperial Court in 1922.[38] The legislator subsequently cemented this court ruling by inserting special provisions for the GmbH & Co. KG into the Commercial Code. Today, most of the 245,000 limited partnerships are organised as GmbH & Co. KG, thus combining the tax advantages of partnership law (tax transparency) with the limited liability protection of company law, potentially the best of both worlds. Other European jurisdictions are less liberal in that respect: In Switzerland, the GmbH & Co. KG is explicitly prohibited by law,[39] in Italy it runs afoul of the unwritten principle of *tipicità delle società*[40]. In France, the *commandite à responsabilité limitée* is legally feasible but hardly ever used in practice;[41] in Portugal it is permissible as well but virtually inexistent due to a lack of tax incentives compared to the Portuguese limited liability company.

A more recent example of a corporate hybrid is the partnership limited by shares *(Kommanditgesellschaft auf Aktien)* with a GmbH or even a European Company (SE) serving as general partner – a legal construction which was accepted by the Federal Court of Justice in 1997.[42] This too has moved beyond the realm of the theoretical: Fresenius, a medical equipment company listed in the DAX 30 index, and Bertelsmann, the nation's biggest mass media company, changed their legal form to a SE & Co KGaA. Things become even more complicated when the position of the general partner is not occupied by a domestic, but rather by a foreign company. This legal phenomenon is called *Kapitalge-*

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[37] See *infra* III.3.

[38] See RG, 4 July 1922, IIb 2/22, RGZ 105, 101.

[39] See Article 594 para. 2 Code of Obligations: "Partners with unlimited liability must be natural persons […]."

[40] See P. SPADA, La tipicità delle società (Padua 1974).

[41] See P. MERLE, *supra* note 7, no°163; from a comparative perspective A. GUINERET-BROBBEL DORSMAN, La GmbH & Co. KG et la commandite à responsabilité limitée française: une illustration de la liberté contractuelle en droit des sociétés (Paris 1998).

[42] See BGH, 24 February 1997, II ZB 11/96, BGHZ 134, 392.

sellschaft & Co.[43] Prominent examples include the airline Air Berlin organised as a Plc & Co. KG, the drugstore chain Müller as a Ltd & Co. KG, and the German subsidiary of the clothes retailer H & M as a BV & Co. KG.

Most recently, the legislator itself has added yet another hybrid by introducing the partnership for the liberal profession with limited professional liability *(Partnerschaftsgesellschaft mit beschränkter Berufshaftung),* coupled with mandatory insurance, in order to offer a domestic alternative to law firms and others who have increasingly chosen the British Limited Liability Partnership (LLP).[44] Whether a German version of the US Limited Liability Company (LLC) will follow, is uncertain, but not very likely, as the GmbH & Co. KG has, to date, satisfied the requirements of business founders to combine tax transparency with limited liability.[45]

II. Main Players in Company Law

In Germany, company law is shaped by three major players: the legislator, the courts and – to a lesser degree – legal scholarship.

1. *The Legislator*

a) *Stock Corporation Act*

The role of the legislator differs in various branches of company law. It has been most noticeable in the field of stock corporations where we have witnessed a piecemeal and permanent legislative reform process *("Aktienrechtsreform in Permanenz").*[46] Since 1965, the year of the last major reform of the Stock Corporation Act, there have been more than 70 minor amendments. With this high frequency of reform bills, the corporate legislator has outdone even the tax legislator who makes changes to the Tax Code once every year. Many of these reforms have been, and still are, scandal-driven. The chronicle of crisis regulation began with the Stock Corporation Reform Act of 1884 in reaction to the stock market crash following the so-called founders' years *(Gründerjahre)* and has continued to the present day.[47] Such

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[43] For a detailed analysis C. TEICHMANN, Die Auslandsgesellschaft & Co., ZGR 2014, 220.

[44] See T. TRÖGER/L. PAFFINGER, Partnerschaftsgesellschaft mit beschränkter Berufshaftung, JZ 2013, 812.

[45] Drawing similar conclusions E. RÖDER, Die Kommanditgesellschaft im Rechtsvergleich, RabelsZ 78 (2014) 152.

[46] W. ZÖLLNER, Aktienrechtsreform in Permanenz – Was wird aus den Rechten des Aktionärs?, AG 1994, 336.

[47] For an overview H. FLEISCHER, Von „bubble laws" und „quack regulation" – Zur Kritik kriseninduzierter Reformgesetze im Aktien- und Kapitalmarktrecht, in: Hommel-

"bubble laws"[48] are, however, not a uniquely German specialty. The same pattern is quite common around the world, starting with the famous Bubble Act of the English Parliament in June 1720.

An additional layer of regulation, albeit of a soft law nature, was introduced in 2002: the German Corporate Governance Code. It primarily[49] addresses listed companies. In large part, the Code explains the statutory governance regime of stock corporations but it also contains guidance for the operation of management and supervisory boards.[50] Compliance with the code is voluntary, following the comply-or-explain-principle. However, companies take it very seriously, as two commentaries written by practitioners indicate,[51] and there is a very high acceptance rate for most recommendations.[52] Only recently did influential voices encourage companies to move away from blind acceptance and develop a stronger culture of deviation as crucial part of the comply-or-explain-mechanism.[53] Echoing this plea, in its foreword the 2013 update of the Code reminds businesses that a well justified deviation from a Code recommendation may be in the interest of good corporate governance.

A more recent phenomenon, which began in the 1990s, has seen the increasing bifurcation between listed and non-listed companies.[54] Under the overarching roof of the Stock Corporation Act, one finds more and more provisions solely addressing listed companies. To give but one example, § 161 AktG requires the management board and the supervisory board of *listed* companies to declare annually its compliance with the recommendations of the Corporate Governance Code or list and explain any non-

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hoff/Rawert/Schmidt (eds.), Festschrift für Hans-Joachim Priester zum 70. Geburtstag (Cologne 1997) 76 et seq.

[48] The title of a law review article by L. E. RIBSTEIN, Bubble Laws, 40 Hous. L. Rev. (2003) 77.

[49] See Foreword: "Primarily, the Code addresses listed corporations and corporations with capital market access pursuant to Section 161(1) sentence 2 of the Stock Corporation Act. It is recommended that companies not focused on the capital market also respect the Code."

[50] See G. KRIEGER, Corporate Governance und Corporate Governance Kodex in Deutschland, ZGR 2012, 205 et seq.

[51] See Ringleb et al. (eds.), Kommentar zum Deutschen Corporate Governance Kodex, 5th ed. 2014; H. WILSING, Deutscher Corporate Governance Kodex, 2012.

[52] Recently A. VON WERDER/J. BARTZ, Corporate Governance Report 2014: Erklärte Akzeptanz des Kodex und tatsächliche Anwendung bei Vorstandsvergütung und Unabhängigkeit des Aufsichtsrats, DB 2014, 905, reporting a general acceptance rate of 91.8% for companies listed in the DAX 30.

[53] References collected by H. RINGLEB, in: Ringleb et al. (eds.), Deutscher Corporate Governance Kodex, 5th ed. 2014, marg. no. 26 with footnote 21.

[54] For a detailed analysis H. FLEISCHER, Das Aktiengesetz von 1965 und das neue Kapitalmarktrecht, ZIP 2006, 456 et seq.

compliance. This declaration is known in legal parlance as declaration of conformity. Incorrect declarations provide a basis for shareholders to challenge resolutions discharging board members made at the annual general shareholders' meeting.[55] This new layer of regulation for listed companies has been aptly called *Börsengesellschaftsrecht*[56] – reflecting the daily practice of big law firms: Two handbooks written exclusively by practitioners seek to explain the special legal regime for listed companies and present it in a comprehensive manner as an amalgam of provisions from stock corporation law and capital markets law.[57]

b) Limited Liability Companies Act

The German GmbH first saw the light of day in 1892 and has been aptly described as a "test-tube baby"[58], a "leap in the dark"[59] or a "legislative invention",[60] due to its lack of historical roots. Surprisingly or not, the original text of the GmbH Act remained largely untouched over many years.[61] The German legislator did not feel compelled to overhaul the GmbH Act until 2008. The reform project started out rather modestly – as a small-scale attempt to combat abuses in the vicinity of insolvency. The mounting success of the English company limited by shares in Germany then led to the conviction among policymakers, practitioners and academics that a complete modernisation of the Act was overdue. The Reform Act, called MoMiG (Act on the modernisation of GmbH law and on the combating of abuses), was primarily aimed at facilitating the incorporation process and streamlining several complex and highly technical aspects of legal capital. Innovative elements included the concept of good faith acquisition of shares and the introduction of the Entrepreneurial Company mentioned above.[62]

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[55] See BGH, 16 February 2009, II ZR 185/07, BGHZ 180, 9; BGH, 21 September 2009, II ZR 174/08, BGHZ 182, 272.

[56] Term coined by P. NOBEL, Börsengesellschaftsrecht?, in: von Büren (ed.), Aktienrecht 1992–1997: Versuch einer Bilanz: Zum 70. Geburtstag von Rolf Bär (Bern 1998) 301 in the Swiss context; adapted for German company law by H. FLEISCHER, Börseneinführung von Tochtergesellschaften, ZHR 165 (2001) 514 et seq.

[57] See Deilmann/Lorenz (eds.), Die börsennotierte Aktiengesellschaft (Munich 2005); Marsch-Barner/Schäfer (eds.), Handbuch der börsennotierten AG (3rd ed. Cologne 2014).

[58] F. RITTNER, Die deutsche GmbH nach der Reform von 1980, ZSR 161 (1982) 171, 182.

[59] W. HALLSTEIN, Die Gesellschaft mit beschränkter Haftung in den Auslandsrechten, verglichen mit dem deutschen Recht, RabelsZ 12 (1938/39) 341, 355.

[60] C. WINDBICHLER, Gesellschaftsrecht (20th ed. Munich 2013) § 20 marg. no. 13.

[61] For a detailed account of reform proposals during the 20th century H. FLEISCHER, *supra* note 24, Einleitung, marg. nos. 82 et seq.

[62] For a good summary of the key points U. NOACK/M. BEURSKENS, in: McCahery/Timmerman/Vermeulen (eds.), Private Company Law Reform (The Hague 2010) 157 et seq.

Notwithstanding the continuity of its textual basis, the GmbH law has changed considerably from its early days. Much of the necessary intervention and doctrinal refinement was accomplished by the courts who established themselves specifically as guardians of creditor and minority protection. The history of GmbH law in Germany is therefore to a large extent a history of judge-made law.[63] Some authors add with an observational tongue in their academic cheek that the text of the GmbH Act, "in light of the overgrowth by case law", is often not a "source of information, but rather one of delusion and misdirection about the current law".[64]

As a whole, the GmbH Act presents itself as a rather slim piece of legislation: Compared to the more than 400 provisions of the Stock Corporation Act, it consists of no more than 85 provisions. Taken together, the legal regime for capital companies in both Acts still looks straightforward and clearly arranged, compared to the UK Companies Act 2006 with its 1,300 sections and 16 schedules. The brevity of the GmbH Act corresponds to a light-touch regulatory approach that leaves many opportunities for private ordering. The lack of a bulky fleshing out of the GmbH legislation has definitely been a contributing factor to its popularity among businesses, albeit one that carries a downside in that many legal problems have not been addressed. To close these regulatory gaps, courts and legal scholars resort to the Stock Corporation Act on the one hand wherever the unsolved problem stems from the structure of the GmbH as a capital company,[65] or rely on partnership law principles as far as the GmbH presents itself as an incorporated partnership.[66]

2. Specialised Courts

After the legislator, specialised business courts have been very influential in shaping German company law. To speak of specialised courts in Germany requires, however, some qualification: Although many courts of first instance have established chambers for commercial matters (Kammern für Handelssachen), consisting of a professional judge as chairman and two lay persons with business experience as honorary assessors, these chambers are by no means comparable to the Delaware Court of Chancery[67] or the Enterprise

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[63] In this sense K. SCHMIDT, *supra* note 8, § 33 II 2 a, 987 et seq.

[64] F. KÜBLERH. ASSMANN, Gesellschaftsrecht (6th ed. Heidelberg 2006) § 18 I 4 a, 265.

[65] For a detailed analysis of analogies drawn from the Stock Corporation Act H. FLEISCHER, Zur ergänzenden Anwendung von Aktienrecht auf die GmbH, GmbHR 2008, 673.

[66] For a detailed analysis of analogies drawn from partnership law H. FLEISCHER, Die Lückenausfüllung des GmbH-Rechts durch das Recht der Personengesellschaften, GmbHR 2008, 1121.

[67] See the contributions of the symposium "The Delaware Court of Chancery", 2 Colum. Bus. L. Rev. (2012) 387–706.

Chamber *(ondernemingskamer)* of the Amsterdam Appellate Court.[68] However, company law expertise is plentiful in some German Appellate Courts and definitely in the Federal Court of Justice: In the latter, a special panel, the famous Second Civil Law Panel *(II. Zivilsenat)* is exclusively responsible for company law cases. Its judges take great pride in being a member of this prestigious institution whose history can be traced back to the Imperial Court. The presiding judge is a public figure in company law no less than Chief Justice STRINE in Delaware, very knowledgeable and often with strong convictions.[69] A telling example of their influence is the evolution of German GmbH groups of companies law, where, for many years, every newly nominated presiding judge developed a new theory of liability in corporate groups.[70] Many judges also write extra-judicially in commentaries or business law reviews, and their comments are carefully read and interpreted by scholars and practitioners alike – we call it *"Kaffeesatzlesen",* reading tea leaves, as the British say.

Here is an illustration of the enormous output of this company law panel: In 2011, the panel rendered 145 decisions and 135 in 2012, of which most were published. This abundance of case law may help to explain a widespread tendency among company law professors to indulge in national navel-gazing: There is always enough domestic legal material to play with and to comment on, and there are many competing business law reviews fiercely fighting for content and competent writers. Company law case notes and articles can be found every week in: *Der Betrieb* (DB), *Betriebs-Berater* (BB), *Zeitschrift für Wirtschaftsrecht* (ZIP), *Wertpapiermitteilungen* (WM), *Deutsches Steuerrecht* (DStR), every two weeks in: *Die Aktiengesellschaft* (AG), *GmbH-Rundschau* (GmbHR), *Neue Zeitschrift für Gesellschaftsrecht* (NZG), and on a quarterly basis in: *Zeitschrift für das gesamte Handels- und Wirtschaftsrecht* (ZHR), *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (ZGR) – a whole universe of business law reviews.

3. Company Law Scholarship

Last but not least, German company law is also influenced by company law scholarship. For different reasons, legal scholars in Germany have long en-

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[68] See Jitta (ed.), The Companies and Business Court from a comparative law perspective, (Deventer 2004); M. J. KROEZE, De kern van het ondernemingsrecht (Alphen aan den Rijn 2007) 86.

[69] For a short survey H. FLEISCHER, Münchener Kommentar zum GmbHG, 2nd ed. 2015, Einleitung, marg. no. 127.

[70] On this and generally on the "self-conscious development of company law *praeter legem* or even *contra legem* by the Federal Court of Justice" P. O. MÜLBERT, Einheit der Methodenlehre? – Allgemeines Zivilrecht und Gesellschaftsrecht im Vergleich, AcP 214 (2014) 210 et seq.

joyed a level of prestige and authority unparalleled in England, France or the United States. Comparativists have often called this phenomenon *Professorenrecht,* i.e. professor-made law.[71] Most regrettably, today the heyday of *Professorenrecht* has passed, although the voice of company law professors still does not go unheard. The close cooperation between judges and academics in company law is still very much alive:[72] Judges regularly attend legal conferences, explain their case law and are willing to listen to opposing views in academic circles. This long-standing tradition of mutual exchange and understanding has proven to be beneficial for German company law as a whole – which may sound a little lofty, but is genuinely the perception in company law circles.[73]

The fruitful dialogue between courts and academia is nicely reflected in the reasoning and style of judicial opinions in Germany. Contrary to Italian or French Supreme Court cases where citations to legal literature are prohibited,[74] and also in contrast to the long-standing UK tradition that judges did not cite works of legal scholarship, at least until the author has passed away (the "better read when dead" convention),[75] German judges do not hesitate to look at academic material. Their judicial opinions often cite and frequently follow arguments developed in academic writing.[76]

Let me add a word on the typical style of company law scholarship in Germany: Traditionally, law professors saw their primary vocation as the systemisation of legal material and the refinement of its dogmatic structure.[77] The most important literary genres for this kind of doctrinal scholarship were – and

[71] See VAN CANEGEM, Judges, Legislators and Professors – Chapters in European Legal History (Cambridge 1987) 67 et seq.

[72] See from the perspective of a former presiding judge of the Second Civil Law Panel W. GOETTE, Dialog zwischen Rechtswissenschaft und Rechtsprechung in Deutschland am Beispiel des Gesellschaftsrechts, RabelsZ 77 (2013) 309.

[73] See GOETTE, *supra* note 72, 321 "At least, in German company law, we have cultivated this approach for many years. Where it does not exist, it must be established as quickly as possible" (author's translation).

[74] See Art. 118 Codice di procedura civile.

[75] See D. E. NEUBERGER, Judges and Professors – Ships Passing in the Night?, RabelsZ 77 (2013) 234 et seq.: "First, by convention, it barred citation of such works, while their authors were still alive. […] The first aspect has been described as the 'better read when dead' approach."

[76] Commenting incredulously on this from the perspective of a judge of the UK Supreme Court A. F. RODGERS, Judges and Academics in the United Kingdom, UQLJ 2010, 32: "In German-speaking countries, where academics are king, the judges often quote extensively from literature. Indeed, it sometimes looks as if they cannot write a clause, far less a whole sentence, without inserting some citation in brackets."

[77] Explaining the function of dogmatic scholarship C. BUMKE, Rechtsdogmatik, JZ 2014, 641.

still are – treatises and commentaries on company law.[78] With respect to commentaries, however, too much of a good thing has been done:[79] In the field of limited liability companies, for example, 16 commentaries are available today, which is, for various reasons, a highly undesirable development. There is as yet no solution for this problem of mass production on the horizon: a ban on new commentaries would run afoul of the constitutional guarantees of freedom of speech and academic freedom. Market-based solutions are not working either, as publishing houses are still willing to launch new projects and to lead the old ones into the brave new world of online commentaries.

In defence of company law professors one should add, however, that scholarly approaches and publication patterns are slowly changing: While traditional doctrinal scholarship is still the basis of German company law, one can clearly observe that comparative company law is flourishing and that law and economics is still on the rise. To put it differently, embedded scholarship remains important, but non-embedded scholarship has gained a lot of ground in recent years.[80] Moreover, the perception of the proper role of company law is changing as well: For many years, company law regulation was understood primarily as the protection of different constituencies; eminent scholars arranged the legal material around key principles such as creditor protection, minority protection, or investor protection.[81] A nice illustration is the concept of legal capital enshrined in the Second Company Law Directive – a faint and final memory of the former influence of German company law in Europe.[82] To be sure, creditor, investor and minority protection are still important goals (today often rephrased in agency terminology), but the focus has shifted: German company law legislation and scholarship has discovered the "enabling" dimension of company law, at least for small and medium-sized enterprises, and seeks to provide a flexible legal infrastructure for doing business in Germany.[83]

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[78] For a guide through company law literature of the 20th century H. FLEISCHER, in: Willoweit (ed.), Rechtswissenschaft und Rechtsliteratur im 20. Jahrhundert (Munich 2007) 485 et seq.

[79] For a similar assessment R. ZIMMERMANN, Juristische Bücher des Jahres: Eine Leseempfehlung, NJW 2011, 3557: "Many commentaries are significant academic contributions […]. Clearly a veritable flood of commentaries has arisen […]. Practically everything is being repeated. Whole hosts of authors are constantly addressing the same material, and it is hardly surprising that the knowledge gained from this repetition is minimal or non-existent" (author's translation).

[80] Explaining this in greater detail H. FLEISCHER, Gesellschafts- und Kapitalmarktrecht als wissenschaftliche Disziplin – Das Proprium der Rechtswissenschaft, in: Engel/Schön (eds.), Das Proprium der Rechtswissenschaft (Tübingen 2007) 52 et seq.

[81] See WIEDEMANN, *supra* note 8.

[82] See LUTTER (ed.), Legal Capital in Europe (Berlin 2006).

[83] See H. FLEISCHER, Gesetz und Vertrag als alternative Problemlösungsmodelle im Gesellschaftsrecht, ZHR 168 (2004) 707: "Considering the whole of the analysis to date

III. Distinctive Features of German Stock Corporation Law

The third part of this chapter seeks to describe and explain some distinctive features of German stock corporation law. To do this as an internal and therefore *biased* participant brings with it some inevitable limitations, but the author's exposure to comparative company law may serve, at least in part, as a *de-biasing* strategy.

1. Interest of the Enterprise ("Unternehmensinteresse")

A first characteristic of German stock corporation law is the theoretical concept of *Unternehmensinteresse* (interest of the enterprise) which can be traced back to WALTHER RATHENAUS famous speech in 1918.[84] This concept was further developed during the Weimar Republic into the doctrine of the *"Unternehmen an sich"* (enterprise in itself),[85] which promoted the idea of incorporating interests other than just the interests of the shareholders into corporate decision-making. The 1937 Stock Corporation Act drew on this idea and specified in its § 70 para. 1 that the management board had to manage the company in such a way as required by the enterprise and its employees and the interests of society at large.[86] The 1965 Stock Corporation Act did not adopt this formulation, but chose a more neutral wording, stipulating that the management board was responsible for managing the company.[87] However, according to the legislative materials it was regarded to be "self evident" that the stakeholder model was still the leading paradigm.[88] This was, and still is, the dominant view in the courts and among academics. When confronted with the basic question "For whom are corporate managers trustees?", the Federal Court of Justice has repeatedly answered that the corporate compass is the

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reveals the dual nature of company law: it serves an enabling function as well as a regulatory function" (author's translation).

84 See W. RATHENAU, Vom Aktienwesen (Berlin 1918).

85 See A. RIECHERS, Das ‚Unternehmen an sich': die Entwicklung eines Begriffs in der Aktienrechtsdiskussion des 20. Jahrhunderts (Tübingen 1996).

86 See § 70 para. 1 AktG 1937: "The management board must independently manage the company in order to best serve the well being of the organisation and its stakeholders as well as the general purposes of the people and the State" (author's translation); explaining this in more detail F. A. MANN, The New German Company Law and Its Background, Journal of Comparative Legislation 19 (1937) 227.

87 See § 76 para. 1 AktG: "The management board shall manage the company under its own responsibility" (author's translation).

88 See Begründung Regierungsentwurf in B. KROPFF, Aktiengesetz (Düsseldorf 1965) 97: "This regulation is the applicable law. The fact that the management board must consider the interest of shareholders and employees in applying any measures is considered to be self-evident, thus not requiring explicit inclusion in the legislation" (author's translation).

interest of the enterprise.[89] Explaining this in more detail, the German Corporate Governance Code states under 4.1.1 "that the management board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value".[90] After the recent financial crisis, the Corporate Governance Commission hastened to add that the management board has to act "in conformity with the principles of the social market economy". It should be noted, however, that over the last decade proponents of a moderate shareholder value approach have been gaining ground in the academic debate.[91]

Lurking behind these phrases is a more general approach to company law and corporate governance which the French economist MICHEL ALBERT has called "Rhenish Capitalism".[92] Key characteristics of this "Rhineland Model", as it is also called, include a well-adjusted balance of power between shareholders and managers, strong stakeholder patterns of corporate governance and a close social partnership between employees and business leaders. The rival approach as presented by Anglo-American capitalism tends to give shareholder interests priority, as encompassed by the enlightened shareholder value approach of the UK Companies Act 2006.[93]

2. Two-tier Board ("duale Führungsstruktur") and Codetermination ("Mitbestimmung")

A second characteristic is the two-tier system of German stock corporation law that differentiates itself from other regimes through a mandatory division of powers between a management board and a supervisory board. The management board is responsible for managing the enterprise (§ 76 para. 1 AktG) and runs the affairs of the company, while the supervisory board is entrusted with monitoring the management of the company (§ 111 para. 1 AktG). While management measures may not be transferred to the supervisory board (§ 111 para. 4 sent. 1 AktG), it does have a veto right over certain major transactions specified in the articles of association or by a resolution of the supervisory board (§ 111 para. 4 sent. 2 AktG). This separation is reinforced by a regulation prohibiting membership on both boards simultaneously (§ 105 para. 1 AktG). The statutory governance scheme is prescribed by law and

89 For ample references J. KOCH, in: Hüffer, AktG, 11th ed. 2014, § 76 marg. no. 28.

90 Commenting on this S. GOSLAR, in: Wilsing (ed.), Deutscher Corporate Governance Kodex, 2012, Point 4.1.1, marg. nos. 12 et seq.

91 The key arguments are developed in H. FLEISCHER, in: Spindler/Stilz, AktG, 3rd ed. 2015, § 76 marg. nos. 28 et seq.

92 See M. ALBERT, Capitalism against Capitalism (New York) 1993.

93 Sec. 172 para. 1 CA 2006; explaining this B. M. HANNIGAN, Company Law (3rd ed. Oxford 2012) 187 et seq.

cannot be modified, not even by a unanimous shareholder vote. Many foreign stock corporation laws are more liberal in this respect: France, for instance, has added a two-tier board *(*structure nouvelle*)* to its 1966 stock corporation law reform as an alternative to its traditional one-tier board *(structure classique),*[94] and Italy has introduced three options since its company law reform of 2003, with the *sistema tradizionale,* the *sistema dualistico* and the *sistema monistico.*[95] Academics have urged the German legislator to follow these examples and to allow for a free choice between a two-tier and a one-tier board,[96] but their proposal fell on deaf ears. Presently, a one-tier board is available for a German stock corporation only by converting it into a European Company.[97]

Concerning the composition and size of the supervisory board, the German system of codetermination provides for a mandatory legal regime which is in many respects unique in the world. If a company regularly employs more than 2,000 employees, the Codetermination Act 1976 (*Mitbestimmungsgesetz* 1976, MitbestG 1976) applies, requiring that half of the supervisory board members are elected by the employees. To avoid a deadlock and to secure a slight majority of shareholders for constitutional reasons, the Chairman of the supervisory board, who, for all practical purposes, is a representative of the shareholders, has the casting vote in the case of split resolutions. For large companies with more than 20,000 employees § 7 para. 1 no. 3 MitbestG provides for a supervisory board of 20 directors, making German boards by far the largest boards in Europe.

3. Mandatory Nature of the Stock Corporation Act ("aktienrechtliche Satzungsstrenge")

A third remarkable feature is the mandatory nature of the German Stock Corporation Act. The most important provision in the minds of many, § 23 para. 5 stipulates:

> "The articles of association may make different provisions from the provisions of this Act only if this Act explicitly so permits. Supplementary provisions may be included in the articles of association unless a regulation in this Act has conclusive effect."

In doctrinal writing, this is referred to as the principle of formal statute stringency *(Grundsatz der Satzungsstrenge).* The German legislator itself assumes full responsibility for a balanced statutory framework. Many practitioners and

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[94] Explaining the legislative motivation behind this P. LE CANNU/B. DONDERO, Droit des sociétés (5th ed. Paris 2013) 537–539.

[95] See M. CAMPOBASSO, Diritto delle società (8th ed. Turin 2012) 361 et seq.

[96] See, e.g., H. FLEISCHER, Der Einfluß der Societas Europaea auf die Dogmatik des deutschen Gesellschaftsrechts, AcP 204 (2004) 521 et seq.

[97] See *infra* under III.4.

scholars believe in the virtues of this legislative paternalism. They point out that mandatory stock corporation law protects retail investors, facilitates standardization and thus helps to save transaction costs when making investment decisions.[98] However, some critical voices emphasise the *enabling* function of corporate law and advocate putting more trust into the monitoring role of capital market forces.[99] A recent case of the Austrian Federal Court of Justice has opened new doors to party autonomy at least for non-listed companies.[100] It remains to be seen whether this court ruling will spark a new debate about the virtues of private ordering in German stock corporation law as well.[101]

In practice, the inflexibility of the Stock Corporation Act is often mitigated by shareholder agreements. Such side agreements, governed by contract and partnership law are valid in principle and quite popular among shareholders of non-listed companies and family businesses.[102] These shareholder agreements are confidential and their contents are unknown to other shareholders and the wider public. This lack of visibility has inspired a Swiss colleague to describe them as "the invisible side of the moon"[103] – alluding to the third stanza of a famous German folksong (*"Der Mond ist aufgegangen",* "The moon has risen").

Given the principle of statute stringency in stock corporation law, those seeking to incorporate under German law and in need of an adaptive statutory scheme usually choose the limited liability company (GmbH) or the limited partnership (KG), both of which offer ample room for private ordering. Alternatively, they may opt for the European Company (SE) which is not quite as flexible as the GmbH or the KG, but still offers more leeway than the AG.

4. Fiduciary Duties of Shareholders ("mitgliedschaftliche Treuepflichten")

A fourth characteristic of German stock corporation law is the importance of fiduciary duties among shareholders. Building on fiduciary duties among fellow partners in partnership law, the courts moved gradually towards the

[98] See KOCH, *supra* note 89, § 23 marg. no. 34.

[99] See, e.g., K. J. HOPT, Gestaltungsfreiheit im Gesellschaftsrecht in Europa – Generalbericht, in: Lutter/Wiedemann (eds.), Gestaltungsfreiheit im Gesellschaftsrecht (Berlin 1998) 123 et seq.

[100] See OGH, 8 May 2013, 6 Ob 28/13f, AG 2013, 716.

[101] Pushing in this direction S. KALSS/H. FLEISCHER, Neues zur Lockerung der Satzungsstrenge bei nicht börsennotierten Aktiengesellschaften, AG 2013, 699 et seq.

[102] See H. FLEISCHER, in: Schmidt/Lutter (eds.), AktG, 2nd ed. 2010, § 54 marg. nos. 17 et seq. with further references.

[103] See P. FORSTMOSER, Corporate Governance – eine Aufgabe auch für KMU?, in: von der Crone et al. (eds.), Aktuelle Fragen des Bank- und Finanzmarktrechts, Festschrift für Dieter Zobl zum 60. Geburtstag (Zurich et al. 2004) 501: "Der Aktionärsbindungsvertrag als 'die unsichtbare Seite des Mondes'".

recognition of fiduciary duties of majority and minority shareholders in limited liability companies.[104] Finally, in a landmark case in 1988, the Federal Court of Justice took the last step, recognising that a majority shareholder has a fiduciary duty *vis-à-vis* minority shareholders in stock corporation law as well.[105] The Court argued basically, that a majority shareholder, by virtue of his voting power, is in a position to affect the interests of minority shareholders which, in turn, requires a corresponding duty to consider to minority interests. In a subsequent decision of 1995, the Federal Court of Justice extended this rationale to cases where a minority shareholder, by virtue of his veto power in a general meeting, blocks a transaction which is in the interest of the enterprise and essential for its survival, e.g. an urgent capital increase, thus recognising a fiduciary duty for the minority shareholder *vis-à-vis* the majority shareholder.[106] From an international perspective, this line of cases has been a remarkable development even if it bears a close resemblance to US corporation law which has long held majority shareholders as subject to fiduciary duties.[107] By contrast, English company law has never taken this step,[108] and the prevailing doctrine in Swiss stock corporation law refuses to take it either.[109] French company law prefers the general concept of abuse of rights.[110] The German development of the 1970s and 1980s, was motivated by a widespread desire to lift the moral standards of the market place. Today, the ethical overtones of that concept have largely disappeared, and fiduciary duties are used more pragmatically as a general clause to solve unforeseen problems in long-term relationships. In practice, company law courts very often resort to fiduciary duties,[111] and there is some concern that they tend to overstretch this general clause.

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[104] See FLEISCHER, *supra* note 102, § 53a marg. no. 49.

[105] See BGH, 1 February 1988, II ZR 75/87, BGHZ 103, 184, 194 et seq.

[106] See BGH 20 March 1995, II ZR 205/94, BGHZ 129, 136, 142 et seq.

[107] See J. D. COX/T. L. HAZEN, The Law of Corporations (3rd ed. St. Paul 2010) § 11:11.

[108] See P.L. DAVIES, Introduction to Company Law (2nd ed. Oxford 2010) 238: "In the US company laws have long regarded majority shareholders as directly subject to fiduciary duties by virtue of their controlling position, which duties they owe both to the company and, more important here, to minority shareholders. British law has never taken this step. […] British law has thus focused on the fiduciary duties of directors, not shareholders."

[109] See P. BÖCKLI, Schweizer Aktienrecht (4th ed. Zurich et al. 2009) § 13 marg. nos. 659 et seq.

[110] See A. CHAMPETIER DE RIBES-JUSTEAU, Les abus de majorité, de minorité et d'égalité (Paris 2010).

[111] See FLEISCHER, *supra* note 102, § 53a marg. nos. 42 et seq.

5. Rescission Suits ("Beschlussmängelklagen") as the Most Important Enforcement Mechanism

With a view to enforcement mechanisms, it is crucial to understand that shareholder derivative actions are not very well developed in German stock corporation law. Despite their legal basis in § 148 AktG, they are hardly ever used in practise due to a lack of financial incentives.[112] A rational shareholder who bears the full risk of litigation without any guarantee of adequate compensation will refrain from filing a derivative action.

Instead, the most forceful weapon in the hands of minority shareholders is the rescission suit, i.e. an action to challenge the validity of resolutions passed by the shareholders' meeting. Pursuant to § 243 para. 1 AktG, a court faced with such a case must inquire whether a resolution of the shareholders' meeting violates either the law or the articles of association. Any shareholder having attended the meeting can file a rescission suit (§ 245 no. 1 AktG), even if he holds only a single share with the nominal value of 1 Euro. No violation of the shareholder's rights or interests is required for a rescission suit to be filed.[113] In fact, the claim that a shareholders' resolution violates the law or the articles of association constitutes sufficient standing, even if the violation only affects another shareholder's interests.[114] For this reason, the rescission suit is said to have an *institutional* function,[115] sometimes described as an "*actio popularis* limited to the group of shareholders"[116] or as a "functionary's action"[117]. If a challenge to the validity of a resolution of the shareholders' meeting is successful, the final judgment voids every legal effect the resolution might have had (§ 241 no. 5 AktG). The shareholder resolution thus becomes void *ab initio*. Given these characteristic features, it should not only be clear that rescission suits can be a powerful and efficient

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[112] For recent reform proposals G. BACHMANN, Reform der Organhaftung? – Materielles Haftungsrecht und seine Durchsetzung in privaten und öffentlichen Unternehmen, Gutachten E zum 70. Deutschen Juristentag (Munich 2014) E 88 et seq.

[113] See BGH, 5 February 1965, II ZR 287/63, BGHZ 43, 261, 265 f.; BGH, 27 April 2009, II ZR 167/07, NJW 2009, 2301.

[114] See for example RG, 10 November 1897, I 235/97, RGZ 40, 80, 83: unlawful refusal to admit a representative of another shareholder to the general meeting, who had not challenged the resolution himself.

[115] See M. LUTTER, Die entgeltliche Ablösung von Anfechtungsrechten – Gedanken zur aktiven Gleichbehandlung im Aktienrecht –, ZGR 1978, 349 et seq., 378 et seq.

[116] H. HORRWITZ, Das Recht der Generalversammlungen der Aktiengesellschaften und Kommanditgesellschaften auf Aktien (Berlin 1913) 88: "Essentially, every shareholder has standing to bring suit, regardless of whether or not a personal interest is at stake […] The rescission suit is an *actio popularis* limited to the group of shareholders" (author's translation); more recently M. SCHWAB, in: Schmidt/Lutter (eds.), AktG, 2nd ed. 2010, § 243 marg. no. 2.

[117] K. SCHMIDT, in: Großkommentar AktG, 4th ed. 2013, § 245 marg. no. 4.

instrument of minority protection, but also that they are open to abuse and frivolous suits. In fact, the emergence of so-called predatory shareholders *("räuberische Aktionäre")* has been, and still is, an object of major concern in German stock corporation law.[118]

In the international literature on company law and corporate governance which is dominated, and sometimes also distorted, by Anglo-American thinking, the German and Continental European concept of rescission suits is often overlooked or underestimated. This may be excused, at least to a certain degree, as a scholarly home bias: English law, in principle, does not contain a general mechanism that allows each and every shareholder to challenge the validity of resolutions of the general meeting.[119] Minority protection is assured by means of common law principles applying to amendments of the articles of associations and – primarily with regard to privately-held companies – an unfair prejudice claim (Secs. 994–999 CA 2006). In addition, English law contains a wide-reaching catalogue of directors' duties (Secs. 170–225 CA 2006), with a degree of detail that closely resembles that of German rescission suit law.[120] In the United States, too, provisions on challenging defective resolutions are very hard to come by.[121] The corporate law in leading US jurisdictions contains nothing that resembles the special procedures for challenging shareholders' resolutions in the same way as §§ 241 et seq. AktG.[122]

6. *Codified Law of Corporate Groups ("Konzernrecht")*

A last German speciality that cannot be explained here in detail,[123], but at least deserves a mention in passing, is the law of corporate groups. Some years ago, a distinguished Swiss scholar coined the memorable phrase that *"Deutschland ist Konzernland"* ("Germany is the land of groups of company law"),[124] referring to the first worldwide codification of groups of companies law in the

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[118] For a comprehensive account D. J. MATHIEU, Der Kampf des Rechts gegen erpresserische Aktionäre (Frankfurt am Main 2014).

[119] From a German perspective W. RINGE/S. OTTE, in: Triebel et al. (eds.), Englisches Handels- und Wirtschaftsrecht (3rd ed. Frankfurt am Main 2012) Chapter V, § 1 marg. no. 17.

[120] See H. FLEISCHER, Reformperspektiven des aktienrechtlichen Beschlussmängelrechts im Lichte der Rechtsvergleichung, AG 2012, 768 et seq.

[121] Taking a comparative law approach to rescission suits and derivative suits recently M. GELTER, Why Do Shareholder Derivative Suits Remain Rare in Continental Europe, 37 Brooklyn J. Int'l L. (2012) 881 et seq.

[122] For a detailed analysis FLEISCHER, *supra* note 120, 768 et seq.

[123] See the thorough discussion by K. LANGENBUCHNER, in this book.

[124] See J. N. DRUEY, Das deutsche Konzernrecht aus der Sicht des übrigen Europa, in: Lutter (ed.), Konzernrecht im Ausland (Berlin 1994 338: "Germany is considered the global capital of groups of company law" (author's translation).

Stock Corporation Act of 1965.[125] The German legislator and law professors involved in the drafting process paraded this precious piece of legislation like a holy relic, but failed to impress other Member States in the European Union.[126] Today, it seems that a recognition of the group interest closely resembling the French *Rozenblum* doctrine may carry the day in Europe.[127]

IV. Gradual Erosion of German Particularities in Company Law

Concluding this "sightseeing flight over German company law",[128] a few observations on the gradual erosion of German particularities in company law may be interesting. A good reference point is a dissertation on the barriers to harmonisation in stock corporation law published in 1998.[129] This dissertation, taking a broad comparative basis, sought to identify core elements of national stock corporation law deeply rooted in national tradition and therefore highly resistant to law reform. For Germany, it singled out three core elements of national legal heritage: two-tier boards, codetermination and real seat theory.[130] How has this analysis stood the test of time 15 years later? In 1999, the *Centros* case of the ECJ[131] and its progeny forced a paradigm shift from real seat theory to incorporation theory, at least for EU companies. Two years later, the summit of Nice paved the way for the European Company, and with it the concept of negotiated codetermination and the option for a one-tier board in a German-based SE.[132] Of the 134 operating SEs in Germany today, half of them have a monistic board.[133] Moreover, quite a few SEs, for example Allianz and BASF, have made use of the option to reduce their supervisory board size from 20 to 12, as the mandatory rules on board size by the Codetermination Act 1976 do not apply to

[125] See, e.g., E. GEßLER, Probleme und Wege von Aktienrechtsreformen, JBl. 1966, 179: "This regulation is without peer or model in the stock corporation world. It may be viewed as *the* reform piece of the German Stock Corporation Act of 1965" (author's translation).

[126] For a concise summary M. HABERSACK/D. A. VERSE, Europäisches Gesellschaftsrecht (4th ed. Munich 2011) § 4 marg. nos. 15 et seq.

[127] See P. CONAC, Director's Duties in Groups of Companies – Legalizing the Interest of the Group at the European Level, ECFR 2013, 194.

[128] Mimicking the title of *Kunz,* Rundflug über's schweizerische Gesellschaftsrecht, 2011.

[129] See M. ULMER, Harmonisierungsschranken des Aktienrechts (Heidelberg 1998).

[130] See ULMER, *supra* note 129, 17 et seq., 52 et seq., 84 et seq.

[131] ECJ, 9 March 1999, case C-212/97, ECR 1999, I-1449.

[132] For a thorough analysis from the perspective of private ordering in company law FLEISCHER, *supra* note 96, 521 et seq., 533 et seq.

[133] See E. SCHUBERTH/R. M. VON DER HÖH, Zehn Jahre „deutsche" SE – Eine Bestandsaufnahme, AG 2014, 442.

a German SE.[134] More recently, the European Commission, while paying lip service to the equality of one- and two-tier-structures in its Action Plan, has done little to adapt its directives to the specialties of two-tier boards. The most recent example is the Commission's proposal for an amendment of the shareholder rights' directive from 2014.[135] Particular the proposed right of the general meeting to vote on the remuneration policy as regards directors and the right to vote on related party transactions would affect a supervisory board in a two-tier system in a completely different way than a single board in a one-tier system.[136] Thus it would appear, for better or for worse, that the winds of change and supranational and international developments seem to be gradually grinding down or covering over Germany's time honoured legal treasures.

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[134] See SCHUBERTH/VON DER HÖH, *supra* note 133, 443.

[135] European Commission COM(2014) final.

[136] Criticising this sharply H. FLEISCHER, Related Party Transactions bei börsennotierten Gesellschaften: Deutsches Aktien(konzern)recht und Europäische Reformvorschläge, BB 2014, 2698 et seq.; C. H. SEIBT, Richtlinienvorschlag zur Weiterentwicklung des europäischen Corporate Governance-Rahmens, DB 2014, 1913 et seq.

I. Directors’ Liability

Directors' Liability and Enforcement Mechanisms in Japan

Kenichi Osugi[*]

I. Theme

In Japan, the number of derivative lawsuits brought against directors of listed companies is not insignificant. Although less than the US, where derivative suits occur most frequently, the rate is Japan is considered relatively high among other jurisdictions where these suits are quite rare.

This paper will detail how derivative lawsuits operate in Japan, why they operate the way they do, and whether or not the system is effective. Comparisons will be made primarily with the US. This research will, however, be useful to other jurisdictions to determine which elements may affect the frequency and efficacy of derivate suits.

[*] This paper is based on my presentation at the conference *German and Asian Perspectives on Company Law*, sponsored by the Max Planck Institute for Comparative and International Private Law held in Hamburg, Germany, 28–29 May 2015. I thank all the participants who attended the seminar and provided me with fruitful comments.

This paper is constructed in the following way. Part II. will provide a brief introduction to the relevant laws and practices in Japan. Part III. presents data on the use of derivative suits in the US and Japan, and formulates a rough comparison. Part IV. will address the central question and account for the differences between the US and Japan. Part V. will further analyze how the frequency and efficacy of derivative suits in Japan have evolved over the past twenty years.

II. Brief Introduction to Japanese Laws and Practices

Before discussing the theme and to avoid potential misconceptions, I will present some of the basic features of Japanese corporate law and how corporate forms are used.

In Japan, most business corporations, including those that are very small, make use of *Kabushiki Kaisha* (Stock Companies, hereinafter: KK) as their vehicle. Most of those stock corporations were not listed on the stock exchange or considered large companies[1] as defined by the Japanese Company Act (JCA).[2]

Most of the directors of those stock companies are executive managers of the company who were formerly employees of the company and were promoted to the position, namely, as inside directors. Until quite recently, this applied even to large, listed companies as well. Put simply, the proportion of external, independent directors on the entire board has been quite low, typically one outsider on the board per ten board members. In a sense, the director in Japan is closer to a *Vorstandsmitglied* (member of the board of directors) than an *Aufsichtsrat* (supervisory board) in a German stock corporation. Moreover, most listed companies in Japan elect three or more *kansayaku*, a term usually translated as corporate auditor, which has its origin in the German *Aufsichtsrat* but has evolved to a position with a very different mandate.[3]

The situation is, however, rapidly changing thanks to recent reforms made primarily by the Financial Services Agency (FSA) and the Tokyo Stock Ex-

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[1] A *Large Company* is defined in Art. 2 para. 6 of the *Kaisha Hō* [Companies Act] (Act No. 86 of 26 July 2005) as a stock company whose stated capital is 500 million Yen (approx. 5 million US-Dollars) or more, or whose total liability is 20 billion Yen (approx. 200 million US-Dollars) or more.

[2] Important acts and ordnances in Japan are translated into English and published on the website: <http://www.japaneselawtranslation.go.jp/law/?re=02>. To locate the Company Act, enter "Act No. 86 of July 26, 2005" into the search box.

[3] On the *Kansayaku* system, see K. OSUGI, Stagnant Japan? Why Outside (Independent) Directors Have Been Rare in Japanese Companies, in: Shishido (ed.), Enterprise Law: Contracts, Markets, and Laws in the US and Japan (Cheltenham 2014) 252 and especially 255 et seqq.

change (TSE) by means of the Stewardship Code in 2014[4] and the Corporate Governance Code in 2015.[5] The latter code recommends that listed companies elect at least two external, independent directors, and a company that chooses not to do so must disclose the fact and the reasons behind it.[6]

III. How Derivative Suits Operate: A Rough Comparison between the US and Japan

Professor Romano published a well-known article on shareholder suits in the US,[7] which included relevant data on how derivative suits operate and a discussion on the pros and cons of the system. In this part, I utilize some distinctive data from her study and conduct my own research on derivative suits in Japan in order to compare the figures.

1. Shareholder Suits in the US

Prof. Romano investigated all suits against company directors brought by company shareholders from the late 1960s to 1987, across 535 randomly selected listed companies. She gathered information regarding shareholder suits, which consisted of both derivative suits and, suits brought by shareholders in their own right, either individually or as a class. There were 128 resolved cases in her database, and two-thirds of the cases resulted in a settlement between the plaintiffs and defendants (see Table 1).

Table 1: Shareholder Suits in the US from the late 1960s through 1987

Sample	535 public corporations, randomly selected
No. of cases and no. of companies that experienced SH suits	139 cases, 99 companies (19%)
Resolved	128 cases
Resolved by settlement	83 cases (65%)

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[4] The Stewartship Code is not a statute but a so-called "soft law". The English translation of the code is available at: <http://www.fsa.go.jp/en/refer/councils/stewardship/20140407.html>.

[5] The Corporate Governance Code not a statute but a "soft law." The English translation of the code is available at: <http://www.jpx.co.jp/english/equities/listing/cg/>.

[6] This can be found in Principle 4.8 of the Code as well as Paragraph 11 on the comply-or-explain approach of the final proposal of the code, which is included in the Corporate Governance Code as an Appendix.

[7] R. ROMANO, The Shareholder Suit: Litigation without Foundation?, 7 J.L. Econ. & Org. (1991) 55.

2. Derivative Suits in Japan

In conducting similar research, I used a database put together by a team of attorneys.[8] The database contained data from lawsuits against directors for the recovery of company losses, filed either by a shareholder (derivative suit) or the company itself (suit by the company), which shall be referred to here as liability suits. It is safe to assume that this database covers almost all cases (more than 90%) in terms of listed companies. In a suit filed by the company, the company is represented by the company's *Kansayaku* or the Resolution and Collection Corporation (RCC) for bankrupt financial institutions. The RCC is an official institution that is liaised with the Deposit Insurance Corporation of Japan (DICJ).

I excluded cases related to non-listed, closely-held companies. I consolidated several cases into one where I believed the cases arose from one single dispute, as in a case where one shareholder sued a director on one day, and another shareholder sued the same director the next day based on the same cause of action. In accounting for the ratio of particular companies among all listed companies, I estimated the number of listed companies in Japan to be 3500[9] (see Table 2).

Table 2: Liability suits in Japan from 1991 through 2011

No. of listed companies	Approx. 3,500
No. of suits and no. of companies that experienced liability suits	Liability Suits: 154 cases (147 companies, 4.2%) Derivative Suits: 121 cases (116 companies, 3.3%)

3. Rough Comparison between the US and Japan

Here we turn to a rough comparison of the two nations in terms of the derivative lawsuits related to listed companies. Although the data collected by both Romano and the Japanese lawyers ranged over 20 years, the rate at which companies faced lawsuits in the entire sample from Japan (3.3%) is significantly lower than that of the US (19%). Even if the number in the US includes direct suits, the difference in frequency between the two nations is evident (see Table 3).

[8] M. SAWAGUCHI et al., *Atarashii Yakuin Sekinin no Jitsumu* [Latest Introduction to the Practice of Directors' Liability] (2nd ed. Tokyo 2012) 348 et seqq.

[9] The number of listed companies in Japan has been approximately 3,500 since 2001. There were fewer prior that date.

Table 3: Frequency of shareholder lawsuit filings in the US and Japan

	US		Japan	
	Incl. direct suits	Sample	Derivative only	Sample
Companies	99 (19%)*	535	116 (3.3%)	3,500

Table 4 below shows the results of the lawsuits, or how those suits were disposed of by the parties or the courts. This table also shows distinctive patterns in the US and Japan. I excluded cases from the database that were not suitable to the analysis of the plaintiffs' success rate, such as cases that came to an end for very unusual reasons or where no results were identified.

Table 4: Case outcomes – numbers of cases (ratio)

	US, incl. direct suits	Japan, derivative only
Sample	128	86
Settled	83 (65%)	23 (27%)
– Monetary recovery	46 (55%)	23 (100%)
– Awards to the attorney	75 (90%)	?
– Governance settlement**	25 (30%)	10 (43%)
– No cash recovery	21 (25%)	0 (0%)
Judgment for the plaintiff	1 (1%)	8 (9%)
Unsuccessful plaintiff	44 (34%)	55 (64%)
– Early termination by the court***	12 (9% of 128) (27% of 44)	10 (12% of 86) (18% of 55)
Not settled, not withdrawn, and not terminated	[20 (16%)]	50 (58%)

* Romano, supra note 7, at 66, presents the number of derivative and direct suits on which she conducted an event study to assess the stock price effects of lawsuit filings. The sample of 66 cases includes 29 derivative suits, 13 class suits, and 23 of both class and derivative suits. Supposing this rate applies to the entire sample of 535, the ratio of companies that experienced a derivative suit would be 99*(29+23)/66/535 = 15%.

** By *governance settlement,* I am referring to a settlement that includes reforming the board composition, executive compensation, defensive tactics, and so on. Romano called it a structural settlement. Because a settlement between a shareholder and a director requires court approval, Romano inferred that those governance provisions were used to justify the settlements, which were essentially in favor of the lawyers involved. Indeed, there are 25 governance settlements in the sample, 21 of which did not accompany a monetary recovery in the US.

*** By *early termination by the court,* I am referring to cases where the court ordered the plaintiff to post bond, where the court dismissed the action through summary judgment, and others cases that were terminated by the court in favor of the defendant at an early stage of the procedure (before trial). It is, however, not accurate to equate a bond order in Japan with summary judgment in the US, because a bond may be ordered at a relatively late stage in the procedure; in Japan, civil litigation is not divided into pre-trial and trial stages.

In the US, there was only one case that finished with a judgment for the plaintiff while 83 cases settled. Of those, only 46 settlements provided for monetary relief. On the other hand, 75 settlements stipulated that the defendant would pay the plaintiff's attorney's fees.

On the other hand, in Japan, only 27% of cases settled and all of those cases provided that the defendant would pay compensation to the company. Of the settled cases, 43% include governance provisions. Although I have no data, I assume that all of the settlements provided for the payment of the plaintiff's attorney's fees.

In all, 9% of cases resulted in a judgment for the plaintiff, and in 64% of all cases, the plaintiffs were not successful.

The number of cases that were not terminated by the court, not settled, and not withdrawn by the plaintiff, namely, the number of cases that took the long road by way of trial to reach a court judgment, is noteworthy. The ratio in Japan is 58%. That of the US is not clear, but, I estimated from the numbers provided by Romano there would have been approximately 20 such cases, which is less than 16% of the sample.

Table 5 shows the success rate of the shareholder suits, which includes direct suits in the US and derivative suits in Japan. How beneficial have those actions been to the plaintiff shareholders? I excluded cases I thought not to be qualified for the purpose of calculating the rate. Interestingly, the results are similar in the two nations, though it seems that the meaning of the success rate is very different between them.

Table 5: Success rate of suits in the two jurisdictions

	US, incl. direct suits	Japan, derivative only
	128	86
Settlement with monetary recovery	46	23
Judgment for the Plaintiff	1	8
Total	47 (37%)	31 (36%)

IV. What Accounts for the Differences between the US and Japan

A shareholder's decision to bring a derivative lawsuit is influenced by both legal and extra-legal considerations. Do differences in the legal rules explain differences in the numbers?

1. Entry Cost

In Japan, when a company sues its director for damages, the filing fee is determined by the amount of the claim, and typically, that fee is significant in keeping with the amount of damages claimed. What about derivative suits?

Until 1993, the Shōhō (Commercial Code)[10] was silent on this question. Courts were split – with some district courts holding that the rule for suits filed by a company also applied to a derivative suit. Others however took a different view – as damages would be recovered by the company and not the shareholder, the value of the subject matter of suit (i.e., the interest alleged in the action) would be impossible to calculate, and thus, the filing fee should be determined to be a fixed amount, regardless of the amount of the claim. The latter position became increasingly popular, and was codified in the 1993 revision. Since then, the filing fee has been around 100 Euros.

This led to a dramatic increase in derivative suits in Japan around the early 1990s.[11] Currently, the entry cost for a derivative suit is quite low in Japan, and thus, the entry cost cannot explain the relatively low frequency of these lawsuits.

2. *Entry Barriers*

In most jurisdictions that permit derivative suits, strict rules, referred to here as barriers, exclude frivolous actions at an early stage. The barriers in German law, US law, and Japanese law are varied: for example, in Germany, only a shareholder with a certain amount of shares can bring a derivative suit, and only subject to several requirements (Art. 148 para. 1 AktG). By contrast, a shareholder with only one share can bring a derivative suit in Japan as well as in the US, although these jurisdictions have barriers in other areas. Japanese law, through a court order, mandates that the plaintiff post a bond of a certain amount if the court believes the plaintiff is acting in bad faith. In the US, on the other hand, a shareholder with a single share can bring a derivative action, but attorneys and judges have developed the use of Special Litigation Committees (SLC).

A lawsuit may be deemed frivolous when 1) the plaintiff uses the suit for the purpose of harassing the defendant (subjective abuse); 2) the probability that the cause of action is affirmed by the court is believed to be quite low even at an early stage (low likelihood of success); or 3) litigation would be detrimental to the interests of the company, and in turn, of the shareholders (objective abuse) by risking the reputation of the company, by distracting the defendant directors from working hard for the company, etc., and thus, the suit should be terminated at an early stage of the procedure even if factor 1 or 2 are not met.

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[10] The law governing stock corporations under the Japanese legal system was stipulated in the Commercial Code until 2005, when it was transferred to the Companies Act enacted the same year. See note 2 and the text accompanying it.

[11] See T. FUJITA, Transformation of the Management Liability Regime in Japan in the Wake of the 1993 Revision, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 17. See also Art. 847-4 para. 1 of the current JCA.

In this respect, the third category above (objective abuse) can be addressed with established rules in Germany and the US, but not in Japan. Art. 148 para 1 of the German Stock Corporation Code stipulates that when a claim for compensation is significantly contrary to company interests, the court will not permit the action. In the US, upon the petition of the SLC asking the court to dismiss the action because it believes the litigation is contrary to company interests, the court may issue summary judgment. In contrast, Japan has only the bond order as a mechanism to exclude frivolous suits. A bond order requires bad faith on the part of the plaintiff. Bad faith is interpreted as involving either factor 1 or 2 above.[12] A recent trend is that courts will not order a bond in cases involving the circumstances in factor 2, but rather, they move forward to a final judgment that dismisses the claim. In essence, the screening for early termination operates only in cases involving the circumstances set out for factor 1 above. Japanese law does not have an entry barrier that excludes the third category.

Therefore, the entry barriers are even lower in Japan than in the US.

3. *Involuntary Settlement*

In the US, it is not shareholders but attorneys who take the initiative in bringing derivative suits. The directors and officers (D&O) insurance creates strong incentives for defendants to settle. This appears to induce the defendant to make a compromise and reach a settlement for nuisance actions, even if the cause of action has a weak legal basis. Attorneys aware of this tendency may bring a suit in search of a settlement if the nuisance value seems to be sufficiently high, despite the low probability of judgment for the plaintiff.

This cycle generates involuntary settlements that can explain the high frequency of these types of actions, the high rate of settlements, and the fact that settlements are often favorable to attorneys rather than shareholders or the company. To cope with this problem, US law discourages involuntary settlements. To settle a derivative action, the parties involved must obtain approval from the court.

There is no similar rule in Japan. It would appear that the low rate of settlements may lead shareholders and attorneys to therefore also think the probability of an involuntary settlement is low.

The differences, however, between the two nations above cannot be explained by different laws but by different expectation levels regarding involuntary settlements. The next question is, where does the nuisance value come from in the US?

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[12] Tokyo High Court Order, 20 February 1995, 252 Hanrei Taimuzu (1995) 895.

4. Rules on Gathering Evidence

One possible explanation for the difference lies in the procedural rules. Discovery in US civil procedure can reveal the nuisance value of a derivative action that, in turn, raises the rate of involuntary settlements. No matter how helpful it is to reveal relevant facts, the discovery procedure imposes a huge burden on the company. There is no discovery equivalent under Japanese law.

It seems that this difference generates different patterns for the expectations of the plaintiff (and his/her attorney) prior to filing. In Japan, a plaintiff may demand that the company pay a reasonable amount of the costs, such as attorney fees, only when she/he wins the derivative suit.[13] There is a similar rule under US law. On the other hand, an attorney can more easily control the amount to be paid in attorney's fees if the case is settled out of court. However, without the burden of discovery, the nuisance value of a derivative suit in Japan is likely much smaller.

Therefore, an attorney tends to support a shareholder in filing a suit only when he/she anticipates a judgment for the plaintiff. However, a success rate of 36% in Japan shows that an accurate prediction of success is not very likely.

Because it is difficult to project success, people have come together to set up a non-profit organization that pools attorneys and certified public accountants to construct a portfolio of derivative suits, some of which will be successful and others that will not. CURTIS MILHAUPT observed this diversification of risk in several East Asian countries, including Japan and Korea.[14] This observation is consistent with the hypothesis I posed above.

5. Substantive Law

Not surprisingly, the rules governing a director's civil liability to the company are similar in the US and in Japan.

Though the so-called Business Judgment Rule has not been codified yet in Japan, case law has evolved to see judges respecting the business judgments of corporate managers in their rulings. The first case to clarify the Japanese version of the Business Judgment Rule was tried in 1993.[15] The Supreme Court of Japan adopted a similar attitude on the issue in 2010.[16] Although the decision did not construct a general formula, it can be summarized as follows: where a decision made by a defendant director relates to a business matter,

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[13] See Art. 852 of the current JCA.

[14] C. MILHAUPT, Nonprofit Organizations as Investor Protection: Economic Theory and Evidence from East Asia, 29 Yale J. Int'l L. (2004) 169. In fact, the idea of NPOs filing derivative actions is institutionalized in Germany as a shareholder forum as set forth in Art. 127a of German Stock Corporation Act.

[15] Tokyo District Court Decision, 16 September 1993, 25 Hanrei Jihō 1469.

[16] Supreme Court Decision, 15 July 2010, 90 Hanrei Jihō2091.

the director breaches the duty of care only when the process or the content of the decision is seriously flawed.

However, declaring a principle is one thing and the application of that principle to complicated facts is another. It appears that the courts in Japan are somewhat more hostile to defendant directors than the courts in the US. If that is the case, this hostility may slightly increase chances of success for the plaintiff and encourage corporate directors to act more carefully. Needless to say, it is an open question whether the level of deterrence is optimal.

V. Why Shareholders Sue

A derivative action does not give the plaintiff monetary relief – prompting the question of why shareholders sue. There are two schools of thought. MARK WEST has argued that monetary incentives are the driving force behind attorneys in Japan[17], while DAN PUCHNIAK and MASA NAKAHIGASHI recently argued that plaintiff shareholders are motivated by non-monetary incentives, such as satisfaction and a sense of justice.[18]

Notice that those two hypotheses are not mutually exclusive. Actually, I contend that both incentives operate in Japan: the probability that a particular dispute is brought to a court as a derivative suit is an increasing function of the sum of the magnitude of the shareholder's sense of justice on one hand and the anticipated attorney's fees on the other. Put simply, a shareholder asks for an attorney's support when he/she believes the defendant is culpable, while the attorney accepts the offer when he/she believes that the court will affirm the cause of action. In other words, both incentives work as driving forces at the same time. The combination of these two incentives can explain the relevant numbers: the relatively low frequency, a success rate of 36%, and the inference that involuntary settlements are rare in Japan.

VI. Other Findings

Apart from comparing some specific numbers from the US and Japan, I conducted additional research on liability suits in Japan. Here, I included in the database cases that involved non-listed, financial companies.[19] Through this research, I found several noteworthy features that may show links between

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[17] M. WEST, Why Shareholders Sue: The Evidence from Japan, 30 J. Legal Stud. 351 (2001).

[18] D. PUCHNIAK/M. NAKAHIGASHI, Japan's Love for Derivative Actions: Irrational Behavior and Non-Economic Motives as Rational Explanations for Shareholder Litigation, 45 Vand. J. Transnat'l L. (2012) 1.

the legal rules and the function of liability suits. This section will address these issues.

I divided the companies involved in the original database into three categories, namely 1) listed, non-financial; 2) listed financial; and 3) non-listed, financial companies. On one hand, I classified securities houses and insurance companies as non-financial companies, because in those companies, directors are not prone to liability suits brought by the RCC (see Part III.3.). Therefore, the listed, financial category involves listed banks or listed bank holding companies[20]. On the other hand, I excluded from the database cases involving agricultural cooperatives or fishery cooperatives, which are not listed, because I attempted to make the comparison between listed and non-listed financial company cases more meaningful. Otherwise, the listed financial categories from category 2 would consist only of listed banks or bank holding companies whereas category 3, non-listed, financial categories, would include cooperatives as well as banks and bank holding companies, which would not be beneficial for comparison purposes. In this way, I prepared my own database for further analysis.

I also divided liability suit cases into 1) derivative suits; and 2) suits by the company (see Table 6).

Table 6: Classification of liability suits in Japan from 1991 through 2011

The company involved	(1) Listed, non-financial	(2) Listed, financial	(3) Non-listed, financial	Total
No. of cases	90	19	16	125
[1] derivative suits	73	13	5	91
[2] suits by the company	17	6	11	34

Moreover, I divided the cases according to the date of filing into four time periods, namely 1991–1995, 1996–2000, 2001–2005, and 2006–2010 and investigated whether those subgroups present different patterns (see Tables 7 through 10).

19 The original database prepared by the team of attorneys and cited in Note 8 above includes non-listed, non-financial company cases as well. I excluded them from my own database, because this fourth category is not exhaustive. Also, liability suits that involve companies in this category tend to be disputes between family members within a closed company, and thus, it does not seem to be meaningful to compare those cases with those involving listed companies. On the other hand, I believe the cases in the database are nearly exhaustive in the third category (suits that involve non-listed, financial companies), and they have much in common with the cases in first two categories in regards to the characteristics of the disputes.

20 Today, most of the banks in Japan are either listed themselves or have listed holding companies as their parent companies. However, that is quite a recent phenomenon. That was not the case during the twenty year period of this research.

Table 7: The first period, 1991 through 1995

The company involved	(1) Listed, non-financial	(2) Listed, financial	(3) Non-listed, financial	Total
No. of cases	18	5	1	24
[1] derivative suits	16	5	1	22
[2] suits by the company	2	0	0	2
[1] success rate	43.8%	20.0%	100%	
[2] success rate	50.0%	–	–	

Table 8: The second period, 1996 through 2000

The company involved	(1) Listed, non-financial	(2) Listed, financial	(3) Non-listed, financial	Total
No. of cases	26	11	11	48
[1] derivative suits	25	6	4	35
[2] suits by the company	1	5	7	13
[1] success rate	36.0%	16.7%	0%	
[2] success rate	100.0%	80.0%	100%	

Table 9: The third period, 2001 through 2005

The company involved	(1) Listed, non-financial	(2) Listed, financial	(3) Non-listed, financial	Total
No. of cases	21	3	4	28
[1] derivative suits	19	2	0	21
[2] suits by the company	2	1	4	7
[1] success rate	15.8%	50.0%	--	
[2] success rate	100.0%	100%	100%	

Table 10: The fourth period, 2006 through 2011

The company involved	(1) Listed, non-financial	(2) Listed, financial	(3) Non-listed, financial	Total
No. of cases	25	0	0	25
[1] derivative suits	13	0	0	13
[2] suits by the company	12	0	0	12
[1] success rate	69.2%	--	--	
[2] success rate	66.7%	--	--	

The findings are as follows. First, liability suits in financial institutions, both listed and non-listed, clustered near the 1996-2000 period, probably because the bubble economy in the late 1980s and the banking crisis in the 1990s resulted in bank manager misconduct. On the other hand, the number of cases in the listed, non-financial company category has been constant through all four periods: 18, 26, 21, and 25, respectively (see Table 11).

Table 11: Number of cases in the listed, non-financial category, during all four periods

	1991–1995	1996–2000	2001–2005	2006–2010
No. of cases	18	26	21	25
[1] derivative suits	16	25	19	13
[2] suits by the company	2	1	2	12
[1] success rate	43.8%	36.0%	15.8%	69.2%
[2] success rate	50.0%	100.0%	100.0%	66.7%

Second, the success rate of suits by the company is higher than that of derivative suits in most subgroups. This is not a surprise, because companies tend to have more evidence regarding the misconduct of directors, whereas outside shareholders, due to that lack of discovery procedures under Japanese law, have difficulty gathering evidence. Therefore, companies are in a better position to determine whether they are likely to win the case before they decide to sue the directors, and thus, the success rate of the suits by the company surpasses that of the derivative suits.

There is however one exception: In the subgroup of listed, non-financial companies, and during the 2006–2010 period, 69% of derivative suits were successful while only 67% of company suits were successful (see Table 11). How could this happen?

As mentioned above, the number of cases in category 1 (listed, non-financial companies) through all four time periods is relatively constant in terms of all of the cases (which means the sum of both derivative suits and suits by the company) and that applies to the number of derivative suits as well. This is, however, not the case with the number of suits by the company. Those numbers remained very small until the third period, and then suddenly spiked in the fourth period.

This suggests that until 2005, a listed, non-financial company tended not to sue its directors unless it strongly believed the suit would be successful, but around 2006, the trend changed, and a listed, non-financial company became more willing to sue its managers when it anticipated a high probability of a derivative suit.

In fact, this change in a company's tendency to sue could, at least partially, be explained by the 2005 revision of the Company Act. The revision introduced a rule to provide notice of the reason not to sue in the current version of Art. 847 para. 4, stipulating

> "[i]n cases where the Stock Company does not file an Action to Enforce Liability within sixty days from the day of the demand [...], if there is a request by the shareholder who made [such] demand [...], it shall, without delay, notify the person who made such a request of the reason for not filing an Action to Enforce Liability in writing [...]."

Third, court orders to post bonds clustered in the early periods; there have been few recent cases. There were ten orders during the 1991–1995 period and six orders during the 1996–2000 period, but there have been no orders since 2001. Those numbers include some cases in which the order was rescinded by a higher court.

As is cited in Part III.3. and Part IV.2., Japan uses the bond order as a mechanism to exclude frivolous suits, but a bond order requires bad faith on the part of the plaintiff.[21] It took nearly ten years to reach a consensus regarding the interpretation of the concept of bad faith because of the outbreak of derivative lawsuits in Japan around 1991. After a consensus was reached, courts in Japan stopped emphasizing the screening of cases at an early stage, but started requesting both parties to submit evidence that could support or negate the claim.[22]

Fourth, though the number of settlements as a whole showed no specific pattern (5, 10, 4, and 13, respectively), that of governance settlements, as defined in Part III.3., increased (see Table 12). All the governance settlements arose from derivative suits and not from suits by the company.

Table 12:. Number of settlements during all four periods, including governance settlements

	1991–1995	1996–2000	2001–2005	2006–2010
No. of cases	24	48	28	25
– derivative suits	22	35	21	13
– settled	5	9	4	8
– suits by the company	2	13	7	12
– settled	0	1	0	5
– Governance settlements	0	1	3	7

This feature enables us to make the following two inferences. First, the governance settlements in Japan are likely to serve the interests of the company involved quite well. As cited in Part III.3., settlements in the US are reached in the interest of plaintiff's' attorneys and governance settlements are often believed to be made as excuses. On the other hand, all the governance settlements in Japan accompany payments to the company. Second, this makes the hypothesis posed in Part V. more plausible – the fact that a particular dispute, brought to a court as a derivative suit, is correlates to the sum of the magnitude of the shareholder's sense of justice on one hand and the anticipated attorney's fee on the other.

[21] See also Art. 847-4 paras. 1, 3 of the current JCA.

[22] This shift in emphasis has been repeatedly noted by judges in Japan involved in liability lawsuits.

VII. Derivative Suits in Japan: Policy Evaluation

As explained in Part IV.1., the Commercial Code reform in 1993 made clear that the filing fee for a derivative suit was a fixed amount, around 100 Euro. This dramatically increased the number of derivative suits.

In 2001 and 2002, I asked a dozen employees of legal departments in large companies whether the reform had changed the decision-making process within those companies – and all answered in the affirmative. They reported that before the reform, the internal check system did not work well if a CEO was planning to make a poor decision, especially in terms of mergers and acquisitions (M&A) transactions abroad. This situation, they continued, changed after the 1993 reform. The power balance within the company changed in favor of the legal department – with the department playing a larger role in transactions than before.[23] This made me believe that the existence of derivative lawsuits plays an important role in corporate governance in Japan.

Here, I used statistics to investigate how derivative suits function in Japan. The results presented in this paper show that the system has worked relatively well, probably much better than in the US. According to the data, there have been fewer frivolous suits filed and fewer settlements in favor of plaintiff's attorneys in Japan. However, that is not the end of the story.

The first issue to be discussed is that liability suits may have an excessively deterrent effect on company managers. Some studies have shown that Japanese companies are not eager to take business risks when compared to companies in other nations.[24] We should consider how this effect can be mitigated if we believe Japanese companies should take more risks.

The second issue to be discussed is that derivative suits in Japan may complement rare public enforcement. An attorney recently told me that his lectures to corporate managers often include the warning that "you should be aware of the risk of derivative suits in Japan, as well as the risk of antitrust and anti-bribery laws in Europe and the US." This could be taken as follows: in those Western countries, laws penalize corporate managers when it is determined that internal control is insufficient to prevent such conduct, with the penalties enforced by public institutions. In similar cases in Japan, however, the penalties are enforced by the public institution against the company, and company losses are passed on to the directors by shareholder derivative suits.

If that is the case, law enforcement in Japan is sub-optimal. The penalty assessed against the company is not based on the directors' capacity to pay.

[23] K. OSUGI, *Torishimariyaku, Kansayaku no sekinin to sono Keigen* [The Liability of Directors and Corporate Auditors, and Alleviation of Them], Hōritsu Jihō 25 (2002) 922.

[24] See, e.g., N. MAKOTO/Y. AOKI, What Explains Widening Profitability Dispersion around the World? (working paper, 2010).

Shareholders sometimes sue the directors, but sometimes do not, and thus, liability is sporadic. The recent use of governance settlements might be understood as an adaptation to the situation, often decreasing the amount of liability damages a defendant has to pay and putting greater emphasis on prevention in the future.

The third issue to be discussed is that the efficacy of liability suits in disciplining managers should be evaluated by considering the big picture of corporate governance.

Table 13: A general picture of corporate governance, comparing three regions

		US	Japan	Germany
Risk Monitoring	by Banks	Small	L → S	L → S
	by SH suits	Medium	S → L	S → M?
Efficiency Monitoring by Outside Directors		Large	Small	S → L?
Incentivized Remuneration		Large	Small	S → M?

Table 13 above presents a rough estimate and comparison of several components of corporate governance in three countries. Roughly speaking, the main bank system, akin to *Hausbank* in Germany, played a disciplinary role from 1950 to 1980, but it ceased playing this role sometime in the 1980s. Derivative suits by shareholders began to substitute the role of the main banks in the early 1990s. However, efficiency monitoring and incentivized compensation packages have not been established in Japanese companies.

As mentioned in Part II., the government of Japan and the TSE established two codes to address corporate governance issues in listed companies. The Corporate Governance Code, for the first time, strongly encourages the election of outside directors, performance-based remuneration, and other best practices. If this reform makes a difference in corporate governance in Japan, derivative lawsuits may, and should, play a lesser role. Also, we should examine whether the existence of derivative suits works as an obstacle to new governance mechanisms. The legal rules related to derivative actions should be periodically scrutinized taking into consideration multiple perspectives.

Corporate Opportunity Doctrine as a Basis for Directors' Liability

A New Statutory Experiment in Korea

Kyung-Hoon Chun

I. Introduction: Hypothetical Scenarios and Comparative Sketch

Suppose that a director of a mining company, who came to learn the existence of a profitable new mine, does not report it to the company and instead personally (or through another company owned by him) develops it (Hypothetical 1). Here, he becomes a competitor of the first company by using valuable information he obtained in the course of performing his duties as a director of the mining company. Or, suppose that a director of a supermarket chain who was negotiating to acquire a new site on behalf of the company personally acquires the site or a neighbouring site with his own money (Hypothetical 2). Here, he is competing with the company not by carrying out the business itself but by acquiring the land. By acquiring the land for himself, the director becomes a potential supplier of the land, which is a valuable (or, depending on the situation, indispensable) resource for the company's business.

The directors did not embezzle or otherwise take corporate assets per se in either case, but somehow appropriated a "business opportunity" from the company which has not yet ripened to be considered an asset. In Hypothetical 1, it was the opportunity to develop a new mine, and in Hypothetical 2, it was the opportunity to buy an attractive piece of real estate that may bring profits to its buyer. Will the director be held liable to the company in these hypothetical situations?

In these situations, courts of many jurisdictions are likely to review, in a broader sense, whether the director breached the fiduciary duties owed to the company. There would be however, some differences in the way they approach the problem. For example, the key issue for the UK courts would be whether there was any conflict of interest between the director and the company, and would apply the "no-conflict rule."[1] On the other hand, German courts are likely to invoke provisions in the German corporate codes prohibiting a director's competition with the company (*Wettbewerbsverbot* or prohibition of competition).[2]

Most peculiarly, US courts are likely to apply the "corporate opportunity doctrine" that was developed through a series of court precendents and try to determine whether the business opportunity exploited by the director constitutes a "corporate opportunity" which belongs to the company. This doctrine, which first appeared in the *Lagarde* case in 1900[3] and was substantially modified in the *Guth* case in 1939[4], was embraced by various federal and state

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[1] Sec. 175 of the Companies Act 2006 (providing that a director of a company must avoid a situation in which he has a direct or indirect interest that conflicts with the interests of the company, further providing that such a rule applies in case of the "exploitation of any property, information or opportunity of the company").

[2] For example, see § 88 Aktiengesetz (prohibiting competition of a management director with the company). Many German scholars discuss *Geschäftschancentheorie* (corporate opportunity theory) in their textbooks and commentaries as *Rezeption* (reception or transplant) of US law, and the prevailing view seems to be that § 88 AktG should be applied directly or analogously in case of exploitation of the corporate opportunity. For Hypothetical 1, § 88 AktG would be more directly applicable, while Hypothetical 2 would warrant more cautious approach.

[3] *Lagarde v. Anniston Lime & Stone Co.,* 28 So. 199 (Ala. 1900). This case is known as having adopted "interest or expectancy" test.

[4] *Guth v. Loft, Inc.,* 5 A.2d 503 (1939). This case is known as having adopted "line of business" test.

courts. One of the most frequently cited cases summarizes this doctrine as follows[5]:

"[…] a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation."[6]

This doctrine was declared in the Principles of the Corporate Governance (1994) prepared by the American Law Institute, and provisions on this doctrine are found in the Model Business Corporation Act ("MBCA")[7] and many state laws. In any event, the corporate opportunity doctrine as a basis for directors' liability was formulated by the courts and not by the statutes. Provisions of the MBCA and other state corporate laws on this doctrine usually provide ways to be exempted from liability under the assumption that the liability may be imposed by the courts. In other words, in these fact patterns, the liability-creating norms mostly stem from case law and not statutes. Statutes on the corporate opportunity doctrine are usually liability-exempting norms which were made to alleviate the harshness of the case law.

How then would the Korean court approach this case? Before April 2012, the court would have had to review whether the director breached his duty of good care or duty of loyalty. Thus, it belonged to the realm of pure *standards* as opposed to *rules*. After April 2012, however, the court must review whether the business opportunity exploited by the director constitutes a "corporate opportunity" as defined in Art. 397-2 of the Korean Commercial Code ("KCC") because the US-style corporate opportunity doctrine was enacted into a black letter statute.[8] This is a very unique attempt one can rarely find in any corporate statute of various jurisdictions.

Since Korea is believed to be a civil law jurisdiction heavily influenced by German law, such new legislation seems quite unusual. What caused this unique experiment in Korea? Why did Koreans think that traditional fiduciary duty would be insufficient to regulate a pattern of fact as presented in Hypothetical 1 and 2 discussed above? How does the Korean statute define the corporate opportunity, and what kind of liability is imposed under which circumstances? What is the reaction to this new law among Koreans? Is this a good law?

As a backdrop for these questions, Section II first provides a brief overview of the Korean law regarding directors' duties and liabilities. Then, two

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5 *Broz v. Cellular Information System, Inc.*, 673 A.2d 148 (Del. 1996).

6 673 A.2d 148, 155.

7 § 8.70 of the Model Business Corporation Act.

8 The new Art. 397-2 was added in 14 April 2011 and came into effect as of 15 April 2012.

high-profile Korean court cases will be reviewed in Section III as they were the main triggers that prompted the legislation of the corporate opportunity. Section IV analyzes the new provision: elements of the "corporate opportunity," processes required for the lawful exploitation of the corporate opportunity, and possible remedies granted to the company and the shareholders. Section V will evaluate the new law after reviewing various criticisms against it and counterarguments from those who support it.

II. Overview of Korean Corporate Law on Directors' Duties and Liabilities

1. Directors' Duties

a) Bases of Fiduciary Duties

The directors of a Korean company owe fiduciary duties to the company pursuant to the KCC. The statutory grounds for such duties are twofold. First, Art. 681 of the Civil Code, which originally applied to mandate contracts *(Auftrag)* also applies to the directors of a company *mutatis mutandis* through Art. 382 para. 2 of the KCC, which requires "a duty of care as a good manager." Second, Art. 382-3 of the KCC adopted in the 1998 revision, states that "a director shall faithfully execute his or her duties for the corporation in accordance with the laws and the articles of incorporation." Some commentators interpret the latter (Art. 382-3 of the KCC) as a "duty of loyalty" distinguishable from the "duty of care" based on the former (Art. 681 of the Civil Code).[9] Although Korean courts as well as many commentators still refuse to clearly distinguish these two duties, it would be fair to say that directors of a Korean corporation owe duties to their corporation, which are functionally equivalent to the fiduciary duties (i.e., duty of care and duty of loyalty) owed in Anglo-American law.[10]

b) Duty of Care

Duty of care requires directors to use "the same degree of care needed generally and objectively as an ordinarily prudent man." In the case where a director is accused of breaching his duty of care, the primary defence for the director would be to assert that the decisions were made in good faith and based on

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[9] "Duty of care" pursuant to Art. 681 of the Civil Code roughly corresponds to *Sorgfaltspflicht* pursuant to the German law, while "duty of loyalty" pursuant to Art. 382-3 of the KCC roughly corresponds to *Treuepflicht* pursuant to the German law.

[10] K. CHUN/K. KIM/H. RHO/O. SONG, Corporations and Partnerships in South Korea (2nd ed. Alphen aan den Rijn 2015) 64.

the reasonable judgment of the director in the best interest of the company. Although the legal implication is not exactly the same as the US equivalent, Korean courts have recognized the business judgment rule as a defence in duty of care cases.[11] If a director is able to show that "a business decision was made in good faith in the best interests of the corporation, based on sufficient review of the necessary information reasonably available," then he will be deemed to have acted within "a permissible range of discretion," and a court review would not find a breach of fiduciary duty "unless the substance of such judgment is egregiously unreasonable."[12] In other words, the failure of business decisions by the directors should not be challenged on hindsight unless there is a lack of "sufficient review of the necessary information" or lack of "good faith for the best interest of the corporation."

The court has consistently held, however, that the business judgment rule does not apply to illegal misconduct. For example, bribery, window dressing, and other breaches of law cannot be justified under this rule even if that misconduct may bring benefits to the company exceeding the damages directly incurred by the company due to the misconduct.[13]

Unlike courts of many other jurisdictions, Korean courts have not clearly declared the business judgment rule inapplicable *per se* in the conflict-of-interest situations (or, in other words, duty of loyalty cases). In reality, however, Korean courts tend to reject business judgment defences and recognize directors' liabilities when a company allegedly incurred losses in transactions with its affiliates.[14]

A ramification of the duty of care is that the director is obliged to monitor the misconduct of management and other directors. The court has held that the duty to monitor also applies to non-standing directors and that it covers matters not included in a board meeting's agenda.[15] In a recent case involving illegal accounting ("window dressing"), directors who were not directly involved in, and even ignorant of, the misconduct were also held liable on the grounds that they were negligent in their duty to monitor the other directors' conduct. The court stated that ignorance of misconduct does not exempt directors from liability should such ignorance result from "a sustained and

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[11] CHUN/KIM/RHO/SONG, *supra* note 10, 65.

[12] Supreme Court, 14 June 2002, 2001Da52407; Supreme Court, 28 October 2005, 2003Da69638; Supreme Court, 11 October 2007, 2006Da33333.

[13] Supreme Court, 28 October 2005, 2003Da69638 (bribery); Supreme Court, 11 October 2007, 2006Da33333 (violation of antitrust law); Supreme Court, 13 December 2007, 2007Da60080 (illegal accounting); Supreme Court, 30 November 2007, 2006Da19603 (illegal accounting).

[14] Supreme Court, 28 October 2005, 2003Da69638; Supreme Court, 11 October 2007, 2006Da33333; Supreme Court, 14 April 2011, 2008Da14633.

[15] Supreme Court, 25 June 1985, 84Daka1954.

systematic failure to exercise oversight,"[16] using language apparently influenced by the *Caremark* case.[17]

c) Duty of Loyalty

Directors are required to avoid conflicts of interest with the company. KCC provides three provisions as statutory examples of the duty of loyalty. First, directors may not compete with the company without prior approval from the board of directors (Art. 397). Second, directors may not engage in self-dealing transactions with the company without prior approval from the board of directors (Art. 398). Third, as will be discussed later, directors may not appropriate "corporate opportunities" without prior approval from the board of directors (Art. 397-2). The third provision was introduced into the KCC in 2011 and became effective as of 2012.

It is noteworthy that in these three circumstances the relevant acts are not prohibited *per se* but may be permitted with prior board approval. Board approval, however, does not necessarily exempt the directors and officers involved from liability. If the directors had approved a director competing with the company, a self-dealing transaction, or appropriation of a corporate opportunity, and the approved acts turned out to be damaging to the company, then the issue would be focused on whether the approving directors had duly performed their fiduciary duties in the course of reviewing and granting the approval.

2. Directors' Liability

a) Liability to the Company

Where a director acts in breach of the law or the articles of incorporation, or fails to perform his duties, the director may be held liable to the company for any loss caused by his breach (Art. 399 para. 1 of the KCC). If more than one director is involved, the directors are jointly and severally liable. Where a statutory auditor of the company is also held liable, the statutory auditor and the responsible directors are jointly and severally liable to the company (Art. 414 para. 3 of the KCC).

Where the conduct in question is based upon a resolution of the board of directors, the directors who have voted in favour of the resolution are also liable to the company (Art. 399 para. 2 of the KCC). If a director's opposition is not recorded in the minutes, the director is presumed to have voted in favour of the resolution in question (Art. 399 para. 3 of the KCC).

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[16] Supreme Court, 11 September 2008, 2006Da68636.

[17] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

Directors may be sued pursuant to Art. 399 of the KCC either by the company through a direct action or by its shareholders through a derivative action. When the company files a direct action against its directors, the statutory auditor must represent the corporation (Art. 394 para. 1 of the KCC). Some examples in which directors were held liable pursuant to Art. 399 of the KCC include: (i) the sale of a company's asset at a price lower than fair market value, (ii) the acquisition of an asset at a price higher than fair market value, (iii) the provision of a guarantee or collateral to another party without receiving fair compensation, (iv) the embezzlement of company's funds or assets, and (v) the provision of loans to financially distressed companies without taking any measures to secure repayment.[18]

b) Liability to Third Parties

A director may also be held liable to a third party if the damage is caused by the director's intentional or grossly negligent failure to perform his duty (Art. 401 para. 1 of the KCC). For example, if a director falsely manipulated financial statements of the company and a creditor extended a loan to the company relying upon these false financial statements, the creditor may file a claim against the director based on Art. 401 of the KCC.[19] The article does not stipulate that the director owes any duty directly to the creditors. Rather, a creditor of the company who suffered damage due to the director's breach of duties may directly sue the directors – due to the director's breach of duty to the company, rather than to the creditor.[20]

As is the case with liability to the company, if more than one director is involved, the directors are jointly and severally liable (Art. 401 para. 1 of the KCC). In order to claim a director's liability to a third party, however, the third party plaintiff faces a higher burden of proof: he has to prove at least gross negligence on the part of the director.

c) Criminal Liability

One distinctive aspect of Korean law regarding corporate governance is the frequent use of criminal charges. Pursuant to the Korean Criminal Code and other statutes, if a person taking care of another person's affairs breaches his duties and causes harm to such a person by obtaining (or causing a third party to obtain) unlawful profits, he will be subject to a criminal fine or imprisonment, which may be extended to life-time imprisonment depending on the

18 CHUN/KIM/RHO/SONG, *supra* note 10, 69.

19 Supreme Court, 11 September 2008, 2007Da31518.

20 CHUN/KIM/RHO/SONG, *supra* note 10, 71.

amount of the unlawful profit (*baeim* or "criminal breach of trust").[21] While civil lawsuits have not been a very effective means of controlling managers' misconduct in Korea for various reasons including the absence of punitive damages and a class action system, prosecutors have played a very important role in the history of Korean corporate governance by treating a range of misconduct by directors and officers as a criminal breach of trust. Civil lawsuits against directors and officers, if any, are often preceded by criminal convictions against them.

III. Two Cases before the Legislation

1. Glovis Case

The Hyundai Motor Group is composed of dozens of companies that are engaged in various industries, including automobile, auto part, steel, and other vehicles manufacturing industries, with its flagship company being Hyundai Motor Company ("HMC"). The group had high demands for logistics services, such as the delivery of parts and raw materials, delivery of completed products, and management of inventory. The group had outsourced these services to independent contractors either directly or through forwarders, but in around 2000, it decided to establish a new company (named Glovis) specializing in logistics services in order to modernize its logistics system. However, the shares of this apparently lucrative new venture did not go the member subsidiaries of the group, but to the natural persons holding the controlling block of HMC. Two individual shareholders of HMC, a father and his son (MK Chung and ES Chung, respectively), invested approximately 2 million US-Dollars and 3 million US-Dollars and became initial shareholders (40% and 60%) of Glovis in 2001. On a related note, these two persons owned less than 10% of the voting stock of HMC but had strong control over HMC and the entire group by way of circular ownerships and pyramidal structures which were usually leveraged through controlling minority shareholders.

Once Glovis was established, HMC and other affiliates, such as Kia Motors (the second largest automobile manufacturer in Korea), Hyundai Mobis (the largest auto part company in Korea), Hyundai Rotem (a train and military vehicle manufacturer), and Hyundai Steel, purchased logistics services almost exclusively from Glovis. As such, Glovis' revenue and profit skyrocketed, and its stock was soon listed in the Korea Exchange. The value of Glovis' shares held by the two Chungs increased to almost 5 billion US-

[21] Arts. 355 para. 2 and 356 of the Korean Criminal Code and Art. 3 of the "Act on Aggravated Penalties on Specific Economic Crimes."

Dollars (from the initial investment amount of 5 million US-Dollars) by October 2010 – a stunning one thousand fold increase within less than 10 years.

In 2008, the minority shareholders of HMC, organized by a shareholders activists group, filed a derivative suit against one of the controlling shareholders (the father) and the CEO of HMC. The plaintiffs alleged, *inter alia,* that the two family members had misappropriated the "corporate opportunity" in breach of their duties of loyalty. Although there were no statutory grounds directly available for this claim at the time of filing the lawsuit in 2008, the plaintiffs argued that the opportunity to provide logistics services to the affiliate companies was a highly profitable business opportunity that belonged, at least partly, to HMC.

According to the plaintiffs' argument, HMC could have enjoyed the profits from the logistics business solely or together with other affiliates under various scenarios. For example, HMC could have operated the logistics service as an internal business unit or a new subsidiary, or HMC could have established Glovis as a joint venture by and among other affiliates who would have been faithful customers of Glovis. If HMC had chosen one of such alternatives, HMC could have shared the profits that had been solely taken by the Chungs. Therefore, the plaintiffs argued that the board of HMC should have considered such alternatives in the best interests of HMC and that failure to consider this scenario constituted breach of fiduciary duties which in effect transferred economic gains from non-controlling shareholders of HMC to the controlling shareholders.

To persuade the court of this logic, the plaintiffs invoked the corporate opportunity doctrine pursuant to US law. They argued that this doctrine can be also inferred from Korean law, that is, the general provisions of "duty of care" and "duty of loyalty" of the KCC.

On this point, the Seoul District Court ruled against the plaintiffs.[22] Stating that only "actual and concrete business opportunities existing in the company" are subject to the prohibition of appropriation, the court held that the establishment of Glovis was not an actual and concrete business opportunity that had existed within HMC. Some commentators observe that the court was influenced by the classic "interest or expectancy test" adopted by the *Lagarde* case.[23] Since neither party appealed the judgment, it became final.

The Glovis case was one of the most well-known corporate disputes in Korea around 2010 because of the sheer amount of profits as well as its skilful succession structure. It is a typical example of *"ilgam morajugi"* or "funnel-

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[22] Seoul Central District Court, 25 February 2011, 2008GaHap47881. The plaintiff partially won against the defendants with respect to certain transactions clearly unfavorable to HMC (and favorable to Glovis).

[23] See *supra* note 3.

ling of business",[24] a concept which requires some explanation. The Korean economy is dominated by a few large business groups (a.k.a. *chaebol*), with the member companies of each business group usually engaged in large volume of intragroup transactions.[25] As the Hyundai affiliates had done in the Glovis case, member companies of these business groups enter into exclusive or semi-exclusive contracts with other member companies to outsource various services, such as IT, advertising, building management, transportation, small construction, maintenance, and repair. For example, Company A (an advertisement company within Group B) earns most of its revenue by making advertisements for other companies of Group B. The price and other terms of each contract may be negotiated on an arms' length basis, but the large volume of stable business coming from its affiliate companies can serve as a great advantage to Company A that its competitors do not enjoy. In most cases, the controlling person for the entire Group B or his close relatives (usually sons and daughters) will have large stakes in Company A, the beneficiary of these "funnelling" practices. The plaintiffs of the HMC derivative suit attempted to challenge the "funnelling of business" practice based on a creative idea of importing the US corporate opportunity doctrine but failed. It is no wonder that the shareholder activists who organized this derivative suit felt a strong need for statutory grounds for the corporate opportunity doctrine.

2. Gwangju Shinsegae Case

Another well-known case on the corporate opportunity doctrine involved a local subsidiary of a department store. Shinsegae, the second largest department store operator in Korea, had a wholly-owned subsidiary (Gwangju Shinsegae, or "G-Shinsegae") which operated a department store in Gwangju, a city of 1.5 million residents in the southwestern part of Korea.[26] In 1998, G-Shinsegae made a rights issue (*pro rata* issuance of new shares to existing

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[24] This translation was used in H. KIM/S. LEE/S. M. WOODCOCK, Favoritism and Corporate Law: The Confused Corporate Opportunity Doctrine in the Hyundai Motor Case, 3 Michigan Journal of Private Equity & Venture Capital Law (2013) 51. It explains "Funneling of Business" as "the transfer of wealth to controlling shareholders and their many related persons by conglomerate's affiliates."

[25] According to the Korea Fair Trade Commission (press release dated 27 August 2015, available in Korean), intragroup revenues of the companies belonging to the 48 large business groups represented 12.4% of their total revenue. However, in the case of companies in which the sons or daughters of the controlling person have substantial stakes (above 20%, 30%, 50%, and up to 100%, respectively), the ratio of their intragroup revenue was notably high (11.2%, 19.5%, 42.7%, and 51.8, respectively). In short, the higher the ratio of stake owned by the sons and daughters of the controlling person, the higher the ratio of revenue earned from other affiliate companies.

[26] Shinsegae operates dozens of department stores nationwide, and most of them are branches while G-Shinsegae is a separate entity.

shareholders) to finance its operations, but the board of Shinsegae decided not to exercise its subscription rights because Shinsegae itself had been short of funds due to the Asian economic crisis at that time. Subsequently, the board of G-Shinsegae granted subscription rights to the son of the largest shareholder of Shinsegae (hereinafter, "S"). By exercising the right, S (who was also a board member of Shinsegae) held 83% of the shares of G-Shinsegae. Soon, the value of G-Shinsegae shares increased substantially, especially after it was listed in the stock exchange in 2002.

In 2008, the minority shareholders of Shinsegae, organized by a shareholders activist group, filed a derivative suit against the directors of Shinsegae including S. The plaintiffs presented multiple grounds for their allegation. First, by becoming a controlling shareholder of G-Shinsegae, S violated Art. 397 of the KCC which prohibits a director's competition with the company. Second, by acquiring new shares from G-Shinsegae, S violated Art. 398 regarding self-transaction because a transaction between G-Shinsegae and S is virtually a transaction between Shinsegae and S (a director of Shinsegae). Third, S misappropriated the corporate opportunity of Shinsegae in breach of the duties of loyalty. Here, the misappropriated "corporate opportunity" was an opportunity to acquire additional shares of G-Shinsegae, which had been waived by Shinsegae's board. As in the Glovis case, this trial took place before the legislation of Art. 397-2 of the KCC, which serves as the statutory grounds for the corporate opportunity doctrine.

In accordance with the trial and appellate courts,[27] the Supreme Court also rejected all three arguments.[28] It denied the existence of competition between S and Shinsegae even though S was a controlling shareholder of G-Shinsegae on the grounds that G-Shinsegae was an integral part or *de facto* branch of Shinsegae. It did not recognize the relevant transaction to be a self-dealing transaction which required board approval in accordance with Art. 398 of the KCC as the transaction had taken place between S and G-Shinsegae and not between S and Shinsegae, where S served as a director. With regards to the corporate opportunity claim, the Supreme Court recognized that the opportunity to subscribe new shares of G-Shinsegae (by exercising statutory preemptive rights by the existing shareholder) may constitute a corporate opportunity for Shinsegae. The court, however, respected the decision of Shinsegae's board of directors not to exercise subscription rights. Since the board had arrived at this decision after deliberation of the relevant facts, such as the unstable financial conditions of Shinsegae and the poor business prospects of G-Shinsegae at the time, the court held that the decision fell under the protection of the business judgment rule.

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[27] Seoul High Court, 16 June 2011, 2010Na70751.

[28] Supreme Court, 12 September 2013, 2011Da57869.

The Supreme Court ruled on this case after the legislation of Art. 397-2 of the KCC but could not apply it as the relevant facts had occurred prior to the legislation. However, the court recognized a director's duty not to misappropriate a corporate opportunity, based on general duty of loyalty by a director without applying Art. 397-2. Unlike the HMC board which did not review the possibility of making investments in Glovis, the Shinsegae board reviewed the possibility of making further investments in G-Shinsegae and weighed the pros and cons of such possible investments. This consideration created room for the business judgment defence, which made G-Shinsegae much easier case to defend than the Glovis case.[29]

IV. New Legislation

1. Art. 397-2 of the KCC

The KCC was amended on 14 April 2011 and came into force on 15 April 2012. It was by far the largest amendment since its initial enactment in 1962. The 2012 amendments sought, among other things, to impose enhanced and expanded fiduciary duty on corporate fiduciaries, including directors, especially in relation to "conflict of interest" cases: (i) self-dealing transactions, in which a director or other related persons enter into a transaction with the company, and (ii) usurpation of corporate opportunity, in which a director misappropriates a business opportunity that rightfully belongs to the company for his own benefit.[30] In order to address the second issue, Art. 397-2 of the KCC was newly added as follows:

Art. 397-2 of the KCC (Prohibition on Appropriation of Corporate Opportunity and Assets)

(1) A director shall not, without approval from the board of directors, use a company's business opportunity, which is or could be beneficial to the company and which falls under any of the following Items, for the benefit of himself or a third party. The approval of the board of directors shall require consent from not less than two-thirds of the directors.

(i) A business opportunity of which a director become aware (x) in the course of performing the director's duties or (y) through the use of the information belonging to the company; or

[29] These two cases are only the tip of the iceberg. Although there were many more suspicious affiliate transactions in large business groups in Korea, these two cases were selected as targets by the shareholders activists group who filed derivative suits.

[30] Various measures were taken to regulate "funnelling of business" and other types of intragroup transactions that cause conflicts of interests. For example, the Corporate Income Tax Law was amended to levy deemed income tax if there were too many intragroup transactions. The Korea Fair Trade Commission, the competition authority of Korea, regulated undue subsidy among affiliates. The legislation of the corporate opportunity doctrine was one such measure to address the problems of massive intragroup transactions.

(ii) A business opportunity that has close relation with a business in which the company is engaged or expects to engage.

(2) A director who causes damages to the company by violating Paragraph (1) and directors who approved shall be jointly and severally liable for the company's damages. Any gains of the director or the third party shall be presumed to be damages for the company.

2. *Notes on Art. 397-2 of the KCC*

a) *Scope of the Business Opportunity*

According to Art. 397-2 of the KCC, a business opportunity belongs to the company if the opportunity is actually or potentially profitable to the company and is either (i) a director became aware of it by use of corporate information or in the course of performing duties, or (ii) is closely related to the company's current or planned business. The definition of "corporate opportunity" pursuant to Art. 397-2 of the KCC is largely based on Sec. 5.05 (b) of the Principles of Corporate Governance of the American Law Institute (the "ALI Principles").[31] Since the definition provided in the ALI Principles was extracted from hundreds of US court cases throughout the 20th century, it is highly abstract and thus difficult to comprehend. To understand its functional significance as well as its doctrinal boundaries, one needs to revisit its purpose.

The purpose of the corporate opportunity doctrine is to avoid or minimize conflict-of-interest situations involving business opportunities. Such issues, which stem from the asymmetries of power and information between the fiduciaries and shareholders, become salient when (i) the corporation can utilize business opportunities more efficiently than the fiduciary, or (ii) the fiduciaries misuse their information and power in order to privately exploit business opportunities. This observation justifies and sheds light on how to interpret the key conceptual elements of corporate opportunity: (i) "business opportunity having a close relation with the corporate business" implies situations where the company may attain greater efficiency through leveraging the

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[31] (b) Definition of a Corporate Opportunity. For purposes of this Section, a corporate opportunity means:

(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:

(A) In connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or

(B) Through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or

(2) Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage.

opportunity than the fiduciaries, and (ii) a director "became aware" of the "opportunity by use of corporate information or in the course of performing duties" indicates situations with a high risk of abuse of the fiduciary's power and information. Existence of these elements justifies granting the company the right of first refusal to such business opportunities.

b) Typical Fact Patterns

Although the underlying policy of the doctrine provides some helpful insights in interpreting its key elements, the concept of the corporate opportunity itself is inevitably broad and hard to define. A comparative review also reveals that various types of fact patterns are loosely labeled as "usurpation of corporate opportunities" without doctrinal coherence. Thus, it would be meaningful to find out the typical fact patterns in which the corporate opportunity doctrine is often invoked.

Based on a review of the corporate opportunity cases in US, UK, Germany, and Korea, the fact patterns may be categorized into one of the following three types: horizontal, vertical, or conglomerate.[32] First, in the case of the horizontal cases, the business opportunity misappropriated by the fiduciary is in a horizontal relationship with the business of the company. Thus, if the fiduciary exploits the opportunity, he will be in competition with the company. Second, in the case of the vertical type, the business opportunity misappropriated by the fiduciary is in a vertical relationship with the business of the company. Hence, if the fiduciary exploits the opportunity, he is likely to be dealing with the company. Third, opportunities which are in neither horizontal nor vertical relationships with the business of the company may be named "conglomerate" fact patterns.

The Hypothetical 1 at the beginning of this paper is a typical example of the horizontal type, while Hypothetical 2 is a typical example of the vertical type. The G-Shinsegae case is horizontal because G-Shinsegae was arguably a potential competitor of Shinsegae. The Glovis case displays a vertical case because the opportunity led to the formation of a business, which became an enormous supplier to HMC.

In any event, it seems inevitable that a corporate opportunity will be quite easily found pursuant to the new provision, as corporate opportunities are defined in a quite broad manner.

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[32] Such categorization was first suggested in K. CHUN, *Gae-jeong-sang-beob-sang Hoesa-gihoe Yuyong Geum-ji Gyu-jeong-eui Hae-seok-ron Yeon-gu* [How to Interpret New Regulations on Usurpation of Corporate Opportunity pursuant to the Recent Amendment to the Korean Commercial Code], *Sang-sa-beob-yeon-gu* [Commercial Law Review] 30-2 (2011) 143.

c) Approval Requirements

Pursuant to Art. 397-2 of the KCC, if a certain business opportunity is deemed a corporate one, the director can only exploit that business opportunity after he presents it to the board and obtains board approval. A breach of this obligation could lead to civil liability and may constitute legal "cause" for dismissal from his directorship position as well. Furthermore, in some extreme cases, the prosecutor may decide to file criminal charges against the directors for a "criminal breach of trust" pursuant to the Korean Criminal Code.

The requirements for board approval are stricter than usual, as the director needs to obtain approval from at least two thirds of all directors in order to pursue a business opportunity that belongs to the company. In addition, interested directors are required to abstain from voting. It is debatable as to whether interested directors who cannot vote should be excluded when counting "all directors" (i.e., the denominator) for the purpose of the two-thirds requirement.

A decision regarding a corporate opportunity matter is substantially different from the approval of self-dealing transactions, as the board lacks reliable benchmarks such as a "fair market price" that may assist in making a decision regarding self-dealing. A decision on a corporate opportunity matter is in essence a business judgment as it requires a forecast and comparison of the anticipated benefits of the different scenarios from which the corporation may choose. Therefore, the board members who decided on a corporate opportunity matter should not be held liable in hindsight, but rather should be protected by a business judgment rule as long as they made the decision in good-faith based on reasonable information with appropriate levels of inquiry and without conflicts of interest. The purpose of this doctrine can be best attained when promoting disclosure to the board (in the case of listed companies, also public disclosure) of any dubious transactions, facilitating careful review by the board and also respecting the reasonable discretion of the board.

In order to limit overreaching scope of this provision, the board of directors should be allowed to use appropriate discretion in deciding whether to utilize or reject corporate opportunities. As Coase observed, a company may choose to expand its business or enter into contracts with other businesses, depending on the level of organizational and transactional costs. In this regard, the directors' business judgment with regards to whether to utilize or reject the opportunity should be respected to the extent that they made an informed decision in good faith after careful review of the relevant information and without conflicts of interest.

Therefore, if there is a possibility or suspicion that certain business opportunities may constitute valuable corporate opportunities, the relevant director should take a conservative approach by reporting the details of such opportunities as well as any relevant interests to the board of directors. The directors reviewing this matter should be provided with sufficient information and access to professional advice, and their decision on whether to take or reject such opportunities should be protected under the business judgment rule. Similarly, *ex post* ratification by the board of directors should be allowed in order to promote candid disclosure even after the event.

d) Remedy

In the US, a company may resort to constructive trust as remedy when a corporate opportunity is misappropriated. Therefore, the company may claim the earnings that the fiduciary obtained from the opportunity in violation of duty without a need to prove the amount of damages incurred by the company. In other words, the US follows a property rule rather than a liability rule. In Germany, the *Eintrittsrecht* is granted as remedy probably based on the similar underlying idea of constructive trust, in that gains obtained from a corporate opportunity belong to the company.

However, Art. 397-2 of the KCC did not declare the remedy in such a manner. Shareholders activists insisted on a constructive trust or other similar mechanisms for the disgorgement of profits, but they were confronted by fierce opposition. As a compromise, Art. 397-2 of the KCC adopted the complex idea of "presuming the gain of a director as damages to the company." It is similar to the position that Japanese corporate law adopted with regards to a director's obligation not to compete.[33]

Hence, misappropriation of corporate opportunity is remedied by monetary damages levied against directors. Considering that it would be very difficult to accurately calculate the amount of actual damages incurred by a company in relation to a director's appropriation of a corporate opportunity, Art. 397-2 of the KCC stipulates that the amount gained by the director or the relevant third party would be presumed to be the amount of damages incurred by the company. It is, however, a rebuttable presumption. If actual damages exceed gains, the company may claim the amount of actual damages. In this case, the burden of proof would lie on the plaintiff. If actual damages are smaller than the gains, the company's claims would be limited to the amount of actual damages, with the burden of proof in this case lying with the defendant.

V. Criticisms and Evaluation

1. Criticisms

As discussed above, the corporate opportunity doctrine was introduced into Korean law, first as a litigation strategy by the plaintiffs of certain high-

[33] Art. 423 *kaishaho* (Japanese Corporate Law).

profile derivative suits and later as an amendment to the statute. The purpose of the doctrine was to regulate and sanction directors and officers who attempted to seek private interests against the interests of their respective companies, especially through widespread practices such as the "funneling of business" as in the Glovis case or "son-buys-unsubscribed-shares" as in the G-Shinsegae case.

Not surprisingly, there has been fierce criticism against Art. 397-2 of the KCC since its initial draft was proposed by the Ministry of Justice in 2006. The most frequently raised criticism is that the definition of corporate opportunity is so broad and unclear that a company cannot determine with certainty whether any business opportunity falls under this definition. Thus, according to the criticism, the company and its directors are always at risk of violating law even if they try to exert their fiduciary duties and comply with the law in good faith. In order to be free from such risks, the companies would have to hold board meetings whenever there is the slightest doubt that corporate opportunities may exist, and such meetings would need substantial time and incur equally substantial costs. Other grounds for the argument that this provision is an excessive restriction include that: (i) few jurisdictions have statutory grounds for prohibiting the appropriation of corporate opportunities; (ii) provisions of the KCC with regards to the duty of care and the duty of loyalty are sufficient; (iii) the new law will suffocate the entrepreneurship of the directors and officers because their attempts to operate new businesses are highly likely to be deemed as violations of the Article.

On the other hand, more radical commentators criticize that the new provision falls far short of attaining its purpose. Their main complaint is that the controlling shareholders are out of reach of this provision. The controlling shareholders, in particular, the controlling minority shareholders of the listed companies that belong to large business groups, have sought private benefits through the appropriation of corporate opportunities in Korea. As such, according to the criticism, the controlling shareholders must be the main target of this doctrine, but Art. 397-2 of the KCC imposes obligations only on directors. Other grounds for the argument that this provisions is insufficient include that: (i) since the new provision gives too much authority to the board of directors, almost any exploitation of corporate opportunities is exempt from liability so long as the board of directors approves them; (ii) equitable remedy, such as constructive trust, is necessary because damage claims are insufficient as remedy.

2. *Comments on this Criticism*

With regards to the argument that the new provisions are too broad and unclear, we may remind ourselves that every core concept in corporate law is also broad and unclear, such as fiduciary duties, loyalty, due care, good faith, and fairness. This is because clear-cut rules cannot entirely replace the standards, especially as the norms of review as opposed to the norms of conduct.[34] The courts of various jurisdictions have struggled to provide more tangible tests and elements to make such unclear concepts and theories more foreseeable. Precedent cases have supplemented the declaratory provisions of the statutes, and the corporate opportunity doctrine will not be an exception.

It is true that the broad definition of corporate opportunity may increase the workload for the board of directors and that frequent board meetings may hinder efficient decision-making capabilities for the company. It is also true, however, that the board of directors or its subcommittee is the most suitable corporate organ to review and determine corporate opportunity matters, in terms of expertise, neutrality, and effectiveness. It is better to ask the board to determine this issue than convene a general shareholders meeting whenever there are any doubts of conflicting interests. It is also better to authorize the board to determine whether the company will take the opportunity ahead of the director rather than authorize the CEO to make the decision unilaterally.

The limiting effect of this doctrine is a legitimate concern. To minimize such concerns, once the corporate opportunity is reported to and duly reviewed by the board of directors, its decision should be respected and should not be challenged on hindsight. The Supreme Court decision of G-Shinsegae case was balanced in this respect.

It is questionable, as some scholars point out, whether such grounds in the statute were really necessary. The courts of the US, UK, Germany, and many other jurisdictions have recognized the corporate opportunity doctrine or somehow arrived at similar conclusions without any provisions such as Art. 397-2 of the KCC to be legislated within their corporate laws. We should note, however, that Korean courts have been quite conservative in applying such flexible concepts as duty of loyalty and still tend to abide by the black letter rules of the statute.[35] Even if the court had come up with some decisions on this matter, they would not be capable of functioning as "rules of conduct" due to the lack of clarity and the case-specific nature. Art. 397-2 of the KCC is also unclear, but it does provide a clear message that any doubtful business opportunities must be reported to the board first before any director personally pursues it.

Considering that the controversial transactions that had prompted this legislation (such as Glovis and G-Shinsegae) clearly served the private interests of the controlling minority shareholders, it is a pity that Art. 397-2 of the

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[34] See M. A. EISENBERG, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham Law Review (1993) 437 et seq.

[35] See K. KIM, The Role of Judges in Corporate Governance: the Korean Experience, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 125–127.

KCC targets only directors. Before further amendments to expand the scope of corporate opportunity doctrine to the controlling shareholders are made, Art. 401-2 of the KCC on the so-called *de facto* director should be actively invoked.[36]

In any event, Art. 397-2 of the KCC was a rare experiment that defined corporate opportunities in the statute and categorically demanded board review and approval. Although it has its problems and limitations that have been criticized by many commentators, its positive effects are expected to most likely dwarf its negative ones. After the legislation, corporate constituencies and the market have paid much more attention to any possible misappropriation of corporate opportunities. Lawyers and regulators advise companies to publicly disclose and report to the board of directors should there be any doubtful transactions or new launchings of businesses. "If in doubt, disclose"[37] became common advice in Korea as well. This alone has been meaningful progress. Hoping that it will contribute to restoring trust with regards to the governance of the large conglomerates in Korea, we are waiting to see more cases where this new provision is invoked.

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[36] In the 1998 revision, the KCC recognized the concept of a "de facto director" or "shadow director". So-called de facto directors shall be deemed to be the directors for the purpose of enforcing the director's liabilities (Art. 401-2). Pursuant to the KCC, de facto directors consist of three kinds of persons, one of which is "one who has given an order to a director by taking advantage of his influence on the company." A controlling shareholder who has influence over and gave an order to a director or management may be held liable as if he is a director. Art. 401-2, however, has been rarely applied since its adoption.

[37] J. ARMOUR, Corporate Opportunities: If in Doubt, Disclose (But How?), The Cambridge Law Journal 63 (2004) 33. Articles in earlier times also advised the same: J. C. SLAUGHTER, The Corporate Opportunity Doctrine, 18 Southwest Law Journal (1964) 104 ("It appears wise […] for an insider to disclose the business opportunity to his corporation before acquiring it personally if such acquisition raises the slightest inference of a corporate opportunity.")

Ordinary Corporate Conduct Standard vs. Business Judgment Rule

A Review of Case Rulings by Beijing Courts between 2005 and 2014

Jianbo Lou

I. Introduction

Director's general duties, as one of the core subjects of corporate governance, have been incorporated into the company law of more and more jurisdictions across the world. The 2005 amendments to the PRC Company Law[1] (herein

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[1] Company Law of the People's Republic of China, adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on 29 December 1993; amended for the first time in accordance with the Decision on Amending the Company

after referred to as "Company Law") introduced director's general statutory duties into Chinese company law for the first time. This amendment requires directors (together with supervisors and other senior management of the company, collectively referred to as "directors" hereinafter)[2] to bear the duties of loyalty and duty of diligence (care) to the company.[3]

In the 2005 amendments to the Company Law, it seems the legislator endeavoured to enhance both the powers and accountability of the directors. As a result, the directors have been given a central position in the operation of companies. The directors of the company have control over the companies' matters, and the shareholder's interests will depend on the diligence and contributions of the directors.[4] As such, whilst the Company Law is granting more powers and authorities to the directors, the law is also encouraging the directors to fulfil their responsibilities and obliging them to promote the best interests of the company. The general duties of directors are of significant value in this regard, and therefore have far-reaching social significance.[5]

Regarding the directors' general duties, the key issue is how to define the standard of the relevant duties, in particular, the duty of diligence. Unfortunately, the Company Law fails to prescribe detailed operative standard and/or guidance in relation to fulfilment of general duties, in particular, the duty of diligence. The lack of a statutory standard and guidance has caused issues in companies' operations and judicial practices. Theoretical studies in recent years have shed some light on the issue, and enriched our understanding of this subject. That said, most of the studies so far are based on theoretical

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Law of the People's Republic of China adopted at the 13th Session of the Standing Committee of the Ninth National People's Congress on 25 December 1999; amended for the second time in accordance with the Decision on Amending the Company Law of the People's Republic of China adopted at the 11th Session of the Standing Committee of the Tenth National People's Congress on 28 August 2004; Revised at 18th Session of the Standing Committee of the Tenth National People's Congress on 27 October 2005; and amended for the third time in accordance with the Decision on Amending Seven Laws Including the Marine Environment Protection Law of the People's Republic of China adopted at the Sixth Session of the Standing Committee of the 12th National People's Congress on 28 December 2013. Unless otherwise stated, the author refers to the Company Law after the 2013 revision.

[2] This is also true in many other jurisdictions. For the convenience of discussion, the author will not distinguish fiduciary duties of directors from those of other company officers.

[3] See Arts. 147–149 Company Law. The contents of those articles have remained the same ever since the 2005 amendments.

[4] See P. Z. GAN, 甘培忠:《公司控制权的正当行使》[The Due Exercise of Corporate Control] (Beijing 2006) 189.

[5] See K. T. CAO, 曹康泰: "2005 年 2 月 25 日在第十届全国人民代表大会常务委员会第十四次会议上关于《中华人民共和国公司法(修订草案)》的说明" [On the Amendments Draft of PRC Company Law, reported to the Standing Committee of NPC on the 25 February 2005]. CAO was then the Director of the Legal Affairs Office of the State Council.

analysis only (with reference to established common law and/or civil law practices) and have hardly looked into the judicial practices in China. On the other hand, the author has noted that Chinese courts have accumulated a significant number of cases regarding director's general duties since 2005, which are yet to be analysed.

As such, this paper aims to conduct a positivist study of the current judicial practice in China with regard to the standard of director's general duties. The author hopes to supplement the existing studies in this field by focusing on how a director's general duties are applied and developed through court proceedings in China. In light of the huge number of court cases across China,[6] this paper will take Beijing courts as examples to show how Chinese courts are interpreting and applying the rules of directors' general duties set forth in the Company Law by reviewing judgments handed down by Beijing courts during the period from 2005 to 2014.

This paper will be divided into three main parts:

In Part I, the author aims to summarise the relevant provisions of the Company Law on directors' general duties and argue that duties of loyalty and diligence in PRC company law are rooted in the fiduciary duties of Anglo-American law. The advantage of fiduciary duty is its flexibility. As in England and the US, the fiduciary duty in China is determined and implemented by the judiciary in accordance with the written law, potentially making a clear and concrete standard of directors' general duties in the Company Law unnecessary.

In Part II, the author will concentrate on the key factors required to establish a director's civil liability towards the company and its shareholders resulting from breaches of general duties. The author will also introduce the approach taken by Beijing courts through the review of relevant cases handled by the courts between 2005 and 2014. After a brief review of the key constituting elements of directors' liabilities, the author will focus on the judicial practice of Beijing courts in relation to the duty of diligence standard. It seems to the author that the Beijing courts have developed their own standard in terms of a director's duty of diligence, which the author has named the "Ordinary Corporate Conduct" (hereinafter referred to as "OCC") standard. The author will then elaborate the elements of this standard and how it is applied by Beijing courts.

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[6] There have been other empirical studies carried in China. See, e.g., T. S. ZHOU, 周天舒：“论董事勤勉义务的判断标准—基于浙江省两个案例的考察” [The Legal Standards of Directors' Duty of Diligence: Based on Two Case Studies in Zhejiang Province], Law Journal 2014, 93; J. WANG, 王军: “公司经营者忠实和勤勉义务诉讼研究——以 14 省、直辖市的 137 件判决书为样本” [On Actions against Directors or Officers for Breaching the Duty of Loyalty or the Duty of Care: An Empirical Study Based on 137 Cases from 14 Provinces in China], Northern Legal Science 2011, 24.

In Part III, the author will take the English law and US law as examples and analyse their respective judicial standard for the duty of care, and will then compare this to the OCC standard.

This paper will draw up a few concluding remarks and point out certain limitations and shortcomings of this study.

The Company Law provides for directors' duty of loyalty and diligence, while in the US and UK, the duty of diligence is often called duty of care. For convenience, the author will retain the term duty of diligence when referring to Chinese Company Law, but will use the term duty of care in comparative studies.

II. The Question Stated

1. Directors' General Duties Under Chinese Law

The concepts of company law and directors' duties are relatively new to the Chinese legal system. The concepts of "director" and "company" were rarely used in the legal context before the adoption of the Company Law in 1993, and there was no explicit legislation setting out directors' general duties until 2005. Nevertheless, the then applicable civil and commercial law imposed specific obligations and duties on directors. A good example might be Art. 59 of the Company Law as amended in 2004, which provides that "directors should comply with the articles of association, duly perform their duties, and promote the interests of the company". This 2004 Company Law further prohibited directors from, *inter alia,* accepting bribes or other unlawful income,[7] or having the company guarantee personal debts.[8] In hindsight, those provisions can be categorized as "duty of loyalty" under the current legislation.

The first legislation in relation to directors' general duties was introduced in 2005. Article 147 of the current Company Law (previously Art. 148 after the 2005 amendments) provides that "[t]he directors, supervisors and senior managers shall comply with laws, administrative regulations and the articles of association. They shall bear the obligations of loyalty and diligence to the company". As such, it seems the Chinese company law has followed the approach adopted by other jurisdictions and classified director's general duties into two categories, i.e., the duty of loyalty and the duty of diligence (which mirrors to the duty of care under common law system).[9]

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[7] See Art. 59 para. 2 Company Law (as revised in 2004).

[8] See Art. 60 para. 3 Company Law (as revised in 2004).

[9] See X. D. ZHAO, 赵旭东:《公司法》（第二版） [Company Law] (2nd ed. Beijing 2006) 408–411.

In terms of duty of loyalty, Art. 148 of the Company Law has a list of typical misconducts that are deemed to be in breach of the duty.[10] The legislation also included a catch-all provision to deal with any other act that is inconsistent with the duty of loyalty.

With respect to the duty of diligence, the Company Law does not take the same approach as that of duty of loyalty. It simply states that the director owes duty of diligence to the company.[11] In this regard, administrative rules and guidance have provided some reference. For instance, Art. 98 of the 2014 China Securities Regulatory Commission ("CSRC") Guidelines for Articles of Association of Chinese Listed Companies (the "Guidelines") provides more detailed rules setting out the scope of duty of diligence for listed companies. The Guidelines require the directors to apply the power granted by the company with care and diligence, and to ensure the operation of the business is in compliance with the laws, regulations and national policies. The Guidelines further require the directors to follow up with the status of management and operations of the company, to treat all shareholders equally, and to ensure that information publicly disclosed by the company is true, fair and transparent. These rules are helpful in understanding the scope of the duty of diligence, but the Guidelines only apply to listed companies.[12]

It is well accepted that the duty of diligence essentially requires the directors to exhibit a reasonable level of knowledge, skill and experience and to give due care to the business and operation of the company; directors failing

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[10] These include:

(1) misappropriating funds of the company;

(2) depositing the company's funds into an account in his own name or in any other individual's name;

(3) without the consent of the shareholders' meeting, shareholders' assembly or board of directors, loaning company funds to others or providing any guarantee to any other person using the company's property in violation of the articles of association;

(4) signing a contract or trading with this company by violating the articles of association or without the consent of the shareholders' meeting or shareholders' assembly;

(5) without the consent of the shareholders' meeting or the shareholders' assembly, seeking business opportunities for himself or any other person by taking advantages of his authority, or operating for himself or for any other person any like business of the company he works for;

(6) taking commissions on the transactions between others and this company into his own pocket; and

(7) disclosing the company's secrets without permit.

[11] See P. Z. GAN, 甘培忠：《企业与公司法学》（第 7 版）, [Enterprise and Corporate Law] (7th ed. Beijing 2014) 265.

[12] See X. S. XU/D. XU, 徐晓松、徐东: "我国《公司法》中信义义务的制度缺陷" [The Fiduciary Duty System Defect in Chinese Company Law], Journal of Tianjin Normal University (Social Science) 2015, 52.

to perform their duties diligently are liable to the company.[13] The written law, however, does not define standards on deciding whether directors have performed their duties diligently. It is proposed that legislature shall make up the loophole by setting up applicable standards of diligence.[14] But is that the right solution?

2. The Anglo-American Root of Directors' General Duties in PRC Company Law

The Anglo-American root of directors' general duties in PRC Company Law is well recognized, despite pervasive explicit statements that directors' duty of loyalty and diligence are based on fiduciary duty from both common law and civil law jurisdictions.[15]

In common law jurisdictions, directors' general duties are largely derived from the fiduciary relationship in equity, and have been developed at common law and in equity over centuries.[16] The application of the fiduciary relationship has gradually extended beyond the realms of trust, agency, partnership law into company law.[17] Over the years, the fiduciary relationship has become one of the core subjects of company law.[18]

Under English law, directors' duties traditionally fall into two main categories, including fiduciary duties of good faith and loyalty and the common law duties of skill and care.[19] Most recently, Sections 171–177 of the Companies Act 2006 of the United Kingdom codified existing common law and

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[13] See X. D. ZHAO (ed.), 赵旭东主编：《新公司法条文释解》，人民法院出版社 [Article by Article Interpretation of the 2005 Company Law] (Beijing 2005) 289.

[14] XU/XU, *supra* note 12, 52.

[15] A survey of literature on duty of loyalty and duty of diligence shows that most authors refer to the business judgment rule or English law in discussing the duty of diligence. See, e.g. ZHAO, *supra* note 9, 408–411.

[16] "For most purposes it is sufficient to say that directors occupy a fiduciary position and all the powers entrusted to them are only exercisable in this fiduciary capacity." F. B. PALMER, Palmer's Company Law, Vol. 1, (24th ed. London 1987) 924.

[17] See W. T. ALLEN, The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law, in: Hopt et al. (eds.), Comparative Corporate Governance: The State of the Art and Emerging Research (Oxford 1998) 314–316.

[18] For the evolution of directors' duties in common law jurisdiction, see, e.g., H. HUANG, 黄辉:《现代公司法比较研究：国际经验及对中国的启示》, 清华大学出版社 [Comparative Corporate Law: International Experiences and Swuggestions for China] (Beijing 2011) 188–190.

[19] It is well established in English case law that "[t]he directors are the mere trustees or agents of the company – trustees of the company's money and property – agents in the transactions which they enter into on behalf of the company." *G.E.Ry. v. Turner,* (1872) L.R. 8 Ch. 149, 152. That explains the dual characteristics of directors' duties under English law. Duties of skill and care are also argued to be duties of equity, HUANG, *supra* note 18, 194.

equitable duties of directors and set out seven general directors' duties including: (1) to act within powers, (2) to promote the success of the company, (3) to exercise independent judgment, (4) to exercise reasonable care, skill and diligence; (5) to avoid conflicts of interest; (6) not to accept benefits from third parties, and (7) to declare an interest in a proposed transaction or arrangement.[20]

In the US, the legal obligations of directors and officers have traditionally been divided into the categories of duty of care (which generally requires that a director pay attention, ask questions and act diligently in order to become and remain fully informed and to bring relevant information to the attention of other directors) and duty of loyalty (or duty of fair dealing, which generally requires that a director make decisions based on the corporation's best interest, and not on any personal interest).[21] Historically, as in England, "courts rather than legislatures have played the central role in shaping the law regarding the duty of care. In the past 25 years, however, over two-thirds of the states have enacted statutory provisions concerning the duty of care."[22]

3. *Why Case Review?*

Having determined the Anglo-American root of directors' general duties in PRC Company Law, it is worth examining their definition in the US and England.

Fiduciary duties may be thought of as judicially defined duties imposed upon one who agrees to accept broad legal power over property, pursuant to an undertaking to exercise that power for the benefit of another; or upon one who agrees to use information disclosed as part of a relationship of trust and dependency only for the benefit of the party disclosing the information.[23] Actually, even if there are written laws on directors' general duties, at least the duty of care remains largely judicially defined and implemented in both the US and UK It is well recognized in both jurisdictions that in terms of duty of care at least, the application of general legal standards must involve "subtle evaluations of specific facts and circumstances."[24]

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[20] It is impossible to treat these complex duties in detail here. Some of the directors' duties were previously uncodified, other such duties were imposed by the complex provisions of Part X of the Companies Act 1985.

[21] See The ALI, Principles of Corporate Governance: Analyses and Recommendations, Vol. 1 (Philadelphia 1994) 137.

[22] The ALI, *supra* note 21, 134.

[23] See R. FLANNAGAN, The Fiduciary Obligation, 9 Oxford Journal of Legal Studies (1989) 285.

[24] See The ALI, *supra* note 21, 134. Similar statement could be found in *Dovey v. Cory* ([1901] A.C., 477, 488), where Lord Macnaghten warned that "I don't think it desirable for any tribunal to do that which Parliament has abstained from doing – that is, to formulate precise rules for the guidance or embarrassment of business men in the conduct of business

In the US, it is recognized that

> "[t]he fiduciary duty to be appropriately attentive is inevitably captured *ex-ante* only in a statement of very great breadth. About the best that can be done with respect to an *ex-ante* articulation of a director's obligation to pay attention is to establish an obligation in broad, almost empty terms: reasonable care in the circumstances then present."[25]

The American Law Institute (ALI) recommends that Section 4.01 of ALI's Principles of Corporate Governance on duty of care and business judgement rule "might be better implemented by judicial decision than by legislative codification."[26]

In the UK, before listing directors' general duties, Sec. 170 para. 3 et seq. of the Companies Act 2006 provide that the statutory duties must be interpreted and applied in the same way as those common law rules and equitable principles, and regard must be had to those rules and principles in applying them. Sec. 174, together with Sections 171 (duty to act within power) and 173 (duty to exercise independent judgment), which lays down the standards for determining whether a director has fulfilled the duty of care, as reconfirmed by the English High Court in *Gregson v HAE Trustees Ltd and others*[27], merely codified the existing case law.

It is perhaps an optimal arrangement that the PRC Company Law remains vague and general in directors' duty of diligence, leaving room for courts to take into consideration particularities in each case.

4. Sources of Cases

To find out the position of Chinese courts in enforcing directors' general duties, the author surveyed cases tried in Beijing courts between 2005 and 2014. The cases reviewed come from two major sources. The first source, in respect of cases between 2005 and 2006, is provided by the High People's Court of Beijing as part of the research project of "Material Issues in the Implementation of New Company Law", a key research project funded by the High People's Court of Beijing in 2007. The author was a member of the research team for this project, and focused on the judicial standard of director's general duties under the Company Law. During the course of this research, the High People's Court of Beijing provided the research team with approximately 2000 judgments made by the Beijing courts between 2005 and 2006. The author found out about 40 cases which are directly relevant to

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affairs. There never has been and I think there never will be much difficulty in dealing with any particular case on its own facts and circumstances; and, speaking for myself, I rather doubt the wisdom of attempting to do more."

25 See ALLEN, *supra* note 17, 317.

26 See The ALI, *supra* note 21, 141.

27 See The High Court of Justice Chancery Division, 8 May 2008, [2008] EWHC (Ch) 1006.

claims based on breach of director's general duties (including both duty of loyalty and diligence).

The second source of cases is from the online database – PKU Law (<http://www.pkulaw.com>), which is an online database maintained by Chinalawinfo Co., Ltd. and Peking University Centre for Legal Information. This database collects and analyses judgements published by courts across China. The author searched the cases on this database following the route "PKU Law" – "judicial cases" – "cases and judgments" – "civil cases" – "civil cases relating to company, securities, insurance and notes" – "corporate disputes" – "disputes for damages to companies' interests" – "Beijing courts". The author selected the period between 1 January 2006 (the date on which the 2005 amendments to the Company Law took effect) and 31 December 2014. There are 114 cases satisfying the criteria referred to above. Again, those not immediately relevant to the topic were excluded.

From those cases valid for the research, the author's preliminary findings were that: (1) Among more than 100 cases in total concerning directors' general duties, only 18 are about duty of diligence (including those involving both duty of diligence and duty of loyalty). This is probably resulting from the fact that the Company Law does not specify the standard for duty of diligence, and therefore it might be more difficult to file a duty of diligence case. (2) The Company Law differentiates between limited liability companies from joint stock companies in terms of size, shareholding, governing structure, etc. Looking at the type of companies involved, however, almost all companies in those cases are limited liability companies. That is possibly due to the fact that most joint stock companies are listed in stock exchanges and have better governance structure, or because of the harsh administrative investigation and punishment of CSRC against unlawful conduct by companies or their directors.

III. Position of Beijing Courts Regarding Directors' General Duties

In practice, the vast majority of the disputes against directors for breach of general duties are resolved through negotiations between the company (or shareholder(s)) and the relevant director without involving formal court proceedings. That said, the author has observed from the survey that, since the amendments to the Company Law back in 2005, there has been an increase in civil litigation against directors for breach of general duties. From the cases reviewed, the author has seen the efforts made by Beijing courts to explore and establish judicial standards regarding general duties of directors, which have provided invaluable references supplementing and clarifying the vague legislative rules.

1. Key Elements of Directors' Civil Liabilities for Breach of General Duties

According to Art. 149 of the Company Law, the company (acting by non-interested director) is entitled to bring a case against the relevant director and claim for damages "if he violates laws, administrative regulations or the articles of association during the course of performing his duties and caused loss to the company". Article 151 (derivative litigation) further entitles shareholders (who, individually or collectively, hold more than 1% of the entire share capital for a continuous period of more than 180 days) to instigate derivative actions where the company refuses to take action against the relevant director.

Cases filed on the basis of Art. 149 of the Company Law are regarded as torts cases. For instance, in *Beijing Ziqiao Real Estate Ltd. v Xiangciquan*[28], the company (as claimant) claimed for damages resulting from director's (as defendant) breach of fiduciary duties. The court commented that, in this case, the first element of a claim for tort liabilities is damages. The courts also repeated this approach in a number of other cases in relation to breach of directors' general duties. It is worth noting that in most cases the company and the relevant director may have contractual relationship (for instance, by way of terms of employment or any company policies that are (or deemed to be) incorporated into the terms of employment). In those cases, the relevant company may have a separate case of action based on breach of contract. However, in such cases the claim will be for a breach of the employment contract rather than breach of a director's general duties, and consequently, the elements of the liability and scope of compensation would be materially different.

Similarly, the shareholders in derivative actions (i.e., filing the case under Art. 151 of the Company Law) are normally suing the relevant directors for tort liabilities (since the relevant shareholder is effectively standing in the shoes of the Company). The shareholders may also have an independent claim for breach of contract if there is a contractual relationship between the shareholder and the relevant director (for instance, by way of a shareholder agreement to which the director is a party. In such a scenario however, the relevant director may act in its capacity as shareholder rather a director of the company).

According to Art. 149 of the Company Law, for the court to make a finding of director's liability for breach of general statutory duties, the claimant needs to prove the following five key elements, i.e.: (1) breach of general duties; (2) fault on the part of the individual; (3) damages to the company; and (4) causation between the breach and the damage.

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[28] See (2006) 一中民初字第 05884 号, Yi Zhong Min Chu Zi, 13 September 2006, No. 05884.

In practice, the key issue is how to determine whether or not, and to what extent, the director has breached statutory general duties. The author will look into this issue in subsections 2 and 3 below.

Regarding the fault element, the Beijing courts have clearly referred to the director's fault as one of the key elements establishing the liabilities. For instance, in *Beijing Fanfei Ltd v Karol Martini and Leonardo Martini,*[29] the court stated that the company (as claimant) should submit sufficient evidences that the relevant director failed to perform their duties. Unfortunately, however, in most cases that the author has reviewed, the courts did not specify whether the "fault" should be intentional or negligent, and if the latter, whether gross negligence is required. In most cases, the court referred to general descriptions such as "deliberate fault", "subjective fault" or "bad faith" when discussing fault. Therefore, there appears to be no unified standard in relation to fault. The author believes that the court did not look into the details in most cases because the presumed fault was a result of the breach of general duties. But clearly, this is an area that needs to be reviewed in greater detail in the future.

Damage is another common issue in determining directors' liability. Chinese law allows the courts to provide injunctive relief (for instance, to confirm a particular act of the faulty director is invalid) in certain cases. But more importantly, the damaged companies or shareholders would also expect to recover their losses in most cases. In this regard, the Company Law has provided that the liable director shall be responsible for compensatory damages, *i.e.*, using damage to place the company in the same position as if the breach of duty had not taken place. However, most cases the author has seen did not involve a complex calculation of damages. The courts normally determine damages based on the actual damage incurred whilst also considering other causal factors. As such, it is still unclear whether consequential damages are recoverable.

Causation is also expressly discussed by the court in some cases. The author has noticed that the courts seemed to apply broad descriptions in this regard, such as "there is no definitive relationship", "not the sole reason", "no immediate relationship", "cannot exclude" and "lead to". In the majority of cases reviewed, the courts rejected claims on the basis that there is no causation between the directors' misconduct and the damages. The limited analysis of the courts seems to suggest that the courts require immediate (or direct) causation between the breach of duties and the damages. The author believes that it is either due to the fact that the causation element in most cases is so obvious or that the relevant parties recognise/acknowledge the causation element. Nevertheless, the author believes the direct causation requirement is

[29] See (2005) 二中民初字第 16126 号, Er Zhong Min Chu Zi, 20 December 2005, No. 16126.

not entirely appropriate in all cases, and the court should take a broader view of causation and the "but for" test would be an appropriate standard provided that the breach and the damage are not too remote.

2. The Court's Practices Regarding Standard of Duty of Diligence

The duty of diligence essentially requires directors to exhibit a reasonable level of knowledge, skill and experience and to give reasonable care to the business and operation of the company. But more importantly, this duty is also about setting out a practical standard to determine whether directors have performed their diligence in a business decision-making process. From the judgments of Beijing courts, it appears that at least Beijing courts have adopted an objective standard in determining a director's duty of diligence, demonstrated in the cases discussed in the following paragraphs.

The first case is *Zhang Guizhi v Baiweiping*[30] where Zhang Guizhi (in his capacity as shareholder of the company) sued the defendant director (also the general manager of the company) for selling company's products at unreasonably low prices, resulting in damages for the company. The court ruled that the defendant, as the manager and legal representative of the company, has the power to manage the daily business of the company. The trading activity under discussion was within the scope of the company's normal business. Consequently, the defendant's agreement to such a sale is within his power and is not in breach of any law, regulation or the company's articles of association. The court therefore rejected the claimant's claim. In this case, the court took the view that the director (as manager of the company) had the power to contract on behalf of the company pursuant to the law, regulations and the company's articles of association. The court did not look into whether the commercial terms (such as the pricing) were reasonable. The substance of the director's conduct did not seem to be a concern of the court. The court did not look into the difference between the contracting price and the then market price, nor did the court try to find out whether the defendant had exhibited due diligence when entering into the contract (in an attempt to get the best price possible).

In a similar case decided by another Beijing court – *Zhou Jianping v Zhou Pincheng,*[31] the claimant (as shareholder of the company) claimed that the defendant sold the assets of the company at a significantly undervalued price. The court pointed out that the sale of assets was within the defendant's authorization. In other words, the court took the position that the defendant, as legal representative of the company, should have the power to make the deci-

[30] See (2006) 丰民初字第 05144 号, Feng Min Chu Zi, 10 March 2006, No. 05144.
[31] See (2006) 年大民初字第 03036 号, Da Min Chu Zi, October 2006, No. 03036.

sion to sell company assets. Again, the court did not look at whether the defendant had exhibited his skill and experience when negotiating the deal.

Another example is *Beijing Xinke Yuntong Info Ltd v Fang Qing and others.*[32] In that case, one of the claimant's arguments were that the defendants (as directors) had breached their duty of diligence by way of withholding the company seal and important documents, dismissing the employees and closing the office of the company. As a result, the company stopped operation completely. The court stated in the judgment that the actions taken by the defendants were corporate conductof the company, and therefore dismissed the claimant's case. It can be seen that the court used the concept of "corporate conduct" in its judgment and concluded that the director's actions were not in breach of the duty of diligence. It is somewhat ambiguous as to what constitutes a "corporate conduct", but it seems that the court was implying that the defendants, as directors, had the power to manage the business of the company. The dismissal of employees and withholding of the company seal were part of the director's power and hence fell into the scope of "corporate conduct". The court did not look at the rationales behind the dismissal of employees or the shutdown of the office in this case. As such, it seems that the court focuses more on the formal aspects rather than the substance. In hindsight, it remains arguable whether the conduct of the relevant director does indeed fall into their scope of power in the particular circumstance, which the court did not elaborate in the judgment.

The Beijing court also looked at another slightly different scenario in *Beijing Ziqiao Real Estate Ltd. v Xiangciquan,*[33] where the company sued the director for waiving the company's rights of claim and claimed for consequent damages. In the judgment, the court confirmed that the defendant (as director) had authority to grant the waiver on behalf of the company, but that the decision should be in the best interests of the company. So again, the court focused on whether the director acted within the power granted to him. However, it is worth noting that the court also mentioned in the judgment that the directors should act in the best interests of the company.

From the cases reviewed so far, it seems that, when looking at whether the directors have exhibited their duty of diligence, the Beijing courts generally do not look into the merit or substance of the decision or the decision-making process, but rather tend to focus on whether relevant directors are acting within their authority. The author names this approach the OCC (Ordinary Corporate Conduct) standard. For the purposes of this paper, the OCC refers to the standard applied by Beijing courts to determine whether there is a breach of director's duty of diligence. In such cases, the Beijing courts look

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[32] See (2005) 东民初字第 7170V, Dong Min Chu Zi, 10 March 2006, No. 7170.

[33] See (2006) 一中民初字第 05884 号, Yi Zhong Min Chu Zi, 13 September 2006, No. 05884.

at the formality of the director's behaviour – if the director is acting within the power granted to him (express or implied in law, regulation or articles of association), then the court will generally recognise that the director has fulfilled his duty of diligence. The court will not typically look at the substance of the director's behaviour unless the claimant (the company or the shareholder) can prove to the court that the director has failed to meet the OCC standard.

The key elements of the OCC standard include the following three aspects:

– The director has conducted management activities. Management activities include those entered into by the director in the ordinary course of business. The scope of such activities ranges from contracting to business strategy and decision making.
– The director has the power to deal with the relevant matter according to laws, regulations and the company's articles of association. This is the key component of the OCC standard, which requires the director to act within the power granted to him by law, regulation and the company's articles of association. The director is protected by the OCC standard when they satisfy this element. From the cases reviewed, it seems the court recognises both general authorisations and specific authorisations in respect to a particular matter. The company or the relevant shareholder, as claimant, shall be responsible to prove that the director in question was not duly authorised to conduct the management activities.
– The director's activities should be in the best interests of the company. This has been mentioned by the Beijing courts. Nevertheless, this element is particularly important as it is essentially the main purpose of setting up director's general duties. It seems to the author, however, that the court would normally presume that the director's behaviour is in the best interests of the company unless proved to the contrary.

3. The Courts' Position Regarding Duty of Loyalty

From the judgments made by Beijing courts between 2005 and 2014, it is clear that the negative-list approach in article 148 of the Company Law is helpful for the courts to identify the breach of the duty of loyalty. Most cases identified by the author involve misapplication of company funds, inappropriate waiver of company rights, or acting in personal self-interest in the company's business. It might be safe to state that most, if not all, claims for breach of duty of loyalty fall under the scope of the misconduct listed in the Company Law one way or another. It seems to the author that Beijing courts have not had many difficulties in determining breach of duty of loyalty cases. This might also be true nationwide.[34]

[34] See e.g., discussion on duty of loyalty in J. WANG, *supra* note 6, 24.

IV. OCC Standard from a Comparative Law Perspective

1. The Two-Part Test in UK and US

a) English Law

The common law duty of skill and care has a long history under English law. Traditionally, the English courts only require directors to exercise such skill as they possess and such care and diligence as would be displayed by a reasonable man in the circumstances (i.e., non-professional agent test).[35] As summarized by Romer J. in Re City Equitable Fire Insurance Co.,[36]

> "[t]here are, in addition, one or two other general propositions that seem to be warranted by the reported cases: (1) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. […] (2) A director is not bound to give continuous attention to the affairs of his company. His duties are of an intermittent nature to be performed at periodical board meetings; and at meetings of any committee of the board upon which he happens to be placed. […] (3) In respect of all duties that having regard to the exigencies of business, and the articles of association, may properly be left to some other officials, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly."

More recently, English courts have however held that the common law standard should mirror the tests laid down in Section 214 of the Insolvency Act 1986, which included an objective assessment of a director's conduct. In *Norman v Theodore Goddard,*[37] a two-part test is applied to determine whether the director has exhibited proper care and skill: (i) a *de minimis*, objective test – which required the reasonable director to carry out the specific functions for which they are responsible, and (ii) a subjective test – whether, considering the experience, skill and knowledge that the individual director has, they have fallen below a certain standard in their conduct.

The Companies Act 2006 codified the two-part test in Sec. 174. Accordingly, a director must exercise the care, skill and diligence which would be exercised by a reasonably diligent person with both (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (ii) the general knowledge, skill and experience that the director actually has. In other words, at a minimum, a director must display the knowledge, skill and experience set out in the objective test, but where a director has specialist knowledge, the higher subjective standard must be met.

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[35] PALMER, *supra* note 16, 924.
[36] See Court of Appeal, 11 July 1924, [1925] 1 Ch. 407, 427.
[37] See The High Court of Justice Chancery Division, 10 July 1991, [1992] BCC 14.

b) US Law

Under US law, a director must perform the duty of care when making decisions or acting on behalf of the company. Historically, courts in the US have not applied duties of care standards harshly and relatively few cases have imposed personal liabilities for damages.[38] Most states have codified the duty of care, generally requiring a director to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management.[39] The judiciary, however, still plays a significant role in defining and implementing duty of care. According to ALI, the duty of care concept, as expressed in statutes and cases[40] states that

> "A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[41]

As in the UK, duty of care in the US has both objective and subjective aspects. As W. T. ALLEN rightly pointed out that the practice of Anglo-American corporate law, observable in the 19th century and earlier 20th century cases, was to announce an objective standard of attentiveness but enforcing a subjective standard.[42] Sec. 4.01 (a) of ALI *Principles of Corporate Governance* also contains both objective and subjective aspects. The Section states that a director or officer must act with the "care that an ordinary prudent person would reasonably be expected to exercise." "Ordinary prudent person" conveys the image of a generalist who has the capacity to perform a given corporate assignment.[43] Without requiring special skills or expertise in the field, the ALI actually proposes an objective test. The ALI, however, doesn't exclude the subjective test. The terms "good faith", "reasonably believes", and "like position" in the Section

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[38] See The ALI, *supra* note 21, 136.

[39] See The ALI, *supra* note 21, 137.

[40] ALI claims that Section 4.01 (a) is consistent with the duty of care standards articulated in most jurisdictions. Almost all current duty of care formulations consist solely of the type of broad standard set forth in subsection (a), except in some state, case law recognizes an "inquiry obligation". The ALI, *supra* note 21, 140. Although a wide array of duty of care formulations have been propounded by courts and legislatures, it is believed that in most states, in a given case, the same legal result would be reached under each of these formulations. The ALI, *supra* note 21, 145.

[41] See Sec. 4.01 (a), The ALI, *supra* note 21, 137.

[42] See ALLEN, *supra* note 17, 312: "[T]he Anglo-American corporation law up through the middle part of the 20th century announced an 'objective reasonable person' standard of care for corporate directors, but when personal liability was at stake, it enforced a different rule."

[43] See The ALI, *supra* note 21, 148.

"recognize that in determining whether reasonable care has been exercised, the special skills, background, or expertise of a director or officer are properly accorded weight. Special skills (e.g., in engineering, accounting, or law) may, for example, alert a director to a significant corporate problem before other directors would recognize it. Such a director, being obliged to act in the best interests of the corporation, cannot reasonably ignore this knowledge."[44]

2. *Business Judgement Rule*

Section 4.01 of ALI Principles of Corporate Governance subjects both the objective and subjective tests to business judgment rules.[45] Accordingly, a director or officer who makes a business judgment in good faith fulfils the duty of care if the director or officer:

"(1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believe that the business judgment is in the best interests of the corporation."[46]

The business judgment rule is in the line with the earlier case practices of applying subjective test whenever personal liabilities for damages are imposed. Business judgement often involves risks and damages to the company, rendering directors more likely to be liable for damages. "The business judgment rule (set forth in § 4.01(c)) is a judicial gloss on duty of care standards that sharply reduces exposure to liabilities."[47]

The relationships between duty of care and business judgment rule might be summarized in the following three perspectives:

First of all, the business judgment rule gives the directors more discretion in making business judgments.

"It is recognized that the word 'rational,' has a close etymological tie to the word 'reasonable' and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase 'rationally believes' is intended to permit a significantly wider range of discretion than the term 'reasonable,' and to give a director or officer a safe harbour from liability for business judgments that might arguably fall outside the term 'reasonable' but are not so removed from the realm of reason when made that liability should be incurred."[48]

Secondly, while duty of care applies when a director or officer is performing the director's or officer's functions, the business judgment rule only grants

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[44] See The ALI, *supra* note 21, 152.

[45] See Section 4.01 reads as follows: "This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable."

[46] See Section 4.01 (c), ALI Principles of Corporate Governance. The ALI, *supra* note 21, 137.

[47] See The ALI, *supra* note 21, 141

[48] See The ALI, *supra* note 21, 142.

protection to directors or officers who are making commercial decisions: "Most business judgment cases deal with 'risky' or 'economic' decisions".[49] The Principles go on to say that "There are, however, cases that apply the business judgment rule to such matters as compensation and the termination of litigation,"[50] and "similarly, various 'preparatory decisions' to the making of a business decision would also be protected by the business judgment rule."[51] In summary, in addition to "risky" or "economic" decisions, the business judgment rule

> "also affords protection to directors or officers who make a wide variety decisions running from the selection and removal of personnel, through the setting of strategic and policy goals, to the apportionment of responsibilities between the board and senior executives."[52]

No matter how broadly we define business judgment, however, the applicable scope of the business judgment rule cannot be as broad as the duty of care. According to ALI, the word "function" is used to include the powers exercised by, and to delineate the corporate tasks that are to be performed by, a corporate body (e.g., the board of directors) or by an individual (e.g., a director).[53] Accordingly, the functions of a director specifically prescribed by the corporation law of a state (e.g., the declaration of dividends or the redemption of stock) and the functions inherent in the director's office constitute basic sources of a director's obligations for duty of care.[54]

> "Additional functions and obligations may be imposed by special legislative provisions (often found in statutes regulating financial institutions) requiring, for example, directors to follow a stipulated process in declaring dividends or requiring a specified number of regular meetings for the boards of banks or insurance companies."[55]

Moreover, the corporation itself is often a primary source of the functions imposed on directors and officers.[56] Last but not least, a director or officer may also take on additional functions by voluntary contractual agreements, or other arrangements, with a corporation.[57] ALI specially emphasizes that the "duty" and "function" components of the duty of care provisions are both flexible and dynamic concepts, and shall be interpreted for different directors at different time.[58]

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[49] See The ALI, *supra* note 21, 173.
[50] See The ALI, *supra* note 21, 173.
[51] See The ALI, *supra* note 21, 174.
[52] See The ALI, *supra* note 21, 174.
[53] See The ALI, *supra* note 21, 145.
[54] See The ALI, *supra* note 21, 145–146.
[55] See The ALI, *supra* note 21, 146.
[56] See The ALI, *supra* note 21, 146.
[57] See The ALI, *supra* note 21, 146.
[58] See The ALI, *supra* note 21, 146–147.

Thirdly, even for business judgment, it is not necessary for directors or officers to be protected by the business judgment rule. According to ALI, duty of care can interact with the business judgment rule in the following ways:[59] (1) If a director or officer has complied with the business judgment criteria with respect to a business judgment, the director or officer will be free of liability of duty of care. (2) A director or officer not acting in good faith or with disinterest or with a lack of information with respect to business decisions cannot enjoy the protection of the business judgment rule and shall be judged under the duty of care standard. (3) A director or officer who has made an irrational decision will also have to meet the higher standard of duty of care, rather than business judgment rule.

3. OCC vs. Business Judgment Rule

It seems to the author that the OCC standard developed by Beijing courts has something in common with the business judgment rule defined by ALI: (1) both standards tend to grant protection to directors; (2) both standards are defined and implemented by the judiciary; and (3) both standards presume that directors' actions are appropriate in normal circumstances.

The name of both standards indicates the intention of business-and-director-protection. In the US, it is well recognized that "the business judgment rule has offered a safe harbour for directors or officers who make honest, informed business decisions that they rationally believe are in the best interest of their corporations."[60] In China, commentators are proposing adopting the Chinese version of the business judgment rule so as to avoid discouraging directors from performing their duties.[61] The OCC is obviously a development in this direction.

Both standards have been developed through judicial practice. There is no doubt that OCC is a judicially developed test in China. In the US, "[t]here are no statutory formulations of the business judgment rule. The business judgment rule has been developed by courts and is well established in the case law."[62]

The presumption is evidenced by the allocation of burden of proof. As mentioned previously, in China, a successful damages claim must prove (1) directors' breach of general duties, (2) fault, (3) damages to the company, and (4) causation between the breach and the damage. In the US, "[t]he business judgment rule has often been stated as a 'presumption' that directors or

[59] See The ALI, *supra* note 21, 142.

[60] See The ALI, *supra* note 21, 173.

[61] See, e.g., X. XU / Z. R. YANG, 徐晓、杨宗仁："论董事义务与商业裁判规则"，《法制与社会发展》 [On Directors' Duties and Business judgment rule], Law and Social Development 2001, 38.

[62] See The ALI, *supra* note 21, 173.

officers have acted properly."[63] According to Sec. 4.01(c) of ALI Principles of Corporate Governance, a person challenging the conduct of director or officer under Section 4.01 (duty of care of directors and officers; the business judgment rule)

"has the burden of proving a breach of duty of care, including the inapplicability of the provisions as the fulfilment of duty under subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation."

The OCC, however, is different from the business judgment rule in many ways.

First of all, the constituting elements of OCC are different from those of business judgment rule. Both the OCC standard and the business judgment rule are based on the assumption that director's behaviours are normally appropriate provided that the directors are acting within the powers granted to them and in good faith. The presumption under OCC, however, carries almost no other qualifications, while the business judgement rule only applies when all the three conditions are met, in particular that the directors are properly informed, and rationally believe that the decision in the best interest of the company.

Secondly, the business judgment rule doesn't apply to directors' duty of care generally, while the OCC standard is generally applied in determining whether directors' have performed their duty of care. Section 4.01 of ALI Principle of Corporate Governance comprises three subsections, with subsection (c) on business judgment rule. It is clear from the wording of Sec. 4.01 that while a director will have a duty or care to the corporation to perform his/her functions, the business judgment rule only grants protection to director who makes a business judgement. The Beijing courts, however, make no distinction between business judgment and other functions of a director.

4. OCC vs. Duty of Care

The OCC is also different from the duty of care in common law jurisdiction. As previously discussed, duty of care in both England and US contains two-part test, namely, an objective test and a subjective test. At least in the cases the author reviewed, however, the OCC does not consider the special skill of the director, or the special circumstances of the case.[64]

[63] See The ALI, *supra* note 21, 173.

[64] The lack of subjective test has been noticed by some other Chinese scholars. See, e.g., S. W. ZHAO, 赵树文:"董事信义义务的立法与修订" [The Legislation and Amendment of the Fiduciary Duties of Directors], Theoretical Exploration 2012, No. 1, 143.

V. Conclusion

After reviewing cases decided by Beijing courts and comparative studies, the author has come up with the following findings:

Firstly, in terms of the practical standard for director's general duties, especially the duty of care, it is impractical and unnecessary to rely entirely on legislation. Instead, it should only give sufficient guidance for the judges to refer to, while leaving the necessary flexibility for judges to exercise their discretion in the trial.

Secondly, the OCC developed by Beijing courts shares similarities with the prevailing business judgment rule developed by US case law, in terms of the presumption of propriety and the protection granted to directors. However, the OCC standard is much more broadly and less strictly applied than the business judgment rule. The Beijing courts make no distinction between "functions" of directors' and business judgment by directors; moreover, the presumption of the OCC bears no qualifications. The OCC is also different from the general duty of care in that it doesn't require both objective and subjective tests.

By pointing out the differences, the author has no intention to criticize Beijing courts for not developing a more subtle standard. First of all, the OCC standard not only reflects the courts' desire to avoid risk (as a civil law jurisdiction, judges are not supposed to have too much discretion), but also shows the courts' respect for the business practices, which is an inevitable choice for the court when looking into complicated business practices. In other words, the Beijing courts are doing the right thing by refrain from substantially reviewing the business decisions of a company. Secondly, unlike in England and the US, where fiduciary duty can be traced back hundreds of years, there is no such concept of fiduciary duty in the history of Chinese law. In other words, fiduciary duty or the duty of diligence is completely alien to the Chinese legal system. It will take time for China to develop a more subtle, better criteria for the duty of diligence. Thirdly, there has been a misreading of the relationship between duty of care and business judgment rule in China. In the US at least, the business judgment rule is not the whole of the duty of care, but a safer harbour for directors who make business judgment. The OCC developed by Beijing courts, however, seems to be the standard for a general duty of diligence, partially because at least some Chinese commentators take the same view. In at least one of the first round of literature studying the US business judgment rule, the Chinese author states that business judgment rule has been developed by the US courts to determining whether or not directors have exhibited their duty of care in the performance of director's duties.[65]

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[65] See D. DING, 丁丁:《商业判断规则研究》[Study on Business Judgment Rules] (Changchun 2005) 10–50.

The findings in this paper, however, are only based on a small number of cases decided by Beijing courts. In other words, the OCC is only a summary of the practice in Beijing. Moreover, almost all the cases reviewed by the author in the paper involved limited liability companies. That also tones down the significance of the finding. The author is expecting to see more research on cases nationwide, in particular, cases on joint stock companies in China.

Directors' Liability and Enforcement Mechanisms from the German Perspective

General Structure and Key Issues

Hans Christoph Grigoleit

I. Introductory Remarks

The issue of directors' liability has been at the center of the German discourse in corporate law for some time – both politically and academically. There have been efforts at legislative reform,[1] some very significant court rulings[2] and a torrent of legal writing.[3] Hence, it did not come as a surprise

[1] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), 22 September 2005, BGBl. I, 2802 (among others, introduction of the *business judgment rule*); Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG), 23 October 2008, BGBl. I, 2026 (stricter liability for payments to shareholders); Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG), 31 July 2009, BGBl. I, 2509 (limits on the corporation's ability to buy D&O insurance on behalf of its directors); Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Einrichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz), 9 December 2010, BGBl. I, 1900 (extension of the limitation period to ten years).

[2] BGH, 21 April 1997, II ZR 175/95, BGHZ 135, 244 – *ARAG/Garmenbeck*; BGH, 21 December 2005, 3 StR 470/04, BGHSt 50, 331 – *Mannesmann* (from the perspective of criminal law); BGH, 10 July 2012, VI ZR 341/10, BGHZ 194, 26; BGH, 8 July 2014, II

that directors' liability was chosen as one of the topics to be analyzed, discussed and voted on at the biannual German Jurists' Conference *(Deutscher Juristentag)* of 2015.[4]

Traditionally, the discussion in Germany has – presumably like anywhere else – oscillated between two conflicting objectives: On the one hand and most obviously, directors' liability serves to achieve effective protection for the corporation against losses caused by directors' faults and wrongdoing.[5] On the other hand, it is common ground that the rules pertaining to directors' liability must preserve the incentive to incur reasonable risk (i.e., directors' liability must avoid over-deterrence by (potentially) overloading directors with ruinous liability).[6]

Recently, a third and rather remarkable dimension has evolved and received significant attention, in particular since the financial crisis: the goal of protecting the public legal order. This overriding principle may even be given priority over the corporation's financial interests through the doctrinal vehicle of the so-called "duty of legality".[7]

The number of questions that are raised by directors' liability far exceed the scope of this paper. Hence, I would like to focus on two targets: first, on presenting and explaining the general structure of the German rules of directors' liability and, second, on sketching and discussing some issues that are particularly contentious currently.

ZR 174/13, BGHZ 202, 26; LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345 – *Siemens/Neubürger*.

[3] E.g., H. FLEISCHER, in: Spindler/Stilz AktG, 3rd ed. 2015, § 93 marg. nos. 1 et seqq.; K HOPT/M. ROTH, in: Großkommentar AktG, 5th ed. 2015, § 93 marg. nos. 1 et seqq.; G. SPINDLER, in: Münchener Kommentar zum AktG, 4th ed. 2014, § 93 marg. nos. 1 et seqq.; M. HABERSACK, Perspektiven der aktienrechtlichen Organhaftung, ZHR 177 (2013) 782; R. HARNOS, Geschäftsleiterhaftung bei unklarer Rechtslage (Berlin 2013); K. RIEGER, Die aktienrechtliche Legalitätspflicht des Vorstands (Munich 2012).

[4] See G. BACHMANN, Gutachten E für den 70. Deutschen Juristentag, 2014; <http://www.djt.de/fileadmin/downloads/70/djt_70_Wirtschaftsrecht_140320.pdf> (official confe rence program overview); <http://www.djt.de/fileadmin/downloads/70/140919_djt_70_beschluesse_web_rz.pdf> (resolutions).

[5] HOPT/ROTH, *supra* note 3, § 93 marg. no. 28; J. KOCH, in: Hüffer, AktG, 11th ed. 2014, § 93 marg. no. 1; H.-J. MERTENS/A. CAHN, Kölner Kommentar zum AtkG, 3rd ed. 2010, § 93 marg. no. 6.

[6] FLEISCHER, *supra* note 3, § 93 marg. no. 60; HOPT/ROTH, *supra* note 3, § 93 marg. no. 31; KOCH, *supra* note 5, § 93 marg. no. 9; SPINDLER, *supra* note 3, § 93 marg. no. 4.

[7] On the duty of legality, see with some detail *infra* II.2.a) and III.1. and FLEISCHER, *supra* note 3, § 93 marg. no. 23; KOCH, *supra* note 5, § 93 marg. no. 6; RIEGER, *supra* note 3; SPINDLER, *supra* note 3, § 93 marg. no. 74.

II. Basic Legal Structure of Directors' Liability

1. Non-Contractual and Mandatory Liability under § 93 AktG

§ 93 AktG *(Aktiengesetz)* is the principal norm governing directors' liability under German law. It is generally recognized that the liability under this provision is not based on the employment contract between director and corporation *(keine vertragliche Haftung);* rather, directors' liability has its grounds in the relationship between the corporation and the director created by statutory law as a result of the director's appointment to the board *(gesetzliche Haftung aus dem Organverhältnis).*[8]

2. Basis of Liability: Breach of Directors' Duties

Liability pursuant to § 93 AktG is grounded in the director's breach of his duties. § 93 para. 1 sent. 1 AktG defines these duties vaguely by employing a general clause, stating that a director has to exhibit the "care of a diligent and conscientious manager". The precise meaning of this standard has to be specified by taking into account the particularities and distinctions explained below.

a) Specifications of Directors' Duties – Care, Loyalty and Legality

According to a widely recognized view, three rough subcategories of directors' duties can be identified. First, directors have a duty of care, i.e., they have to act diligently in arriving at every management decision.[9] The scope of the diligence required is to be determined with regard to the corporation's financial benefit and other objectives under the corporate charter. In general, the consequences must appear to be directly or at least indirectly profitable for the company at the time and under the conditions the decision is made.[10] As a result, managers may – for example – carry out investments only if they appear to be reasonably promising after proper research into the investment's prospects. Another demand of the duty of care is to ensure that the corporation is organized effectively in a way that enables it to reach its goals.[11]

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[8] BGH, 18 June 2013, II ZR 86/11, NJW 2013, 3636, 3637 (on limited corporations); FLEISCHER, *supra* note 3, § 93 marg. no. 178; W. HÖLTERS, in: Hölters AktG, 2nd ed. 2014, § 93 marg. no. 232; HOPT/ROTH, *supra* note 3, § 93 marg. no. 45; SPINDLER, *supra* note 3, § 93 marg. no. 11.

[9] BGH, 20 February 1995, II ZR 143/93, NJW 1995, 1290, 1291 (on limited corporations); FLEISCHER, *supra* note 3, § 93 marg. no. 41; HOPT/ROTH, *supra* note 3, § 93 marg. no. 58; KOCH, *supra* note 5, § 93 marg. no. 6; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 66; SPINDLER, *supra* note 3, § 93 marg. nos. 22, 25.

[10] FLEISCHER, *supra* note 3, § 93 marg. no. 73 et seq.; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 23.

The second fundamental subcategory is the directors' duty of loyalty.[12] This obligation bars them from (consciously) pursuing objectives in conflict with the corporate benefit. For example, a violation may occur when a director is involved in a deal through which he grants preferential treatment to relatives or to other corporations in which he personally holds shares.

The third specification of the directors' duties is commonly defined as the duty of legality.[13] Under this label, a director has a duty towards the corporation to absolutely comply with all legal provisions in managing a corporation.[14] As already mentioned, the significance and eccentricity of this duty results from its potential conflict with the corporation's (and thus the shareholders') financial benefit. For example, it is a breach of the duty of legality towards the corporation to use bribes in order to secure new business – even if the probability of such a practice being discovered is so low that the activity has a positive expectancy value for the corporation.[15]

b) The So-called Mortal Sins

§ 93 para. 3 AktG provides further specifications of the directors' duties. This list contains several violations that are especially grave and therefore called "mortal sins".[16] The list contained in § 93 para. 3 AktG largely refers to statutorily specified duties with regard to dealing with corporate assets, e.g., the prohibition of any irregular distribution of corporate assets to shareholders or illegal transfers of assets in the event of legally relevant insolvency.

c) Individual Culpability

In order for a director to be held liable for an (objective) violation of one of the duties mentioned, it is undisputed that the breach must be one for which the

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[11] FLEISCHER, *supra* note 3, § 93 marg. no. 56; HÖLTERS, *supra* note 8, § 93 marg. no. 43; HOPT/ROTH, *supra* note 3, § 93 marg. nos. 151, 160 et seqq.; SPINDLER, *supra* note 3, § 93 marg. no. 98.

[12] BGH, 21 December 2005, 3 StR 470/04, NJW 2006, 522, 523 = BGHSt 50, 331 – *Mannesmann* (from the perspective of criminal law); FLEISCHER, *supra* note 3, § 93 marg. no. 73; HÖLTERS, *supra* note 8, § 93 marg. no. 114; KOCH, *supra* note 5, § 93 marg. no. 28, § 84 marg. no. 10; SPINDLER, *supra* note 3, § 93 marg. no. 108.

[13] See, e.g., FLEISCHER, *supra* note 3, § 93 marg. nos. 14, 23 et seq.; KOCH, *supra* note 5, § 93 marg. no. 6; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 132; SPINDLER, *supra* note 3, § 93 marg. no. 74. RIEGER, *supra* note 3.

[14] This is due to the duty's derivation from the legal order as such, see *infra* at III.1.a).

[15] See FLEISCHER, *supra* note 3, § 93 marg. no. 36; H. FLEISCHER, Aktienrechtliche Legalitätspflicht und „nützliche" Pflichtverletzungen von Vorstandsmitgliedern, ZIP 2005, 141, 148 et seq.; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 71; HOPT/ROTH, *supra* note 3, § 93 marg. no. 134; SPINDLER, *supra* note 3, § 76 marg. no. 90.

[16] FLEISCHER, *supra* note 3, § 93 marg. no. 260; KOCH, *supra* note 5, § 93 marg. no. 68; T. LIEBSCHER, in: Beck'sches Handbuch der AG, 2nd ed. 2009, § 6 marg. no. 136.

director is individually (subjectively) culpable.[17] In practice, however, this additional criterion of personal culpability *(Verschulden)* will rarely help a director to avoid liability if an objective breach of duty has been established. On the one hand, the need to specify the general standard of duty allows for individual conditions of the conduct in question to be taken into account when the "objective" demands to the director are defined. This is true in particular as far as the so-called duty of care is concerned. On the other hand, it is undisputed that the individual culpability under civil law is primarily determined by objective measures.[18] Thus, it is hardly conceivable that (objective) breaches of the duty of care may be excused on the grounds of lack of culpability. The same applies for a breach of the duty of loyalty, where an element of intent establishing culpability will almost inevitably be present.

It is worth noting, however, that the requirement of culpability may become relevant with regard to a breach of the duty of legality. Here, the aspect of lack of culpability may provide ground for a valid defense if the director could not reasonably have recognized the demands of the law that he eventually infringed (unavoidable error of law – *unvermeidbarer Verbotsirrtum*).[19] Yet, the German courts are very reluctant to hold an error of law to be unavoidable[20] – for good and quite obvious reasons.

3. Recognition of Directors' Discretion (Safe Harbor)

The issues of over-deterrence and of overloading directors with excessive claims (see *supra* at I.) are – above all other provisions – addressed by the so-called business judgment rule which was inserted some ten years ago in § 93 para. 1 sent. 2 AktG, following the model of US law.[21] The business judgment rule is supposed to grant directors a "safe harbor" – an element of leeway immune from judicial oversight – providing certain conditions that ensure the general soundness of the decision in question are met.[22] The protec-

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[17] E.g., FLEISCHER, *supra* note 3, § 93 marg. no. 205; HOPT/ROTH, *supra* note 3, § 93 marg. no. 391; KOCH, *supra* note 5, § 93 marg. no. 43; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 136; SPINDLER, *supra* note 3, § 93 marg. no. 176.

[18] See FLEISCHER, *supra* note 3, § 93 marg. no. 205; HOPT/ROTH, *supra* note 3, § 93 marg. no. 392; SPINDLER, *supra* note 3, § 93 marg. no. 176.

[19] See FLEISCHER, *supra* note 15, 141, 149 et seq.; HARNOS, *supra* note 3, 297.

[20] See BGH 09 February 1951, I ZR 35/50, NJW 1951, 398; BGH 26 January 1983, IVb ZR 351/81, NJW 1983, 2318, 2321; BGH, 12 July 2006, X ZR 157/05, NJW 2006, 3271, 3272 et seq. (all decisions pertaining to matters outside of corporate law; affirming culpability if a party could foresee that a court's legal opinion might be different). An example of a more lenient recent verdict is mentioned *infra* at III.2.d).

[21] BegrRegE BT-Drs. 15/5092, 11 ("Vorbilder aus dem angelsächsischen Rechtskreis"); FLEISCHER, *supra* note 3, § 93 marg. no. 60; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 14.

[22] On the actual effectiveness of this "safe harbor", see *infra* at III.2.a).

tion of business judgments accounts for the uncertainties in assessing the outcome of an entrepreneurial decision and addresses the issue of judicial hindsight bias, i.e., the danger of court decisions based on a too severe standard of liability caused by the *ex post* damage experience.[23] In cases in which the conditions of a "protected" business judgment are met, liability is excluded *a priori*, i.e., the full test as to whether a director has acted in breach of his duties is not carried out.

One must note, however, that the scope of protection for business judgments is limited. To begin with, it is only applicable when a breach of the duty of care is at issue. Conversely put: It is well recognized that there is no "safe harbor" for violations of the duty of loyalty. Hence, a decision of a director made under a conflict of interest will be fully scrutinized by the courts.[24] The business judgment rule does not apply to the duty of legality either – at least if it is clear that the decision in question was unlawful.[25] On top of these unwritten requirements for achieving exemption from liability, the explicit conditions under § 93 para. 1 sent. 2 AktG must be met. These shall be further explained in the following paragraphs.

a) *Entrepreneurial Decision*

The business judgment rule under § 93 para. 1 sent. 2 AktG only applies to "entrepreneurial decisions". Although the exact definition of this criterion is subject to some debate, it is generally agreed that an entrepreneurial decision is characterized by its prognostic framework. Entrepreneurial decisions involve an element of uncertainty because the consequences of the decision will only become fully apparent in the future.[26] Examples include investments in new technologies, the introduction of new products, and M&A transactions.[27] Whether a legal judgment can be an entrepreneurial decision if there was legal uncertainty at the time of the decision is contentious.[28]

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[23] FLEISCHER, *supra* note 3, § 93 marg. no. 60.; HOPT/ROTH, *supra* note 3, § 93 marg. no. 63; SPINDLER, *supra* note 3, § 93 marg. no. 36.

[24] See, e.g., FLEISCHER, *supra* note 3, § 93 marg. no. 72; SPINDLER, *supra* note 3, § 93 marg. no. 60.

[25] See *infra* at III.2.d).

[26] FLEISCHER, *supra* note 3, § 93 marg. nos. 60, 68; H. FLEISCHER, Das Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts, NJW 2005, 3525, 3528; KOCH, *supra* note 5, § 93 marg. no. 16; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 17; SPINDLER, *supra* note 3, § 93 marg. nos. 37, 41.

[27] FLEISCHER, *supra* note 3, § 93 marg. nos. 68; see also HOPT/ROTH, *supra* note 3, § 93 marg. no. 87.

[28] See *infra* at III.2.d).

b) Acting for the Benefit of the Company

In order to attain the protection of the "safe harbor" provision in § 93 para. 1 sent. 2 AktG, a director has to act for the benefit of the company, i.e., with the subjective goal of furthering the corporate aim.[29]

c) No Evident Violation of Corporate Interests

Even when a director acts with the intention of furthering the corporate interest, liability cannot be excluded in cases in which his behavior is utterly unjustifiable on objective grounds, in particular if the negative financial outcome of the decision (including all direct and indirect consequences) was obvious. This reservation is sometimes illustrated by reference to cases in which an independent observer would deem a director's actions to be irresponsible.[30]

d) Adequate Information

Every entrepreneurial decision must be based on a sufficient factual basis. The question of whether the information basis taken into consideration by a corporate director is sufficient depends on the significance of the decision in question on the one hand and on the cost or effort necessary to procure further information on the other.[31] In general, exemption from liability does not require a director to gather all information or even the best information that can possibly be attained. However, according to the prevailing opinion, corporate directors do have the duty to engage in as much research as is adequate for the decision at hand.[32] This is a requirement that should not be taken for granted, though; it is debatable whether § 93 para. 1 sent. 2 AktG is still applicable in cases of insufficient information if the decision was in fact economically viable.[33]

4. Burden of Proof: Breach of Duty and Causation

According to the unambiguous wording of § 93 para. 2 sent. 2 AktG, the director bears the burden of proof as far as breaches of his or her duties are

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[29] FLEISCHER, *supra* note 3, § 93 marg. no. 75; HOPT/ROTH, *supra* note 3, § 93 marg. no. 87; KOCH, *supra* note 5, § 93 marg. no. 23.

[30] BegrRegE BT-Drs. 15/5092, 11; HOPT/ROTH, *supra* note 3, § 93 marg. nos. 87 et seq.; FLEISCHER, *supra* note 3, § 93 marg. no. 75; KOCH, *supra* note 5, § 93 marg. no. 23; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 23.

[31] HOPT/ROTH, *supra* note 3, § 93 marg. no. 108; SPINDLER, *supra* note 3, § 93 marg. no. 48.

[32] FLEISCHER, *supra* note 3, § 93 marg. no. 70; HOPT/ROTH, *supra* note 3, § 93 marg. no. 108; MERTENS/CAHN, *supra* note 5, § 93 marg. nos. 33 et seq.; SPINDLER, *supra* note 3, § 93 marg. no. 48.

[33] See *infra* at III.2.c).

concerned. However, according to the prevailing view, this only applies in cases in which the corporation presents and proves facts which point to a potential violation.[34] This reservation is rather sound, as the element of fault would be questioned if the directors' burden of proof was not dependent on some indications of the breach. Without this reservation, directors' liability would almost amount to strict liability – an excessive and unnecessary over-deterring result.

It must be stressed that the allocation of the burden of proof to the director under § 93 para. 2 sent. 2 AktG refers to the issue of breach of duty only and not to causation or amount of damages – the corporation bears the burden in respect of these. Yet, even in this respect, the standard of evidence is lowered pursuant to § 287 ZPO *(Zivilprozessordnung)*.[35] Under this provision, a plaintiff need not convince a court beyond any reasonable doubt with regard to causation and damages in order to be granted an award. Rather, a court may base its decision on an assessment that a director's actions were much more likely to be the cause of damages than not – if that assessment is based on a secure factual basis.[36]

5. Scope of Liability: Unlimited Liability for any Breach of Duty – No Privilege or Limitation in Statutory or Judge-Made Law

The statutory provisions of § 93 AktG do not contain any explicit privilege or limitation to directors' liability. Under the general rules governing liability and remedies (in particular §§ 249 et seqq. BGB – *Bürgerliches Gesetzbuch*), this means that the director has to compensate the corporation in full for its injury, no matter how small his fault may have been and no matter how ruinous his liability may be, unless there is a disclaimer or waiver that the corporation has agreed to in a legally binding way (see *infra* at II.6).

Some legal authors, however, have suggested that certain general principles would indeed allow the courts to apply some unwritten limitations to directors'

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[34] BGH, 15 January 2013, II ZR 90/11, NJW 2013, 1958, 1959; BGH, 08 July 2014, II ZR 174/13, NZG 2014, 1058, 1061 = BGHZ 202, 26; OLG Nürnberg, 23 September 2014, 12 U 567/13, ZIP 2015, 427 et seqq.; W. GOETTE, Zur Verteilung der Darlegungs- und Beweislast der objektiven Pflichtwidrigkeit bei der Organhaftung, ZGR 1995, 648, 671 et seqq.; W. PAEFGEN, Die Darlegungs- und Beweislast bei der Business Judgment Rule, NZG 2009, 891, 893.

[35] BGH, 18 February 2008, II ZR 62/07, NJW-RR 2008, 905, 906; FLEISCHER, *supra* note 3, § 93 marg. no. 221; see HOPT/ROTH, *supra* note 3, § 93 marg. no. 108 for a somewhat skeptical view as far as the applicability of § 287 ZPO is concerned.

[36] See BGH, 22 October 1987, III ZR 197/86, NJW-RR 1988, 410; BGH, 21. July 2005, IX ZR 49/02, NJW 2005, 3275, 3277 (both decisions pertaining to contractual damages outside corporate law); G. SCHIEMANN, in: Staudinger BGB, 14th ed. 2005, Vor § 249 marg. no. 103.

liability.[37] Among the advocates of this position in general, one approach claims that the corporation's duty of loyalty towards its directors would entail certain limits to damages claims, while another proposal favors an extension of the liability privilege that employees enjoy towards directors. These concepts have an understandable basis in the notion that unlimited liability may have a detrimental effect on the directors' risk taking and may be unfair in that "regular" faults are almost unavoidably connected with entrepreneurial action and therefore better attributed to the company than to the director. Yet, these policy considerations cannot be reconciled with the written law. Thus, these propositions to limit directors' liability on the grounds of these general principles are not endorsed by the majority of legal authors and have no basis in the precedents of the German Supreme Court (*Bundesgerichtshof* – BGH). I consider this important point in more detail later (*infra* at III.4.)

6. Limits to Liability through Disclaimers, Waivers (etc.) on the Part of the Corporation

Given the unavailability of privileges or limitations as a matter of law, the potential for mitigating the questionable effects of directors' liability is focused on specific agreements entered into by the corporation. However, even such voluntary measures entered into by the corporation are considerably restrained by the law.

a) Ex Ante Disclaimer: Provisions in the Corporate Charter or in the Employment Contract

Under the current law governing the stock corporation, it is well recognized that provisions in the corporate charter limiting liability are void. The rationale for this rather disturbing position is simple: The rules provided for in the AktG are generally of mandatory character (§ 23 para. 5 AktG) and there is no explicit provision allowing for the insertion of liability limitations into the corporate charter.[38] The same notion applies to disclaimers in the employment contract, making such clauses void as well.[39]

One may note, however, that of all the reform proposals currently under discussion, those pertaining to the goal of mitigating the detrimental effects

[37] See H. FLEISCHER, Ruinöse Managerhaftung: Reaktionsmöglichkeiten de lege lata und de lege ferenda, ZIP 2014, 1305 et seqq. for an overview.

[38] FLEISCHER, *supra* note 3, § 93 marg. no. 3; FLEISCHER, *supra* note 37, 1305 et seq.; HOPT/ROTH, *supra* note 3, § 93 marg. no. 47; SPINDLER, *supra* note 3, § 93 marg. no. 27; see B. GRUNEWALD, Haftungsvereinbarungen zwischen Aktiengesellschaft und Vorstandsmitgliedern, AG 2013, 813 et seqq. for an opinion to the contrary.

[39] FLEISCHER, *supra* note 3, § 93 marg. no. 3; M. HABERSACK, Enthaftung des Vorstandsmitglieds qua Anstellungsvertrag?, NZG 2015, 1297 et seqq.; HOPT/ROTH, *supra* note 3, § 93 marg. no. 47; SPINDLER, *supra* note 3, § 93 marg. no. 27.

of directors' liability by permitting charter provisions are probably the least controversial.[40]

b) Ex Ante Approval (by Shareholders or the Supervisory Board) of the Conduct Giving Rise to Liability

While *ex ante* arrangements on limits to liability are generally void, directors can be kept exempted from liability if they have obtained the consent of the shareholders for the decision in question. Under § 93 para. 4 sent. 1 AktG, directors cannot be held liable for an action if it is based on a lawful shareholder resolution. As opposed to this, *ex ante* approval by the supervisory board does not have any effect on directors' liability, § 93 para. 4 sent. 2 AktG.

A shareholder resolution is lawful in the sense of the liability exemption if it is neither *(ipso iure)* void on the grounds of the particularly severe legal flaws listed in § 241 AktG nor voidable under § 246 AktG – the latter being the general rule for (regular) violations of the law. The precondition of lawfulness creates significant uncertainty for the discharging effect of the shareholders' participation. In cases of voidable shareholder resolutions, for example, directors can still be liable if they fail to take an action of voidance.[41] Moreover, they can be liable for having exercised unlawful influence on the shareholder assembly, by providing incorrect or by withholding material information, for example.[42] Additionally, shareholder resolutions have no effect with regard to the claims of the corporation's creditors in cases of gross misconduct (§ 93 para. 5 sent. 3 AktG).

c) Ex Post Measures: Waiver and Settlement

As an alternative to *ex ante* arrangements, the severe effects of directors' liability can, as a matter of course, be mitigated by measures taken after the damage claim has fully come into existence. As a general rule, dealings with the directors are within the exclusive authority of the supervisory board (§ 112 AktG). However, the supervisory board – at least when acting on its own – is unable to enter into a waiver or settlement agreement pertaining to a specific damages claim against a director. Waivers and settlements are usually to be initiated by the supervisory board, but they are subject to approval by the shareholder assembly and can even be vetoed by a minority holding 10%

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40 See the resolutions of the German Jurists' Conference of 2015, available at <http://www.djt.de/fileadmin/downloads/70/140919_djt_70_beschluesse_web_rz.pdf>, 17.

41 FLEISCHER, *supra* note 3, § 93 marg. no. 273; HOPT/ROTH, *supra* note 3, § 93 marg. no. 487; KOCH, *supra* note 5, § 93 marg. no. 74; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 156; SPINDLER, *supra* note 3, § 93 marg. nos. 208 et seq.

42 See H. C. GRIGOLEIT/L. TOMASIC, in: Grigoleit AktG, 2013, § 93 marg. nos. 73 et seqq.; FLEISCHER, *supra* note 3, § 93 marg. no. 272; HOPT/ROTH, *supra* note 3, § 93 marg. no. 488.

of the shares (§ 93 para. 4 sent. 3 AktG). Furthermore, waivers and settlements are only permissible once three years have passed since the claim came into existence (§ 93 para. 4 sent. 3 AktG). Moreover, as it is the case for *ex ante* approvals by the shareholder assembly, waivers and settlements have no effect with regard to the corporation's creditors in cases of gross misconduct (§ 93 para. 5 sent. 3 AktG).

Some authors claim that the supervisory board can exercise a "regular" business judgment in reaching a settlement – however, there are good reasons to doubt whether this is actually the case.[43]

d) Coverage of a Director's (Personally Incurred) Penalties by the Corporation

If the supervisory board intends to cover, on behalf of the corporation, penalties which a director has personally incurred as a result of his unlawful business conduct, it is required to obtain the shareholder assembly's approval pursuant to § 93 para. 4 sent. 3 AktG.[44] The reason is that burdening the corporation with the fine constitutes (further) loss; covering the sanction has the same effect as a waiver pertaining to the damages.[45]

7. D&O Insurance

A corporation is generally free to buy D&O insurance on behalf of its directors. However, as a matter of mandatory law, the insurance policy must provide for a deductible which (1) for individual damage claims, may not be lower than 10%, but (2) can have an annual cap of at least 150% of the fixed annual salary (§ 93 para. 2 sent. 3 AktG). Additionally, one has to take into account that D&O coverage is often spotty as most policies have gaps that go beyond the deductible mandated by law, such as maximum coverage sums, exceptions for directors knowingly violating their duties and conditions subsequent to the policy.[46] Thus, it is well recognized that D&O policies neither necessarily provide a reliable safety net for directors and nor mitigate the issue of excessive liability decisively.

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[43] See *infra* at III.5.b).

[44] This was recently decided in BGH, 8 July 2014, II ZR 174/13, BGHZ 202, 26.

[45] BGH, 08 July 2014, II ZR 174/13, NZG 2014, 1058, 1059 = BGHZ 202, 26; M. ZIMMERMANN, Aktienrechtliche Grenzen der Freistellung des Vorstands von kartellrechtlichen Bußgeldern, DB 2008, 687, 690 et seq.; FLEISCHER, *supra* note 3, § 93 marg. no. 287; HOPT/ROTH, *supra* note 3, § 93 marg. no. 528; SPINDLER, *supra* note 3, § 84 marg. no. 97.

[46] For an overview of the potential shortcomings of the D&O coverage, see, e.g., M. PELTZER, Konstruktions- und Handhabungsschwierigkeiten bei der D&O Versicherung, NZG 2009, 970 (on the difficulties of enforcement); K. V. SCHENCK, Handlungsbedarf bei der D&O-Versicherung, NZG 2015, 494, 498 et seq. (on conditions subsequent).

8. Enforcement

a) Enforcement by the Supervisory Board – Mandatory Enforcement Under the ARAG/Garmenbeck Doctrine

The supervisory board has the authority to enforce claims against the corporation's directors as a corollary of the general supervisory duty and its power to represent the corporation as far as affairs with directors are concerned (§§ 111 and 112 AktG, respectively). This competence is associated with the duty to actually enforce such claims under the famous *ARAG/Garmenbeck* doctrine of the Supreme Court. Broadly speaking, that doctrine holds that there is a general duty on the part of the supervisory board to investigate potential misconduct of the directors and to enforce existing claims.[47] In fulfilling that duty, the supervisory board has no ("regular") business discretion (business judgment).[48]

At the core of the assessment required from the supervisory board lies its analysis of the risks associated with a potential trial. This analysis includes the factual and legal basis of the damages claim as well as the debtor's liquidity. If a claim is "likely" to be enforceable (i.e., with a likelihood clearly greater than 50% – *voraussichtlich durchsetzbar*), the supervisory board is generally bound to enforce the claim.[49] An exception is only made in the exceptional cases in which "important interests of the corporation" outweigh the benefits of enforcing the claim (e.g., exceptionally negative consequences for a company's reputation/business activities; interference of the trial with the management board's day-to-day affairs).[50] Acts of individual leniency towards a director can only be justified in extreme cases in which the burden on the director would be grossly disproportionate.[51]

It is worth noting that the duty to enforce does not necessarily require the supervisory board to pursue the maximum award. Rather, the supervisory board may well negotiate a settlement on the basis of which it can show con-

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[47] BGH, 21 April 1997, II ZR 175/95, BGHZ 135, 244 – *ARAG/Garmenbeck*.

[48] BGH, 21 April 1997, II ZR 175/95, NJW 1997, 1926, 1928 = BGHZ 135, 244 – *ARAG/Garmenbeck;* GRIGOLEIT/TOMASIC, *supra* note 42, § 111 marg. no. 5; M. HABERSACK, in: Münchener Kommentar zum AktG, 4th ed. 2014, § 116 marg. no. 35; KOCH, *supra* note 5, § 111 marg. no. 6; U. HÜFFER, Die leitungsbezogene Verantwortung des Aufsichtsrats, NZG 2007, 47, 48.

[49] BGH, 21 April 1997, II ZR 175/95, BGHZ 135, 244 – *ARAG/Garmenbeck;* HABERSACK, *supra* note 48, § 116 marg. no. 35; G. SPINDLER, in: Spindler/Stilz AktG, 3rd ed. 2015, § 116 marg. no. 58.

[50] BGH, 21 April 1997, II ZR 175/95, BGHZ 135, 244 – *ARAG/Garmenbeck;* HABERSACK, *supra* note 48, § 116 marg. no. 36; KOCH, *supra* note 5, § 93 marg. no. 10; SPINDLER, *supra* note 49, § 116 marg. no. 59.

[51] BGH, 21 April 1997, II ZR 175/95, NJW 1997, 1926, 1928 = BGHZ 135, 244 – *ARAG/Garmenbeck;* HABERSACK, *supra* note 48, § 116 marg. no. 37; SPINDLER, *supra* note 49, § 116 marg. no. 60.

sideration for the directors' interests and thereby avoid significant negative effects of directors' liability – bad publicity and an over-deterrence of the corporation's management.[52] Such a settlement is subject to the shareholder assembly's approval and the resulting uncertainty, § 93 para. 4 sent. 3 AktG. Policy-wise, the *ARAG/Garmenbeck* doctrine has been subject to some criticism,[53] as it might force supervisory boards to pursue lawsuits whose benefit to the corporation is debatable. However, the strict position of the Supreme Court is not entirely without merit, for it can plausibly be seen as a powerful instrument in disciplining supervisory boards.[54]

b) Enforcement by Shareholders – Derivative Suits

(1) Majority Initiative – Appointment of a Special Agent

The shareholder assembly can coerce the supervisory board into enforcing claims against directors under § 147 para. 1 AktG. The shareholder assembly can also appoint a special representative for enforcement (§ 147 para. 2 sent. 1 AktG). A special representative for enforcement can also be appointed by a court upon the request of a shareholder minority holding at least 10% of the corporation's shares or shares representing at least 1 million Euros of the corporation's legal capital (§ 147 para. 2 sent. 1 AktG).

(2) Minority Initiative

If the damages claim is not enforced by the corporation or by a special agent, a minority group holding 1% of the shares or shares representing 100,000 Euros of the corporation's legal capital can file a motion pursuant to § 148 AktG that a court empower the minority shareholders to enforce a claim in their own name, but for the benefit of the company. However, this proceeding to admit a derivative suit *(Klagezulassungsverfahren)* is dependent upon

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[52] See F. DIETZ-VELLMER, Organhaftungsansprüche in der Aktiengesellschaft: Anforderungen an Verzicht oder Vergleich durch die Gesellschaft, NZG 2011, 248, 250 et seq.; KOCH, *supra* note 5, § 93 marg. no. 10.

[53] See A. CAHN, Aufsichtsrat und Business Judgment Rule, WM 2013, 1293, 1295 et seqq.; W. GOETTE, Grundsätzliche Verfolgungspflicht des Aufsichtsrats bei sorgfaltswidrig schädigendem Verhalten im AG-Vorstand?, ZHR 176 (2012) 588 et seqq.; H.-J. MERTENS, Schadensersatzhaftung des Aufsichtsrats bei Nichtbeachtung der Regeln des ARAG-Urteils über die Inanspruchnahme von Vorstandsmitgliedern, in: Bitter et al. (eds.), Festschrift für Karsten Schmidt zum 70. Geburtstag (Cologne 2009), 1183 et seqq.; W. PAEFGEN, Die Inanspruchnahme pflichtvergessener Vorstandsmitglieder als unternehmerische Ermessensentscheidung des Aufsichtsrats, AG 2008, 761 et seqq., all of whom are in favor of granting the supervisory board discretion in order to curb its enforcement duty. For an overview, see J. KOCH, Die schleichende Erosion der Verfolgungspflicht nach ARAG/Garmenbeck, NZG 2014, 934 et seqq.

[54] See *supra* at III.5.a).

several rather restrictive conditions (see § 148 para. 1 nos. 1–4 AktG): First, the shareholder must have acquired the stock prior to attaining knowledge of breaches of duty or of financial loss. Second, the shareholder needs to prove that they have in vain set the corporation a deadline to take action by itself. Third, there must be facts that warrant the suspicion that the loss was caused in bad faith or through gross violation of a directors' duty. Fourth and finally, the claim must not be excluded by corporate interests which outweigh the interest in enforcing the claim.

(3) Relevance of Derivative Suits

The requirement that the minority initiative be sponsored by shareholders holding shares representing at least 1% of the corporation's legal capital is a relatively new and low threshold introduced by the *UMAG,*[55] which did away with a similar legal instrument that stipulated a 10% requirement.[56] However, the attempt to facilitate derivative suits has not motivated shareholders to enforce the provisions on directors' liability – the practical relevance of such suits is still very low.[57] Presumably, there are several reasons for this. A lack of information on the part of the shareholders makes it difficult for them to evaluate the merits of the claim.[58] This issue of uncertainty is aggravated by the strict and (in part) vaguely drafted conditions that must be met for the admission of the suit. Furthermore – and maybe most importantly – the incentives are not aligned in a way that might create a boost in derivative suits, as such suits are costly and the shareholders pursuing enforcement are not provided with a special premium in the case of successful litigation.[59]

Nevertheless, there are probably some beneficial effects of the rules on derivative suits even if they rarely occur: The mere possibility of derivative suits puts some pressure on the supervisory board to seriously investigate potential claims and their merits.[60]

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[55] See *supra* note 1.

[56] See H. SCHRÖER, Münchener Kommentar zum AktG, 4th ed. 2014, § 114 marg. nos. 7 et seqq., for a detailed account of the amendments pertaining to minority initiatives.

[57] HABERSACK, *supra* note 3, 790; KOCH, *supra* note 5, § 148 No 3; S. MOCK, Spindler/Stilz AktG, 3rd ed. 2015, § 147 marg. no. 5; K. U. SCHMOLKE, Die Aktionärsklage nach § 148 AktG, ZGR 2011, 398, 402 et seq.; J. VETTER, Reformbedarf bei der Aktionärsklage nach § 148 AktG, in: Krieger et al. (eds.), Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 1319 et seq.

[58] MOCK, *supra* note 57, § 147 marg. no. 83; SCHMOLKE, *supra* note 57, 432 et seq.

[59] SCHMOLKE, *supra* note 57, 404 et seqq.; see also MOCK, *supra* note 57, § 147 marg. no. 6.

[60] SCHRÖER, *supra* note 56, § 114 marg. no. 15.

9. Statute of Limitations

Directors' liability is subject to a special and unusually long limitation period. The period is ten years for public corporations and five for privately held stock corporations (§ 93 para. 6 AktG). Both periods run from the time the liability claim comes into existence. The limitation period of directors' liability is questioned by several experts who demand that the period be shortened.[61]

III. Fundamental Issues Under Current Discussion – Key Arguments

Let us now turn to some issues that are at the center of the corporate law discourse in Germany. As it is impossible to cover all current problems or the full range of arguments in this paper, I will stress some facets that, in my opinion, are rather fundamental.

1. Duty of Legality

As I have mentioned, the duty of legality has played a major role in the discourse on directors' liability for some time, and certain assumptions are well recognized with regard to this duty. However, several aspects are still to be clarified.

a) Legal Source: Protection of the Infringed Law in Question (not Protection of the Corporation)

One point yet to be specified is the legal source of this duty, which may have a significant impact on dealing with a variety of issues arising in the context of the duty of legality. Since the duty of legality claims priority over the duty to pursue profits (see *supra* at I., II.2.a), it cannot be derived from a corporation's charter or a corporation's interests. It is sometimes argued that the duty of legality can be based on the company's financial interests, as it serves to avoid civil liability and fines.[62] However, this argument neglects the potential of violations with a positive expectancy value (see *supra* at II.2.a)). It is the very function of recognizing a specific duty of legality that the lawful conduct in question is – from the (solely relevant) *ex ante* perspective of business decisions – not necessarily in line with the financial interests of the corporation.

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[61] See the resolutions of the German Jurists' Conference of 2015, available at <http://www.djt.de/fileadmin/downloads/70/140919_djt_70_beschluesse_web_rz.pdf>, 17.

[62] E.g., T. RAISER/R. VEIL, Recht der Kapitalgesellschaften, (6th ed. Munich 2015) § 14 marg. no. 81.

Therefore, one must identify another source from which the duty of legality can be derived. That source can only be the legal system as such, whose commands the duty of legality serves to enforce, effectively and preemptively.[63] Thus, the duty of legality is a tool that goes beyond the shareholders' and other stakeholders' interests and uses the corporation to serve the general public. One of its effects is an asymmetrical risk structure: The corporation stands to earn coincidental and unmerited profits as it has the opportunity to realize profits from unlawful business activities. At the same time, it is being relieved of the liability risks associated with such activities. The peculiar consequences of this risk structure are yet to be explored.

b) Adjustment for Profits

Another common issue connected to the duty of legality is the question of how to deal with profits that have accrued from unlawful business conduct. Some court decisions and authors have held that for preventive reasons potential profits should not be subtracted from the damages claim that the corporation has sustained from liability and fines.[64] Yet, in order to avoid disproportionate financial burdens on corporate directors on the one hand and unjustified windfall profits for corporations on the other hand, gains derived from its directors' unlawful activities should generally be subtracted from a corporation's damages claim in order to arrive at the actual damages caused by directors' actions.[65] The preventive goal the duty of legality seeks to achieve does

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[63] M. HABERSACK, Die Legalitätspflicht des Vorstands der AG, in: Burgard (ed.), Festschrift für Uwe H. Schneider (Cologne 2011) 435; A. LOHSE, Schmiergelder als Schaden?, in: Kindler et al. (eds.), Festschrift für Uwe Hüffer zum 70. Geburtstag (Munich 2010) 598 et seq.; SPINDLER, *supra* note 3, § 93 marg. no. 92; C. THOLE, Managerhaftung für Gesetzesverstöße – Die Legalitätspflicht des Vorstands gegenüber seiner Aktiengesellschaft, ZHR 173 (2009) 504, 516 et seq.

[64] BGH, 11 January 1988, II ZR 192/87, NJW-RR 1988, 995, 996 (on the violation of the articles of association in a partnership); OLG München, 17 September 1999, 23 U 1514/98, NZG 2000, 741, 743; G. KOPPENSTEINER/M. GRUBER, in: Rowedder/Schmidt-Leithoff GmbHG, 5th ed. 2013, § 43 marg. no. 22; M. LÖBBE, in: Ulmer/Habersack/Löbbe Großkommentar GmbHG, 2nd ed. 2014, § 43 marg. no. 182 (both commentaries on limited corporations); LOHSE, *supra* note 63, 598 et seqq.

[65] BGH, 15 January 2013, II ZR 90/11, NJW 2013, 1958; W. BAYER, Legalitätspflicht der Unternehmensleitung, nützliche Gesetzesverstöße und Regress bei verhängten Sanktionen – dargestellt am Beispiel von Kartellverstößen, in: Bitter et al. (eds.), Festschrift für Karsten Schmidt zum 70. Geburtstag (Cologne 2009) 94; FLEISCHER, *supra* note 3, § 93 no 38; H. FLEISCHER, Kompetenzüberschreitungen von Geschäftsleitern im Personen- und Kapitalgesellschaftsrecht Schaden – rechtmäßiges Alternativverhalten – Vorteilsausgleichung, DStR 2009, 1204, 1209 et seq.; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 63; HABERSACK, *supra* note 63, 439; KOCH, *supra* note 5, § 93 marg. nos. 47, 49; SPINDLER, *supra* note 3, § 93 marg. nos. 171 et seq.; see LAG Düsseldorf, 20 January 2015, 16 Sa 459/14, ZIP 2015, 829, 830 et seqq. (judgment not final – decision by the Federal Labor

not warrant skipping the step of adjusting a damages claim for profits.[66] However, the burden of proof lies with the corporate director as far as the existence and extent of deductible benefits of his unlawful behavior are concerned.[67]

c) *Organizational Safeguards – Compliance Requirements*

Aside from the management board's virtually absolute duty to – in its own actions – comply with the law, it also has the duty to ensure that the enterprise as a whole only carries out lawful business activities.[68] It is important to note, that this duty, even in German discourse commonly referred to by the English term of "compliance", cannot be "absolute" – as opposed to the demands posed on the legality of the directors' own (direct) conduct. Otherwise, directors would be strictly liable for employees' conduct and the incentive to invest in safety measures would be excessive and socially harmful.

Therefore, directors must be granted some discretion as to how to fulfill the organizational demands of an adequate compliance system. The requirements differ on a case-by-case basis; in general, directors have to do whatever is necessary and proper based on their individual company's situation. For example, they have to take into account their company's structure, its field of business, its regional orientation, the density of applicable regulation and the occurrence of suspicious activity.[69] Moreover, the scope of the required safeguards may vary within a single company according to the diversity of risks triggered by the business activity in its different divisions.[70]

Court *[Bundesarbeitsgericht]* pending) for a more drastic view: claims based on fines against the corporation are supposed to be excluded generally.

[66] See W. BAYER/P SCHOLZ, Zulässigkeit und Grenzen des Kartellbußgeldregresses, GmbHR 2015, 449, 450 et seq.

[67] BGH, 15 January 2013, II ZR 90/11, NJW 2013, 1958, 1961 (on the adjustment for profits in cases of directors' liability in particular); BGH, 31 May 2010, II ZR 30/09, NJW 2010, 2506, 2508 (on the adjustment for profits in general); FLEISCHER, *supra* note 3, § 93 marg. no. 38; FLEISCHER, supra note 65, 1206; KOCH, *supra* note 5, § 93 marg. no. 47.

[68] LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345, 348 – *Siemens/Neubürger*; FLEISCHER, *supra* note 3, § 93 marg. no. 108; HOPT/ROTH, *supra* note 3, § 93 marg. no. 182; SPINDLER, *supra* note 3, § 93 marg. no. 98.

[69] See LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345 – *Siemens/Neubürger*; FLEISCHER, *supra* note 3, § 93 marg. nos. 109 et seq.; HOPT/ROTH, *supra* note 3, § 93 marg. no. 187; H. MERKT, Compliance und Risikofrüherkennung in kleinen und mittleren Unternehmen, ZIP 2014, 1705, 1708 et seqq.; SPINDLER, *supra* note 3, § 91 marg. no. 28.

[70] See FLEISCHER, *supra* note 3, § 93 marg. no. 109; G. WAGNER, in: Münchner Kommentar zum BGB, 6th ed. 2013, § 823 marg. no. 338 (on the general duty under civil law to ensure public safety).

The details of this duty of organizing legality are still very much uncertain. Recently, a decision handed down by Munich's Regional Court *(Landgericht München I)*[71] set rather high demands that corporate directors have to meet in order to comply with the duty. In particular, the Court held that all members of the management board must effectively react to any occurrence of wrongdoing in the company regardless of which department is concerned. Furthermore, the Court drew far-reaching conclusions from the continuous occurrence of suspicious activity for the directors' breach of duty and for causation with regard to the resulting losses.[72] This decision has been met with quite a bit of criticism, even if there are positive voices as well.[73] The criticism is not entirely unwarranted as some elements of the decision are certainly questionable, in particular the very strict deductions from a quite diffuse factual context.[74]

As the decision by the Munich Court became final and was not examined by a higher court, its future relevance remains uncertain. In general, the details of compliance demands are still to a large extent *terra incognita*. In the upcoming process of exploring this *terra* it would be wise to refrain from laying down a set of requirements that are rather general and formal (appointment of specialized officers or directors, specific kinds of documentation, etc.) as such rules have the tendency of creating unnecessary transaction costs as well as eliciting legal advisors' creativity in rendering them ineffective.

2. Business Judgments – Protection of Directors' Discretion

Even though the business judgment rule has been codified in some detail (§ 93 para. 1 sent. 2 AktG, see *supra* at II.3.), the relevance and concrete consequences of this provision remain elusive.

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71 LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345, 348 – *Siemens/Neubürger*.

72 LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345, 348 – *Siemens/Neubürger*.

73 For critical opinions, see G. BACHMANN, Anmerkung zum Urteil des LG München I vom 10.12.2013 – 5 HK O 1387/10 – Zur Haftung des Vorstands für Mängel des Compliance-Systems, ZIP 2014, 579; S. MEYER, Compliance-Verantwortlichkeit von Vorstandsmitgliedern – Legalitätsprinzip und Risikomanagement. Besprechung von LG München I v. 10.12.2013 – 5 HK O 1387/10, DB 2014, 1063; C. SEIBT/J. CZIUPKA, 20 Thesen zur Compliance-Verantwortung im System der Organhaftung aus Anlass des Siemens/Neubürger-Urteils, DB 2014, 1598. For generally positive reactions see T. BÜRGERS, Compliance in Aktiengesellschaften, ZHR 179 (2015) 173, 183 et seq.; J. BÜRKLE, Compliance als Aufgabe des Vorstands der AG – Die Sicht des LG München I, CCZ 2015, 52; H. FLEISCHER, Aktienrechtliche Compliance-Pflichten im Praxistest: Das Siemens/Neubürger-Urteil des LG München I, NZG 2014, 321.

74 BÜRKLE, *supra* note 73, 54 et seq.

a) *Defining a "Safe Harbor" for Business Judgments – Limits to Legal Certainty*

On closer inspection, the business judgment rule as laid down in § 93 AktG para. 1 sent. 2 does not keep the promise of providing corporate directors with a safe harbor of legal certainty.[75] Instead, the safe harbor has been made dependent upon vague criteria that do not replace the assessment of business decisions but in fact call for a substantive evaluation of the decision ("appropriate information", "reasonable assumption to act for the good of the corporation").[76]

In trying to find specific rule-like guidelines for business decisions, the problem the legislature, the courts and some commentators alike tend to disregard is that the fundamental issue is an empirical one: The core reason for protecting the directors' business decisions lies in the insoluble difficulties associated with calculating a definite expectancy value for prognostic business decisions. In other words: If there were an easy and reliable way for directors to calculate the financial consequences of their decisions – and for the courts, as well, in assessing such decisions – there would not be a need for a business judgment rule.

b) *Ex Ante Perspective and the Standard of Evidence*

To address this rather limited empirical issue, there are only two aspects that demand normative handling: First and rather obviously, courts have to assess business decisions from an *ex ante* perspective; a decision is not invalidated by events taking a bad turn.[77] Second, directors must be afforded a considerable degree of latitude in coming up with acceptable decisions.[78] This discre-

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[75] On the following considerations, see H. C. GRIGOLEIT, Gesellschafterhaftung für interne Einflussnahme im Recht der GmbH, (Munich 2006) 367 et seqq. for a more detailed account. With a similar critique but slightly different conclusions, see G. BACHMANN, Das "vernünftige" Vorstandsmitglied – Zum richtigen Verständnis der deutschen Business Judgment Rule (§ 93 Abs. 1 Satz 2 AtkG), in: Habersack et al. (eds.), Festschrift für Eberhard Stilz zum 65. Geburtstag (Munich 2014) 26 et seqq.

[76] H.-C. IHRIG, Reformbedarf beim Haftungstatbestand des § 93 AktG, WM 2004, 2098, 2102; KOCH, *supra* note 5, § 93 marg. no. 9; J. KOCH, Das Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), ZGR 2006, 769, 783.

[77] N. BOSCH/K. W. LANGE, Unternehmerischer Handlungsspielraum des Vorstandes zwischen zivilrechtlicher Verantwortung und strafrechtlicher Sanktion, JZ 2009, 225, 229; B. DAUNER-LIEB, in: Henssler/Strohn Gesellschaftsrecht, 2nd ed. 2014, § 93 AktG marg. no. 18; FLEISCHER, *supra* note 3, § 93 marg. no. 60; HOPT/ROTH, *supra* note 3, § 93 marg. no. 61; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 13; SPINDLER, *supra* note 3, § 93 marg. nos. 5, 26.

[78] DAUNER-LIEB, *supra* note 77, § 93 AktG marg. no. 17; FLEISCHER, *supra* note 3, § 93 marg. no. 60; KOCH, *supra* note 5, § 93 marg. no. 21; HOPT/ROTH, *supra* note 3, § 93 marg. no. 61; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 13; SPINDLER, *supra* note 3, § 93 marg. no. 36.

tion has to be brought about by courts limiting themselves to finding only evidently unjustifiable decisions unlawful.[79] The criterion of an evidently unjustifiable decision is not identical to the criterion of gross negligence;[80] while evidently unjustifiable decisions are often based on gross negligence, they need not necessarily be (e.g., a misconception arrived at through slight negligence may lead to an evidently unjustifiable decision).

c) *The Function of Reasonable Information*

Another flaw of § 93 para. 1 sent. 2 AktG results from the reference to "proper information". Its wording implies that the business judgment rule and the corresponding margin of discretion does not apply if the manager has decided on the basis of no or insufficient information. However, a decision that was in effect economically sound cannot be a basis for liability even if a director had not informed himself as thoroughly as he should have before arriving at the decision. The assessment of economical soundness is inevitably subject to the empirical issue of uncertainty – whatever the information basis may have been. Therefore, as a matter of practical necessity, the margin for finding a business decision to be sound must be the same regardless of whether or not the director acted on sufficient information. Thus, the legal margin of discretion granted to the director is always the same.[81] The information deficit may only be used as circumstantial evidence against the director in determining whether or not a decision was evidently unjustifiable.

d) *Discretion in Questions of Law – "Legal Judgments"*

Under the majority opinion, the business judgment rule does not apply to judgments relating to questions of law. It is generally up to directors to hire qualified lawyers to find out what the law is and to act accordingly.[82] Thus, an unresolved question of law is generally not treated as a business prognosis but as a simple fact-finding exercise.

This assumption does not hold up when one looks into the actual realities of the legal world.[83] There are numerous situations in which corporate direc-

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[79] See OLG Frankfurt a. M., 07 December 2010, 5 U 29/10, NZG 2011, 62; BOSCH/LANGE, *supra* note 77, 229; FLEISCHER, *supra* note 3, § 93 marg. no. 75; KOCH, *supra* note 5, § 93 marg. no. 23; HOPT/ROTH, *supra* note 3, § 93 marg. no. 61; SPINDLER, *supra* note 3, § 93 marg. no. 56.

[80] For a different approach, see BACHMANN, *supra* note 4, 46.

[81] See HOPT/ROTH, *supra* note 3, § 93 marg. no. 102 for a similar approach: The criteria of an "acceptable decision" and of "reasonable information" form a uniform criterion for judging a decision's economic soundness; see also H. FLEISCHER, Die „Business Judgment Rule": Vom Richterrecht zur Kodifizierung, ZIP 2004, 685, 689, who alludes to a similar conception.

[82] BGH, 21 April 1997, II ZR 175/95, NJW 1997, 1926, 1928 – *ARAG/Garmenbeck*.

tors cannot foresee whether the actions they take will be deemed legal or illegal by the courts. One may think, for example, of the decision to self-waive the duty to *ad-hoc* disclosure pursuant to the vague standard of § 15 para. 3 WpHG or of the rather delicate decision to go forward with an agreement that might be impermissible under the antitrust rules in Art. 101 para. 1 and para. 3 TFEU (Treaty on the Functioning of the European Union). The almost insurmountable uncertainty in these and many other cases basically stems from the courts' discretion in construing legal norms.

Directors should not have the degree of discretion given to judges. Yet, it would be unsound to force directors in situations of legal uncertainty to choose a course of action that is guaranteed to be lawful. Apart from being highly inefficient, such a view would have the unwelcome consequence that directors would have a strong disincentive against challenging (potentially flawed) administrative practices or jurisdiction. Hence, directors should only be denied the discretion to follow the most favorable line of legal argument if there is a definite course settled on by the courts and/or by legal literature. If there is, however, considerable legal uncertainty from the perspective of a reasonable and responsible director, he should be granted discretion and be allowed to assume the position most advantageous to his corporation.[84]

An alternative concept to protect a director from liability in a situation of legal uncertainty is the criterion of an excusable error of law that relieves him from culpability. There has been a recent verdict by the Supreme Court that shows a more generous tendency to excuse errors of law.[85] One may certainly achieve the same result in resolving the issue of legal uncertainty here by granting some form of discretion to the director. But one should note that the error-criterion does not accurately reflect the director's mindset in cases of legal uncertainty, as it suggests that there was an opportunity for definite determination of the law before a court has removed the uncertainty.

3. Collective and Individual Responsibility

Under the German AktG, the directors' duties generally refer to the board collectively *(der Vorstand)* and not to the individual members *(Vorstandsmitglieder).* It is economically sensible and common practice, however, to divide the board's tasks up into several distinct divisions. Consequently, responsibility and liability must be examined and determined individually for each director (§ 93 AktG). This raises the question of how to determine individual responsibility and, in particular, of how to deal with the division of

[83] For a critical approach to the opinion of the Supreme Court, see FLEISCHER*, supra* note 15, 141, 149 et seq.; HARNOS, *supra* note 3, 297.

[84] See FLEISCHER*, supra* note 3*,* § 93 marg. no. 30; FLEISCHER, *supra* note 15, 149 et seq.; SPINDLER, *supra* note 3, § 93 marg. nos. 85 et seqq.

[85] BGH, 28 April 2015, II ZR 63/14, NJW-RR 2015, 988.

functions ((a) below). Another problem of individual responsibility stems from the voting procedure, in which the criterion of causation becomes questionable if each single vote is not relevant for the result under the concrete majority conditions ((b) below).

a) Division of Functions and Individual Responsibility

In general, the management board is collectively responsible for all its duties and decisions, and, as a result, all directors are individually responsible as well. With regard to some fundamental duties, such as the duty to ensure an effective general organization or the duty to file for insolvency proceedings, the collective responsibility is mandatory and not diminished by the division of functions.[86] On a less fundamental level, the collective tasks of the board may well be divided between the individual members. But the division will not completely relieve the directors of liability for actions and decisions outside their departments. Rather, dividing functions has the consequence that the general duties of management are transformed into supervision duties.[87] The duty to supervise may vary in content and in intensity. If there are signs of significant problems, it becomes stricter and may turn into a duty to intervene (e.g., financial crisis; unlawful conduct).[88]

While these mandatory residual duties are well recognized in principle, there is a lot of uncertainty about what is specifically required in practice.[89] At the least, each director has to ensure an effective reporting and information management system that allows him to reasonably oversee the status of the affairs in his co-directors' departments.

b) Responsibility for Participation in a Board Decision

There is general agreement that all directors who have voted for an unlawful or otherwise detrimental decision are liable for that decision even if their individual vote did not make a difference as far as the result is concerned.[90] While this finding is in contrast to the general rules of causation and has no

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[86] For an overview, see H. WICKE, Der CEO im Spannungsverhältnis zum Kollegialprinzip Gestaltungsüberlegungen zur Leitungsstruktur der AG, NJW 2007, 3755, 3756.

[87] See FLEISCHER, *supra* note 3, § 77 marg. no. 49; HOPT/ROTH, *supra* note 3, § 93 marg. no. 376; KOCH, *supra* note 5, § 93 marg. no. 42; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 92; SPINDLER, *supra* note 3, § 93 marg. no. 98.

[88] See FLEISCHER, *supra* note 3, § 93 marg. nos. 107, 109.

[89] There are only a few cases decided by the courts, e.g., BGH, 8 October 1984, II ZR 175/83, GmbHR 1985, 143, 144 (duty to intervene if there are signs that taxes are not properly prepared by employees); OLG Koblenz, 10 June 1991, 6 U 1650/89, ZIP 1991, 870 (duty to remove access to a bank account if there are signs of unlawful withdrawals).

[90] See, e.g., FLEISCHER, *supra* note 3, § 93 marg. no. 217; GRIGOLEIT/TOMASIC, *supra* note 42, § 93 marg. no. 64.

clear basis in statutory law, it may be derived by analogy from § 830 para. 1 sent. 2 BGB.[91] Under this provision, several tortfeasors are jointly liable if it can be proven that they all acted unlawfully, each of them potentially caused the damage and at least one of them must have actually caused the damage. If these conditions are fulfilled, joint liability accrues if it cannot be proven whose individual wrongdoing caused the damage done.

Furthermore, a director can even be liable for an unlawful or otherwise detrimental board decision if he voted against the decision. This may be the case if the opposing director failed to take appropriate action against that decision (e.g., complaint to the supervisory board).[92]

4. Privileges for Directors Resulting from General Principles and Judge-Made Law

Considering the rigidity and potentially ruinous effects of directors' liability under statutory law, it is widely perceived that liability should be mitigated by deriving a less strict standard of liability from non-statutory doctrines and principles.[93] As a result of this perception, there is a pronounced discourse in legal literature as to how to construct a less strict standard, or a reduction of liability under the current law of the stock corporation.[94] Subsequently, I outline and discuss the three most popular concepts ((a)–(c) below), before attempting to carve out and emphasize the most significant obstacle to any limitation to liability that might be developed by the courts – the strict conception of unlimited directors' liability under § 93 AktG ((d) below).

a) Application of the Doctrine of Employee Privilege

A fairly common proposition to mitigate directors' liability is to apply the so-called "employee privilege".[95] In cases of professional misconduct, an em-

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[91] See H. FLEISCHER, Zur Verantwortlichkeit einzelner Vorstandsmitglieder bei Kollegialentscheidungen im Aktienrecht, BB 2004, 2645, 2647; FLEISCHER, *supra* note 3, § 93 marg. no. 217; HOPT/ROTH, *supra* note 3, § 93 marg. no. 414 (citing § 830 para. 1 sent. 1 BGB); SPINDLER, *supra* note 3, § 93 marg. no. 175.

[92] LG München I, 10 December 2013, 5 HKO 1387/10, NZG 2014, 345, 348 –*Siemens/Neubürger*; FLEISCHER, *supra* note 91, 2651; SPINDLER, *supra* note 3, § 93 marg. no. 167.

[93] See the resolutions of the German Jurists' Conference of 2015, available at <http://www.djt.de/fileadmin/downloads/70/140919_djt_70_beschluesse_web_rz.pdf>, 17.

[94] See FLEISCHER, *supra* note 37, 1305 et seqq. for an overview. For a more comprehensive analysis, see P. SCHOLZ, Die existenzvernichtende Haftung von Vorstandsmitgliedern in der Aktiengesellschaft (Jena 2014) 265 et seqq.

[95] See G. HOFFMANN, Existenzvernichtende Haftung von Vorständen und Aufsichtsräten?, NJW 2012, 1393, 1396 et seq.; BACHMANN, *supra* note 73, 582; see *also* BACHMANN, *supra* note 4, 56 et seqq. („schadensrechtliche Billigkeitsklausel": § 254a BGB) for a solution to be implemented in statutory law. A. FUCHS/M. ZIMMERMANN, Reform der Organ-

ployer faces strong restrictions in holding a "simple employee" liable. Full compensation without any restrictions will usually only be awarded for wrongdoing carried out with intent. There is no compensation at all for damages arising from acts of slight negligence and only *pro-rata* compensation for acts of ordinary negligence; in cases of gross negligence, the employer is usually entitled to full compensation, but even then he faces a cap based on the employee's gross monthly income.[96] These restrictions generally apply to employees holding management positions as well.[97] The liability privilege of employees is mainly based on the rationale that the risk materializing in cases of professional misconduct can be controlled by the employer and is an inseparable element of the general risk associated with his enterprise.[98] This reasoning has been generalized into the proposition that the person in whose interest a task is carried out always has to bear some of the associated risk.[99]

Yet, under a significant majority opinion, this doctrine cannot be transferred to the directors, i.e., to the top management of the corporation *(Organe)*.[100] First, corporate directors are generally able to control entrepreneurial risk themselves. Hence, the notion that liability should be less strict in an environment controlled by other people cannot be applied.[101] Second – and even more importantly – § 93 AktG contains a comprehensive *statutory* rule governing directors' liability, which is cogent law pursuant to § 93 para. 5 AktG, leaving no room for applying a more lenient standard of *judge-made* law.[102]

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haftung? – Materielles Haftungsrecht und seine Durchsetzung in privaten und öffentlichen Unternehmen, JZ 2014, 838, 842 et seq. are against such a statutory solution.

[96] On the effects of the degree of culpability on liability, see BGH, 11 March 1996, II ZR 230/94, NJW 1996, 1532; BAG, 24 November 1987, 8 AZR 524/82, NJW 1988, 2816; BAG, 12 November 1998, 8 AZR 221/97, NJW 1999, 966; BAG, 28 October 2010, 8 AZR 418/09, NJW 2011, 1096. For an overview see, e.g., M HENSSLER, in: Münchner Kommentar BGB, 6th ed. 2012, § 619a marg. nos. 32 et seqq.

[97] See BGH, 25 June 2001, II ZR 38/99, NJW 2001, 3123, 3124.

[98] See BAG, 27 September 1994, GS 1/89 (A), NJW 1995, 210, 212.

[99] C.-W. CANARIS, Risikohaftung bei schadensgeneigter Tätigkeit in fremdem Interesse, RdA 1966, 41 et seqq.

[100] See BGH, 27 February 1975, II ZR 112/72, WM 1975, 467, 469; FLEISCHER, *supra* note 37, 1306 et seq.; P. HEMELING, Reform der Organhaftung? – Erwartungen an den 70. Deutschen Juristentag, ZHR 178 (2014) 221, 223 et seq.; HOPT/ROTH, *supra* note 3, § 93 marg. nos. 395 et seqq.; M. KAULICH, Die Haftung von Vorstandsmitgliedern einer Aktiengesellschaft für Rechtsanwendungsfehler (Berlin 2012) 296 et seq.; J. KOCH, Beschränkungen des gesellschaftsrechtlichen Innenregresses bei Bußgeldzahlungen, in: Liber Amicorum für Martin Winter (Cologne 2011) 338 et seqq.; PAEFGEN, AG 2014, 554, 568 et seq.

[101] BGH, 5 December 1983, II ZR 252/82, NJW 1984, 789, 790.

[102] See FLEISCHER, *supra* note 37, 1306 et seq.; GRIGOLEIT, *supra* note 75, 390 et seq.; J JOUSSEN, Der persönliche Anwendungsbereich der Arbeitnehmerhaftung, RdA 2006, 129, 135; HENSSLER, *supra* note 96, § 619a marg. no. 19; K. MACK, Die Regresshaftung von Vorstandsmitgliedern einer Aktiengesellschaft (Frankfurt a. M. et al. 2015) 212.

b) Privilege Based on the Corporation's Duty of Loyalty

Another – quite recent – approach holds that there should be a system of proportionately limited liability based on the corporation's duty of loyalty to its directors.[103] This approach, however, does not ultimately do much more than find a new, rather meaningless and elusive label for transposing the employee privilege.[104] In other words, the reference to the duty of loyalty does not present any specific *legal* reason why and how directors' liability should be limited. Thus, the duty of loyalty is used as a random label for the widespread policy argument that directors' liability should be limited. But in a developed legal system this coarse approach is insufficient for resolving the tension between the proposed limitation of liability and the unlimited liability decreed by §§ 93, 23 para. 5 AktG.[105]

c) Privilege with Regard to Fines Imposed Upon the Corporation

The third (rather new and increasingly popular) position to be mentioned here seeks to limit directors' liability at least in cases in which fines have been imposed upon the corporation by public authorities as a result of its directors' unlawful behavior (e.g., antitrust fines).[106] A recent and quite prominent deci-

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[103] J. KOCH, *supra* note 100, 337; W. BAYER, Vorstandshaftung in der AG de lege lata und de lege ferenda, NJW 2014, 2546, 2548; SCHOLZ, *supra* note 94, 267 et seqq. See also A. BROMMER, Folgen einer reformierten Aktionärsklage für die Vorstandsinnenhaftung, AG 2013, 121, 127 et seq.; HARNOS, *supra* note 3, 106 et seq.; G. SPINDLER, Organhaftung in der AG – Reformbedarf aus wissenschaftlicher Perspektive, AG 2013, 889, 894 et seq.

[104] FLEISCHER, *supra* note 37, 1307. Even the proponents of this concept do not deny the similarities, see, e.g., BAYER, *supra* note 65, 97 ("Anleihe"); J. KOCH, Beschränkung der Regressfolgen im Kapitalgesellschaftsrecht, AG 2012, 429, 435 ("Wertungstransfer").

[105] With a similar assessment see FLEISCHER, *supra* note 37, 1307 et seq.; FUCHS/ZIMMERMANN, *supra* note 95, 843; GOETTE, *supra* note 53, 591; HABERSACK, *supra* note 3, 801 et seqq.; KAULICH, *supra* note 100, 302; THOLE, *supra* note 63, 533; G. WAGNER, Organhaftung im Interesse der Verhaltenssteuerung – Skizze eines Haftungsregimes, ZHR 178 (2014) 227, 276 et seqq.

[106] See M. DREHER, Die kartellrechtliche Bußgeldverantwortlichkeit von Vorstandsmitgliedern. Vorstandshandeln zwischen aktienrechtlichem Legalitätsprinzip und kartellrechtlicher Unsicherheit, in: Dauner-Lieb et al. (eds.), Festschrift für Horst Konzen zum siebzigsten Geburtstag (Tübingen 2006) 85, 103 et seqq.; GOETTE, *supra* note 53, 603 et seq.; N. HORN, Die Haftung des Vorstands der AG nach § 93 AktG und die Pflichten des Aufsichtsrats, ZIP 1997, 1129, 1136; P. KINDLER, Pflichtverletzung und Schaden bei der Vorstandshaftung wegen unzureichender Compliance, in: Altmeppen/Fitz/Honsell (eds.), Festschrift für Günther H. Roth zum 70. Geburtstag (Munich 2011) 367, 372; MERTENS/CAHN, *supra* note 5, § 93 marg. no. 56. Some authors recommend limiting liability instead of excluding it: see, e.g., M. CASPER, Hat die grundsätzliche Verfolgungspflicht des Aufsichtsrats im Sinne des ARAG/Garmenbeck-Urteils ausgedient?, ZHR 176 (2012) 617, 625 et seq.; R. KOCH, Ersatzfähigkeit von Kartellbußen – Zugleich Anmerkung zum Urteil des LAG Düsseldorf vom 20.1.2015, VersR 2015, 655, 660; R. MARSCH-BARNER, Vorteil-

sion by the Regional Labor Court in Düsseldorf *(Landesarbeitsgericht Düsseldorf)*[107] supports that view. In its judgment, the court refused to grant the corporation damages for antitrust fines imposed upon it after one of its directors had entered into an agreement prohibited under antitrust law. The decision was based on the grounds that the fine's purpose was to impose a sanction on the corporation, a goal which could not be achieved if the corporation could seek compensation from its directors.[108]

That argument, however, does not hold up upon closer inspection. There is no convincing reason to distinguish the case of regulatory fines from other damages inflicted upon the corporation by the director.[109] In particular, the (economic) goal of aligning incentives effectively does not require one to rule out recovery for the fine. It rather implies that the acting manager should be held (at least partly) responsible.[110] While the purpose of the fine may in fact be to sanction the corporation, the law imposing the fine is silent on the question of how the financial burden of the fine should be dealt with within the company.[111] In particular, it is not likely that the legislature aimed at implicitly derogating from § 93 AktG and its clear resolution for directors' liability in passing the penalty law (in the case decided by the court, the law providing for the antitrust penalty).

Yet, there is one reservation to be rightfully made with regard to the corporation's recourse claim against the director: If (and in as much as) the fine is calculated to skim off corporate profits that may have resulted from the unlawful business conduct, the recourse against the director should not be granted.[112] This exception corresponds to the notion that directors' liability for breach of the duty of legality is to be adjusted for profits received by the

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sausgleich bei der Schadensersatzhaftung nach § 93 AktG, ZHR 173 (2009) 723, 730; THOLE, *supra* note 63, 533 et seqq.

107 LAG Düsseldorf, 20 January 2015, 16 Sa 459/14, ZIP 2015, 829.

108 LAG Düsseldorf, 20 January 2015, 16 Sa 459/14, ZIP 2015, 829, 830 et seqq. For authors supporting this decision, see, e.g., G. BACHMANN, Anmerkung zum Teilurteil des LAG Düsseldorf vom 20.1.2015 – 16 Sa 459/14, BB 2015, 911 and G. BACHMANN, Die Geschäftsleiterhaftung im Fokus von Rechtsprechung und Rechtspolitik, BB 2015, 771, 775; A. LOTZE/S. SCHIMANSKI, Entschärfung der Organhaftung für kartellrechtliche Unternehmensgeldbußen, NZKart 2015, 254 et seqq.; S. THOMAS, Bußgeldregress, Übelszufügung und D&O-Versicherung, NZG 2015, 1409, 1410 et seqq. For a critical view towards the court's line of argument, see, e.g., MACK, supra note 102, 174 et seqq.; SCHOLZ, *supra* note 94, 47 et seqq.

109 BAYER, *supra* note 65, 97; BAYER/SCHOLZ, *supra* note 66, 455 et seq.; KOCH, *supra* note 104, 433.

110 H. FLEISCHER, Regresshaftung von Geschäftsleitern wegen Verbandsgeldbußen, DB 2014, 345, 348, J. KOCH, *supra* note 104, 434; R. KOCH, *supra* note 106, VersR 2015, 655, 658; THOLE, *supra* note 63, 533.

111 See, e.g., H. FLEISCHER, Kartellrechtsverstöße und Vorstandsrecht, BB 2008, 1070, 1073.

corporation from the unlawful conduct (see *supra* at III.1.b). As the fruits of the infringement are not worthy of protection, it is not acceptable to retrieve them through the avenue of directors' liability if they have already been withdrawn through the fine. This limitation of the recourse against the director arises from general principles on the law of remedies specifying the amount of recoverable damages.[113] Therefore, to qualify it as an exception to the unlimited liability of directors under § 93 AktG is not necessary from a doctrinal point of view.[114]

d) The Unambiguous Denial of Any Privilege by the Positive Order of § 93 AktG

In discussing the limitation proposals, we have in this paper again and again been confronted with the crucial obstacle of the strict conception of directors' liability under § 93 AktG. Hence, it is worthwhile to emphasize and clarify the statement that this provision makes with regard to any attempt to justify the mitigation of directors' liability on the basis of general (unwritten) principles.

The fundamental statutory finding is that the detailed rules of § 93 AktG unambiguously refer to the weakest form of culpability (para. 1) and do not provide for any reduction by law, whatever the amount the damages claim may be.[115] The only limitation that is statutorily recognized is a settlement or a waiver granted by the shareholders (§ 93 para. 4 sent. 3 AktG). This finding evokes an *argumentum e contrario* – or, to put it poetically, a finding of eloquent silence *(beredtes Schweigen),* if the general rules of legal methodology are taken seriously.[116] The provisions of § 93 AktG do not only positively establish liability, but they also express the negative statement that no limitations by law are to be recognized and that the courts must restrain themselves from creating them. The inversion argument is confirmed by several (recent) statutory interventions in the conditions of liability (for example, demanding a mandatory D&O deductible at the expense of the director (§ 93 para. 2

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[112] See FLEISCHER, *supra* note 110, 348; HORN, *supra* note 106, 1136; G. KRIEGER, in: Schneider/Krieger Handbuch Managerhaftung, 2nd ed. 2010, § 3 marg. no. 39; C. SEIBT, 20 Thesen zur Binnenverantwortung im Unternehmen im Lichte des reformierten Kapitalmarktsanktionsrechts, NZG 2015, 1097, 1101; THOLE, *supra* note 63, 528.

[113] See BAYER/SCHOLZ, *supra* note 66, 450 et seq.; FUCHS/ZIMMERMANN, *supra* note 95, 843 et seq.; M. ZIMMERMANN, Kartellrechtliche Bußgelder gegen Aktiengesellschaft und Vorstand: Rückgriffsmöglichkeiten, Schadensumfang und Verjährung, WM 2008, 433, 438 et seq.

[114] ZIMMERMANN, *supra* note 113, 438 et seq.; ET SEQ. HACK, Vorstandsverantwortlichkeit bei Kartellrechtsverstößen (Frankfurt am Main et al. 2012) 81 et seq.; probably also THOMAS, *supra* note 108, 1414 et seq.

[115] See, e.g., FLEISCHER, *supra* note 37, 1306 et seq.; T. SCHÖNE/S. PETERSEN, Regressansprüche gegen (ehemalige) Vorstandsmitglieder – quo vadis?, AG 2012, 700, 704 et seq.

[116] See HABERSACK, *supra* note 3, 802 et seq.

sent. 3 AktG), and the extension of the limitation period (§ 93 para. 6 AktG)). Thus, the legislature has been working thoroughly on directors' liability in recent times, but he has not been inclined to limit directors' liability; rather, liability has been tightened.

Another good reason that the issue cannot be taken care of by the courts and should be resolved by the legislature is that there is a large number of conceivable ways to implement limitations:[117] One may, for example, put a cap on the award (absolute in size or relative to the damage or to the directors' individual salary), adjust the amount of liability according to different degrees of wrongdoing, or grant the supervisory board or the shareholders greater discretion in contracting on disclaimers. Since statutory law provides for none of these options, it should be considered to be beyond the competence of the courts to derive, discretionarily, one of these instruments from general standards that are basically meaningless and provide no specific guidance.

Finally, one may take into account the mandatory character of the law of stock corporations (§ 23 para. 5 AktG). As it is generally established that corporations or shareholders must not contractually limit directors' liability, it would be inconsistent to allow the courts to do so.

5. Enforcement by the Supervisory Board

Another quite pronounced element of the rigor of directors' liability under German law is the general duty of the supervisory board to enforce claims as stipulated by the Supreme Court (see the following section). From an international perspective, such a duty is rather eccentric. In conjunction with the absence of effective limitations by law, the enforcement duty narrows down the potential for acting out of a sense of proportionality or leniency in the individual case. One must take into account, in particular, that the members of the supervisory board themselves are always at risk of being held liable if they desist from enforcing a claim. Against this background, I would like to briefly reconsider the rationale of the enforcement duty ((a) below) and to examine the supervisory board's mandate in drafting and negotiating a settlement agreement on directors' liability ((b) below).

a) Duty to Enforce Claims Against Directors (ARAG/Garmenbeck Case)

The general duty of the supervisory board to enforce claims against the corporation's directors as stipulated by the Supreme Court is hard to justify by employing a corporation's aim to pursue profits.[118] In particular, it is not

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[117] For an overview, see FLEISCHER, *supra* note 37, 1309 et seqq.

[118] See M. LUTTER, Zum Beschluss des Aufsichtsrats über den Verzicht auf eine Haftungsklage gegen den Vorstand, in: Festschrift für Michael Hoffmann-Becking zum 70.

plausible to assume, as a general rule, that the enforcement of directors' liability is in the best financial interest of the corporation. The opposite assessment seems more credible, i.e., that the negative consequences of enforcement will generally outweigh the benefits to be gained by holding a director liable.[119] One has to allow for the potentially negative effects on the corporation's reputation[120] and on the (productive) risk appetite of active directors and managers.[121] Furthermore, in many of the most prominent cases in which enormous losses have occurred, the potential coverage from a liability award would not carry significant weight as the directors' assets are usually negligible in comparison. The potential litigation costs will often threaten to exhaust any gains from litigation. Thus, the recognition of the supervisory board's duty to enforce can – if at all – only be based on a justification other than the corporation's financial interest.

In fact, there are some plausible rationales for the duty to enforce. First, imposing a duty on the supervisory board may address a systematic conflict of interest. The supervisory board may be reluctant to seek damages from the directors, as it may be afraid of revealing potential faults of its own in controlling the management board.[122] Second, the duty to enforce claims against corporate directors serves to protect the shareholder assembly's rights in foregoing claims and reaching settlements (§ 93 para. 4 sent. 3 AktG).[123]

Third – and even more importantly, but so far not sufficiently taken into consideration – the supervisory board's duty to enforce liability should be interpreted and properly used as an effective tool to complement and safeguard the directors' duty of legality. From this perspective, the real purpose of the enforcement duty is to serve the public interest in ensuring proper business conduct rather than furthering corporate interests. If it were not for the enforcement duty recognized under the *ARAG/Garmenbeck* doctrine, the supervisory board's incentive to investigate and sanction directors' wrongdo-

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Geburtstag (Munich 2013) 752; P. ULMER, Die Aktionärsklage als Instrument zur Kontrolle des Vorstands- und Aufsichtsratshandelns, ZHR 163 (1999) 290, 296 et seq.; HABERSACK, *supra* note 3, 788 et seq.

119 See LUTTER, *supra* note 118, 752; ULMER, *supra* note 118, 296 et seq.; HABERSACK, *supra* note 3, 788 et seq.

120 For evidence of the impact of reputation damage on share prices, see, e.g., J. KARPOFF, in: Barnett/Pollock (eds.), The Oxford Handbook of Corporate Reputation (Oxford 2012) 361, 364 et seqq.

121 Further aspects are elaborated on by – among others – W. GOETTE, „Zur ARAG/GARMENBECK-Doktrin" in: Liber Amicorum für Martin Winter (Cologne 2011) 164 and GOETTE, *supra* note 53, 610.

122 BegrRegE BT-Drs. 15/5092, 19 et seq.; HABERSACK, *supra* note 3, 785 et seq.; M. LUTTER, Bankenkrise und Organhaftung, ZIP 2009, 197, 201 et seq.; WAGNER, *supra* note 105, 239 et seq.

123 BGH, 21 April 1997, II ZR 175/95, NJW 1997, 1926, 1928 = BGHZ 135, 244 – *ARAG/Garmenbeck*.

ing would be rather diminutive.[124] This becomes all the more obvious if one takes into account the systematic conflict of interests just mentioned.

b) Duties and Discretion with Respect to Negotiating Settlements Concerning Director's Liability

I have mentioned above that the supervisory board's enforcement duty can be fulfilled by entering into a settlement agreement, providing that the shareholder assembly consents to it (§ 93 para. 4 sent. 3 AktG, *supra* at II.6.c). This raises the question as to whether the supervisory board has discretion in negotiating the settlement and submitting it to the shareholder assembly or whether it is bound to a certain extent by its corporate duties. This issue has not yet been resolved by the courts and is not clearly dealt with by the legal authors.

Some voices suggest that the members of the supervisory board should be granted a wide margin of discretion with regard to the terms of the settlement – just like the discretion afforded to the business judgments of directors (§ 93 para. 1 sent. 2 AktG, *supra* at II.3.). This position is primarily based on the consideration that the actual decision on the settlement is the decision of the shareholder assembly, which can supervise and correct the proposal that the supervisory board has submitted.[125]

This conclusion is subject to some reservations if one takes the demands of the *ARAG/Garmenbeck* decision seriously. The requirements stipulated in *ARAG/Garmenbeck* mandate that the supervisory board properly enforce claims against a corporation's directors, which should include an obligation to ensure appropriate damages awards in settlements. To a certain extent, the shareholder assembly's involvement pursuant to § 93 para. 4 sent. 3 AktG might help to reject inappropriate settlement agreements. However, the assembly is not in a position to flexibly and effectively handle, the matter on its own. While it has some enforcement rights (see in particular § 147 AktG), taking such action is rather complicated. Therefore, even in the light of the assembly's participation, the supervisory board's handling of the liability matter is essential for effective and successful enforcement.[126] It follows that even in

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[124] From a quite general perspective with similar considerations, H.-J. HELLWIG, Die Finanzkrise – Fragen und Antworten, in: Grunewald / Westermann (eds.), Festschrift für Georg Maier-Reimer zum 70. Geburtstag (Munich 2010) 214 on the importance of holding the director liable for infringing the legal order as such.

[125] W. BAYER/P. SCHOLZ, Die Pflichten von Aufsichtsrat und Hauptversammlung beim Vergleich über Haftungsansprüche gegen Vorstandsmitglieder, ZIP 2015, 149, 152; DIETZ-VELMER, *supra* note 52, 251; FLEISCHER, *supra* note 3, § 93 marg. no. 278; HOPT/ROTH, *supra* note 3, § 93 marg. no. 503; KOCH, *supra* note 5, § 93 marg. no. 76.

[126] Similarly T. TRÖGER, Durchsetzung der Vorstandshaftung, ZHR 179 (2015) 453, 480 et seqq., who endorses the competence of the shareholders, but also emphasizes the function of the supervisory board.

settlement agreements, the supervisory board has no "regular" business discretion but is under a duty to appropriately serve the best interests of the corporation and to implement the purposes which the rules on directors' liability seek to achieve. Yet, the peculiarities of a settlement pertaining to corporate liability should be taken into account by granting the supervisory board a *greater degree of discretion* than in cases of mere non-enforcement.[127]

IV. Conclusions

At the beginning of this paper I mentioned that the German discussion on directors' liability oscillates between three poles: providing effective protection to corporate assets against directors' mismanagement, avoiding over-deterrence and safeguarding the public legal order. This papers shows that the interaction between these poles is unbalanced under the current German directors' liability legal order – to the detriment of both the directors and the corporations. From a general perspective, the latter are likely to lose potential gains or even incur losses through (inefficient) risk aversion and legal costs resulting from (inefficient) legal enforcement costs triggered by the law.

It is a combination of several different legal characteristics that creates an overly rigorous set of rules on liability. This tendency is constituted of three main elements: first, the sheer number and vague scope of organizational duties, for which the duty to effectively organize "compliance" and the vague and unreliable standards for the division of responsibilities are paradigmatic. Second, the restrictive approach to liability limitations, i.e., in particular the far-reaching ban on limitation by agreement and the unavailability of privileges by law. And, third, the duty of the supervisory board to enforce valid claims, which renders a flexible and potentially lenient reaction to individual cases of mismanagement or wrongdoing at least very complicated and sometimes even impossible.

It is not surprising that, according to a common perception, there is a need to mitigate elements of the rules on directors' liability.[128] However, the particulars of sensible and effective mitigation measures are rather difficult to determine. The first aspect, the number and vagueness of directors' duties, does not appear to be suitable for legislative action and doctrinal relief, as

[127] One should note that there are even proponents of a "strict application" of the *ARAG/Garmenbeck* doctrine on the settlement decision; see, e.g., K. HASSELBACH, Der Verzicht auf Schadensersatzansprüche gegen Organmitglieder, DB 2010, 2037, 2040.

[128] See, e.g., SPINDLER, *supra* note 103, 889, 894 et seqq.; HABERSACK, *supra* note 3, 800; SPINDLER, *supra* note 3, § 84 marg. no. 64; K. SCHMIDT, Gesellschaftsrecht, (4th ed. Cologne et al. 2002) § 14 V = p. 426; M. PELTZER, Mehr Ausgewogenheit bei der Vorstandshaftung, in: Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 865 et seqq.

these demands correspond to the practical challenges of managing a company. These duties can only be specified by the judiciary over time. The third aspect, the supervisory board's duty to enforce liability claims, is a crucial tool to safeguard the directors' duty of legality. In the light of this function, it should not be prematurely abandoned.

Therefore, the focus of reform should be on the area of limitation of liability. The most obvious and simple improvement would be to allow the insertion liability limitations into the corporate charter. Equally plausible would be the recognition of liability limitations as a matter of law, namely a rule corresponding to the employees' liability privilege or a flexible cap on liability for negligence by reference to a quota of the individual's compensation. But in the light of the unambiguous statutory provisions these limitations can only be achieved by the legislature. Any significant intervention by the courts would be *contra legem* and arbitrary. Yet, the reform needed does not appear to be imminent, as these days politicians do not seem to wish to live under the suspicion of letting the big fish go free.

II. Capital Maintenance

Legal Capital in Japan and the Influence of German Law

Gen Goto

I. Introduction

When Japan enacted its first corporate law in 1890s as a part of its Commercial Code, rules regarding legal capital were imported largely from German law.[1] Since then, legal capital has been playing an important role in Japanese

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[1] For the history of early corporate law in Japan, see H. KANSAKU/M. BÄLZ, Gesellschaftsrecht, in: Baum/Bälz (eds.), Handbuch Japanisches Handels- und Wirtschaftsrecht (Cologne 2011) 75–76.

corporate law as the threshold for distribution to shareholders.[2] It is also used as a rough measure of the size of a company in corporate law and other areas of law,[3] as well as in society.[4]

Over the years, however, Japanese law has moved away from its German tradition. To give a few examples, the so-called warning function of legal capital (i.e. the duty of directors to call a shareholders' meeting when the company's net equity falls below one half of the amount of legal capital) and their duty to file for bankruptcy when the company's asset base became less than its debt were both abolished in 1938. The minimum capital requirement, which was introduced in 1991 for stock companies, was also abolished in 2005.

These changes invoked a paradigm shift on the functions of rules regarding legal capital. While the traditional view in Japan was that both capital maintenance rules and capital contribution rules protect creditors, recent scholars view the latter as protecting shareholders rather than creditors. This paradigm shift was in turn the theoretical basis for the reform of 2005, which also partly deregulated rules on contribution to shares. These deregulations by the 2005 reform were partly justified by an idea that the protection of creditors is better achieved by *ex post* remedies.

The remainder of this article proceeds as follows. Part II begins with an overview of the current state of rules regarding legal capital under Japanese law, focusing on differences from and commonalities with German law. Then, Part III analyzes the reform of 2005 and the paradigm shift on the functions of legal capital that supported such reform. After a critical analysis of liability

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[2] Currently, Art. 446 and Art. 461, *Kaishahô* (Companies Act), Law No. 86 of 2005. Similar rules were in place before the enactment of the Companies Act in 2005. See Art. 219 *Kyû-shôhô* (the Old Commercial Code), Law No. 32 of 1890 (1890–1899); Art. 195 *Shôhô* (Commercial Code), Law No. 48 of 1899 (1899–1938); Art. 290 Commercial Code (1938–2005).

[3] For example, stock companies with legal capital of 500 million Japanese Yen or more are classified as "large companies" and are required to appoint certified a public accountant as outside auditor. Art. 2 no. 6 and Art. 328 Companies Act. In the field of tax law, companies with legal capital of 100 million Japanese Yen or less qualify for preferential treatment such as lower taxation rates and loss carried forward. Art. 57 para. 1 and para. 11 no. 1 (a) and Art. 66 paras. 1 et seq. *Hôjinzeihô* (Corporation Tax Act), Law No. 34 of 1965. Recently, SHARP, a Japanese giant manufacturer in financial distress with an annual turnover of more than two trillion Japanese Yen, took back its plan to reduce the amount of legal capital from 121,800 million to 100 million Japanese Yen to qualify for preferential tax treatment due to criticism from politicians suggest the unreasonableness of using legal capital as a measure of the size of companies. See "*SHARP '1-oku en genshi' dannen, hihan kôryo, 5-oku en ni* [SHARP Gave Up Reducing Its Legal Capital to 100 Million Yen in Consideration of Criticisms, Now to 500 Million Yen]", Nihon Keizai Shinbun, 13 May 2015, 2:02 JST, available at <http://www.nikkei.com/article/DGXLASDZ12I79_S5A510C1TJ2000/>.

[4] For example, applicants for a credit card are usually asked to provide the amount of legal capital of their employer, presumably to judge how stable the applicant's income is.

for undercapitalization as an *ex post* remedy in Part IV, Part V concludes with a short deliberation on the future of legal capital in Japanese law.

II. Legal Capital under Japanese Law

1. Differences from German Law

a) No Minimum Capital Requirement

Starting with the differences between Japanese and German law on the issues of legal capital, the first point to be raised should be that there is no minimum capital requirement in Japan.[5] It was introduced in 1991, requiring 10 million Japanese Yen (approximately 75,000 Euros) for stock companies *(kabushiki kaisha)* and 3 million Japanese Yen (approximately 22,500 Euros) for limited companies *(yugen kaisha)*.[6] As mentioned earlier, these requirements were abolished in 2005.[7] Thus, it is now possible to incorporate a stock company with legal capital of just one Japanese Yen.

b) No Duty of Directors upon Loss of One Half of Legal Capital or Insolvency

The second difference from German law is that, in Japan, directors are not required to call a special shareholders' meeting when the amount of shareholders' equity falls below one half of the amount of legal capital. Directors are also not required to file for bankruptcy even when the company is in balance-sheet insolvency (i.e. the amount of the debt of the company exceeding that of its assets) or equity insolvency (i.e. the company is unable to pay its debts as they fall due). These duties, which could be traced to German law,[8] were abolished as early as in 1938.[9]

It must be noted, however, that although there are no explicit duties requiring directors to call shareholders' meeting or file for bankruptcy, there is a provision in the Companies Act that imposes liability on directors against

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[5] In contrast, German law requires minimum capital of 50,000 Euros for stock companies (§ 7 AktG) and 25,000 Euros for limited liability companies (§ 5 para. 1 GmbHG).

[6] Art. 168 para. 4 Commercial Code (before the 2005 reform); Art. 9 *Yûgen Kaishahô* (Limited Companies Act), Law No. 74 of 1938 (before its repeal in 2005).

[7] See *infra* III.4.

[8] See § 92 para. 1 and para. 2 AktG. While some European countries go further to require companies "to recapitalize or to liquidate" when the amount of shareholders' equity falls below one half of the amount of legal capital, such rules could be inefficient. See L. ENRIQUES/J. R. MACEY, Creditors Versus Capital Formation: The Case against the European Legal Capital Rules, 86 Cornell Law Review (2001) 1165, 1183–1184, 1201–1202.

[9] See Art. 174, Commercial Code (before the 1938 reform).

third parties,[10] and directors could be held liable against creditors for continuing to trade in financial distress.[11]

c) *Calculation of the Amount of Legal Capital*

The third difference, which may sound rather technical, is the way the amount of legal capital is calculated.[12]

Traditionally, the amount of legal capital, which was to be stated in the articles of incorporation,[13] was calculated by multiplying the number of shares issued by the par value of shares.[14] However, such relationship between the amount of legal capital and the shares had been gradually eroded,[15] and does not exist anymore.[16]

Under the current rule, where par-value shares are not permitted,[17] a company must record one half or more of the issuance price of shares as its amount of legal capital.[18] Since the issuance price could differ for each issuance, the amount of legal capital recorded corresponding to same amount of shares could be different. The remainder of the issuance price shall be capital

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[10] Art. 429 para. 1 Companies Act (directors are liable against third parties who suffered damages as a result of the directors' gross negligence in performance of their duties to the company). See for details M. VENTORUZZO et al., Comparative Corporate Law (St. Paul 2015) 354–357.

[11] See for example Fukuoka High Court, Miyazaki Division, 14 May 1999, Hanrei Taimuzu 1026 (2000) 254. Some commentators propose reintroducing directors' duty to file for bankruptcy when the company is insolvent. See Y. KIGAWA, *Tôsan tetsuduki kaishi môshitate gimu no saisei* [Reviving the Duty to File for Bankruptcy Procedure], Hogaku Shinpo 113 No. 9-10 (2007) 157; M. YANAGA, *Saikensha hogo* [Creditor Protection], in: Asagi et al. (eds.), *Kenshô kaishahô* [Companies Act Examined] (Tokyo 2007) 483, 508–510.

[12] In Germany, the legal capital of an *Aktiengesellschaft* must be stated in its articles of incorporation and divided into the part for shares with par value, which is further divided by the amount of par value and the number of shares with such par value, and the part for shares without par value, which is further divided by the number of such shares. § 23 para. 3 nos. 3 et seq. AktG. See also § 5 para. 3 GmbHG.

[13] Art. 166 para. 1 no. 3 Commercial Code (before the 1950 reform).

[14] Arts. 199 and 202, Commercial Code (before the 1950 reform) (requiring the amount of legal capital to be divided equally into shares).

[15] The beginning of such erosion was the introduction of shares without par-value in the 1950 reform. Art. 199, Commercial Code (after the 1950 reform).

[16] For the history of reforms in this area, see T. INABA, *Shihon /jyôyokin bunpai kisei* [Legal Capital and Regulation on Distribution to Shareholders], in: Inaba/Osaki (eds.), *Kaiseishi kara yomitoku kaishahô no ronten* [Issues of the Companies Act Analyzed from the Viewpoint of Legislative History] (Tokyo 2008) 273–283.

[17] Par-value shares were abolished in the 2001 reform.

[18] Art. 445 paras. 1–2 Companies Act. This formula was introduced in the 1981 reform and was applied to both par-value shares and shares without par-value. See Art. 284 para. 2 Commercial Code (after the 1981 reform).

reserve.[19] The amount of legal capital is disclosed in the corporate register,[20] but it is not necessary to state it in the articles of incorporation.[21] Thus, it does not trigger the procedure necessary for amendment of the articles of incorporation to raise the amount of legal capital.

2. Commonalities with German Law

a) Restrictions on Distributions to Shareholders

Turning to what Japanese law has in common with Germany, legal capital still provides the threshold for distribution to shareholders.[22] Leaving all technicalities aside, the amount of assets distributable to shareholders of a stock company is calculated by subtracting the amount of its legal capital and statutory reserves[23] from the amount of its net equity.[24] To reduce the amount of legal capital and/or statutory reserves, the company needs to provide security to creditors objecting to the reduction unless it proves that the reduction is not likely to damage the creditor's interest.[25] When a company distributes more assets than it is permitted, shareholders who received and directors and officers involved in such distribution are liable to the company to pay the whole distributed amount.[26]

One important difference from German law is that this restriction on distributions to shareholders is applicable only to dividends and share-repurchases.[27] In other words, it is not applicable to "disguised dividends" such as payment of excessive salaries to shareholders who are also managers or sales

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[19] Art. 445 para. 3 Companies Act.

[20] Art. 911 para. 3 no. 5 Companies Act.

[21] See Art. 27 Companies Act (not listing the amount of legal capital as a mandatory item of the articles of incorporation).

[22] See § 57 AktG and § 30 GmbHG.

[23] Statutory reserves consist of capital reserve and retained earnings reserve. When declaring dividends, stock companies are required to increase either capital reserve or retained earnings reserve by one tenth of the amount distributed as dividends until the amount of statutory reserves in aggregate reaches one fourth of the amount of legal capital. Art. 445 para. 4 Companies Act and Art. 22 *Kaisha keisan kisoku* [Ordinance on Accounting of Companies], Ordinance of Ministry of Justice No. 13 of 2006.

[24] The book value of assets distributed to shareholders may not exceed the company's distributable amount, which is calculated by doing some additions to and subtractions from the surplus, on the day of such distribution. Art. 461 paras. 1 et seq. Companies Act. In turn, the surplus is calculated basically by subtracting the amounts of debts, legal capital and statutory reserves from that of the assets of the company. Art. 446 Companies Act.

[25] Art. 449 Companies Act.

[26] Art. 462 Companies Act. See also Art. 463 Companies Act (limitation of the right of remedy over of the directors and officers against the shareholders receiving distribution in bona fides; the right of creditors of the company to sue the shareholders directly).

[27] Art. 461 para. 1 Companies Act lists transactions subject to the restriction of distribution exhaustively.

of company's assets to shareholders at a substantially low price.[28] In these cases, creditors may resort to other remedies such as the doctrine of piercing the corporate veil or the liability of directors against third parties.[29,30]

b) Regulation of Contribution to Shares

Another feature that Japan shares with Germany is the detailed rules on contribution to shares. First, for contributions in kind, a report by an independent expert appointed by the court is required as a rule to prevent over-valuation of the contributed assets.[31] Second, contributions to shares are limited to cash or other assets that can be seized by creditors, which do not include undertakings to perform work for the company.[32] Third, subscribers of shares are required to pay the whole issuance price at the time of issuance.[33] In other words, partial contribution is not permitted,[34] and shareholders' obligations to make contributions may not remain unperformed after issuance of shares.

As noted earlier, however, some of the rules regarding contributions to shares were deregulated in 2005.[35] Behind this reform was a paradigm shift on the functions of rules regarding legal capital.

III. Paradigm Shift of 2005

1. Traditional View

The traditional view, which is deeply influenced by German law, placed much importance on legal capital for protection of creditors.[36]

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[28] K. EGASHIRA, *Kaisha hôjinkaku hinin no hori* [The Doctrine of Piercing the Corporate Veil] (Tokyo 1980) 391 note 8. For the doctrine of disguised distribution in Germany and Europe, see A. CAHN, Capital Maintenance, in this volume, and H. FLEISCHER, Disguised Distributions and Capital Maintenance in European Company Law, in: Lutter (ed.), Legal Capital in Europe (Berlin 2006) 94.

[29] For example, see Tokyo District Court, 25 July 2001, Rôdô Hanrei 813 (2001) 15 (piercing the corporate veil); Tokyo District Court, 26 April 1994, Hanrei Jihô 1526 (1995) 150 (liability of directors against creditors). For intra-group transactions see E. TAKAHASHI, Recht und Wirklichkeit der verbundenen Unternehmen in Japan, in this volume.

[30] It remains an interesting research question why Japanese courts did not take up the doctrine of disguised dividends and favored the doctrine of piercing the corporate veil while their German counterparts relied on the former.

[31] Art. 33 and Art. 207 Companies Act. For Germany, see § 33 para. 2 no. 4, § 33a and § 183 para. 3 AktG.

[32] See Art. 576 para. 1 no. 6 Companies Act (limiting contribution of undertaking to members without limited liability). For Germany see § 27 para. 2 AktG.

[33] Art. 34 and Art. 208 Companies Act.

[34] In contrast, German law permits partial contribution. See § 36a para. 1 AktG.

[35] See *infra* Part III.3.

According to this view, it is fundamental for the protection of creditors to ensure that companies possess assets amounting to legal capital, as shareholders benefit from limited liability and company's assets are the only recourse for creditors. In this regard, the principle of capital maintenance plays a core role by prohibiting the outflow of assets that correspond to the amount of legal capital.

It is also argued that for the principle of capital maintenance to function properly, the principle of capital contribution, which requires assets that correspond to the amount of legal capital to be fully contributed at the time of incorporation or issuance of shares, and the minimum capital requirement, which prevents the amount of legal capital being set too low, are necessary.

2. Functional Approach of the Companies Act 2005

Such traditional view, however, was criticized by some academics based on economic analysis of law as placing too much importance on the abstract ideas of "capital maintenance" or "capital contribution" and failing to analyze its actual function.[37] The drafters of the 2005 reform sided with this critique and took more functional approach in analyzing the then-existing rules,[38] which were already different from the original German-law based legal capital system we have seen in Part II.

It was first observed that, as directors are not required to call a shareholders' meeting or to file for bankruptcy when the net equity of the company falls below a certain threshold,[39] rules regarding legal capital under Japanese law do not guarantee the existence of assets corresponding to the amount of legal capital, and the only function of legal capital in Japan is to provide a

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[36] See INABA, *supra* note 16, 271–272. See also T. SUZUKI/A. TAKEUCHI, *Kaishahô* [Corporate Law] (3rd ed. Tokyo 1994) 25–29; H. MAEDA, *Kaishahô nyûmon* [Introduction to Corporate Law] (12th ed. Tokyo 2009) 19–24.

[37] T. FUJITA, *Kaishahô to saikensya hogo* [Corporate Law and Protection of Creditors], in: Shôhô Kaikei Seido Kennkyû Kondankai [Research Group on Accounting System under Commercial Code] (ed.), *Shôhô kaikei ni kakaru shomondai* [Issues of Accounting System under Commercial Code] (Tokyo 1997) 15, 34–42; Y. KANAMOTO/T. FUJITA, *Kabunushi no yûgen sekinin to saikensha hogo* [Shareholders' Limited Liability and Protection of Creditors], in: Miwa/Kanda/Yanagawa (eds.), *Kaishahô no keizaigaku* [Economics of Corporate Law] (Tokyo 1998) 191, 210–216.

For a similar analysis by a German scholar, see A. ENGERT, Life Without Legal Capital: Lessons from American Law, in: Lutter (ed.), Legal Capital in Europe (Berlin 2006) 646, 649–663. See also ENRIQUES/MACEY, *supra* note 8.

[38] D. KÔRIYA/T. IWASAKI, *Kaishahô ni okeru saikensya hogo (jyô)* [Protection of Creditors under the Companies Act (I)], Shôji Hômu 1746 (2005) 42–43.

[39] See *supra* Part II.1.b.

threshold for distribution to shareholders.[40] In this regard, the drafters proposed not using the term "capital maintenance" as it may be misleading.[41]

From this viewpoint, it is argued that increasing the amount of legal capital by more than the actual value of the assets contributed to shares,[42] a situation which the principle of capital contribution is trying to prevent, does not harm the interests of creditors, but is rather beneficial for them as it makes distribution to shareholders more difficult.[43] The aim of the rules regarding contribution to shares, for example the requirement of an independent expert's report for the value of contributions in kind, should be understood as protecting shareholders other than the contributor in question from dilution of their shares caused by overvaluation of the contribution.[44]

Although there are refutations from the traditional side,[45] in the author's view, the deregulation of contributions to shares and the abolition of the minimum capital requirement in the 2005 reform was basically reasonable. The following sections will analyze these reforms in detail.

3. Deregulation of Contributions to Shares

a) Contributions in Cash

When founders solicit others to become shareholders in the incorporation process, the bank to which founders and other subscribers pay their cash contributions must certify upon request of the founders that such contributions were deposited without any limitations on withdrawal and held until the company come into existence.[46] The rationale is that this certification is nec-

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40 KÔRIYA/IWASAKI, *supra* note 38, 49–50.

41 KÔRIYA/IWASAKI, *supra* note 38, 50.

42 Think for example of increasing the amount of legal capital by 20,000 Euros for a contribution in kind of an automobile worth 10,000 Euros.

43 KÔRIYA/IWASAKI, *supra* note 38, 53. While the overvaluation of the contributed assets on the balance sheet is problematic, the situation arises when the company purchases overpriced assets. This problem should be dealt with by accounting rules forcing depreciation of impaired assets and other measures to prevent financial misrepresentation. KÔRIYA/IWASAKI, *supra* note 38, 53–54.

44 KÔRIYA/IWASAKI, *supra* note 38, 51; T. AIZAWA/Y. TOYODA, *Kabushiki (kabushiki no heigô tô, tangen kabushiki-sû, bosyû kabushiki no hakkô to, kabuken, zassoku)* [Shares: Consolidation of Shares, Share Units, Issuance of Shares, Share Certificates, Miscellaneous Rules], Shôji Hômu 1741 (2005) 26–28.

45 The most vigorous critic is Prof. Takeo Inaba, who was in charge of corporate law reforms during 1970s and 1980s at the Ministry of Justice of Japan. See, INABA, *supra* note 16.

46 Art. 64 Companies Act.

essary to ensure that founders do not abscond with the contributions of subscribers.[47]

The 2005 reform abolished this certification requirement for incorporations where founders do not intend to solicit other subscribers, as founders are able to monitor the incorporation process by themselves.[48] The view that shareholders are the primary beneficiaries of rules regarding contributions is well reflected in this reform.

b) Contributions in Kind

In contrast, an independent expert's report for contributions in kind is required even when all the founders agree on the value of the asset.[49] The drafters do not offer convincing explanation for not carrying through their shareholder protection focus here.[50]

Still, the scope of exemption from this requirement has expanded. For example, in order to simplify the procedure for debt-equity swaps, an expert's report is not required for contributions of a monetary claim against the company itself by its creditor when the claim is already due and valued on its face value, even when the company is in a financial distress and the claim would be traded at a discount.[51]

c) Liability for Unpaid Shares

When subscribers of shares failed to pay their contribution, Japanese law traditionally imposed responsibility on founders and directors to assume the liability to pay for those unpaid shares.[52] The idea was that such responsibility was necessary to protect creditors and shareholders by securing that the planned amount of capital was contributed in full.[53]

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[47] T. AIZAWA/T. IWASAKI, *Kaishahô sôsoku / kabushiki kaisha no setsuritsu* [General Provisions of the Companies Act and Incorporation of Stock Companies], Shôji Hômu 1738 (2005) 11.

[48] AIZAWA/IWASAKI, *supra* note 47, 11.

[49] Art. 28 (i) and Art. 33 Companies Act.

[50] One possible explanation is that such a requirement protects the interest of future shareholders who invest in the company believing that the value of the asset in question is indeed high. This problem, however, could be better solved by liability for financial misrepresentations.

[51] Art. 207 para. 9 no. 5 Companies Act. For other items added to the exemption, see AIZAWA/TOYODA, *supra* note 44, 25–26; T. AIZAWA/D. KÔRIYA, *Teikan no henkô/ jigyô no jyôto tô/ kaisan/ seisan* [Amendment to the Articles of Incorporation, Sales of Business, Dissolution and Liquidation], Shôji Hômu 1747 (2005) 7–8.

[52] Arts. 192 and 280-13 Commercial Code (before the 2005 reform).

[53] See SUZUKI/TAKEUCHI, *supra* note 36, 84–85.

Unsatisfied with this explanation based on the principle of capital contribution, the 2005 reform abolished this responsibility.[54] Under this regime, subscribers who fail to pay their contribution lost their right to become a shareholder,[55] shares above the value of their contribution are not issued to them, and the amount of legal capital will be calculated only in relation to those paid-up shares.[56]

While this new system would not be problematic in cases of simple non-payment,[57] it soon turned out that that is not the case for disguised payments (e.g. payment with cash borrowed from the company itself) for issuance of new shares by listed companies. In such cases, subscribers would be able to profit from selling their shares "acquired" by disguised payment, thus deceiving the market. When the scheme comes to light, other shareholders will suffer from the dilution of their shares.

The legislature responded to this problem by imposing liability on subscribers who disguised their payment and requiring any directors and officers involved to pay the disguised amount to the company.[58] For the purpose of this article, it is worth noting that this new liability is not explained as a corollary of the principle of capital contribution but as a measure to protect shareholders.[59]

4. Abolishing the Minimum Capital Requirement

While the abolition or reduction of the minimum capital requirement is a phenomena observed also in Europe,[60] it must be noted that the economic background of such reform in Japan is different from that in the EU as there is no serious regulatory competition between Japan and neighbouring states

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[54] AIZAWA/IWASAKI, *supra* note 47, 10; AIZAWA/TOYODA, *supra* note44, 28.

[55] Art. 36 para. 3, Art. 60 para. 3 and Art. 208 para. 5 Companies Act.

[56] While articles of incorporation must state the minimum amount to be contributed upon incorporation (Art. 27 no. 4 Companies Act), it is not necessary to determine the number of shares to be issued at that moment or the amount of legal capital by the articles of incorporation. See also, *supra* Part II.1.c).

[57] The drafters of the 2005 reform refer to Art. 429 para. 2 of the Companies Act, which imposes liability on directors who made false statements in the corporate register, to protect the interest of creditors, if any, who suffered damages by trusting the amount of legal capital falsely increased by unpaid shares. AIZAWA/TOYODA, *supra* note 44, 28 note 9.

[58] Art. 52-2, Art. 213-2 and Art. 213-3 Companies Act.

[59] See SAKAMOTO (ed.), *Ichimon ittô heisei 26 nen kaisei kaishahô dai 2 han* [Questions and Answers on the 2014 Reform of the Companies Act, 2nd ed.] (Tokyo, 2015) 153–154.

[60] For example, France abolished the minimum capital requirement for SARL in 2003, and Germany permitted incorporation of GmbH without minimum legal capital *(Unternehmergesellschaft)* in 2008. See Art. L 223 para. 2 Code de Commerce (France), § 5a GmbHG (Germany).

regarding incorporation.[61] The objective was the promotion of new business and entrepreneurship in order to re-boost the economy,[62] after more than a decade of recession since the burst of the bubble economy in 1991.[63] Given this objective, the Ministry of Economy, Trade and Industry (METI) preceded the 2005 reform with a special statute in 2003 granting a five year exemption from the minimum capital requirement for companies incorporated by individuals who was not doing their own business beforehand.[64]

From the viewpoint of creditor protection, the minimum capital requirement was also criticized as a non-effective measure, first because of its one-size-fits-all approach, and secondly as it can only secure contributions of assets at the time of incorporation and without being able to prevent their depletion in the course of business.[65] As such, an oft-mentioned function of the minimum capital requirement as "the price for limited liability" is, at best, just a metaphor. The minimum capital requirement does provide a minimum threshold for distribution, but this function could be introduced separately. Thus, while abolishing the minimum capital requirement, the Companies Act prohibits distribution to shareholders when the net equity of the company is below three million Japanese Yen.[66]

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[61] For regulatory competition among European countries on corporate law and creditor protection, see J. ARMOUR, Legal Capital: An Outdated Concept? in: Eidenmüller/Schön (eds.), The Law and Economics of Creditor Protection: A Transatlantic Perspective (The The Hague 2008) 3, 20–24; L. ENRIQUES/M. GELTER, Regulatory Competition in European Company Law and Creditor Protection, in: Eidenmüller/Schön (eds.), The Law and Economics of Creditor Protection: A Transatlantic Perspective (The Hague 2008) 421.

[62] AIZAWA/IWASAKI, *supra* note 47, 8; KÔRIYA/IWASAKI, *supra* note 38, 48–49.

[63] For the situation of Japanese economy and policy discussions in the post-bubble era, See T. ITO/H. PATRICK, Problems and Prescriptions for the Japanese Economy: An Overview, in: Ito/Patrick/Weinstein (eds.), Reviving Japan's Economy (Cambridge/London 2005) 1. In contrast, the minimum capital requirement was introduced in the 1991 reform of the Commercial Code, the discussions for which took place before the burst of the bubble economy, with the purpose of limiting use of the form of stock companies to large enterprises and deterring "light-hearted" incorporation. See G. GOTO, *Kabunishi yûgen sekinin seido no heigai to kasyô shihon ni yoru kabunushi no sekinin* [Demerits of Limited Liability and the Shareholder's Liability for Undercapitalization] (Tokyo 2007) 73–74.

[64] Art. 10 *Shin-jigyô sôshutsu sokushin hô* (Act for Promotion of New Businesses), Law No. 152 of 2002.

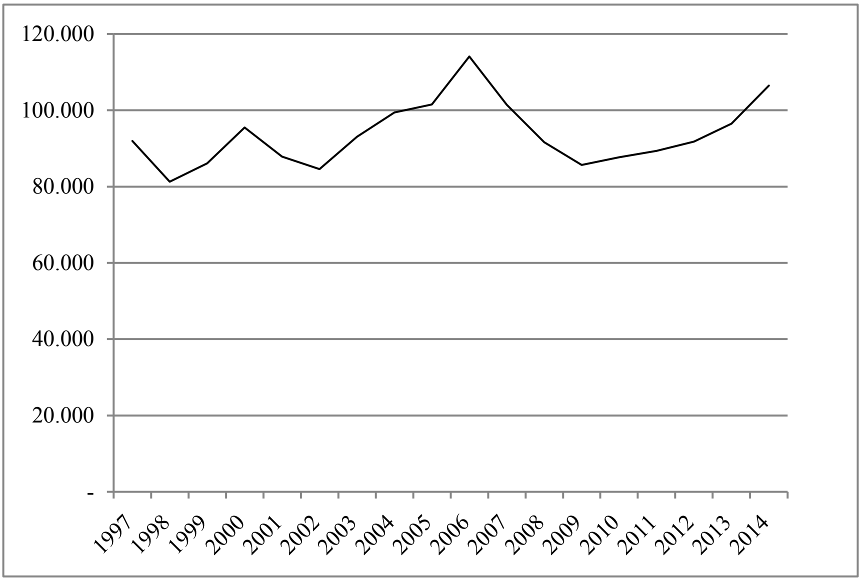
[65] KANAMOTO/FUJITA, *supra* note 37, 214–215. See also P. O. MÜLBERT, A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection, in: Eidenmüller/Schön (eds.), The Law and Economics of Creditor Protection: A Transatlantic Perspective (The Hague 2008) 390–391.

[66] Art. 458 Companies Act. Three million Japanese Yen was the amount required for former limited companies, which were integrated to stock companies under the Companies Act. To be precise, Art. 458 only prohibits distribution by companies whose net equity is previously below three million Japanese Yen. Essentially, the calculation of distributable amount will ensure that the net equity after the distribution is not less than three million

5. Any Effect on New Businesses?

Did the 2005 reform succeed in promoting entrepreneurship by abolishing the minimum capital requirement as an entry barrier?

Graph 1: Total Number of Incorporation[67]



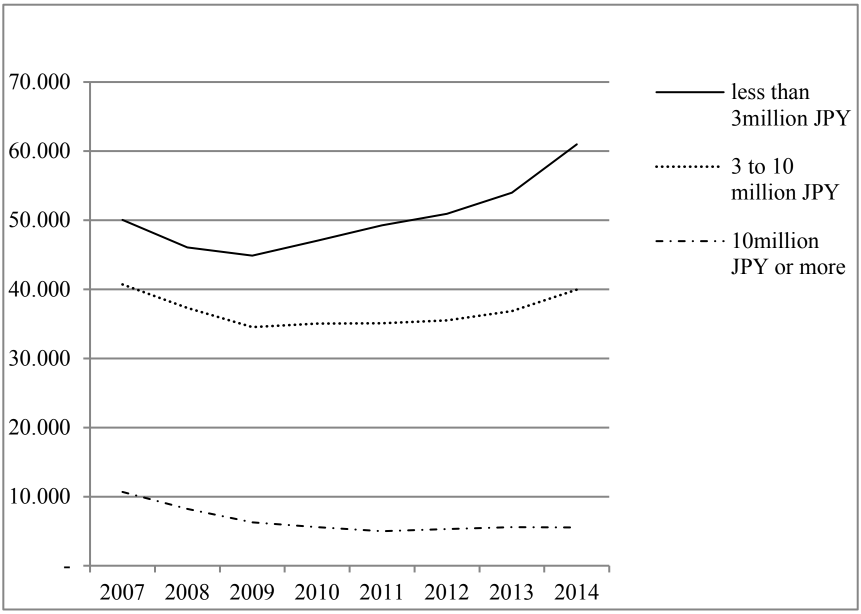
Graph 1 above shows the total number of incorporations for every year. The spike in 2006, which is the year when the 2005 reform entered into force, suggests that the reform did have a positive effect. Although the number of incorporations decreased in 2007 and that trend continued until 2009, the drop in 2008 and 2009 could be attributed to the recession caused by the global financial crisis.[68] One possibility for explaining the decrease in 2007 is that many potential entrepreneurs who had been hesitating because of the minimum capital requirement went into business in 2006 and not much was left for the next year.

Japanese Yen. See Art. 461 para. 2 no. 6, Companies Act and Art. 158 no. 6, Ordinance on Accounting of Companies.

[67] Graphs 1 and 2 show the aggregate number of incorporations of stock companies, limited companies (until 2006) and limited liability companies (since 2006) obtained from data of Ministry of Justice of Japan (<http://www.moj.go.jp/housei/toukei/toukei_ichiran_touki.html>).

[68] There is also a possibility that the number of incorporations in 2008 and 2009 could have been much smaller if the minimum capital requirement had still been in place.

Graph 2: Number of Incorporations by the Amount of Legal Capital



When differentiated by the amount of legal capital as in Graph 2 above,[69] incorporations of companies with legal capital less than 3 million Japanese Yen, which would not have been possible if the minimum capital requirement was in place, recovered soon after the financial crisis, while the numbers for companies with higher amount of legal capital have not. It is also worth noting that 8545 companies were incorporated within one year (from February 2003 to January 2004) under the five-years exemption from the minimum capital requirement introduced by METI in 2003.[70] This number amounts to nearly 10% of the average number of incorporations for the period covered in Graph 1,[71] and accounts for the entire increase in incorporations from 2002 to 2003.[72]

Overall, it would be fair to say that the 2005 reform, and the preceding attempt by METI, did succeed at least to some extent.

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[69] Unfortunately, this type of data for 2006 and earlier is not available.

[70] KEIZAISANGYÔSHÔ [Ministry of Economy, Trade and Industry], *Saitei-shihonkin kisei tokurei seido riyô jittai chôsa no chôsa kekka ni tsuite* [The Results of the Survey on the Exemption of the Minimum Capital Requirement] (April 2004), available at <http://www.meti.go.jp/policy/mincap/downloadfiles/tokureichousagaiyou.pdf>. For the exemption, see *supra* note 64 and accompanying texts.

[71] The average number of annual incorporations from 1997 to 2014 is 93,651.

[72] The number of incorporations was 84,612 in 2002 and 93,012 in 2003, the difference of which is 8,400.

IV. Shareholder's Liability for Undercapitalization[73]

1. *Ex Post Liability for Lack of Adequate "Cushion"?*

Upon abolishing the minimum capital requirement, the drafters of the 2005 reform noted that the protection of creditors and others is better achieved by *ex post* remedies, such as the doctrine of piercing the corporate veil.[74] Given that, should shareholders be liable for company's debts when the company is undercapitalized, i.e. when it lacks an adequate amount of shareholders' equity in relation to its risk? Professor Kenjiro Egashira, an influential scholar who chaired the governmental committee for the 2005 reform, had already proposed liability for undercapitalization in 1980.[75]

Although it is understandable that this kind of liability is attractive to the supporters of the minimum capital requirement, in the author's view, it is not clear why shareholders should be held liable when a company is undercapitalized.[76] In other words, more attention should be paid to how the interests of creditors is injured because of undercapitalization. The fact that creditors of a company are left unpaid when the company fails is a logical consequence of shareholders' limited liability und should not be deemed problematic in itself.

In this regard, Prof. Egashira asserts that equity adequate for the risk of business must be contributed to the company as a cushion to protect creditors so that they will not suffer damage immediately when the company experiences losses.[77] Other commentators emphasize the necessity of such a cushion to prevent companies entering into bankruptcy due to balance-sheet insolvency rather than damage to creditors.[78]

However, while it is true that shareholders' equity, regardless of its amount, functions as a cushion making it less likely for the company to become insolvent, it is a different issue as to whether it is efficient in preventing companies from becoming insolvent by requiring them to possess an adequate amount of equity

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[73] This part is based largely on GOTO, *supra* note 63. Short English summary of this book is available at G. GOTO, Demerits of Limited Liability and the Shareholder's Liability for Undercapitalization, Shiho 70 (2008) 251–253.

[74] KÔRIYA/IWASAKI, *supra* note 38, 49.

[75] EGASHIRA, *supra* note 28, 150–153, 354–366, 402–405. German legal scholarship *(die Normzwecklehre)* was one of the main sources of his inspiration, together with American case law. For an analysis of Prof. Egashira's argument, see GOTO, *supra* note 63, 41–46.

[76] Merely stating the necessity of an adequate amount of equity as a cushion to protect creditors is, without further description on how such cushion functions, again just a metaphor or tautology.

[77] K. EGASHIRA, *Kigyô no hôjinkaku* [Judicial Personality of Enterprises] in: Takeuchi/Tatsuta (eds.), *Gendai kigyôhô kôza dai ni kan: Kigyô soshiki* [Modern Enterprise Law Vol.2: Organization of Enterprises] (Tokyo 1985) 75–76. See also MÜLBERT, *supra* note 65, 396–397.

[78] See sources cited in GOTO, *supra* note 63, 91, note 200.

and denying limited liability when they fail to do so.[79] First, balance-sheet insolvency does not necessarily mean the liquidation of a company, as such insolvency could be temporal, or the going-concern value of the company could be larger than its liquidation value and the company should be reorganized. Second, it is arguably not always efficient to avoid bankruptcy as it is sometimes necessary to force inefficient businesses out of the market. Moreover, as liability for undercapitalization would usually come into question after the company entered into bankruptcy, there is a risk of 20–20 hindsight determining that the company lacked an adequate cushion merely because it went bankrupt.

2. *Limited Liability and Incentive of Shareholders*

Rather than focusing on the adequacy of the amount of equity (or legal capital), this article proposes turning to shareholders' incentives under limited liability.[80]

As shareholders do not have to bear losses greater than the amount of investment when the company fails, while they can benefit from the upside when it succeeds, shareholders have an incentive to shift the business strategy of the company towards riskier endeavours.[81] Shareholders also have an incentive to engage in dangerous activities without taking necessary precautions as limited liability externalizes the costs of accidents.[82] The less the amount of equity of the company in question has, the stronger these incentives are.

Although it may not be easy to establish a workable standard for shareholders' liability based on the viewpoint above,[83] focusing on the amount of equity is not only not helpful, but may be rather misleading.[84]

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[79] For discussions in this paragraph, see GOTO, *supra* note 63, 83–87.

[80] In the author's view, these incentives had been the true issues hidden behind the discussions on liability for undercapitalization. GOTO, *supra* note 63, 143–144, 494–503. See also MÜLBERT, *supra* note 65, 397 (describing a shift to a riskier business strategy as a source of subsequent undercapitalization).

[81] M. C. JENSEN/W. H. MECKLING, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 Journal of Financial Economics (1976) 334–336, 345. See also C. W. SMITH JR./J. B. WARNER, On Financial Contracting: An Analysis of Bond Covenants, 7 Journal of Financial Economics (1979) 118–119, 153–154.

[82] S. SHAVELL, Foundations of Economic Analysis of Law (Cambridge/London, 2004) 230–231.

[83] The author has proposed imposing liability on controlling shareholders when i) such shareholders actively increased the risk of the company's business without giving creditors an opportunity to renegotiate, ii) such shareholders took part either directly or indirectly in the accident in question, or iii) such shareholders made the company judgment-proof for example by providing the assets necessary for business in form of lease or by dividing the enterprise into unnecessarily small companies. See GOTO, *supra* note 63, 542–551.

[84] See MÜLBERT, *supra* note 65, 411–412.

V. Conclusion: Future of Legal Capital in Japan

To summarize the analysis above, the Japanese law on legal capital has gradually deviated from German law, and now it seems to stand on a quite different viewpoint in terms of how it functions.

Nonetheless, legal capital remains the threshold for regulating distributions to shareholders. It is also quite unlikely in the author's view that Japan will adopt recent reform proposals in Europe[85] or the tests used in California or by the Revised Model Business Corporation Act of the United States. This is because there are no serious complaints against its current regulation based on legal capital from any of creditors, debtor companies or shareholders, while such reform would certainly invoke an extensive academic debate.[86]

However, if Japan decides to adopt the IFRS in the future, some consideration would be necessary. As of December 2015, Japanese listed companies are not required, but are permitted, to prepare consolidated financial statements based on the IFRS.[87] However, voluntary application of the IFRS entails substantial cost, as individual financial statements, which are used for calculating distributable amount to shareholders, are still required under the Japanese GAAP.[88] When the IFRS is made mandatory for all listed companies, it is quite likely that it would also permit the application of the IFRS to individual statements to reduce these costs.[89] At this stage, the fair-value approach of the IFRS may come into conflict with the current position of Japanese law prohibiting the distribution of unrealized profits from the viewpoint of a traditional realization-basis approach, which often accompanies the legal

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[85] D. KUBO, *Shihon seido / bunpai kisei ni kanren shite* [On Legal Capital and Regulation of Distribution to Shareholders], Shôji Hômu 1974 (2012) 22–26 analyzes the recent proposals in Europe. For these proposals see J. RICKFORD, Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests, in: Eidenmüller/Schön (eds.), The Law and Economics of Creditor Protection: A Transatlantic Perspective (The Hague 2008) 135.

[86] The drafters of the 2005 reform maintained the current standard based on legal capital not because they found it an appropriate standard, but because it was difficult to establish a different standard that was clear and easily applicable. D. KÔRIYA/T. IWASAKI, *Kaishahô ni okeru saikensya hogo (ge)* [Protection of Creditors under the Companies Act (II)], Shôji Hômu 1747 (2005) 21–24. See also KUBO, *supra* note 85, 28.

[87] See IFRS Application around the World, Jurisdictional Profile: Japan (15 December 2015), available at <http://www.ifrs.org/Use-around-the-world/Documents/Jurisdiction-profiles/Japan-IFRS-Profile.pdf>.

[88] K. AKIBA, *IFRS to kaishahô kaikei* [The IFRS and Accountings under Companies Act], in: Egashira (ed.), *Kabushiki kaishahô taikei* [Handbook of Stock Company Law] (Tokyo 2013) 341, 346, 355–356.

[89] AKIBA, *supra* note 88, 353.

capital system.[90] Given the greater experience with the IFRS, discussions in Germany are still of great importance to Japanese corporate law looking for a means to reconcile the IFRS with the current regulation of distribution.

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[90] KUBO, *supra* note 85, 27 [citing W. SCHÖN, Balance Sheet Tests or Solvency Tests – or Both?, in: Eidenmüller/Schön (eds.), The Law and Economics of Creditor Protection: A Transatlantic Perspective (The Hague 2008) 181 and B. PELLENS/T. SELLHORN, Improving Creditor Protection through IFRS Reporting and Solvency Tests, in: Lutter (ed.), Legal Capital in Europe (Berlin 2006) 365]. It must be noted that while the current Japanese law generally takes the realization-basis approach, it does already allow distribution of profits from appreciation of the market value for securities held for the purpose of trading based on understanding that they are "realized" profits as these securities can be easily converted into cash. AKIBA, *supra* note 88, 362–365. See also D. KÔRIYA, *IFRS dônyû/tekiyô ni kansuru kaishahô-jyô no ronten* [Issues under the Companies Act Regarding Introduction and Application of the IFRS], Shôji Hômu 1905 (2010) 41–42 (arguing that it is not difficult to exclude unrealized profits recognized under the IFRS when each item of "other comprehensive interest" is examined in details).

Capital Maintenance

Andreas Cahn

I. The Function of Capital Maintenance in a Legal Capital Regime

Capital maintenance rules are part of a legal capital regime that consists of rules on raising capital and rules on maintaining it. The function of these rules is the protection of the corporation's creditors. This is evidenced by the fact that in both public and private companies the provisions on legal capital are not open to disapplication or variation even with unanimous shareholder consent. Thus, providing the company with a minimum of funding and ensuring equal treatment of shareholders are mere reflexes of creditor protection or, at best, ancillary purposes of legal capital.

Legal capital is part of a corporation's equity. The key feature of equity is that it ranks behind the claims of other stakeholders in the distribution of a corporation's assets. Consequently, equity will also be the first part of a corporation's funds to be depleted by losses. Capital maintenance rules seek to enforce this order of priority for different groups of stakeholders by restricting distributions to shareholders. Such restrictions are not unique to legal systems that have adopted a legal capital regime. A prominent example of a statute that has eliminated mandatory legal capital is the Delaware General Corporation Law. § 154 DGCL leaves it up to the directors to decide whether any part of the consideration received by the corporation for its shares shall be attributed to capital. Thus, a Delaware corporation need not have any stated capital. This has a significant impact on the funds available for distribution to shareholders: pursuant to § 170(a) DGCL dividends may only be paid out of surplus or, in the absence of surplus, out of net profits of the current or preceding fiscal year. Surplus is defined in § 154 DGCL as the excess of a corporation's net assets over the amount of its capital, and net assets as the amount by which total assets exceed total liabilities. A corporation without stated capital may therefore, distribute all of its net assets to its shareholders and continue business without any equity on its balance sheet. This highlights the difference between the different approaches to creditor protection in Germany and the US. Both legal systems acknowledge the priority of creditors over shareholders in corporate distributions. However, German law seeks to give creditors additional safeguards by requiring companies to raise and maintain additional layers of assets above and beyond those corresponding to the company's liabilities, assets which may not be depleted by way of distributions to shareholders. While private companies must merely raise and maintain their stated capital, public companies are required to raise and maintain additional equity accounts unavailable for distributions to shareholders such as the share premium account[1] and the legal reserve.[2]

In recent years a number of objections have been raised against this concept of creditor protection. Critics argue that contractual arrangements are a more efficient means of protecting the interests of creditors.[3] Capital maintenance does not prevent creditors from negotiating for more stringent protection of their claims such as collateral or financial covenants. It does, however, provide a minimum standard of protection for the benefit of creditors who lack commercial experience or bargaining power or who, like tort victims, are simply unable to negotiate for contractual safeguards. Capital maintenance ensures that their protection against excessive distributions does not depend on large creditors who are free to waive covenants that, in effect, benefit all creditors in exchange for individual arrangements that work exclusively in their favor.

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[1] §§ 272 para. 2 no. 1 HGB, 150 paras. 3 and 4 AktG.

[2] § 150 AktG.

[3] J. ARMOUR, Legal Capital: An Outdated Concept?, EBOR 7 (2006) 5, 11 and 18; B. MANNING/ J. J. HANKS, Legal Capital (3rd ed. Westbury, N.Y 1990) passim.

Another objection is that the capital maintenance rules are likely to deceive creditors because they restrict only distributions to shareholders but not the use of funds in other ways, such as for payment of the company's operating expenses.[4] Thus, the actual funds contributed towards the company's capital are depleted over time while the capital remains unchanged on the company's financial statements.[5] As "capital" is an accounting item on the equity side of the balance sheet, the concern that creditors might confuse capital accounts with the company's assets can hardly be reconciled with the argument that legal capital should be eliminated because creditors are sufficiently sophisticated to negotiate more efficient contractual protection. The further argument that restricting distributions to shareholders cannot save a company from a depletion of its assets in the course of business and from eventual bankruptcy[6] is also misguided because it assumes a policy purpose that capital maintenance cannot, and in fact does not, seek to achieve. Capital maintenance is not concerned with avoiding insolvency because of business failure but has the more modest aim of giving effect to the rule that creditors' claims take priority over those of shareholders. It does so by ensuring that company funds are not distributed to shareholders up to the very limit where the balance sheet value of the company's assets barely suffices to cover its liabilities. In theory even distributions to this level should not compromise the creditors' interest. In practice, however, the priority of creditors over shareholders becomes an issue mainly, if not exclusively, in a situation of bankruptcy. Company bankruptcy sees the value of assets in a going concern replaced by their usually much lower break-up values, with the consequence of an immediate and generally severe shortfall.[7] Thus, in effect, prior transfers of value to shareholders may have been made at the expense of creditors. While capital maintenance cannot, and does not seek to, prevent bankruptcy of companies it does restrict transfers of value to shareholders, particularly when the company's net value is declining rather than relying on *ex post* measures such as the avoidance of fraudulent transfers in bankruptcy.

The argument that the statutory one-size-fits-all minimum capital of 50,000 Euros does not substantially enhance creditor protection beyond that of jurisdictions without a minimum capital requirement[8] does not take into account that companies will generally not be able to obtain debt financing

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[4] See F. FERRAN, Company Law and Corporate Finance (Oxford 1999) 47.

[5] L. ENRIQUES/J. R. MACEY, Creditors Versus Capital Formation: The Case against the European Legal Capital Rules, Cornell Law Review 86 (2001) 1165, 1186.

[6] For a discussion of this argument see P. O. MÜLBERT/M. BIRKE, Legal Capital – Is There a Case against the European Legal Capital Rules?, EBOR 3 (2002) 695, 718.

[7] T. BEZZENBERGER, Das Kapital der Aktiengesellschaft (Cologne 2005) 184 et seq.

[8] P. O. MÜLBERT, A Synthetic View of Different Concepts of Creditor Protection, or: A High-Level Framework for Corporate Creditor Protection, EBOR 7 (2006) 386 et seq. with further citations.

unless they raise their equity to an adequate level in relation to the size and risk of their business.[9] Raising such additional capital serves to also bolster equity accounts unavailable for distribution, including the share premium reserve. Thus, capital maintenance does, in fact, impose significant restrictions on distributions to shareholders, thereby giving effect to the priority of creditors over shareholders.

Another concern voiced against capital maintenance is that its reliance on the balance sheet is misplaced because accounts are not an appropriate tool to determine the amount of assets a company can afford to distribute to its shareholders since the relevant accounting rules serve a number of purposes other than creditor protection.[10] The determination of distributable profits does, indeed, heavily depend upon the way company assets and liabilities are processed through accounting principles. The higher the values assigned to assets and the lower the values assigned to liabilities, the greater will be the distributable profit. The annual accounts on which distributions are based must be prepared according to the German accounting principles in the *Handelsgesetzbuch* (HGB). These principles are designed to minimize the available profits The HGB includes a principle of conservative valuation,[11] and a realization principle and lowest value principle for assets,[12] which together with the principle of highest value for liabilities, work to decrease assets and increase liabilities in comparison to the results achieved through accounting principles designed to present a true and fair view.[13]

Traditional capital maintenance seeks to ensure that a layer of assets above and beyond those corresponding to the company's liabilities will not be distributed to shareholders. However, the balance sheet value of a company's assets does not necessarily mean that liquidity will be available to pay the company's debt as and when they fall due. German legislation has, therefore, added new solvency restrictions on distributions as part of the 2008 MoMiG[14] reform. Pursuant to § 92 para. 2 sent. 3 *Aktiengesetz* (AktG) and § 64 sent. 3 *Gesetz betreffend die Gesellschaften mit beschränkter Haftung* (GmbHG), directors are liable for payments to shareholders that would render the com-

[9] See H. EIDENMÜLLER/A. ENGERT, Die angemessene Höhe des Grundkapitals der Aktiengesellschaft, AG 2005, 100 et seq.

[10] For a detailed discussion see E. FERRAN, Place for Creditor Protection on the Agenda for Modernisation of Company Law in the European Union, ECFR 2006, 200 et seq.; J. RICKFORD, Legal Approaches to Restricting Distributions to Shareholders: Balance Sheet Tests and Solvency Tests, EBOR 7 (2006) 166 et seq.

[11] § 252 para. 1 no. 4 HGB.

[12] § 253 para. 1 and para. 5, § 280 para. 1 HGB.

[13] See e.g. A. CAHN/D. C. DONALD, Comparative Company Law (Cambridge et al. 2010) 225.

[14] Law for the Modernisation of the Limited Liability Company Act and the Prevention of Abuse – Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen (MoMiG) of 23 October 2008.

pany insolvent, unless a prudent and diligent director was unable to foresee the company's insolvency. Unlike the capital maintenance provisions, these solvency restrictions are not concerned with preserving company assets with sufficient value to cover liabilities and capital, but rather with the company's ability to pay its debts as they fall due. The scope of these new provisions has, however, turned out to be rather limited. Pursuant to §§ 15a, 17 *Insolvenzordnung*, directors of a company must file for insolvency if the company is unable to pay its debts as they fall due. In order to assess whether the company's solvency will be impaired more than just temporarily,[15] directors must prepare a cash budget which must also account for shareholder claims against the company. If the company is unable to honor these claims as they fall due, the company's insolvency will be triggered by their entry into the cash budget rather than by their subsequent settlement.[16]

II. The Scope of the Capital Maintenance Rules

The capital maintenance provisions are not very specific as to the scope of their application: § 57 para. 1 AktG provides that contributions may not be refunded to shareholders, and pursuant to § 58 para. 5 AktG, distributions may be made in kind rather than in cash if the articles so provide. Finally, § 57 para. 3 AktG states that prior to the dissolution of the company, only balance sheet profit may be distributed to shareholders. The rules for private companies are even less detailed: § 30 para. 1 GmbHG merely prohibits the distribution of assets that are required to maintain the company's share capital.

These provisions give rise to a number of questions. By definition, only shareholders can be recipients of dividends or the purchase price paid in a share repurchase. It is clear that the capital maintenance rules apply to these distributions (1.). But do they also catch transfers of value to shareholders through transactions not at arm's length, the so-called disguised distributions (2.)? If so, do they apply to all such transactions, even if the agents acting on behalf of the company are not aware of the fact that the terms of the transaction are unfavorable or that the receiving party is a shareholder, or only to transactions designed to benefit a shareholder because of his capacity as a member of the company (2.d)).

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[15] According to the jurisprudence of the Federal Court of Justice solvency impairments of up to three weeks are deemed to be merely temporary and don't trigger the duty to file for insolvency, provided that the shortfall of liquidity does not exceed 10% of the liabilities that are due during this period, see BGH, 9 October 2012, II ZR 298/11, BGHZ 195, 42, 44 marg. no. 8 with further citations.

[16] See BGH, 9 October 2012, II ZR 298/11, BGHZ 195, 42, 45 et seq. marg. nos. 9 et seq.

1. Open Distributions Through Dividends or Share Repurchases

The prohibition of § 57 para. 1 AktG on contribution refunds is not limited to a shareholder's actual contribution or its value but covers all company assets other than those expressly permitted to be distributed.[17] Pursuant to § 57 para. 3 AktG only the balance sheet profit is available for distributions to shareholders. Calculation of balance sheet profit begins with the annual net profit or annual net loss as determined in the profit and loss statement. Then profit or loss carried forward from the previous year and transfers to and withdrawals from certain reserves are added and subtracted in accordance with §§ 150 and 158 para 1 AktG. Distributions to shareholders of an AG may only be made if the value of the company's assets as recorded on the balance sheet exceeds the liabilities, stated capital and mandatory reserves. While other reserves may be used to fund distributions, they may only be appropriated for this purpose on the basis of an audited financial statement and a directors' resolution to make a withdrawal from such reserves. Finally, § 174 AktG requires a formal resolution of the shareholders' meeting on the payment of a dividend, thereby, in effect, ensuring that dividend will be declared only once a year at the annual general meeting. Thus, the Aktiengesetz creates both substantive and procedural checks on distributions.[18] Since share repurchases are an alternative means of transferring value from the company to its shareholders, a similar regime applies to such transactions. Pursuant to § 71 para. 2 sent. 2 AktG a stock corporation may repurchase shares only if it could create a reserve in the amount of the expenses for such acquisition without reducing the share capital or any of the reserves not available for distribution. Thus, only funds that would be available for dividend distributions may be paid as consideration in a share repurchase. Share repurchases are therefore subject to essentially the same substantive safeguards as dividends as well as to a set of procedural checks set out in detail by § 71 AktG.

In contrast, the distribution regime applicable to private companies is far more relaxed in substance as well as procedure. Provided that a distribution to shareholders does not reduce the balance sheet value of companies' assets below the level required to cover liabilities and stated capital, directors may distribute funds to its shareholders at any time without regard for the formalities prescribed by the AktG for stock corporations. Just as with stock corporations, private companies may pay the consideration for a share repurchase only from assets that would be available for distribution to shareholders.[19]

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[17] BGH, 13 November 2007, XI ZR 294/07, NZG 2008, 106, 107 marg. no. 16; OLG Hamburg, 18 September 2009, 11 U 183/07, AG 2010, 502, 504 marg. no. 73; A. CAHN/M. VON SPANNENBERG, in: Spindler/Stilz, Aktiengesetz, 3rd ed. 2015, § 57 marg. no. 14.

[18] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 10; CAHN/DONALD, *supra* note 13, 223.

[19] See § 33 para. 2 GmbHG.

2. Disguised Distributions

a) The Concept of Disguised Distributions

According to established German doctrine, the scope of capital maintenance provisions is not limited to open distributions but encompasses all transfers of value to a shareholder through transactions without adequate consideration for the company, called disguised distributions because the transfer of value is concealed by a transaction on other than an arm's length basis.[20] The adequacy of the consideration received by the company is assessed by applying the business judgment of a diligent and prudent director.[21] In the straightforward case of the purchase of an asset from a shareholder, a diligent and prudent director would usually not pay more than the market price of the asset.[22] Similarly, a diligent and prudent director would not sell a company asset for less than its market price unless it were commercially advisable to grant the shareholder a discount.[23] If a market price comparison is not feasible because of the specific, individual features of the asset, management has wider discretion with regard to the purchase or sales price. Transactions with a shareholder will not be deemed to violate the capital maintenance rules as long as the terms are not unreasonable.[24] Generally accepted methods of valuation can provide guidance for the assessment of whether a prudent and diligent director exercising due care would have agreed to the terms of the transaction.[25]

b) Book Values, Market Values and Business Interests of the Company

As the preceding remarks on sales to a shareholder or purchases from a shareholder indicate, the assessment of whether value is transferred from the company to a shareholder in violation of the capital maintenance rules is based on market values rather than book values. While the book value a shareholder has attributed to an asset is, obviously, irrelevant for the scrutiny of the purchase price paid by the company, the same cannot be said for the valuation of an asset in the company's accounts when assessing whether the

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[20] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 14; T. DRYGALA, in: Kölner Kommentar zum Aktiengesetz, 3rd ed. 2010, § 57 marg. nos. 3 et seq., both with further citations.

[21] OLG Köln, 28 May 2009, 18 U 108/07, AG 2009, 584, 587; OLG Koblenz, 25 April 2007, 6 U 342/04, AG 2007, 408, 409; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 19.

[22] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 21; DRYGALA, *supra* note 20, § 57 marg. no. 61, both with further citations.

[23] W. BAYER, in: Münchener Kommentar zum Aktiengesetz, 3rd ed. 2008, § 57 marg. no. 38; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 21.

[24] BAYER, *supra* note 23, § 57 marg. no. 40; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 22; DRYGALA, *supra* note 20, § 57 marg. no. 64 et seq.

[25] OLG Koblenz, 25 April 2007, 6 U 342/04, AG 2007, 408, 409 et seq.; H. FLEISCHER, in: Schmidt/Lutter, Aktiengesetz, 2nd ed. 2010, § 57 marg. no. 13.

sale of the asset to a shareholder amounts to a distribution. After all, the concept of capital maintenance is based on a comparison of items – assets versus liabilities and equity – on the company's balance sheet. One might, therefore, well argue that the legitimate interests of creditors are not compromised if the consideration paid by the shareholder equals the book value of the asset acquired from the company, as such a transaction does not reduce the overall value of company's assets as recorded in its financial statements.

United Kingdom legislation has adopted this view for cases where a company has profits available for distribution.[26] Sec. 845 (2) (a) Companies Act 2006, deals with distributions consisting of including, or treated as arising in consequence of, the sale, transfer or other disposition by a company of a non-cash asset, stating that the amount of a distribution is taken to be zero where the amount or value of the consideration for the disposition is not less than the book value of the asset. In contrast, German law takes a stricter approach to creditor protection by comparing the consideration for the disposition with the "real" value of the asset.[27] This understanding of the term "distribution" reflects the fact that when looking to satisfy their claims, creditors may look to the full value and not just the book value of the company's assets, thus any transfer of value to a shareholder without full consideration impairs the priority of creditors over shareholders. It also takes into account that it is not unusual for assets to be recorded at less than their market value as a consequence of the conservative German accounting principles under the HGB that seek to minimize the amount of profits available for distribution to shareholders in order to effectively protect creditors. Since assets may not be recorded at more than their historic acquisition cost, assets that do not depreciate but rather tend to increase in value over time, such as real estate, are frequently shown in the company's accounts at unrealistically low values. Similarly, the choice of a declining method of depreciation that many companies employ for tax reasons can result in a substantial undervaluation of depreciable assets. The creditor protection intended by these accounting principles would be at the disposal of management if such unrealized profits could be distributed to shareholders through a sale of such assets at their book value.

Contracts for services provided by the company for shareholders are another example of disguised distributions whose impact is not reflected on the company's balance sheet.[28] Consider the case of employees providing services to a shareholder during times when they could not be gainfully employed on company business. Since the company would be liable to pay the

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[26] L.C.B GOWER/P. L. DAVIES, Principles of Modern Company Law (9th ed. London 2012) marg. nos. 11 et seq.

[27] BEZZENBERGER, *supra* note 7, 220 et seq.; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 16; DRYGALA, *supra* note 20, § 57 marg. no. 54; FLEISCHER, *supra* note 25, § 57 marg. no. 17.

[28] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 16.

employees' salaries even if they had not worked on behalf of the shareholder, the arrangement does not increase the company's expenditures. Nevertheless, the fair value of the services is deemed to have been distributed to the shareholder.

While capital maintenance provisions thus apply to transfers of value from the company to a shareholder irrespective of their impact on the company's balance sheet, they are not designed to catch transactions for fair value merely because such transactions may be incompatible with business interests of the company.[29] Thus, directors may be liable for mismanagement if they purchase an asset the company does not need from the shareholder or if they sell an asset that the company requires for its business, and the sale or purchase may even be void or voidable if the agent acting on behalf of the company evidently abused his power to act on behalf of the company. However, such transactions do not amount to a violation of the capital maintenance rules if the company receives fair value.

c) Examples

(1) Company Loans to Shareholders

As the recent history of the treatment of company loans to shareholders shows, the departure from a strictly balance sheet based approach to capital maintenance tends to introduce an element of uncertainty into the application of the statutory regime. In what is referred to as its 2003 "November" judgment, the German Federal Court of Justice (Federal Court) held that for capital maintenance purposes, loans to shareholders were to be assessed as if the company did not have a claim for repayment, thus treating loans like gifts.[30] The court based its decision on the arguments that (a) deferred claims for repayment were not as valuable for the corporation's creditors as liquid assets and that (b) with respect to the loan, the corporation's creditors lost their priority over the shareholder's creditors. This disregard of a valuable claim constituted a departure from the balance sheet approach to capital maintenance and presented a major obstacle to corporate finance techniques such as cash pooling. In 2008 the legislature reversed the November judgment by adding a new provision to the AktG and GmbHG capital maintenance rules. Pursuant to § 57 para. 1 AktG and § 30 para. 1 GmbHG,[31] a loan to shareholders is not an illegal distribution if the claim for repayment is unimpaired (*vollwertig*). In a judgment concerning the responsibility of a subsidiary's management pursuant to §§ 311, 318 AktG, the Court explicitly abandoned the principles developed in its November judgment and adopted the view

[29] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 17.
[30] BGH, 24 November 2003, II ZR 171/01, BGHZ 157, 72.
[31] These provisions were added by Art. 1 no. 20 and Art. 5 no. 5 of the MoMiG.

expressed in the new statutory rules.[32] The German Federal Court acknowledged the return to the traditional balance sheet approach and suggested that the relevant test is whether the claim for repayment is impaired by a concrete probability of default *(konkrete Ausfallwahrscheinlichkeit).* Since neither the statute nor the new judgment explain the circumstances under which a "concrete probability of default" is to be presumed, the new rules have introduced substantial legal uncertainty for managers faced with the decision of whether to approve a company loan to a shareholder.[33] The Federal Court has clarified, however, that failure to agree on an arm's length interest rate will not disqualify the loan as an illegal distribution per se.[34]

(2) Collateral for Shareholder Loans

Similar considerations apply when a company provides collateral for loans that shareholders obtain from third parties. The majority of courts and scholars agree that a transfer of value to the shareholder occurs at the time when the company furnishes the collateral rather than when the financial situation of the shareholder deteriorates or when the creditor ultimately realizes the security interest provided by the company.[35] The relevant test relies on whether the company's claim for recourse against the shareholder is unimpaired at the time when the security interest is established. There is however still is some debate as to whether this takes proper account of the risk incurred by the company given that collateral is usually enforced when the debtor is unable to discharge the secured liability.[36]

(3) Assumption of Prospectus Liability in a Secondary Placement of Shares

The Deutsche Telekom III case[37] ably highlights the broad scope of capital maintenance. Deutsche Telekom AG (DT-AG), the largest German telecommunications company, was initially a state owned enterprise of the Federal Republic of Germany (FRG). In two offerings conducted in 1996 and 1999 DT-AG offered shares resulting from capital increases on national and inter-

[32] BGH, 1 December 2008, II ZR 102/07, BGHZ 179, 71, 76 et seq. (MPS).

[33] A. CAHN, Kredite an Gesellschafter – zugleich Anmerkung zur MPS-Entscheidung des BGH, Der Konzern 2009, 69 et seq.

[34] BGH, 1 December 2008, II ZR 102/07, BGHZ 179, 71, 80 marg. no. 17 (MPS).

[35] OLG Koblenz, 10 February 1977, 6 U 847/75, AG 1977, 231 et seq.; OLG München, 11 July 1979, 15 U 1532/78, AG 1980, 272 et seq.; OLG Düsseldorf, 24 October 1979, 11 U 47/79, AG 1980, 273, 274; OLG Hamburg, 23 May 1980, 11 U 117/79, AG 1980, 275, 278 et seq.; BAYER, *supra* note 23, § 57 marg. no. 104; DRYGALA, *supra* note 20, § 57 marg. no. 79; for a detailed discussion see P. O. MÜLBERT, Sicherheiten einer Kapitalgesellschaft für Verbindlichkeiten ihres Gesellschafters, ZGR 1995, 586 et seq.

[36] See e.g. T. LAUBERT, in: Hölters, AktG, 2nd ed. 2014, § 57 marg. no. 21 with further citations.

[37] BGH, 31 May 2011, II ZR 141/09, NJW 2011, 2719.

national capital markets. With the second offering the existing shares held by the FRG and KfW, Germany's largest state owned bank, were also admitted to trading. During the year 2000, DT-AG, the FRG, KfW, who together still owned a majority of DT-AG's shares, and a group of underwriters entered into an agreement for a third share offering, in which 200 million DT shares owned by KfW would be publicly offered to private investors across the globe. The agreement provided that each party would be liable to the underwriters for the information provided by that party. This arrangement was to be additional to, not in lieu of, any other liability to which the parties were subject. DT-AG attempted but failed to obtain an agreement with the FRG and KfW in which these shareholders would indemnify the DT-AG from prospectus liability with respect to any claims made by investors. DT-AG filed the necessary registration statement including the prospectus required by US law for an offering of shares to private investors in the US and assumed responsibility for the content of the registration statement and the prospectus in the US the FRG and KfW shared the proceeds of the US placement of DT-AG shares owned by KfW. US investors sued DT-AG because of alleged misrepresentations in the prospectus. DT-AG agreed to a settlement of the lawsuit and paid a total of 120 million US-Dollars to the US plaintiffs. It then proceeded to sue the FRG and KfW for reimbursement of this amount as well as of its alleged legal costs for a total of almost € 113 million, based, inter alia, on §§ 57, 62 AktG.

The District Court held in favour of DT-AG, a decision which the Court of Appeals reversed. Upon DT-AG's further appeal the German Federal Court held that the company's assumption of the cost for drawing up the prospectus and of the liability to investors in a secondary offering of shares constituted a distribution to the shareholders whose shares were placed on the market because the benefits, in particular the proceeds from the sale of the shares to investors, accrued to these shareholders rather than to the company.[38] According to the Federal Court neither the inability of the shareholders to provide or verify the information required for a prospectus nor negligence of the company in drafting the prospectus affected the character of the assumption of prospectus liability as a distribution within the meaning of the capital maintenance provisions.[39] The fact that the secondary placement may benefit the company by virtue of a diversification of its shareholder base or by facilitating its presence on a foreign stock market was not deemed to be sufficient compensation for the assumption of the risk of prospectus liability, as the value of such potential advantages is not quantifiable.[40] As a rule, a violation of the capital maintenance provisions can only be avoided if the relevant

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[38] BGH, 31 May 2011, II ZR 141/09, NJW 2011, 2719, 2720 marg. no. 15.
[39] BGH, 31 May 2011, II ZR 141/09, NJW 2011, 2719, 2721 marg. no. 22.
[40] BGH, 31 May 2011, II ZR 141/09, NJW 2011, 2719, 2721 marg. no. 25.

shareholders agree to indemnify the company from prospectus liability.[41] The decision has triggered a lively scholarly debate and the implications regarding secondary placements are not yet entirely clear.[42]

d) Disguised Distributions and Transactions with Shareholders in Their Capacity as a Third Party Distinguished

(1) Nexus between Transaction and Shareholder Status

While only shareholders can be entitled to receive dividend payments by virtue of their equity investment in the company, sales and purchases, loans, service contracts and other types of agreements that may be used to disguise distributions are typically concluded with third parties. Such agreements between the company and an unrelated party are valid and binding even if the terms are unfavorable for the company due to negligence or incompetence on the part of the agents acting on the company's behalf or because the third party was particularly shrewd. It is still subject of debate whether the mere fact that the counterparty happens to be a shareholder is sufficient to trigger the application of capital maintenance provisions or whether a disguised distribution requires a specific link between the shareholder status of the counterparty and the conclusion of the agreement. The controversy is relevant for unfavorable transactions not motivated by the counterparty's status as a member of the company. This applies both when the agents acting on behalf of the company were unaware they were dealing with a shareholder, or because the counterparty's stake in the company is clearly insignificant. Examples of these transactions include the purchase of an asset for more than its market price or fair value or excessive remuneration for a director where the recipients of the benefit happen to own some shares of the company.

Advocates of the traditional strict approach argue that creditor protection should depend neither on the motivations of the parties nor on the diligence or foolishness, as the case may be, of the agents acting on behalf of the com-

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41 BGH, 31 May 2011, II ZR 141/09, NJW 2011, 2719, 2721 marg. no. 25.

42 Arbeitskreis zum Deutsche Telekom III-Urteil des BGH, Thesen zum Umgang mit dem „Deutsche Telekom III – Urteil" des BGH vom 31.05.2011 bei künftigen Börsengängen, CFL 2011, 377, 378; M. ARNOLD/S. AUBEL, Einlagenrückgewähr, Prospekthaftung und Konzernrecht bei öffentlichen Angeboten von Aktien, ZGR 2012, 144 et seq.; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 40; M. HABERSACK, Die Umplatzierung von Aktien und das Verbot der Einlagenrückgewähr – Folgerungen aus der "DTAG"-Entscheidung des BGH, insbesondere hinsichtlich des Regresses des Aktionärs, in: Erle/Goette/Kleindiek (eds.), Festschrift für Peter Hommelhoff zum 70. Geburtstag (Cologne 2012) 312; L. KRÄMER/B. GILLESSEN/A. KIEFNER, Das „Telekom III"-Urteil des BGH – Risikozuweisungen an der Schnittstelle von Aktien- und Kapitalmarktrecht, CFL 2011, 328 et seq.; C. SCHÄFER, Einlagenrückgewähr und Risikoübernahme im faktischen AG-Konzern – Was folgt aus der Telekom-Entscheidung des BGH?, in: Krieger/Lutter/Schmidt (eds.), Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 997, 1005 et seq.

pany. Just as objective criteria rather than the estimate by the (future) shareholder or the company determine the valuation of contributions to the company's capital, the application of the capital maintenance provisions to transactions between the company and its shareholders must depend solely on an impartial assessment of the consideration received by the company.[43]

In contrast, proponents of a less rigid interpretation of the statutory regime submit that the capital maintenance provisions are not meant to protect the company from normal business risk in its dealings with shareholders. In their view, the concept of disguised distributions is only supposed to ensure that shareholders do not receive undue benefits at the expense of the company and its creditors because of their membership in the company. In particular, the capital maintenance provisions seek to prevent that influence shareholders may have on management and their superior information in company matters are abused to the disadvantage of the company's creditors. Therefore, only transfers of value that are attributable to the fact that the recipient is a shareholder *(causa societatis)* are in violation of the capital maintenance regime, while genuine mistakes in business judgment are not sufficient to qualify a transfer of value as a disguised distribution.[44] The practical difficulties of proving the causal link between membership in the company and transfer of value can be addressed by placing the burden of proof on the defendant and by applying the capital maintenance provisions unless it is certain that the membership of the recipient was irrelevant for the transaction.[45]

(2) Claims of Investors Because of Fraud or Misrepresentation

Tort liabilities are typical examples of such claims. Even the majority view acknowledges that claims for damages based on torts attributable to the company are not subject to capital maintenance restrictions.[46] Thus, even controlling shareholders are not estopped from enforcing claims for damages against the company if they are victims of injuries caused by goods produced or ser-

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[43] RG, 20 December 1935, II 113/35, RGZ 150, 28, 35; BGH, 14 December 1959, II ZR 187/57, BGHZ 31, 258, 276; BGH, 1 December 1986, II ZR 306/85, NJW 1987, 1194, 1195; BGH, 14 December 1992, II ZR 298/91, BGHZ 121, 31, 41 et seq.; BGH, 13 November 1995, II ZR 113/94, NJW 1996, 589; BAYER, *supra* note 23, § 57 marg. no. 45; C. GRIGOLEIT/R. RACHLITZ, in: Grigoleit, Aktiengesetz, 2013, § 57 marg. no. 16; J. KOCH, in: Hüffer, Aktiengesetz, 11th ed. 2014, § 57 marg. no. 11.

[44] BEZZENBERGER, *supra* note 7, 232 et seq.; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 25 et seq.; DRYGALA, *supra* note 20, § 57 marg. no. 89; W. FLUME, Der Gesellschafter und das Vermögen der Kapitalgesellschaft und die Problematik der verdeckten Gewinnausschüttung, ZHR 144 (1980) 19 et seq.; D. VERSE, Der Gleichbehandlungsgrundsatz im Recht der Kapitalgesellschaften (Tübingen 2006) 196 et seq.

[45] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 28; DRYGALA, *supra* note 20, § 57 marg. no. 90; FLEISCHER, *supra* note 25, § 57 marg. no. 20.

[46] M. LUTTER, in: Kölner Kommentar zum Aktiengesetz, 2nd ed. 1988, § 57 marg. no. 22.

vices rendered by the company in the course of its business. Presumably, this consensus is due to the fact that no one chooses to be a tort victim, so that there can be no question of whether the establishment and terms of the legal relationship are affected by the shareholders status of the injured party. Claims for damages by investors who have acquired shares due to misrepresentations attributable to the company are the only case where the application of capital maintenance to tort liabilities is intensely discussed. Unlike other types of tort injuries which can be suffered by shareholders and third parties alike, only shareholders can assert to have been lured into acquiring shares. The question of how claims based on intentional fraud and deception of investors rank in relation to claims of other creditors has been subject of debate since the times of the Imperial Court.[47] While a majority of authors argues that the capital maintenance provisions never apply to claims of deceived investors against the company[48] others submit that reimbursement of damaged shareholders would be in violation of § 57 AktG[49] or that only claims arising from an acquisition on the secondary market are exempt while those of subscribers to shares from the company are not.[50] Yet others propose that compensation may only be paid from funds available for distribution to shareholders[51] or that the investors' claims for damages are subordinate to those of other creditors in the company's insolvency.[52] The Federal Court tends to agree with the majority of scholars,[53] and the European Court of Justice has recently ruled that compensation of defrauded investors from company funds is compatible with the European Law capital maintenance framework.[54]

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[47] See RG, 28 April 1909, I 254/08, RGZ 71, 97, 98 et seq.; RG, 2 June 1916, III 61/16, RGZ 88, 271, 272 et seq.; for a detailed review of the Imperial Court's jurisprudence see W. BAYER, Emittentenhaftung versus Kapitalerhaltung, WM 2013, 962 et seq.

[48] BAYER, *supra* note 23, § 57 marg. no. 29; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 49; FLEISCHER, *supra* note 25, § 57 marg. no. 66 et seq.; GRIGOLEIT/RACHLITZ, *supra* note 43, § 57 marg. no. 6.

[49] P. KINDLER, Gesellschaftsrechtliche Grenzen der Emittentenhaftung am Kapitalmarkt – Eine Nachlese zum Fall „EM.TV" vor dem Hintergrund zwischenzeitlicher Entwicklungen, in: Kindler et al. (eds.), Festschrift für Uwe Hüffer zum 70. Geburtstag (Munich 2010) 421 et seq.

[50] L. KRÄMER/M. BAUDISCH, Neues zur Börsenprospekthaftung und zu den Sorgfaltsanforderungen beim Unternehmenskauf, WM 1998, 1169; E. SCHWARK, Prospekthaftung und Kapitalerhaltung in der AG, in: Schmidt et al. (eds.), Unternehmen, Recht und Wirtschaftsordnung – Festschrift für Peter Raisch zum 70. Geburtstag (Cologne et al. 1995) 287; this view is shared by English courts, see *Soden and another v. British and Commonwealth Holdings plc* [1998] AC 298, 4 All ER 353.

[51] H. HENZE, Reichweite und Grenzen des aktienrechtlichen Grundsatzes der Vermögensbindung – Ergänzung durch die Rechtsprechung zum Existenz vernichtenden Eingriff?, AG 2004, 407 et seq., 410.

[52] T. BAUMS, Haftung wegen Falschinformation des Sekundärmarktes, ZHR 167 (2003) 170; K. LANGENBUCHER, Kapitalerhaltung und Kapitalmarkthaftung, ZIP 2005, 244 et seq.

[53] See BGH, 9 May 2005, II ZR 287/02, NJW 2005, 2450, 2451 et seq. "EM-TV".

e) Disguised Distributions Involving Third Parties

Capital maintenance provisions are designed to prevent transfers of value from a company to its shareholders and they are worded accordingly, mentioning the company as the transferor and its shareholders as the transferees. The effect of such transfers can, however, easily be achieved through transactions involving substitutes for the company as well as the recipient shareholder. A clear example is a transaction between a nominee of the company and a nominee of the shareholder. The company reimburses its nominee for his expenses while the recipient passes on the benefit to the shareholder. If such evasions were allowed to stand, the creditor protection which capital maintenance is seeking to ensure would be at the disposal of the company and its shareholders. In order to give effect to the rationale of enforcing the priority of creditors over shareholders the scope of the relevant provisions must, therefore, be expanded beyond their narrow wording.

German courts and scholarship have adopted a principle-based approach in order to distinguish evasions of the capital maintenance rules from transactions where the application of the relevant provisions would be inappropriate. The relevant criteria for applying the capital maintenance provisions to transactions with third party transferees is whether the economic benefit of the transaction has accrued – albeit indirectly – to the shareholder or, alternatively, whether the transfer of value is due to the shareholder having exercised his influence on the company, the latter case being treated as if the benefit had been transferred to the shareholder and then passed on to the third party.[55] Direct or indirect accrual of benefits to a shareholder may arise from transfers of value to his nominees or agents,[56] to related parties including companies in which the shareholder has a controlling stake[57] or the payment of a shareholder's debt.[58] As mentioned above, the economic effect of a distribution can also be achieved if a third party rather than the company itself acts as the transferor. Besides transactions with nominees or agents of the company, the most relevant cases of this category are transfers by direct or indirect subsidiaries of the company.[59]

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[54] ECJ, C-174/12 marg. nos. 22 et seq.

[55] BAYER, *supra* note 23, § 57 marg. nos. 56 et seq.; A. CAHN, Kapitalerhaltung im Konzern (Cologne 1998) 16 et seq.; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. nos. 72 et seq., all with further citations.

[56] BGH, 13 November 2007, XI ZR 294/07, NZG 2008, 106; OLG Hamburg, 23 May 1980, 11 U 117/79, AG 1980, 275, 278.

[57] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. nos. 77 et seq. with further citations

[58] BGH, 29 May 1973, II ZR 25/70, BGHZ 60, 324, 330 et seq.

[59] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. nos. 59 et seq. with further citations.

III. Legal Consequences of Violations of the Capital Maintenance Provisions

§ 62 para 1 AktG provides that shareholders shall make restitution to the company for benefits received from the company contrary to the provisions of the AktG. Pursuant to traditional doctrine, distributions in violation of the capital maintenance provisions are void.[60] The company retains ownership of assets it has transferred to a shareholder. Consequently, the term "restitution" is to be interpreted literally so that the recipient of the benefit is liable to return in kind the asset he received from the company and the company can enforce its claim in full even in the shareholder's bankruptcy.[61] The traditional understanding of the term restitution does, however, entail a number of unattractive and inappropriate consequences. Capital maintenance is concerned with transfers of value to shareholders rather than with the preservation of specific assets. Thus, the objections against transactions with shareholders at other than arm's length are directed against the inadequacy of the consideration received by the company rather than against the acquisition from or disposal of assets to shareholders. Frequently, such transactions serve a legitimate business interest of the company which would be impaired if the transaction were reversed. Moreover, transactions such as contracts for services, leases or the sale or acquisition of assets that have perished or depreciated since the time of the transfer cannot be unwound by simply returning the items that have been exchanged to their original owners.

These reasons have led the Federal Court and a majority of scholars to develop an alternative interpretation of the term "restitution" in the context of capital maintenance. According to this concept the meaning of "restitution" must be determined so as to give effect to the purpose of capital maintenance as preventing the transfer of value to shareholders. This purpose requires that the company is adequately compensated for any transfer of value to a shareholder.[62] Whether such compensation is made in kind or in cash is irrelevant. While this generic understanding of the term "restitution" avoids the necessity for distinctions between different types of distributions it does give rise to a number of issues that have not yet been resolved, the most urgent of which is whether the company or the recipient of the distribution has the right to choose if restitution is made in kind or in cash.[63]

[60] H. HENZE, in: Großkommentar zum Aktiengesetz, 4th ed. 2000, § 57 marg. no. 203 et seq.; LUTTER, *supra* note 46, § 57 marg. no. 63.

[61] H. WIEDEMANN, Gesellschaftsrecht I (Munich 1980) 442.

[62] BGH, 12 May 2012, II ZR 179/12, BGHZ 196, 312, 316 et seq. marg. nos. 15 et seq.; BAYER, *supra* note 23, § 57 marg. no. 157 et seq.; CAHN, *supra* note 55, 114 et seq.; DRYGALA, *supra* note 20, § 57 marg. no. 133 et seq.; KOCH, *supra* note 43, § 57 marg. no. 32.

[63] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. nos. 96 with numerous citations.

IV. Intra-Group Transfers and Modifications of the Capital Maintenance Regime by the Law of Corporate Groups *(Konzernrecht)*

1. The Issue of Intra-Group Transfers

Corporate groups consist of a controlling shareholder (the parent) and one or more companies over which he can exercise control (the subsidiaries). Typical examples of intra-group transactions that can affect capital maintenance on the subsidiary level are upstream loans and upstream securities for debts of the parent. As mentioned above (II.2.e)), the scope of the capital maintenance provisions as interpreted by German courts is not limited to transactions between the company and its shareholders but extends to transfers of value between related parties. The most relevant examples of such transfers are transactions involving subsidiaries of the company or the shareholder. If, for instance, a wholly owned subsidiary rather than the company itself enters into a transaction at other than arm's length with a shareholder of its parent company, the economic effects of the transfer of value on the parent company are very similar to those of direct transfer from the parent company to its shareholder. The value of the parent's stake in the subsidiary decreases by the amount of the distribution, thereby reducing the funds available for claims from the parent's creditors. Similar concerns for the protection of creditors arise if two subsidiaries of the same shareholder enter into other than arm's length transactions. The fact that value has remained within the corporate group does not benefit the creditors of the transferee company, since only assets of their debtor but not those of other group members are available for the satisfaction of their claims. Typical examples of intra-group transactions involving several subsidiaries include contracts for goods and services at transfer prices or cash pooling schemes.

Pursuant to the capital maintenance rules, transfers by a subsidiary to a shareholder of its parent company trigger the transferee's liability to reimburse the subsidiary, thereby compensating the indirect outflow of funds from the parent company. Whether or not the parent company itself were liable to the subsidiary would depend on the capital maintenance regime applicable to the company and on whether the transfer is due to the parent company having exerted its influence on the subsidiary.[64] The treatment of transfers between companies with the same controlling shareholder (sister companies) is highly controversial. While some authors argue that such transactions should be treated as if the transfer had been made to the common parent and then passed on to the recipient company, with the consequence of the parent's

[64] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. nos. 59 et seq. with numerous citations

liability to reimburse the transferor,[65] others submit that the parent should only be accountable if the transaction is due to its influence on the transferring company, effectively absolving the parent company from liabilityfor genuine mistakes of business judgment.[66]

2. The Transferee's Liability Under Group Law

a) The Bifurcated Statutory Groups of Companies Law Regime of the Aktiengesetz

Unlike most other jurisdictions, Germany has introduced a body of statutory provisions regulating groups of companies. The groups of companies law *(Konzernrecht)* of §§ 15–19 and 291–328 AktG modifies the rules applicable to independent stock companies in order to strike a balance between protectimg dominated stock companies, their minority shareholders and their creditors from exploitation by a controlling shareholder and that shareholder's interest in integrating the dominated company into a group of companies.[67] Integration can – and in fact frequently does – entail transactions at other than arm's length and, thus, transfers of value within the group. In sum, the losses and benefits of such intra-group transactions may well balance out over time. However, the capital maintenance provisions look at individual transfers of value without regard to unrelated transactions between the company and the same shareholder that may, in effect, eventually compensate the original loss.

Under the *Aktiengesetz* a parent-subsidiary relationship is either based on the influence the controlling shareholder has by virtue of his voting rights (de facto group or *faktischer Konzern*) or on an enterprise agreement between the parent and the subsidiary *(Vertragskonzern).* Different sets of rules apply to either type of relationship, each of them modifying the capital maintenance regime applicable to the relationship between a company and a non-controlling shareholder.

b) Enterprise Agreements and Capital Maintenance

Enterprise agreements may subject the subsidiary's management to the instructions of the parent (domination agreement – *Beherrschungsvertrag*) or oblige the subsidiary to transfer its entire annual profit to the parent (profit transfer agreement – *Gewinnabführungsvertrag*). Transfers from subsidiary to parent are exempted by §§ 57 para. 1 sent. 3 and 291 para. 3 AktG. While this

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[65] E.g. BAYER, *supra* note 23, § 57 marg. no. 72; GRIGOLEIT/RACHLITZ, *supra* note 43, § 57 marg. no. 32.

[66] A. CAHN, *supra* note 55, 66 et seq.; CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 79; DRYGALA, *supra* note 20, § 57 marg. no. 128.

[67] For a comprehensive summary and analysis see K. LANGENBUCHER'S contribution to this volume.

exemption appears to be at odds with the restrictions on distributions to shareholders under Art. 15 of the Second Directive (now Art. 17 of the Directive 2012/30/EU), German courts and scholarship agree that national legislators are able to issue special provisions on corporate groups[68]. They also agree that, in substance, the parent company's obligation under § 302 AktG to compensate the subsidiary for any annual net loss incurred over the duration of the enterprise agreement, irrespective of its cause, is a sufficient substitute for capital maintenance. Thus, if an enterprise agreement between the subsidiary and the parent is in place, the capital maintenance provisions do not apply to transfers of value to the parent or to third parties with the consent of the parent, the latter case being assessed as if the subsidiary had made the transfer to the parent and the parent had passed it on to the third party.

Some scholars submit that the disapplication of the capital maintenance rules contained in §§ 57 para. 1 sent. 3 and 291 para. 3 AktG should be suspended if it is unclear whether the parent will be able to satisfy the subsidiary's claim for compensation of its annual net loss pursuant to § 302 AktG.[69] Enterprise agreements are, however, meant to provide legal certainty for dealings between the company and its controlling shareholder. Legal certainty would be severely impaired if the duty of the subsidiary's management to comply with the controlling shareholder's instructions were open to discussion about the controlling shareholder's prospective ability to compensate the subsidiary for its future annual net loss.[70]

c) De Facto Control and Capital Maintenance

Domination is defined in § 17 para. 1 AktG as the ability of an enterprise (the parent) to exercise control over another enterprise (the subsidiary), while § 17 para. 2 AktG in conjunction with § 16 para. 1 AktG presumes that this ability exists if an enterprise owns the majority of the shares or voting rights in another enterprise. If a controlling shareholder actually exercises this influence

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[68] W. SCHÖN, Deutsches Konzernprivileg und europäischer Kapitalschutz – ein Widerspruch?, in: Forster (ed.), Festschrift für Bruno Kropff (Düsseldorf 1997) 285, 299; R. VEIL, in: Spindler/Stilz, Aktiengesetz, 3rd ed. 2015, § 291 marg. no. 75.

[69] E.g. H. ALTMEPPEN, Cash Pooling und Kapitalerhaltung bei bestehendem Beherrschungs- oder Gewinnabführungsvertrag, NZG 2010, 364; J. FRIDRICH, Der Schutz des Kapitals der Aktiengesellschaft bei fremdfinanzierter Übernahme (Berlin 2010) 354 et seq.; M. HABERSACK/J. SCHÜRNBRAND, Cash Management und Sicherheitenbestellung bei AG und GmbH im Lichte des richterrechtlichen Verbots der Kreditvergabe an Gesellschafter, NZG 2004, 690.

[70] CAHN/VON SPANNENBERG, *supra* note 17, § 57 marg. no. 136; FLEISCHER, *supra* note 25, § 57 marg. no. 17; H. GELHAUSEN/S. HEINZ, in: Krieger/Lutter/K. Schmidt (eds.), Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 357, 371; GRIGOLEIT/RACHLITZ, *supra* note 43, § 57 marg. no. 4; K. STEPHAN, Zum Stand des Vertragskonzernrechts, Der Konzern 2014, 22.

to the disadvantage of a controlled stock corporation, § 311 AktG requires the subsidiary be compensated for any loss incurred as a consequence of the parent's interference. Unlike restitution pursuant to § 62 AktG for a violation of capital maintenance, compensation for the exercise of controlling influence to the disadvantage of a stock corporation may be deferred until the end of the business year and may be postponed even further, provided a claim of the subsidiary against the parent, specifying the time, amount and type of compensation is established by the end of the business year in which it occurred. German courts and scholarship have not adopted[71] the objection that this relaxed standard of liability is incompatible with the European capital maintenance framework.[72]

As disadvantage frequently occurs through transfers of value to the parent or to third parties at the instruction of the parent, enforcement of capital maintenance provisions which call for immediate restitution to the subsidiary would conflict with the deferral of compensation allowed by § 311 AktG. According to the majority view, shared by the Federal Court, the special rules of groups of companies law override the general capital maintenance provisions,[73] with the somewhat peculiar consequence that the controlling shareholder's liability for transfers that occurred at his bidding is less stringent than his liability for transfers in which he was not involved.[74]

Unlike directors of a company bound by a domination agreement who must comply with the instructions of the other party's management, the responsibility to manage a de facto subsidiary remains with its directors. They are not under an obligation to follow the instructions of the controlling shareholder and are not immune from liability if compliance with such instructions has damaged the company. The directors of the subsidiary are, therefore, responsible for the assessment of whether it is compatible with the interests of their company to comply with suggestions of the controlling shareholder due to the latter's ability to compensate for potential disadvantage caused by such compliance.

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[71] See e.g. BEZZENBERGER, *supra* note 7, 325 et seq.; P. O. MÜLBERT, Kapitalschutz und Gesellschaftszweck bei der Aktiengesellschaft, in: Schneider (ed.), Festschrift für Marcus Lutter zum 70. Geburtstag (Cologne 2000) 536 et seq.

[72] SCHÖN*, supra* note 68, 294 et seq.

[73] BGH, 1 December 2007, II ZR 102/07, BGHZ 179, 71, 77 marg. no. 11; KOCH, *supra* note 43, § 311 marg. no. 49.

[74] Since the application of §§ 311 et seq. AktG is triggered by an exercise of the controlling shareholder's influence, even the advocates of the majority view agree that these provisions do not replace the capital maintenance provisions with respect to transactions in which the controlling shareholder was not involved.

V. Conclusion

As the preceding remarks have shown, the capital maintenance provisions as construed by German courts and scholarship restrict not only dividend payments but also transfers of value that are disguised as alleged arm's length transactions, including contracts to which neither the company nor a shareholders is a party. This aspect of capital maintenance appears to have been neglected by its critics who advocate the elimination of the current mandatory capital rules in favor of contractual creditor protection based on covenants. In order to catch disguised distributions as effectively as the statutory capital maintenance regime, covenants would have to cover all such transactions between the company and its shareholders including transactions between related parties. It is not clear whether covenants could effectively address all the transactions caught under the principle-based interpretation of capital maintenance rules and whether it would be feasible for a creditor to monitor all such transactions. Arguably, the remedies available would not be as effective as those available under the capital maintenance regime since the obligation of the transferee to return an illegal distribution cannot be replicated in agreements between the company and its creditors.

From Legal Capital to Subscribed Capital

Capital Rule in China and its Economic Background

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I. Introduction

Since the first corporate law in China was passed in 1993 (the 1993 Corporate Law), China took a rather strict approach to enforcing capital maintenance requirements, particularly through requiring a minimal registered capital. This approach survived the substantial revision of corporate law, taking effect in the year of 2005 (the 2005 Corporate Law). In 2013, the requirement was abandoned rather dramatically with the issuance of a set of regulatory rules by the State Administration of Industry and Commerce (the company registrar), subsequently confirmed in a set of amendments to the corporate law (the 2013 Corporate Law). The reactions to this rather sudden change were split. Some praised this change as a revolution which would liberate the market and unleash the power of investment. Others, however, expressed reservations and deep concern, especially with respect to the protection of creditors of small to medium sized companies without a track-record in the market.[1]

The evolution of the capital maintenance requirement in China fits well with the general trend and patterns in other jurisdictions: moving from a stringent legal capital regime towards a more liberalized and flexible capital regime, such as seen in France, Germany, Japan and Korea. Meanwhile, this process presented certain features unique to China, which shall be the focus of this chapter. In particular, the evolution has closely tracked the economic reform in China from a centrally planned economy to a more market-oriented economy. Meanwhile, the capital maintenance rule in China is still a work-in-progress in terms of achieving the goal of protecting creditors' interests with a liberalized subscribed capital regime, leaving critical gaps and challenges.

The rest of the Chapter is organized as follows. Section I provides a brief overview of China's economic reform for the past four decades and its impact on corporate law in general, and the evolution of the capital maintenance rule in particular. Section II provides an overview of the legal capital regime under the 1993 Corporate Law and 2005 Corporate Law. Section III sets out the various costs of the legal capital regime. Section IV introduces the new capital rule regime created under the 2013 Corporate Law, especially the subscribed capital regime. Section V sets out a few challenges embedded in this new regime. A brief conclusion follows at the end.

[1] Critique of Chinese scholars on this reform are mainly reflected in a series of papers presented at a conference on the reform of legal capital rule (公司法资本制度改革研讨会) on 28 April 2014 in Beijing, sponsored by the Legal Research Institute of the Social Academy and another conference on application of corporate law (公司法司法适用高端论坛) on 11 May 2014, sponsored by a number of institutions including the Supreme Court.

II. China's Economic Reform and its Impact on Corporate Law in China

1. China's Economic Transformation since the 1970s

Before the Cultural Revolution, China's economy was dominated by the state. On the one hand, all resources were essentially owned by the state and allocated through planning and administrative orders. Meanwhile, the government and government-owned entities were the only ones allowed to engage in trade and investment and individuals were simply not allowed to form association for commercial or any other purposes. Therefore, individuals were either waiting to be employed or already employees of the state or state-owned entities. The operation of such a command economy resulted in declining production and even serious famines in some places in China.

Since late 1970s, China embarked on an economic transformation with the goal to change from a planning economy towards a new economy where the market plays a bigger role in allocating resources. A critical part of this reform was the liberalization of various restrictions on trade and investment and the opening of the economy to the global market. Foreign trade and foreign direct investment hence surged to historical record, making China the most popular destination in the world in the world for investment. Subsequently, domestic trade and investment by Chinese citizens also came to be allowed, encouraged and grew quickly. As a consequence, China has delivered two-digit GDP growth for the last two decades, leading almost all major players in the global market to establish a substantial presence in China. The non-state sector has in many ways outperformed the state-sector, making enormous contributions to the economy through production and absorbing a substantial portion of the nation's labor force. For example, by the end of 2013, the private sector contributed more than 60% of the GDP nationwide and more than 80% of the GDP in Guangdong province, one of the top 3 largest provincial economies in China; it has also provided more than 200 million jobs.[2]

However, Chinese economy has never become a full-blown market economy. After about four decades of economic reform, the government still plays a central role in allocating resources. State-owned enterprises (SOEs) still dominate many industries in the economy, largely because of the monopoly created under the government's regulatory regime, preferential treatment provided by government, such as financial subsidies, and services received

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[2] See the news release of the official XINHUA NEWS AGENCY on 28 February 2014, available at <http://news.xinhuanet.com/fortune/2014-02/28/c_119558098.htm>.

from the government but not otherwise available in the market.[3] Such preferential status of SOEs in the market makes it very costly for private investors and enterprises to compete, hence discouraging consumption by individuals and investment by private entities in the domestic market as well as the global market. Resentment and dissatisfaction are therefore frequent, generating deep instability in the society. As a consequence, maintaining social stability and preventing conflicts and confrontation between entities in society have become one of the highest priorities for law and government policy.

2. *The Impact of the Economic Transformation on Corporate Law*

Corporate law directly affects incentives and specific arrangements for investment and is thus frequently used throughout the whole process of economic reform in China to help achieve overall policy goals and objectives. The evolution of corporate law in China since the late 1970s has therefore closely tracked the features and patterns of economic transactions.[4] When restrictions on market transactions were lifted, modern and pro-market corporate laws were also introduced to encourage and facilitate investment. For example, in the 1970s, in order to attract foreign direct investment and associated technical assistance from abroad, China implemented various corporate law rules when the government provided preferential tax treatment and subsidized resources to foreign investors. Similarly, when the domestic capital market was burdened with the abuse of minority shareholders by insiders, a substantially revised corporate law and a new securities act were promulgated in 2005 to restore investors' confidence in the capital market by enhancing the protection of minority shareholders through modern corporate governance, and more stringent regulation, among other measures.

This being said, we should recognize that Chinese corporate law also reflects certain features that are rather unique to China, which may sometimes conflict with the goal of encouraging investment and protection of minority shareholders. In particular, corporate law had been used to help transform SOEs from an internal department of the government into profit-driven commercial entities. As a consequence, the 1993 Corporate Law mainly targeted SOEs, providing corporate vehicles for existing SOEs and facilitating a change of the state's role from one of being able to dictate day to day man-

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[3] For example, employees of SOEs have much better access to residency status in mega cities in Beijing, housing benefits and quality primary education for their children.

[4] See in general R. CHEN, The Evolution of Corporate Law in China: A Mission Possible to Reform State-owned Enterprises?, a paper presented at the 10th Annual Meeting of the Asian Law and Economics Association held at National Taiwan University College of Law on 20–21 June 2014, Ch. 9 in forthcoming volume: Wang/Chang/Shen (eds.), Private Law in China and Taiwan: Economic and Legal Analyses (Cambridge 2016).

agement to one of mere shareholder, without diluting the power of the state over state-owned assets.

The specification and the evolution of the capital maintenance rule in China serves as a great example of the above impact of China's economic transformation on corporate law. On the one hand, the transformation from a rigid legal capital regime to a more flexible subscribed capital regime fits well with the general philosophy and trends in liberalizing investment restrictions to encourage investment. On the other hand, the transformation is still a work-in-progress, leaving many gaps in law and practice that are actually necessary to serve certain legitimate functions of modern corporate law, such as creditors' protection.

III. The Legal Capital Regime

Like many civil law countries, China adopted a legal capital regime for corporations when the first corporate law took effect in 1994. This regime survived the 2005 revision of the corporate law, with rather minor adjustments. The legal capital regime in China consists of three components. The first one sets a required minimal registered capital for incorporation, the amount and nature of which are specified under corporate law. In addition to the rigid minimal registered capital requirement, the legal capital regime includes other measures designed to preserve capital in particular and assets in general in the interest of creditors. The second component consists of change restrictions for registered capital and the third restricts payments by the company to its shareholders, especially dividend distributions.

1. The Mandatory Minimal Registered Capital

Since the promulgation of the first corporate law in 1994, China has implemented a stringent capital maintenance regime. The core element of this regime is the minimal registered capital amount required from investors in setting up a corporation, which was 10 million RMB for a joint stock company and 100,000 RMB for a limited liability company under the 1993 Corporate Law (Art. 81 of the 1993 Corporate Law). The threshold was lowered substantially under the 2005 Corporate Law, to 5 million RMB and 30,000 RMB respectively (Art. 26 of the 2005 Corporate Law). In addition, shareholders were granted the ability to pay their contribution in instalments, subject to the requirement that the first installment must be no less than 20% of the total registered capital amount with the rest to be fully paid within two years of incorporation of a company, or five years for investment companies (Art. 26 of the 1995 Corporate Law).

Nevertheless, other requirements relating to the registered capital regime remained after the promulgation of the 2005 corporate law. In-kind contributions were permitted albeit only in a limited number of specific forms set out in the corporate law and rules for company registration, which did not include covenants to provide service and interests under contracts (Art. 31 of the 2005 Corporate Law). In addition, the value of in kind contributions must amount to no more than 30% of the total amount of registered capital (Art. 27 of the Corporate Law). Furthermore, agreement from all shareholders is not sufficient for confirming the legality and value of in-kind contributions to registered capital. Instead, a third party pre-certified by the company registrar must verify the validity and value of in-kind contributions as well as their actual contribution. Should any discrepancy between the actual value of the in-kind contribution and its verified value arise, the relevant shareholder is obliged to make an additional contribution and all initial shareholders are jointly and severally liable for such a discrepancy (Art. 31 of the 2013 Corporate Law). The certified third parties can also be found liable under Art. 208 of the 2013 Corporate Law: in cases of fraud or negligence, they will face sanctions in the forms of fines and revocation of their license and will be held liable for compensating creditors' loss occurred due to omission of critical information in the reports caused by their fraud or negligence.

2. Restrictions on Change of Capital

To increase the registered capital, one also needs to comply with the same substantive and procedural requirements imposed upon the making of initial contributions to registered capital.

Reducing registered capital is even more cumbersome (Art. 178 of the 2013 Corporate Law). The company needs to go through multiple rounds of public notification to creditors and to allow creditors substantial time to raise their claims. Afterwards, the company needs to either repay or settle all of its debts. The comprehensive report for any such repayment and settlement must be verified by a certified accounting firm and be filed with the company registrar for approval. The requirements for minimal registered capital do not allow the reduced amount of registered capital to be below the statutory minimal registered capital.

3. Distribution of Dividends and Other Payment by Company to Shareholders

Corporate law in China has adopted universal restrictions on dividend distributions. A company may only distribute dividends from its profits; where profits are insufficient, and distribution of dividend would lead to shareholders being held liable the return of the distributed amount to the company (Art. 167 of 2013 Corporate Law).

As a catch-all provision, Art. 36 of the 2013 Corporate Law imposes a general prohibition on shareholders from taking back contribution to the registered capital *(Chou Tao Chu Zi).* A breach of this general prohibition could result in civil, administrative and criminal sanctions up to five (5) years in prison.[5] The Supreme Court of China has issued a number of guiding cases as to what would be covered by this provision and the respective consequences. For example, the Supreme Court ruled that in such circumstances, the company has lost its independent legal personality and that equity investors shall assume full liability for all the outstanding debts of the enterprise.[6] The Supreme Court later consolidated the relevant rules into a set of interpretations of the Corporate Law in December 2011.[7]

When a company did not receive any contribution from shareholders to its registered capital or the paid-in capital amount contributed by shareholders is lower than the statutory minimal registered capital amount, which may be taken as evidence that capital has been taken back, the shareholders may have to face a few serious consequences. They may lose or face the dilution of other statutory rights granted by the shareholder standing, such as the right to dividend, pre-emptive rights to subscribe for the new issue of shares and right to distribution in liquidation (Sec. 16). In serious circumstances, they may be deprived of the status of shareholder through a shareholders resolution of the company, provided that the relevant shareholder failed to make the payment of the full amount of the contribution despite being requested to do so (Sec. 18). Similarly, such activities could lead to a shareholder being required by the regulator to transfer his or her shares (Art. 151 of the 2013 Corporate Law).

IV. Costs of the Legal Capital Regime

The central objective of the minimal registered capital regime is to protect creditors' interests. When almost all bank creditors are state-owned and trade-creditors are largely SOEs, such an objective was understandable. Through the lens of a modern financial and accounting framework, however, this regime looks exceptionally rigid and ineffective: using a static indicator, i.e. the registered capital amount at the time of establishment of the company, to

[5] Art. 159, Criminal Law of the People's Republic of China (中华人民共和国刑法), passed by the Standing Committee of the National People's Congress and effective as of 1 November 2015.

[6] See the Supreme Court, Reply Regarding Civil Liability When a Company Set Up by Another Enterprise has been Cancelled or Gone Out of Business, 30 March 1994 (最高人民法院关于企业开办的其他企业被撤销或者歇业后民事责任承担问题的批复).

[7] Sec. 16, The Supreme Court Interpretations of the Corporate Law (III) (最高人民法院关于适用《中华人民共和国公司法》若干问题的规定（三）), issued by the Supreme Court and effective as of 20 February 2014.

assess a dynamic risk, i.e. the risk of default by debtors. Moreover, the regime is not only ineffective, but wasteful.

The minimal registered capital amount seemed by law unsubstantial even for individuals, especially under the 2005 Corporate Law, which only required 30,000 RMB for a limited liability company. The real costs the regime imposed upon investors, however, went far beyond this and has had profound implication for investors. In the World Bank ranking of all countries in terms of the costs and ease of starting a business, China was ranked 128 of 189 countries for the year of 2014 and lower in previous years.[8]

As a typical *ex ante* tool of regulation, it bears information and enforcement costs universal to other *ex ante* measures. Other scholars have commented that such a capital system is both ineffective and costly.[9] In China, this system has also imposed extremely high private costs on investors: financial costs, administrative costs and costs of rent-seeking activities.

1. Financial Costs

The ideological and practical focus on registered capital created by the corporate law has resulted in an escalation of registered capital requirements in other scenarios. Government regulators in China have imposed very substantial thresholds on registered capital in granting certificates and licenses to market players. To be a certified construction company, a company's registered capital amount needed to be at least 1 million RMB with at least 50 million RMB in registered capital was required to be certified as a tier-one construction company.[10] The requirements are even more substantial for financial institutions: e.g. at least 200 million RMB in registered capital required for insurance companies[11] and 300 million RMB for trust companies.[12] Lenders also used the registered capital amount as a core indicator to assess potential borrowers' credibility and the risks of default. It would appear to have triggered a race to the top among investors to incorporate companies with a larger amount of registered capital. For investors with big endowments and cheap access to capital, such a race is not only affordable, but advanta-

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[8] See a summary of *Doing Business 2015* data for China at: <http://www.doingbusiness.org/data/exploreeconomies/china>.

[9] L. Enriques/J. Macey, Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules, 86 Cornell L. Rev. (2000) passim.

[10] Sec. 5, Rules on the Administration of Real Estate Developing Enterprise Qualification (房地产开发企业资质管理规定), last amended by the Ministry of Housing and Urban-Rural Development of China (住房和城乡建设部) and effected as of 4 May 2015.

[11] Art. 69, Insurance Law of the People's Republic of China (中华人民共和国保险法), passed by the Standing Committee of the National People's Congress and effective as of 1 August 2014.

[12] Sec. 10, Rules on the Administration of Trust Companies (信托公司管理办法), passed by the China Banking Regulation Commission and effective as of 1 March 2007.

geous. However, for the investors faced with less advantageous finance options and most private entities with very limited or no access to capital, the race is detrimental. Where a formal market fails, a black market naturally emerges. It is therefore no surprise that a very substantial informal market of bridge loans particularly targeting registered capital contributions has therefore has been in existence from the very beginning of the minimal registered capital regime. As in any other informal lending market, these bridge loans come with prime interest rate, adding a substantial cost for the borrowers.

2. Administrative Costs

The second type of cost is less explicit and has been embedded in the process of satisfying the statutory requirements in terms of the form and value of contributions to registered capital. Compliance with these requirements necessarily involves applying for approval from the company registrar, and potentially other regulatory authorities as well. Official waiting times for each step along the procedure is relatively short (a day or few more) and the official charge for each service is very minor, ranging from free to a few hundred RMB. The reality, however, is much more complicated. The official timeline won't start ticking until the relevant officials formally accept the formal application, which is often a result of a few rounds of back and forth, revising and supplementing documents to meet the formal requirements. Given that the company registrar has the authority to review and approve the capital contribution evaluation and verification reports, applicants face a high degree of uncertainty in obtaining approval.

This third party evaluation approach is in line with standard practice in many civil law countries. In contrast, common law jurisdictions have adopted less costly measures to regulate the forms of contribution[13], which might be a valuable option. In commonwealth nations, information regarding in-kind capital contributions and relevant contracts must be filed with the company registrar and made available to the public, with court review limited to formalistic matters. The US takes a more liberal route, leaving it to the business judgment of the directors.

Returning to the costs in China, another even more negative aspect is that procedural costs are not evenly distributed across different groups of investors. Enterprises better connected with the government, such as state-owned entities are likely to be able to use their connections with the government and to negotiate for special treatment on a case-by-case basis. Less well-connected entities, however, can only use their own funds to purchase fast-track services offered by middlemen who have closer connections with gov-

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[13] Y. LIU, 公司法资本制度改革的逻辑和路径——基于商业实践视角的观察，《法学研究》, [The Logic and Evolution of the Capital System in Company Law: From the Perspective of Commercial Practice], 2014 年第 5 期 [Legal Research (2014)] 32–56.

ernment departments. These services command substantial prices further adding to the real costs for less-connected investors in contrast to their government favored counterparts.

3. Costs of Rent-seeking Activities

Targeting the same group of clients, bridge-loan services and the fast-track services are often combined and arranged by the same middlemen, creating enormous rent seeking opportunities. These costs consume substantial resources for less privileged investors who are thus further disadvantaged against well-connected entities. Scandals and corruption have become widespread with respect to the registered capital regime.[14] The waste and corruption generated by this third type of costs incurred under the registered capital regime is particularly alarming. It goes against the general policy of the Chinese government in growing the economy and making it more efficient. Since regulators may be tempted to expand the regulatory regime thereby attracting social resources into rent-seeking opportunities,[15] it is wasteful and may generate a strong vested interest group against market-oriented reform of incorporation and investment.

Every company must meet certain standard regulatory requirements in the regime, such as making capital contributions in cash and having the name of the company approved by the company registrar. Therefore, the need for services to help meet these standard requirements has become substantial enough to generate a market of bridge loans and fast-track services. With respect to non-typical and more case-specific requirements, such as the legality of certain in-kind capital contributions and their value, these involve more complicated communication and negotiation with the company registrar, services for which would either be ridiculously expensive if available at all in the market. As a consequence, less well-connected entities face much higher costs and hurdles in these circumstances, including high rent-seeking costs incurred in obtaining access to and negotiation with the authorities on a case-by-case basis, not to mention the uncertainty regarding the final decisions by the company registrar.

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[14] For example, the ex-deputy head of the company registrar was recently suspended and put under investigation for potential corruption, see the news available at: <http://politics.people.com.cn/n/2014/1226/c70731-26278674.html>.

[15] K. MURPHY/A. SHLEIFER/R. VISHNY, The allocation of talent: implications for growth, 106 The Quarterly Journal of Economics (1991) 503–530.

V. Subscribed Capital Regime: the 2013 Corporate Law Reform

A new round of economic reform started in China in 2013 after the new president came into power. One priority in this round of economic reform was to encourage private sector investment. Reaching this goal was inhibited by the costs of the statutory minimal registered capital regime outlined above. It is hence no surprise that the legal capital regime was addressed immediately. Before the change to the national law and practice, a number of local governments such as Shenzhen, at the forefront of China's economic reform had carried out experiments in liberalizing the legal capital regime.[16] In October 2013, the State Council, the administrative branch of the central government in China, announced five policies regarding capital rules for companies and company registration. These included abolishing the statutory requirement for a minimal registered capital, establishing a subscribed capital regime, and cancelling the minimum initial capital contribution requirement and the time restrictions for installment payments of capital contribution.[17] A new capital regime was formally established with the passage of the 2013 Corporate Law. This Section provides an overview of this new regime, consisting of a subscribed capital regime and a set of sanctions against undue transfers of funds from companies to their shareholders.

1. The Subscribed Capital Regime: Freedom of Contract

Compared with the heavy-handed statutory registered capital regime, the subscribed capital regime provides a much broader scope for freedom of contract among investors. Investors are free to agree on the total capital of the company and the amount of capital subscribed and payable by each investor. The pace of capital contributions by shareholders is also purely a matter of contract among investors, with no limit on the number of installments and the amount of each installment. Similarly, whether each investor has fulfilled its obligation with respect to capital contributions has become purely a contractual matter, whose enforcement falls to the investors or other interested parties. As a consequence, it is no longer necessary for the government and third parties certified by the government to verify the actual contribution of capital by investors and investors' compliance with the relevant restrictions and

[16] See the Rules on Commercial Matter Registration in Shenzhen Special Economic Zone (深圳经特区商事登记若干规定), passed by the Standing Committee of Shenzhen People's Congress and effective as of 1 March 2013 and the Rules in Zhuhai Special Economic Zones (珠海经济特区商事登记条例), passed by the Standing Committee of Zhuhai People's Congress and effective as of 1 March 2013.

[17] See the Registered Capital Regime Reform Plan (注册资本登记制度改革方案), issued by the State Council on 25 October 2013.

requirements. Capital verification has hence ceased to be a task of the government (Art. 89 of the 2013 Corporate Law).

Another step to grant freedom of contract to shareholders is the elimination of the minimal percentage of cash contributions to the total amount of capital, which was 30% under the 2005 Corporate Law. A related issue is the ceiling of 20% imposed upon capital contributions in the form of intellectual property rights and non-patented technology, as stipulated under the 1993 Corporate Law (Art. 24). Even though this restriction had a carve-out for high-tech companies specifically approved by the government, it had become a major obstacle when the value and importance of intellectual property increased dramatically over time. The liberal position taken under the 2013 Corporate Law therefore rightly reflected the increasing value of human capital and technology in the market and paved the way for a more flexible and friendly environment for investment in valuable technology and intellectual property rights.

2. *Illegal Taking Back of Capital*

In the new capital regime, the benchmark of registered capital no longer exists and the focus for protecting creditors has shifted in terms of the timing of regulation: from the time before the company was established, *ex ante,* to the time of after the company was established and capital was contributed, *ex post,* emphasizing directors' liability for accepting irregular contributions or for causing the company to make undue payment of dividends.[18] Therefore, the various sanctions with respect to illegally taking back capital have become more prominent and worthy of detailed discussion.

Neither previous statues nor the 2013 Corporate Law provided details on what constitutes the illegal taking back of capital. Instead, the Supreme Court listed the following actions in a judicial interpretation in December 2011, which are binding upon all lower courts and arbitration tribunals. This included following ways of causing a company to transfer funds to shareholders: (1) immediately after the verification of the contribution; (2) through fake contracts; (3) through distribution of dividends from fake profits recorded in fraudulent accounts: (4) through connected party transactions; and (5) other ways of illegally taking back capital without going through legally permitted procedures.[19]

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[18] For example, see F. DENG, 邓峰: "资本约束制度的进化和机制设计—以中美公司法的比较为核心",《中国法学》[The Evolution of the Capital Restriction Systems and Mechanism Design: A Comparison of Corporate Law between China and the US], 2009 年第 1 期 [China Law Journal (2009)] 99–110.

[19] Sec. 12, The Supreme Court Interpretations of the Corporate Law (III) [最高人民法院关于适用《中华人民共和国公司法》若干问题的规定（三）], issued by the Supreme Court and effective as of 20 February 2014.

The deterrence against the illegal transfer of capital from company to shareholder not only targets shareholders. In addition, directors, supervisors, other senior managers and the *de facto* controlling entities (altogether "senior managers") can be held jointly and severally liable with the relevant shareholders for compensating creditors with respect to the amount illegally transferred to shareholders, if any of them was found to have been assisting such illegal transfers (Sec. 14). It is worth noting that the liability of these other entities is secondary to that of the shareholders even though the term *joint and several liability* is used, because shareholders are not entitled to seek indemnity from the senior managers for the amount for which they have been found liable and have fully compensated the creditors.

Third-party lenders in the informal bridge loan market are another party to be held jointly and severally liable for the illegal transfer of funds from company to shareholders. This informal bridge loan market has existed since the creation of the statutory minimal registered capital regime, but only came to be addressed in 2011, when the Supreme Court stipulated that the third party lender shall be jointly and severally liable to creditors for funds provided to shareholders for the sole purpose of making contribution.

VI. Challenges of the "Thin" Capital Regime

The new regime had long been expected and was warmly welcomed in the market. For example, as a comparison between the new and the old regimes, the annual total number of newly incorporated companies dramatically increased by 40% in Shenzhen, the first city to adopt the new capital regime. Nevertheless, some scholars strongly criticized the seemingly market-oriented reform as a "poisoned pill" largely driven by the local government's pursuit of GDP growth in premature circumstances, which would generate "dwarf companies" (with a very small amount of capital) and "gangster companies" (large subscribed capital payable over an unreasonably long period of time).[20] Such concerns and dangers cannot be dismissed lightly simply because other jurisdictions have also adopted a similar capital system for corporations. Again, the rather unique path of evolution of the market and corporate law in China has determined that China's legal system for protecting creditors is still a work-in-progress, with some of the other supplementary creditor protection institutions seen in other jurisdictions, such as the practice of piercing corporate veil, but lacking of other measures, such as a strong

[20] P. GAN, 甘培忠, "论公司资本制度颠覆性改革的环境与逻辑缺陷及制度补救"《科技与法律》[On the Underlying Circumstances for and Defects of the Revolution of the Corporate Capital System and Institutional Solutions], 2014 年第 3 期 [Technology & Law (2014)] 498–515.

statute against fraudulent transfer between a company and its shareholders, especially in the bankruptcy regime. In this sense, the new capital regime in China is still very thin in terms of creditors' protection.

1. Abuse and Strategic Use Without Supplemental Institutions

Where investors may determine the amount of capital to be maintained, the obligation to maintain a company's capital diminishes. The so-called "dwarf companies" seemed popular. For example, in Hong Kong, by the end of April 2008, around 80% of the companies had no more than 10,000 HKD of issued share capital and around 36% had actually issued capital of 100 HKD or less.[21] Even though this response from the market renders the principles of capital maintenance much less relevant nowadays, creditors of these companies cannot be easily convinced, given that the amount of issued capital is more or less transparent and creditors are therefore aware of it. Another type of abuse by investors, however, is much more capricious, hence deceptive: It sets out a substantial amount of subscribed capital but pays in installment over a long period of time, e.g. a company with 10 billion RMB in subscribed capital payable over 100 years, without restrictions on how many installments are allowed and how much each installment must be. Given that the actual amount of paid-in capital is not an item required to be registered with the company registrar, it is not necessarily known to the public.

Even though Germany and the US adopted measures to deter and sanction late payments, such as imposing penalty interest, restrictions on the right to dividends and even disqualification as shareholders. These measures, in the end, proved too complicated and costly. Japan went so far as to specifically prohibit installment payments of subscribed capital in the 1950s. Scholars hence proposed that China should follow the global trend and simply prohibit payment by installments, or at the very least impose specific legal obligations for shareholders to make installment payments according to set terms for each installment, with failure to do so leading to penalty and liability. In the absence of such obligations and liabilities, this form of abuse is unlikely to disappear on its own.[22]

Meanwhile, we should be fully aware that many of these risks can be resolved by market and commercial practice,[23] such as due diligence conducted by sophisticated investors and covenants given by a borrower to a lender. This being said, China's market is relatively young and even professional institutional investors can be naive and make mistakes about risks of fraud

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21 Sec. 3.6, Ch. 3 The Capital Maintenance Regime, FSTB, the Third Public Consultation on Companies Ordinance Rewrite (issued on 26 June 2008), available at: <http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/3thPCCOR_Chapter3_e.pdf>.

22 LIU, *supra* note 13.

23 LIU, *supra* note 13.

and default. Small institutions and individual investors are even more vulnerable in China than in other countries – raising a third class of creditors in China who deserve attention – that of torts creditors. They have no information about the potential risks or the chance to negotiate for a proper price and risk management measures. In China, they are also vulnerable when it comes to seeking specific performance or compensation from the tortious party. In summary, while the market is still developing quickly, legal sanctions should play a much more critical role than in the matured markets of Asia and the West.

2. *Distribution of Dividends*

The flip side of shareholder contributions to a company is the distribution of dividends to shareholders. Without any restrictions on the distribution of dividend, any requirements regarding contributions of capital can easily be circumvented. A new issue emerging under the subscribed capital regime asks whether the company should be allowed to distribute dividends where subscribed capital is partially or entirely unpaid, and what to do, if a company did so. Chinese corporate law is silent on this issue, probably because the reforms occurred so quickly that not enough thought was given to possible scenarios under the subscribed capital regime.

As a technical matter, under both the old corporate law regime and the new one, any distribution of dividends can only be paid out of distributable profits. As such, if the amount of dividend equals the outstanding amount of subscribed capital, and law requires that the dividend received by shareholders shall first be used towards payment of the outstanding amount of the subscribed capital, the two transactions would cancel each other out from a creditors' point of view: A company distributes dividends to shareholders and the shareholders then contribute the amount to the company's subscribed capital. Following this rationale, we could imagine a rule allowing a distribution of dividends to shareholders when the subscribed capital remains outstanding in total or in part, if all of the following conditions are met: (1) the company's profits are equal to or are more than the amount of dividend, (2) the shareholders shall use the dividend proceeds to settle, in full, any outstanding amount of the subscribed capital. This hypothetical rule, however, suffers from one critical shortcoming: the costs for enforcing the second condition are likely to be very high as the government would need to make sure that the shareholders actually transfer the dividend proceeds back to the company. Creditors of the company would have to face the risk of default and risk of bankruptcy of the shareholder. In the real world, very different rules have been put into place.

In Germany, for an "entrepreneurial company (with limited liability)", i.e. German "*Unternehmergesellschaft (haftungsbeschränkt)* (UG)", which is a type of GmbH, at least 25% of the annual profits of such a company must go to capital until its capital reaches the statutory minimal amount of EUR25,000.[24] It implies that, at least for such companies, 75% of the annual profits of a company may be distributed to shareholders before the subscribed capital amount is fully paid. In Japan, no dividend is allowed until the company's net asset value reaches 3 million Yen,[25] which also implies that dividends are allowed before the subscribed capital is fully paid, as long as the company has 3 million in capital. Both countries allow the distribution of dividends to shareholders before the subscribed capital is fully paid and both share the same rationale in that some part of the profits needs to be kept in the company as capital, which could then be used to repay creditors.

Certainly, both the 25% requirement and the 3 million threshold are apparently arbitrary. In fact, any solution with a similar structure would necessarily involve a similarly arbitrary amount of profits to be kept in the company for creditors while allowing the company to distribute profits to shareholders. In comparison, the fixed amount of 3 million Yen seems much more arbitrary than the 25% threshold for the following reasons. First of all, the Japanese legislator seems to have decided that 3 million Yen is an amount sufficient for creditors, which seems completely unfounded. Secondly, the Japanese standard seems to completely disregard the amount of capital and profits of any given company, which can, however, differ greatly across companies. For an extremely profitable company, 3 million Yen may be a tiny figure, while being a high threshold for a company with little profits.

Moreover, the Japanese rule provides fewer incentives for shareholders to pay their full contribution to the capital of a company, as long as the company has 3 million Yen in capital. The incentives to make further contributions decline dramatically once the 3 million threshold is met. In contrast, the German rule provides stronger incentives for payment of outstanding amounts of subscribed capital, because the earlier the capital is fully paid, the more dividends shareholders can receive. Furthermore, the Japanese rule essentially sets a minimum net assets of 3 million Yen for dividend distribution, which in turn opens this solution to some of the costs incurred in the statutory minimal capital regime mentioned above.

Instead of using incentives, Japan applies deterrence to ensure timely payment of outstanding subscribed capital: The directors would be liable for the company's outstanding debt if the company paid dividends when the its subscribed capital is still outstanding.

[24] Law Modernising German Limited Liability Company Law and Combating Abuse, effective as of 1 November 2009.

[25] Art. 458, Companies Act of Japan, effective as of 1 May 2006.

3. Share Buy-back

The purchase of its own shares by a company (share buy-back) involves the reduction of capital of a company and is thus generally prohibited in China, with only a limited number of exceptions. In addition, as a share buy-back necessarily involves the reduction of a company's capital, the mandatory procedures for capital reduction also apply to share buy-backs, which creates quite a high level of uncertainty given that creditors need to be notified and either repaid or collaterals are provided for the repaymentsettled with security. The two different types of companies, i.e. limited liability companies and joint stock companies, are treated differently in this regard.

a) Limited Liability Company

For a limited liability company, the question of a share buy-back was first addressed in the 2005 Corporate Law and remained unchanged under the 2013 Corporate Law. The statute only specified one scenario for share buy-back and treats it as an exit right for shareholders. A shareholder who voted against the following matters may require the company to purchase his or her shares at a reasonable price if: (a) the company did not distribute any dividends for five consecutive years even though the company made profits during the same period of time; (b) corporate merger, split, or transfer of major assets: (c) the company passed a resolution to renew the lifetime of itself upon the expiration of the original term of business or occurrence of any event for dissolution of the company as specified under the company's articles of association. Failure to reach a purchase agreement enables the shareholder to file a lawsuit in court to compel the share buy-back.

An apparent problem with this provision is that it is too broad, hence impractical for shareholders to use. On the one hand, the statute provides no clue as to what counts as a reasonable price, when a comparable market price rarely exists for most limited liability companies which cannot be a public company. On the other hand, the statute fails to interpret what counts as a transfer of major assets, creating a heavy burden upon the claimant shareholder. Therefore, this remedy is rarely used in practice.

Another gap in the law regarding the limited liability company is whether share buy-back is allowed in scenarios other than providing an exit for shareholders. In at least one case, a local court judge ruled that share buy-back is prohibited for a limited liability company unless it is for the matters set out under Art. 75 of the Corporate Law, even where the shareholders have unanimously amended the company's articles and passed a shareholder resolution to that effect.[26] Such a ruling, however, is debatable. In particular, in the new

[26] Chong Qing First Intermediary People's Court (重庆第一中级人民法院): (2007) 江法民初字第 278 号二审: (2007) 渝一中法民终字第 1454 号, available at People's Judiciary 2010,

capital regime, where paid-in capital can be quite insubstantial, to take such a rigid view might not be the best choice.

b) Joint Stock Company

For the joint stock company, share buy-back is also generally prohibited with a number of exemptions: reduction of registered capital, merger with a shareholder, buy back of shares for employee incentive schemes and meeting the request of shareholders who voted against a proposed merger or split. The regulatory regime dates back quite far being provided for under the 1993 Corporate Law and surviving the next two rounds of amendments. However, share buy-back transactions did not occur in the market until the year 2005, when the China Securities Regulation Commission issued a set of guidelines for listed companies.[27]

To engage in a share buy-back, a listed company must meet a few requirements imposed in the above guidelines and the cooperate law. First of all, it must have been listed for more than a year and have a record of full compliance without breach of law, which is easy to prove and unlikely to be controversial. The second and third are financial tests. On the one hand, the listed company must be able to continue its usual business after the share buy-back. On the other hand, share buy-back necessarily leads to the reduction of share capital of the listed company. Under China's Corporate Law, the reduction of capital cannot be completed unless the listed company is able to repay the debts that are not yet due or be able to provide security for the repayment of these debts when they are due.

Even though the second (the ability continue usual business) and the third requirement (the ability to repay or to provide security for debts) are financial tests, they have been criticized as being contradictory.[28] The second test is one without definition, leaving much scope for discretionary and arbitrary decisions and high risks of abuse by corporate insiders and their advisors.

The third test, meanwhile, is an objective test that imposes significant restrictions on the cash flow of the listed company. When both criteria are applied at the same time, a "market for lemons"[29] would emerge. When one

83–85 (《人民司法》, 2010 年第 20 期。) under <http://www.pkulaw.cn/fulltext_form.aspx?Db=qikan&Gid=1510118839&keyword=%e8%82%a1%e4%bb%bd%e5%9b%9e%e8%b4%ad&EncodingName=&Search_Mode=accurat>.

[27] Administration Rules on Purchase of Public Float Shares by Listed Companies, issued by the CSRC in June 2005 (《(上市公司回购社会公众股份管理办法 (试行)》).

[28] H. LU, 陆华强，上市公司股份回购准入标准探析——以 K 公司股份回购案为中心，《证券法苑》[An Analysis for the Entry Criteria for Share Buy-back by Listed Companies: A Case Study of the Share Buy-back of Company K], 第 14 卷, 2015 年 [14 Securities Law Review (2015)] 172–193.

[29] G. A. AKERLOF, The market for "lemons": Quality Uncertainty and the Market Mechanism, 84 The Quarterly Journal of Economics (1970) passim.

criteria can always be met one way or another and the second criteria sets the bar too high almost all parties, "good" companies would shy away while "bad" companies are likely to take a risk by cheating on the second criteria. Given that a share buy-back can easily push up the stock price and provides fertile soil for self-interested transactions between the company and insiders, the 'lemon market' became a reality in China. Even though creditors can successfully stop an attempted share buy-back initiated by corporate insiders, thanks to the remedy provided under corporate law, this contradiction stays unresolved. Scholars therefore urge the elimination of the corporate law restriction with respect to the ability to repay or provide security for debts not due and provide clearer and more specific guidelines to ensure the financial health of the listed company after its share buy-back and to prevent using share buy-backs to channel interests from the listed company to insiders.[30]

4. *Change of Role of the Company Registrar*

Under the old capital regime, the company registrar enjoyed enormous power and responsibility, especially with respect to the verification of registered capital payments and registration of the various particulars of companies. Almost out of convenience, the company registrar started providing certain services relating to share capital: confirmation of capital contributions, administration of pledges of shares, the enforcement of freezing orders issued by the court over share transfers and the enforcement of statuary and court-ordered share transfers. The provision of these services attracted handsome fees and rents for the company registrar, and thus became very popular among them. The increasing robustness of administrative law in China combined with more procedural safeguards in this area saw the number of disputes regarding these services also increase. Company registrars across the whole country came to find themselves swamped by disputes, administrative review and even administrative litigation for alleged fraud, collusion and gross negligence in providing such services. The handling of these procedures is extremely burdensome for the government, especially as very few of these companies have in-house lawyers. When the claimants are successful, the company registrar needs to pay substantial compensation and the officials in charge would face negative outlooks for their future promotion and benefits. Over the years, as the benefits in providing said services shrank dramatically due to more financial and legal discipline imposed upon government, the costs started to outweigh the benefits. The company registrars in less developed areas started seeking opportunities to cut down the provision of such services.

The 2013 corporate law reform gave the company registrar a golden opportunity to cut back on this burdensome provision of services. An unintend-

30 LU, *supra* note 28.

ed consequence occurred: the company registrars in many locations ceased providing certain services relating to capital registration, such as share pledge and share transfers. The company registrars were able to do so as they were no longer responsible for the registration of paid-in capital that corresponded to the paid shares of a company. This sudden and unexpected reaction from regulatory bodies is completely rational, reflecting a sensible cost-benefit analysis by officials who are facing enormous administrative, financial and psychological burdens. These burdens are real costs of the new capital regime, which should have been taken into account and carefully addressed, but instead were completely overlooked in the legislative process.

With respect to such services, the regulatory authority should not necessarily be the only proper provider, and indeed it is not in some jurisdictions, such as the US. However, China may pose an exceptional case where the government should remain the sole provider of such services. As a historical matter, a lot of infrastructure, such as computerized information collection and processing systems, has been built up within the government system and it would be a waste of these sunk costs to now build up completely new sets of infrastructure. Moreover, regulatory officials in China working with the existing infrastructure have accumulated valuable human capital that is costly if not impossible for private parties to acquire within a short period of time. It therefore makes sense to the government to continue providing these services to the market.

VII. Conclusion

China has gone a long way in establishing a modern corporate legal system for its market-oriented economic transformation and overall social transformation. The evolution of rules and the most recent reform in 2013 regarding a company's capital best exemplify China's achievement as well as the challenges it faces. When citizens and the market craved more freedom of contract and space for autonomous governance, corporate law reacted, somewhat reluctantly with haphazardly. Many existing issues remain unresolved and unintended consequences have emerged to create new problems and challenges. To review this process of evolution and to look towards its future opens up many interesting questions, such as the role of the government in the market, the balancing game between protecting state-owned creditors and encouraging private investment, and the creation of cost-effective tools of regulation and market practice etc. In a globalized era, the journey of pursuing answers to these questions is inevitably beyond geographical and ideological boundaries, because the market and its players are already members of one big family who can assess each other's creation of institutions and can learn from each other.

III. The Role of Shareholders

The Role of Shareholders in Public Companies

Gerald Spindler

I. Introduction

Shareholders play – of course – a decisive role in the corporate governance (and the structure) of public companies[1] in Germany. The basic principle-agent paradigm of informational asymmetry between management and shareholders also applies to German companies (as well as to all other countries) as shareholders usually cannot monitor the behavior of directors inducing a state of rational apathy. For small shareholders it is not worth attending a general meeting of shareholders as their ability to influence elections or the policy of the corporation is limited. Hence, they abstain from general meetings and simply exit the corporation instead of voting (exit-or-vote). Thus, German listed stock corporations are confronted with the same problems of corporate governance, such as majority-minority conflicts or principal-agent problems, as other publicly owned corporations across the globe.

However, before the era of globalization (and convergence of corporate systems) in the 1990s, Germany's approach to corporate governance differed greatly from the Anglo-Saxon systems, mainly due to divergent capital mar-

[1] Public companies are in general companies listed at a stock exchange. We do not deal here with close corporations and non-listed companies.

ket evolution and distinctive social insurance systems. It must also be remembered that German capital markets were lagging behind Anglo-Saxon markets because of various factors that restricted the further evolution and general needs of capital markets: the mandatory social insurance system, including pension funds and health insurance is one of those factors as it reduces the need for individuals to invest their money in capital markets.[2] Thus, the relevance of stock markets in Germany could not be compared to those of the US or of the UK. Moreover, German capital markets suffered from the political turmoil of the First and Second World War. Domination of the financial sector was another contributing factor, in particular the banks that benefitted from a specific proxy voting system that automatically gives them proxies for clients with shares kept in the bank (account voting rights).[3] Further hindering development, many German companies used to favor a close relationship with a particular bank *(Hausbank)* instead of financing investments by means of the capital market, and those that did enter the market often remained controlled by large, less flexible block holding ownerships.[4] Last but not least, political discussions about corporate governance in Germany had been largely influenced by a general democratization movement, particularly during the 60s, leading to the co-determination model[5] as well as to efforts to introduce and strengthen "shareholder democracy" in 1965 (when the stock corporation act had been largely reformed).

In the following, we will analyze different aspects of shareholder rights and which role they play in practice, starting with the general framework for shareholder rights and their individual rights as well as their duties and responsibilities. In addition we will examine the protection of minorities as well as recent developments of virtual general meetings.

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[2] In contrast, public pension funds were not mandatory on a broad scale in countries like the United States and played a much more active role in using their shareholder rights, R. ROMANO, Public Pension Fund Activism in Corporate Governance Reconsidered, 93 Columbia Law Review (1993) 795.

[3] Though this factor might have hindered the evolution of individual market participation, it has also been viewed as a monitoring advantage by some American scholars, who sought to approximate the American shareholder system to the German universal bank model or the Japanese keiretsu system during the 1990s, see e.g. B. BLACK, Next Steps in Proxy Reform, 18 The Journal of Corporation Law (1992) 1.

[4] This is particularly true for formerly family owned stock corporations, W. RINGE, Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG, American Journal of Comparative Law 63 (2015) 493, 495 et seq.

[5] Some outside commentators even suggest that a presumed inherent weakness of the two tier and co-determination model might be responsible for a lower demand and thus the reluctant growth of German capital markets, M. J. ROE, German Codetermination and German Securities Markets, Columbia Business Law Review (1998) 167, 177.

II. The General Framework for Shareholders' Rights

The role of shareholders in a German stock corporation depends largely on the powers assigned to the general meeting and the individual rights of shareholders. As mentioned before, the German legislator[6] intended to strengthen "shareholder democracy" in 1965[7] – however, the legislator stuck to the traditional distribution of powers between the different organs of the German stock corporation (introduced in 1937, however, already prepared during the Weimar Republic at the end of the 20s). Thus, the board of (executive) directors *(Vorstand)* is the only organ which is entitled to act on behalf of the stock corporation[8] and leads the corporation under § 76 of the German Stock Corporation Act (*Aktiengesetz* – AktG). The supervisory board is in charge of monitoring the behavior of directors (§ 111 AktG) as well as selecting them (§ 84 AktG). The general meeting is held usually once per year and is entitled to discuss and vote on basic issues of the corporation, such as modifying the charter or the capital basis of the corporation, merging the corporation with other companies, electing the members of the supervisory board, and voting on dividend distribution (based upon proposals of the supervisory board and the board of directors).[9] However, the German Federal Court has introduced an unwritten power for the general meeting concerning fundamental issues for the corporation which can be compared to a modification of the charter, e.g. the sale of important assets of the corporation, thus changing the whole character of the corporation.[10]

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[6] For a brief overview compare B. KROPFF, Reformbestrebungen im Nachkriegsdeutschland und die Aktienrechtsreform von 1965, in: Bayer/Habersack (ed.), Aktienrecht im Wandel (Tübingen 2007), Vol. I Ch. 16, 670 with more references.

[7] The focus on individual rights is a historic continuum in German corporate law, whereas "corporate democracy" in other countries, especially the United States, has rather been the field of entire corporate governance activism groups who are seeking to gain collective influence via the company's proxy statements, D. T. MITCHELL, Shareholders as Proxies: The Contours of Shareholder Democracy, 63 Washington and Lee Law Review (2006) 1503.

[8] With the notable exception of § 112 AktG stating that the supervisory board has to represent the corporation concerning contracts etc. with directors.

[9] Compare the catalogue of powers in § 119 AktG. For more details compare G. SPINDLER, in: Schmidt/Lutter, Aktiengesetz, 3rd ed. 2015, § 119 marg. no. 8 et seq.

[10] Compare Bundesgerichtshof (BGH), 26 April 2004, II ZR 155/02, BGHZ 159, 30, 43; BGH, 26 April 2004, II ZR 154/02, ZIP 2004, 1001; a detailed discussion of this heavily disputed issue is outside the scope of this article, a brief overview in P. O. MÜLBERT, in: Großkommentar zum AktG, 4th ed. 2009, § 119 marg. no. 21 et seq.; SPINDLER, *supra* note 9, § 119 marg. no. 26 et seq.; for a brief comparison of this so called "Holzmüller Doktrin" with the *de facto* merger doctrine in the United States, see W. T. ALLEN/ R. H. KRAAKMAN/G. SUBRAMANIAN, Commentaries and Cases on the Law of Business Organizations (New York 2016) 487–488.

In general, all shareholder rights are centered "around" the general meeting, in other words shareholders are not entitled to exercise their rights (asking questions, voting etc.) outside the general meeting.[11]

One essential element of the German stock corporation is the right to appeal any decision of the general meeting on grounds of a violation of individual shareholders' rights. This right to appeal is not bound to a specific quorum so that any shareholder holding even just one share can appeal any decision. Due to the fact that lengthy court procedures may hamper a corporation`s strategy, such as a merger etc., the phenomenon of "predatory shareholders" has emerged, blackmailing the corporation by appealing important economic resolutions (votes) of the general meeting. German legislators sought a balance between shareholders' rights and corporate interests for decades, and introduced new forms of civil procedure to prevent "predatory shareholders" from appealing resolutions of the general meeting.

It is crucial to understand these mechanisms in order to get an idea of how important formal requirements and individual shareholders rights are in practice whilst preparing for and carrying out a general meeting. As many appeals have been based upon infringements of formal requirements such as incorrect invitations or the duration of the general meeting, the preparation of a general meeting has become expensive for an average listed stock corporation.[12] Hence, the scope and range of individual rights of shareholders which we will discuss below play an important role in corporate governance, albeit more on the level of civil procedures than in the actual general meeting itself.

III. Right to Ask and Be Informed

One of the fundamental rights of shareholders refers to the right to ask and to be informed as well as to discuss corporate matters during the general meeting, § 131 AktG. Every shareholder, regardless of the number of shares held, can ask directors questions related to the affairs of the corporation. The notion of "affairs of the corporation" is usually widely interpreted so that relations to other corporations are covered by the right to ask.[13] The scope of

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[11] For more details compare SPINDLER, *supra* note 9, § 118 marg. no. 15; MÜLBERT, *supra* note 10, § 118 marg. no. 15 et seq.

[12] Overview and reform proposals by W. BAYER/T. HOFFMANN/T. SAWADA, Beschlussmängelklagen, Freigabeverfahren und Berufskläger, ZIP 2012, 897; W. BAYER/T. FIEBELKORN, Vorschläge für eine Reform des Beschlussmängelrechts der Aktiengesellschaft, ZIP 2012, 2181; W. BAYER/T. HOFFMANN, "Berufskläger" in der aktuellen rechtspolitischen Diskussion, ZIP 2013, 1193; A. KEINATH, Nochmals: "Berufskläger" in der aktuellen rechtspolitischen Diskussion, ZIP 2013, 1205 plus additonal references.

[13] For more details compare SPINDLER, *supra* note 9, § 131 marg. no. 28 with more references.

issues that can be addressed also covers the affairs of affiliated companies and even foreign subsidiaries.[14] However, directors may refuse to answer questions if the answer would lead to disadvantages for the corporation.

It is evident that the crucial balance of interests between questions of shareholders and interests of corporations is one of the main sources for the appeals lodged by "predatory shareholders" motivated by nuisance value alone. One of the main strategies of these predatory shareholders involves asking as many questions as possible, thus, rendering it virtually impossible for directors to respond adequately to all questions posed. By asking too many questions, those shareholders seek to create a reason to attack a decision of the general meeting claiming that the general meeting had not been informed correctly. In practice, predatory shareholders have presented more than 50 questions to directors, with an additional 50 questions prepared in response to answers given by directors.

The German legislator reacted by introducing several measures to cope with mass questions and predatory shareholders: Directors may collect similar questions, even before the general meetings, and answer them in a "Frequently-asked-question" manner. Thus, according to § 131 para. 3 no. 7 AktG it is sufficient to make FAQ available on the internet 7 days before and after the general assembly. Moreover, the charter may empower the leader of the general meeting to limit the amount of questions and the time allocated to present them at the general meeting under § 131 para. 2 AktG.[15] The last resort to block such behavior refers to the general limit on the exercise of rights, the abuse or misuse of rights – based on the concept of shareholders' duty of loyalty.[16] However, it seems to be risky for the chair of a general meeting to invoke such a general clause as these rights are deemed to be essential for shareholders and cannot easily be put aside.

Finally, shareholders are entitled to ask questions only during the general meeting. However, as daily practice shows, directors are eager to attract investors to their corporations by giving them specific information outside of general meetings. The "investor relationship" has become one of the pivotal elements of capital markets strategy employed by boards of directors for keeping in touch with investors, mainly institutional investors. However, this kind of privileged information strategy leads to conflicts concerning the equal treatment of shareholders; § 131 para. 4 AktG clearly requires all information given to specific shareholders to be distributed to all shareholders upon re-

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[14] Compare SPINDLER, *supra* note 9, § 131 marg. no. 37 et seq.

[15] For more details see SPINDLER, *supra* note 9, § 131 marg. no. 66 et seq. with more references.

[16] Compare in general BGH, 20 March 1995, II ZR 205/94, "Girmes", BGHZ 129, 136, 148 et seq.; BGH, 1 February 1988, II ZR 75/87, "Linotype", BGHZ 103, 184, 194 et seq.; for more details SPINDLER, *supra* note 9, § 131 marg. no. 92 et seq. with more references.

quest.[17] However, this obligation is restricted to information given to shareholders outside general meetings; information handed to potential investors is not covered by § 131 para. 4 AktG.[18]

IV. Right to Cast a Vote

It goes without saying that the right to vote is also one of the basic rights for shareholders – however, we have to bear in mind that stock corporation acts across the globe recognize different classes of shares, including shares which do not grant shareholders a right to vote but instead grant preferential rights for dividends *(Vorzugsaktien)* as is the case in § 139 AktG. Notwithstanding these specific classes of shares of preferential rights, the German Law prohibits shares with multiple voting rights. The "one share – one vote" principle conferred by § 12 para. 2 AktG effectively prohibits "golden shares" and their congeners (note, however, that these kinds of shares had been quite common in history in order to ensure the influence of municipalities and states on certain corporations, such as coal mines or steel manufacturing companies).[19]

While general civil law provides for an exclusion from voting where there is a conflict of interests, corporate law is less strict, permitting shareholders to pursue their own interests. Thus, § 136 AktG excludes voting on grounds of conflict of interests only in three cases: discharge of directors, release of liability, or the enforcement of claims against the voting shareholder. Any other issue is not included, even where the shareholder is keenly intent on pursuing his own interests; the general rules of conflicts of interests do not apply to stock corporations regarding the casting of votes.[20]

In general, every shareholder is considered as casting his own vote without regard to the behavior of other shareholders. However, capital market regulations have had (and still have) a strong impact upon these traditional corporate law rules and have modified them, particularly the rules on acting in concert. After some discussion about the scope of acting in concert rules, the German Federal Court handed down a decision narrowing the application of acting in concert with respect to voting during general meetings[21] – which promptly led to a legislative response broadening the range of acting in con-

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[17] Compare H. FLEISCHER, Investor Relations und informationelle Gleichbehandlung im Aktien-, Konzern- und Kapitalmarktrecht, ZGR 2009, 505; H. FLEISCHER/L. BAUER/T. WANSLEBEN, Investorenkontakte des Aufsichtsrats: Zulässigkeit und Grenzen, DB 2015, 360 concerning contacts between investors and supervisory board.

[18] More details in SPINDLER, *supra* note 9, § 131 marg. no. 97 et seq. with more references.

[19] See KROPFF, *supra* note 6, Vol. I. Ch. 16, 670 marg. no. 80, 303 et seq.

[20] SPINDLER, *supra* note 9, § 136 marg. no. 29 et seq. with more references.

[21] BGH, 18 September 2006, II ZR 137/05, "WMF", BGHZ 169, 98.

cert.[22] Today, according to sec 30 of the securities trading act (*Wertpapierhandelsgesetz* – WpHG) every commonly adopted strategy between shareholders may qualify as being some sort of coalition, thus endangering the shareholders involved with being identified as controlling shareholders with all the associated consequences (take-over law, group of companies). Hence, the distinction between "normal" coalitions in a general meeting (following traditional examples of democratic procedures) on one side and acting in concert involving conduct strategically aimed at controlling a corporation has become crucial. There is a cut-off point between sporadic cooperation as opposed to a coherent and constant collaboration on strategic issues, such as the election of directors of the supervisory board.[23]

V. Representation of Shareholders

Shareholders are not required to be physically present in order to cast their vote (or ask questions etc.). Stock corporation law has always allowed shareholders to be represented by agents – thus enabling the evolution of the specific German type of corporate governance centered around financial institutions such as banks by making use of the "account voting rights" of their clients. As this specific kind of representation was deemed a danger to shareholder democracy for a long time (till the end of the 1980s) the "account voting right" is regulated in a very detailed manner in § 135 AktG. However, financial globalization and the change of the banking system saw banks becoming less interested in representing their clients in general meetings, leading to a loss of significance of the "account voting right".[24] The "old" system is being replaced by a new form of proxy voting which has more in common with the US American proxy voting system, enabling representatives of the corporation (such as employees, trustees etc.) to vote for shareholders in general meetings. However, the German legislator remained relatively silent on these new forms of "corporate proxy voting" – § 134 para. 3 AktG permits these new ways of representing shareholders but refrains from regulating

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[22] See S. PLUSKAT, Acting in Concert in der Fassung des Risikobegrenzungsgesetzes - jetzt alles anders?, DB 2009, 383; M. KORFF, Das Risikobegrenzungsgesetz und seine Auswirkungen auf das WpHG, AG 2008, 692 with further references.

[23] See BGH, 29 July 2014, II ZR 353/12, "Postbank", BGHZ 202, 180; H. KRAUSE, Zum richterrechtlichen Anspruch der Aktionäre auf angemessene Gegenleistung bei Übernahme- und Pflichtangeboten, AG 2014, 833; P. SCHEIBENPFLUG/G. TÖNNESEN, Interessenschutzklausel als acting in concert und Rechtsfolgen eines verspäteten Übernahmeangebots, BKR 2015, 140; in general see M. SCHOCKENHOFF/J. CULMANN, Shareholder Activism in Deutschland, ZIP 2015, 297.

[24] See SPINDLER, *supra* note 9, § 135 marg. no. 2 et seq. with more references to the evolution of the account voting rights.

them in the same way as the "account voting right" had been.[25] Nevertheless, it is quite obvious that corporate representatives must act in the interests of shareholders rather than those of the corporation (and its directors) if these forms shall be accepted; if not, directors would elect themselves, no control would ever be exercised. Thus, explicit orders by shareholders are required, leaving no discretion for company representatives. Moreover, an absolute independency from the board of directors (and any influence) is mandatory meaning these relationships may not suffer from conflicts of interest or involve protection from dismissal or similar.[26] However, Germany still eschews any regulations on proxy voting in general and in particular on proxy fights (which still do not exist in Germany) – thus, the general provisions on obtaining a proxy as seen in the US since the Great Depression are not available.[27]

VI. Duties and Responsibilities of Shareholders

1. Duties of Loyalty

A stock corporation is in principle characterized by an anonymous group of shareholders who lack a personal relationship with each other – relationships which are however typical for close corporations and the basis of duties of loyalty (which are characteristic for partnerships and close corporations). However, the courts have developed some duties of loyalty even for shareholders in publicly held corporations, depending upon the impact or influence of shareholders on decisions taken by the general meeting. Even for small shareholders, the German Federal Court held the representative (agent) of a group of small shareholders liable for opposing a restructuring plan put forward by a major bank for a stock corporation, thus resulting in insolvency.[28] However, despite garnering a lot of criticism[29] the decision is still the exception: it has not been followed by any further decisions of the German Federal Court or lower courts. Thus, small shareholders can usually not be held liable

[25] See more details in M. HABERSACK, Aktienrecht und Internet, ZHR 165 (2001) 187; U. NOACK, Stimmrechtsvertretung in der Hauptversammlung nach NaStraG, ZIP 2001, 61.

[26] Oberlandesgericht (OLG) Karlsruhe, 24 February 1999, 6 U 142/98, ZIP 1999, 750, 752 et seq.; consenting HABERSACK, *supra* note 25, 187; NOACK, *supra* note 25, 62; D. A. ZETZSCHE, NaStraG – ein erster Schritt in Richtung Virtuelle Hauptversammlung für Namens- und Inhaberaktien, ZIP 2001, 684; more details in SPINDLER, *supra* note 9, § 134 marg. no. 63 with more references.

[27] In fact, those proxy regulations are notoriously known for their extensive and detailed instructions, see sec. 14(a) of the Securities Exchange Act of 1934 and the accompanying regulation 14A by the Securities and Exchange Commission (SEC).

[28] BGH, 20 March 1995, II ZR 205/94, BGHZ 129, 136, 159 et seq.

[29] M. DREHER, Treuepflichten zwischen Aktionären und Verhaltenspflichten bei der Stimmrechtsbündelung, ZHR 157 (1993) 156 et seq. with associated references.

for their votes nor for their discussions or motions during a general meeting.[30] The situation changes if shareholders have a substantial minority position capable of blocking important decisions such as mergers or raise of capital.[31]

In general, § 117 AktG provides for liability of shareholders only in cases when they exercise an undue and intentional (!) influence upon the board of directors and/or the supervisory board (for non-controlling shareholders). There are only a few cases which have been decided by courts based upon § 117 AktG, most of which dealt with controlling shareholders to whom § 117 AktG does not apply (rather, as far as controlling shareholders are concerned, the provisions on corporate groups apply, which are outside of the scope of this article).

2. *Misuse of Shareholder Rights*

As mentioned above, the chance for each shareholder to appeal decisions of the general meeting is one of the Achilles' heels of German corporate governance. Legislators and courts have developed a range of remedies to cope with the phenomenon of predatory shareholders, such as claims for damages intending to cause damage to the corporation (§ 826 of the German Civil Code – *Bürgerliches Gesetzbuch* (BGB)).[32] The legislator tried to reduce incentives for predatory shareholders (as well as for companies) by introducing mandatory transparency of settlements between those shareholders and the company, §§ 248a, 149 para. 2 et seq. AktG, thus indirectly bringing in sanctions against directors infringing those transparency rules (by means of criminal sanctions such as infidelity, § 266 of the German Criminal Code – *Strafgesetzbuch* (StGB)). Moreover, § 246a AktG now provides for a clearance procedure / approval process *(Spruchverfahren)* which decouples claims for adequacy of compensation from appeals against decisions of general meetings – due to the fact that a lot of individual appeals had claimed inadequate compensation for a merger. Thus, decisions concerning mergers, squeeze-outs etc. involving compensation can no longer be delayed by attacking them in court.

While these reforms have, to some extent, relieved the pressure on courts and corporations alike, the phenomenon of predatory shareholders still lingers on. Hence, discussions are ongoing concerning the introduction of *de-minimis*-requirements such as 1% or 5% of shares in order to file an action as well as other restrictions of appealing a decision of the general meeting.[33]

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[30] For more details see G. SPINDLER, in: Münchener Kommentar AktG, 4th ed. 2014, § 117 marg. no. 77 with associated references; A. CAHN/M. A. VON SPANNENBERG, in: Spindler/Stilz, AktG, 3rd ed. 2015, § 53a marg. no. 50.

[31] R. THAETER/R. GUSKI, Shareholder Activism: Gesellschaftsrechtliche Schranken aktiven Aktionärsverhaltens, AG 2007, 301, 303; SPINDLER, *supra* note 30, § 117 marg. no. 78.

[32] OLG Frankfurt, 13 January 2009, 5 U 183/07, ZIP 2009, 271.

VII. Institutional Shareholders

Institutional shareholders play a crucial role for corporate governance as they usually do not suffer from the phenomenon of rational apathy, given their professional knowledge and interest in corporate affairs.[34] Thus, it is not surprising that discussions about enhancing corporate governance also focused on institutional investors, in particular those who are more "passive" such as pension funds. The recently enacted Stewardship Code in the UK served as a blueprint for some proposals in Germany that would enhance transparency by requiring institutional investors at least to disclose their investment strategy.[35] However, the German legislator (as well as the European legislator) still refrains from introducing these rules or from making them mandatory; even in the UK the Stewardship Code is an instrument of self-regulation. Also, the German Corporate Governance Codex does not generally provide any shareholder obligation, focusing on the duties of directors on the executive or supervisory board. Nevertheless, in the EU the question of implementing mandatory disclosure rules to enhance transparency and the conduct of institutional shareholders is still a matter of active debate. The directive on Alternative Investment Funds Management[36] has already provided a rule requiring funds to disclose their investment strategy in Art. 23 para. 1 lit. a – however this does not extend to their specific voting intent.[37]

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[33] For an overview of the proposals see M. HABERSACK/E. STILZ, Zur Reform des Beschlussmängelrechts, ZGR 2010, 710 with more references.

[34] While American scholars have recently started to view institutional investors, and hedge funds in particular, as a potential solution to the problem of rational apathy, see e.g. M. KAHAN/E. B. ROCK, Hedge Funds in Corporate Governance and Corporate Control, 155 University of Pennsylvania Law Review (2007) 1021, German commentators have traditionally been more reluctant to embrace the benefits that might arise from concentrated, financial shareholder power.

[35] H. FLEISCHER/C. STROTHOTTE, Ein Stewardship Code für institutionelle Investoren – Wohlverhaltensregeln und Offenlegung der Abstimmungspolitik als Vorbild für Deutschland und Europa?, AG 2011, 221; R. FREITAG, Neue Publizitätspflichten für institutionelle Anleger?, AG 2014, 647; C. STRENGER/D. A. ZETZSCHE, Institutionelle Anleger, Verbesserung der Corporate Governance und Erleichterung der grenzüberschreitenden Stimmrechtsausübung, AG 2013, 397.

[36] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010.

[37] For a general overview of the AIFM-directive compare D. A. ZETZSCHE, Fondsregulierung im Umbruch – ein rechtsvergleichender Rundblick zur Umsetzung der AIFM-Richtlinie, ZBB 2014, 22; G. SPINDLER/S. TANCREDI, Die Richtlinie über Alternative Investmentfonds (AIFM-Richtlinie), WM 2011, 1441.

VIII. Overcoming Rational Apathy?

Another set of actions aimed at enhancing corporate governance attempts to improve the incentives for (small) shareholders to participate in general meetings or to keep their investments in a corporation. Thus, voluntary bonuses (such as additional shares, "loyalty shares") for shareholders who have retained their shares for a certain time have been approved. Other incentives such as bonuses for participation in general meetings raise fundamental questions in the light of the equal treatment of shareholders.[38] Whereas some jurisdictions in the EU, such as Spain, have already introduced enabling clauses for corporations, the prevailing opinion in Germany still rejects such ideas.

Last but not least, a regulation of professional intermediaries offering advice to vote for shareholders – but refraining from representing them – is being discussed.[39] As these intermediaries obviously influence voting behaviour, rules regarding transparency and disclosure of advice provided, among others, are being discussed in Germany. However, neither the German nor the European legislator have developed new approaches to regulate those intermediaries as they already are covered by financial regulations such as those governing financial advisors.[40]

IX. Protection of Minorities

Closely related to shareholder rights are provisions which aim to protect minorities against misuse of power by majorities. In stock corporations, the answer to this (fundamental) issue in companies refers to formal requirements: Thus, for fundamental issues such as modification of the charter or

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[38] B. DAUNER-LIEB, Aktuelle Vorschläge zur Präsenzsteigerung in der Hauptversammlung, WM 2007, 9; H. FLEISCHER, Zweifelsfragen der verdeckten Gewinnausschüttung im Aktienrecht, WM 2007, 909; E. VETTER, Handgeld für in der Hauptversammlung präsente Aktionäre?, AG 2006, 32; H. KLÜHS, Präsenzbonus für die Teilnahme an der Hauptversammlung, ZIP 2006, 107.

[39] L. KLÖHN/P. SCHWARZ, Die Regulierung institutioneller Stimmrechtsberater, ZIP 2012, 149; H. FLEISCHER, Zur Rolle und Regulierung von Stimmrechtsberatern (Proxy Advisors) im deutschen und europäischen Aktien- und Kapitalmarktrecht, AG 2012, 2; C. H. SEIBT, Richtlinienvorschlag zur Weiterentwicklung des europäischen Corporate Governance-Rahmens, DB 2014, 1910; H. WILSING, Corporate Governance in Deutschland und Europa, ZGR 2012, 291.

[40] As for now, professional intermediaries have not gained a dominant foothold in Germany and the European Union, unlike the United States, where proxy advisers like ISS have become powerful corporate governance players and attracted the attention of regulatory institutions, S. EDELMAN, Proxy Advisory Firms: A Guide for Regulatory Reform, 62 Emory Law Journal (2013) 1374 et seq.

raising of capital § 179 AktG requires at least a three-quarter majority. Even when this threshold has been passed, courts frequently applied a rule of reason to the decisions, in particular a proportionality test, seeking other courses of action which caused less harm to minority interests. However, the German Federal Court gave up this kind of control by lowering the standard to create a "real misuse of power" test. Thus, today only evident harm to minority shareholders are subject to judicial control. Moreover, the German Federal Court upheld the position that a decision to liquidate a corporation is justified in every sense and cannot be controlled by a court.

X. Virtual General Meetings

One of the hopes regarding shareholder democracy is to lower transaction costs for participation in general meetings. The opportunities offered by the Internet seem perfectly suited to lowering transaction costs for shareholders in terms of their participation, discussions, and voting in general meetings. Thus, the idea of virtual general meetings was on the table quite early as one of the essential means of enhancing shareholder participation and their exercise of rights.[41] Harmonization efforts accompanying Directive 11 July 2007 on the exercise of certain rights of shareholders in listed companies 2007/36/EC[42] saw Germany (as well as other European member states) introduce an option for corporations to provide for different models of participation in their charter. Thus, a corporation can opt for representation of shareholders by agents whilst also establishing a direct line of communication with shareholders so that they can give their directions and orders in real time. A more sophisticated model would allow shareholders to directly cast their vote via the Internet and ask questions online, a model which comes very close to

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[41] J. THAN, Auf dem Weg zur virtuellen Hauptversammlung – Eine Bestandsaufnahme, in: Lutter (ed.), Festschrift für Martin Peltzer zum 70. Geburtstag (Cologne 2001) 577 et seq.; K. HASSELBACH/S. SCHUMACHER, Hauptversammlung im Internet, ZGR 2000, 260 et seq.; M. HÜTHER, Aktionärsbeteiligung und Internet (Köln, Berlin, Bonn, München 2002) 288 et seq.; B. RIEGGER, Hauptversammlung und Internet, ZHR 165 (2001) 204, 216; U. NOACK, Neue Entwicklungen im Aktienrecht und moderne Informationstechnologie 2003–2005, NZG 2004, 301; U. NOACK, Hauptversammlung der Aktiengesellschaft und moderne Kommunikationstechnik – aktuelle Bestandsaufnahme und Ausblick, NZG 2003, 245 et seq.; C. MUTHERS/M. ULBRICH, Internet und Aktiengesellschaft, WM 2005, 215 et seq.; D. A. ZETZSCHE (ed.), Die virtuelle Hauptversammlung (Berlin 2002); G. SPINDLER, Internet und Corporate Governance – ein neuer virtueller (T)Raum?, ZGR 2000, 440 et seq.

[42] Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007 on the exercise of certain rights of shareholders in listed companies.

a "real" virtual general meeting.[43] However, in practice, the model using the Internet merely as another broadcasting channel seems to dominate. Corporations are obviously still afraid of appeal actions from shareholders if technological bugs hampered a general meeting.

XI. Résumé

For more than 100 years, corporate governance and the role of shareholders in particular have been the subject of intense discussion and legislative action across the globe. Nevertheless, the phenomenon of rational apathy still lingers on – and seems to be a substantial element of (public) stock corporations which cannot simply be overcome by legal changes. A combination of different tools offer some promise in lessening rational apathy syndrome, such as introducing bonuses for participating shareholders and enhancing markets for voting intermediaries[44] (rather than regulating shareholder advice services). However, as shareholders are not willing to invest money in being represented, a model has to be found that makes the company cover the cost of intermediaries whilst avoiding conflicts of interest – a task that is not trivial and will involve economics as well as comparative legal analysis.

[43] For more details compare SPINDLER, supra note 9, § 118 marg. no. 49 et seq. with more references.

[44] Still worthwhile for reading: T. BAUMS/P. VON RANDOW, Der Markt für Stimmrechtsvertreter, AG 1995, 145.

Declining Relevance of Lawsuits on the Validity of Shareholder Resolution in Korea

A Comparative Essay

Kon-Sik Kim/Moon-Hee Choi

I. Introduction

Over the past few decades, a convergence in corporate law has been in progress between civil law and common law jurisdictions. Proliferation of outside directors, adoption (or promotion) of shareholder derivative suits and emphasis on internal control may be presented as prime examples in corporate governance. In corporate finance, a permissive attitude toward stock repurchases and share issuance to a third party is becoming a new norm. In the midst of this tide toward convergence, a notable exception is lawsuits contesting the validity of shareholder resolutions ("SR lawsuits"). It is well known that SR lawsuits play only a trivial role in the US.[1] In contrast, they serve as an important remedy in civil law jurisdictions. The rules on SR lawsuits, however, vary widely even among civil law countries such as Korea, Japan and Germany.[2] Although those rules are not identical among European jurisdictions[3], disparity appears greater between Europe and East Asia. The disparity lies not just in the contents of the relevant rules, but also in the role of such lawsuits in corporate governance in reality.

The purpose of this paper is to examine the law and reality of SR lawsuits in Korea in comparison with German law and from a broader comparative perspective. This paper shall first set the stage for our discussion of SR lawsuits in Korea, presenting some background information about Korean company law in general (II.). Secondly, it will provide a short sketch on historical development of the rules of SR lawsuits (III.), before setting out the law and reality of SR lawsuits in Korea (IV. and V.). Fourthly, based on the infor-

[1] M. GELTER, Why do Shareholder Derivative Suits Remain Rare in Continental Europe?, 37 Brooklyn Journal of International Law (2012) 883; H. FLEISCHER, Entwicklungslinien des aktienrechtlichen Beschlussmängelrechts: Rechtsvergleichung – Dogmengeschichte – Reformvorschläge, in: Fleischer/Kalss/Vogt (eds.), Aktuelle Entwicklungen im deutschen, österreichischen und schweizerischen Gesellschafts- und Kapitalmarktrecht (Tübingen 2013) 84.

[2] FLEISCHER, *supra* note 1, 84.

[3] FLEISCHER, *supra* note 1, 69 et seq.

mation provided in the previous sections, we will then discuss some of the salient features of Korean law on SR lawsuits in comparison with German law (VI.). Finally, we will conclude with a few remarks about the declining relevance of SR lawsuits in Korea (VII.).

II. Some Background Information

1. *Korean Commercial Code*

Unlike most advanced jurisdictions, Korea still does not have an independent code of company law. The statutes related to companies are contained mostly in the third book of the Commercial Code ("KCC") (Arts. 288–542-13 KCC), which was enacted in 1962 and came into effect in 1963. The KCC provides for five types of companies, which all have a legal personality: general partnership companies; limited partnership companies; limited liability companies; limited companies; and joint stock companies ("corporations") (Art. 170 KCC). These five types of companies differ mainly in the scope of the member's liability for company debt. The KCC has a set of special provisions for listed firms as well. In an idiosyncrasy of the Korean system, corporate finance matters are covered by a different piece of legislation called the Financial Investment Business and Capital Markets Act.

2. *Overwhelming Popularity of Corporation as a Form of Business*

Among these five types of companies, the corporation is by far the most popular form of business, accounting for about 92 percent of all the companies in Korea. Table 1 shows the number of corporations by paid-in capital as registered in the official commercial registry. According to Table 1, slightly over 800,000 corporations exist as of January 2015.[4] Of these corporations, about 1,900 firms are listed in Korea Exchange, the only stock exchange in Korea.

Table 1: Number of Corporations (as of January 2015)[5]

Paid-in Capital (Korean Won)	Firms	Percentage
More than 500 billion	88	0.01%
100 billion to 500 billion	356	0.04%
50 billion to 100 billion	417	0.05%
10 billion to 50 billion	2,697	0.34%
5 billion to 10 billion	3,078	0.38%
1 billion to 5 billion	27,323	3.41%

4 Only about half of these corporations are reported to be actually in operation.

5 Commercial Registration Statistics.

Paid-in Capital (Korean Won)	Firms	Percentage
100 million to 1 billion	250,832	31.26%
50 million to 100 million	125,429	15.63%
10 million to 50 million	284,373	35.44%
10 million or less	107,725	13.43%
Others	30	0.004%
Total	802,348	100%

As the overwhelming majority of companies have adopted the form of corporation, it is not surprising that most of these corporations are small in size. Table 1 reveals that less than five percent of them have a paid-in capital of 1 million US-dollars or more. These small corporations often ignore the formalities of the general shareholders meeting ("GSM"), giving rise to SR lawsuits. Additionally, the prevalence of smaller firms in turn makes it more difficult to strengthen the requirements for the GSM.

3. Major Corporate Organs and the General Shareholders Meeting

In principle, the KCC requires every corporation to have the following three organs: (i) the GSM; (ii) the board of directors and representative directors; and (iii) statutory auditors. Korea has adopted a one-tier board that is composed solely of directors appointed at the GSM.[6] While the board of directors is empowered to make decisions regarding management of the firm, it is the representative directors that are in charge of implementing those decisions. A functional equivalent of the chief executive officer in the US., the representative director is generally appointed by the board (Art. 389 para. 1 KCC) and is authorized to represent the firm as against third parties (Arts. 389 para. 3, 209 para. 1 KCC). A statutory auditor is an organ originally derived from the German supervisory board *(Aufsichtsrat),* but in contrast to its German prototype, it is not equipped with the power to appoint directors.[7]

The KCC now allows a corporation to employ an alternative structure. A corporation can have statutory officers instead of representative directors (Art. 408-2 KCC), or an audit committee instead of statutory auditors (Art. 415-2 KCC). The KCC allows a small corporation to dispense with the board of directors (Art. 383 paras. 1, 4 KCC), but requires a large listed corporation to establish an audit committee (Art. 542-11 para. 1 KCC).

The most significant corporate organ when dealing with SR lawsuits is the GSM. The power of the GSM under the KCC is quite extensive, more exten-

[6] Large listed corporations are required to appoint a majority (not less than three) of external members to the board (Art. 542-8 para. 1 KCC).

[7] K. KIM, Transplanting Audit Committees to Korean Soil: A Window into the Evolution of Korean Corporate Governance, 9 Asian-Pacific Law & Policy Journal (2007) 163.

sive than that of, say, Delaware law. Under the KCC, the GSM may decide on such matters as are specified in the KCC or in the articles of incorporation (Art. 361 KCC). The KCC explicitly subjects a broad range of matters to the resolution at the GSM. For example, the GSM is authorized to appoint directors, determine CEO remuneration (Art. 388 KCC), declare dividends (Art. 462 para. 2 KCC), and select audit committee members in some listed firms (Art. 542 para. 1 KCC). In addition, the KCC explicitly indicates that the firm may empower the GSM to decide on matters such as issuance of new shares (Art. 416 KCC) and the appointment of representative directors (Art. 389 para. 1 KCC) by inserting an appropriate provision in the articles of incorporation. It is also widely agreed that even in the absence of such an explicit reference in the KCC, the firm can choose to expand the GSM's scope of authority by so providing in the articles of incorporation.[8]

Of these various powers of the GSM, the power to appoint directors may be the most crucial from a corporate governance perspective.[9] Selection (or dismissal) of directors has often been a subject of dispute in a majority of SR lawsuits in Korea.

III. Historical Development of the Rules on SR Lawsuits

1. General

During the period when Korea was under Japanese control, Japanese codes were applicable in Korea. The Japanese Commercial Code ("JCC"), which contained company statutes, was one of such codes applied in Korea. Although Korea was liberated from Japan in 1945 and the government was established in 1948, it took almost two decades for Korea to enact its own commercial code, the KCC. The KCC and its provisions regarding SR lawsuits, however, were strongly influenced by the JCC.[10] The JCC of 1899[11] and the rules on SR lawsuits were in turn developed under the heavy influence of the German commercial code of the day (*Allgemeines Deutsches Handelsgesetzbuch* (ADHGB) of 1861) and its successive codes, such as the new German commercial code (*Handelsgesetzbuch* (HGB)) of 1897 and the Corporation Code (*Aktiengesetz* (AktG) of 1937). Accordingly, a short description of historical developments in Germany and Japan is in order.

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[8] Supreme Court, 10 May 2007, 2005 Da 4284.

[9] The power to appoint directors may be more important in Korea than in Germany because Korea, unlike Germany, has a one-tier board without co-determination.

[10] K. KIM, Codification in East Asia: Commercial Law, in: Wang (ed.), Codification in East Asia (Cham 2014) 61–79.

[11] This code is often called the new Commercial Code in contrast to the old Commercial Code of 1898 replaced by it.

2. Development in Germany

The ADHGB of 1861 had no provision on SR lawsuits. Rules on SR lawsuits were formed by court decisions and scholarly articles.[12] SR lawsuits were first recognized by a court decision in 1873[13] and introduced into the ADHGB of 1884, which provided that "a shareholder resolution in violation of law or the company contract can be rescinded by means of a lawsuit" (§ 190a ADHGB). This provision on rescission lawsuits, without much modification, was inherited by the HGB of 1897 (§§ 271–273 HGB).[14] It was around the turn of the 20th century that discussion started as to whether lawsuits for nullification of a resolution ("nullity lawsuits") should be allowed. Commentators, however, could not reach a consensus on how to distinguish between rescission and nullity lawsuits as grounds for a claim. It was the AktG of 1937 that formally adopted the provisions on nullity lawsuits (§§ 195, 196 AktG),[15] completing the skeleton of German law on SR lawsuits. These rules remained largely the same in the AktG of 1965.

3. Development in Japan

The JCC of 1899 had a provision for SR lawsuits (Art. 163 JCC)[16], which was modelled on the ADHGB of 1884.[17] The Japanese provision differed from its German counterpart in that the ground for rescission was limited to a violation of the law or the articles of incorporation in "the procedure employed in convening a GSM or in passing a resolution,"[18] i.e., procedural defects. Although the wording of the first draft was quite similar to that of § 190a ADHGB of 1884, it was changed to cover only procedural defects later in the legislative process. The reason for this change is not entirely clear, but is presumed to be the promotion of legal certainty regarding the firm's legal relations.[19]

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[12] FLEISCHER, *supra* note 1, 101.

[13] ROHG, 22 April 1873, Rep. 120/73, ROHGE 9, 273 et seq.; ROHG, 23 October 1874, Rep. 736/74, ROHGE 14, 354, 356.

[14] FLEISCHER, *supra* note 1, 109–111.

[15] The lawsuit for nullification was a subject for discussion at the Meeting of German Jurists in 1926.

[16] Although it was indicated as a lawsuit for nullification, it was to be filed to seek rescission, not nullification of a resolution. The term was later changed to a lawsuit for rescission in the JCC of 1938.

[17] S. IWAHARA, *Kabunushi Sokai Ketsugi o Arasou Sosho no Kozo (1)* [Structure of Lawsuits Attacking Resolutions of the General Shareholders Meeting (1)], 96 Hogaku Kyokai Zassi (1979) 678.

[18] IWAHARA, *supra* note 17, 678–679.

[19] T. ISHII, *Kabunushi Sokai no Kenkyu* [A Study of the General Shareholders Meeting] (Tokyo 1958) 209–210.

The JCC of 1899 was criticized for its failure to cover procedural issues involved in SR lawsuits. Under the influence of the HGB (§§ 271–273 HGB), the JCC was revised in 1911 to provide for relevant procedural issues, such as consolidation of lawsuits, exclusive jurisdiction and public notice. It was the revision of the JCC in 1938 that formed the basic structure of Japanese law on SR lawsuits. Following the AktG of 1937, the JCC of 1938 adopted a provision for a nullity lawsuit. The dividing line between rescission and nullity lawsuits, however, was drawn differently from that of German law and will be discussed in detail later. Other changes, also made in the 1938 revision, include the introduction of so-called discretionary dismissal, which will also be covered in detail later.

In 1981, the JCC formally adopted a new type of lawsuit, the lawsuit for confirming non-existence of a shareholder resolution ("non-existence lawsuit"), which had been generally recognized by the courts and commentators even in the absence of an explicit provision. The structure of Japanese law on SR lawsuits basically remains intact now under the new Company Act ("JCA"), which was enacted as an independent code in 2005.

4. Development in Korea

As mentioned earlier, the KCC of 1963 was drafted under the strong influence of the JCC of 1950. For some unknown reason, however, the core provisions on SR lawsuits under the KCC of 1963 were virtually identical to those of JCC of 1938. Although the KCC has been revised several times since 1963, the provisions on SR lawsuits have been changed only twice, in 1984 and in 1995. In 1984, the KCC was revised to grant an additional standing to statutory auditors to file a rescission lawsuit (Art. 376 para. 1 KCC). Also, following the JCC of 1981, the KCC explicitly adopted a non-existence lawsuit (Art. 380 para. 1 KCC).

The revision of 1995 made two changes regarding SR lawsuits. First, a judgment in favor of the plaintiff was changed to have retroactive effect as well (Arts. 376 para. 2, 380, and 190 KCC). Second, violation of the articles of incorporation was changed from a ground for nullification into a ground for rescission (Art. 376 para. 1 KCC).

Although Korea and Japan have recently followed different routes in company law legislation, the current provisions on SR lawsuits under the KCC (Arts. 376–381 KCC) are still quite similar to those of the JCA (Arts. 830, 831 JCA). Table 2 shows the history of the SR Lawsuits in Germany, Japan, and Korea.

Table 2: History of SR Lawsuits

GERMANY	ADHGB 1861 *No provision*	➡ ADHGB 1884 §§ 190a, 190b, 222 *Rescission*	➡ HGB 1897 §§ 271–273	➡ AktG 1937 §§ 195–202 *Nullity Added*	➡ AktG 1965 §§ 241–257	➡ AktG 1994, 2005, 2009, 2012 *Freigabe-verfahren*
JAPAN		JCC* 1899 Art. 163 * Commercial Code	➡ JCC 1911 Arts 163–163-4 *Procedural provision added*	➡ JCC 1938 Arts. 247–252 *Nullity & Discretionary dismissal*	➡ JCC 1981 *Violation of the articles: grounds for Rescission*	➡ JCA* 2005 Arts. 830–831 * Company Act
KOREA				KCC 1962 Arts. 376–380	➡ KCC 1984 *Violation of the articles: grounds for Rescission*	Current

IV. SR Lawsuits in Korea: Law

1. General

The KCC provides for four types of SR lawsuits: (i) lawsuits to rescind a resolution ("rescission lawsuit"); (ii) lawsuits to confirm nullity of a resolution ("nullity lawsuit"); (iii) lawsuits to confirm non-existence of a resolution ("non-existence lawsuit"); and (iv) lawsuits to set aside an unfair resolution ("unfairness lawsuit"). The last category, unfairness lawsuits, is a product of a peculiar feature of the KCC. The KCC prohibits a shareholder with special interests in a resolution from voting at the GSM (Art. 368 para. 3 KCC). The interested shareholder may file a lawsuit to rescind or change the resolution involved if the following two conditions are satisfied (Art. 381 para. 1 KCC): (i) if the resolution passed without the shareholder's participation turns out to be grossly unfair to that shareholder, and (ii) the shareholder could have blocked it had the shareholder been allowed to vote. The unfairness lawsuit was originally imported from the JCC of 1938. Although Japan abolished the unfairness lawsuit in 1981, the KCC still retains it. As it is rarely used in practice,[20] we will focus on the remaining three types of SR lawsuits in this paper.

The three types of SR lawsuits can be differentiated by type of defect. Defects may be divided into procedure defects and substance defects. The former refers to defects in the procedure of the GSM, while the latter refers to defects in the substance of the resolution involved. Prior to 1995, a substance defect could justify a nullity lawsuit. Since the revision of 1995,[21] however, a substance defect involving violation of the articles of incorporation, rather than law, may generate a rescission lawsuit. On the other hand, if a procedure defect is so extreme as to render a resolution non-existent in effect, a non-existence lawsuit may be filed.

2. *Rescission Lawsuits*

a) *Grounds for Rescission*

The KCC recognizes two grounds for rescinding a shareholder resolution: (i) where the procedure employed in convening a GMS or in passing a resolution is in violation of laws, decrees or the articles of incorporation, or is grossly unfair (Art. 376 para. 1 KCC; procedure defect); and (ii) where the substance of a resolution is in violation of the articles of incorporation (Art. 376 para. 1 KCC).[22] Examples of the procedure defect (ground (i)) include the absence of a board resolution calling for the convening of a GSM,[23] and the participation of a non-shareholder in the resolution[24]. An example of the ground (ii) exists when directors are appointed in excess of the number specified in the articles of incorporation.

b) *Limitations*

Rescission lawsuits are subject to various limitations while non-existence and nullity lawsuits are not. First, the standing is limited to shareholders, directors and statutory auditors (Art. 376 para. 1 KCC).[25] Second, a rescission lawsuit may be filed within two months from the date of the resolution (Art. 376

[20] Of 128 Supreme Court decisions issued during the ten year period from 2005 to 2004 (until October 16), none were unfairness lawsuits.

[21] This revision was an attempt to reflect a change in the JCC.

[22] The ground (ii) was added to the grounds for a rescission lawsuit based on the view that it may be more reasonable to allow the shareholders to give up on a lawsuit as the articles of incorporation may be changed by the shareholders.

[23] Supreme Court, 28 April 1987, 1986 DaKa 533.

[24] Supreme Court, 23 August 1983, 1983 Do 748.

[25] As discussed in detail later, the standing requirement is much more broadly construed than in Germany.

para. 1 KCC). Third, even when there is a procedure defect, the court can, at its discretion, dismiss the plaintiff's claim based on various factors such as the content of the resolution and the status of the corporation (Art. 379 KCC). This discretionary dismissal will be discussed later in detail.[26] Finally, although non-existence or nullity of a resolution may be asserted without necessarily requiring a lawsuit, rescission can be claimed only by way of a rescission lawsuit.

3. *Nullity Lawsuits*

a) *Grounds for Nullity*

Under the KCC, a ground for nullity exists when the substance of a resolution is in violation of laws or decrees. Although the ground for nullity appears quite comprehensive, such lawsuits are rarely filed in practice. Commentators generally agree that grounds for a nullity lawsuit exist in any of the following resolutions: (i) a resolution in violation of the principle of equal treatment of shareholders; (ii) a resolution on matters not within the scope of authority of the GSM; and (iii) a resolution constituting an abuse of majority power.[27]

b) *Comparison with the Rescission Lawsuit*

A nullity lawsuit is also subject to a set of procedural exceptions applicable to rescission lawsuit (Art. 380 KCC) as discussed later. Thus, for example, a judgment of nullity is binding not only on the plaintiff but also on third parties (Arts. 380, 190 KCC). There are some differences, however, between the two types of lawsuits.[28] First, nullity of a resolution does not necessarily need to be claimed by means of a lawsuit. Second, there is no limitation on the standing of the plaintiff in a nullity lawsuit. Any party with a legitimate interest in the resolution involved may bring a nullity lawsuit. Thus, a creditor may be entitled to sue depending on the circumstances.[29] Third, there is no two-month statute of limitation for a nullity lawsuit. Fourth, a nullity lawsuit is not subject to discretionary dismissal.

4. *Non-existence Lawsuit*

a) *Grounds for Non-existence*

A ground for non-existence lawsuit exists where a gross procedural defect effectively renders the resolution non-existent. Examples of gross procedural defects include: (i) a GSM convened by an unauthorized person in the ab-

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[26] VI.3.c).

[27] K. KIM, *Hoesabop* [Corporate Law] (Seoul 2015) 321.

[28] The same differences exist between a non-existence lawsuit and a rescission lawsuit.

[29] Supreme Court, 27 October 1980, 1979 Da 2267. Such a case, however, is rare.

sence of the board's resolution; and (ii) a resolution passed at a meeting mostly composed of non-shareholders.[30]

b) Comparison With Nullity Lawsuits

Non-existence lawsuits are treated just like nullity lawsuits under the KCC. The special provisions applicable to nullity lawsuits also apply to non-existence lawsuits (Art. 380 KCC). Also, non-existence of a resolution can be claimed not necessarily by means of a lawsuit.

c) Comparison With Rescission Lawsuits

The distinction between rescission and non-existence lawsuits is very important as rescission lawsuits are subject to various limitations while non-existence lawsuits are not. A limitation that often becomes critical in practice is the two-month statute of limitation. So when a shareholder wants to dispute the validity of a resolution after two months, the only option available is to claim non-existence. Thus, differentiating between rescission and non-existence is crucial in such cases.

As mentioned above, non-existence is recognized when the procedural defect involved is so extreme as to render the resolution non-existent in effect. The degree of seriousness of the defect required for a non-existence lawsuit, however, is not necessarily clear. A resolution will certainly be deemed non-existent when only the minutes were prepared without actually holding a meeting, or when only non-shareholders attended the GSM. Distinction between non-existence and rescission becomes less obvious when a substantial number of shareholders have participated in the resolution. In a case where sixty percent of the shareholders were not given notice of the GSM, the Supreme Court confirmed non-existence of the resolution.[31]

5. Procedural Provisions

A corporate law dispute differs from a general private lawsuit in that the former potentially involves far more interested parties than the latter. As for lawsuits involving certain corporate law matters, the KCC provides for a set of exceptions to the rules of general civil procedure. These rules are applicable to all kinds of SR lawsuits. They relate to such matters as exclusive jurisdiction (Arts. 376 para. 2, 186 KCC), public notice of the lawsuit (Arts. 376 para. 2, 187 KCC), consolidation of lawsuits (Arts. 376 para. 2, 188 KCC),

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[30] Supreme Court, 31 January 1968, 1967 Da 2011.

[31] Supreme Court, 13 July 1993, 1992 Da 40952. In a case where only forty one percent of the shareholders were not notified, non-existence was not recognized. Supreme Court, 26 January 1993, 1992 Da 11008.

effect of the judgment (Arts. 376(2), 190 KCC), liability of the losing plaintiff (Arts. 376 para. 2, 191 KCC) and security deposit (Art. 377 para. 1 KCC).

What attracts most attention among these exceptions may be the effect of the judgment. A judgment in favor of the plaintiff is binding not only on the plaintiff but also on third parties (Arts. 376 para. 2, 190 KCC). A judgment against the plaintiff, however, does not bind a third party. A judgment in favor of the plaintiff takes effect retrospectively as well as prospectively. Thus, a legal relationship formed on the basis of the defective resolution must be dissolved in principle as a consequence of the judgment.

V. SR Lawsuits in Korea: Reality

1. *Some Statistics*

We will set forth here some basic statistics about the reality of SR lawsuits in Korea. Table 3 shows the number of decisions resulting from SR lawsuits from 1990 to 2014.[32] It only covers decisions of the Supreme Court, the five high courts and the seven district courts in the Seoul metropolitan area.[33] According to Table 3, the number of such decisions has been generally on the increase, especially since 1997/1998, the beginning of the financial crisis in Korea. The increase is most conspicuous in the number of district court decisions.

Table 3: Number of SR Lawsuits (1990–2014)

Year	Supreme Court	High Courts	Seven District Courts
2014	10	5	12
2013	7	34	44
2012	8	23	64
2011	7	32	57
2010	14	30	68
2009	24	32	46
2008	9	44	52
2007	14	22	58
2006	22	19	57
2005	13	33	57
2004	17	36	45
2003	11	27	37
2002	7	20	47
2001	4	21	31
2000	4	17	29

[32] The decisions were handpicked by means of the internal decision search system of the Supreme Court of Korea. The figures for 2014 reflect only those announced until October 16 for the Supreme Court decisions and until September 20 for lower court decisions.

[33] It is presumed that a majority of SR lawsuits in Korea are taking place in these courts.

Year	Supreme Court	High Courts	Seven District Courts
1999	5	16	28
1998	7	16	22
1997	5	11	20
1996	5	12	11
1995	3	8	13
1994	7	11	15
1993	18	7	11
1992	9	22	11
1991	7	12	13
1990	1	13	12
Total	238	523	860

2. *Relative Importance of SR Lawsuits*

SR lawsuit decisions, however, account for only a small percentage of the private law decisions as a whole. In 2013, they amount to less than 0.1% (10)[34] of the total private law decisions (10,576)[35] produced by the Seoul Central District Court, the largest district court in Korea. Focusing solely on the Supreme Court decisions, the percentage is slightly higher, 7 out of 4,691 decisions (0.15%).[36]

Although the number of SR lawsuit decisions still remains modest, it is far larger than that of derivative suit decisions, as illustrated by Table 4. Table 4 shows the numbers of derivative suit decisions and SR lawsuit decisions announced by the Seoul Central District Court during the period from 1995 to 2013. According to Table 4, SR lawsuit decisions (253) outnumber derivative suit decisions (38) by more than six times.[37]

Table 4: Number of SR Lawsuits vs. Derivative Suits in Seoul District Court (1995–2013)

Year	Derivative Suits	SR Lawsuits
1995	–	3
1996	–	6
1997	–	8
1998	1	11
1999	–	15
2000	–	13
2001	–	13

[34] See Table 4.

[35] They include only decisions issued by a panel of judges.

[36] The figure covers only those Supreme Court decisions arising from a decision made by a panel (not a single judge) of a district court.

[37] They are more than three times as many as derivative suit decisions made by all the district courts during the same period.

Year	Derivative Suits	SR Lawsuits
2002	4	16
2003	–	13
2004	4	14
2005	3	16
2006	6	16
2007	6	21
2008	2	23
2009	1	13
2010	3	16
2011	5	22
2012	2	21
2013	1	10
Total	38	253

3. Number of SR Lawsuits by Type of Lawsuits

Let's now move to the number of SR lawsuits by type of SR lawsuit. During the period from 2005 to 2014 (until October 16), the Supreme Court handed down 128 decisions.[38] To classify them according to case name, there were 64 non-existence cases, 34 rescission cases, and 29 nullity cases.[39] The case name is normally determined by the plaintiff filing a complaint with the court and serves to help the court and the parties identify the case. As it is rarely changed during the litigation, it often fails to coincide with the final claim of the plaintiff. That is exactly the case with the nullity lawsuits – of those decisions classified as nullity lawsuits on the base of case name, we have found only one real nullity lawsuit.[40] The rest would properly be reclassified either as rescission or non-existence lawsuits.

4. Prevalence of Non-existence Lawsuits

According to the statistics mentioned earlier, non-existence lawsuits are commonplace in Korea, accounting for a majority of SR lawsuits. This may strike one as a little strange given that they are only allowed for extremely serious defects. This naturally raises the question of why there are so many non-existence lawsuits in Korea? We suspect that at least three factors may contribute to the prevalence of non-existence lawsuits. First, as mentioned earlier, even small firms prefer to take the corporate form in Korea. These often fail to respect formalities of the GSM, with many dispensing with cum-

[38] The result obtained from a personal survey of the court database by one of the authors.

[39] One case is not classified as any of three types of lawsuits.

[40] Supreme Court, 24 September 2014, 2013 Da 71821 (a decision holding a resolution null and void when the resolution exceeds the scope of the court approval on calling the special GSM).

bersome meetings altogether. Second, the identity of eligible shareholders is often in dispute because of the peculiarities of Korean corporate law. In principle, under the KCC, only those who appear as shareholders in the official list of shareholders can vote (Art. 337 para. 1 KCC). In some exceptional instances, however, the court grants voting rights to real shareholders, rather than nominal shareholders. A typical instance exists when one holds shares in the name of a different person who agrees to such an arrangement.[41] If the corporation is aware of this "borrowed-name holding" arrangement and can easily prove it, which is often the case in a close corporation, the corporation is required not to let the nominal shareholder vote.[42]

Third, as the two-month statute of limitation applies to a rescission lawsuit, the plaintiff has no other option than to file a non-existence lawsuit if the two month statute of limitation has expired. Thus the plaintiff may have a strong incentive to characterize a procedural defect as a ground for non-existence.

5. Who Files an SR Lawsuit?

SR lawsuits are mostly filed by shareholders (or those who claim to be shareholders). Although directors and statutory auditors have standing to sue under the KCC, they rarely file an SR lawsuit except in an unusual situation where they were dismissed or an opponent has appointed new directors or statutory auditors at the GSM.[43] Unlike in Germany, however, there is no evidence of professional shareholders who specialize in filing SR lawsuits in expectation of settlement payments from the firm. This may be primarily due to the fact that an SR lawsuit under Korean law is not as great a threat. We will come back to this point later.

6. Matters Disputed in SR Lawsuits

Table 5 shows the items disputed in SR lawsuits. According to Table5, by far the most popular subject of SR lawsuits is appointment and dismissal of directors and statutory auditors. The firms involved in such lawsuits are mostly closely held corporations, *de facto* partnerships among a few business partners who serve as board members.[44] When their relationship turns sour, the majority shareholder often attempts to evict his or her business partner/s from the board.

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[41] This borrowed-name holding has been widely practiced primarily for tax purposes.

[42] Supreme Court, 8 September 1998, 1996 Da 45818.

[43] In such situations, they are also likely to be shareholders at the same time.

[44] According to the disclosures made by the Korea Stock Exchange during the one year from 15 March 2014 to 14 March 2015, there were 10 SR lawsuits involving appointment or dismissal of directors or statutory auditors in listed firms.

Table 5: Items Disputed in SR Lawsuits[45]

Items disputed in SR lawsuits	Number
Appointment/Dismissal of directors/statutory auditors	56
Amendment of articles of incorporation	13
Agendas in the ordinary general meeting	5
– *ex)* approval of financial statements; dividend; approval of directors'/statutory auditors' compensation	
Reduction of legal capital/decrease of no. of shares	5
Fundamental changes	5
– mergers; divisions; sales of assets	
Dissolution/Liquidation/Continuation	4
Stock option	2
Total	90

VI. Comparative Analysis

1. Dividing line Between Rescission and Nullity Lawsuits

a) General

Although the rules on SR lawsuits under the KCC largely originated from German law, the division of SR lawsuits differs widely in Korea and Germany. Both jurisdictions have rescission and nullity lawsuits. As mentioned earlier, the KCC recognizes yet another category, non-existence lawsuits, while the AktG does not formally recognize a non-existence lawsuit as a separate category.[46] Functionally, however, these non-existence lawsuits do not differ greatly from nullity lawsuits. Both nullity and non-existence can be claimed by anybody, anytime, and not necessarily by means of a separate lawsuit.

On the other hand, a disgruntled shareholder in Germany may file a nullity lawsuit to attack a resolution with a certain procedural defect. A procedural defect specified as a ground for nullity under the AktG (Art. 241 no. 1 KCC) is broad enough to cover some of the gross procedural defects regarded as grounds for non-existence in Korea. Thus, this difference with respect to non-existence lawsuits does not matter much in practice. Of much more importance is the dividing line between rescission and nullity lawsuits. While the dividing line between the two types of lawsuit is straightforward in Korea, the German situation is much more diffuse.

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45 Some important cases of the Supreme Court of Korea

46 Although there is some dispute as to whether or not the category of non-existence should be recognized, Germany does not formally adopt non-existence lawsuits. J. KOCH, in: Hüffer, Aktiengesetz, 11th ed. 2014, § 241 marg. no. 3.

b) Differences

In Korea, division between revocation and nullity lawsuits depends on the nature of defect involved. While a procedural defect, except in extreme cases, constitutes a ground for rescission, a defect of substance, except for those that violate the articles of incorporation, constitutes a ground for nullity. In contrast, Germany adopts a more pragmatic approach. In Germany, violation of law or the articles of incorporation constitutes a ground for rescission in principle (§ 243 para. 1 AktG). As the AktG does not limit grounds for rescission to procedural defects, defects of substance also constitute grounds for rescission, although the AktG specifies a set of grounds for nullity (§§ 241, 250, 253 AktG).

These statutory grounds for nullity include procedural as well as defects of substance. The procedural defects specified as grounds for nullity under the AktG are two-fold: (i) violation of law in convening the GSM ("convening defect"), and (ii) violation of law in recording the resolution ("recording defect") (§ 241 nos. 1, 2 AktG). Both of these procedural defects appear rather technical from a Korean perspective. As the KCC does not recognize recording defects, we will focus on convening defects from a comparative perspective.

Convening defects specified in the AktG are as follows: (i) absence of a lawful resolution of the management board to convene the GSM, or lack of proper authority of the person who has actually convened the GSM; (ii) failure to indicate in the notice of the GSM the firm's business name, domicile, or time and place of the GMS; (iii) absence of the notice of the GSM. These convening defects would also constitute a ground for rescission in Korea except in extreme situations. For example, if the notice was not given to a majority of shareholders, who could not attend the GSM as a consequence, the resolution passed at the GSM would be regarded as non-existent.[47]

Let us now turn to defects of substance. Unlike in Korea, a defect of substance constitutes a ground for rescission in principle in Germany (§ 243 para. 1 AktG). As an exception to this rule, the AktG provides for the following two categories of substance defects constituting ground for nullity (§ 241 nos. 3, 4 AktG): (i) when a resolution "is not compatible with the nature of the company or by its terms violates provisions which exist exclusively or primarily for the protection of the company's creditors or otherwise in the public interest", and (ii) when a resolution "by its terms is unethical".[48] Of these two categories, the first category (i) seems more relevant in practice. It is noteworthy that the law covered by the first category does not include provisions intended to protect the interests of shareholders. So in Germany, vio-

[47] Supreme Court, 13 July 1993, 1992 Da 40952.

[48] English translation based on Norton Rose Fulbright, German Stock Corporation Act.

lation of the principle of shareholder equality (§ 53a AktG), abuse of majority power, and violation of the fiduciary duty of shareholders, for instance, can only generate rescission lawsuits.[49] Table 6 illustrates the division among the three types of SR lawsuits in Korea.

Table 6: Grounds for Rescission vs. Nullity

	Korea	Germany
Rescission (Voidable)	Procedural Defect Extreme Cases: Non-Existence	Principle: Violation of laws or the articles (§ 243)
Nullity (Void)	Violations of the Articles Substance Defect	Exceptions: (1) Procedural Defect (§ 241 no .1, no. 2) (2) Defect of Substance (§ 241 no. 3, no. 4)

c) History

From its beginning, the law diverged from its German source. When the JCC of 1899 first introduced a rescission lawsuit,[50] the Japanese legislators decided to restrict its grounds to procedural defects. It is not clear why Japanese legislators chose to deviate from the German model in that respect.[51] One reason given for limiting the ground for a rescission lawsuit to a procedural defect was the need to promote stability in corporate legal relations.[52] Nullity lawsuits were first adopted in the JCC of 1938 (Art. 252 JCC).[53] The legislators, however, did not follow the AktG of 1937 on differentiating between rescission and nullity lawsuits.

d) Two Observations

Regarding the dividing line between rescission and nullity lawsuits, we would like to make two observations, one for each country. Beginning with Korea: distinguishing nullity and revocation lawsuits based on the nature of defect as in Korea and Japan is certainly straightforward and easy to implement, alt-

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[49] KOCH, *supra* note 46, § 243 marg. nos. 5, 21; K. LANGENBUCHER, Aktien- und Kapitalmarktrecht (3rd ed. Munich 2015) 207.

[50] To be precise, it was called a lawsuit for announcing nullity under the JCC of 1899.

[51] ISHII, *supra* note 19, 209.

[52] ISHII, *supra* note 19, 210.

[53] Even before the JCC of 1938, however, it was generally agreed that a lawsuit could be filed, as a lawsuit under the general civil procedure, to confirm the nullity of a resolution with a substance defect.

hough only a few countries have adopted this approach.[54] One weakness of this approach lies in its lack of flexibility: while a procedural defect is less problematic in terms of rigidity, it may lead to a non-existence lawsuit if it is regarded as too serious. On the other hand, rigidity may matter in the case of a defect of substance. If the defect of substance involved is not material, it may be better to treat it as a ground for rescission, which is subject to requirements such as the statute of limitation and discretionary dismissal. Such a change was already made with the 1995 reforms to the KCC that treated violation of the articles of incorporation as a ground for rescission.

It may be better for Korea to follow the German approach in this respect by treating a defect of substance as a ground for rescission, if the alleged legal violation relates to the interest of minority shareholders, rather than that of third parties or the general public. Under this new approach, violation of the principle of equality of shareholders, for example, could constitute a ground for rescission, rather than nullity. As the equality principle purports to protect the interests of minority shareholders, these should have the option of not blocking a resolution that allegedly violates that principle.[55] Indeed, a lower court decision does seem to have adopted a similar logic.

The case involves a shareholder resolution to approve a statutory auditor's taking office of a conflicting position. The KCC explicitly prohibits a statutory auditor from serving concurrently as a director or employee of the firm or its subsidiary (Art. 411 KCC). This provision is generally presumed to be mandatory, meaning that it cannot be avoided by an approval of the GSM or the board of directors. On the other hand, the GSM's authority under the KCC extends only to such matters as provided in the KCC or in the articles of incorporation (Art. 361 KCC). The plaintiff asserted that a resolution approving a statutory auditor's appointment to a conflicting position was in violation of the latter provision, which constituted grounds for nullity suit. The court, however, rejected the plaintiff's claim, holding that "a resolution in violation of a certain provision is null and void only when the violated provision is material enough to be characterized as mandatory. Art. 361 KCC is not mandatory."[56]

Let us now turn to Germany. As mentioned earlier, the AktG specifies two types of procedural defects, i.e., convening and recording defects, as grounds for nullity. Although at least some of these procedural defects appear quite technical, they can, in contrast to Korea, still give rise to nullity lawsuits.

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[54] A notable example of such countries is Netherland. W. HALLSTEIN, Die Aktienrechte der Gegenwart (Berlin 1931) 280. The Current Dutch Civil Code *(Burgerlijk Wetboek)* §§ 2:14 (null and void resolutions); 2:15 (voidable resolutions).

[55] This seems generally in line with what A. HUECK and T ISHII proposed several decades ago.

[56] Daejeon District Court (Cheonan Branch), 13 June 2013, 2014 KaHap 10056; translated from Korean by the authors.

Moreover, unlike the case of rescission lawsuits, the AktG does not provide for an exception based on negligibility.

Rigidity arising from the AktG's emphasis on procedure may not create much difficulty in Germany as German corporations are generally much larger than most corporations in Korea and are in a better position to comply with formalities. But even in Germany, a majority view argues that the negligibility exception should be permitted for a nullity lawsuit.[57] This may be justified from the perspective that a blocking remedy like SR lawsuits should be used sparingly – a view reflected already in the AktG as well. The AktG acknowledges that some procedural defects may be remedied with the passage of time or a sepcific event (e.g., registration) (§ 242 AktG). So, in reality, the difference between the two countries may not be as great as it first appear.

2. *Effect of Pending SR Lawsuits*

What is potentially more important is the difference in effect of a pending SR lawsuit in Korea and Germany. Under German law, important resolutions regarding restructuring *(Umwandlung),* share issuance and change in the articles of incorporation become effective only after the registration with the commercial registry (e.g., § 181 para. 3 AktG).[58] If a lawsuit is filed with respect to a resolution yet to be registered, the court in charge of registration may, and often does, suspend the registration until the judgment becomes finalized (§§ 381, 21 FamFG[59]). As an SR lawsuit has a potential to block implementation of the relevant shareholder resolution, a plaintiff may file an SR lawsuit merely to hinder its progress, i.e. with intent to realize its nuisance value, thus making corporations naturally concerned about a potential SR lawsuit.[60]

The German legislature attempted to ameliorate this problem by adopting a new provision in the AktG in 2005,[61] which allows the court to go ahead with the required registration even in the middle of a lawsuit (§ 246a AktG). This procedure, widely called a release procedure *(Freigabeverfahren),* was evaluated as inadequate to deter "predatory shareholders" *(räuberische Aktionäre)* from

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[57] H. FLEISCHER, Bagatellfehler im aktienrechtlichen Beschlussmängelrecht, ZIP 2014, 149.

[58] M. LUTTER, Die Eintragung anfechtbarer Hauptversammlungsbeschlüsse im Handelsregister, NJW 1969, 1873.

[59] Gesetz über das Verfahren im Familiensachen und in den Angelegenheiten der freiwilligen Gerichtsbarkeit (BGBl. I 2008, 2586).

[60] M. WINTER, Die Anfechtung eintragungsbedürftiger Strukturbeschlüsse de lege lata und de lege ferenda, in: Habersack et al. (eds.), Festschrift für Peter Ulmer zum 70. Geburtstag am 2. Januar 2003 (Berlin 2003) 699.

[61] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG), 22.9.2005, BGBl. I 2005, 2802.

filing abusive SR lawsuits.[62] As a consequence, the provision was again revised in 2009 to enhance the possibility of securing such a release from the court.[63]

In contrast, Korean law does not generally require notarization or registration as a prerequisite to a resolution taking effect. Korean law does require certain matters to be registered, and when such a matter is determined by a shareholder resolution, the firm is required to submit the minutes of the GSM,[64] which must in turn be notarized.[65] There is however no dispute about the resolution being effective, even without the minutes or notarization.[66] Should a plaintiff wish to suspend the effect of a particular resolution, the plaintiff may, and often does, seek a provisional injunction from the court. This injunction affords the court a broad discretion and an excuse for declining a claim deemed to be abusive is often easily found.

3. Dealing with Abusive or Inefficient Lawsuits

a) General

A powerful blocking remedy, an SR lawsuit has great potential for abuse. Indeed, the abuse of SR lawsuits and its reduction have been a hot research topic in Germany. In contrast, however, such abuse is much less serious in Korea. Even in the absence of abusive intent on the part of the plaintiff, it may be unwise as a practical matter to invalidate a resolution depending on the circumstances. In a large listed firm, it takes substantial resources to hold the GSM. Once a resolution is passed, it may serve as the base for a wide range of legal relationships involving numerous parties. Subsequent invalidation of a resolution may undermine legal certainty, and makes less sense given the firm could secure the same resolution at a new GSM. This is not to denigrate the value of SR lawsuit as a remedy for minority shareholders – only to highlight the importance of finding a balance between the two conflicting considerations: protection of minority shareholders and minimizing abuse of SR lawsuits.

In this regard, two features of Korean law on SR lawsuits are worthy of attention: (i) broad standing and (ii) discretionary dismissal. While broad stand-

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[62] T. BAUMS/D. GAJEK/A. KEINATH, Fortschritte bei Klagen gegen Hauptversammlungsbeschlüsse? Eine empirische Studie, ZIP 2007, 1629; RegE ARUG, BT-Drucks. 16/11642, 20, 40.

[63] Regarding the impact of the revision on abusive SR lawsuits, see, e.g. T. BAUMS/F. DRINHAUSEN/A. KEINATH, Anfechtungsklagen und Freigabeverfahren. Eine empirische Studie, ZIP 2011, 2329; W. BAYER/T. HOFFMANN, "Berufskläger" in der aktuellen rechtspolitischen Diskussion, ZIP 2013, 1193.

[64] Art. 91 Commercial Registration Act; Art. 130 Commercial Registration Rules.

[65] Art. 66–2(1) Notary Public Act.

[66] Supreme Court, 28 June 2007, 2006 Da 62362.

ing purports to facilitate SR lawsuits[67], discretionary dismissal serves as a means to weed out abusive or inefficient lawsuits. These two features shall be examined individually.

b) *Standing requirement for plaintiff*

The standing requirement for plaintiff is quite broadly interpreted in Korea to enhance access to SR lawsuits as a remedy for minority shareholders. First of all, there is no minimum shareholder requirement, meaning even a shareholder with just one share can file an SR lawsuit. That shareholder is also entitled to sue, when she voted in favor of the relevant resolution, when she failed to attend the GSM,[68] when she has bought the shares after the relevant GSM, or when she is not directly affected by the procedural defect.[69]

Historically, the JCC of 1911 imposed additional restrictions on the plaintiff shareholder following the lead of the ADHGB of 1884 (§ 190a ADHGB) and the HGB of 1897 (§ 271 para. 3 HGB). In the revision of 1938, however, the JCC eliminated these restrictions (Art. 241 JCC) and adopted discretionary dismissal (Art. 251 JCC) instead.

In contrast, the standing requirement under German law is much narrower than under Korean law. The AktG grants standing to a shareholder with a single share, but with some restrictions (§ 245 nos. 1–3 AktG). For example, the shareholder has no standing if she acquired the shares after the publication of the agenda, or if she attended the GSM but did not vote against the resolution according to the minutes.

Recently, proposals have been made to further restrain the plaintiff's standing by imposing a minimum holding requirement.[70] These proposals, which have been made to address concerns about abusive lawsuits have not been adopted, rightly in our opinion.

c) *Discretionary Dismissal*

The KCC has a unique and potentially powerful weapon against abusive SR lawsuits. Under the KCC, the court can dismiss the plaintiff's claim, if it finds rescission to be inappropriate, considering "the content of resolution, the current status of the firm and other relevant factors" (Art. 379 KCC). It is generally agreed that the provision applies only to a rescission lawsuit based on a procedural defect, although this is not explicitly stated in the KCC. The court can

[67] Korean law imposes relatively modest court costs on the plaintiff of an SR lawsuit, which amount to about 200 US dollars. Art 2 para. 1 no. 2, para. 4 Act on Stamp Duty for Civil Litigation and Others, Art. 15 para. 2 Rules on Stamp Duty for Civil Litigation and Others. This low court costs may serve as another factor facilitation SR lawsuits.

[68] Supreme Court, 27 March 1979, 1979 Da 19.

[69] Supreme Court, 12 May 1998, 1998 Da 4569.

[70] FLEISCHER, *supra* note 1, 129–130.

ex officio dismiss the claim at its discretion, a practice that is quite often seen in practice: of 59 district court decisions dealing with the issue (during 1994–2014), the court granted discretionary dismissal in 19 decisions.[71]

The provision on discretionary dismissal was modelled after the JCC of 1938 (Art. 251 JCC). Although the current JCA still maintains a provision on discretionary dismissal, (Art. 831 para. 2 JCA) it is different in substance from its Korean counterpart. Japanese law allows the court to grant discretionary dismissal when two requirements are satisfied: (i) materiality of a procedure defect and (ii) causal relationship between the defect and the resolution involved.

The requirements under Korean law are less strict. The critical test is whether or not rescission of the resolution is appropriate. Inappropriateness of rescission is not necessarily equated with abuse. It is instead a forward-looking approach. So even if there is a material defect which affected the resolution, the court can still find rescission inappropriate and dismiss the suit based on "the content of resolution, the current status of the firm and other relevant factors" These relevant factors include interests of shareholders or of the firm[72], transactional safety[73] and possibility of financial crisis.[74] Materiality of defect[75] and causal relationship between the defect and the resolution[76] are often considered, but not necessarily regarded as essential, unlike under the JCA.

The following case illustrates the forward looking attitude of the court well:[77] The case involved a corporation needing to amend its articles of incorporation to comply with government policy. Minority shareholders opposed to the firm's proposal to amend the articles of incorporation, making other unrelated demands. The firm excluded the minority shareholders from the meeting hall and passed the resolution to change the articles. The court held in favor of the firm, finding the discretionary dismissal justified even when the defect affected the result of the resolution.[78]

The permissive attitude of Korean courts toward discretionary dismissal does not seem to be in accord with German law. Scholars and the court in

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[71] Discretionary dismissal, however, is rarely disputed in the Supreme Court. We could find only four such cases.

[72] Supreme Court, 8 September 1987, 1986 DaKa 2971; Supreme Court, 11 July 2003, 2001 Da 45584.

[73] Supreme Court 27 April 2004, 2003 Da 29616; Supreme Court, 11 July 2003, 2001 Da 45584.

[74] Seoul High Court. 8 August, 1998 Na 5267.

[75] Supreme Court, 11 July 2003, 2001 Da 45584.

[76] Supreme Court, 27 April, 2003 Da 29616.

[77] Supreme Court, 8 September 1987, 1986 DaKa 2971.

[78] For a decision following a similar line of reasoning, see Supreme Court, 10 October 2003, 2001 Da 56225.

Germany are of the view that rescission should not occur where the provision claimed to have been violated is not significant to the shareholder.[79] This so-called *Relevanztheorie* was partly adopted in the revised AktG in 2005. Under the AktG (§ 243 para. 4 AktG), a rescission lawsuit based on a procedural defect involving incorrect, incomplete or refused information can only be recognized if a reasonable shareholder would have regarded the information as essential to exercise his rights.

d) Plaintiff's Liability and Security Deposit

Another means of limiting abusive lawsuits is to hold the unsuccessful plaintiff liable for the damages. Under the KCC, a plaintiff acting in bad faith or gross negligence is liable for damages to the firm (Arts. 376 para. 2, 191 KCC), although this liability is rarely recognized in practice. Even if the firm manages to win the case, the plaintiff may be judgment proof. To protect itself against a judgment proof plaintiff, the company may request the court order the plaintiff shareholder to deposit a security with the court (Art. 377 KCC). This order requires the company to show *prima facie* evidence of bad faith on the part of the plaintiff. Bad faith is not necessarily interpreted as filing an ill-founded claim, but as knowingly putting the firm in difficult situation. In reality, the court rarely orders the plaintiff to deposit security.[80]

4. SR Lawsuits as a Shareholder Remedy

The SR lawsuit is a powerful shareholder remedy, enabling a shareholder to block a corporate action which the shareholder does not like. It can be an inadequate and even wasteful remedy especially when the firm can simply produce the same resolution by holding another GSM. In Korea however, SR lawsuits have been serving as a major shareholder remedy in the absence of other effective remedies. Attracting much attention from academics as well as practitioners, SR lawsuits have been widely invoked and long comprised a substantial portion of corporate law disputes in court. But with the rise of other remedies, such as derivative suits and dissenting shareholders' appraisal remedy, SR lawsuits have lost some of their luster in corporate governance.

This is by no means surprising given that an SR lawsuit often falls short of an adequate remedy, generating a less than ideal solutions to an underlying dispute. In many cases, an SR lawsuit arises from a dispute among partners in

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[79] W. ZÖLLNER, in: Kölner Kommentar zum Aktiengesetz, 1st ed. 1985, § 243 marg. no. 94; BGHZ 149, 158 (164 et seq.); 153, 32 (36 et seq.); 160, 385 (391 et seq.).

[80] We could find only two such cases, including Seoul Central District Court, 24 October 2011, 2011 KaHap 3638.

a closely-held firm.[81] When partners fall out with each other, the majority shareholder often tries to alienate a minority shareholder from the company's affairs. In such an awkward situation, an SR lawsuit may be an only remedy available to the minority shareholder to potentially nullify a major corporate action. This does not however resolve the underlying discord, and the plaintiff's minority status remains unchanged.

We do not mean to downplay the significance of SR lawsuits, however. Although not perfect, they are still powerful as a blocking remedy. Moreover, they constitute a convenient remedy for a disgruntled shareholder thanks to the relaxed standing requirements discussed earlier. As long as the burdensome shareholding requirements for derivative suits[82] and the strict stance of the court on such suits remain unchanged, a minority shareholder will be likely to resort to an SR lawsuit.

VII. Concluding Remarks

Unlike in Anglo-Saxon countries, SR lawsuits serve as an important shareholder remedy in practice in civil law jurisdictions such as Germany and Korea. Although originally modelled after German law, provisions on SR lawsuits under the KCC are quite different from their current counterparts under the AktG. As discussed earlier, however, the difference between the two countries, from a functional perspective, is not as substantial as it may first appear. Also, the role of SR lawsuits in corporate governance seems to be on the decline, albeit slowly, in both countries. Convergence of the practice of SR lawsuits in the two countries may be due to the widely shared view that it may not be wise from a policy perspective to block a shareholder resolution purely on procedural grounds. Such developments may be more justified if accompanied by the strengthening of other shareholder protection mechanisms such as shareholder derivative suits. If such change continues, however, the corporate governance terrain of the two countries may further approach that of Anglo-Saxon countries.

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[81] An SR lawsuit may be invoked even in a listed firm when there is a dispute between the controlling shareholder and a group of activist or employee shareholders over a major business decision.

[82] One percent for non-listed firms and 0.01% for listed firms (Arts. 402, 542-6 para. 6 KCC).

The Role of Shareholders in Public Companies

Hiroyuki Kansaku

I. Introduction

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled.[1] Corporate governance has two main goals: to ensure sound management according to the rules and regulations and to control the efficient and successful management of companies.

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[1] A. CADBURY, Report of the Committee on the Financial Aspects of Corporate Governance, para. 2.5 (December 1992), <http://www.ecgi.org/codes/documents/cadbury.pdf>. Concerning various concepts and definitions of corporate governance, see K. J. HOPT, Comparative corporate governance: the state of the art and international regulation, in: Fleckner/Hopt (eds.), Comparative Corporate Governance (Cambridge 2013) 10–11.

The board of directors is always at the center of corporate governance. Nonetheless, shareholders can also play an important role in corporate governance in two ways. One is for shareholders to exercise their rights, such as voting, inspection and the filing of derivative suits. Furthermore, institutional investors can affect corporate governance via communication and engaging with management directly regarding strategy and objectives, board leadership, board and committee composition or succession, the management remuneration policy, etc. The second way is to sell and buy their stock on the market, typically in hostile takeover bids. The accumulation of individual investment decisions on the part of shareholders may affect corporate governance through changes in corporate control.

The more people are interested in efficient and successful management, the more shareholders are expected to play a role in corporate governance. According to the new G20/OECD Principles of Corporate Governance in 2015, the corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders.[2] Furthermore, the G20/OECD Principles establish a new principle that describes how the corporate governance framework should provide sound economic incentives throughout the investment chain and ensure that the stock market functions in a way that contributes to good corporate governance.[3]

In recent years, shareholders, among others institutional investors, have become expected to play a more active role by exercising shareholders' rights and engaging with management in order to enhance the corporate governance of their invested company.[4] This idea is economically rational because the price of stocks theoretically represents the longstanding value of the company as a residual claimant, and, therefore, shareholders have a quite legitimate incentive to pursue shareholder-value maximization.[5] Furthermore, equity

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[2] G20/OECD Principles of Corporate Governance, Principle II (September 2015), <http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf>. Corporate governance is defined in these principles as a set of relationships between a company's management, its board, shareholders and other stakeholders (p. 9).

[3] G20/OECD Principles of Corporate Governance, *supra* note 2, Principle III.

[4] J. KAY, The Kay Review of UK Equity Markets and Long-Term Decision Making (2012) 10, <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf#search='Kay+Review'>; European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM(2014) 213 final, 12–13.

[5] OECD, The Role of Institutional Investors in Promoting Good Corporate Governance (2011) 10, <http://www.oecd-ilibrary.org/docserver/download/2611111e.pdf?expires=1452584254&id=id&accname=ocid195240&checksum=DF6C4518B27F6F8BD7D2F5E57BE85003>.

capital as a residual claim on corporate earnings is adequate finance for uncertain and long-term returns, such as on research, product development and innovation.[6]

The percentage of shareholdings by institutional investors is increasing both in Japan and Germany. Institutional investors, such as pension funds and mutual funds, normally create investment portfolios in order to diversify investment risk. Diversified portfolios can be insulated from the effects of firm-specific risks. Therefore, diversified shareholders must expect the firm to take more risks. On the other hand, the managers of a company are undiversified, in contrast to institutional investors, because they have human capital tied up in their firm.[7] From the perspective of modern portfolio theory, the notion that corporate governance mechanisms consequently encourage managers to take risks through the exercise of shareholders' rights and engagement with management may be justified.

Nevertheless, traditional institutional investors have followed the so-called "Wall Street rule" of selling stocks when they disapproved of management, but seldom challenging them openly or engaging with them.[8] An investment policy according to the modern portfolio theory under which institutional investors hold the market as a whole may invite a decreased incentive to monitor individual corporations in the portfolio closely.[9] The OECD concluded that in many cases shareholders vote in a mechanical manner – relying on proxy voting advisers – and generally fail to challenge boards in sufficient number to make a difference.[10]

It is thus not easy and may not be adequate for laws and regulations to regulate affairs such as the enhancement of shareholder control because one size does not fit all in this regard.[11] For these reasons, the Japanese Stewardship Code (JSC)[12] was introduced in 2014. This code is expected to work with the

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[6] M. ISAKSSON/S. ÇELIK, Who Cares? Corporate Governance in Today's Equity Markets, OECD Corporate Governance Working Papers No. 8 (2013) 9, <hrrp://dx.doi.org/10.1787/5k47zw5kdnmp-en>.

[7] J. ARMOUR/J. N. GORDON, Systemic Harms and Shareholder Value, 6 Journal of Legal Analysis (2014) 35, 36, 50–53.

[8] J. C. COFFEE/H. A. SALE, Securities Regulation, (12th ed. St. Paul 2012) 41.

[9] COFFEE/SALE, *supra* note 8, 40.

[10] OECD, Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles (February 2010) 10, <http://www.oecd.org/daf/ca/corporategovernanceprinciples/44679170.pdf>.

[11] The Business Sector Advisory Group on Corporate Governance, Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets (27 March 1998) 13–15 <http://www.oecd-ilibrary.org/docserver/download/9298041e.pdf?expires=1455632072&id=id&accname=ocid57015174&checksum=B8B7DEF8536A65A477E4EF82B5D0141B>.

[12] *Nihon-han Stewardship Code ni Kansuru Yushiki-sha kento-kai* [The Council of Experts Concerning the Japanese Version of the Stewardship Code], *Sekinin aru Kikantoshika*

Corporate Governance Code of Japan (JCGC),[13] which was put in place in 2015 as a listed rule of the Tokyo Stock Exchange. These two codes use a principle-based approach and are enforced via a "comply or explain" rule.

I focus on the role of shareholders in listed companies in the context of corporate governance, especially via exercising shareholders' rights, among other voting rights, and engagement with management by institutional investors. First, I compare the authority of shareholders' meetings and individual or minority shareholders' rights under Japanese and German corporate law, with a brief reference to the special connection between Japanese corporate law and German law (II.). Then, I depict the features of traditional corporate governance in both Japan and Germany and also the recent transformation from the viewpoint of, among others, the limits of shareholder control on invested companies (III.). I focus on the recent measures encouraging the engagement of institutional investors with management and diminishing cross-shareholding (which would impede the effective exercise of shareholders' rights) in order to enhance the quality of corporate governance through effective corporate control of shareholders. I will deal not only with the laws and regulations but also with the so-called soft laws such as the Stewardship Code and the Corporate Governance Code (IV.). Finally, I analyze the meaning of the transformation of corporate governance in Japan in respect of institutional shareholder control via the exercise of shareholders' rights and engagement with management – this being done through a comparative lens considering the counterpart of Germany (V.).

II. Shareholders' Rights in Japanese and German Joint-stock Company Law

1. Short History of Japanese Joint-stock Company Law

I will sketch the history of the Japanese joint-stock company law very briefly.[14] The current Japanese commercial law was enacted in the Meiji Era, in 1899, when Japan opened its country and attempted to introduce western science and a western social system, including a western legal system. Japa-

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no Sho-gensoku [Principles for Responsible Institutional Investors (Japan's Stewardship Code)] (26 February 2014). English Translation (7 April 2014), available at <http://www.fsa.go.jp/en/refer/councils/stewardship/20140407.html>.

[13] *Kabushiki-kaisha Tokyo Shoken Torihiki-sho* [Tokyo Stock Exchange, Inc.], *Corporate Governance Code~Kaisha no Jizoku-teki na Seicho to Chu-choki-teki na Kigyokatchi no Kojo no tameni~* [Japan's Corporate Governance Code – Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term] (1 June 2015). Provisional English translation (1 June 2015), available at <http://www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jdy-att/20150513.pdf>.

nese commercial law was fundamentally based on a draft by German law scholar and economist Carl Friedrich Hermann Roesler, who took account not only of German law but also of French and English law as well as several other European countries' commercial laws. Thus, Japanese commercial and company law was chiefly influenced by German commercial law, namely the General German Commercial Code of 1861 (*Allgemeines Deutsches Handelsgesetzbuch* – ADHGB). Thereafter, the General German Commercial Code was revised and enacted in 1990 as the Commercial Code (*Handelsgesetzbuch* – HGB), together with the German Civil Code (*Bürgerliches Gesetzbuch* – BGB). Japanese company law is therefore classified as a German-type company law system within the civil law system.

After World War II, the influence of the German Joint-stock Company Act on Japanese corporate law diminished but continued to exist. The German Joint-Stock Companies Act (*Aktiengesetz* – AktG) of 1965, which had its 50th anniversary in 2015, had little impact on Japanese corporate law. Although many corporate law scholars were interested in the *Aktiengesetz* and researched, among other topics, *Konzernrecht*, Japanese commercial law did not introduce the systematic regulation of groups of companies. The Japanese Companies Act (JCA)[15] still lacks systematic protection for minority shareholders and creditors in subsidiaries. The introduction of the co-determination system by shareholders and employees has only been discussed as a theoretical issue in Japan.

After World War II, Japanese joint-stock company law was reformed under the strong influence of Anglo-American corporate law. Many American company law rules and systems were included, such as boards of directors, derivative suits and the inspection rights of minority shareholders. Japanese corporate law introduced the board of directors *(torishimariyaku-kai)* as a managing and supervisory organ in joint-stock companies but also maintained the traditional company auditor *(kansa-yaku).* The company auditor was originally modeled after the supervisory board system in Germany, but it is largely different from the current Germany advisory board *(Aufsichtsrat)* in that it has no right to appoint and dismiss managing directors.

The Japanese Companies Act (JCA) was formerly separated from commercial law, and it was substantially reformed in 2005.[16] The private limited liability company, which was modelled on the German GmbH, was abolished

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[14] Concerning the historical transformations of Japanese corporate law, see J. J. du Plessis/A. Hargovan/M. Bagaric/J. Harris, Principles of Contemporary Corporate Governance (Cambridge 2015) 434–438.

[15] *Kaisha Ho* [Companies Act], Law No. 86 (26 July 2005), English Translation (2 March 2015), available at <http://www.japaneselawtranslation.go.jp/?re=01>.

[16] Concerning the present Japanese statutory corporate governance regime of listed companies, see N. Nakamura, Japan – Listed companies' corporate governance, in: Fleckner/Hopt (eds.), Comparative Corporate Governance (Cambridge 2013) 244–263.

and substantially converged into the joint-stock company under the Japanese Companies Act of 2005.[17]

2. Authority of Shareholders' Meetings and Individual or Minority Shareholders' Rights

a) Japan[18]

Pursuant to the amendments to the Commercial Code of 1950,[19] which introduced many Anglo-American rules, the authority of the shareholders' meeting was restricted, and pre-emptive rights of shareholders in issuance of new shares were abolished, while a board of directors was introduced. On the other hand, individual or minority shareholders' rights were strengthened, e.g. the filing of derivative suits, petitions for injunctive relief and the provision of various types of information, including inspection rights. Appraisal rights were also introduced to enhance minority shareholder protection in cases of mergers and acquisitions.

In accord with several amendments to Japanese corporate law put in place after World War II, individual or minority shareholders' rights have been strengthened further. For example, a shareholder who holds either 1% or more of the total number of votes, or 300 votes or more, is able to request that his or her company convene a shareholders' meeting pursuant to the Commercial Code reform of 1981.[20] Such a shareholder has the right to have his or her proposal included in the notice of the meeting. The threshold for the percentage of shareholdings required for inspection rights was reduced from 10% to 3% under the amendments of 1993,[21] and the scope of these inspection rights was extended to include the documents of subsidiaries under the amendments of 1999.[22] The amendments to the Japanese Companies Act of 2014[23] permitted multiple-layered derivative suits, in which a shareholder of a parent company, who has shareholdings of 1% or more, is able to file a

[17] See *supra* note 15.

[18] Concerning the history of Japanese corporate law to 1899, see H. BAUM/ E. TAKAHASHI, Commercial and Corporate Law in Japan: Legal and Economic Developments after 1868, in: Röhl (ed.), History of Law in Japan since 1868 (Leiden et. al 2005) 330, 335–362.

[19] *Sho Ho no Ichibu wo Kaisei suru Horitsu*, Law No. 167 [1950 Amendments to the Commercial Code] (10 May 1950).

[20] *Sho Ho to no Ichibu wo Kaisei suru Horitsu*, Law No. 74 [1981 Amendments to the Commercial Code, etc.] (9 June 1981).

[21] *Sho Ho to no Ichibu wo Kaisei suru Horitsu*, Law No. 62 [1993 Amendments to the Commercial Code, etc.] (14 June 1993).

[22] *Sho Ho to no Ichibu wo Kaisei suru Horitsu*, Law No. 125 [1999 Amendments to the Commercial Code, etc.] (13 August 1999).

[23] *Kaisha Ho no Ichibu wo Kaisei suru Horitsu*, Law No. 90 [2014 Amendments to Companies Act (27 June 2014).

derivative suit pursuing the liability of its subsidiary's directors if the parent company holds all of that subsidiary's outstanding shares and the book value of the subsidiary's stocks accounts for more than 20% of the parent company's total assets.

The authority of shareholders' meetings in a Japanese joint-stock company depends on the company's governance structure, including whether it has a board of directors or not. A public joint-stock company *(kokai-kaisha),* in which all or some shares can be transferred without the approval of the company, must establish a board of directors. On the other hand, a closed joint-stock company *(hi-kokai-kaisha),* in which all shares can be transferred only with approval of the company, may voluntarily establish a board of directors.

The authority of a shareholders' meeting in a joint-stock company with a board of directors is limited to the matters provided for by the Japanese Companies Act and by the articles of association, while a shareholders' meeting in a closed company without a board of directors is able to resolve any matter concerning the organization and business of the company (Art. 290 paras. 1 and 2 JCA). A listed company always has a board of directors because it must be a public joint-stock company. Therefore, the authority of a shareholders' meeting in a listed company is narrower than that in companies without a board of directors.

Nevertheless, the authority of a shareholders' meeting in a company with a board of directors is sufficiently broad under the Japanese Companies Act; it should include the power to do the following: (1) amend the articles of association; (2) appoint and dismiss board members (directors and company auditors); (3) remunerate board members; (4) approve additional shares whose amount to be paid is particularly favorable to subscribers, (5) reduce share capital; (6) transfer all or a substantial amount of business; (7) create fundamental structural changes, such as the conversion of corporate forms, mergers, stock exchanges *(kabushiki-kokan)* and corporate splits; (8) approve of surplus dividends and annual financial statements; and (9) dissolve the company.

Furthermore, the limits of the autonomy, as defined in the articles of association, are generally interpreted broadly. The terms in the articles are, in principle, valid unless they are in violation of mandatory rules and regulations or public order.[24]

The reform of the Japanese Commercial Code (JCC) of 1981 purported to improve the shareholders' meeting and voting because they had been formalistic and had included little discussion. With the reform, Japan introduced a compulsory postal voting system for absent shareholders if the number of shareholders in a company was 1,000 or more (Art. 298 para. 2 JCC). Other companies may use the postal voting system according to the resolution of

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[24] K. EGASHIRA, *Kabushiki-kaisha Ho* [Laws of Stock Corporations] (6th ed. Tokyo 2015) 55–58.

the board of directors (Art. 298 para. 1 subpara. 3 JCC). The directors of a company that uses a postal voting system must provide shareholders with such information and voting cards as are required by law and regulations (Art. 301 para. 1 JCC) in order to facilitate a reasonable decision regarding the agenda and proposals prior to the shareholders' meeting. The convocation of a shareholders' meeting, the exercising of voting rights and the provision of information can be performed not with documents but by way of electronic communication according to the company law reform of 2001(Art. 298 para. 1 subpara. 4 JCC).[25] In practice, the Tokyo Stock Exchange (TSE) established an "Electronic Voting Platform for Foreign and Institutional Investors" to foster an environment in which foreign and institutional investors can exercise voting rights properly and promptly. The platform has been in operation since the end of 2005. More than 550 listed companies at the TSE have already agreed to participate in the platform.[26]

Thus, the Japanese Companies Act of 2005 can be said to be shareholder-friendly at least in terms of both the authority of shareholders' meetings and individual or minority shareholders' rights, such as proxy access and filing derivative suits.[27] In recent years, shareholders' rights have been strengthened further and ameliorated due to amendments to the Japanese Companies Act. Thus, there are few legal limitations or institutional obstacles from the viewpoint of shareholders' rights and powers in Japan.

b) Germany[28]

Under the German Joint-stock Company Act (*Aktiengesetz* – AktG), a company has a dual board system in which the supervisory board *(Aufsichtsrat)* is separate from the management *(Vorstand)*.[29] This separation is ensured by another-regulation: Members of the supervisory board are banned from being management, and management responsibilities cannot be conferred on the supervisory board. The supervisory board appoints and determines the aggregate remunera-

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[25] *Sho Ho to no Ichibu wo Kaisei suru Horitsu*, Law No. 128 [2001 Amendments to the Commercial Code] (28 November 2001).

[26] Japan Exchange Group, Electronic Voting Platform <http://www.jpx.co.jp/equities/improvements/voting-platform/>.

[27] G. GOTO, Legally "Strong" Shareholders of Japan, 3 Michigan Journal of Private Equity & Venture Capital Law (2014) 129–139.

[28] H. MERKT, Germany – Internal and external corporate governance, in: Fleckner/Hopt (eds.), Comparative Corporate Governance (Cambridge 2013) 521–571.

[29] MERKT, *supra* note 28, 529–536; K. J. HOPT, The German Two-Tier Board: Experiences, Theories, Reforms, in: Hopt/Kanda/Roe/Wymeersch/Prigge (eds.), Comparative Corporate Governance. The State of the Art and Emerging Research (Oxford 1998) 227–258; K. J. HOPT, The German Law of and Experience with the Supervisory Board, ECGI Law Working Paper No. 305/2016 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2722702>.

tion of the management; additionally, the board supervises the management and major corporate policies and strategies, such as increases in capital in a conditional capital system. If the articles of association require specific types of transactions and the approval of the supervisory board, a shareholders' meeting may approve individual administration of the business. The supervisory board consists of representatives of not only the shareholders but also the employees according to the Co-determination Act.[30] The German Joint-stock Company Act relies on internal corporate institutions, namely the two boards and the general shareholders' meeting, to constrain managerial power, rather than the discipline of stock markets. These institutional constraints were designed to protect the interests of creditor banks and employees as important stakeholders in the firm. The stakeholder model in Germany is partially codified.

The authority of shareholders' meetings in German joint-stock companies is limited compared not only with that in Japanese joint-stock companies having no boards of directors but also with that in such companies having boards of directors. The shareholders' meeting must resolve all matters expressly stated in the German Joint-stock Company Act and the articles of association (§ 119 para. 1 AktG), and the articles may contain different provisions from those of the German Joint-stock Company Act only if the act explicitly so permits (§ 23 para. 5 AktG). For the following matters, the resolution of a shareholders' meeting is required by the German Joint-stock Company Act: (1) the appointment and dismissal of the members of the supervisory board and the auditor, (2) the approval of dividends, (3) amendments to the articles of association, (4) measures to increase or reduce the share capital, and (5) the dissolution of the company (§ 119 para. 1 AktG) as well as various other fundamental structural measures, such as mergers and the conclusion of enterprise agreements (§§ 293 para. 1, 319 para. 1, 320 para. 1, 327a para. 1 AktG, §§ 13 para. 1, 59, 76 para. 2, 128 UmwG – *Umwandlungsgesetz* (German Transformation Act). Furthermore, a shareholders' meeting may decide on matters concerning the management of the company only if required to by the management board (§ 119 para. 2 AktG). A shareholders' meeting has the right to receive relevant information regarding issues such as mergers, acquisitions, capital increases and major changes in business strategies.

Regarding individual and minority shareholders' rights, a shareholders' meeting can be called by shareholders whose holdings in aggregate equal or exceed one-twentieth of the share capital (§ 122 para. 1 AktG). Shareholders whose shares amount, in aggregate, to not less than one-twentieth of the share

[30] K. J. HOPT, Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe, 14 International Review of Law and Economics (1994) 203; K. PISTOR, Codetermination: A Socio-Political Model with Governance Externalities, in: Blair/Roe (eds.), Employees and Corporate Governance (Washington D.C. 1999) 164–193.

capital or represent an amount of the share capital corresponding to 500,000 Euros have the right to demand that items be placed on the agenda of a shareholders' meeting (§ 122 para. 2 AktG).

Shareholders whose aggregate holdings at the time of the filing of the petition equal or exceed one-tenth of the share capital or one million Euros may file a petition to appoint persons other than the representatives appointed by the shareholders' meeting who can assert claims on the part of the company for damages against members of the management board or supervisory board with respect to the management of the company or against persons who exerted influence on the company or induced a member of the management board or the supervisory board to act to the disadvantage of the company or its shareholders if the court acknowledges that such an appointment is appropriate for the proper assertion of such claim (§ 147 para. 2 AktG). Furthermore, shareholders whose aggregate holdings at the time of the filing of the petition equal or exceed one percent of the share capital or amount to at least 100,000 Euros may file a petition for the right to assert claims of the company for damages mentioned above in their own names (§ 148 para. 1 AktG).

Upon petition by shareholders whose aggregate holdings at the time of the filing of the petition equal or exceed one percent of the share capital or amount to at least 100,000 Euros, the court shall appoint special auditors provided that facts exist that give the court reason to suspect that improprieties or gross breaches of the law or the articles have occurred in connection with such a matter (§ 142 para. 2 AktG) or if this appears necessary for reasons relating to the individual special auditor appointed, namely if such an auditor lacks the expertise required for the subject matter of the special audit or if concerns as to his impartiality or doubts as to his reliability exist (§ 142 para. 2 AktG).

A control agreement or profit-transfer agreement will, in addition to the obligation to provide compensation (§ 304 AktG), include the obligation of the other contracting party to acquire the shares of any outside shareholder upon demand by such shareholder against payment of an adequate settlement specified in the agreement (§ 305 para. 1 AktG). The former shareholders of the integrated company are entitled to an adequate settlement.

If the cash compensation is inadequate, the court determined by § 2 of the Act on Valuation Proceedings under Corporate Law (SpruchG – *Gesetz über das gesellschaftsrechtliche Spruchverfahren*) will set adequate cash compensation. The same applies if the principal shareholder has not duly offered cash compensation (§ 327f AktG).

When the ratio applicable to the exchange of shares in a merger has been specified at too low a value, each of the owners of shares in this legal entity may demand that the acquiring legal entity provide compensation via an additional cash payment (§§ 15 para. 1, 125, 196, 212 UmwG).

The board members being acquired are under obligation, jointly and severally, to provide compensation for those damages suffered by the company or the owners of its shares as a result of the merger (§§ 25 para. 1 UmwG). The claims may only be asserted by a special representative. The court having jurisdiction at the registered seat of a legal entity being acquired is to appoint such a representative upon a corresponding petition having been filed by a shareholder (§ 26 para. 1 UmwG). When a joint-stock company merges by way of absorption with a legal entity having a different legal form or when a listed joint-stock company merges into an unlisted company, the acquiring legal entity is to offer – in the merger agreement to each of the owners of shares recording an objection against the merger resolution adopted by the company being acquired – to acquire those owners' shares in return for appropriate cash compensation (§ 29 para. 1 UmwG). Where an owner of shares asserts that the cash compensation that was to be offered to him has been specified in the merger agreement or in its draft at too low a value, a shareholders can petition the court to determine the appropriate cash compensation in accordance with the regulations set out in the Act on Valuation Proceedings under Corporate Law (SpruchG). The same will apply if the cash compensation was not offered or not offered in a proper manner where a joint-stock company merges by way of absorption with a legal entity having a different legal form, or where a stock corporation listed on the stock exchange merges into an unlisted stock corporation (§ 34 para. 1 UmwG).

Thus, the German Joint-stock Company Act of 1965 and the Transformation Act of 1994 can also be said to be shareholder-friendly in terms of both the authority of shareholders' meetings and individual or minority shareholders' rights, such as proxy access and the filing of derivative suits. Minority shareholders in particular are strongly protected from any disadvantage that may arise due to the influence of the controlling enterprise.

III. Limits of Shareholder Control and the Transformation of Corporate Governance in Japan and Germany

1. Background

Notwithstanding the broad authority of the shareholders' meeting and strong individual or minority shareholders' rights under the Japanese Companies Act, it has been pointed out that the reality does not correspond with the legal system.[31] This has been evidenced by almost no successful hostile takeovers,[32] a

[31] GOTO, *supra* note 27, 142–144.

[32] K. OSUGI, Transplanting poison pills in foreign soil, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 37; C. J. MILHAUPT/K. PISTOR, Law & Capitalism (Chicago 2008) 90–91.

failure of confrontational hedge fund activism,[33] only few shareholder proposals,[34] and only few derivative suits[35] in Japan.

On the other hand, the stock prices of Japanese listed companies have long been stagnant after the burst of the bubble economy of the 1990s. The median of ROE (return on equity) of listed companies in Japan is evidently low in international comparison (Figure 1). The reason for this is not apparent, but, among other aspects, the weak control on the part of shareholders over financial institutions may be responsible to some extent.[36] The weak control on the part of shareholders and the ineffective exercise of shareholder rights can be structurally observed in Japanese listed companies, specifically as regards (1) the concentration of a substantial amount of the power of a joint-stock company within management,[37] (2) the weakening of shareholders' rights according to cross-shareholding,[38] and in a broader context (3) law stands in the background in Japan, its being available to coerce recalcitrant parties into cooperation and compliance but not being the first tool used to regulate economic activities[39] or achieve other desired ends. The stakeholder model and cultural

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33 J. BUCHANAN/D. H. CHAI/S. DEAKIN, Hedge Fund Activism in Japan – The Limits of Shareholder Primacy (Cambridge 2012) 240–281.

34 The number of shareholder proposals in listed companies in Japan was formerly very small but has been increasing in recent years. For example, the number of shareholder proposals was only two in fiscal year 1985 (from 1 April 1985 to 31 March 1886), thirteen in 1995, twenty-one in 2005 and forty-four from 1 July 2014 to 30 June 2015. T. NAKANISHI, *Kabunusi sokai to no hensen* (7) [Transformation of Shareholders' Meeting No. 7], Siryoban Shoji Homu 338 (2012), Graf 1, 20, and T. MAKINO, *Kabunusi sokai no jirei bunseki – Heisei 26 nen 7 gatsu sokai ~ Heisei 27 nen 8 gatsu sokai* [Shareholders' Meeting from 1 July 2014 to 30 June 2015], Siryoban Shoji Homu 378 (2015) 92.

35 The derivative action system was introduced by the 1950 company law reform under the influence of American corporate law. The total number of derivative suits in Japan during the period of 1950 to 1990 was approximately only 20 (C. J. MILHAUPT, A Lost Decade for Japanese Corporate Governance Reform?: What Changed, What Hasn't, and Why, Columbia Law and Economics Working Paper No. 234 (2003) 12). Due to the reduction of the filing fee for derivative suits achieved by the corporate law reform of 1993, the number of derivative suites increased from near zero to an average of over 150 suits per year (T. FUJITA, Transformation of the management liability regime in Japan in the wake of the 1993 revision, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 16–18). M. NAKAHIGASHI/D. PUCHNIAK, Land of rising derivative action: revisit in irrationality to understand Japan's unreluctant shareholder litigant, in: Puchniak (ed.), The Derivative Action in Asia (Cambridge 2012) 128-185.

36 G. JACKSON/H. MIYAJIMA, Introduction: The Diversity and Change of Corporate Governance in Japan, in: Aoki/Jackson/Miyajima (eds.), Corporate Governance in Japan: Institutional Change and Organizational Diversity (Oxford 2007) 20.

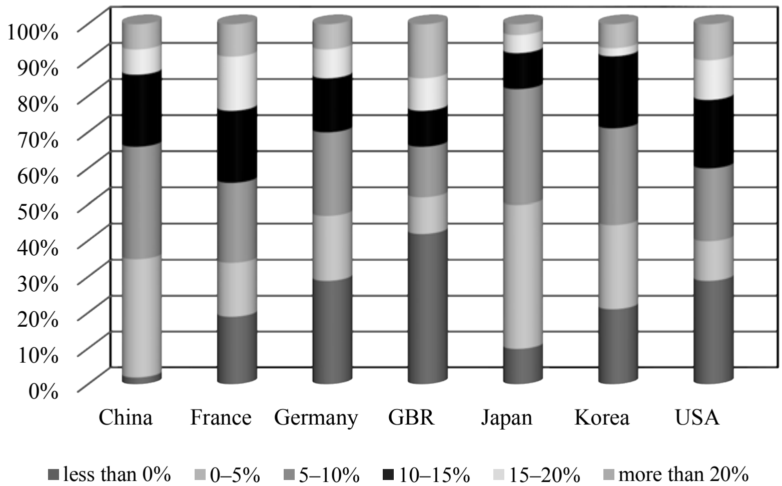
37 EGASHIRA, *supra* note 24, 49-50.

38 MILHAUPT/PISTOR, *supra* note 32, 90; DU PLESSIS/HARGOVAN/BAGARIC/HARRIS, *supra* note 14, 456.

39 MILHAUPT/PISTOR, *supra* note 32, 91.

background, which are based on traditional Japanese corporate governance, that is, the concentration of power within management and core employees, may contribute to the weak and ineffective exercising of shareholder rights.[40]

Figure 1: International Comparison of ROE –Past 10 years (2000 to 2010)[41]



	China	France	Germany	GBR	Japan	Korea	USA
Median	7.13	8.40	5.94	3.77	4.97	6.99	7.72
Standard Deviation	13.03	25.15	39.28	964.11	10.38	16.77	158.25

Interestingly, German and Japanese corporate governance share some important common features, in contrast with the Anglo-American corporate governance model.[42] The similarities in corporate governance in both of the countries are as follows: First, the stakeholder-oriented model prevails in Germany and Japan, in contrast to the shareholder-oriented model which prevails in Anglo-American countries.[43] Second, the main banks have tradi-

[40] K. OSUGI, Stagnant Japan? Why outside (independent) directors have been rare in Japanese companies, in: Shishido (ed.), Enterprise Law (Cheltenham et al. 2014) 251.

[41] Individual companies' median value for the past 10 ten years was calculated based on 2000–2010 data in Compustat Global. The chart shows the distribution of individual companies' median value. Reference: T. KAGAYA, Toward the Sustainable Creation of Value by Japanese Companies – 1st Year Achievements by the Corporate Reporting Lab, (2013.7)

[42] M. AOKI, Information, Corporate Governance, and Institutional Diversity: Competitiveness in Japan, The USA, and the Transitional Economies, translated by Stacy Jehlik (Oxford 2001).

tionally monitored borrowing companies vigilantly.[44] A main bank has monitored the borrower corporation's management and provided assistance with finance and personnel in cases where the corporation has become financially troubled.[45] Third, cross-shareholding is prevalent. The core purpose of the Japanese and German corporate governance system is to produce stability for systems that were characterized by massive uncertainty after World War II.[46] Nevertheless, these trends have seemed to change recently in both of these two countries.

Under the stakeholder-oriented model, there is a tension between the incentives of risk-averse, fixed creditors and shareholders as residual claimants. Under the shareholder-oriented model, it is easy to detect and repair flaws or defects in a shareholder's own corporate governance system because the goal of corporate governance is clear and simple, namely the maximization of value for shareholders. Therefore, the United States has been repairing its corporate governance system by freeing up the market for corporate control and loosening the regulation of hedge funds and private equity funds.[47] On the other hand, management tends to avoid large amounts of risk, especially under the stakeholder-oriented model, in which employees and occasionally banks are the most important stakeholders and the goal of corporate governance is unclear because of conflicts in the various stakeholders' interests.

Nevertheless, these trends have begun to change in both Japan and Germany. First, the concept of shareholder value maximization is gradually prevailing in both countries. There could be various reasons for the change. Shareholder activism and pressure from institutional investors are increasing in both Japan and Germany. Also, the changes in the legal framework based on this concept may be connected to the transformation.[48] Secondly, related to the first point, the ratio of shareholdings on the part of banks is on the decline.[49] Thirdly, corporate ownership in Japan and Germany is currently becoming more international than ever before, especially the ratio of sharehold-

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43 M. J. LOEWENSTEIN, What Can We Learn from Foreign Systems? Stakeholder Protection in Germany and Japan, 76 Tulane Law Review (2001–2002) 1673.

44 M. J. ROE, Some Differences in Corporate Structure in Germany, Japan and the United States, 102 Yale L.J. (1993) 1927, 1946–1948; R. T. GILSON/R. KRAAKMAN, Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate, 45 Stan. L. Rev (1993) 987–989.

45 C. J. MILHAUPT/M. D. WEST, Economic Organizations and Corporate Governance in Japan: The Impact of Formal and Informal Rules (Oxford 2004) 13.

46 J. R. MACEY, Corporate Governance (Princeton 2011) 233 and 318.

47 MACEY, *supra* note 46, 225.

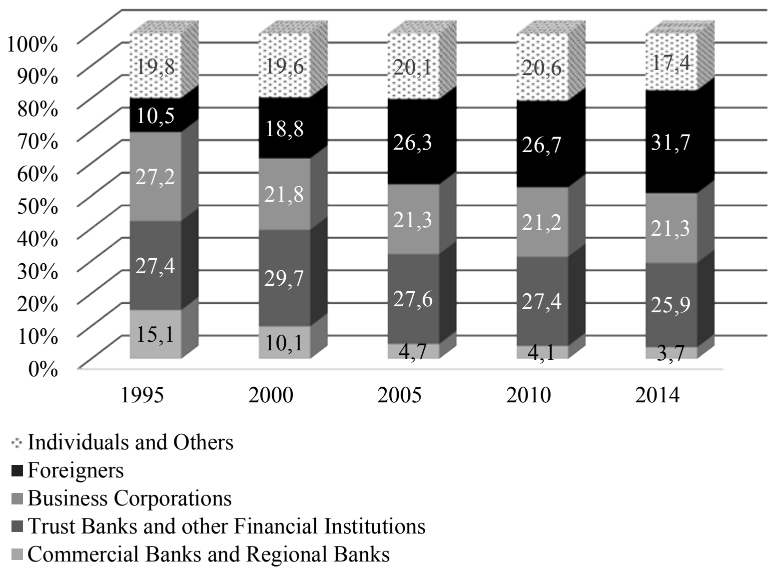
48 MERKT, *supra* note 28, 551; C. J. MILHAUPT, Introduction: the (uneven, incomplete, and unpredictable) transformation of corporate governance in East Asia, Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 2.

49 W.-G. RINGE, Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG, 63 Am. J. Comp. L. (2015) 494.

ings by foreign institutional investors is dramatically increasing. Due to globalization and market pressure, the costs of holding an undiversified block of shares in a company began to exceed the blockholders' private benefits, and the economic case for blockholding is disappearing.[50] All of these transformations are thus in line with the new task of facing increased managerial agency costs in listed companies.

2. *Limits of Shareholder Control in Japan*

Figure 2: Ownership Structure in Japanese Listed Companies by Investment Sector[51]



As of 31 January 2016 the total number of listed companies on the Tokyo Stock Exchange (TSE) stood at 3,506. The TSE accounts for about 80% of the nation's listed stock companies. As of 31 December 2014 a total market capitalization valued at 524.8 trillion Yen.[52] The ownership structure of Japa-

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[50] J. N. GORDON, Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany, 5 Colum. J. Eur. L. (1999) 221.

[51] Source: Tokyo Stock Exchange, Shareholder Survey Data. Unit: %. Figures are based on data as of each fiscal year-end.

[52] Japan Securities Dealers Association Fact Book 2015 (2015) 27. Regarding the ownership structure in the 20th century, see J. FRANKS/C. MAYER/H. MIYAJIMA, The Ownership of Japanese Corporations in the 20th Century, ECGI Finance Working Paper no. 410/2014 (2014).

nese listed companies is as follows:[53] As of March, 2015, the ratio of stocks held by foreign investors was 31.7%, 27.4% being held by financial institutions, 21.3% by industrial companies and 17.3% by individuals and others. The percentage of shareholding by commercial and regional bank accounts was only 3.7%. The percentage of stocks held by financial institutions has been increasing and is currently 59.1%. This means that the ownership of stocks has become highly concentrated, and collective action on the part of financial institutions has become more feasible. In Japan, shareholding by financial institutions contributes to the stability of the ownership structure and thus the stability of management. One reason for this is an investment strategy known as passive or index management, which large financial institutions usually adopt. Once a portfolio is structured, a fund manager has less incentive to monitor individual companies in the portfolio. A second reason is the problem of conflicts of interest. The interests of ultimate investors are not necessarily aligned with the interests of financial institutions.

More than one-third of the listed companies do not have a shareholder with more than 10% of the shares, while over 90% of listed companies do not have a shareholder who has more than 50% of the shares.

The power in a Japanese listed company is usually concentrated within the management and core employees.[54] Thus, the management of a listed company takes primarily the employees' interests into account rather than the shareholders' interests. This feature depends partly on the Japanese internal career advancement system. In a traditional Japanese corporation, management and core employees are promoted according to seniority under the lifelong employment system. In other words, the CEOs of Japanese listed companies often come from among their employees. A rigid pyramid is established in which the CEO is placed at the top and new, young employees form the bottom based upon a lifelong employment system.[55] Management prefers avoiding employee lay-offs to hiring new employees or to receiving additional compensation.[56] On the other hand, the external labor market for managers, employees and outside directors is underdeveloped, notwithstanding the fact that the liquidity of the labor market is gradually increasing.

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[53] The Tokyo Stock Exchange, The Nagoya Stock Exchange, The Fukuoka Stock Exchange & The Sapporo Stock Exchange, 2014 *nendo kabushiki bunpu jokyo chosa no gaiyo* [Investigation], p. 4.

[54] EGASHIRA, *supra* note 24, 49–50; B. E. ARONSON, Japanese Corporate Governance Reform: A Comparative Perspective, 11 Hastings Bus. L.J. (2015) 95.

[55] DU PLESSIS/HARGOVAN/BAGARIC/HARRIS, *supra* note 14, 458.

[56] R. J. GILSON/M. J. ROE, Lifetime Employment Labor Peace and the Evolution of Japanese Corporate Governance, 99 Colum. L. Rev. (1999) 538; S. M. JACOBY, Employee Representation and Corporate Governance: A Missing Link, 3 U. Pa. J. Lab. & Emp. L. (2001) 462.

Furthermore, it is pointed out that the concentration of power within management and core employees in a Japanese listed company is connected to cultural background. A Japanese listed company is often equated not with its shareholders but with a "community firm" that is not run primarily for the benefit of shareholders but for the company itself as a continuing entity. The notion of a community firm connotes certain values concerning the way that a company is seen by its employees and the way in which managers interpret their duties as owed to the organization.[57] In this community, firm-specific skills and contextual knowledge are deemed important and attachment to manufacturing is emphasized. This is complemented by the ownership structure and culture.[58]

Cross-shareholdings in Japanese listed companies were caused by the liquidation of the traditional "zaibatsu" corporate groups after World War II.[59] Many stocks were distributed among individual investors. Hence, the ratio of shares held by individuals peaked at 69.1% in 1949. However, the shares held by individuals were gradually sold in the market, and companies purchased them mutually.[60] Furthermore, since the regulation of foreign exchange and capital transfer was liberalized in the 1960s, Japanese listed companies have sought to protect against mergers and acquisitions by foreign capital. The main measure taken was to construct a stable ownership structure based on cross-shareholdings between industrial companies and financial institutions, especially major banks. The ratio of shareholdings by financial institutions was high in 1986, at 61.8%. Traditional financial institutions like banks and insurance companies are motivated to maintain and continue their business relationship by cross-shareholdings, rather than to obtain dividends and capital gains.[61] This bank-centered system was formerly characteristic of the Japanese financial system and there was usually pressure to construct a larger corporate group to facilitate bank financing.

Thereafter, the percentage of shareholdings on the part of commercial banks gradually decreased to 3.7% by 2014 fiscal end (Figure 2). From the 1990s the ownership ratio of domestic banks and insurance companies decreased rapidly, and in their place, the ownership ratio of trust banks and foreign institutional investors increased substantially.[62] Cross-shareholdings

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[57] BUCHANAN/CHAI/DEAKIN, *supra* note 33, 107–110.

[58] OSUGI, *supra* note 40, 261–264.

[59] Japan Securities Research Institute, Securities Market in Japan 2014 (2014) 57–59.

[60] Concerning the history of cross-shareholding in Japan, see H. MIYAJIMA/F. KUROKI, The Unwinding of Cross-Shareholding in Japan: Causes, Effects, and Implications, in: Aoki/Jackson/Miyajima (eds.), Corporate Governance in Japan: Institutional Change and Organizational Diversity (Oxford 2007) 79–124.

[61] BUCHANAN/CHAI/DEAKIN, *supra* note 33, 155–159.

[62] H. MIYAJIMA/T. TODA, Ownership Structure and Corporate Governance: Has an Increase in Institutional Investors' Ownership Improved Business Performance?, Policy

are also decreasing. After a burst of high stock prices in Japanese capital markets, the stock price declined sharply in the late 1990s. This was caused mainly by the banking crisis of 1997–1998; subsequently, banks were forced to release their shareholdings because of new regulations requiring that as of 2001 the values of shareholdings must be evaluated at their market prices.[63] Furthermore, banks had to deduct 60% of their unrealized losses from their earned surplus.

Nevertheless, it is to be noted that the unwinding of cross-shareholding and the increase in foreign investment is taking place primarily in large public corporations, while small and medium-sized listed corporations still seem to have a relatively high ratio of cross-shareholdings and a lower percentage of shareholding by foreign investors.[64] Furthermore, in the 2000s, cross-shareholdings among nonfinancial companies started to rise again, perhaps as defensive measures against hostile takeover bids.[65]

3. Limits of Shareholder Control and the Transformation in Germany

At the Deutsche Börse AG shares of 711 enterprises were trading at the end of July 2014, and they had a market capitalization of around 1,200 billion Euros.[66] The features of German corporate governance include the strong influence of block-shareholders, the presence of cross-shareholdings between companies and the powerful role of banks. In addition to their direct shareholdings, banks are also able to vote using shares that they hold on behalf of clients as depositories. German banks represented 84% of all voting rights present in general shareholder meetings of German blue chip companies and held 12% of all available board seats in 1992.[67]

Several of these features are addressed in law and regulation. Minority shareholder protection was the natural response to strong controlling shareholders. Therefore, the German legal system provides a number of such protective tools known as the law of corporate groups *(Konzernrecht)*.[68] The strong influence of controlling shareholders seems to be reflected in German company law regulation.

German listed corporations are often, though increasingly rarely, controlled by one shareholder or a group of shareholders. On the other hand,

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Research Institute, Ministry of Finance, Japan, Public Policy Review, Vol. 11, No. 3 (2015) 365.

[63] Japan Securities Research Institute, *supra* note 59, 59.

[64] GOTO, *supra* note 27, 145–146.

[65] Japan Securities Research Institute, *supra* note 59, 59.

[66] Deutsche Bundesbank Monthly Report September 2014, p. 20.

[67] T. BAUMS/P. V. RANDOW, Shareholder Voting and Corporate Governance: The German Experience and a New Approach, in: Aoki/Kim (eds.), Corporate Governance in Transitional Economies: Insider Control and the Role of Banks, The World Bank (1995) 435.

employees and labor unions have the right to have their representatives seated in the monitoring board according to the Co-determination Act. The features of corporate governance are recognized as a stakeholder model, which is authorized by law.

The ownership structure of listed companies, which was characterized as concentrated ownership for a long time, has now become quite dualistic with a number of enterprises still under tight control but with others now having a broad ownership base.[69] The ownership structure of listed companies in Germany is more concentrated than that of Japanese companies (Table 1). The proportion of "free float" in companies belonging to the DAX30 has grown from 64.5% in 2001 to 82.6% in 2009.[70] Furthermore the free float of the largest 30 companies comprising the DAX increased from 64.5% in 2001 to over 80% in 2010;[71] additionally foreign and domestic institutional institutes own 70% of the outstanding shares, and foreign ownership now exceeds 50% in a number of them.[72]

Furthermore, the ownership structure in German listed corporations is characterized by frequent cross-participation, sometimes between industrial companies, but more frequently between industrial companies and banks. Unlike the Japanese web of individually intertwined small groups (*keiretsu*), one of the hallmarks of the German system is its exhibiting one large web of cross-participation, formerly covering almost the entire population of large German firms.[73]

Table 1: Ownership Structure of DAX-Companies (in %)[74]

Year / Owner	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Domestic Investor	44.1	41.9	35.1	43.9	36.9	36.5	38.1	36.6	35.4	36.3
Private Investors	14.4	12.2	10.6	11.5	13.7	13.9	14.3	13.7	12.7	12.9
Institutional Investors	27.1	27.2	22.3	30.0	21.1	20.9	21.8	20.9	21.0	21.7
Non-financial Investors	7.6	8.8	9.3	17.8	10.1	10.2	10.2	9.6	9.7	9.8

68 P. HOMMELHOFF, Protection of Minority Shareholders, Investors and Creditors in Corporate Groups: The Strengths and Weaknesses of German Corporate Group Law, EuR. 2 Bus. Org. L. Rev. (2001) 61.

69 OECD, *supra* note 5, 112.

70 The definition of "free float" is that shares do not belong to a block of shares constituting 5% or more of the total. Aktionärsstruktur von DAX-Unternehmen, Bundeszentrale für Politische Bildung (25 September 2010), <http://www.bpb.de/nachschlagen/zahlen-und-fakten/globalisierung/52596/aktionaersstruktur-dax>.

71 OECD, *supra* note 5, 113.

72 OECD, *supra* note 5, 115.

73 RINGE, *supra* note 49, 498.

74 Source: Deutsche Bundesbank Monthly Report September 2014, p. 27.

Owner \ Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Financial Investors	19.5	18.4	13.0	12.2	11.0	10.7	11.7	11.3	11.2	11.9
Bank	6.3	5.8	3.3	3.5	2.3	2.0	2.2	2.1	2.7	3.3
Mutual Funds	10.7	10.4	7.6	7.3	7.6	7.7	8.7	8.5	8.0	7.7
Insurance Companies	1.7	1.6	1.7	1.0	0.9	0.8	0.7	0.6	0.4	0.5
Other financial Investors	0.8	0.6	0.5	0.4	0.2	0.2	0.1	0.1	0.2	0.3
Foreigners	55.9	58.1	64.9	56.1	63.1	63.5	61.9	63.4	64.6	63.7
EU (without Germany)	29.5	30.9	35.2	31.3	34.6	32.4	27.9	32.7	34.6	33.8
Switzerland	5.0	4.3	4.2	4.0	4.9	5.3	5.4	5.5	5.2	5.2
USA	13.1	15.0	16.8	14.2	15.9	18.6	20.7	16.9	16.4	16.5
Other Countries	6.3	5.4	5.5	5.0	6.5	7.0	6.7	7.5	7.8	7.6

Nevertheless, the ownership structure of listed companies in Germany has been drastically transformed in recent years. In companies that made up the DAX30 in 2001 and 2014, the size of the average largest share block dropped from 28.89% to 17.91% respectively.[75] Concerning the ownership structure at the end of May 2014,[76] the domestic share amounted to 42.9%. Domestic institutional investors, as a whole, held 29.4% of all German equities, with 18.3% being attributable to non-financial investors and 11.1% being attributable to financial investors. Non-financial investors include all enterprises that predominantly produce goods and non-financial services, as well as holding companies that hold stakes in other non-financial corporations. Domestic mutual funds held 6.3% of all German equities.

German banks and financial investors have generally tapered their investment in German equities over the course of the crisis, primarily in response to tighter regulatory requirements, much like those seen in Japan. They have been replaced by non-financial institutional investors, such as holding companies, which have enlarged their stakes in German listed companies.[77] More than half of the market capitalization of German publicly-held joint-stock companies (57.1%) was held by foreign ownership. However, only around 10% of foreign holdings are held directly by non-resident households or financial and non-financial institutional investors using German banks or central securities depositories. The remainder of the foreign ownership share is held in custody by foreign central securities depositories and banks with German account-keeping institutions. Thus, it can be plausibly assumed that the non-resident investors are almost entirely institutional investors.[78]

[75] RINGE, *supra* note 49, p. 509.
[76] Deutsche Bundesbank Monthly Report September 2014, p. 24.
[77] Deutsche Bundesbank Monthly Report September 2014, p. 19.
[78] Deutsche Bundesbank Monthly Report September 2014. p. 23.

The system of strong networks dominated by blockholders and cross-shareholdings may no longer exist in Germany.[79]

The transformation has been caused not only by globalization and market pressure but also by changes in capital gains taxation put into place in 2002. Namely, higher capital requirements for banks and the implementation of new insider trading regulation have led to a substantial unwinding of cross-holdings in the last ten years.[80] The presence of bankers as board members has also declined, and they now emphasize that they are acting in a personal capacity. Since 1998 depositaries also need explicit approval to vote shares held as a custodian. *Deutschland AG* in its traditional form, with numerous cross-holdings and shared non-executive directorships and retiring CEOs routinely becoming chair of the supervisory board, is very much becoming a thing of the past.[81]

IV. Measures to Enhance Shareholders' Corporate Control

1. Expectations of and Impediments to Effective Corporate Control by Shareholders

Individual shareholders cannot be expected to exercise shareholders' rights effectively because of rational apathy and their lack of information.[82] Although institutional investors are expected to control the management of invested companies effectively, there are three impediments and limits.

Firstly, there are several reasons why institutional investors will impede the appropriate exercise of shareholders' rights, including voting rights.[83] Normally, non-activist institutional investors are also "rationally reticent".[84] Concretely, traditional institutional investors adopt passive investment strategies. The high level of portfolio diversification dictated by the prudent investor rule limits the portion of a company's capital that can be held. These investors do not have an incentive to incur costs for actions or the exercise of

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[79] RINGE, *supra* note 49, 516.

[80] OECD, *supra* note 5, 112.

[81] Commission Staff Working Document Impact Assessment, Accompanying the document Proposal for a Directive of the European Parliament and of the Council on amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement and Commission Recommendation on the quality of corporate governance reporting ('comply or explain'), SWD (2014) 127 final, 17–25; OECD, *supra* note 5, 112.

[82] MACEY, *supra* note 46, 199.

[83] OECD, *supra* note 5, 12–16.

[84] R. J. GILSON/J. N. GORDON, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. (2013) 867.

shareholders' rights that would cause a free-riding problem.[85] On the other hand, significant economic costs are associated with implementing voting and engagement strategies.

Secondly, there are external situations regarding the listed companies. For example, cross-shareholding will impede the effective exercise of voting rights by other shareholders, especially when the exercise of voting rights based on cross-shareholding is substantial and biased by the shareholding.[86]

Thirdly, a lengthy and complex investment chain makes it difficult for shareholders, especially foreigners, to exercise their rights in a timely and appropriate way. Such an investment chain entails the insertion of various intermediaries between ultimate equity holders and the issuing company, e.g. asset owners, asset managers and proxy advisors. The investment chain creates an agency problem between ultimate shareholders and these various intermediaries. For example, while the end-beneficiaries of institutional investors have an interest in long-term performance, the performance of those intermediaries, typically external asset managers, is being evaluated on a short-term basis. This situation can be called "the separation of ownership from ownership".[87]

The G20/OECD Principles of Corporate Governance stipulate that the exercise of ownership rights by all shareholders, including institutional investors, should be facilitated (Principles II.F). The G20/OECD Principles also stipulate the best practices for institutional investors. First, they must disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place to determine their use of their voting rights when they act in a fiduciary capacity. Second, they must disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments. Third, the Principles include so-called engagement with management which is a way that contributes to good corporate governance (OECD Principles III.). Institutional shareholders should be allowed to consult with each other on issues concerning their basic shareholder rights, subject to exceptions to prevent abuse (OECD Principles II.D).

On the EU level, the European Commission analyzed the causes of the 2008 financial crisis and raised questions about the role of institutional investors with respect to their strong tendency to privilege short-termism and maintain a passive attitude towards management and boards. The European Commission

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[85] M. BECHT/J. FRANKS/C. MAYER/S. ROSSI, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, in: Bratton/McCahery (eds.), Institutional Investor Activism (Oxford 2015) 224.

[86] See *supra* note 38 and accompanying text.

[87] Kay Review, *supra* note 4, 22; U. RODRIGUES, Corporate Governance in an Age of Separation of Ownership and Ownership, 95 Minn. L. Rev. (2011) 1822.

published an action plan in 2012 that focused on long-term investment and shareholder engagement.[88] Based on the action plan, the European Commission published a draft of the directive on the rights of shareholders for revision (Directive 2007/36/CE) in April of 2014.[89] The draft in question emphasizes the need for transparency on the part of institutional investors and asset managers regarding their investment and engagement policies.

2. *Japan*

a) *Voting Rights and Engagement*

First of all, there are specific problems impeding the effective exercise of voting rights by institutional investors in Japan.[90] First, the period for examination and consideration regarding voting is short because the convening notice for a shareholders' meeting is to be sent to all shareholders no later than two weeks prior to the meeting's date (Art. 299 para. 1 JCA). It is especially difficult for foreign shareholders to examine proposals after the receipt of the convocation. Second, the dates of shareholders' meetings in Japanese listed companies are concentrated at the end of June. For example, in 2014, shareholders' meetings in 80% of listed companies in the Tokyo Stock Exchange took place within a period of only four days, from 24 June to 27 June. The concentration of shareholders' meetings in Japan is prevalent because the business year of most Japanese company starts on 1 April and ends on 31 March of the next year, and the record date for voting rights and dividend claims is often set as 31 March. In Japan, most listed companies' shareholders' meeting takes place at the end of June, since a record date is effective for those rights that are exercised within three months of the date (Art. 124 paras. 1 and 2 JCA). Third, the setting of a record date causes another problem, so-called "empty voting". A shareholder who was listed in the shareholders' register on a record date and sold his or her shares after the date is not only entitled to attend and vote at a shareholders' meeting in June but also to receive the dividends. Some law professors criticize the practice regarding record date for a general shareholders' meeting in Japan as unreasonable.[91]

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[88] European Commission, Action Plan: European company law and corporate governance – 12 December 2012.

[89] See *supra* note 4.

[90] Ito Review of Competitiveness and Incentives for Sustainable Growth – Building Favorable Relationships between Companies and Investors – Final Report (August 2014), <http://www.meti.go.jp/english/press/2014/pdf/0806_04b.pdf> Section 12, para. 18, pp. 111–112.

[91] W. TANAKA, *Teiji kabunushi sokai ha naze rokugatsu kaisai nanoka* [Why Do General Shareholders' Meetings in Japan Take Place in June?], *Egashira Kenjiro Sensei Kanreki Kinen: Kigyo ho no riron* [Festschrift for Prof. Kenjiro Egashira for his 60th birthday: The Theory of Enterprise Law] (Chuo-ku 2007) 415–497.

In Japan, issues that impede the effective exercise of shareholders' rights are expected to be resolved via not only company law reform but also via a soft-law approach. Reform initiatives intended to enhance effective reform include the introduction of proposal rights by shareholders and voting by documents according to the reform of the Japanese Companies Act (II.B(1)). With regard to enhancement of shareholder control over corporate governance via a soft-law, Japan's Stewardship Code of 2014 (JSC) and Corporate Governance Code of 2015 (JCGC) should be noted.

The engine powering the formation of the Stewardship Code and the Corporate Governance Code was the Japanese government.[92] The backdrop of the policy of the Japanese government is longstanding, low stock prices and ROE in Japanese listed companies. The enhancement of the attractiveness of Japanese stock markets and the improvement of the stock price of Japanese listed companies are the goals of the Japanese government. This is indicated by the fact that in Japan, the Stewardship Code was created before the Corporate Governance Code.[93]

These two codes adopt a principles-based approach so as to achieve their goals in accordance with each company's particular situation. Furthermore, these codes assume that if a company finds specific principles to be inappropriate in view of its individual circumstances, the general principles need not be complied with provided that the company fully explains the reasons it does not wish to comply.

While an institutional investor voluntarily signs up for Japan's Stewardship Code, a listed company must subject itself to Japan's Corporate Governance Code according to the securities listing regulation. The "comply or explain" rule is enforced with sanctions by the Tokyo Stock Exchange and by market forces.

According to Japan's Corporate Governance Code of 2015, companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively (JCGC, General Principle 1). Furthermore, companies

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[92] Concerning the background of Japan's Stewardship Code, see Principles for Responsible Institutional Investors "Japan's Stewardship Code" – To promote sustainable growth of companies through investment and dialogue – (26 December 2013) 1–2, <http://www.fsa.go.jp/news/25/singi/20140227-2/05.pdf>.

[93] Corporate governance is defined in the Japan's Corporate Governance Code as a structure for transparent, fair, timely and decisive decision-making by companies, with due attention being paid to the needs and perspectives of shareholders, customers, employees and local communities, compare The Council of Experts Concerning the Corporate Governance Code, Japan's Corporate Governance Code [Final Proposal], Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term (5 March 2015) 1, <http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1.html>. This code has become a part of the securities listing regulation of the Tokyo Stock Exchange.

should engage in a constructive dialogue with shareholders, even outside the general shareholder meeting, in order to contribute to sustainable growth and increase corporate value over the mid- to long-term. During such dialogue, senior management and directors should listen to the views of shareholders, pay due attention to their interests and concerns, clearly explain business policies to shareholders in an understandable manner so as to gain their support, work to develop a balanced understanding of the positions of shareholders and other stakeholders, and act accordingly (JCGC, Principle 5).

Concerning shareholders' meeting, companies should strive to send convening notices for shareholders' meetings early enough to allow shareholders sufficient time to consider the agenda (JCGC, Supplementary Principle 1-2-2). During the period between the board approving the convening of the shareholders' meeting and the sending of the convening notice, the information included in the convening notice should be disclosed via electronic means, such as through TDnet (a trading system dedicated for off-auction trading operated by the Tokyo Stock Exchange) or on the company's website (JCGC, Supplementary Principle 1-2-2). The determination of the date of the shareholders' meeting and any associated dates should be done so as to facilitate sufficient constructive dialogue with shareholders and ensure the accuracy of the information necessary for such a dialogue (JCGC, Supplementary Principle 1-2-3).[94]

Japan's Stewardship Code of 2014 stipulates the code of conduct for institutional investors, including asset owners and asset managers.[95] According to the code, institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities, and they should publicly disclose the policy (JSC, Principle 2) because their voting and engagement could be biased by conflicts of interest. Institutional investors should monitor invested companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies (JSC, Principle 3), and they should seek to arrive at a common understanding with invested companies and work to solve problems through constructive engagement with the management of invested companies (JSC, Principle 4).

In order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term, companies should engage in constructive dialogue with shareholders, even outside of general shareholder meetings

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[94] *Zenkoku Kabukon Rengo Kai* [Listed Companies Association of Japan] published a Guideline on Attendance at the General Shareholders Meetings of Japanese Listed Companies, in order to facilitate global institutional investors attending shareholders' meeting in Japanese listed companies, 13 November 2015, <https://user.kabukon.net/pic/43_1.pdf>.

[95] R. UEDA, How is corporate governance in Japan changing?: Developments in listed companies and roles of institutional investors, OECD Corporate Governance Working Papers, No. 17 (2015) 73–78, <http://dx.doi.org/10.1787/5jrw7j3s37hh-en>.

(JCGC, Principle 5). This effort on the part of companies will enable further corporate governance improvements that are supported by a purposeful dialogue with institutional investors based on Japan's Stewardship Code.

In this sense, Japan's Corporate Governance Code and Japan's Stewardship Code are "the two wheels of a cart", and it is expected that they will work together so as to achieve effective corporate governance. Thus, the enhancement of the effective exercise of shareholder rights will be pursued via a soft-law approach in Japan.

b) Cross-shareholding

One of the common features of corporate governance in Germany and Japan has been the presence of cross-shareholdings. Intricate networks of cross-shareholdings, combined with the dispersed ownership structure of large publicly-held corporations, can exclude the influence and control of shareholders. Cross-shareholdings construct the ownership networks that insulate corporations from hostile takeovers.

These points are partly addressed by regulation. In Japan, the voting rights of a shareholder are excluded when that shareholder has substantial control over the invested company through holding one-quarter or more of the votes of all shareholders (Art. 308 para. 1 JCA). Furthermore, concerning shareholdings of other corporations, listed companies are required to disclose the purpose and the aggregate book value in their annual reports under the securities regulation. On the other hand, cross-shareholding may be useful, for example, in maintaining an efficient long-term trading relationship by discouraging opportunistic behavior on the part of trading partners and encouraging the companies to make relationship-specific investments.[96]

Therefore, Japan has dealt with this problem complementarily via Japan's Corporate Governance Code. According to the code, a company should disclose its policy regarding cross-shareholding when it holds shares of other listed companies as cross-shareholdings. In addition, the board should examine the mid to long-term economic rationale and future outlook of major cross-shareholdings on an annual basis, taking into consideration both associated risks and returns. The annual examination should result in the board's detailed explanation of the objective and rationale behind cross-shareholdings. Companies should establish and disclose standards with respect to voting rights regarding their cross-shareholdings (JCGC, Principle 4-1). The disclosure will be evaluated by the market and its participants. After the enactment of Japan's Corporate Governance Code, three Japanese mega banks – Mitsubishi Tokyo UFJ Bank, Mizuho Financial Group and Mitsui Sumitomo

[96] R. J. GILSON/M. J. ROE, Understanding the Japanese Keiretsu, 102 Yale L.J. (1993) 891–895.

Bank – announced that they will principally have no stocks excluding group companies and they will within the next 5 years sell such stocks, which they are holding with worth more than 4 trillion yen.[97]

3. Germany

a) Voting Rights and Engagement

The German Joint-stock Company act requires a company to send the convening notice of the shareholders' meeting no later than thirty days prior to the date of the meeting (§ 123 para. 1 AktG), but it does not require the notice being sent to all shareholders. Nevertheless, the management board will, at least twenty-one days before the meeting, communicate with those credit institutions and shareholders' associations that have exercised voting rights on behalf of shareholders in the preceding shareholders' meeting or have requested a notice of the meeting (§ 125 para. 1 AktG). A credit institution that either has custody of bearer shares on behalf of shareholders of the company at the beginning of the twenty-first day before the meeting or that is entered in the share register for shares that it does not own mustwill promptly transmit to such shareholders any communications received by a company regarding a shareholders' meeting (§ 128 para. 1 AktG).

The lawmakers in Germany have responded to changes by enacting legal reforms in the 21st century, regarding matters such as the use of information technology and facilitation of the exercise of shareholder rights.[98]

The NaStraG of 2001 introduced registered shares and facilitated the exercise of voting rights by shareholders. Then, the UMAG of 2005 introduced the record date system and modernized the action for contesting the resolution of a shareholders' meeting. A person who is a shareholder at the record date is entitled to attend a shareholders' meeting and exercise voting rights, notwithstanding whether he or she is a shareholder on the date of the shareholders' meeting (§ 123 para. 3 AktG). The ARUG of 2009 implemented the EU Shareholder Rights Directive.

The German Joint-stock Company Act *(Aktiengesetz)* purported to encourage the presence of shareholders at the shareholders' meeting with the aid of information technology for this purpose by means of legal reforms. The goal of this reform is to strengthen the involvement of equity holders and the role of shareholders and to support shareholders' control of management.

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[97] *Nihon Keizai Shinbun* [Nikkei Newspaper], 6 November 2015. MIWA and RAMSEYER pointed out that the main banks in Japan never dominated borrowing firm governance and never agreed even implicitly to rescue firms in distress even in their heyday of the 1960s, Y. MIWA/M. RAMSEYER, The Multiple Roles of Banks? Convenient Tales from Modern Japan, in: Hopt/Wymeersch/Kanda/Baum (eds.), Corporate Governance in Context (Oxford 2005) 527–566.

[98] MERKT, *supra* note 28, 547–550; RINGE, *supra* note 49, 530–534.

One of the powers of banks in Germany has come from the exercise of voting rights pertaining to depositary stocks.[99] Germany has specific regulations regarding depositary stocks. Formerly, banks were able to vote using depositary stocks that they held on behalf of clients. Since 1998, depositary stocks could not be used for voting by credit institutions without an explicit proxy. A credit institution can only exercise voting rights arising under bearer shares that it does not hold if it has been authorized to exercise such voting rights by a proxy with explicit instructions. Due to deregulation, credit institutions may exercise voting rights according to their own proposals or the proposals of the management board or the supervisory board even if there are no expressed instructions from shareholders (§ 135 para. 1 AktG). The bank must provide the shareholder with its proposals for the execution of voting rights regarding the individual items of the agenda if it will exercise those voting rights according to its own proposals (§ 135 para. 2 AktG). If the shareholder has not given the bank instructions regarding the exercise of voting rights in this case, the bank will be required to exercise such voting rights in accordance with its own proposals, unless the bank can assume that the shareholder would, if he or she had knowledge of the facts, approve of a different exercise of voting rights (§ 135 para. 3 AktG). If the bank wishes to exercise voting right according to the proposals of the board, it must make the management board's and the supervisory board's proposals available to the shareholders (§ 135 para. 4 AktG).

Investment funds, which are the most popular collective investment vehicle in Germany, are overseen by investment management companies, which are regulated by the Capital Investment Act (*Kapitalanlagegesetzbuch* – KAGB). The act requires these companies to act in the sole interest of the customer in order to strengthen integrity of the market (§ 26 para. 1, para. 2 no. 1 KAGB). The act also stipulates that, in principle, an investment management company is to exercise its voting rights directly, as a shareholder "itself" (§ 94 para. 1 KAGB).

The German Investment Funds Association (BVI) published the "Code of Conduct", in which an investment company must always act exclusively in the best interests of investors and market integrity and exercise shareholder rights associated with the holdings of each fund independent of any third-party interest, particularly depository banks and affiliated corporations. Furthermore, the investment management company has to disclose its principles regarding voting policy in an appropriate manner.[100]

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[99] J. R. MACEY/G. P. MILLER, Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States, 48 Stan. L. Rev. (1995) 88–89.

[100] BVI, Code of Conduct, I. (6), <http://www.bvi.de/fileadmin/user_upload/Regulierung/Wohlverhaltensregeln_.pdf>.

An OECD report observed that institutional investors in Germany acquit themselves of their shareholder responsibilities through voting and the option of taking action in shareholders' meetings via the submission of counterproposals, all of which are performed through management companies, and as a result they are among the most active institutional investors in Europe.

b) Cross-shareholding

In Germany, voting rights based on cross-shareholding are partly regulated by the Joint-stock Company Act. If a joint-stock corporation and another enterprise have cross-shareholdings, the rights arising from shares that are held by any one enterprise within the other enterprise may not be exercised with respect to more than one-fourth of all shares of that other enterprise as from the date on which that other enterprise has received knowledge of the existence of such cross-shareholdings (§ 328 paras. 1 and 2 AktG).

Germany supported the unwinding of cross-shareholdings in industrial companies by banks given preferential tax treatment, which abolished capital gains taxes on the sale of cross-shareholdings. The enhancement of corporate governance was one of the goals of the tax reform, along with provision of a means of improving the liquidity of stock markets by increasing the proportion of actively traded shares.

This tax law reform facilitated the release of cross-shareholdings and improved the liquidity of stock markets in Germany by increasing the proportion of shares actively traded.

As a consequence, banks have reduced their involvement and lost their dominant role in corporate control. In particular, they have stopped voting via proxies and have begun to sell their holdings in industrial companies. As a result, the attendance rates at company shareholder meetings dropped sharply between 1998 and 2005.[101]

The German Corporate Governance Code (*Deutscher Corporate Governance Kodex* – DCGK) was stipulated in 2001 and consists of three elements. First, it describes legal regulations for the management and supervision of German listed companies (corporate governance), these regulations mainly referring to the German Joint-stock Company Act. The recommendations and suggestions, which represents internationally and nationally acknowledged standards for good and responsible corporate governance, are not mandatory. A listed company must disclose whether it complies with the code or not. When it does not comply with a recommendation, it must explain the reason why it does not comply in the annual declaration of conformity (§ 161 AktG).

According to the current code (DCGK of 24 June 2014, § 7.1.4), the company is to publish a list of third-party companies, including the names and the

[101] Handelsblatt, 27 September 2006.

amounts of all important shareholdings. However, the trading portfolios of banks and financial services companies, upon which voting rights are not exercised, are disregarded in this context. Nevertheless this provision was deleted by the amendments to the code for 2015 because regulation by law is sufficient and the code's regulation is no longer necessary.

V. Concluding Remarks

Based on the comparison between Japan and Germany, we have found several common features in terms of corporate governance, namely a stakeholder-oriented model, dependence on banks for financing along with strong bank power, and the prevalence of cross-shareholding in the aftermath of World War II. Nevertheless, dependence on banks and the prevalence of cross-shareholding between banks and non-financial companies are diminishing of late, and the percentage of shareholdings by institutional investors including foreigners is increasing in Japan and Germany.

On the other hand we have also found two differences. First, in Japan, issues related to shareholders' corporate control, including engagement and cross-shareholding, have been dealt with mainly in soft law, namely Japan's Stewardship Code and Corporate Governance Code. On the other hand, it seems that most issues have been dealt with via hard law in Germany, this including legislation regulating the co-determination system (as a stakeholder-oriented model) and the bank-deposit shares voting system.

Second, the extent and the speed at which regulatory reforms and change of ownership structure in public companies have transformed corporate governance seem to be different in Japan and Germany. Although Japan introduced the organizational structure of joint-stock companies and shareholders' rights following American-style corporate law already in 1950, the above-mentioned stakeholder-oriented model of corporate governance has, nevertheless, subsequently been created.[102] On the other hand, following the regulatory reforms and the decline of bank power, the German system seems to be moving toward a shareholder-oriented model of corporate governance. This is indicated by the fact that the German institutional investors are now observed as the most active shareholders in Europe, and a number of enterprises are still under the tight control of large shareholders. The regulatory reform and the transformation of ownership structures are bringing about the shareholder-oriented model of corporate governance directly and promptly.

[102] M. D. WEST, The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States, 150 U. Pa. L. Rev. (2001) 527.

Third, the power of institutional investors seems to be stronger in Germany than in Japan.[103] It is in particular difficult in Japan for confrontational activists to achieve their aims on account of the rejection they meet across boards of directors, investors, officials and the courts.[104]

What explains these differences between Germany and Japan?

The issues seem to be closely related. In Germany, the structure of corporate governance and the distribution of the authority and the roles among the shareholders' meeting, management and supervisory board are elaborately and rigidly formulated by the German Joint-stock Company Act and the Codetermination Act. There seems to be less room to affect the role of shareholders via soft-law – without a conflict with the mandatory norms – than under Japanese company law. Although the German Corporate Governance Code is not legally binding, it does exist in the shadow of laws and regulations. For example, the engagement of institutional investors with the management would conflict with the authority and role of the supervisory boards and the co-determination system under German law, which adopts the two-tier board system.

On the other hand, the power and authority of the shareholders' meeting can be extended more flexibly and thus the engagement of institutional shareholders with management would hardly conflict with the company auditor system in Japan, which essentially belongs to the one-tier board system. In Japan, it is instead seen that the engagement is regulated as "acting in concert" under the tender offer regulation and the principle of equal treatment of shareholders by management.

In other words, the discrepancy between the law on the books (which leans toward a shareholder-oriented model) and corporate governance in practice (which embraces the "community firm" notion) has been large in Japan, whereas the discrepancy has been smaller in Germany.

In Japan, it is expected that corporate governance will be enhanced by shareholders, including institutional investors, under both the legal system and the soft-law system. This should allow capital market participants to implement a shareholder-oriented management approach. There is evidence that the Japanese listed companies that have been invested in by many foreigners and domestic pension funds and mutual funds are realizing superior

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103 MERKT, *supra* note 28, 569

104 BUCHANAN/CHAI/DEAKIN, *supra* note 33, 240–281. The Japanese Supreme Court permitted a target company to take defensive measures. Pursuant to the measures, a target company was allowed to issue warrants conferring options to receive three new shares without payment for each one held by all its shareholders, but the tender offeror would not be allowed to convert their options into new shares (The Japanese Supreme Court, 7 August 2007, Minshū 61, 2215).

performance and higher stock prices than the other companies.[105] Corporate governance is expected to move in the direction of a shareholder-oriented model that aims at shareholder value maximization. Nevertheless, it is still unclear whether the recent change in corporate governance in Japan is really a transformation into such a model.

What does the transformation of the traditional features of Japanese corporate governance mean, as I asked in Section III.3? In Japan, the answer is controversial and divided. Has the Japanese system already moved toward a shareholder-oriented model of corporate governance, or do the essential features of Japanese corporate governance remain?

A panel of board members which are proposed by an insider-controlled board will likewise be insider-controlled and comprise mostly internally promoted employees. The features of the "community firm" will not be easily changed solely by the recent transformation of corporate governance in Japan. Despite the increasing number of foreign investors in Japanese equity markets, they have not yet acquired the largest shareholdings: the most significant shareholders remain domestic corporations, insurance companies, mutual funds and pension funds. Japan has therefore more outside investors, but it does not behave like an outsider system in the Anglo-American sense.[106] I think therefore that the answer depends deeply on the conduct of Japanese non-activist institutional investors, such as trust banks, insurance companies and pension funds. In spite of the enactment of the Japan's Stewardship Code, there are large differences in engagement among institutional investors due to their varying business models.[107] Transparency regarding engagement is to be ensured, and empirical studies need to be undertaken to determine the extent to which enhanced shareholder value correlates to the degree of institutional investor's engagement with management.

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105 MIYAJIMA/TODA, *supra* note 62, 378–380. According to the research, ownership by domestic and foreign institutional investors increases to produce governance effects. On the other hand, the ownership ratio of banks and insurance companies had a significantly negative impact on all performance indices. The research suggests that the enhancement of performance in companies invested in by foreign institutional investors and domestic pension funds and mutual funds is caused through pressure based on their exits and voices, while domestic banks and insurance companies are bound by their business relationships such as loan contracts, insurance contracts and keiretsu relationships.

106 M. AOKI, Conclusion: Whither Japan's Corporate Governance? in: Aoki/Jackson/Miyajima (eds.), Corporate Governance in Japan: Institutional Change and Organizational Diversity (Oxford 2007) 443–447.

107 Concerning the categorization of engagement due to business models, see S. ÇELIK/M. ISAKSSON, Institutional investors and ownership engagement, OECD Journal: Financial Market Trends, 2013/2 (2014) 93–114.

IV. Groups of Companies

Regulation of Corporate Groups in China

Junhai Liu

I. Introduction to Corporate Groups in China

In this chapter, corporate group refers to a group of two or more companies connected through a shareholding. The literature speaks of parent companies and subsidiaries, but, to continue the metaphor, typical corporate groups include grandparent corporations, parent corporations, subsidiaries and grand subsidiaries. Of course, there are also siblings, uncles, aunts, nephews and cousins in the corporate family tree.

The family metaphor is an apt one. Corporate groups are similar to families, in that families could be classified as nuclear family or elementary family, single-parent family and larger extended family. There are both commonalties and differences between traditional nuclear corporate family, single-parent family and larger extended corporate family.

1. The Legal Reform of the Company Law of 2013 to Aid the Growth of Corporate Groups

In China, it is very easy to incorporate a group of companies especially after the reform of the Chinese Company Law[1] on 27 December 2013, when several investor-friendly measures were introduced. These new measures took effect on 1 March 2014.

The first of these measure abolished minimum mandatory capital requirements as a general principle except for the 27 industries or companies stipulated by the State Council, making it possible to have a company with 1 RMB of registered capital. The exceptions mentioned above cover 27 types of com-

[1] 《中华人民共和国公司法》*(zhong hua ren min gong he guo gong si fa),* enacted 1993, as amended on 28 December 2013. Reference of an English translation available under: <http://www.fdi.gov.cn/1800000121_39_4814_0_7.html>.

panies governed by minimum mandatory capital requirements, including the companies created by public offerings, banks, insurance corporations, security firms, investment funds management corporations, etc.

Second, no actual payment of the restored capital is necessary upon the founding of the corporation. Under Art. 26 para. 2 Company Law 2005, 20% of the subscribed capital has to be paid upon founding, the remaining capital has to be paid in within two years of incorporation, or within five years of incorporation for investment corporations. Under the Company Law 2013, the amount of the capital and the date is must be paid in will be decided by the shareholders in the memorandum of incorporation. Sponsor shareholders are allowed to freely determine a payment schedule of capital contributions in the company's articles of association.

Third, the mandatory procedure of verifying equity contributions by an external auditor was abolished. In Art. 29 Company Law 2005, it stipulates that, "after the shareholders have made their capital contributions, such capital contributions shall be subject to capital verification by a capital verification authority set up according to law, which shall issue capital verification certificates". This article was abolished by the Company Law 2013.

Fourth, the system of annual examination was replaced by the system of annual report. The difference is that the system of annual examination implies the pledge of the government reputation to every corporation, while the system of annual report requires every company to be responsible for the authenticity and accuracy of the annual reports.

Fifth, the requirement for a registered domicile has been deregulated. Traditionally, companies needed to buy or rent an independent office unit as the registered domicile.

After the reform of 1 March 2014, the requirements for registered domicile have been relaxed significantly. Therefore, many companies could be registered at the same address of a secretary company. A coffee house could be also registered as the domicile for the company frequented by a regular customer.

Sixth, an electronic business license was introduced to facilitate the incorporation process. The electronic license issued by the corporate registration authority is equally valid as the paper version of the business license. The electronic license could also encourage the firms to actively conduct the business on the internet.

Seventh, a business registration certificate is issued prior to applying for an administrative permit. The philosophy is that the function of the business registration certificate is to recognize the legal personality of the corporation, while the function of an administrative permit is to authorize the company to engage in the business which it would otherwise is not be permitted to do.

Eighth, the incorporation process has been simplified by coalescing all registration certificates into one single registration document with unique and single identification number for each and every corporation. As a result, the incorporation process could be shortened from 15–20 days to 3–4 days on average.

Additionally, even before the reform of the Chinese Company Law of 2013, some liberal measures had already been introduced in the Company Law 2005. For instance, parent corporation reinvestment in subsidiaries was no longer limited to 50% of the net assets of the parent company. Companies were allowed to act as partners, although SOEs and listed companies are only qualified to act as limited partners, and could be incorporated as a one-man corporation, which can in turn, incorporate subsidiary one-man corporation. In comparison, although one individual may only register one-man corporation, that one-man company may not incorporate one-man corporation. Of course, such prohibitions are very easily avoided by a nominal shareholder.

2. *Encouraging Policy by Chinese Governments*

Keeping in mind the investor-friendly legal reforms, it is not very difficult to achieve the dream of incorporating a corporate group in China. Furthermore, both central government and local governments encourage the growth of corporate groups. For instance, Chengdu Authority of Industry & Commerce issued its "Opinions on supporting the development of Corporate Groups" in 2015, promising to lower the thresholds for incorporation and encourage the formation of cross-industry and cross region corporate groups through mergers, acquisitions and franchises. Well-known multinational companies and domestic corporate groups were thus made welcome to set up the headquarters in Chengdu.[2]

3. *Growing Number of Domestic and Multinational Corporate Groups*

Large Chinese companies are always members of corporate families. For instance, almost all the 3000 listed companies in China are members of corporate groups, regardless of the private ownership or public ownership of the parent corporation.

According to the Fortune 500 List of 2015, the number of shortlisted Chinese companies rose for the 12th year in a row to 106, with six more entering for the first time. The US still has the largest number, 128, unchanged from last year, but the list's compilers estimate that China will overtake the US tally by 2020.[3] All the 106 Chinese companies are members of corporate groups. Many Fortune 500 Chinese companies indicate their corporate group in their names (group or holding corporation).

2 <http://www.cddrc.gov.cn/detail.jsp?id=861546>.

3 <http://europe.chinadaily.com.cn/business/2015-07/24/content_21393307.htm>; <http://fortune.com/global500/>.

Although the private sector is expanding very fast, most of the major corporate groups are controlled by state shareholders. Most are listed companies either in China or overseas. Some of the most profitable State-owned Enterprises (SOEs) rely more or less heavily on the monopoly policy granted by the State. As China is encouraging equal development of the private and public sector, it is expected that both State-owned and private-owned corporate groups will continue to grow.

In addition to domestic corporate groups, most world class multinational companies (MNEs) have their subsidiaries, branches or representative offices in China. China was the top place for attracting foreign capital among developing countries for a 23rd consecutive year until 2013, and ranked first worldwide in 2014. According to the Global Investment Trends Monitor issued by UNCTAD, global foreign direct investment (FDI) inflow in 2014 reached 1.26 trillion US-Dollars. China reached 119.6 billion US-Dollars (excluding data for banking, securities and insurance), with the FDI flow ranking first for the first time.[4]

Chinese companies are expanding their groups as they globalize. China is still in the 3rd position worldwide in outbound foreign investment. In 2014, the overseas investment of non-financial sectors topped 100 billion US-Dollars for the first time, hitting 102.9 billion US-Dollars with a 14.1% increase, staying at the 3rd position worldwide. If profit reinvestments abroad and overseas investments through a third country by Chinese enterprises are included, China has in effect become a net exporter of capital.[5]

II. The Pros and Cons of Corporate Groups

1. *Advantages of Corporate Groups*

There are pros and cons with corporate groups. Corporate groups have demonstrated extreme economic power in producing new products, rendering new services, stimulating technology innovation, creating jobs, paying tax, and eradicating poverty nationwide and/or worldwide. Corporate groups have become more and more economically influential than small political states.

2. *Opportunism Arising from Corporate Groups*

The corporate group has made traditional corporate governance problems in particular agency problems more complicated and costly. There are three

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[4] <http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201501/20150100875304.shtml>.

[5] <http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201501/20150100875304.shtml>.

types of agency problems in the corporation: conflicts between shareholders and management, conflicts between the controlling shareholder and non-controlling shareholders, and conflicts between insiders and outsiders. These three types of agency problems have been exacerbated in the context of corporate governance.

For instance, shareholders' limited liability and corporate independent legal personality might be systematically abused by corporate groups against the creditors, minority shareholders, employees, consumers, tax authorities and many other stakeholders. The most frequent abuses include unfair related party transactions, undisclosed and unreasonable transfer pricing, defrauding minority shareholders, environmental pollution, and violations of labour rights.

Some MNEs abuse subsidiaries to avoid national laws including public law and private law, substantive law and procedural law such as civil procedures and arbitration rules.

In company law, MNEs often use indirect transfers of equity interest in the joint ventures to outsiders, and successfully sidestep the mandatory pre-emptive right of minority shareholders.

In arbitration law, some parent companies benefit from the contracts entered into by their subsidiaries, but are not bound by the arbitration clause, as a result of the privacy of the arbitration contracts.

In tax law, many MNEs conduct aggressive schemes of base erosion and profit shifting (BEPS). For example, although measuring the scope of BEPS proves challenging, the findings of work performed since 2013 confirm the potential magnitude of the issue, with estimates indicating that global corporate income tax (CIT) revenue losses could be between 4% to 10% of global CIT revenues, i.e. 100 to 240 billion US-Dollars annually.[6] Needless to say, some MNEs also have strong lobbing power to influence the local legislative process.

3. The Right Attitude Towards the Corporate Groups

Like water, the corporate group itself is neither angel nor devil. While sufficient water is vital for life, flood is disastrous. Great Yu's wisdom in fighting against flood holding that dredging is better than blocking, and leading or channeling is better than dredging could offer the correct approach to addressing the misconduct of corporate groups.[7]

Therefore, national legislatures and international community should encourage corporate groups to maximize the public welfare by and through

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[6] OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD, 4.

[7] Drawing on lessons from the predecessor's failure, he used methods of channeling and dredging instead of blocking and damming the water up. To better manage the people and eliminate catastrophe, he divided the people into nine sections and dispatched them

optimization of their profits, and discourage corporate groups wrongdoings or moral hazards.

III. The Regulatory Framework for Corporate Groups in China

As indicated earlier, there are a huge number of corporate groups in China. However, there is neither separate statute on corporate groups as in Germany, nor a special chapter dedicated to corporate governance in the Company Law 2013. Although China has not codified corporate groups yet, they are regulated by different branches of law, including but not confined to the Company Law, securities law, anti-trust law, tax law, accounting law and international law.

1. Company Law

Corporate groups are governed by the Company Law, which addresses the complicated relationships between and among parent corporations, the subsidiaries and their creditors and minority shareholders. Although the legal problems are more complicated in the context of the corporate group than in the context of single corporation, these legal problems can generally be solved.

2. Securities Law

In the case of listed corporations, public investors including minority shareholders of listed companies are protected by the Chinese Securities Law)[8] of 2005. The most important protective measures include disclosure requirements, anti-fraud provisions on fraudulent issue of shares, misrepresentation, insider trading, and market manipulation. The Securities Law also recognizes the authority of the stock exchange in monitoring the governance of listed corporations, their parent companies and de facto controllers.

3. Anti-trust Law

Corporate mergers and acquisitions which could trigger accusations of monopoly privilege abuse are regulated by the Chinese Anti-Trust Law)[9] of

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into nine different areas. Under his leadership, the flood water flowed into the sea through nine newly-dredged rivers. See <http://www.cultural-china.com/chinaWH/html/en/33History569.html>.

[8] 《中华人民共和国证券法》*(zhong hua ren min gong he guo zheng quan fa),* enacted 1998, amended 2005, official English translation available under: <http://www.npc.gov.cn/englishnpc/Law/2007-12/13/content_1384125.htm>.

[9] 《中华人民共和国反垄断法》*(zhong hua ren min gong he guo fan long duan fa),* enacted 2007, official English translation available under: <http://www.npc.gov.cn/englishnpc/Law/2009-02/20/content_1471587.htm>.

2007. Although China encourages the growth of corporate groups, and monopolies per se are not illegal, it is illegal for a corporate group to abuse its monopoly position. Chapter 4 of the Anti-Trust Law of 2007 deals strives to protect competition by dealing with corporate concentrations.

4. Tax Law

The corporate group is treated as a special taxpayer under the Corporate Income Tax Law of 2007, as there are widespread and aggressive tax planning activities associated with corporate groups. Chapter 6 of the Chinese Corporate Income Tax Law[10] of 2007 deals with special adjustments to transfer pricing in the context of corporate groups based on the principle of transactions at arm's length.

5. Accounting Law

The corporate group is also a very important focus for accounting law and accounting principles in China. For instance, Art. 28 of the Regulations on Corporate Financial Accounting Reports[11] requires the parent company to prepare consolidated financial reports in addition to its individual financial reports. Consolidated financial reports are intended to ensure financial transparency of corporate groups and are outlines in No. 33 of the Corporate Accounting Principles.[12]

6. International Law

As Chinese corporate groups structure their associates across borders, their associates with an internal commercial presence might be also subject to foreign law and international law including but not confined to bilateral and multilateral treaties. For example, subsidiaries in Germany might be subject to the two-tier board corporate governance regime including a board of supervisors, while the subsidiaries in the US may be subject to a one-tier board corporate governance regime involving independent directors. Of course, for listed companies registered in China, independent directors and supervisors co-exist in the same corporation. Another illustration arises in situations of bankruptcy – where all members of the corporate group may be subject to all relevant bankruptcy regulations in their jurisdiction of residence might be relevant.

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[10] 《中华人民共和国企业所得税法》*(zhong hua ren min gong he guo qi ye suo de shui da),* enacted 2007. English translation available under: <http://www.npc.gov.cn/english npc/Law/2009-02/20/content_1471133.htm>.

[11] 《企业财务会计报告条例》*(qi ye cai wu kuai hi bao gao tiao li),* enacted 2000.

[12] 《企业会计准则第 33 号−合并财务报表》*(qi ye kuai ji zhun ze di san shi sa hao he bing cai wu bai biao),* enacted 2014.

7. Outlook on the Codification of Corporate Groups in China

German Codified Law of Corporate Groups (Konzernrecht) was one of the alternative legislative solutions in China in 2005. As *Druey* indicated, "Germany is considered the global capital of groups of company law." Moreover, the civil law tradition represented by Germany is very appealing to the Chinese audience, and therefore has strong impacts on Chinese private law including the Company Law. Although the Supreme Court proposed a draft to introduce a special chapter on corporate groups into the Company Law of 2005, it was not accepted by the legislature.

Heavily influenced by the civil law family, China has recently been working very hard on a codification of private laws. For instance, the Chinese legislature is codifying its civil law, and will publish the General Principles of Civil Law in 2017. In my opinion, it is necessary and possible for China to establish a separate Chapter on corporate groups within the Company Law framework in the near future, and to codify a separate uniform statute on corporate groups in China.

Of course, both the codification approach and the comprehensive approach have their own advantages and weakness. Codification could simplify the relationships between the corporate groups and outsiders, while the parent corporation's privilege of limited liability towards the obligations and debts of its subsidiaries might be restricted to some extent. The comprehensive approach could protect the flexibility of corporate groups by treating its members separately, although transaction costs between the corporate group and its outsiders are significant, and the parent corporation's privilege of limited liability and the single entity doctrine might be abused to defraud creditors and other outsiders.

However, both jurisdictions with codification for corporate groups and jurisdictions without such codification have to face and address the same complex and serious challenge, in that the members of corporate groups are economically and substantially a single and unitary business entity, although they are legally and formally separate independent entities.

In my opinion, the legislature and the regulator should require corporate groups to keep the legal distance required between the members of corporate groups for the purpose of safety and security for both corporate groups and their partners. However, the parent company may have substantial control over the business structures of the group, group culture, group strategy and intra-group transactions.

IV. Fiduciary Duty of Controlling Shareholders in Company Law

1. Corporate Groups Are Governed by Company Law

It is important to know that all the rules on the rights, obligations and liabilities of shareholders under the Company Law also apply to parent corporations. Furthermore, there are special rules on the core issues of corporate groups in the Company Law. The statute does not use the term "corporate group" or "parent corporation", using instead three equivalent and significant concepts including "controlling shareholder", "de facto controller" and "affiliation" as defined in Art. 216 Company Law.

The reason for the absence of the wording "parent corporation" is that although most controlling shareholders are legal persons, many of them are individuals or natural persons, rather than corporations. Therefore, it does make sense for the legislature to use the broader terminology of "the controlling shareholder" rather than the narrower "parent corporation". As the concept of "controlling shareholders" refers to parent companies in the context of corporate groups, all corporate groups are regulated by the Chinese Company Law, and it is easy to apply its rules to corporate groups by interpreting "controlling shareholder" as the parent corporation.

2. Shareholders' Fiduciary Duty Under Art. 20 Company Law

Article 20 Company Law aims to protect both the internal beneficiaries, namely the company and all the shareholders as a whole, and the external beneficiaries, namely outside stakeholders including the creditors, employees, suppliers and the local community.

The first paragraph of Art. 20 Company Law imposes the following general fiduciary duty on shareholders:

> "The shareholders of a company shall comply with the laws, administrative regulations and articles of association, and shall exercise their shareholder's rights according to law. None of them may injure the interests of the company or of other shareholders by abusing their shareholder's rights, or injure the interests of any creditor of the company by abusing the independent status of legal person or the shareholder's limited liabilities".

This is a general requirement for the shareholders, especially the controlling shareholders or parent corporations, and must be observed when dealing with the corporation, the creditors of the corporation, and their fellow shareholders. This general provision covers both controlling shareholder and minority shareholders, who might also abuse their minority rights for the purpose enriching themselves in unreasonable way.

This general provision could be deployed as the guiding principle of for corporate groups. In my opinion, this provision has created a fiduciary duty for the shareholders' fiduciary duty, although the term "fiduciary duty" is not expressly used here. The internal beneficiary of the fiduciary duty is the company and other shareholders, while, the external beneficiary of the fiduciary duty is the creditors of the corporation.

However, the law has teeth. To protect the internal beneficiary, the second paragraph of Art. 20 stipulates that, "If a shareholder of the company abuses its shareholder's rights, thereby causing losses to the company or other shareholders, the shareholder shall be liable for compensation according to the law".

To protect the external beneficiary, the third paragraph of Art. 20 stipulates that, "If a shareholder of the company abuses the independent status of the company as a legal person and the limited liability of shareholders to evade debts and seriously harms the interests of the creditors of the company, it shall bear joint and several liability for the debts of the company". Therefore, the second paragraph aims at protecting the interests of the company and its shareholders as a whole, while the third paragraph are is relevant to the doctrine of piercing of the corporate veil for the purpose of protecting the creditors of the corporation.

3. Controlling Shareholders' Fiduciary Duty Under Art. 21 Company Law

In addition to Art. 20, Art. 21 sets forth special obligations on the fiduciary duties of the controlling shareholder and the de facto controller:

> "The controlling shareholder, de facto controller, directors, supervisors and senior officers of a company may not use their affiliation to harm the interests of the company. Anyone that violates the provisions of the preceding paragraph and causes losses to the company shall be liable for compensation".

This provision could be used by courts or arbitration bodies to order shareholders abusing their rights, including the parent companies, to be liable to the victim shareholders or victim company depending on the nature of the breach of the fiduciary duty.

"Controlling shareholder" is defined by Art. 216 Company Law as the shareholder whose capital contribution accounts for 50% or more of the total capital of a limited liability company or whose shareholding accounts for 50% or more of the total share capital of a company limited by shares; or the shareholder whose capital contribution or shareholding is less than 50% but whose voting rights pursuant to such capital contributions or shareholding are sufficient to have a major impact on the resolutions of the board of shareholders or general meeting.

"De facto controller" is defined by Art. 216 Company Law as a person who, although not a shareholder of the company, is capable of actually controlling the operation of the company through investment relations, agreements or other arrangements. De facto controller usually refers to the grand parent company or the controlling shareholder of the controlling shareholder.

"Affiliation" refers to the relationship between the controlling shareholder, de facto controller, director, supervisor or senior officers of a company and an enterprise directly or indirectly controlled by him as well as any other relationship that may lead to a transfer of the interests of the company. However, no affiliation is deemed to exist between State-controlled enterprises merely due to the fact that the State has a controlling interest.

4. The Ideal Relationship Between the Parent Company and the Subsidiary

In economic or commercial reality, subsidiaries are always economically and substantially controlled by the parent corporation. Without this control, a parent company would lack the motivation to establish corporate groups. However, based on the doctrine of independent and separate entity and shareholder's limited liability, the parent company and the subsidiary should be treated as separate and independent entities from the perspective of corporate governance procedure and legal formality. Namely, the parent and the subsidiary should be independent in terms of management, financial and human resources.

In my opinion, the intelligent parent should be able to skillfully transform their intentions and plans into the actions of the subsidiary by and through the platform of the general meeting of shareholder, board of supervisors, board of directors, informal communication and corporate culture.

V. Piercing the Corporate Veil in the Context of Corporate Group

1. One Exception to the Principle of Shareholder's Limited Liability

Every principle has its exception. The exception to the principle of shareholder's limited liability is the doctrine of piercing or lifting corporate veil. This doctrine has been used against the parent companies in both domestic and international litigation. In recent years, several Chinese parent companies have been listed as co-defendants along with their subsidiaries in international law suits brought by the creditors of their subsidiaries.

I have been retained by a number of law firms to issue legal opinions to Chinese and foreign courts on the possible application of piercing corporate veil. In this context, I wrote an expert opinion on the independence of the legal personality of state-owned enterprises in Chinese law for the United States District Court, Eastern District of Louisiana in *Re First Investment Company of The Marshall Islands v. Fujian Mawei Shipbuilding Ltd. of the People's Republic of China et al* in 2011. The result was that the parent company was not held liable for the debt of its subsidiary in this case. Similarly, I also wrote an expert opinion on the doctrine of piercing corporate veil in the context of the Chinese Company Law for United States District Court, Eastern District of Louisiana in *Re Chinese-Manufactured Drywall, Mdl No. 2047,* Products Liability Litigation in 2012.

The Chinese legislation on piercing the corporate veil is the first statute dealing with the complicated case law for this issue. In research conducted on piercing the corporate veil for my book "Protection of Shareholders' Rights" of 1997,[13] strong recommendations resulted for the legislature to introduce the doctrine of piercing corporate veil in Art. 20 para. 3 Company Law 2005.[14]

2. Piercing the Corporate Veil as Legal Consequence for Shareholder Disregard for the Corporate Legal Personality

As indicated earlier, Art. 20 para. 1 in particular recommends specific shareholder conduct in relation to the creditors and stakeholders of the corporation. The rationale here is that shareholders, especially the controlling shareholder is obligated to create and respect corporate legal personality with regard to capital and governance. This obligation will not only advance the best interests of the corporation, but also advance the best interest of the stakeholders, in particular the creditor's interest. As such, this obligation is the price the shareholder is supposed to pay for the privilege of limited liability.

Thus, when a shareholder abuses the corporation's independent status or shareholder limited liability, that shareholder will not be qualified to enjoy their limited liability privilege anymore. To some extent, piercing the corporate veil under Art. 20 para. 3 could be considered punishment for breaching the default promise to create and respect the corporate legal personality, while limited liability is the privilege or reward for honest promise-keeping shareholders.

The application of Art. 20 para. 3 depends heavily on the definition of abuse of corporate independent status or the limited liability of shareholders. The abuse of corporate independent status or the limited liability of shareholders implies any form of utilization or taking advantage of the independent corporate status or the limited liability of shareholders in violation of the principle of honesty, integrity or public policy. Common or frequent forms of abuse include undercapitalization and commingling of legal personalities between the company and its shareholder.

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[13] 《股份有限公司股东权的保护》*(gu fen gong sh gu dong quan de bao hu),* 法律出版社 *(fa lv chu ban she)* (Beijing 1997).

[14] For more details of my arguments on piercing corporate veil, see J. LIU, 《新公司法中揭开公司面纱制度的解释难点探析》 *(xin gong si da zhong jie kai gon si mian sha zhi du de jie shi nan dian tan xi)* [The Difficult Issues to be Interpreted in the Doctrine of Piercing Corporate Veil in Chinese New Company Law], Journal of Tongji University 6 (2006) 1111–1118.

The courts should exercise their own discretion in judging whether corporate legal personality has actually been abused by a single shareholder or controlling shareholder, depending on the unique facts and circumstances in the specific case. However, although judiciary discretion is broad, it is not infinite.

In my opinion, where judges are not quite sure about the decision on piercing corporate veil, the shareholder's limited liability should be respected. There should also be differentiated categories of creditors. For instance, the claims of tort victims should be given priority over the claims of contractual creditors, as the victim of a tort, in contrast with the contractual creditor, has no opportunity to negotiate with the debtor company before the tort occurs.

3. Under-capitalization

Under-capitalization refers to the situation where the shareholder invested unreasonably insufficient equity capital into the company or companies in relation to the excessively higher debt capital, taking into account the factors and circumstances of the corporate business nature, operation scale, employment size and potential risks, etc.

The lower mandatory minimum equity capital requirements of the Company Law 2005 and the subsequent abolishment of minimum capital requirements in all but 27 sectors under the Company Law 2013 render mandatory minimum equity capital requirements ill-suited as a precise and effective indicator of undercapitalization.

In other words, undercapitalization should be identified if the shareholder was supposed to subscribe and pay more equity capital to support the existence and growth of the corporation, regardless whether the shareholder has actually fully paid up the subscribed capital above the mandatory minimum equity capital requirements mandated by the statutes for certain industries.

Although the Company Law 2013 abolished the minimum mandatory capital requirement as a principle, the courts or arbitration bodies may still have the authority to examine the adequacy of the capitalization level in terms of the ratio between equity capital and debt capital, the nature of the business model, the potential risks to the creditors and the difficulty of due diligence for creditors, etc.

4. Commingling of Legal Personalities

Confusion of legal personality is the most likely root cause for triggering a piercing of the corporate veil. Commingling or confusion of legal personalities between the company and its shareholder usually implies the disappearance of the legal separation between the company and its shareholder. While under-capitalization represents the failure of corporate capital regime, commingling of legal personalities reflects the failure of corporate governance, especially the failure to observe corporate governance rules and formalities.

Commingling may take various forms, including but not confined to the following: (i) Commingling of assets including but not confined to cash, movable and immovable property, intellectual property, information and opportunities; (ii) Unreasonable overlapping of legal representatives, directors and senior executives; (iii) Commingling of corporate governance organs including the general shareholders' meeting, board of directors, board of supervisors and the management; (iv) Sharing the same financial officers, accountants, bank accounts and auditors; (v) Commingling of business activities including failure to properly account for joint business activities; (vi) Other relevant factors and features, such as using the same logos, business cards, office space, telephone number, email address, mail envelopes, advertisements, etc. The list of factors considered by Chinese courts is non-exhaustive.

5. Piercing the Corporate Veil of a One-man Corporation

The legal rules on piercing the corporate veil of one-man company are unique in Chinese Company Law. I introduced the one man company to the Chinese audience in my research on EU Company Law directives under the EU-China Higher Education Program in 1998. My book Protection of Shareholders' Rights of 2004[15] proposed a very simple rule of presumption of abuse of legal personality by a one-man shareholder, leading to an automatic piercing of the corporate veil in the absence of contradictory proof. This suggestion was codified in Art. 64 Company Law 2005, and later in Art. 63 Company Law 2013.

Article 63 Company Law 2013 reads as follows:

> "If the shareholder of a one-person limited liability company is unable to prove that the property of the company is independent from the shareholder's own property, the shareholder shall bear joint and several liability for the debts of the company".

The rationale behind this is that the creditors of one-man corporation, as outsiders, are relatively vulnerable in relation to the company and its single shareholder in terms of information asymmetry. In contrast, the single shareholder, whether a corporate or individual shareholder, has the resources and ability to delineate between shareholder and corporation. Such institutional arrangements are very creditor-friendly, but also fair and reasonable for the single shareholder.

The presumption of the abuse of legal personality is necessary and practical, as many parent companies are unable to differentiate shareholder's rights and corporate property rights. In other words, they too often ignore the line between property law and company law. Some parent companies operate as if all property in all companies is the private property of the parent corporation, without due regard to the existence of their fellow minority shareholders.

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[15]《股份有限公司股东权的保护》*(gu fen you xian gong si gu dong quan de bao hu),* 法律出版社 (Beijing 2004) 22.

6. The Relationship Between Art. 20 para. 3 and Art. 63 Company Law 2013

It is important to understand the relationship between Art. 20 para. 3 and Art. 63 Company Law 2013, and the substantial differences between them.

Firstly, Art. 20 para. 3 is located in the general provisions of Chapter 1 of the Company Law, Art. 63 is located in the special provisions of Sec. 3 of Chapter 2 of the Company Law.

Secondly, Art. 20 para. 3 serves as the general rule and is applicable to all forms of corporation, while Art. 63 serves as the special rule applicable in the case of single shareholder corporations.

Thirdly, although the plaintiff must prove the existence of the abuse of corporate legal personality by the defendant shareholder under Art. 20 para. 3, the defendant single shareholder bears the burden of proof for establishing the distinction between shareholder and company under Art. 63. In other words, the single shareholder in a one man corporation bears the burden of proof.

Despite the differences indicated above, Art. 20 para. 3 and Art. 63 Company Law 2013 are closely connected. When Art. 63 Company Law 2013 is silent, Art. 20 para. 3 may be applied in the case of piercing the corporate veil. For instance, even if the single shareholder is able to demonstrate the separation between personal and corporate assets, the creditor is still entitled to request the courts or arbitration bodies pierce the corporate veil by producing evidence of undercapitalization or commingling of legal personalities on the part of the defendant debtor corporation.

VI. Protecting Subsidiaries' Creditors under the Company Law

1. Public Disclosure of Credit Information for Corporate Groups

Since 1 March 2014, an official website displaying the credit information of corporations, launched by State Authority of Industry & Commerce, has been made available to the public.[16] In August 2014, the State Council promulgated the Interim Regulations on the Disclosure of Corporate Information.[17]

According to the Interim Regulations, the corporate information is disclosed via two channels. The first source of information is the corporation. Under Art. 8 of the Interim Regulations, each and every company is obligated to file an annual report to the corporate registration authority by filing their annual report with the credit information website between 1 January and 30 June of every year. Under Art. 9 of the Interim Regulations, the information

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[16] The address of this website is <www.gsxt.saic.gov.cn>.

[17] 《企业信息公示暂行条例》*(qi ye xin xi gong shi zan xing tiao li),* issued by the State Council on 7 August 2014.

in the annual reports includes but is not confined to the contact information for the corporation, the status of the company, i.e. as a going concern or facing liquidation, the creation of subsidiaries, the acquisition of shares, the amount and form of capital contributions from shareholders. The company also needs to disclose the latest information regarding shareholder's capital contributions, the transfer of an equity interest for limited liability corporations, the acquisition, change and renewal of administrative licenses, the pledge of intellectual properties and administrative penalties.

The second source of information is the government. Articles 6 and 7 of the Interim Regulations require the corporate registration authority and other government agencies to disclose information generated in the process of legal enforcement.

The disclosure of information on corporate groups could help creditors more effectively evaluate the potential risks arising from transactions with corporate groups before making final decisions.

Of course, further work needs to be done to improve the transparency of corporate groups by integrating and analyzing all credit information based on big data methodology. In my opinion, a project for the near future should feature the publication of a nation-wide or even global databank for companies and corporate groups, available 24 hours a day.

2. *Outdated Beliefs on Registered Capital*

Given that mandatory minimum capital requirements were abolished, and that shareholders may freely determine the date of payment of subscribed capital, creditors should become more sophisticated, and should not count on abstract amounts of equity capital subscribed by the shareholders.

3. *New Challenges for Due Diligence*

Traditional due diligence relies too heavily on audited financial reports. However due diligence should be upgraded to reflect the reforms of the Chinese Company Law to include the information and credibility of corporate groups. In my opinion, creditors and their attorneys and accountants should pay more attention to the credibility of the debtor corporation, such as examining the amount of electricity and water consumed for the production or business operation, the scale of sales, the salaries and the social insurance fees paid by the debtor corporation.

4. *Valid and Adequate Collateral Measures*

Regardless of the adequacy of capital in the debtor corporation, the validity and adequacy of collateral measures are always very important for secured transactions. The creditor should demand valid and adequate collateral from the debtor. Of course, collateral either in the form of movable or immovable assets must be assessed by the creditor for potential risk.

5. Shareholder's Liability for Breach of the Obligation to Contribute and Maintain Equity Capital

The shareholder has the obligation to contribute and maintain equity capital. If the shareholder has failed or refused to make sufficient equity contributions, or if the shareholder has withdrawn the equity contributions from the corporation, the shareholder should be held liable to the creditors of the debtor company to the amount of insufficient equity capital, or the amount withdrawn by the shareholder. This attitude is recognized by Art. 13 and Art. 14 of the No. 3 Judicial Interpretation of Company Law by the Supreme Court of 2014.[18]

6. Proactive Approach to Abuse of the One-man Corporation

As abuse is much more likely with a one-man company in comparison with corporations with multiple shareholders, the Company Law has set several restrictive minimum standards for the one-man corporation.

First, a one-man company must indicate whether it is wholly owned by a natural person or wholly owned by a legal person in the company registration and specify the same in the company's business license (Art. 59).

Second, although a one-man company does not have a general meeting of shareholders, all decisions that would require a general meeting of shareholders must be made in writing and kept in the company after it is signed by the shareholder (Art. 61). Third, a one-man company shall prepare an audited financial report at the end of each fiscal year (Art. 62).

Fourth, if the shareholder of a one-man company is unable to prove that the corporate property is independent from the shareholder's own property, the shareholder shall bear joint and several liability for corporate debts (Art. 63).

7. Mandatory Audit Requirement

Mandatory audit requirements apply to listed corporations,[19] state-owned enterprises,[20] and one-man corporations.[21]

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[18] 《最高人民法院关于适用中华人民共和国公司法若干问题的规定（三）》*(zui gaoren min fa yuan guan yu shi yong zhong hua ren min gong he guo gong si fa ruo gan wen ti de gui ding, No. 3),* issued by the Chinese Supreme Court on 6 December 2012, as amended on 20 February 2014.

[19] Art. 9 of No. 2 Rules on the Content and Format of Disclosure Annual Report by Public Issuers《公开发行证券的公司信息披露内容与格式准则第 2 号—年度报告的内容与格式》*(gong kai fa xing zheng quan die gong si de xin xi pi lu nei rong yu ge shi zhun ze, No. 2 – nian*

An unresolved question is to whom the audit firms owe their fiduciary duty, whether it is the company to be audited, the creditors or the public investors? The reality is that accounting firms are usually accountable to the management of the company to be audited. If the accounting firms consider the company being audited as the principal and beneficiary, this places the creditors and the public investors as the end users of the audit report at risk.

The real reason for some audit firms to move away from creditors is that they tend to consider themselves as the trustee and agent of the retaining corporation, instead of its creditors or public investors. The audit firm is always chosen and paid by the corporation, rather than the end users (including creditors) even though the end users of the audit report are creditors and public investors. Therefore, audit firms tend to consider themselves the protector of the corporation under audit, rather than for vulnerable creditors. The defects in the audit service have exacerbated the vulnerable situation of public investors by placing them against both a financial burden and a sophisticated enemy.

Hence, I argue that audit firms should be defined as a trustee for the creditors, owing a fiduciary duty to the creditors of the corporation, and being liable for their own negligence in rendering a misleading audit report should any losses be suffered by the creditors.

VII. Company Law Protection of Subsidiaries' Minority Shareholders

As the minority shareholders of subsidiaries are vulnerable in comparison with parent corporations, minority shareholders deserve legal protection. Where the rights of minority shareholders are breached, effective and fair judicial remedies should be available.

1. Direct Actions in Company Law

Minority shareholders are entitled to take direct action to enforce their individual rights. Direct action includes individual and class actions, and is more relevant to a plaintiff shareholder than indirect litigation, which is why most shareholder litigation takes the form of direct action.

The Company Law offers several types of direct action for minority shareholders. First, the minority shareholder may act based on the right to infor-

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du bao gao de nei rong yu ge shi), issued by China Securities Regulatory Commission, as amended on 9 September 2012.

[20] Art. 67 of the Law of State-Owned Assets in Enterprises《中华人民共和国企业国有资产法》*(zhong hua ren min gong he guo qi ye guo you zi chan fa),* enacted 2008.

[21] Art. 62 Company Law.

mation under Art. 33 Company Law 2013, with the right to inspect and copy the books and records of the corporation. In certain circumstances, a former shareholder who requires information obtainable from the inspection of books and records to support litigation claiming insufficiency of the price agreed in an equity transfer contract will also be granted the right of inspection. Second, based on the pre-emptive right to buy under Art. 71 of Company Law 2013, existing shareholders may challenge the transfer of equity interest from other fellow shareholders to outsiders. Third, the dissenting shareholders may utilise their right to an appraisal based on Art. 74 Company Law 2013. Fourth, if the interest of an individual shareholder, rather than the corporation, is damaged by the directors or senior executives, the affected shareholder may take direct action against the wrongdoers under Art. 152. Fifth, a shareholder may qualify to take action to wind up the company in case of deadlock under Art. 182 Company Law 2013. Sixth, although not recognized by legislation or judicial interpretation, minority shareholders may apply to the court to declare mandatory dividends in extremely exceptional cases. A prime example is where a company has been profitable for more than five years but the minority shareholder has received neither dividend nor the opportunities of substantial income from the corporation, while the controlling shareholder or insiders have received substantial benefits via generous compensation and related-party transactions but not in the form of dividends. It seems that this embarrassing situation is designed to bully or squeeze out the minority shareholder.

Of course, in reality, it is very rare for Chinese courts to declare mandatory dividends – although mandatory declaration of dividends is controversial, this judicial remedy should be open to certain minority shareholders who have been trapped in a deadlock, but do not want to leave the corporation.

2. Direct Actions Under the Securities Law

The Securities Law of 2005 recognized several direct actions as individual actions. First, investors may take direct action against the misrepresentations of wrongdoers under Art. 69 Securities Law in the primary market. Second, investors may take direct action against insider trading under Art. 76 Securities Law. Third, investors may take direct action against manipulation under Art. 77 Securities Law. Fourth, investors may take direct action against fraudulent securities firms and their employees under Art. 79 Securities Law.

Although there was an upswing in direct litigation in the area of insider trading and manipulation of the market after investors sued the Everbright Securities Firm for market manipulation, most direct actions focus on misrepresentation in the prospectus and other disclosure documents.

3. *Public Interest Litigation in the Securities Market*

Class actions are not recognised in either the Company Law 2005 or the Securities Law. In early 2002, the Supreme People's Court issued a notice entitled "Acceptance of Cases of Disputes over Civil Tort Arising from False Statements in the Securities Market" ("2002 Securities Notice").[22] Although it permitted courts to accept securities fraud suits, the 2002 Securities Notice prohibited plaintiffs from bringing "group actions." This author agrees with the commentators who believe that it has been applied in Chinese securities litigation to mean that those cases must, in effect, be brought as either individual actions or joint actions.

However, depending on one's definition, two cases vie for designation as the "first" Chinese class action securities fraud lawsuit.[23] In 2001, 363 investors filed a class action suit against Yorkpoint Science & Technology Co. However, the following day, the Supreme People's Court promulgated a notice temporarily prohibiting lower courts from accepting securities lawsuits from private parties The main reason is that courts were not yet prepared to hear securities lawsuits in terms of social responsibility and professional expertise.

After the Supreme Court issued the Judicial Interpretation on Civil Liabilities Arising from the Misrepresentation on the Securities Market on 9 January 2003,[24] investors brought a suit against Daqing Lianyi Co. and Shenyin Wanguao Securities Corporation, the entity that was the listing promoter and main underwriter of the securities during the public offering. The court required the 381 original plaintiffs divide into groups of ten to twenty. As a result, the plaintiff investors were successfully awarded some of their claims damages. This series of litigation was the first comparatively large scale litigation in the securities market, although they were substantially different from the typical class actions in the US.

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[22] 《关于受理证券市场因虚假陈述引发的民事侵权纠纷案件有关问题的通知》*(guan yu shou li zheng quan shi chang yin xu jia chen shu yin fa de min shi qin quan jiu fen an jian you guan wen ti de tong zhi),* issued by Chinese Supreme Court (最高人民法院，*zui gao ren min da yuan*) on 15 January 2002. For the details of the process of making this notice, see then Justice Li Guoguang's introduction under: <http://www.chinacourt.org/article/detail/2008/12/id/333945.shtml>.

[23] D. M. MUIR/J. LIU/H. XU, The Future of Securities Class Actions Against Foreign Companies: China and Comity Concerns, 46 University of Michigan Journal of Law Reform (2013) 1315–1360.

[24] 《最高人民法院关于审理证券市场因虚假陈述引发的民事赔偿案件的若干规定》*(zui gao ren min fa yuan guan yu shen li zheng quan shi chang yin xu jia chen shu yi fa de min shi pei chang an jian de ruo gan gui ding),* No. 2/2013 issued by Chinese Supreme Court. Official English translation is not available. For the Chinese version, see: <http://www.chinalaw.gov.cn/article/fgkd/xfg/cfjs/200303/20030300045803.shtml>.

Article 55 of the Chinese Civil Procedure Law[25] of 2012 introduced the new mechanism of public interest litigation, stating that "Relevant authorities and social organizations may take litigation against the infringements of the public interest especially those involving environmental pollution or damaging mass consumers' legal rights and interests." As the relevant authorities and social organizations play the leading role of plaintiff in this public interest litigation, it differs from the American class action in which the lawyers are the active organizer of the class action against a contingency fee.

Article 47 of the Chinese Consumer Protection Law[26] further extends public interest litigation to consumer disputes, and authorizes the Chinese Consumer Association and provincial level consumer organizations to act as the plaintiff. This consumer-friendly philosophy has led the Chinese Supreme Court to draft two separate judicial interpretations of public interest litigation in the field of consumer disputes and in the field of environmental protection.

In my opinion, public interest litigation should also be extended to the societies market. The China Investors' Association qualifies as an ideal plaintiff to represent public investors in direct litigations. If the Investors' Association holds the shares in many listed corporations, it is also qualified take derivative actions against controlling shareholders, insiders and other third parties infringing on the interests of the company where internal remedies have been exhausted.

This author argues that as Art. 28 of the Consumer Protection Law of 2013 considers consumers in the securities, banking and insurance industries as the target of the Consumer Law, the China Consumers' Protection Company should be empowered to take class actions on behalf of public investors, before an investors' association is established.

4. Indirect Derivative Actions

Shareholders are entitled to take indirect derivative actions to enforce corporate rights as a whole. The most significant indirect action is the shareholder's derivative action.

Traditional civil procedure rules are based on the hypothesis that every party, including a plaintiff and defendant, is rational and reasonable. That means that every party, except the mentally incompetent, knows very well whether to bring litigation to court or not. As mentioned above, Art. 119 of the Civil Procedure Law requires the plaintiff to have direct interest in the litigation. Although the victim company is supposed to sue the directors of

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[25] 《民事诉讼法》*(min shi su song fa),* enacted by the Standing Committee of National People's Congress on 9 April 1991, as amended on 31 August 2012.

[26] 《消费者权益保护法》*(xiao fei zhe quan yi bao hu fa),* enacted by the Standing Committee of National People's Congress on 31 October 1993, as amended on 25 October 2013. The latest version of this Law was effective on 15 March 2014.

the company, often it chooses not to sue when the defendant controls the victim corporation. This effectively represents a hostage situation – with the defendant holding the victim company hostage, and thus unable to sue in its own name. In such cases, traditional civil procedure rules leave corporate victim no justice.

Therefore, it is critically important to encourage and enable shareholder derivative actions in the interest of the victim company pursuant to Art. 151 Company Law 2013. Therefore, any eligible minority shareholder may take legal action in their own name on behalf of the corporation for the damage suffered by the corporation against the directors, supervisors and controlling shareholders who have abused their position.

The function of the shareholder's derivative action is not limited to corporate governance, but also covers the secondary capital market. For instance, under Art. 47 Securities Law, shareholder derivative actions could also be used for disgorgement of short-term trading or short swing profits acquired by the directors, senior executives and shareholders with more than 5% of the outstanding shares of the listed corporation.

Shareholder derivative actions are not only for minority shareholders. In fact, any vulnerable non-controlling shareholder may qualify to use this tool. For instance, this author was once consulted in a derivative action filed by a non-controlling majority shareholder holding 65% of shares in a real estate company against the controlling minority shareholder holding 35% of shares for embezzlement of corporate funds.[27] In this case, the plaintiffs not a minority shareholder, as it owned majority of the equity capital in the real estate company. However, the plaintiff did not have the controlling power in the company, as the defendant, the minority shareholder had full control of the company. Therefore, minority shareholder is not necessarily vulnerable, and majority shareholder is not always the controlling shareholder as average people might consider at first sight.

To make sure that the plaintiff shareholders fairly and adequately represent the victim corporation, and to deter suits designed to oppress minority or other shareholders, Art. 151 Company Law only permits certain minority shareholders who are in fact self-appointed representatives of the victim corporation, to act as the plaintiff when filing derivative actions. The qualification requirements vary depending on the type of corporation.

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[27] In this case, the plaintiffs not a minority shareholder, as it owned majority of the equity capital in the real estate company. However, the plaintiff did not have the controlling power in the company, as the defendant, the minority shareholder had full control of the company. Therefore, minority shareholder is not necessarily vulnerable, and majority shareholder is not always the controlling shareholder as average people might consider at first sight.

Any shareholder of a limited liability company, regardless of the size or duration of shareholding size, is entitled to take derivative actions. The rationale behind this is that the number of shareholders in typical LLCs is very limited, and the fellow shareholders are usually family members, relatives, colleagues or close friends. Therefore, a rational minority shareholder would not launch a derivative action where the conduct of other majority shareholders or management did not merit it. However, if a minority shareholder is determined to file a derivative action, there must be a compelling reason to enforce the rights of the companies in good faith, making the frivolous use of a derivative action suit unlikely. The relatively lower threshold for derivative actions is very helpful in keeping directors accountable and diligent, and thus strengthening the solidarity and mutual confidence of between and among fellow shareholders and directors in closely held corporations.

Quite contrary to the case of closely held corporations, not every single shareholder in a publicly held company has the standing to file a derivative action. In order to prevent the abuse of derivative actions, Art. 151 Company Law has rigid requirements both in terms of size and duration of the shareholding by the plaintiff. First, the plaintiff must possess at least 1% of the total outstanding shares issued by the company. For listed companies with enormous capital resources, the threshold of 1% of total shares is not easy to satisfy. Therefore, the legislature permits two or more minority shareholders to work together as joint plaintiffs, and to aggregate their shares to satisfy the shareholding size requirements. Second, the plaintiff must have been a shareholder in the particular company for at least 180 days or six months. This is intended to ensure that the plaintiff is a genuine investor instead of a speculator, and while there is some doubt as to the effectiveness of the 180 day test, the basic idea is that speculators or investors with a speculative intent are not justified in representing the corporation. The Chinese Supreme Court interprets the180 days as the duration before the plaintiff files a complaint with the court of justice.[28] Therefore, the plaintiff does not need to have been a shareholder when the misconduct occurred, nor does the plaintiff need to maintain the shareholding through the end of the whole court proceeding.

In reality, many investors use the doctrine of trust to invite their close friends to act as the nominal shareholder, and then hide themselves behind this nominal shareholder. In this way, an anonymous shareholder maintains privacy, while receiving the fruits of the investment and bearing little of the

[28] Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Company Law of 2005 (promulgated by the People's Supreme Court, 28 April 2006), udicial interpretation No. 3 (2006), Art. 4, published by the News of People's Court (China). <http://www.chinacourt.org/law/detail/2014/02/id/147551.shtml>. The Chinese title of this document is: 《最高人民法院关于适用〈中华人民共和国公司法〉若干问题的规定（一）》(法释〔2006〕3 号.

risks. The legislature is silent on the eligibility of anonymous shareholders taking derivative actions. This author argues that an anonymous shareholder remains eligible where a nominal shareholder fails to file a derivative action, because the anonymous shareholder acts as the beneficiary shareholder and the nominal shareholder acts as a trustee in their relationship. The court has no reason to deny the eligibility of the beneficiary shareholder when moral hazards against the beneficiary occur on the part of the trustee.

Nonvoting shareholders are also not clearly excluded from the scope of the plaintiff shareholders. Although the voting rights differ from the right to file a derivate suit, nonvoting shareholders are more vulnerable than voting shareholders and generally have more reason to take derivative action.

The requirement to exhaust internal remedies could be abused by the insiders, with directors and supervisors scratching each other's backs. For instance, a close personal friendship between the directors engaging in inappropriate conduct and supervisors, may see the supervisors promise to file a suit, thus discouraging a suit with the shareholder as plaintiff. Dishonest supervisors acting in this way may deliberately lose the corporate claim, thus benefiting the directors. I therefore propose that if directors or supervisors claim to have exhausted corporate internal remedies, the proposed plaintiff shareholder has the right to oversee the corporate litigation. If the proposed plaintiff shareholder has evidence that the directors or supervisors have not demonstrated due loyalty and diligence in the course of the trial, that shareholder should be entitled to step in to file a derivative suit.

In China, derivative actions have not yet become prevalent since the reform of the Company Law in 2005, partly because of the required prepaid court fee calculated based on the amount of the claim. As recovery in derivative actions generally runs to the victim corporation, instead of the shareholder plaintiff, derivative actions could be loosely regarded as "public interest litigation" in the corporate kingdom. Therefore, this author argues that the shareholder plaintiff should only need to prepay a small amount of the court fee ranging from 50 to 100 Chinese Yuan, pursuant to Item 3 of Art. 13 para. 2 of the Regulations on the Litigation Fees[29] for non-pecuniary cases. Another alternative is to allow the shareholder plaintiff to petition the court to postpone, reduce, or waive prepayment of the court fee, as Art. 118 para. 2 of Civil Procedure Law offers this remedy to parties who have difficulties paying litigation expenses.

Regardless of the amount of the prepaid court fee, the successful shareholder plaintiff will be reimbursed by the unsuccessful defendant directors, under the traditional rule in China that the loser bears the court fee. Article 29 para. 1 of the Regulations on Litigation Fees also makes it very clear, stating

[29] 《诉讼费用交纳办法》*(su song fei yong jiao na ban fa),* issued by the State Council on 19 December 2006, effective on 1 April 2007.

that “the litigation expenses should be born by the losing party, unless the winning party is willing to bear”.

VIII. Social Responsibility of Corporate Groups

1. Corporate Social Responsibility in Chinese Law

Corporate groups in China have made great progress in accepting and practicing the core values of corporate social responsibility. However, there are still many challenges ahead.

My academic work “Corporate Social Responsibility”[30] based on my research while visiting the Norwegian Institute of Human Rights from 1996 to 1997, was published by Press of Law in 1999 as the first monograph on the research of CSR. Many of the suggestions in this book were endorsed by Art. 5 and other articles of the Company Law 2005.

Art. 5 para. 1 Company Law 2005 has a general clause on corporate social responsibility:

> “In its operational activities, a company shall abide by laws and administrative regulations, observe social morals and commercial ethics, persist in honesty and good faith, accept supervision by the government and the public, and assume social responsibility.”

2. ISO 26000:2010

As the result of five years of negotiation and bargaining among many different stakeholders across the world, the International Standard Organization issued ISO 26000:2010, Guidance on Social Responsibility on 1 November 2010.[31] It provides harmonized, globally relevant guidelines for private and public sector organizations of all types, based on international consensus among expert representatives of the main stakeholder groups, and encourages the implementation of best practices in social responsibility worldwide. ISO 26000:2010 represents an international consensus to some extent. Although ISO 26000: 2010 is a voluntary standard, it helps clarify social responsibility by translating principles into effective actions, and sharing global best practices.

3. Justification for the Theory of Optimization of Profits

Optimization of profits, instead of maximization of profits, is the logical reflection of corporate responsibility and business ethics in the corporate core

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[30] 《公司的社会责任》*(gong si de she huiz ze ren),* 法律出版社 *(fa lv chu ban she),* (Beijing 1999).

[31] ISO 26000:2010, Guidance on Social Responsibility, available under: <http://www.iso.org/iso/catalogue_detail?csnumber=42546>.

value framework. Profit optimization represents a certain degree of restraint, requiring reasonable profits to be made in legal, ethical, and respectable ways. This conclusion finds ample support in the literature surrounding recent developments in the corporate social responsibility movement, which seeks to augment the factors that motivate corporate decision-making.[32] Proponents of the movement, for instance argue that myriad interests relate to and should play a direct role in deciding corporate affairs, including (but not limited to) the concerns of environmentalists, creditors, consumers, and employees.[33] According to this theory, the possessors of these interests, "stakeholders", have a right to participate in corporate decision-making.[34]

As reflected in the recent backlash from the GSK scandal[35] and as embodied by the Chinese Company Law mandate that companies "observe social morals and commercial ethics and assume social responsibility," the goal of the corporate responsibility movement is not to hijack the corporate form. To the contrary, its purpose is to impress upon corporations, and especially upon MNEs, the necessity of subjecting their pursuit of profits to ethical and legal limitations. For this reason, it is the concept of optimizing profits – of maximizing profits within the boundaries set by legal, moral, and cultural standards – that best encapsulates the global movement that continues to call for more sustainable and inclusive business practices.

CSR has increasingly become a philosophy of Chinese legislation, as seen in the Labour Contract Law[36] of 2007, the Consumer Protection Law[37] of 2013 and the Food Safety Law[38] of 2015 and environmental protection legislation. All the legislation relevant to companies requires the company to be friendly to all the stakeholders including shareholders and non-shareholder groups. In my opinion, every piece of legislation and case-law relevant to business should reflect CSR principles.

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[32] K. Y. TESTY, Linking Progressive Company Law with Progressive Social Movements, 76 Tulane Law Review (2002) 1229.

[33] TESTY, *supra* note 32, 1238.

[34] TESTY, *supra* note 32, 1238.

[35] For the details of the GSK case, see: C. A. SCHIPANI/J. LIU/H. XU, Doing Business in a Connected Society: the GSK Bribery Scandal in China, 1 University of Illinois Law Review (2016) 63.

[36] 《劳动合同法》*(lao dong he tong fa),* enacted on 29 June 2007, effective on 1 January 2008.

[37] 《消费者权益保护法》*(xiao fei zhe quan yi bao hu fa),* enacted on 31 October 1993, as amended on 25 October 2013.

[38] 《食品安全法》*(shi pin an quan fa),* enacted on 28 February 2009, as amended on 24 April 1994.

4. Diversified Forms of Corporate Social Responsibility

CSR could take different forms, including but not confined to donations. Some CSR requirements have been translated into mandatory legal obligations, while other CSR requirements take the form of recommendations based on business ethics or best practices – generally, legal CSR requirements are hard and limvited, while methical CSR requirements are soft but unlimited and far reaching.

CSR requirements could be expressed either in the form of decision procedures or in the form of decision outcome. As far as CSR friendly corporate governance is concerned, the German experience has influenced the Company Law to demand employee participation on the board of supervisors in every company, and demand employee participation on the board of directors in State-owned companies. As far as CSR friendly decision outcomes are concerned, the board of directors is also empowered to use its best discretion to consider and respect the interests of stakeholders in significant contexts such as hostile take-overs.

5. MNEs Need to Pay More Attention to Corporate Social Responsibility in the Chinese Market

Despite the requirement for CSR under company law, large corporate groups are still frequently criticized for their irresponsible behaviour against consumers and the environment by the media and public opinions. In addition to domestic corporate groups, MNEs have been attracting attention from regulators and the public.

Some MNEs are criticized for discriminating against Chinese stakeholders including consumers and employees. For instance, some MNEs take different consumer policies for the same product or service towards Chinese consumers than for consumers in other jurisdictions. They frequently seek to justify this by citing that the level of legal protection in China is lower than in other jurisdictions, when in fact, the current Chinese consumer protection law is close to the most advanced in the world. This has led to repeated warnings to MNEs to read and comply with Chinese consumer law.[39]

I urge MNEs to learn both Chinese business law and business culture. Some foreigners may think that China is based on 'who you know', but this approach is fundamentally flawed. The rule of law was included in the Constitution in

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[39] My remarks on Apple's unfair stand on post sale service policy on CCTV on 29 March 2013 was quoted frequently by media as the following: "I noticed that Apple has a missing part on its logo. I think the missing part is Apple's deep understanding of China's 'Law on Protection of Consumer Rights and Interests', and its gratitude to Chinese consumers", <http://offbeatchina.com/whats-bitten-off-of-apples-logo-a-theory-from-a-chinese-law-professor>.

1999, and China is gradually building a body of law based on current reality. It is extremely important for MNEs to take legal issues in China seriously, as the law has sharp teeth, and the market has equally sharp eyes.

IX. Conclusion

This paper has examined the regulatory framework of corporate groups doing business in China. It is clear that although China has not codified corporate groups in a separate chapter or statute, corporate groups are still protected and regulated by different legal branches, including but not confined to company law, securities law, anti-trust tax law and environmental law. The fiduciary duty of the parent company, the protection of minority shareholders and public investors of the subsidiary, the protection of creditors of the subsidiary, and the strengthening of corporate social responsibility in the subsidiary and the corporate group as a whole will continue to be significant issues in the future. Globalization represents both challenges and opportunities for China to further reform its regulatory framework of corporate groups based on best practice in Germany and other jurisdictions. The goals of legal reform of corporate groups in this regard is to enable Chinese corporate groups to be strong and globalized, to encourage foreign corporate groups to enter the Chinese market, and to promote an inclusive and sustainable win-win business ecology between and among corporate groups and all relevant stakeholders.

Corporate Groups in Korea

Reconciliation of Individualism with Collectivism

Hyeok-Joon Rho

I. Introduction

The development of the Korean economy has seen a proliferation of corporate groups. Every year, the Korean Fair Trade Commission (KFTC) announces the list of major corporate groups known as Large Scale Corporate

Groups, which require total assets worth no less than 5 trillion Won.[1] As of 2011, 62 Large Scale Corporate Groups, including global conglomerates like Samsung and Hyundai Motors, were reported, accounting for 52.6% of the national turnover and 51.1% of the national added value in the manufacturing or mining industry.[2] Corporate groups in Korea, whether large or small, undoubtedly play an important role in the Korean economy with the phenomenon of "group management", which enables diversification and synergy.

Korean corporate law, however, is based on the traditional approach of "individualism", according to which a company in a corporate group is viewed as independent and isolated from other member companies. Some statutes in several countries, most notably in Germany, reflect the corporate group phenomenon and allow group management, provided that appropriate defensive measures are given to interested parties. It is unclear, though, whether the controlling company and the dependent company in Korea will welcome the codification over the corporate group: a controlling company may wish to exercise its de facto influence on a dependent company while taking no responsibility for the failure of its subsidiary; a dependent company, on the other hand, may want to get financial and administrative assistance from its controlling company while turning down any binding directions. In addition, Korean scholars and practitioners have been unwilling to introduce such vague concepts as group interest and fair compensation, which may be abused by the founding families of a corporate group to the detriment of minority stakeholders. Thus, Korean corporate law, as in many other jurisdic-

[1] Art. 14 Monopoly Regulation and Fair Trade Act (MRFTA).

[2] KDI, A Research on Market Structure, KFTC Project Research Paper (2013) 126, see <http://www.prism.go.kr>. According to the analysis, the shares of Large Scale Corporate Groups in the manufacturing or mining industry are as follows:

(billion Won/person)

	Turnover		
	2009	2010	2011
Nationwide	1,125,813	1,328,896	1,494,210
Large Scale Corp. Group	569,728	671,538	785,904
Share	50.6%	50.5%	52.6%
	Added Value		
	2009	2010	2011
Nationwide	2,465,265	2,647,948	2,705,918
Large Scale Corp. Group	476,609	502,852	534,002
Share	19.3%	19.0%	19.7%
	Employee		
	2009	2010	2011
Nationwide	376,404	437,166	482,174
Large Scale Corp. Group	181,227	218,417	246,632
Share	48.1%	50.0%	51.1%

tions, takes a conservative position with only a handful of provisions considering parent-subsidiary relationships.[3]

The discussion in this paper, therefore, is not to explore in detail whether Korean legislature should reform its current individualist approach and head in a different direction. Rather, it tackles the practical issues that are frequently faced by corporate groups in Korea, and provides pinpoint remedies to fill some loopholes and to avoid unreasonable results. Issues on corporate groups may be reviewed from various angles. One may compare legal issues on the formation of a corporate group with those on the management of a corporate group. This paper, however, structures itself according to the status of a company in a corporate group because the concerns of the controlling company's stakeholders tend to be different from those of the dependent company.

The rest of this paper proceeds as follows. Section II provides statutes and statistics on shareholding structures in Koran corporate groups. Section III deals with the aspect of the controlling company. The questions raised by this Section include how to secure authority to make directions and how to protect minority shareholders in the controlling company. In contrast, Section IV explores various aspects of a dependent company: the duty of directors in a dependent company, procedural requirements for a transaction with a controlling company, and the protection of stakeholders in a dependent company with regards to shareholder liability. Section V provides a conclusion.

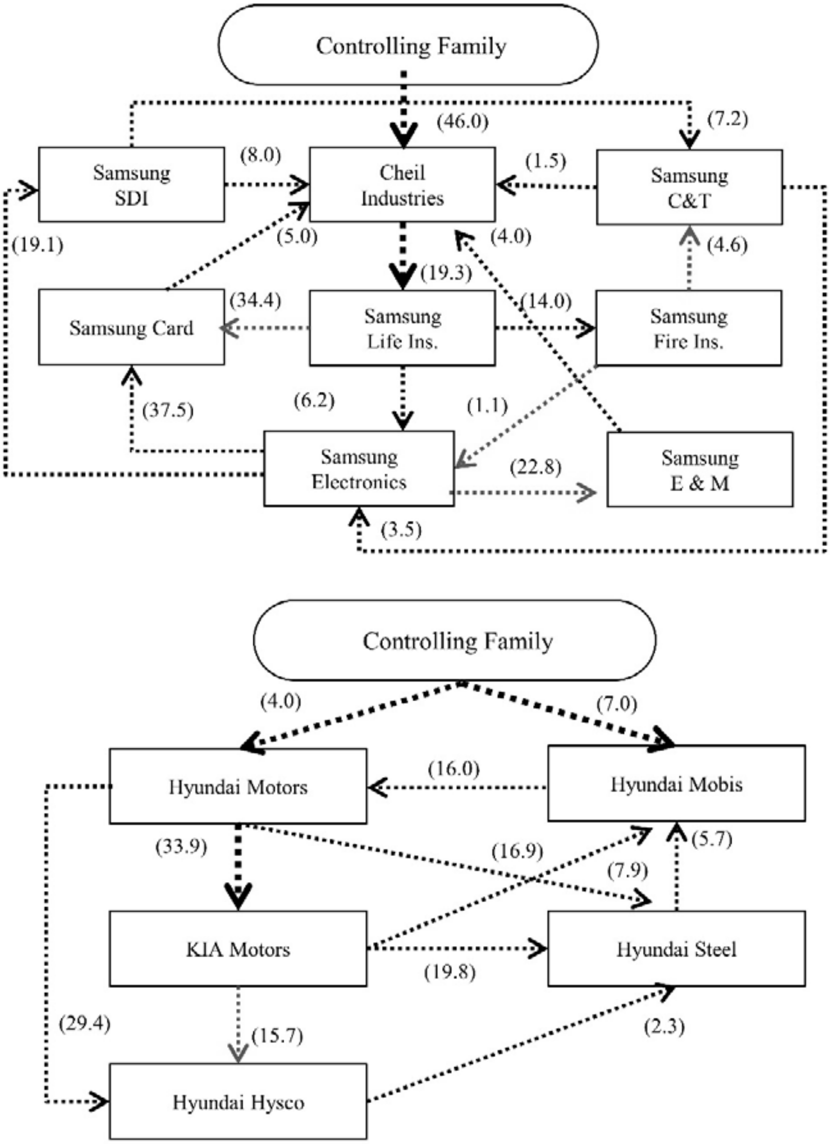
II. Shareholding Structure in Korean Corporate Groups

If dependent companies were wholly owned by controlling companies, the life of a corporate law professor researching the topic of corporate groups would have been simpler. While the issue of protecting creditors and other stakeholders in a dependent company would still exist, the issue of wealth transfer among corporate group members or the expropriation of minority shareholders in dependent company would be less critical. The shareholding structures in Korean large corporate groups, though, have been far from simple and transparent. Diagram 1 shows the shareholding structure of Samsung and Hyundai Motors, Korea's biggest and second biggest private corporate groups, respectively.[4]

[3] For example, Art. 412-5 Korean Commercial Code (KCC) provides the authority of statutory audit to supervise the subsidiary's business under certain circumstances.

[4] In terms of overall size of total assets, Hyundai Motors ranks third, following KEPCO (Korea Electric Power Company), a state-owned corporate group.

Diagram 1: Shareholding Structure of Samsung and Hyundai Motors[5]



[5] KFTC, Press Release, Circular Shareholding in Large Scale Corporate Groups, 24 August 2014.

The reasons why many Korean corporate groups feature circular shareholding are varied: combined investments by corporate group member companies into new businesses might have resulted in complex shareholding; the exchange of shares among founding family members or the companies under their control might have led to circular shareholding, or the controlling company might have created a complicated chain of control in order to maintain their influence in the face of dilution from new shares issued by the dependent company.[6] Regardless of its background, circular shareholding reduces transparency, and it is these opaque and complex structures that are to be blamed for the so-called “Korean discount” for securities issued by those conglomerates.

In an effort to reform the shareholding structure of corporate groups, the Korean government began encouraging the simplification of this complex system in 1999 by adopting special provisions in the Monopoly Regulation and Fair Trade Act (MRFTA). Before 1999, the MRFTA viewed a holding company as a vehicle for concentrating economic power, and prohibited the operation of the holding company, whose main role is to manage its subsidiaries. This was quite a unique regulation, and its rationale was severely criticized. Through the reforms, the government sought a holding company scheme to replace traditional circular shareholding. A typical example of the simplification of the shareholding structure can be seen in the case of LG Group, which voluntarily transformed into a Holding Company structure under the MRFTA in 2002.

[6] KON-SIK KIM/KYUNG-HOON CHUN, A Research over Limitation on Voting Right of the Circularly-Held Shares, Report to the Ministry of Justice of Korea (Seoul, 2012) 24 et seq. The typical example of the formation of circular shareholding in pursuit of fending off dilution is shown below (KFTC, White Paper 2014, 2014, 281)

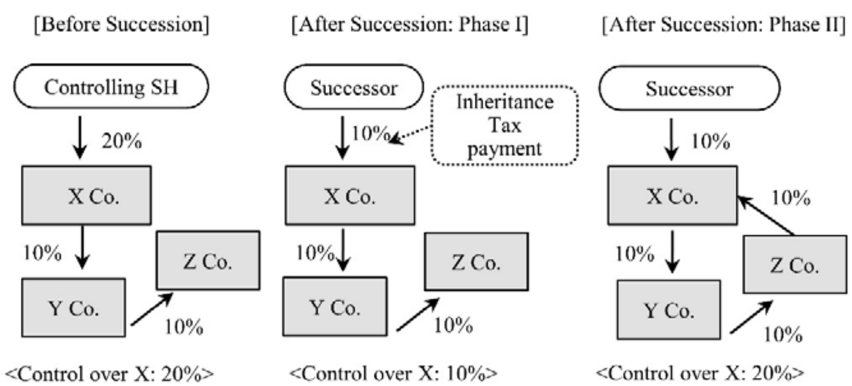
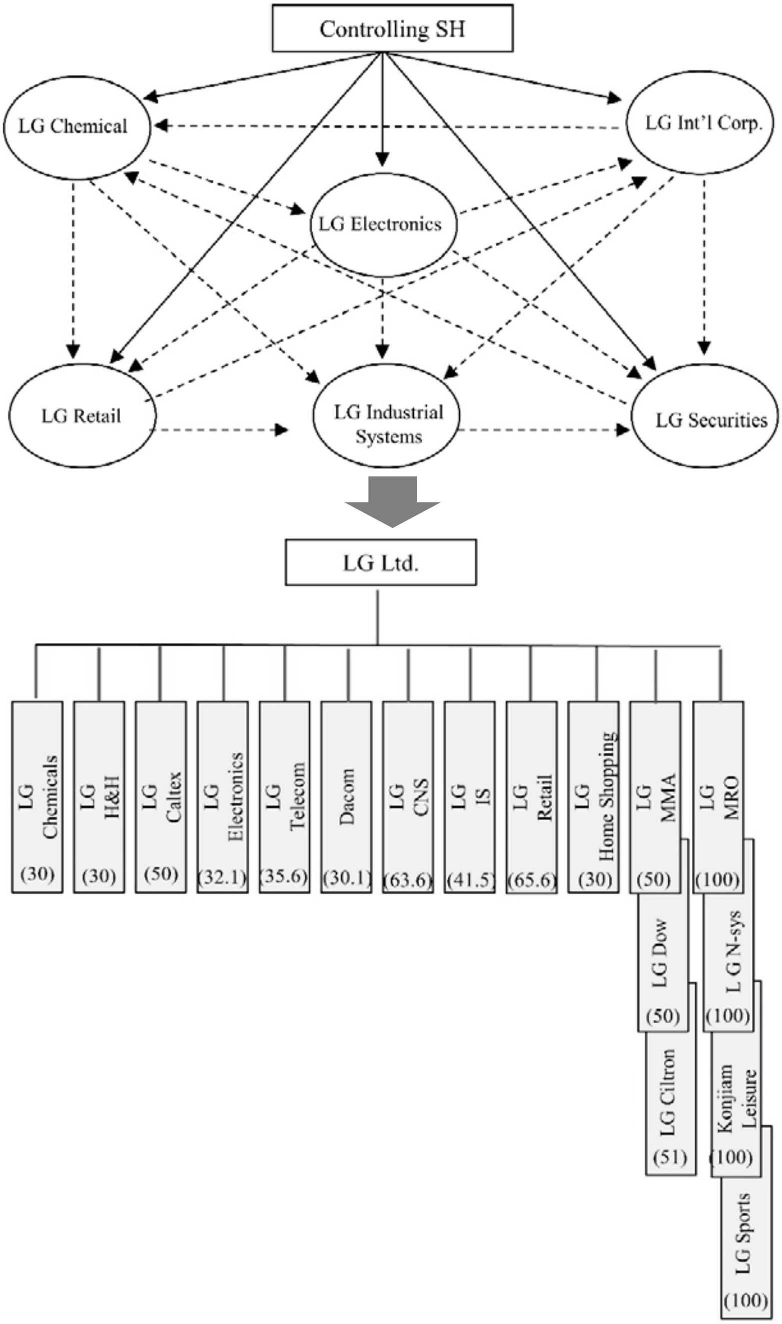
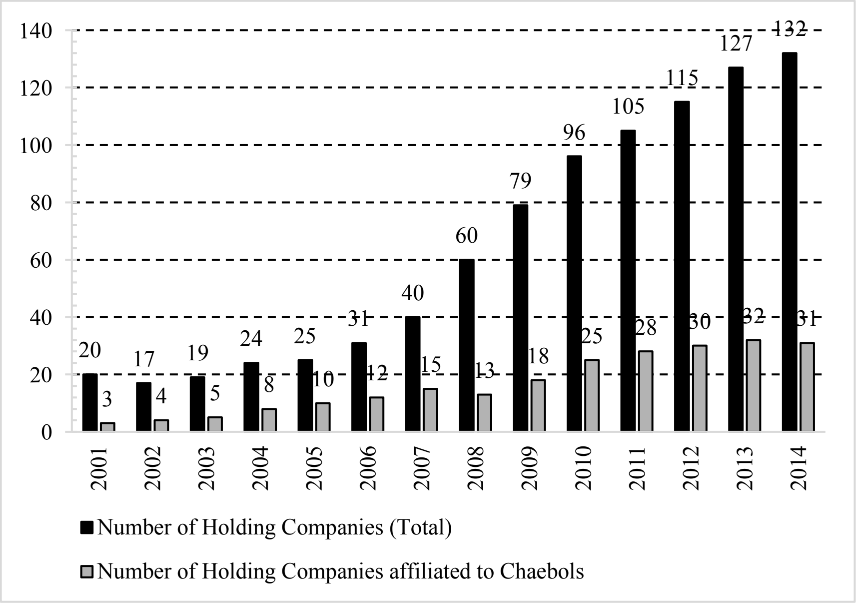


Diagram 2: The Reshuffling of LG Group



The concept of the Holding Company under Art. 2 MRFTA, is basically for regulatory purposes: if a company with assets of 100 billion Won or more has a portfolio of subsidiary(s)' shares accounting for not less than 50% of the whole asset of the company, it falls into the category of the Holding Company under the MRFTA, and the regulation applies. Among the various obligations imposed upon a Holding Company and its subsidiaries, the most critical apply to the ownership of shares: a Holding Company should own not less than 40% (20% in the case of a listed subsidiary) shares in its subsidiary; a subsidiary should own not less than 40% (20% in the case of a listed subsidiary) shares in its subsidiary (i.e. the 'grandson' or sub-subsidiary of a Holding Company); this third level subsidiary may have only 100% subsidiary (i.e. the grand-grandson of a Holding Company); companies within the shareholding chain shall not obtain any shares in other affiliated companies within the group. Thanks to such shareholding regulations, a corporate group member under a Holding Company, as per the MRFTA, is not allowed to circularly hold shares in affiliated group members. As shown in Diagram 2, the transformation into the Holding Company regime enables a simpler and clearer shareholding structure. The trend of transforming into Holding Company is clear, as shown in Diagram 3.

Diagram 3: The Trend of Transforming into Holding Companies[7]



[7] KFTC, Press Release, Statistics on the Holding Company under the MRFTA, 2014 <www.kftc.go.kr>.

The black bars, which represent the number of corporate groups that have adopted a Holding Company regime, show a steady increase since 2001. The increasing trend also applies to the gray bars, which stand for the number of Large Scale Corporate Groups that have adopted the Holding Company regime. As of 2015, Korea has 40 Large Scale Corporate Groups that have controlling founding families, 15 (or 37.5%) of which have adopted the structure of Holding Company regime. So, what was the driving force for such a transformation? A key factor was that the market and the government welcomed a move away from the complicated circular shareholding. The market reacted positively because the Holding Company scheme reduced the potential for risk to spread to other subsidiaries. Further, in the process of selling and buying shares in affiliated companies, the controlling shareholders strengthened their grip over the holding companies, which reduced the possibility of a hostile takeover.

The KFTC estimated that the reform of 1999, which refined the Holding Company scheme, was quite successful, and that one cannot deny that the change from circular shareholding to Holding Company structure represents progress. However, there are several points worth mentioning. First, the Holding Company structure under the MRFTA basically assumes a pyramidstructure and is far from solving fundamental corporate law issues. For example, the obligation of the controlling company to have shares in the dependent company is only limited to 40% (20% in the case of a listed subsidiary), and thus there are still minority shareholders in a subsidiary who are at risk of being abused by the controlling company. Second, the regulations based upon the MRFTA are quite rigid. Due to the rule prohibiting the ownership of affiliated companies' shares, sister companies in a Holding Company group face difficulties in co-establishing a joint venture company. While a Holding Company scheme looks better than the old circular shareholding structure, the best shareholding scenario should be decided by shareholders, not by the law. From that perspective, the provision of a corporate law mechanism harmonizing conflicting interest minimizingdeserves greater attention. The corporate law jurisprudence shall be analyzed from two angles as follows: from the aspect of the controlling company, and that of the dependent company.

III. Aspects of a Controlling Company

1. How to Secure the Authority to Make Directions

A controlling company, as a major shareholder, may exercise its voting rights and other shareholder's rights to monitor and influence the dependent company. The directors in the dependent company are likely to respect the intent of the controlling company, because their tenure depends upon the votes received by the controlling company. But what if the directors refuse to follow the instructions from the controlling company? Can a controlling company give legally binding instructions to the directors of a dependent company?

In Germany, a domination agreement *(Beherrschungsvertrag)* enables a controlling company to issue instructions on the directors of a dependent company. Once a contract-based *Konzern* under § 291 *Aktiengesetz* (AktG) is formed, the management board of the dependent company shall be subject to the controlling company's instructions, regardless of whether they are detrimental to dependent company (§ 308 para. 1 AktG). A controlling company may exercise its rights to issue instructions *(Weisungsrecht),* unless it apparently serves against the interest of the controlling company or corporate group as a whole (§ 308 para. 2 AktG).

The KCC, as in other jurisdictions, does not provide the German-style domination agreement. Thus, it has often been discussed how a controlling company may secure the authority to issue directions to a dependent company. Tensions between some renowned financial holding companies and their fully owned subsidiaries were reported following the refusal to follow the holding company's directions by the directors of fully owned subsidiaries. From the perspective of the controlling company, there is a controversial list of methods to keep control over the dependent company, which shall be analyzed below.

a) Management Agreement

Art. 374 para. 1 KCC provides a management agreement: if a company is (i) to lease all of its businesses to another party; (ii) to let the other person manage its businesses; (iii) to share its entire profits and losses with another person, or (iv) to execute a contract having equivalent effects to the lease etc., the company should obtain a special resolution by the shareholders' meeting.

Leasing all the company's businesses (as in (i)) implies the temporary transfer of the business, and thus does not subject the lessor to the lessee's direction. A contract to share the entire profits and losses (as in (iii)) does not provide the other person with the right to direction, because the contract deals solely with sharing profits and losses, not powers. However, what about the management agreement (as in (ii))? Can a holding company and its subsidiary enter into a management agreement so that the former may secure its authority to direct the latter? Typical management agreements under this provision are made to support and give advice to an affiliated company. For example, some holding companies, through the management agreement, provide human resource training systems as well as services for market analysis and strategy. Because the purpose of the agreement, in this case, is to boost the business of the subsidiary, it is unimaginable that a direction under this agreement may involve sacrificing the interest of the subsidiary. But one may also argue that a holding company can execute a different type management agreement with its subsidiary and impose instruction with detrimental effect, because Art. 374 para. 1 KCC allows the other person to "manage" its business (as in (ii)), and further acknowledges various types of management agreements (by adding (iv)). According to this argument, shareholder safeguards are provided through special resolution and appraisal remedy.

The prevailing view in Korea, however, is that a managerial agreement under Art. 374 para. 1 KCC shall not be created for the benefit of the holding company. Under the civil law jurisprudence of mandate, the holder of the mandate should discharge its duty of care and serve for the benefit of the entity subject to that mandate. Thus, a disadvantageous directions or management by the holding company (i.e. the holder of the mandate) against the subsidiary (i.e. subject to that mandate) contradicts the concept of mandate under Art. 374 para. 1 KCC. From a practical procedural perspective, it is difficult to obtain approval at the shareholders' meeting for a management agreement that is designed against the interest of the subsidiary; the holding company may not vote in the meeting because a shareholder whose interest is associated with the meeting's agenda is disqualified from voting (Art. 368 para. 1 KCC), and the granting of a mandate to a holding company is a clear case of vested interest.[8]

b) Inscription in the Articles of Incorporation or By-laws

Under Art. 433 KCC, the articles of incorporation may be amended by special resolution approved at a shareholders' meeting. A holding company with super majority shares may try to insert a clause into the articles of incorporation of its subsidiary, providing it with a right to direct its subsidiary. On the other hand, a holding company may want to revise the by-law which regulates how a decision is made in a board meeting of its subsidiary: by adding a provision that requires an approval or direction from the major shareholder or the holding company for important business decisions, the holding company may secure its authority to direct. Unlike the articles of incorporation, the amendment of the by-law only requires a resolution of the board meeting. This raises the question of whether provisions to this effect into instruments of a subsidiary are valid and enforceable.

The KCC separates the powers of shareholders and that of the director's board: shareholders meeting shall be entitled to vote on fundamental issues

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[8] Under Art. 368 para. 3 KCC, a controlling company shall be prohibited from voting at a subsidiary's shareholders' meeting where the agenda is about the business transfer between itself and its subsidiary (as opposed to an agenda on a merger between itself and its subsidiary).

(Arts. 434, 518, 522 etc.),[9] whereas the board is responsible for the daily business (Art. 393). Some authority of the board may be assigned to the shareholders' meeting if the articles of incorporation so provide. For example, Art. 416 KCC provides that the articles of incorporation may give the shareholders' meeting the authority to issue new shares. The extension of the shareholders' power in such surroundings is based upon the individual enabling provision of the KCC. Where there is no enabling extension provision, if a holding company, as a major shareholder, is able to legitimately obtain some critical power of its subsidiary's board, it may actually exercise the right to direct the subsidiary's management. Some emphasize the supremacy of the shareholders' meeting over the board of directors, and the articles of incorporation may re-design the intrinsic separation of powers between shareholders and directors. The prevailing view in Korea, however, is that the assignment of the board's authority through the articles of incorporation has its limitations, and that the managerial right should be given to the board. The directors of a company should pursue the interest of the company they belong to, and the assignment of power to the shareholder shall be possible as long as it does not hurt the fundamental separation of powers or disadvantage the company.

The same logic applies to by-laws. A by-law cannot be used for justifying the board's decision that is advantageous for the major shareholders despite being detrimental for the company itself. If a by-law allows the involvement of a holding company in major business decisions, the adoption of such a by-law shall be regarded as letting other people manage its business, an event that is subject to special resolution of the shareholders' meeting under Art. 374 KCC.

In summary, it is unfeasible to secure the authority to direct a subsidiary by adding a special clause to the articles of incorporation or to the by-laws in Korea.

c) Combined Directorship

While a statutory audit of a holding company shall be disqualified as a director of its subsidiary,[10] a director of a holding company may be designated as a director of its subsidiary. A person with double directorship may contribute to the cooperation of both the holding company and its subsidiary. By designating its director as a board member of its subsidiary, a holding company might secure practical influence over the subsidiary's board. The influence here, which is indirect and factual, has its limits.

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[9] Amendment of Charter (Art. 434 KCC); dissolution (Art. 518 KCC); statutory merger (Art. 522 KCC).

[10] Art. 411 KCC provides "A statutory audit shall not assume the office of a director, a manager or an employee of the company and its subsidiary."

First, best practice in Korea recommends that a person with combined directorship should refrain from voting on any transaction that causes conflict between the holding company and its subsidiary. While a person with combined directorship may try to persuade his/her colleagues on the subsidiary's board, he/she cannot cast a vote in favor of the holding company. Second, a person with combined directorship has a duty as a director of not only the holding company but also its subsidiary. Even if this person succeeds in persuading the other directors of the subsidiary into executing disadvantageous transactions with the holding company, it is likely that this person and his/her colleagues shall be jointly and severally liable for any loss borne by the subsidiary.

Combined directorships are often found in corporate groups in Korea. The main function of such a combined system is to enable smooth communication and cooperation between affiliated companies. It is very difficult, though, for a holding company to impose its will upon the subsidiary's board through combined directorship. If it has successfully forced its subsidiary to proceed with a disadvantageous deal, such deals necessarily entail a damage claim against the directors in the subsidiary.

d) Case Law on Wholly Owned Subsidiaries and Its Applicability

The Korean Supreme Court acknowledges the unique feature of 100% shareholding relationships and allows special jurisprudence in the operation of fully owned subsidiaries: if the sole shareholder has written up a minute for the shareholders' meeting, the resolutions under the meeting shall be valid regardless of whether the meeting was actually held[11]. In some cases, including granting approval for a transaction between a director and the company he belongs to, the board resolution may be replaced with the approval of the sole shareholder.[12]

Without any minority shareholders, a sole shareholder can influence operations of the company as he intends. In consideration of the case laws that emphasize the authority and function of the sole shareholder, may the intent of the sole shareholder replace the formal resolution of board? If the answer is "yes", a holding company may secure its authority to direct its subsidiary, as long as the former has 100% shares in the latter.

Even though the Supreme Court allows an exception to a sole shareholder company with regards to the general management of the company, the jurisprudence has not reached a denial of separation of powers between shareholders and directors. Especially in business matters, it is the director's intrinsic authority to direct, and the board may not assign its managerial power

[11] Supreme Court, 11 June 1993, 1993 Da 8702.

[12] Supreme Court, 12 July 2002, 2002 Da 20544.

to shareholders as a whole. Thus, the case law for a sole shareholder cannot be used to secure the sole shareholder's authority to direct.

e) Monitoring through Information Rights

Faced with difficulties in procuring authority to direct, a holding company may take the indirect route to secure its influence by way of monitoring. First, a holding company may exercise its shareholder status to monitor its subsidiary. Under the KCC, a shareholder has various information rights: a shareholder with not less than 3%[13] shares may demand the company to show its accounts and related documents (Art. 466 KCC); a shareholder with not less than 3%[14] may apply to the court for the appointment of an inspector, if there is a reason to suspect dishonest management (Art. 467 KCC).

The KCC further stipulates the authority of statutory audit of a holding company over its subsidiary: a statutory audit of a company (parent company) with more than 50% shares in another company (subsidiary company) may demand that the subsidiary company reports on its business, as long as the report is necessary for carrying out the duties of the statutory audit (Art. 412-5 para. 1 KCC). If the subsidiary company fails to report, or if it is required to verify the contents of such reporting, the statutory audit of the parent company may investigate the business affairs and status of the properties in the subsidiary company (Art. 412-5 para. 2 KCC). While the authority over the subsidiary company seems strong, the monitoring function of statutory audit in the parent company focuses upon the management of the parent company, not that of subsidiary. The audit over the subsidiary company is only possible for as long as it is necessary to audit the parent company itself. Thus, the statutory audit of the parent company may not serve as a vehicle for extensive monitoring rights over the subsidiary company's management.

In summary, monitoring through information rights under the KCC may contribute to an indirect influence over the subsidiary, but it is far from satisfying the intent of the holding company to direct its subsidiary.

2. Protection of Minority Shareholders in the Controlling Company

In general, controlling companies have minority shareholders as well as majority shareholders. Unlike majority shareholders who are interested in securing control over its subsidiary, as discussed above, minority shareholders are concerned about decisions that could depreciate the value of the holding

[13] For listed company, the shareholding requirement is lowered to 0.1% (for special listed company, 0.05%), as long as the shareholder has held the shares not less than six months (Art. 542-6 para. 4 KCC).

[14] For a listed company, the shareholding requirement is lowered to 1.5%, as long as the shareholder has held the shares for not less than six months (Art. 542-6 para. 1 KCC).

company. Such worries can be materialized in various cases: the board of directors might fail to appropriately monitor its subsidiary; or, the board of directors might transfer the holding company's major business onto its subsidiary, a transaction which can make the shareholder's monitoring of that business difficult. On the other hand, the board of directors might decide to buy a substantially sized company without prudent deliberation. For such transactions, a minority shareholder may file a lawsuit (usually in the form of derivative action) against the directors for damages borne by the company. However, the lawsuit can be costly in terms of time and money, and proving wrongdoing on the part of directors and the scope of the damage may not be feasible.

In this part, we shall explore the protection minority shareholders. For the balanced development of a corporate group, it is important to consider the perspectives of outside shareholders as well as insiders.

a) Sale of Business by the Controlling Company

In the formation of a corporate group, a controlling company may separate some of its business to create a new subsidiary. From a business perspective, this decision may be justified because a specialization or a downsizing often boosts competitiveness in a specific field. For a minority shareholder who is interested in the business, however, such separation makes it difficult, if not impossible, to monitor the performance of that segment. Further, the separation often implies a change in character of the company that has been invested in. This Section explores the measures that are taken to balance the protection of minority shareholders with the strategic demand for reshaping the controlling company's business.

(1) German Case Law

The German Supreme Court made several well-known decisions on the protection of minority shareholders who are against the segregation of important businesses. In the *Holzmüller* case,[15] the company (X) tried to transfer one of its main businesses to a newly incorporated 100% subsidiary (Y), and the minority shareholder challenged the decision. The German Supreme Court stood by the minority shareholder, stating that the transfer would have an important impact on shareholders and that the board should get approval from the shareholders' meeting in accordance with § 119 para. 2 AktG.[16]

[15] BGH, 25 February 1982, II ZR 174/80, BGHZ 83, 122, 136 et seq.

[16] "The general meeting may only resolve on matters relating to the management of the company if requested to do so by the management board."

In 2004, the German Supreme Court specified the applicability of *Holzmüller*'s jurisprudence through the *Gelatine* case.[17] The plaintiffs, who were minority shareholders in the company (A), argued that the transfer of shares violated the principle provided by *Holzmüller.* Company A had 100% shares in its subsidiaries B, C, and D, respectively, and transferred its shares in C and D to B. In short, under this transaction, C and D were changed from a 100% subsidiary of A to a 100% sub-subsidiary. The Supreme Court turned down the argument, stating that *Holzmüller*'s jurisprudence applies only to very exceptional circumstances. The transaction challenged was not judged as requiring the amendment of A's articles of incorporation and was considered to be under the board's authority.

(2) Discussion in Korea

Under Art. 374 para. 1 KCC, a special resolution of the shareholders' meeting is required for a company to transfer all or important parts of its business. Shareholders who are against the suggested transfer may have their shares repurchased by the company (Art. 374-2 KCC). Thus, the minority shareholders in a company are provided with protective remedies in the case of the separation of business in the company. A transfer of business, however, is a different concept to mere asset transfers, as it implies an assignment of organized business facilities and infrastructure in terms of both human resources and physical equipment.[18] Individual transfers of assets only need the approval of the board of directors, leaving shareholders unable to influence it. An unusual exception, where an asset transfer is subject to a shareholders' special resolution, is when the asset is so critical in the operation of the company that the transfer would result in the shutdown of the company.[19] In this situation, which is equivalent to the liquidation of the company, the board must obtain the shareholders' special resolution.

What if the company is to sell its "shares" instead of its business, as is shown in the German *Gelatine* case? Under the traditional dichotomy in Korea, shares are classified as assets and thus the sale of shares does not require the shareholders' approval. The rationale reflects the fact that in practice, share deals are frequently made as part of M&A, and the burdensome requirement of obtaining the shareholders' approval would discourage economically efficient M&A activities. However, the traditional approach, which adheres to the dichotomy, fails to reflect the reality of a transaction associated with the corporate group. A holding company may manage its own business indirectly through its subsidiary. In the shareholders' eyes however the economic consequence of the sale of shares in the subsidiary will be the same as

[17] BGH, 26 April 2004, II ZR 155/02, BGHZ 159, 30.
[18] Supreme Court, 8 July 2004, 2004 Da 137717.
[19] Supreme Court, 18 August 1992, 1991 Da 14369, 18.

the disposal of the holding company's own business. In consideration of the rationale behind Art. 374 KCC, which is to protect minority shareholders from fundamental changes in the company's business, an assignment of shares equivalent to a transfer of business should be subject to the shareholders' approval.[20] At the very least, if the sale of shares results in the shutdown of the holding company, the board should discuss the transaction at the shareholders' meeting for a special resolution.

b) Purchase of Business by a Controlling Company

As opposed to the sale of business, the purchase of business enlarges the size and boundary of a corporate group. In this case, limitations to monitoring potential are less of a concern for minority shareholders. The purchase of the new business, however, might bring fundamental characteristic changes to the controlling company, and even detrimental results, especially when the consideration is too high. Thus Art. 374 para. 1 KCC regulates the purchase of businesses: if a company is to purchase all or a part of another company's business and the transaction has a critical impact on the purchasing company's business, the transaction should be approved by special resolution of the shareholders' meeting in the purchasing company.

In this approach the concept of 'business', as in the sale of the business, is limited to organized business facilities and infrastructure and, therefore, the mere transfer of assets shall not amount to the purchase of a business.

What about the purchase of shares? In practice, it is regarded as an asset deal and no shareholder resolution is required for a company to purchase another company's shares. The criticism has been raised that there should be a regulation to avoid inappropriate and inefficient empire building by a company's board. Theoretically speaking, purchase of shares in mega-enterprises has a greater effect than the ordinary purchase of a business; the purchase of shares often implies a fundamental change in the company. While shareholders' involvement may cost more time and money, procedural requirements for the purchase of businesses that have a critical influence on the purchaser should be implemented. In fact, a legislative initiative has begun to require special resolution by shareholders' meeting if the size of the asset transaction is not less than 50% of equity capital of the purchaser.[21]

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[20] Japanese corporate law was revised in 2014 to adopt a new provision that requires a special resolution by shareholders' meeting in a holding company in case of the substantial sale of subsidiary's shares (Art. 467 para. 1 no. 2 Japanese Corporation Act).

[21] Draft Art. 542-14 KCC Bill No. 5513 as of 17 June 2013.

c) *Double Derivative Action*[22]

(1) Concept of Double Derivative Action and a Recent Supreme Court Case

A double derivative action refers to a derivative action brought by shareholders of the parent company against the directors of its subsidiary. As opposed to a single or normal derivative action, it is the shareholder's (i.e. parent's) shareholder that initiates the derivative action. Whether the parent company's shareholders also have standing in a derivative action against the subsidiary's directors has long been discussed in Korea and was finally dealt with by the Supreme Court.[23]

In that case, shareholders of the parent company (corporation "A") brought a derivative action on behalf of its subsidiary (corporation "B"). Around 80.55% of outstanding shares in B were held by A. The defendant, B's representative director accused of misappropriation, argued that the plaintiffs failed to satisfy the standing requirement because they were not the shareholders of B.[24] The Supreme Court turned down the derivative action. Interpreting narrowly and strictly the provisions of the KCC, the Supreme Court stated that the plaintiff(s) in a derivative action should be shareholders of the corporation involved, not shareholders of its parent corporation. Though the parent company controls the subsidiary, they should not be regarded as one entity, the Court added.

(2) Analysis

According to the Supreme Court decision, a double derivative action is not permissible. However, an attempt has been made to allow double derivative actions by revising the KCC. In 2006, the Ministry of Justice released a draft KCC reform bill that covered a wide range of issues.[25] It included a new provision (Art. 406-2) explicitly allowing double derivative actions: "The shareholder(s) holding one percent or more of a corporation may file a derivative action to seek the liability of directors of its subsidiary company." But this provision was later deleted from the government's final reform bill, which was passed in 2011 at the National Assembly.[26]

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[22] For detailed analysis, see H. RHO/K. KIM, Invigorating Shareholder Derivative Actions in South Korea, in: Puchniak/Baum/Ewing-Chow (eds.), The Derivative Action in Asia (Cambridge 2012) 198–199.

[23] Supreme Court, 23 September 2004, 2003 Da 49221.

[24] For details of this case, see K. KIM, The Role of Judges in Corporate Governance: The Korean Experience, in: Kanda/Kim/Milhaupt (eds.), Transforming Corporate Governance in East Asia (London 2008) 126 et seq.

[25] Ministry of Justice Doc. No. 2006-106 (dated 4 October 2006).

[26] KCC, Bill No. 177463 as of 21 September 2007.

Double derivative actions should be permitted, as the possibility of derivative action has *ex ante* positive effects for improving corporate governance. Moreover, under the current legal system, the interest of the parent's shareholders is not well protected. In theory, they may file a lawsuit against the parent's directors for their failure to sue the subsidiary's directors.[27] It would be very difficult, however, to win a case on the basis of such a cause of action.[28] Since the parent's directors may well try to justify their decision not to sue as their 'business judgment,' it would be very difficult to prove negligent or intentional wrongdoing of directors. Double derivative actions are particularly crucial in circumstances where the holding company structure is widely adopted in the business community, as in Korea.

d) Monitoring of the Subsidiary by Minority Shareholders in the Holding Company

Art. 466 KCC secures the information rights of a shareholder over the company: a shareholder with not less than 3%[29] shares may demand the company disclose its accounts and related documents. Under this provision, a qualified minority shareholder may inspect the accounts of the company. But what about the accounts of its subsidiary? Such information rights concerning the subsidiary have important practical implications if a shareholder of a holding company wants to file a lawsuit against the directors of the subsidiary (by way of double derivative action).

Based on Art. 466 KCC, the Korean Supreme Court allowed the inspection of the subsidiary's accounts, which were kept in the holding company, arguing that the author or drafter of the documents was irrelevant.[30] The decision, however, could not be interpreted as providing shareholders in a holding company with general information rights on the subsidiary's accounts; rather, it emphasized that the documents were kept in the hands of the holding company.

It is difficult to interpret Art. 466 KCC as allowing a shareholder of the holding company to inspect accounting document kept by the subsidiary. The issue seems closely associated with a lawsuit against directors in the subsidiary. For active monitoring of the subsidiary's management, the information right of a holding company's shareholders is essential, and the inspection rights as well as the right to raise double derivative action should be adopted.

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[27] The Seoul District Court Southern Branch, 19 September 2003, 2003 GaHap 1749, acknowledged the possibility of such lawsuits.

[28] In Seoul District Court Southern Branch, 19 September 2003, 2003 GaHap 1749 case, the court eventually dismissed the claim by mentioning that the plaintiff failed to prove misconduct by directors.

[29] As mentioned in note 13, lighter shareholding requirement shall apply for listed companies.

[30] Supreme Court, 26 October 2001, 1999 Da 58051.

3. *Preliminary Conclusion*

From the perspective of controlling company, Section III dealt with two major issues: the authority to make directions and the protection of minority shareholders. Unlike the German AktG, the KCC does not adopt the concept of *Konzern* and Korean controlling companies often struggle to secure the authority to issue directions to dependent companies. They may feel dissatisfied with the current range of legal devices including management agreements, inclusion in the articles of incorporation, combined directorship, etc. Does the Korean government need to adopt explicit legislation as in Germany? The failure of the current rules to secure a controlling company's complete control over dependent companies does not necessarily mean a drastic change is required. The legalization of corporate group management without providing protective devices for minority stakeholders in member companies might be misused to justify the pursuit of the controlling members' interests. If holding companies in Korea are not ready to take the responsibility arising from an authority to issue directions, new legislation stipulating detailed rights and obligations for a controlling company is unlikely to be used. The feasibility and usefulness of explicit corporate group legislation in Korea should be cautiously reviewed.

For minority shareholders in a controlling company, the protections provided by the KCC are far from sufficient. While the KCC allows minority shareholders monitoring rights for financial information, such rights are basically associated with the financial documents made by the controlling company, not by the dependent company. Additionally, the Korean Supreme Court has ruled out double derivative actions. Above all, the sale or the purchase of the controlling block in a dependent company is beyond the control of the shareholders' meeting. Particularly where the controlling company's main role is to hold shares in dependent companies and most real business activities are conducted by dependent companies, the minority shareholders of the controlling company should be given more rights concerning dependent companies: double derivative actions should be adopted to deter wrongdoings by directors in dependent companies; the KCC should be revised to require approval by the shareholders' meeting, if the sale or the purchase of controlling block would bring about a fundamental change in the controlling company.

IV. Aspects of Dependent Company

1. *Duty of Directors in Dependent Company: Justification of Corporate Group Interests*

One of the major advantages of a corporate group is its ability to create synergies by pursuing harmonized management among group members. However, under the traditional approach that views a director as an agent of the company he belongs to, the director of each member company should principally serve his company. This raises the question of whether that director is able to prioritize corporate group interest over the interest of his own company. This is particularly critical,in Korea, because a Korean director who fails to carry out his duty as a director may be subject to criminal responsibility as well as civil liability.

Under the German AktG, corporate group interest is recognized and respected, provided that sufficient reward is provided. Firstly, in a contract-based corporate group, directors in the dependent company should follow legitimate instructions from the controlling company. However, in cases where the direction appears disadvantageous to the corporate group, the director should disregard the instruction (§ 308 para. 2 AktG). A minority shareholder of the dependent company may ask the controlling company to purchase of his/her shares at a reasonable price (§ 305 AktG). An outside shareholder of the dependent company, instead of selling his shares, may claim for compensation *(Ausgleich)* of dividends from the controlling company as stipulated by the domination contract or benefit transfer contract (§ 304 AktG). Secondly, in a *de facto* corporate group, a controlling company should not cause the dependent company to enter into any disadvantageous transaction or cause it to take or abstain from taking any measure whereby it suffers a disadvantage, unless this detriment or disadvantage is compensated by equivalent gains or advantages (§ 311 AktG). In other words, a director in the dependent company may pursue the corporate group's interest, provided that the loss borne by the dependent company is compensated by the controlling company.

In Korean criminal practice, the argument of corporate group interest is frequently raised for a director of the dependent company: while the director may have behaved in a way that was detrimental to his company, the actions were intended to benefit the interests of the corporate group. Such arguments, however, have generally failed to persuade the courts. Without any compensation mechanism as established in Germany, it might lead to opportunistic behavior to allow directors exemptions based upon such vague concepts as corporate group interest. In order to assert the fulfillment of his duty, a director should prove that the pursuit of corporate group interest serves the best long-term interests of his own company with concrete evidence.

Enforcement against directors in the dependent company raises various legal issues in Korea. Currently, the reasonableness of criminal charges for directors is the subject of some debate. From the corporate group's perspective, the adoption of the French *Rozenblum* doctrine[31] as well as the German concept of corporate group interest is also being discussed. However, no matter what theory is adopted, the dependent company's directors may not

[31] Cass. crim., 4 February 1985, no. 84-91581 (PB).

pursue the vague concept of corporate group interest without receiving reasonable compensation or reward from the controlling company or other corporate group members.[32] The management of a corporate group should not impose unexpected harm upon minority shareholders and creditors in the dependent company.

2. Procedural Requirements for a Transaction with the Controlling Company

Apart from corporate group interest, a dependent company is prone to exploitation via transactions with the controlling company. With that in mind, Korean statutes have long been regulating transactions between a company and its major shareholders, provided that the company is listed: a listed company should not grant credit to its major shareholders, unless the act falls under three narrow exceptions[33] (Art. 542-9 para. 1 KCC). A large listed company[34] should get approval from the board if it is to enter into a contract, the size of which is larger than the standard[35] specified in the Presidential Decree (Art. 542-9 para. 3 KCC). A major shareholder is a person with 10% or more shares, or a shareholder who may influence critical management issues like electing directors (Art. 542-8 para. 2 KCC). A grant of credit includes a lease of property, a guarantee, a subsidiary through purchase of securities, or other direct or indirect transactions that create a credit risk (Art. 542-9 para. 1 KCC).

Recent corporate group regulation in Korea focuses on the protection of stakeholders in a dependent company that is susceptible to unreasonable instructions from its controlling company. An unfair transaction between the controlling company and the dependent company has been criticized for enabling the unjust enrichment of the founding families of a *chaebol* group, because such transactions transfer the wealth of the shareholders in the dependent company to those in the controlling company. Hence the revision of

[32] The issue is closely associated with the authority of the controlling company to make binding directions. If such authority is allowed, the concept of group interests is relatively easy to be justified.

[33] The exception is provided in Art. 542-9 para. 2 KCC is as follows:

1. Granting of credit determined by Presidential Decree, such as lending money to directors or auditors in order to promote their welfare;

2. Granting of credit allowed by other Acts and subordinate statutes; or

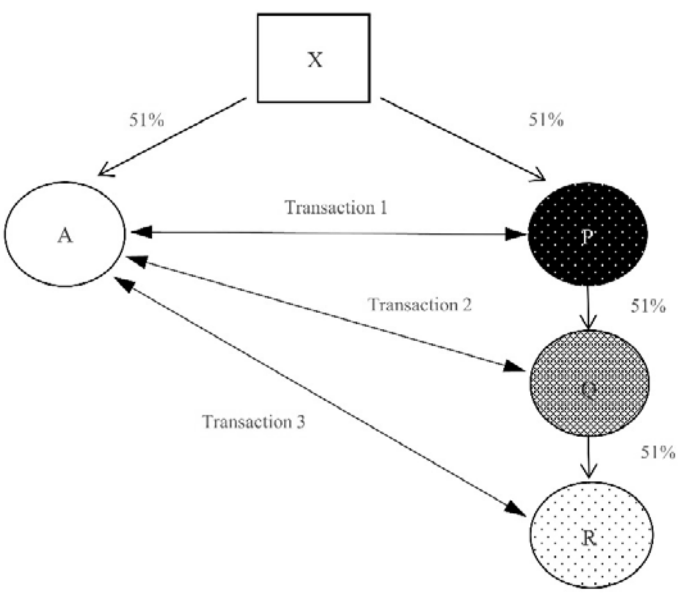
3. Other credit granting determined by Presidential Decree, such as the lending of money unlikely to undermine the sound management of listed companies.[34] According to Art. 35 para. 4 Presidential Decree, it means a listed company whose total asset is not less than 2 trillion Won.

[34] According to Art. 35 para. 4 Presidential Decree, it means a listed company whose total asset is not less than 2 trillion Won.

[35] According to Art. 35 para. 6 Presidential Decree, 1% of the total asset in the case of financial companies; 1% of total turnover in the case of non-financial companies.

Art. 398 KCC imposed procedural requirement for such transaction. Prior to the revision of the KCC in 2011, Art. 398 discussed the transaction between a company and its director. After the revision, major shareholders (including a controlling company) are to be treated like directors when conducting transactions with a dependent company. According to the enhanced procedural requirements under Art. 398 KCC, prior approval from the dependent company's board is required for a transaction with the controlling company. The transaction must be conducted under fair terms and approved by a two-thirds majority of the board members. From the perspective of corporate group regulation, Art. 398 KCC not only regulates transactions with the controlling company, but also with other companies controlled by the controlling company; with another subsidiary, sub-subsidiary or sub-sub-subsidiary of the controlling company are also subject to the regulations in Art. 398 KCC. As shown in Diagram 4, if company A, which is a dependent company of X, carries out a transaction with P, Q, R (the subsidiaries of the controlling company regardless of which tier), requires the board approval from company A. Such strict regulation is only applicable up to the third-tier (i.e. the sub-sub-subsidiary of the controlling company).

Diagram 4: Intra-group Transactions



3. Protecting Stakeholders in the Dependent Company Through Shareholder Liability

Unlike in the US, Korean jurisprudence does not know the duty of loyalty for a controlling shareholder towards other shareholders. A controlling shareholder may be liable in some cases, for the debts of the company it controls, and minority shareholders, creditors and other stakeholders of the company may be protected.

a) Piercing the Corporate Veil

The well-known piercing corporate veil theory is often acknowledged by Korean courts: creditors may pierce the corporate veil to reach a shareholder completely who dominates the business and management of the company and where the assets of the shareholder and the company are comingled.[36] In Germany, the BGH adopted *Existenzvernichtungshaftung* (liability economic destruction of the company) theory to protect creditors of a GmbH company.[37] While the purpose is similar to that of piercing the corporate veil, the theory focuses on protecting the capital and the existence of a GmbH company: if a controlling shareholder has abused his power to remove substantial assets from a GmbH company, which has resulted in its insolvency or a radical reduction in its capacity to pay debts, he is liable to the company's creditors under tort law. In Korea, though, the usefulness of legal capital is not clear,[38] and the Korean Supreme Court is more focused on the abuse of privileges for limited liability by a controlling shareholder.[39]

b) Shadow Director Liability

Another arrangement in Korea renders the controlling shareholder liable for inappropriate influence using "shadow director" liability under Art. 401-2 KCC. This article was modeled on Art. 251 UK Companies Act. According to this, a shadow director is a person whose directions or instructions are generally followed by the company's directors.[40] A company is not regarded as the shadow director of its subsidiary for the purpose of the general duties only because the directors of the subsidiary are accustomed to acting on the in-

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[36] Korean Supreme Court, 19 January 2001, 1997 Da 21604.

[37] BGH, 17 September 2011, II ZR 178/99, BGHZ 149, 10, 17 et seq.; BGH, 25 February 2002, II ZR 196/00, BGHZ 150, 61; BGH, 24 June 2002, II ZR 300/00, BGHZ 151, 181.

[38] In Korea the minimum capital requirement was 50 million Won but the KCC was revised in 2009 to abolish this requirement.

[39] See Supreme Court, 25 August 2006, 2004 Da 26119; 12 November 2004, 2002 Da 66892.

[40] Art. 251 para. 1 UK Companies Act.

structions of the parent.[41] Thus, a controlling company may impose a common policy on the group of companies that it controls without placing itself in breach of duty to the subsidiary.[42] A holding company holding sufficient shares in the dependent company is not automatically a shadow directorship, it is therefore not common for a holding company to be found liable as a shadow director in the UK.[43]

Under Art. 401-2 para. 1 KCC, a person who has issued business instructions to a director by using his influence over the company shall be deemed a director as far as the director's liabilities for the company and the third party are concerned. The provision was codified to impose liability upon the controlling family members who generally exercise their directing influence in informal and unofficial ways. The Supreme Court extended the applicability of the provision to the controlling company as well as the controlling family members[44]. In cases where 100% of the parent company was sued by the creditors of its subsidiary for having issued wrongful instructions to its subsidiary, the Supreme Court stated that a controlling company or a natural person, could also qualify as a shadow director under Art. 401-2 KCC.[45] This provision therefore renders both the controlling company and the director of the controlling company liable, if he has used his influence to issue wrongful instructions. The director of the dependent company who has followed those instructions should be also liable. In this situation, the director of the controlling company, and the dependent and the controlling company itself, shall be jointly and severally liable.[46]

At a glance, the shadow director's liability for controlling the shareholder should be quite effective in protecting shareholders or creditors in the dependent company. In reality, no case has been reported where a controlling company was found liable based on Art. 401-2 KCC; although a few natural persons were recognized as shadow directors in some cases. The reason behind this phenomenon lies in the requirement of Art. 401-2 KCC that the plaintiff prove the exercise of influence by the shadow director. However, it

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41 Art. 251 para. 3 UK Companies Act.

42 L. GOWER/ P. DAVIES, Principles of Modern Company Law (London 2012) 514. However, this provision does not answer the question of whether the director of the subsidiary can agree to implement the group policy without placing themselves in breach of duty to the subsidiary.

43 D. MILMAN, Group of Companies: the Path towards Discrete Regulation in Regulating in: Milman (ed.), Enterprise: Law and Business Organizations in the U.K. (Oxford 1999) 233.

44 Korean Supreme Court, 25 August 2006, 2004 Da 26119.

45 In this case, however, the Supreme Court did not acknowledge liability of the parent company because the plaintiff failed to prove the wrongfulness of parent company's direction.

46 Art. 399 para. 1 KCC provides joint and several liability of directors.

is quite difficult for outsiders to identify the specific flow of instructions, especially where the influence has been exercised in secret, or in unofficial ways. Due to the difficulty in presenting proof, Art. 401-2 KCC cases have rarely been successful since its codification in 1998. Another reason for this is that it is very difficult to draw a line between the legitimate exercise of a shareholder's right and inappropriate influence. A director of the controlling company, in order to discharge his duty to the controlling company, can and should monitor the dependent company, and may give directors of the dependent company recommendations and advice. As the UK statutes have shown, those activities should not be interpreted as instructions subject to shareholder liability. From that perspective, the protection of stakeholders in the dependent company through Art. 401-2 KCC has its limits.

4. *Preliminary Conclusion*

Dependent companies, by their nature, are subject to exploitation by the controlling company. Being aware of the risk, the KCC imposes procedural and substantial requirements on a transaction between a dependent company and a controlling company. Further, outside stakeholders may pursue the shareholder liability against the controlling company (by piercing the corporate veil or shadow director liability).

From a collectivist perspective, which is ready to accept group management, directors of a dependent company have some leeway to pursue corporate group interest to the detriment of the dependent company itself. The emphasis on corporate group interest and group synergy, however, risks justifying unfair wealth transfer among corporate group members. Accordingly, the courts in Korea have followed traditional individualism, separating the interest of each corporate group member. The underdevelopment of corporate group theory or collectivism in Korea may be attributed to weak protective devices for minority shareholders, as witnessed by the scarcity of enforcement against directors and abusive controlling shareholders.

V. Concluding Remarks

The characteristics of formation and management of corporate groups in a country influence its legislation. As noted in Section II, the shareholding structure in many large corporate groups in Korea can be characterized as having controlling minority shareholders (CMS). Some controlling minority shareholders exercise their control through circular shareholding in corporate groups, while others depend upon the share ownership structure allowed by the Holding Company structure under the MRFTA. When analyzing corporate statutes in Korea, the potential for tunneling or pursuit of private benefit by the CMS should also be noted.

This paper reviewed the Korean jurisprudence on corporate groups from the perspectives of the controlling company and the dependent company. We may reclassify the legal issues from two different perspectives: issues with regard to the formation of a corporate group, and issues dealing with the management of a corporate group.

In forming a corporate group, the sale or the purchase of business is problematic. Those who cannot initiate fundamental corporate changes at least have voting rights at shareholders' meeting. The KCC has few protective mechanisms for minority shareholders of the controlling company in the sale or purchase of a controlling block in the dependent company. A further revision is required to protect minority shareholders in a restructuring of the controlling company.

In managing a corporate group, two major issues emerge: the authority to issue instructions by the controlling block and its responsibility, and the issue of an unfair transfer of wealth among group members. Firstly, while a controlling company wishes to secure its authority to direct the dependent company, explicit and binding instructions might imply legal responsibility based upon such jurisprudence as piercing the corporate veil and shadow directors. The authority of the controlling company to make directions and its responsibility may be streamlined by importing German *Konzern* regulations into the KCC. It is not clear, however, whether the Korean corporate group members want to clarify the legal implications of a corporate group, and whether controlling companies are eager to take on those responsibilities in exchange for the legal authority to make directions.

Unfair transfer of wealth among group members is the second among the controversial issues. Particularly where a controlling company has different stakes in its subsidiaries, it may try to transfer wealth of less interested subsidiaries to those of a closely held subsidiary. Under the CMS structure in Korea, the alleged pursuit of corporate group interest might be misused to justify the unfair transfer of wealth. The individualism in Korean corporate practice, which denies corporate group interest and imposes strict regulations over intra-group transactions, could be understood from this perspective. An approach that emphasizes independence and separateness would better serve the goal of protecting outsider stakeholders in dependent companies. Further, the rights of the controlling company's shareholders to raise double derivative actions and monitor the subsidiary are also associated with wealth transfer: a transfer from dependent companies to controlling family members in a controlling company. Like outsider stakeholders in dependent companies, those in controlling companies are also vulnerable to such exploitation. The board of the controlling company, to its own detriment, may turn a blind eye to the wrongdoings of the subsidiary's directors who have served the personal interests of the founding families of corporate groups, but failed to discharge his/her duty as a director. Minorities in the controlling company, as well as those in the dependent company, should be protected.

The statutes and case law in Korea have not sufficiently reflected the phenomenon of the corporate group, and are often criticised for failing to address business reality. The legalization of corporate group management without providing protective devices for minority stakeholders in member companies might be misused to justify the pursuit of the controlling family members' interests under the vague concept of 'corporate group interest'. however The pyramiding or circular shareholding structure in Korean large corporate groups makes such misuse highly likely. Unfair transfer of wealth should be punished through an efficient enforcement system. While the KCC adopted procedural requirements for intra-group transactions *(ex ante),* the enforcement by minority stakeholders *(ex post)* are far from satisfactory: shareholder lawsuits are rare, and the Korean Supreme Court has rejected double derivative actions. An organized corporate group legislation would make the controlling company and the controlling family members more responsible and contribute better to the corporate governance of the corporate group as a whole. The feasibility and usefulness of explicit corporate group legislation in Korean business surroundings, however, should be cautiously reviewed. In the meantime, the *ex ante* and *ex post* devices designed to prevent unfair wealth transfer should be refined. This refinement would also help to justify the genuine business judgments of the board members of a corporate group, and will generate significant synergies from group management.

Recht und Wirklichkeit der verbundenen Unternehmen in Japan

Eiji Takahashi *

I. Einleitung

Mit der Reform des japanischen Gesellschaftsgesetzes (GesG)[1] von 2014 fand erstmals in der japanischen Rechtsgeschichte eine umfassende Regelung der verbundenen Unternehmen Eingang in den Gesetzestext.[2] Konkret handelte es sich dabei um Regelungen zur Konzernbildungskontrolle bei der Ausgabe

* Der Verfasser dankt Herrn DR. OLIVER KIRCHWEHM für die sprachliche Korrektur und die wertvollen Hinweise bei der Abfassung dieses Aufsatzes.

[1] Zum Gesellschaftsgesetz siehe H. KANSAKU/M. BÄLZ, in: Baum/Bälz (Hrsg.), Handbuch Japanisches Handels- und Wirtschaftsrecht (Köln 2011) 63 et seqq.; I. KAWAMOTO/Y. KAWAGUCHI/T. KIHARA, Corporation and Partnership in Japan (The Netherlands 2012) 105 et seqq.; H. ODA, Japanese Law (3. Aufl. Oxford 2009) 217 et seqq.

[2] E. TAKAHASHI, Die Zukunft des japanischen Konzernrechts – Die Reform des Aktienrechts von 2014, AG 2014, 493 et seqq.

neuer Aktien (Art. 206-2 GesG), zur Einführung eines Double Derivative Suite (Art. 487-3) und zu einem *Squeeze out* (Art. 179 GesG).

Der Gesetzgeber bezweckte mit diesen Regelungen ein höheres Schutzniveau für die Muttergesellschaften und deren Aktionäre. Regelungen mit dem Ziel eines weitergehenden Schutzes von Minderheitsaktionären oder Gläubigern der Tochtergesellschaft sucht man indessen auch nach der Reform von 2014 vergebens. Damit drängt sich die Frage auf, ob mit der jüngsten Reform ein vollständiges und abgeschlossenes Konzernrecht etabliert wurde (und damit weitere Regelungen zu verbundenen Unternehmen nicht erforderlich sind) oder ob vielmehr auch nach der Reform weitergehende konzernrechtliche Regelungen erforderlich sind.

Ziel dieses Vortrags ist es, die Rolle und die Aufgaben des Konzernrechts in Japan darzustellen. Dabei soll zunächst ein Überblick über die tatsächliche Situation der verbundenen Unternehmen in Japan gegeben werden (II.). Im Anschluss daran möchte der Referent ein eigenes Modell der Regelungen der verbundenen Unternehmen in Japan skizzieren (III.) um diesen Vortrag dann mit einigen Kernthesen zur zukünftigen Entwicklung des Rechts der verbundenen Unternehmen in Japan abzuschließen (IV.).

II. Die tatsächliche Situation verbundener Unternehmen in Japan

1. Fakten zur Eigentumslage börsennotierter Aktiengesellschaften in Japan

Am 19. Juni 2014 veröffentlichten die vier japanischen Börsen (Tokyo, Nagoya, Fukuoka und Sapporo) einen Bericht zu den Eigentumsverhältnissen von 3.525 börsennotierten japanischen Aktiengesellschaften im Jahr 2013. Dem Bericht zufolge standen 21,3 % aller börsennotierten Aktien im Eigentum von aktiv erwerbstätigen Unternehmen. Dieser Prozentsatz sank in den vergangenen drei Jahren kontinuierlich ab. Im Gegensatz hierzu stieg der Anteil der von ausländischen Aktionären gehaltenen Aktien erneut an: Mit 30,8 % sind ausländische Aktionäre heute die größte Eigentümergruppe in den japanischen börsennotierten Aktiengesellschaften. Von natürlichen Personen werden dagegen nur 18,7 % der Aktien gehalten.[3]

Der ökonomische Grund für den wachsenden Anteil ausländischer Anleger liegt in der sogenannten „Abenomics", also der Wirtschaftspolitik des japanischen Premierministers *Shinzō Abe*. Kennzeichnend für diese Wirtschaftspolitik ist die Lockerung der Finanzpolitik mit einer damit verbundenen Ausschüttung großer Geldmengen auf den japanischen Finanzmarkt. Aufgrund dieser Wirtschaftspolitik gingen ausländische Investoren von einem Kursan-

[3] Die aufgeführten Zahlen stammen aus der Nihonkeizaishimbun (Nikkei) von 20. Juni 2014.

stieg der japanischen börsennotierten Aktien aus und investierten dementsprechend in den japanischen Aktienmarkt. Was vor einigen Jahren noch undenkbar war, wird so zunehmend zur Realität: eine ausländische Gesellschaft als Konzernmutter einer japanischen börsennotierten AG. Dieses Phänomen konfrontiert heute die japanische Gesellschaftsrechtswissenschaft zunehmend mit internationalen gesellschaftsrechtlichen Problemen wie etwa der Frage, wie Minderheitsaktionäre und Gläubiger einer japanischen Tochtergesellschaft auf Grundlage der richterlichen Rechtsfortbildung vor benachteiligenden Eingriffen einer ausländischen Muttergesellschaften geschützt werden können.

Aus juristischer Sicht liegt der Grund für den starken Anstieg des Anteils ausländischer Aktionäre darin, dass in den letzten Jahren das System der wechselseitigen Beteiligungen stetig abgebaut wurde und immer weniger börsennotierte japanische AGs Abwehrmaßnahmen gegen feindliche Übernahmen umsetzten.

2. *Fakten zu verbundenen Unternehmen in Japan*

Zur Verdeutlichung der Organisationsnatur können die verbundenen Unternehmen in Japan in drei Gruppen eingeteilt werden: „wechselseitige Beteiligungen", „Unternehmensgruppen" und „Konzerne". Im Folgenden soll die aktuelle Situation der Unternehmensverbindungen in Japan innerhalb der einzelnen Kategorien dargestellt werden.

a) *Wechselseitige Beteiligungen*

Die wechselseitigen Beteiligungen (auch „Ringbeteiligungen" genannt) wurden lange als Symbol für den geschlossenen japanischen Kapitalmarkt angesehen.[4] Das System geriet jedoch mit dem Zusammenbruch der *Bubble Economy* am 28. Dezember 1990 und den damit verbundenen drastischen Kursverlusten auf den japanischen Kapitalmärkten ins Wanken. Spätestens mit der Umstellung der Bilanzierung von Unternehmensanteilen auf die Marktpreismethode mussten Banken mit vielen wechselseitigen Beteiligungen nun ihre Aktien zum tatsächlichen Kurs bilanzieren und so hohe Verluste verbuchen.[5] Das Netz der wechselseitigen Beteiligungen in japanischen börsennotierten

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[4] „Japan Inc. Owns 70% of itself". R. ZIELINSKI/N. HOLLOWAY, Unequal Equities, Power and Risk in Japan's Stockmarket (Tokyo 1991) 24. Vgl. H. BAUM, Aktienbesitz und Publizität in Japan, in: Leser/Isomura (Hrsg.), Festschrift für Zentaro Kitagawa zum 60. Geburtstag am 5. April 1992 (Berlin 1992) 626; H. BAUM., Marktzugang und Unternehmenserwerb in Japan (Heidelberg 1995) 72; E. TAKAHASHI, Changes in the Japanese Enterprise Groups?, in: Baum (Hrsg.), Japan: Economic Success and Legal System (Berlin 1997) 229.

[5] M. YOSHIKAWA/M. ITŌ, *Kabushikimochiai wa naze kaishōshitanoka* [Warum lösen sich die wechselseitigen Beteiligungen auf?], Gekkan Shihonshijō 236 (2005) 40 et seqq.

Unternehmen wurde seither zunehmend negativ beurteilt. Ein weiterer Grund für den Rückgang der wechselseitigen Beteiligungen ist darin zu sehen, dass diese mehr und mehr ihre Bedeutung als Maßnahme zur Abwehr feindlicher Übernahmen verloren haben, da den Unternehmen nach den Reformen des Gesellschaftsrechts der jüngeren Vergangenheit heute andere Abwehrmaßnahmen (wie etwa ein „rights plan“)[6] zur Verfügung stehen.[7]

Aktuell befindet sich der Anteil der wechselseitigen Beteiligungen innerhalb börsennotierter AGs auf einem historischen Tiefststand: Ende 2013 lag der Wert der wechselseitig gehaltenen Aktien bei nur 10,5 % des Wertes sämtlicher an der Börse gehandelter Aktien.[8] Trotz der sinkenden Bedeutung der wechselseitigen Beteiligungen üben ausländische institutionelle Investoren indessen weiterhin Druck auf japanische börsennotierte AGs aus, die von dem Unternehmen gehaltenen Aktien zu verkaufen und so die liquiden Mittel der Gesellschaft zu erhöhen.[9]

b) *Unternehmensgruppen*

In Japan existieren zwei Typen von Unternehmensgruppen. Zum einen sind dies die *Zaibatsu*-Gruppen mit Wurzeln in den ehemaligen japanischen Mega-Konzernen („Zaibatsu“)[10]. Hierzu gehören etwa Mitsui, Mitsubishi und Sumitomo. Zum anderen gibt es die Banken-Gruppen, die die japanischen Großbanken mit ihren Geschäftspartnern gegründet haben. Als Beispiele sind hier vor allem Fuyō, UFJ (ehemals Sanwa) und Daiichikangin zu nennen.

Die strukturellen Charakteristika der Unternehmensgruppen sind wechselseitige Aktienbeteiligungen innerhalb der Gruppe sowie das Bestehen eines „Präsidenten-Clubs“, in dem sich hochrangige Vertreter der Mitgliedsunternehmen einmal pro Monat zu einem Meinungs- und Informationsaustausch treffen.[11] In den Mitgliedsunternehmen gibt es ein deutliches Zusammengehörigkeitsbewusstsein, das insbesondere in den *Zaibatsu*-Gruppen dadurch verstärkt wird, dass die Firmennamen (etwa „Mitsui“, „Mistubishi“ oder „Sumitomo“) und Marken (etwa die drei Diamanten des Mitsubishi-Logos) der

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[6] H. BAUM/M. SAITO, in: Baum/Bälz (Hrsg.), Handbuch Japanisches Handels- und Wirtschaftsrecht (Köln 2011) 367.

[7] O. KIRCHWEHM, Reformen der Corporate Governance in Japan und Deutschland (Frankfurt a.M. 2010) 20.

[8] Nikkei, 13. Juli 2014.

[9] Nikkei, 13. Juli 2014.

[10] H. MORIKAWA, Zaibatsu: The Rise and Fall of Family Enterprise Groups in Japan (Tokyo 1992) 3 et seqq.

[11] E. TAKAHASHI, Japanese Corporate Groups under the New Legislation, ECFR 2006, 289; E. TAKAHASHI, Konzern und Unternehmensgruppe in Japan – Regelung nach dem deutschen Modell? (Tübingen 1994) 29 et seqq.; E. TAKAHASHI, Change in the Japanese Corporate Groups?, in: Baum (Hrsg.), Japan: Economic Success and Legal System (Berlin 1997) 232.

Gruppe von all ihren Mitgliedern genutzt werden können. Dabei besteht üblicherweise innerhalb der *Zaibatsu*-Gruppen ein eigener Ausschuss, der prüft und entscheidet, ob ein neues Mitgliedsunternehmen die Namen und Logos nutzen darf.[12]

Die Unternehmensgruppen werden oft als *Keiretsu* bezeichnet[13] und gelten im Ausland als Symbol der Geschlossenheit des japanischen Markts. *Yoshikazu Miyazaki* begründete eine Auffassung, nach der jede *Keiretsu*-Gruppe ihre Tätigkeit in einem neuen Industriebereich auf nur eines ihrer Mitgliedsunternehmen beschränkt.[14] Dieser Verhaltenstypus der Unternehmensgruppe wird als „*one-set*-Prinzip" bezeichnet.[15] Tatsächlich kommt es nur sehr selten vor, dass Mitgliedsunternehmen der gleichen Unternehmensgruppe zueinander in Konkurrenz treten. *Eisele* sah das *one-set*-Prinzip dabei deutlicher in *Zaibatsu*-Gruppen und weniger deutlich in den Banken-Gruppen ausgeprägt.[16]

Vor dem zweiten Weltkrieg gehörte ein Drittel des gesamten in den japanischen Unternehmen gebundenen Kapitals zu den 10 großen *Zaibatsu*-Gruppen wie Mitsui, Mistubishi, Sumitomo oder Yasuda.[17] Im Jahr 1989 gehörten immerhin noch 17,24 % des Kapitals aller japanischen Unternehmen zu den sechs größten Unternehmensgruppen Mitsui, Mistubishi und Sumitomo, Fuyō, Sanwa und Daiichikangin. Bis zum Jahr 1999 sank dieser Anteil indessen auf 13,15 % ab.[18]

Dass die Unternehmensgruppen heute keine statischen Verbünde darstellen, zeigt etwa die Gründung der Mitsui-Sumitomo Bank durch die Fusion der beiden Banken im Jahre 2001.[19]

Da die Unternehmensgruppen nur noch wenig Einfluss auf die japanische Wirtschaft ausüben, hat die *Fair Trade Commission* (FTC) mittlerweile die empirischen Untersuchungen zu den sechs Unternehmensgruppen in Japan eingestellt.[20]

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[12] E. M. HADLEY, Antitrust in Japan (Princeton 1970) 250.

[13] M. GERLACH, Keiretsu Organization in the Japanese Economy, in: Johnson/Tyson/Zyman (Hrsg.), Politics and Productivity: The Real Story of Why Japan Works (Brie 1989) 141 et seqq.; E. M. HADLEY, Fn. 12, 203 et seqq.; U. EISELE, Holdinggesellschaften in Japan (Tübingen 2004) 65 et seqq.

[14] Y. MIYAZAKI, *Sengo nihon no keizaikikō* [Die Wirtschaftsstruktur Japans nach dem zweiten Weltkrieg] (Tokyo 1966) 53.

[15] T. KIKKAWA, *Nihon no kigyōshūdan: Zaibatsu no renzoku to danzetsu* [Die Unternehmensgruppe in Japan – Kontinuität und Umbruch der Zaibatsu] (Tokyo 1996) 192 et seqq.

[16] U. EISELE, Fn. 13, 73 et seq.

[17] Nikkei, 25. August 2013.

[18] Vgl. FTC, *Kigyōshūdan no jittaichōsa – Dainanaji Chōsahōkokusho* [Empirische Untersuchung der Unternehmensgruppen – siebter Bericht], 2 (1) Bild 1, 18. Mai 2001.

[19] Nikkei, 25. August 2013.

Es gibt jedoch einige Beispiele dafür, dass die Mitgliedsunternehmen der Unternehmensgruppe ihr Gruppenzugehörigkeitsgefühl nach wie vor nicht verloren haben. Hier ist etwa der Fall der Mitsubishi Motors AG zu nennen. Nachdem sich die Daimler-Chrysler-Gruppe als Hauptaktionär des Unternehmens im Jahr 2004 geweigert hatte, zusätzliche Mittel für Restrukturierungsmaßnahmen bereit zu stellen, übernahmen die Mitsubishi Schwerindustrie AG, die Mitsubishi Handelshaus AG und die Tokyo-Mitsubishi-UFJ Bank AG im Jahr 2005 die Vorzugsaktien von Daimler-Chrysler.[21] Die Kapitalbeteiligung der drei zur Mitsubishi-Gruppe gehörenden Unternehmen dauert nicht nur bis heute an, sie wurde durch eine Umwandlung der Vorzugsaktien in Stammaktien am 12. September 2013 sogar noch weiter gestärkt.[22]

c) Konzerne

Es entsprach lange der herrschenden Meinung, dass eines der zentralen Charakteristika der japanischen Konzerne in der dezentralen Entscheidungsfindung auf Ebene der Tochtergesellschaften liegt.[23] Die Muttergesellschaft entscheidet hiernach zwar unmittelbar über die Personalpolitik und zentrale gesellschaftsrechtliche Fragestellungen der Tochtergesellschaften, gewährt diesen aber in allen die eigentliche Geschäftsführung betreffenden Fragen weitgehende Entscheidungsfreiheiten. Die dezentrale Entscheidungsfindung in japanischen Konzernen hat den Vorteil, dass die Muttergesellschaft die Vor-Ort-Kenntnisse der Tochtergesellschaften *(„on the spot knowledge“)*[24] im Rahmen der Konzernführung nutzen kann, wodurch die japanischen Konzerne auch auf kleine Änderungen im Marktumfeld schnell und flexibel reagieren können.[25]

Die nicht konzentrierte Entscheidungsfindung und die Ermöglichung selbstständiger Entscheidungen der Tochtergesellschaft bleiben nach wie vor wichtige Eigenschaften der japanischen Konzerne. So sagte der Präsident der *Japan Air Lines* (JAL) im Jahre 2014, dass es der Konzernpolitik des Unternehmens entspreche, die Tochtergesellschaften subjektiv selbstständig auszurichten. Der Präsident von HITACHI erklärte im Jahre 2014 als organisatori-

[20] FTC, *Kigyōshūdan no jittaichōsa – Dainanaji Chōsahōkokusho* [Empirische Untersuchung der Unternehmensgruppen – siebter Bericht], 18. Mai 2001.

[21] G. HIRAI, *Sengogata Kigyōshūdan no keieishi* [Betriebsgeschichte der Unternehmensgruppe nach dem zweiten Weltkrieg] (Tokyo 2013) 417.

[22] Nikkei, 12. September 2013.

[23] H. ITAMI, The “Human Capitalism” of the Japanese Firm as an integrated System, in: Imai/Komiya (Hrsg.), Business Enterprise in Japan: Views of Leading Japanese Economists (Cambridge 1994) 78.

[24] M. AOKI, Horizontal vs. Vertical Information Structure of the Firm, The American Economic Review 76 (1986) 973.

[25] E. TAKAHASHI, Japanese Corporate Groups, Yesterday and Tomorrow, The Journal of Interdisciplinary Economics 9 (1998) 8.

sches Unternehmensziel, innerhalb eines Jahres die Unternehmensaktivitäten in die Geschäftsbereiche Finanzierung, öffentliche Verbände, Industrie und Elektrizität aufzuteilen und die Entscheidungskompetenzen innerhalb der einzelnen Tochtergesellschaften anzusiedeln.[26]

Anders sieht die Lage jedoch bei den ausländischen Tochtergesellschaften japanischer Konzerne aus. Multinationale Konzerne mit Sitz der Muttergesellschaft in Japan sind in der Regel stark konzentriert organisiert.[27] Die Befugnisse zur Entscheidung über die Geschäftsführung der Tochtergesellschaft sind hier zu einem großen Teil bei der Muttergesellschaft angesiedelt. Den Direktoren einer ausländischen Tochtergesellschaft werden dagegen nur verhältnismäßig geringe Kompetenzen eingeräumt und auch ihre Chancen, Direktor der Muttergesellschaft zu werden, sind nur gering. Offenbar vertraut die japanische Muttergesellschaft in diesem Fall nicht den *„men on the spot",* was nicht zuletzt zu einem Motivationsverlust der Direktoren und führenden Arbeitnehmer der ausländischen Tochtergesellschaften führt.[28]

Interessant ist in diesem Zusammenhang, dass japanische Unternehmen, die von ausländischen Unternehmen übernommen wurden, oft sehr erfolgreich geführt werden. Das Paradebeispiel hierfür ist wohl die Nissan Automobil AG, der es vor allem seit März 1999 unter Führung ihrer französischen Mutter Renault gelungen ist, tiefgreifende Restrukturierungsmaßnahmen umzusetzen und wieder erfolgreich auf dem Markt zu agieren. Dabei ist hier besonders hervorzuheben, dass zu Beginn der Restrukturierung der bisherige japanische Unternehmenspräsident entlassen und als neuer CEO ein von *Renault* entsandter Manager *(Carlos Ghosn)* eingesetzt wurde.

Zu einem ähnlichen Ergebnis kommt der Engländer *George Olcott* nach der empirischen Untersuchung von fünf aus dem Ausland übernommenen japanischen Unternehmen. In seinem Buch „Conflict and Change: Foreign Ownership and the Japanese Firm" stellt er fest, dass die Übernahme eines japanischen Unternehmens durch ein ausländisches Unternehmen zwar kurzfristig zu kulturellen Konflikten führt, langfristig aber keine negativen Effekte für das japanische Unternehmen bestehen.[29] In seinem Schlussresümee stellt er dementsprechend fest, dass ein ausländisches Mutterunternehmen bei der Stärkung der Wettbewerbsfähigkeit eines japanischen Unternehmens eine durchweg positive Rolle spielen kann.[30]

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[26] Nikkei, 10. September 2014.

[27] K. MOTOHASHI, *Seizōgyōhukkatsu eno kadai, jou, Genchika de nihon wa okure* [Der Wiederaufbau der Produktionsindustrie als Aufgabe, Teil. 1, Verspätete Lokalisierung der japanischen Unternehmen], Nikkei, 30. Dezember 2013.

[28] MOTOHASHI, Fn. 27.

[29] G. OLCOTT, *Gaishi ga kaeru Nihonteki keiei: Haibriddo keiei no soshikiron* [Conflict and Change: Foreign Ownership and the Japanese Firm] (Tokyo 2010) 240 et seqq.

[30] G. OLCOTT, Fn. 29, 248.

III. Zukünftige Regelungen verbundener Unternehmen in Japan

1. Zukünftige gesetzliche Regelungen der wechselseitigen Beteiligungen

Hauptmotiv für die Einführung wechselseitiger Beteiligungen war, Übernahmeversuche und sonstige Einflussnahmen seitens Drittunternehmen abzublocken. Von diesem Druck befreit war es den Unternehmen in der Vergangenheit möglich, langfristige Geschäftsstrategien zu verfolgen.[31] Andererseits befreien wechselseitige Beteiligungen zwar die betroffenen Unternehmen vom Druck feindlicher Übernahmen, schwächen aber zugleich auch die Kontrolle der Unternehmensleitung durch die Aktionäre.[32] Letztlich resultiert das System der wechselseitigen Beteiligungen also in einem Machtausbau der Direktoren der Gesellschaft, die daher nur wenig motiviert sind, die wechselseitigen Beteiligungen aufzulösen.[33] Unter dem Gesichtspunkt einer Stärkung der Rolle der Aktionäre lässt sich daher ein Bedürfnis nach gesetzlichen Regelungen zur Beschränkung der wechselseitigen Beteiligungen nicht von der Hand weisen.

Das aktuell geltende Recht entzieht wechselseitig beteiligten Unternehmen mit einem gegenseitigen Anteilsbesitz in Höhe von jeweils mindestens 25 % vollständig das Stimmrecht (Art. 308 Abs. 1 GesG). An Stelle dieses radikalen Stimmrechtsausschlusses wäre jedoch eine Regelung vorzugswürdig, die eine Stimmrechtsbeschränkung nur noch für den Fall der Wahl von Direktoren vorsieht, in diesem Fall aber auch bei einer Beteiligung von weniger als 25 % am jeweils anderen Unternehmen. Hier könnte insbesondere die deutsche Regelung nach § 328 Abs. 3 AktG Pate stehen, wonach wechselseitig beteiligten Unternehmen nur bei der Wahl der Direktoren sein Stimmrecht nicht ausüben kann.

2. Zukünftige gesetzliche Regelungen der Unternehmensgruppe

Der Anteil wechselseitiger Beteiligungen innerhalb von der Mitsubishi Gruppe und der Sumitomo Gruppe lag in den siebziger Jahren bei über 25 Prozent. Spitzenreiter war hier die Sumitomo Gruppe mit 28,1 % im Jahre 1973.[34]

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[31] K. YOSHIHARA, *Kabushiki no mochiai* [Wechselseitige Aktienbeteiligungen], Shōjihōmu 1466 (1997) 16.

[32] O. KIRCHWEHM, Fn. 7, 18 f.; H. BAUM, Marktzugang und Unternehmenserwerb in Japan (Heidelberg 1995) 74 f.; U. EISELE, Fn. 13, 78 et seq.

[33] E. TAKAHASHI, Unternehmensübernahmen in deutschem und japanischem Kontext: Betrachtung von Aktionärsstrukturen, externer Corporate Governance und Unternehmensverständnis in Japan, in: Assmann et al. (Hrsg.), Markt und Staat in einer globalisierten Wirtschaft (Tübingen 2010) 83.

[34] J. HASHIMOTO/H. TAKEDA (Hrsg.), *Nihonkeizai no hatten to kigyōshūdan* [Entwicklung der japanischen Wirtschaft und Unternehmensgruppen] (Tokyo 1992) 313. Zur Beteiligungsstruktur der Sumitomo-Gruppe im Jahr 1986 siehe I. KAWAMOTO, Neue Entwick-

Damals wurde die Gefahr diskutiert, dass die Unternehmensgruppen durch ihren Präsidenten-Club gemeinsam einen beherrschenden Einfluss auf ein Mitgliedsunternehmen ausüben und dieses so schädigen könnten. Zu dieser Zeit drehte sich die Diskussion von gesetzlichen Regelungen der Unternehmensgruppe vor allem um die Einführung einer Schadensersatzregelung für den Fall einer Schädigung durch eine gemeinsam beherrschende Gruppe.[35] Heute werden entsprechende Regelungen indessen nicht mehr benötigt, da mit dem Rückgang der wechselseitigen Beteiligungen auch der Einfluss des Präsidenten-Clubs auf die einzelnen Unternehmen einer Unternehmensgruppe erheblich zurückgegangen ist.[36]

3. Zukünftige gesetzliche Regelungen der Konzerne im Spiegel der aktuellen Rechtsprechung

a) Konzernbildungskontrolle

Mit dem Ziel einer Stärkung der Rechte der Bestandsaktionäre wurden durch die Reform von 2014 Regelungen zur Ausgabe neuer Aktien, die einen Wechsel des beherrschenden Aktionärs bewirken, eingeführt (Art. 206-2 GesG). Erhält hiernach der Erwerber neu ausgegebener Aktien auf Grund der Neuausgabe über die Hälfte der Stimmrechte, so sind die bisherigen Aktionäre mindestens 2 Wochen vor der Ausgabe hierüber zu informieren (Art. 206-2 Abs. 1 GesG). Statt einer Mitteilung direkt an die einzelnen Aktionäre ist dabei auch eine öffentliche Bekanntmachung oder – in börsennotierten Gesellschaften – die Abgabe eines Wertpapierberichts möglich (Art. 206-2 Abs. 2 und 3 GesG).

Verweigern innerhalb der zweiwöchigen Frist mindestens 10 % aller Stimmrechte die Zustimmung zu diesem Kontrollwechsel, so bedarf die Ausgabe der neuen Aktien der Zustimmung durch die Hauptversammlung (Art. 206-2 Abs. 4 GesG). Der entsprechende Beschluss ist dabei mit einfacher Mehrheit zu fassen (Art. 309 Abs. 1 GesG). Eine Ausnahme besteht jedoch für den Fall, dass die finanzielle Situation der Gesellschaft so schlecht ist, dass die Ausgabe neuer Aktien für den Fortbestand des Unternehmens erforderlich ist (Art. 206-2 Abs. 4 GesG).

In der jüngeren Vergangenheit hat ein Fall für einiges Aufsehen gesorgt, bei dem die 2014 eingeführten Konzernbildungsregeln zum Tragen gekommen wären, wenn sie damals bereits gültiges Recht gewesen wären. Dem am 26. März 2014 entschiedenen *Hikari Tsūshin*-Fall[37] lag folgender Sachverhalt

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lungen im Bereich des Gesellschaftsrechts in Japan, in: Coing et al. (Hrsg.), Die Japanisierung des westlichen Rechts (Tübingen 1990) 222 et seq.

[35] E. TAKAHASHI, Konzern und Unternehmensgruppe in Japan – Regelung nach dem deutschen Modell? (Tübingen 1994) 111.

[36] E. TAKAHASHI, *Kaishahō gaisetsu dai 3 han* [Die Prinzipien des Gesellschaftsrechts] (3. Aufl. Tokyo 2015) 116 et seqq.

zu Grunde: Auf der einen Seite der Auseinandersetzung stand die Keiō's Holding AG, ein börsennotiertes, mit der Vermittlung von Telekommunikationsdienstleistungen befasstes Unternehmen. Auf der anderen Seite stand die Hikari Tsūshin AG als mit einem Anteilsbesitz von 22,48 % größter Aktionär der Keiō's Holding. In einer finanziell schwierigen Unternehmenssituation fasste der Verwaltungsrat der Keiō's Holding den Beschluss, neue Aktien an die Nojima AG auszugeben. Durch die Ausgabe der neuen Aktien wäre der Anteilsbesitz von Nojima auf 52,09 % gestiegen, so dass die Keiō's Holding eine Tochtergesellschaft von Nojima geworden wäre. Hikari Tsūshins Beteiligung wäre dagegen auf 10,77 % gesunken. Gemeinsam mit anderen Aktionären beantragte Hikari Tsūshin daraufhin den Erlass einer einstweiligen Verfügung auf Unterlassung der Ausgabe der neuen Aktien. Das *Distriktgericht Sendai* lehnte den Antrag jedoch ab und begründete dies damit, dass die Ausgabe der neuen Aktien im Ermessensspielraum der *Business Judgement Rule* des Verwaltungsrats der Keiō's Holding liege und die Rechte der Aktionäre nicht auf grob unbillige Art und Weise verletze (Art. 210 Nr. 2 GesG).

Da der Hikari Tsūshin-Fall vor Inkrafttreten der Reform des GesG von 2014 stattfand, kam die neue Konzernbildungsregelung des Art. 206-2 GesG nicht zur Anwendung. Andernfalls hätte die Keiō's Holding AG über die Ausgabe neuer Aktien an die Hikari Tsūshin AG eine ad-hoc-Meldung abgeben müssen (Art. 206-2 Abs. 1 GesG). Hikari Tsūshin, die mit über 10 Prozent an der Keiō's Holding beteiligt war, hätte dieser Ausgabe neuer Aktien daraufhin widersprechen können, woraufhin die Ausgabe neuer Aktien nur nach Fassung eines zustimmenden Beschlusses der Hauptversammlung möglich gewesen wäre. Ein entsprechender Beschluss wäre jedoch keinesfalls zustande gekommen, da Hikari Tsūshin und die auf ihrer Seite stehenden Aktionäre vor der Ausgabe der neuen Aktien über insgesamt 51,08 % der Stimmrechte der Keiō's Holding verfügten.

Shisaku Iwahara, der Vorsitzende der Gesellschaftsrechtsabteilung des Gesetzgebungsrats, kommentierte die Konzernbildungskontrolle nach Art. 206-2 GesG in der Fassung von 2014 wie folgt: „Diese Regelung ist dazu geeignet, eine in tatsächlicher Hinsicht missbräuchliche Ausgabe neuer Aktien zu verhindern".[38] Der *Hikari Tsūshin*-Fall zeigt, dass die Konzernbildungskontrolle nach der Reform von 2014 durchaus einen höheren Schutz der Interessen der Aktionäre einer Tochtergesellschaft bewirken kann.

b) *Die Konzernleitungspflichten in der japanischen Rechtsprechung*

Nach herkömmlich vertretener Ansicht besteht keine Pflicht der Direktoren einer Muttergesellschaft zur Aufsicht über die Geschäfte einer Tochtergesell-

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[37] Distriktgericht Sendai, 26. März 2014, Kinyūshōjihanrei 1441, 57.

[38] S. IWAHARA, *„Kaishahō no minaoshi ni kansuru yūkōan" no kaisetsu* [Erläuterung des „Entwurf der Grundsätze des Gesellschaftsrechts"], Shōjihōmu 1976 (2012) 7.

schaft. Dieser Standpunkt wurde etwa auch im Jahr 2001 in einem Urteil des Distriktgerichts Tokyo[39] im sogenannten Nomura-Fall vertreten. In diesem Fall verletzte die US-amerikanische, 100%ige Enkelgesellschaft des japanischen Mutterhauses Nomura Vorgaben der SEC und musste ein Bußgeld in Höhe von 1,18 Millionen Dollar zahlen, woraufhin einige Aktionäre des Mutterhauses Aktionärsklage gegen deren Direktoren erhoben. In seiner Entscheidung betonte das Distriktgericht Tokyo, dass das Trennungsprinzip auch in der Beziehung zwischen einer Mutter- und einer Tochtergesellschaft gelte:

> „Muttergesellschaft und Tochter- oder Enkelgesellschaft sind selbstständige juristische Personen mit jeweils eigenem Geschäftsführungs- und Aufsichtsorgan. Die Geschäfte der Tochtergesellschaft werden von deren Direktoren geführt. Die Direktoren der Muttergesellschaft haften grundsätzlich auch dann nicht, wenn die Tochtergesellschaft durch die Geschäftsführung ihrer Direktoren benachteiligt ist und infolgedessen auch die Interessen der Muttergesellschaft beeinträchtigt werden."

Auch in der Entwurfsphase des japanischen Gesellschaftsrechts von 2003 wurde eine Aufsichtspflicht der Direktoren der Muttergesellschaft gegenüber der Tochtergesellschaft überwiegend abgelehnt.[40] Begründet wurde dies damit, dass die Anerkennung solcher Pflichten zu einem Ausbau der Konzernleitung durch die Direktoren der Muttergesellschaft führen würde: Um einer Haftung wegen Verletzung von Aufsichtspflichten zu entgehen, könnten die Direktoren der Muttergesellschaft den im traditionell dezentralisierten japanischen Konzern bestehenden weiten Ermessensspielraum der Tochtergesellschaften deutlich einengen,[41] was letztlich zu einem Verlust des Organisationsvorteils der japanischen Konzerne führen würde.

Seit dem Jahr 2008 wird entsprechend *Hommelhoffs* Theorie der „Konzernleitungspflicht"[42] eine Auffassung vertreten, die Kontrollpflichten der Direktoren der Muttergesellschaft gegenüber der Geschäftsführung einer Tochtergesellschaft anerkennt. Begründet wird dies damit, dass die Beteiligung an einer Tochtergesellschaft einen Vermögensbestandteil der Muttergesellschaft darstellt und somit aus der Pflicht der Muttergesellschaft, ihre Vermögenslage zu verbessern, auch die Pflicht zur Kontrolle der Geschäftsführung ihrer Tochtergesellschaften folgt.[43]

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39 Distriktgericht Tokyo, 25. Januar 2001, Hanreijihō 1760, 144.

40 T. SAKAMOTO, Anmerkung, Hogakuzasshi 50 (2003) 106.

41 K. EGASHIRA, *Kigyōketsugōhō no rippō to kaishaku* [Gesetzgebung und Auslegung des Konzernrechts] (Tokyo 1995) 198 et seqq.; K. YOSHIMOTO, Anmerkung, Hanreitaimuzu 975 (1998) 20; T. SAKAMOTO, Fn. 40, 110.

42 P. HOMMELHOFF, Konzernleitungspflicht (Köln 1982) 43 et seqq.

43 K. FUNATSU, *„Gurūpu keiei" no gimu to sekinin* [Pflichten und Haftung in „Gruppenunternehmen"] (Tokyo 2010) 268 et seqq.

Dieser Auffassung der „Konzernleitungspflicht“ folgte in einigen Fällen der jüngeren Vergangenheit auch die Rechtsprechung.[44] An erster Stelle ist hier das Urteil des Distriktgerichts Tokyo aus dem Jahr 2011[45] zu nennen, wonach einen vertretungsberechtigten Direktor einer Muttergesellschaft beim Erwerb eines Grundstücks für die Fabriken einer 100 %igen Tochtergesellschaft eigene Untersuchungspflichten treffen, wenn der Erwerb für den ganzen Konzern von erheblicher Bedeutung ist. Vernachlässigt der vertretungsberechtigte Direktor der Muttergesellschaft diese Untersuchungspflichten, so verletzt er eine ihm gegenüber der Muttergesellschaft obliegende Sorgfaltspflicht.

Der Gedanke der Konzernleitungspflicht fand auch in die japanische Rechtswissenschaft Eingang und unter seinem Einfluss wurde in Japan bei der Reform des GesG von 2012 die Einführung einer Pflicht des Verwaltungsrats zur Kontrolle der Geschäfte der Tochtergesellschaft diskutiert.[46]

Dieser Gesetzesvorschlag wurde allerdings nur als Alternative für den Fall diskutiert, dass die Einführung einer repräsentativen Klage der Aktionäre der Muttergesellschaft gegen die Direktoren der Tochtergesellschaft nicht umgesetzt werden kann. Da eine solche Klagemöglichkeit mit der Reform des GesG von 2014 eingeführt wurde, verzichtete der Gesetzgeber letztlich auf die Einführung einer Regelung zur Konzernleitungspflicht.[47]

Diese legislatorische Entscheidung ist auch grundsätzlich zu begrüßen, da die Einführung einer Konzernleitungspflicht sicher zur Verstärkung der Kontrollmacht der Direktoren der Muttergesellschaft führen und die japanischen Konzerne damit den Organisationsvorteil einer lockeren Konzernstruktur verlieren würden.

In der deutschen Lehre[48] wird im Zusammenhang mit einer konzernweiten Compliance-Verantwortung[49] eine Pflicht der Direktoren von Muttergesellschaften zur Ergreifung vorbeugender Maßnahmen gegen illegale Handlungen der Direktoren von Tochtergesellschaften diskutiert. Weitergehende

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[44] Zur Rechtsprechung siehe H. KANSAKU, *Oyakokaisha to gurūpukeiei* [Konzern und Gruppenunternehmen], in: Egashira (Hrsg.), *Kabushikikaishahō taikei* [Das System des Aktienrechts] (Tokyo 2013) 98 et seqq.

[45] Distriktgericht Tokyo, 24. November 2011, Hairejihō 2153, 109.

[46] Kaishahōseibukai shiryō Nr. 23 *„Oyakokaisha ni kansuru kiritsu ni kansuru nokosareta ronten no kentō“* [Die Betrachtung zum sonstigen Schwerpunkt der Regelungen der Mutter- und Tochtergesellschaften] 1.

[47] E. TAKAHASHI, Ansatzpunkte für eine Rezeption der deutschen Gesellschaftsrechtslehre in Japan, in: Kaal et al. (Hrsg.), Festschrift zu Ehren von Christian Kirchner (Tübingen 2014) 379 et seq.

[48] Vgl. M. HABERSACK, Gedanken zur konzernweiten Compliance-Verantwortung des Geschäftsleiters eines herrschenden Unternehmens, in: Bechtold/Jickeli/Rohe (Hrsg.), Recht, Ordnung und Wettbewerb – Festschrift zum 70. Geburtstag von Wernhard Möschel (Baden-Baden 2011) 1175, Fn. 1.

[49] D. A. VERSE, Compliance im Konzern, ZHR 175 (2011) 402.

Kompetenzen oder gar Pflichten der Direktoren der Muttergesellschaft zur Kontrolle der Geschäftsführung der Tochtergesellschaft sollten jedoch nicht begründet werden.

c) Schutz der Gläubiger von Tochtergesellschaften

Da sich über die Durchgriffslehre eine unmittelbare Haftung der Muttergesellschaft gegenüber den Gläubigern einer Tochtergesellschaft begründen lässt, spielt sie in Japan eine besondere Rolle im Zusammenhang mit dem Schutz der Gläubiger von Tochtergesellschaften. Durch die Rechtsprechung wurde die Durchgriffslehre erstmals im Jahr 1969 durch ein Urteil des Obersten Gerichtshofs[50] anerkannt und findet seither auf das Verhältnis einer Mutter- zu ihren Tochtergesellschaften Anwendung.[51]

Nach der Rechtsprechung des Obersten Gerichtshofs[52] bestehen zwei Fallgruppen für die Anwendung der Durchgriffslehre. Die erste Fallgrupp betrifft das sogenannte „Leerwerden der Rechtspersönlichkeit", also Fälle, in denen (etwa bei einer Einpersonengesellschaft) der Gesellschafter und die Gesellschaft faktisch identisch sind. Anerkannt wird dieser Fall beim kumulativen Vorliegen der folgenden Voraussetzungen: eine Vermögensvermischung zwischen der Gesellschaft und dem Gesellschafter, die Vermischung der Geschäftsführung der Gesellschaft mit der Geschäftsführung des Gesellschafters und die Nichtbefolgung gesellschaftsrechtlicher Normen zur Einberufung der Hauptversammlung.

Die zweite Fallgruppe der Durchgriffslehre betrifft Fälle des Missbrauchs der Rechtspersönlichkeit der Gesellschaft. Dabei handelt es sich insbesondere um Fälle, in denen ein Gesellschafter die Gesellschaft beherrscht und deren eigenständige Rechtspersönlichkeit in unzulässiger Weise missbraucht.

In der japanischen Arbeitsrechtswissenschaft besteht Einigkeit darüber, dass die Arbeitsnehmer einer Tochtergesellschaft eines besonderen Schutzes bedürfen, wenn diese Tochtergesellschaft seitens der Muttergesellschaft zwangsweise aufgelöst und ihr Geschäftsbetrieb von der Muttergesellschaft oder anderen mit der Muttergesellschaft verbundenen Unternehmen übernommen wird. In letzterem Fall ist jedoch umstritten, ob die Arbeitnehmer ihren Anspruch auf Weiterbeschäftigung gegen das konzernverbundene Unternehmen, das den Geschäftsbetrieb übernommen hat, oder gegenüber die Muttergesellschaft selbst zu richten haben. Die herrschende Meinung vertritt die Auffassung, dass in diesem Fall das Arbeitsverhältnis grundsätzlich nur gegenüber dem Unter-

[50] Oberster Gerichtshof, 27. Februar 1969, Minshū 23, 511.

[51] Distriktgericht Sendai, 26. März 1950, Hanreijihō 588, 38; Distriktgericht Osaka, 26. März 1952, Hanreijihō 666, 87; Distriktgericht Fukuoka, 20. Juli 1995, Haireijihō 1543, 3.

[52] Oberster Gerichtshof, 27. Februar 1969, Minshū 23, 511; Oberster Gerichtshof, 26. Oktober 1973, Minshū 27, 1240.

nehmen besteht, dass den Geschäftsbetrieb tatsächlich übernommen hat.[53] Die Gegenmeinung vertritt die Auffassung, dass das Arbeitsverhältnis in diesem Fall grundsätzlich auf die Muttergesellschaft übergeht.[54]

Im Daiichi Kōtsū-Fall folgte das Obergericht Osaka der von *Nishitani* vertretenen Auffassung eines Übergangs des Arbeitsverhältnisses direkt auf die Muttergesellschaft. Die Daiichi Kōtsū AG, ein Taxiunternehmen, übernahm sämtliche Aktien der Sano Daiichi Kōtsū AG, übertrug deren zentralen Geschäftsbetrieb auf eine ihrer Tochtergesellschaften (die Mikage Diichi Kōtsū AG) und löste die Gesellschaft sodann auf. Motiv der Aktion war in erster Linie, sich durch die Unternehmensauflösung der gewerkschaftsangehörigen Arbeitnehmer der Sano Daiichi Kōtsū AG entledigen zu können.

Das Obergericht Osaka[55] sah hier einen eindeutigen Fall des Missbrauchs der Rechtspersönlichkeit und wandte dementsprechend die Durchgriffslehre an. Dabei erkannte es den Übergang des Arbeitsverhältnisses der Arbeitnehmer der ehemaligen Sano Daiichi Kōtsū AG direkt auf das Mutterunternehmen des Geschäftsnachfolgers an. Die Arbeitnehmer der Sano Daiichi Kōtsū AG mussten also im Ergebnis direkt von Daiichi Kōtsū weiterbeschäftigt werden.

Die japanische Form der Durchgriffshaftung der Muttergesellschaft weist dogmatisch sowohl Elemente der Verhaltenshaftung[56] als auch der Zustandshaftung nach deutschem Recht auf. Das Obergericht *Osaka* stützte den Schutz der Arbeitnehmer der Tochtergesellschaft auf einen Missbrauch der Rechtspersönlichkeit und damit auf die Logik der Verhaltenshaftung. Dieser Lösung ist zuzustimmen, da hier die Daiichi Kōtsū AG und die Sano Daiichi Kōtsū AG unter einheitlicher Leitung standen und die Muttergesellschaft durch die bezweckte Beseitigung unangenehmer Arbeitnehmer ein missbräuchliches Motiv verfolgte.

Es gehört heute zu den wichtigsten Aufgaben der Gesellschaftsrechtswissenschaft, ein klares Konzept für den Schutz der Gläubiger von Tochtergesellschaften auszuarbeiten.

Meines Erachtens nach ist insbesondere die im Daiichi Kōtsū-Fall angewandte Durchgriffshaftung dazu geeignet, die Gläubiger von Tochtergesellschaften zu schützen. Ein Direktanspruch gegenüber einer Muttergesellschaft würde hiernach in Fällen bestehen, in denen die Tochtergesellschaft zwangs-

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[53] K. KANNO, *Kaishakaisan to koyōkankei – Jigyōjōtokaisan to jigyōhaishikaisan* [Die Auflösung der Gesellschaft und das Arbeitsverhältnis – Auflösung durch Aufgabe des Geschäftsbetriebs und Auflösung durch Geschäftsübertragung], Kanno/Nakajima/Watanabe (Hrsg.), *FS Kōichirō Yamaguchi, Yūai to Hō – Kōichiō Yamaguchi Kokikinenn* [Freundschaft und Recht - Festschrift zum 70. Geburtstag von Kōichiō Yamaguchi] (Tokyo 2007) 162.

[54] S. NISHITANI, *Kokaisha kaisan to hōjinkaku hinin no hōri* [Auflösung der Tochtergesellschaft und Durchgriffslehre], Rōdōhōritsujunpō 1561 (2003) 38.

[55] Obergericht Osaka, 26. Oktober 2007, Rōdōhōritsujunpō 1689, 47.

[56] K. SCHMIDT, Verlustausgleichspflicht und Konzernleitungshaftung im qualifizierten faktischen GmbH-Konzern, ZIP 1989, 546.

weise von der Muttergesellschaft aufgelöst wird und gleichzeitig ihren Geschäftsbetrieb der Muttergesellschaft oder einem anderen mit der Muttergesellschaft verbundenen Unternehmen überlässt. Flankierend müsste der Gesetzgeber eine Regelung einführen, wonach eine Muttergesellschaft gegenüber den Gläubigern der Tochtergesellschaft unmittelbar haftet, wenn die Muttergesellschaft im Wege der einheitlichen Leitung der Tochtergesellschaft deren Insolvenz verursacht.[57]

d) Schutz der Minderheitsaktionäre einer Tochtergesellschaft

Im Gesetzgebungsprozess wurde die Meinung vertreten, dass eine Beeinträchtigung von Tochtergesellschaften durch die Muttergesellschaft schlichtweg nicht existiert. Diese Auffassung vermag jedoch keineswegs zu überzeugen – tatsächlich gibt es immer wieder Fälle einer Beeinträchtigung der Interessen einer Tochtergesellschaft durch deren Muttergesellschaft. Hier ließe sich etwa ein Fall nennen, in dem eine Tochtergesellschaft, deren Aktien zu 52 % von einer anderen Gesellschaft gehalten wurden, von dieser Muttergesellschaft dazu gedrängt wurde, einer anderen Tochtergesellschaft ein Darlehen ohne Sicherheiten zu geben und dieser Weisung letztlich auch folgen musste.[58] In einem anderen Fall wurde eine Tochtergesellschaft von deren Muttergesellschaft dazu gedrängt, ihre Produkte so lange unter dem Marktpreis zu liefern, bis die Muttergesellschaft neue Produkte auf dem Markt eingeführt hat. In Japan wird im Allgemeinen vermutet, dass Transaktionen zwischen einer Mutter- und einer Tochtergesellschaft nicht zu marktüblichen Bedingungen stattfinden.

Da die Lehre der Treuepflichten der Aktionär in Japan noch nicht anerkannt wird,[59] versucht man die hierdurch entstehende Lücke zunächst über die Lehre der faktischen Direktoren zu füllen. Für einen Schutz der Minderheitsgesellschafter einer Tochtergesellschaft ist diese Lehre jedoch untauglich, da sich die Muttergesellschaft intensiv mit der internen Geschäftsführung der Tochtergesellschaft beschäftigen muss, um als faktischer Direktor der Tochtergesellschaft anerkannt zu werden.[60]

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57 E. TAKAHASHI, AG 2010, 823.

58 M. FUJITA, *Shihaikaisha ni yoru hutō na atsuryoku ni kakaru taiōtō no kentō* [Untersuchung zu Maßnahmen gegen eine ungerechtfertigte Beeinflussung durch die beherrschende Gesellschaft], Bericht des Kansaishōjihōkenkyūkai [Handelsrechtsforschungsgruppe Kansai] vom 25. Juli 2009, 1.

59 E. TAKAHASHI, Gleichbehandlungsgrundsatz und Treuepflicht im japanischen Gesellschaftsrecht, in: Stürner (Hrsg.), Die Bedeutung der Dogmatik für die Rechtsentwicklung (Tübingen 2010) 270 et seqq.

60 M. FUJITA/K. TAKAHASHI, *Jijitsujō no torishimariyakuriron ni kansuru saibanrei ni tsuite* [Über die Rechtsprechung zum faktischen Direktor], Bericht des Kaisaishōjihōkenkyūkai [Handelsrechtsforschungsgruppe Kansai] vom 25. Oktober 2014, 18.

Ein weiteres Problem ist, dass es einer juristischen Person nach Art. 331 Abs. 1 Nr. 5 GesG verboten ist, den Posten eines Direktors einer AG auszuüben. Die Muttergesellschaft kann sich also nicht unmittelbar selbst, sondern nur über ihre Vertretungsorgane oder sonstigen Vertreter an der Geschäftsführung einer Tochtergesellschaft beteiligen. Über die Figur des faktischen Direktors kann aber nur die unmittelbar als Direktor fungierende Person selbst in Anspruch genommen werden. Bis zum heutigen Tag existiert daher kein Urteil eines japanischen Gerichts, mit dem eine Muttergesellschaft als faktischer Direktor ihrer Tochtergesellschaft anerkannt und in Haftung genommen wurde.

Unproblematisch sind dagegen Fälle, in denen sich der vertretungsberechtigte Direktor der Muttergesellschaft in einem Doppelmandat als Direktor einer Tochtergesellschaft mit deren interner Geschäftsführung beschäftigt. Auch wurde in der Rechtsprechung[61] bereits anerkannt, dass der vertretungsberechtigte Direktor der Muttergesellschaft als faktischer Direktor einer in Konkurs gegangenen Tochtergesellschaft deren Gläubigern gegenüber nach den Grundsätzen der Außenhaftung der Direktoren (jetzt Art. 429 Abs. 1 GesG) zum Schadensersatz verpflichtet sein kann.

In das GesG von 2005 wurde schließlich eine Regelung eingeführt, wonach eine AG Dritten gegenüber zum Schadensersatz verpflichtet ist, denen das Vertretungsorgan der AG anlässlich der Geschäftsführung einen Schaden zugefügt hat (Art. 350 GesG). Übt also ein vertretungsberechtigter Direktor einer Muttergesellschaft zugleich auch das Amt eines Direktors einer Tochtergesellschaft aus und benachteiligt im Verhältnis der Mutter- zur Tochtergesellschaft die Interessen der Tochtergesellschaft vorsätzlich oder fahrlässig (etwa durch den Abschluss eines Kaufvertrags zwischen beiden Unternehmen mit für die Tochtergesellschaft nachteiligen Konditionen), so ist die Muttergesellschaft gemäß Art. 350 GesG der Tochtergesellschaft gegenüber zum Schadensersatz verpflichtet. In der Rechtsprechung wurde eine entsprechende Haftung einer Muttergesellschaft bisher jedoch in keinem einzigen Fall anerkannt.

Der japanische Gesetzgeber steht daher nach wie vor in der Pflicht, Regelungen zu schaffen, unter denen eine Tochtergesellschaft ihre Muttergesellschaft wegen Beeinträchtigung ihrer Interessen in Regress nehmen kann. In einem typischen japanischen Konzern, der wesentlich durch ein großes Maß an Selbstständigkeit der Tochtergesellschaften gekennzeichnet ist, wird es jedoch in der Praxis schwierig sein, eine kausale „Veranlassung“ des Schadens durch die Muttergesellschaft nachzuweisen. Hier wäre eine Beweislastumkehr wünschenswert, etwa in Form einer gesetzlichen Vermutung, wonach eine die Interessen einer Tochtergesellschaft beeinträchtigende und für die Muttergesellschaft vorteilhafte Handlung von der Muttergesellschaft veranlasst wurde.

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[61] Distriktgericht Kyoto, 5. Februar 1992, Hanreijihō 1436, 115.

Erforderlich wäre daneben auch die Einführung einer Regelung nach dem Modell der §§ 317 Abs. 4, 309 Abs. 4 des deutschen AktG, die den Minderheitsaktionären einer Tochtergesellschaft die Möglichkeit eröffnet, die Geltendmachung von Schadensersatzansprüchen gegenüber der Muttergesellschaft im Wege der Aktionärsklage durchzusetzen. Diese Klagemöglichkeit müsste dann durch das Recht der Minderheitsaktionäre einer Tochtergesellschaft flankiert werden, im Falle einer möglichen Schädigung der Tochtergesellschaft durch die Muttergesellschaft eine Sonderprüfung veranlassen zu können. Problematisch ist hier jedoch, dass die Minderheitsaktionäre in aller Regel so gut wie keinen Einblick in die Geschäftsführung des Unternehmens erhalten. Damit das Recht zur Veranlassung einer Sonderprüfung nicht ins Leere läuft, sollten die Aktionäre dabei nicht nur über sämtliche für die Tochtergesellschaft nachteilige Geschäfte mit der Muttergesellschaft informiert werden, sondern auch über sämtliche auf Veranlassung der Muttergesellschaft von der Tochtergesellschaft vorgenommenen Handlungen.[62] Dies könnte im Wege einer unmittelbaren Informationspflicht realisiert werden, denkbar wäre aber auch die Erweiterung des Prüfungsauftrags des Prüfers *(kansayaku)* oder des Wirtschaftsprüfers der Tochtergesellschaft um die Erstellung eines Berichts zu den Auswirkungen der Geschäfte mit der Muttergesellschaft auf die Interessen der Tochtergesellschaft.[63]

Hilfsweise und nur für den Fall, dass die oben beschriebene Schadensersatzhaftung keine volle Kompensation der Interessenbeeinträchtigung der Minderheitsaktionäre herbeiführen kann, sollte den Minderheitsaktionären der Tochtergesellschaft auch ein Anspruch auf Erwerb ihrer Aktien durch die Muttergesellschaft zu einem angemessenen Preis zugestanden werden. So lange hier eine ausdrückliche gesetzliche Regelung fehlt, hätte die Rechtsprechung die Möglichkeit, einen entsprechenden Anspruch der Minderheitsaktionäre über die Drittwirkung von Grundrechten (in diesem Fall der Eigentumsgarantie aus Art. 29 Abs. 1 der japanischen Verfassung) zu konstruieren.[64]

Ein Nebeneinander von Schadensersatzhaftung und Rückkaufverpflichtung der Muttergesellschaft würde es auch ermöglichen, an die unterschiedlichen Organisationsformen japanischer Konzerne[65] angepasste Rechtsfolgen zu

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[62] Mit der gleichen Zielrichtung schlug M. HABERSACK im Gutachten des 69. DJT in München die Offenlegung des Abhängigkeitsberichts vor: Staatliche und halbstaatliche Eingriffe in die Unternehmensführung, Gutachten E, Ständige Deputation des Deutschen Juristentages (Hrsg.), Verhandlungen des 69. Deutschen Juristentages (München 2012) E 103.

[63] Vgl. E. TAKAHASHI/K. SHINTSU, Einführung eines Konzernrechts in Japan: Der Zwischenentwurf und die ergänzenden Erläuterungen, ZJapanR/J.Japan.L. 33 (2012) 18.

[64] E. TAKAHASHI, Die Zukunft des japanischen Konzernrechts – Die Reform des Aktienrechts von 2014, AG 2014, 498.

[65] T. KAGONO/N. SUNAGAWA/N. YOSHIMURA, *Corporate governance no keieigaku* [Die Betriebswirtschaftslehre zur Corporate Governance] (Tokyo 2010) 269.

setzen.[66] Im Grundtypus des japanischen Konzerns als lockerem Zusammenschluss von im Wesentlichen selbständigen Unternehmen erscheint in erster Linie die Schadensersatzhaftung der Muttergesellschaft sinnvoll. In einem durch strikte konzernweit einheitliche Führung geprägten Konzern erscheint dagegen im Falle einer dauerhaften Beeinträchtigung der Interessen einer Tochtergesellschaft ein ergänzender Anspruch der Minderheitsaktionäre auf Erwerb ihrer Aktien durch die Muttergesellschaft angemessen.[67]

Dieses Regelungsmodell entspricht auch der ökonomischen Natur des Konzerns als einer Zwischenform von „Markt und interner Organisation“[68]. Im lockeren Konzern, der das strukturelle Schwergewicht auf den “Markt“ legt, kann das Gebot der ausgleichenden Gerechtigkeit *(iustitia commutativa)* in der Regel durch eine Schadensersatzhaftung bei Verletzung des Grundsatzes des *arms length trading* sichergestellt werden. In einem eng verbundenen Konzern, der das strukturelle Schwergewicht auf die „interne Organisation“ legt, sollte darüber hinaus auch das Gebot der Verteilungsgerechtigkeit[69] *(iustitia distributa)* durch die Einführung einer Möglichkeit des Austritts aus der Aktionärsgemeinschaft gegen eine angemessene Abfindung berücksichtigt werden.[70]

IV. Thesen

1. Auch bei wechselseitigen Beteiligungen von weniger als 25 % sollte in Japan das Stimmrecht bei der Wahl von Direktoren beschränkt werden.

2. Nachdem die gemeinsame Einflussnahme über den „Präsidenten-Club“ innerhalb der Unternehmensgruppen mit dem Rückgang der wechselseitigen Beteiligungen nur noch schwach ausgeprägt ist, sind Regelungen zur Unternehmensgruppe in Japan nicht mehr erforderlich.

3. Der deutschen herrschenden Lehre zur konzernweiten *Compliance*-Verantwortung folgend ist lediglich eine Pflicht der Direktoren der Mutterge-

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66 E. TAKAHASHI, *Doitsu to nihon ni okeru kabushikikaishahō no kaikaku* [Die Reform des Aktienrechts in Deutschland und Japan] (Tokyo 2007) 45 et seqq.

67 Vgl. M. HABERSACK, Gesellschafts- und Gruppeninteresse im Recht der abhängigen AG, in: Kalss/Fleischer/Vogt (Hrsg.), Gesellschafts- und Kapitalmarktrecht in Deutschland, Österreich und der Schweiz 2013 (Tübingen 2014) 19 et seqq.

68 Zu diesem Konzept siehe O. E. WILLIAMSON, Markets and Hierarchies: Analysis and Antitrust Implications (New York 1975).

69 ARISTOTELES, Nikomachische Ethik, übersetzt von ILGONG PARK (Kyoto 2002) 240 et seqq.

70 E. TAKAHASHI, Market–Organization–Corporate Group: An Economic Analysis of the Law of Corporate Groups, 22 The Journal of Interdisciplinary Economics (2010) 45 et seqq.

sellschaft zur Vorhinderung illegaler Handlungen durch die Direktoren der Tochtergesellschaft anzuerkennen.

4. Der japanische Gesetzgeber sollte eine Regelung einführen, wonach eine Muttergesellschaft im Falle der Insolvenz einer ihrer Tochtergesellschaften unmittelbar haftet, wenn die Insolvenz durch die einheitliche Leitung der Muttergesellschaft verursacht wurde.

5. Der japanische Gesetzgeber sollte sich zeitnah mit der Einführung einer Regelung befassen, die es einer Tochtergesellschaft ermöglicht, ihre Muttergesellschaft im Falle einer Interessenbeeinträchtigung durch diese auf Schadensersatz in Anspruch nehmen zu können. Kann auf Grund der dauerhaften umfassenden Leitung der Muttergesellschaft allein durch eine Schadensersatzverpflichtung keine genügende Kompensation der Aktionäre realisiert werden, so ist den Minderheitsaktionären der Tochtergesellschaft ein Anspruch auf Erwerb ihrer Aktien durch die Muttergesellschaft zu einem angemessenen Preis zuzugestehen.

Do We Need a Law of Corporate Groups?

Katja Langenbucher

"Corporate groups are a fact of life".[1] This was the starting point for a group of renowned European experts to deliver a report on a possible Directive on corporate group law in 2000.[2] We all know that no such Directive has been issued.[3] However, recently, a fresh group of eminent experts has started, among other things, to develop an initiative "on groups of companies".[4] One reason for a European regulation to take its time might be the enormous national differences in dealing with group situations. While some countries, notably the UK,[5] rely on general company law to deal with corporate groups, others provide very detailed rules specifically for groups of companies.[6] German law provides an example of the latter.

Do we need a law of corporate groups? Most countries regulate one or another aspect of group law.[7] This is probably most common for tax and for accounting law. Insolvency law will often take group situations into account and the same is true for labour law. Regulatory oversight for financial institutions or insurance companies usually includes a group dimension. Competition law necessarily does so as well. However, in what follows when we speak about "group law" we will focus on regulation more specifically tuned to genuine questions of company law such as the protection of minority shareholders or creditors, the standards for managerial behavior and the "enabling" function of legal structures.

I. Are Groups Different?

In a legal order that provides genuine group law for corporations, it will be claimed that groups pose different problems than stand-alone companies, requiring specific norms addressing these issues.[8]

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1 FORUM EUROPAEUM CORPORATE GROUP LAW, Corporate Group Law for Europe, EBOR 1 (2000) 167; see also K. J. HOPT, in: Schmitthoff/Woolridge, Groups of Companies, 1991, 83 with a historical overview.

2 See FORUM EUROPAEUM CORPORATE GROUP LAW, *supra* note 1, 165 note * for the members of this group.

3 K. J. HOPT, *supra* note 1, 86; T. H. TRÖGER, Corporate Groups, SAFE Working Paper No. 66 (22 September 2014) 10.

4 <http://ec.europa.eu/transparency/regexpert/index.cfm?do=groupDetail.groupDetai&groupID=3036>; K. J. HOPT, Europäisches Gesellschaftsrecht im Lichte des Aktionsplans der Europäischen Kommission vom Dezember 2012, ZGR 2013, 209 et seq.

5 See in detail A. CAHN/D. C. DONALD, Comparative Company Law (Cambridge 2010) 675 et seq.

6 K. J. HOPT, Groups of Companies, A comparative study on the Economics, Law and Regulation of Corporate Groups, ecgi Law Working Paper No. 286/2015, 8 et seq.

7 HOPT, *supra* note 1, 87; HOPT, *supra* note 6, 11.

8 FORUM EUROPAEUM CORPORATE GROUP LAW, *supra* note 1, 169 and 171.

Typically, corporate law deals with the interests of shareholders, management and outside creditors. Particularly where shares are held in dispersed ownership, the focus of corporate law regulation will be on making sure that management's incentives are aligned with those of the owners and that outside creditors are treated fairly.[9]

Where shares are distributed unevenly between a major blockholder and minority shareholders, corporate law faces the additional problem of weighing the interests of blockholders against those of minority shareholders. There are, however, no third party interests involved in managing a stand-alone company. This changes in a group situation.

1. The Controlling Shareholder May Pursue Third Party Interests

Not every blockholder changes the typical principal-agent pattern so fundamentally that it develops into a group situation. What differentiates a group situation from more general conflicts between majority and minority shareholders is the existence of third party interests.[10] In a group situation, the blockholder may not only seek rents for his own benefit. Instead, he may aim at aligning the company with the interests of a parent company or a group of companies. The difference between classic rent-seeking activities of a blockholder and bringing in third party interests is that the transactions he might favour could harm the company as well as his own position as a shareholder in that company, but further the interests of another company.[11] Hence, German group law requires the blockholder to have a business interest that goes beyond managing his own assets.

2. Management May Not Prevail Against the Controlling Shareholder

At first glance, management provides natural checks and balances for such behavior. Classic conflicts between management and shareholders may concern the profitability of different management strategies, the division of profits made, or at times dealing with greedy shareholders or greedy management. However, the common denominator of both, shareholders and management, in these situations is the interest of the company they are invested in or are running. This common denominator is lacking once a group is established because the blockholder may be interested in aligning the steering of the company with third party interests.[12]

Management's role as the guardian of the company's interest will often be impaired in another way. The controlling shareholder typically insists on

[9] HOPT, *supra* note 6, 4 et seq.
[10] HOPT, *supra* note 6, 5.
[11] HOPT, *supra* note 6, 5.
[12] HOPT, *supra* note 6, 5.

board seats reflecting his role, exercising pressure on board members to follow the path he prefers. Even if there are strict managerial liability rules in place, which aim at preventing management from complying with a controlling shareholder's wishes, management will often be forced to comply with plans decided upon elsewhere.

3. Creditors May Be More Exposed

Groups are different not only with respect to shareholder's and management's incentives. The fact that a company will be steered as a subsidiary rather than a stand-alone entity puts creditors in a different position as well. Covenants may not work out as planned, the assumptions underlying an internal rating assessment of the company may change in important ways and reporting or accounting may become more opaque.[13]

II. The Formation of a Corporate Group

We have said above that legal systems such as the German one, relying on a specific legal regime for group situations, claim that the incentive structure at work in corporate groups differs in important respects from that in stand-alone companies. Group law aims at addressing these concerns
There are a number of ways in which a group of companies may be created.[14] We will focus on two paradigm situations, (i) the purchase of shares by the future parent company and (ii) the carve-out of assets from the parent company and establishment of a subsidiary.

1. Purchase of Shares

The most natural way for a parent-subsidiary structure to be created if the subsidiary is a listed company is the purchase of its shares. German law has not regarded this process as raising questions of group law, hence traditionally not regulated the creation of a group.[15]

European law has changed this assessment. Reporting requirements are triggered once a shareholder controls 3% of the shares of a listed stock corporation and further require notice to capital markets when the percentage of

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13 HOPT, *supra* note 6, 6 et seq.

14 CAHN/DONALD, *supra* note 5, 678 et seq.

15 H. ALTMEPPEN, Münchener Kommentar zum AktG, 4th ed. 2015, Einleitung zu §§ 291 et seq. marg. no. 16, Vor. § 311 marg. no. 33; H. C. GRIGOLEIT, in: Grigoleit, AktG, 2013, § 311 marg. no. 2; HOPT, *supra* note 1, 98; J. VETTER, in: Schmidt/Lutter, AktG, 3rd ed. 2015, § 311 marg. no. 1; H. MÜLLER, in: Spindler/Stilz, AktG, 3rd ed. 2015, Vor § 311 marg. no. 37.

shares controlled reaches 5, 10, 15, 20, 25, 30, 50 or 75%.[16] Once 30% of the shares are under the control of the bidder, he is required to make a mandatory offer to the remaining shareholders to buy their shares, § 35 para. 1 WpÜG. The underlying idea is contractual: a shareholder invests in a listed corporation making certain assumptions about the company and its shareholder structure. Once the latter changes in significant ways, the shareholder is granted a right to reassess the investment contract he concluded. Should he wish to exit, he will be guaranteed the right to do so under fair conditions. The price the bidder is required to offer is based on the stock price during the last six months as well as purchases by the bidder and related parties.

Under the premises of take-over law it is assumed that shareholders who do not wish to exit the company which has been taken over, voluntarily accept the new situation. In this spirit one might argue that there is no need for further minority shareholder protection. Under German law, this is not the case. Instead, German law combines these controls on take-over with a law of corporate groups once the take-over has resulted in a group situation.

2. *Carve-out of Assets*

Instead of purchasing a formerly independent company, a group situation might also be created by a hive-down. The future parent carves out assets and establishes a subsidiary as a new legal entity. The parent may hold the new company as a 100% subsidiary, bring in other blockholders or go public, aiming for dispersed ownership while holding a controlling majority himself.

German law provides for rules with a statutory and a case law background for transactions like these. The Code on hive-downs, spin-offs and mergers aims to consolidate different ways of rearranging an existing group or creating a new one in a carve out. It offers building blocks and a legal framework for the process of a hive-down as well as for a spin-off off an entity or a merger of companies and it offers protection for creditors, shareholders and employees.

There is however case law intended to protect the shareholders of the parent company.[17] Any carve out of an essential part of the parent company's

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[16] Art. 9 para. 1 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC of 28 May 2001.

[17] BGH, 25 February 1982, II ZR 174/80, BGHZ 83, 122; BGH, 26 April 2004, II ZR 155/02, BGHZ 159, 30; BGH, 26 April 2004, II ZR 154/02, NZG 2004, 575; P. Conac/ L. Enriques/M. Gelter, Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany, and Italy, ECFR 2007, 515; S. Herrler, in: Grigoleit, AktG, 2013, § 119 marg. no. 21 et seq.; Hopt, *supra* note 1, 98 et seq.; J. Koch, in: Hüffer, AktG, 11th ed. 2014, § 119 marg. no. 16 et seq.; D. Kubis, in: Münchener Kommentar zum AktG, 3rd ed. 2013, § 119 marg. no. 32 et seq.; K. Langenbucher, Aktien-

assets, with 80% serving as a rough guideline, requires the approval of 75% of the shareholders' assembly.

III. The Management of a Corporate Group

So far we have discussed different strategies for creating a corporate group. German law regulates both the take-over of a stand-alone company and the carve-out of assets to, establish a new subsidiary. However, in many ways neither area is perceived as the core of German corporate groups law. Its main focus lies in regulating the management of a corporate group. The goals underlying corporate groups law show most clearly when we compare them to the legal answers a legal system without specific corporate groups lawprovisions.

1. The Situation Without Group Law

A jurisdiction without specific regulation tailored to corporate groups operates under the premise that problems arising in a group context will be handled appropriately by standard corporate law, amended by the judiciary to fit the groups of companies situation.[18] The subsidiary is regarded in the same way as any stand-alone company would: Its management must keep the company's interest in mind and its shareholders owe a duty of loyalty to the company and possibly to fellow shareholders.

If a parent company tries to steer a company in which it holds a controlling share against that company's best interest, dependent on the legal heritage of its company law, different legal rules apply. The parent company as a major shareholder may be in breach of duties of loyalty towards the company and towards minority shareholders. If the controlling shareholder tries to extract private benefits, there may be rules requiring disclosure or shareholder approval of related party transactions aimed at limiting such behavior.

Management must solely act in the subsidiary's interest, disregarding what may be good for the parent or for the group as a whole. Managers who give in to pressure from the controlling shareholder are faced with the threat of managerial liability.

Outside creditors benefit from standards such as capital maintenance rules which help to hinder the shifting of cash or assets from the subsidiary to the

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und Kapitalmarktrecht (Munich 2015) § 6 marg. no. 42 et seq.; G. SPINDLER, in: Schmidt/Lutter, AktG, 3rd ed. 2015, § 119 marg. no. 27 et seq.; J. HOFFMANN, in: Spindler/Stilz, AktG, 3rd ed. 2015, § 119 marg. no. 22 et seq.

[18] FORUM EUROPAEUM CORPORATE GROUP LAW, *supra* note 1, 172 et seq.; CAHN/DONALD, *supra* note 5, 687 et seq.; CONAC/ENRIQUES/GELTER, *supra* note 17, 491 et seq.; HOPT, *supra* note 1, 85; TRÖGER, *supra* note 3, 4.

parent or to a third company. Some legal systems accept instances where a "piercing of the corporate veil" allows a creditor to claim compensation from a shareholder instead of being relegated to the subsidiary.[19] Similar rules apply if the parent company is regarded as a "shadow director" and liability ensues.[20] If no comparable remedy is available, there is no way for the creditor to hold the parent company accountable for exercising undue influence on the controlled company.

2. The Situation With Group Law

German group law aims to address two concerns. First, it wishes to provide considerably wider leeway for managing a corporate group than that allowed by "normal" corporate law. Second, it is felt that minority shareholders and outside creditors need enhanced protection in group situations.

a) "Enabling" Components

The first aim of allowing group management to operate smoothly functions as "enabling" law. Shareholder and management duties of "normal" corporate law are adjusted to fit the group situation. Depending on the type of group, no duty of loyalty prohibits the controlling shareholder from pursuing group interests running against those of the subsidiary as a stand-alone company. Instead, the parent company has a legal right to order that the subsidiary carry out specific transactions.

Restrictions on capital maintenance do not apply to certain group situations. The intra-group shifting of assets or liquidity is made possible without triggering disclosure requirements or the necessity for the shareholders' assembly to consent to a related party transaction.

The duties of the controlled company's management are not restricted to furthering that company's interest exclusively. Instead, they allow for an orientation towards group interests. This enables the subsidiary's management to openly cater to the wishes of the parent company instead of being

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[19] D. H. BARBER, Piercing the Corporate Veil, 17 Willamette Law Review (1980) 371 et seq.; F. A. GEVURTZ, Piercing Piercing: An Attempt to Lift the Veil of Confusion Surrounding the Doctrine of Piercing the Corporate Veil, 76 Oregon Law Review (1997) 853 et seq.; C. S. KRENDL/J. R. KRENDL, Piercing the Corporate Veil: Focusing the Inquiry, 55 Denver Law Journal (1978) 1 et seq.; HOPT, *supra* note 6, 22 et seq.; R. B. THOMPSON, Piercing the Corporate Veil: An Empirical Study, 76 Cornell Law Review (1990) 1036, 1039; skeptical S. M. BAINBRIDGE, Abolishing Veil Piercing (21 July 2000) research paper available at <http://ssrn.com/abstract=236967>.

[20] HOPT, *supra* note 6, 21 et seq; R. CAROLL, Shadow Director and Other Third Party Liability for Corporate Activity, in: Ramsay (ed.), Corporate Governance and the Duties of Company Directors (15 August 2006) working paper available at <http://ssrn.com/abstract=924312>, 162 et seq.

torn between giving in to pressure from the major blockholder and trying to evade liability for doing so.

b) Protective Components

The "enabling" function of corporate groups law is complemented by rules designed to protect minority shareholders and outside creditors.[21] Because the parent company profits from a number of ways in which it may reorient the subsidiary from being a stand-alone entity towards acting as a group member, the law requires the parent to compensate those whose interests are harmed.

Depending on the type of corporate group chosen, minority shareholders may profit directly from appraisal rights or guaranteed dividends. In other cases they benefit indirectly from the parent company being liable for any damage caused to the subsidiary.

Outside creditor's interests are often compromised if they have contracted with a stand-alone company which then turns into a subsidiary. German group law protects these parties in ways similar to the protection of minority shareholders. They profit indirectly from compensation owed to the subsidiary by the parent. If compensation is not granted, creditors may sue in their own right.

3. The Dual-track of German Corporate Group Law

German law offers two options for organizing a corporate group. The first does not require the controlling shareholder to act in any specific way. It is automatically attached once a subsidiary is "dependent" *("abhängig")* on a shareholder. It is called a "de facto group" *("faktischer Konzern").* For the second option to apply, the controlling shareholder must conclude a contract with the subsidiary. This option is called a "contractual group" *("Vertragskonzern").*

IV. The De Facto Group *("faktischer Konzern")*

1. The Concept of "Dependency"

The rules on "de facto groups" are applicable as soon as a company is "dependent". § 17 AktG defines a "dependent company" as a legal entity being under the direct or indirect influence of a "dominating company". Dependen-

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[21] ALTMEPPEN, *supra* note 15, § 291 marg. no. 1; W. SERVATIUS, in: Grigoleit, AktG, 2013, § 291 marg. no. 2; KOCH, *supra* note 17, § 291 marg. no. 3; H.-G. KOPPENSTEINER, in: Kölner Kommentar zum AktG, 3rd ed. 2004, Vor. § 291 marg. no. 5; P. O. MÜLBERT, in: Großkommentar AktG, 4th ed. 2012, Vor. §§ 291 et seq. marg. no. 2; HOPT, *supra* note 1, 88; K. LANGENBUCHER, in: Schmidt/Lutter, AktG, 3rd ed. 2015, § 291 marg. no. 7; MÜLLER, *supra* note 15, Vor. § 311 marg. no. 2.

cy is assumed if the dominating company holds a majority of the shares, § 17 para. 2 AktG. However, "dependency" is not limited to this situation.[22] A subsidiary may also be "dependent" if a controlling company has decisive influence on appointing board members or disposes of other instruments of corporate law to make the subsidiary comply. On the other hand, the mere possibility of threatening unpleasant consequences for non-compliance, such as stopping a business relationship, do not qualify, as long as there is no corporate law background.

The "dominating company" will not necessarily be a legal entity. A natural person qualifies as a "dominating company" under § 17 AktG if any form of that person's third party business engagement raises concerns about his willingness to align his interests with the best interest of the dependent company.[23]

2. Enabling Component: Make Use of Influence But Compensate Within a Year

a) Using Influence to the Disadvantage of the Dependent Subsidiary is Legal…

At first glance, §§ 311, 317 AktG do not display any "enabling" feature. Indeed, § 311 para. 1 AktG reads as a prohibition addressed to the dominating corporation of using its influence in a way which results in any form of disadvantage for the dependent subsidiary. However, this prohibition does not extend to cases where those disadvantages are compensated within the accounting year, § 311 para. 2 AktG.

This rule triggers the "enabling" effect of de facto group law: Rules prohibiting major blockholders from using their influence to the disadvantage of the company they are invested in do not apply as long as the disadvantage is compensated.[24] This compensation need not be immediate, but can be made over the course of an entire year[25] and may also consist of a claim granted to the subsidiary.[26]

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[22] V. EMMERICH/M. HABERSACK, Aktien- und GmbH-Konzernrecht, 7th ed. 2013, § 17 AktG marg. no. 18 et seq.; GRIGOLEIT, *supra* note 15, § 17 marg. no. 9 et seq.; KOCH, *supra* note 17,§ 17 marg. no. 9; HOPT, *supra* note 6, 2 et seq.; KOPPENSTEINER, *supra* note 21, § 17 marg. no. 40 et seq.; A. SCHALL, in: Spindler/Stilz, AktG, 3rd ed. 2015, § 17 marg. no. 38 et seq.

[23] W. BAYER, in: Münchener Kommentar zum AktG, 3rd ed. 2008, § 15 marg. no. 13; GRIGOLEIT, *supra* note 15, § 15 marg. no. 17; KOCH, *supra* note 17, § 15 marg. no. 10; KOPPENSTEINER, *supra* note 21, § 15 marg. no. 56; SCHALL, *supra* note 22, § 15 marg. no. 10.

[24] ALTMEPPEN, *supra* note 15, § 311 marg. no. 1 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 1; E. TAKAHASHI Konzern und Unternehmensgruppe in Japan – Regelung nach dem deutschen Modell? (Tübingen 1994) 71 et seq.

[25] BGH, 1 December 2008, II ZR 102/07, BGHZ 179, 71, 78; ALTMEPPEN, *supra* note 15, § 311 marg. no. 303; GRIGOLEIT, *supra* note 15, § 311 marg. no. 49 et seq.; V. EMMERICH/M. HABERSACK, Konzernrecht (10th ed. Munich 2013) § 24 marg. no. 10 et

b) Duties of Loyalty and Capital Maintenance Are Overruled…

German law provides for a number of rules prohibiting a major blockholder from taking actions which result in damages for the company he is invested in. Actions executed intentionally that allow the company (plus under certain circumstances the fellow shareholders) to claim damages are captured under § 117 AktG.[27] A more general basis for the company and fellow shareholders to claim damages for a blockholder's breach of loyalty are covered by § 280 BGB.[28] Capital maintenance rules, which are backed by a European Directive, prevent the company from transferring assets or cash to any of its shareholders.

All of those prohibitions are overruled by § 311 AktG.[29] If this rule applies, neither liability for intentional harm according to § 117 AktG nor liability for a breach of duties of loyalty ensues. The same applies to capital maintenance rules, although there is some discussion about the compatibility of this result with the European Directive.[30]

c) Management of the Subsidiary May Lawfully Abide by the Wishes of the Dominating Parent Company…

We have said above that the subsidiary's management will often find itself in a difficult situation. General corporate law requires consideration of the inter-

seq.; KOCH, *supra* note 17, § 311 marg. no. 3; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 128; VETTER, *supra* note 15, § 311 marg. no. 6; MÜLLER, *supra* note 15, § 311 marg. no. 54.

26 EMMERICH/HABERSACK, *supra* note 22, § 311 marg. no. 72 et seq.; GRIGOLEIT, *supra* note 15, § 311 marg. no. 51; KOCH, *supra* note 17, § 117 marg. no. 46 et seq.; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 129 et seq.; VETTER, *supra* note 15, § 311 marg. no. 95 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 57 et seq.

27 L. TOMASIC, in: Grigoleit, AktG, 2013, § 117 marg. no. 1, 18 et seq.; KOCH, *supra* note 17, § 117 marg. no. 1; H. J. MERTENS/A. CAHN, in: Kölner Kommentar zum AktG, § 117 marg. no. 19 et seq.; C. WITT, in: Schmidt/Lutter, AktG, § 117 marg. no. 20 et seq.; SCHALL, *supra* note 22, § 117 marg. no. 13.

28 BGH, 9 June 1954, II ZR 70/53, BGHZ 14, 25, 38; BGH, 1 February 1988, II ZR 75/87, BGHZ 103, 184, 195; BGH, 20 March 1995, II ZR 205/94, BGHZ 129, 136, 143.

29 ALTMEPPEN, *supra* note 15, § 311 marg. no. 15 et seq.; EMMERICH/HABERSACK, *supra* note 25, § 24 marg. no. 25 et seq.; GRIGOLEIT, *supra* note 15, § 311 marg. no. 57; KOCH, *supra* note 17, § 311 marg. no. 49, 52; MÜLLER, *supra* note 15, § 311 marg. no. 63, 66 et seq.; D. LEUERING/A. GOERTZ, in: Hölters, AktG, 2nd ed. 2014, § 311 marg. no. 9, 15.

30 In favor of compatibility: EMMERICH/HABERSACK, *supra* note 22, § 311 AktG marg. no. 82; M. HABERSACK/D. A. VERSE, Europäisches Gesellschaftsrecht (4th ed. Munich 2011) § 6 marg. no. 48; GRIGOLEIT, *supra* note 15, § 311 marg. no. 56; KOPPENSTEINER, *supra* note 21, Vor. § 311 marg. no. 7; VETTER, *supra* note 15, § 311 marg. no. 117; MÜLLER, *supra* note 15, § 311 marg. no. 63; doubting compatibility: W. SCHÖN, Deutsches Konzernprivileg und europäischer Kapitalschutz – ein Widerspruch?, in: Forster et al. (eds.), Festschrift für Bruno Kropff (Düsseldorf 1997) 295 et seq.

est of the subsidiary exclusively as a stand-alone corporation. At the same time, the controlling shareholder will often exert considerable pressure on the management to make sure the subsidiary is in line with group interests.

De facto group law relieves some of this pressure. The subsidiary's management is not necessarily required to act upon what is in the best interest of the subsidiary viewed as a stand-alone company. Instead, it may lawfully abide by wishes of the dominating shareholder if certain conditions are fulfilled. Firstly, this requires the actions contemplated to be lawful and in accordance with the company's articles of association.[31] Secondly, the actions may not endanger the solvency of the company.[32] Thirdly, any damage potentially caused must be able to be assessed and quantified so as to allow for a later compensation.[33]

If all of these conditions are fulfilled, the subsidiary's management may follow the parent company's strategy. It does not violate its duties vis-à-vis the subsidiary, even if its strategy furthers group interests at the expense of the subsidiary. It is, however, not required to comply with the dominating company's wishes. Put differently, the parent has no legal right to force the subsidiary act according to its wishes.

d) … as Long as Compensation Is Granted Within a Year…

The "enabling" function of group law is inextricably linked with full compensation being given by the parent company. The lawfulness of the subsidiary's management following the parent company's strategy requires first that any disadvantage which may ensue be assessed and quantifiable *ex ante*.[34] Examples[35] for possible disadvantages include discounts offered to the parent on

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[31] EMMERICH/HABERSACK, *supra* note 25, § 25 marg. no. 42; GRIGOLEIT, *supra* note 15, § 311 marg. no. 53; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 100; VETTER, *supra* note 15, § 311 marg. no. 111.

[32] ALTMEPPEN, *supra* note 15, § 311 marg. no. 305, Anhang § 317 marg. no. 47; EMMERICH/HABERSACK, *supra* note 25, § 25 marg. no. 42; GRIGOLEIT, *supra* note 15, § 311 marg. no. 53; VETTER, *supra* note 15, § 311 marg. no. 111.

[33] T. FETT, in: Bürgers/Körber, AktG, 3rd ed. 2014, § 311 marg. no. 60; EMMERICH/HABERSACK, *supra* note 25, § 25 marg. no. 43; GRIGOLEIT, *supra* note 15, § 311 marg. no. 53; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 141; VETTER, *supra* note 15, § 311 marg. no. 112; MÜLLER, *supra* note 15, § 311 marg. no. 62.

[34] ALTMEPPEN, *supra* note 15, § 311 marg. no. 172; GRIGOLEIT, *supra* note 15, § 311 marg. no. 29; LEUERING/GOERTZ, *supra* note 29, § 311 marg. no. 57; KOCH, *supra* note 17, § 311 marg. no. 26; VETTER, *supra* note 15, § 311 marg. no. 112 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 29.

[35] ALTMEPPEN, *supra* note 15, § 311 marg. no. 225 et seq.; EMMERICH/HABERSACK, *supra* note 25, § 25 marg. no. 21 et seq.; GRIGOLEIT, *supra* note 15, § 311 marg. no. 38 et seq.; KOCH, *supra* note 17, § 311 marg. no. 29 et seq., 36; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 77 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 41 et seq.

the subsidiary's products, loans extended to the parent without requiring adequate securities, participation in cash-pooling agreements or offering business opportunities found by the subsidiary to the parent[36]. Second, the parent company must pay full compensation for any disadvantage suffered by the subsidiary. If full compensation is not paid out, the dominating company is in breach of § 117 AktG and has compromised its duties of loyalty and capital maintenance rules.[37]

e) ... and the Parent's Strategy Serves the Group Interest

De facto group law enables the parent company to manage the dependent subsidiary in line with a parent and/or a group strategy. Although there is no explicit legal rule to this effect, it is commonly assumed that this does not allow for aligning the subsidiary with interests of unrelated third parties.[38]

3. Protective Component: Compensating the Company, Minority Shareholders and Creditors

So far we have focused on the "enabling" function of de facto group law. The privilege it entails, namely to allow the parent to manage a company it dominates, comes with the obligation to compensate that company for any individual disadvantage suffered in the course of the respective business year.[39]

a) Compensation Given to the Company

A number of conditions need to be fulfilled for § 311 para. 2 AktG to apply. Firstly, it requires the dominating company to make use of its "influence" *("Einfluss")* in order to commit the dependent subsidiary to a disadvanta-

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[36] GRIGOLEIT, *supra* note 15, § 311 marg. no. 38; KOCH, *supra* note 17, § 311 marg. no. 29; M. HABERSACK, Geschäftschancen im Recht der verbundenen Aktiengesellschaften, in: Krieger/Lutter/Schmidt (eds.), Festschrift für Michael Hoffmann-Becking zum 70. Geburtstag (Munich 2013) 425 et seq.

[37] GRIGOLEIT, *supra* note 15, § 311 marg. no. 55, 57; KOCH, *supra* note 17, § 311 marg. no. 49; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 161, 167 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 63 et seq.

[38] ALTMEPPEN, *supra* note 15, § 311 marg. no. 306; KOCH, *supra* note 17, § 311 marg. no. 43; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 102; VETTER, *supra* note 15, § 311 marg. no. 110; MÜLLER, *supra* note 15, § 311 marg. no. 53.

[39] ALTMEPPEN, *supra* note 15, § 311 marg. no. 303; CONAC/ENRIQUES/GELTER, *supra* note 17, 503 et seq.; GRIGOLEIT, *supra* note 15, § 311 marg. no. 43 et seq.; KOCH, *supra* note 17, § 311 marg. no. 37; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 98; MÜLLER, *supra* note 15, § 311 marg. no. 48 et seq.; VETTER, *supra* note 15, § 311 marg. no. 4.

geous transaction or business decision.[40] This is generally understood rather broadly as encompassing any type of influence, ranging from outright orders to mere tips or expectancies.[41]

Secondly, the influence exercised needs to result in a disadvantage *(“Nachteil”)*.[42] A disadvantage comprises actual losses as well as a mere exposure to risk of the subsidiary’s assets or earnings.[43]

Thirdly, the disadvantage needs to be triggered by the parent dominating the subsidiary. This is typically assessed by an *ex ante* comparison between what a reasonable manager, profiting from the business judgment rule,[44] would have done and what the subsidiary’s management did.[45]

If these conditions are met, the dominating company will need to compensate the disadvantage incurred by the dependent subsidiary.[46] This may be done by a transfer of an advantageous position from the parent to the subsidiary or by a contractual agreement allowing the subsidiary to claim such an advantageous position. In order to qualify as advantageous, the position needs to be appraisable.[47] Although most commentators are of the opinion that advantages are not limited to positions which can formally be represented in a balance sheet, it must result in a transfer of assets which offsets any loss of assets suffered due to the influence of the parent company.[48]

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[40] GRIGOLEIT, *supra* note 15, § 311 marg. no. 17; LEUERING/GOERTZ, *supra* note 29, § 311 marg. no. 40; KOCH, *supra* note 17, § 311 marg. no. 23; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 2; MÜLLER, *supra* note 15, § 311 marg. no. 12.

[41] ALTMEPPEN, *supra* note 15, § 311 marg. no. 75 et seq.; KOCH, *supra* note 17, § 311 marg. no. 13 KOPPENSTEINER, *supra* note 21, § 311 marg. no. 3; MÜLLER, *supra* note 15, § 311 marg. no. 12.

[42] KOCH, *supra* note 17, § 311 marg. no. 24; MÜLLER, *supra* note 15, § 311 marg. no. 27; TRÖGER, *supra* note 3, 7.

[43] GRIGOLEIT, *supra* note 15, § 311 marg. no. 27; KOCH, *supra* note 17, § 311 marg. no. 24; VETTER, *supra* note 15, § 311 marg. note 40 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 27.

[44] GRIGOLEIT, *supra* note 15, § 311 marg. no. 27; KOCH, *supra* note 17, § 311 marg. no. 25; VETTER, *supra* note 15, § 311 marg. note 48; MÜLLER, *supra* note 15, § 311 marg. no. 31.

[45] KOCH, *supra* note 17,§ 311 marg. no. 25; HOPT, *supra* note 6, 22; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 36; MÜLLER, *supra* note 15, § 311 marg. no. 29 et seq.

[46] On difficulties assessing the disadvantage caused ALTMEPPEN, *supra* note 15, § 311 marg. no. 188 et seq.; GRIGOLEIT, *supra* note 15, § 311 marg. no. 27 et seq.; HOPT, *supra* note 1, 103; KOCH, *supra* note 17,§ 311 marg. no 31 et seq.; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 57 et seq.; VETTER, *supra* note 15, § 311 marg. note 48 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 30 et seq.

[47] ALTMEPPEN, *supra* note 15, § 311 marg. no. 347; GRIGOLEIT, *supra* note 15, § 311 marg. no. 46; KOCH, *supra* note 17, § 311 marg. no. 39; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 109; VETTER, *supra* note 15, § 311 marg. no. 86; MÜLLER, *supra* note 15, § 311 marg. no. 50.

If the dominating company does not deliver adequate compensation, § 317 AktG provides a claim for damages against the parent company. The nature of the damage is assessed from an *ex post* perspective.[49]

b) Compensation for Minority Shareholders and Creditors

Minority shareholders and outside creditors benefit indirectly from the requirement for the dominating company to compensate the dependent subsidiary.[50] Compensation is given to the corporation as a legal entity, not to individual shareholders or creditors on a first come, first served basis.

This rule is extended for the benefit of minority shareholders by § 317 para. 1 sent. 2 AktG, and captures two situations. The shareholder may bring a claim against the parent company, demanding a payout to the subsidiary company, whose management may not actively pursue potential claims. The shareholder may also demand payment to himself if he suffers a loss other than the decline in value of his stock, for example a smaller dividend payout.[51]

A similar possibility is provided for outside creditors as §§ 317 para. 4, 309 para. 4 sent. 3 AktG allow for creditors to pursue the claim of the dependent company. A creditor who is not a shareholder may claim payment for himself if his demands against the dependent company are not met.[52]

Both parties are aided to some extent by reporting duties. According to § 312 AktG, management must report the extent of influence from a dominating parent company *("Abhängigkeitsbericht").* The report is not made public, hence neither minority shareholders nor creditors can consult it directly when pursuing a claim against the parent company. However, public accountants (§ 313 AktG) and supervisory board members (§ 314 AktG) have a legal duty to verify that any disadvantage suffered has been compensated. Any hesita-

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[48] EMMERICH/HABERSACK, *supra* note 25, § 25 marg. no. 52; GRIGOLEIT, *supra* note 15, § 311 AktG marg. no. 51; KOCH, *supra* note 17, § 311 marg. no. 44; KOPPENSTEINER, *supra* note 21, § 311 marg. no. 106 et seq.; MÜLLER, *supra* note 15, § 311 marg. no. 50.

[49] GRIGOLEIT, *supra* note 15, § 317 marg. no. 6; KOCH, *supra* note 17, § 317 marg. no. 7; KOPPENSTEINER, *supra* note 21, § 317 marg. no. 15; MÜLLER, *supra* note 15, § 317 marg. no. 10.

[50] GRIGOLEIT, *supra* note 15, § 317 AktG marg. no. 1; HOPT, *supra* note 6, 22.

[51] CONAC/ENRIQUES/GELTER, *supra* note 17, 511; GRIGOLEIT, *supra* note 15, § 317 marg. no. 15; KOCH, *supra* note 17, § 317 marg. no. 8, 14; KOPPENSTEINER, *supra* note 21, § 317 marg. no. 40; VETTER, *supra* note 15, § 317 marg. no. 32 et seq.; MÜLLER, *supra* note 15, § 317 marg. no. 6.

[52] GRIGOLEIT, *supra* note 15, § 317 marg. note 11; LEUERING/GOERTZ, *supra* note 29, § 317 marg. no. 27; KOCH, *supra* note 17, § 309 marg. no. 23; KOPPENSTEINER, *supra* note 21, § 317 marg. no. 39, § 309 note 53 et seq.; VETTER, *supra* note 15,§ 317 marg. no. 27; MÜLLER, *supra* note 15, § 317 marg. no. 21.

tions in this regard provide a basis for minority shareholders and outside creditors to prepare potential claims.

V. The Contractual Group *("Vertragskonzern")*

When the AktG was reformed in 1965, the legislator was not focused on de facto group law, but the law of contractual groups.[53] If compared to the de facto group, the contractual group offers further reaching options to manage a dependent subsidiary according to the strategy of the parent or of the group. It may rest on one of two forms of a contractual agreement between the parent company and the subsidiary. The first form of contract allows for profit made by the subsidiary to be distributed to the parent company *("Gewinnabführungsvertrag").* The second form puts the entirety of managing the subsidiary in the hands of the parent *("Beherrschungsvertrag").*

1. Concluding the Contract

Any of the two forms of contract mentioned above must be agreed upon by the boards of both companies, with § 293 paras. 1, 2 AktG requiring a minimum of 75% consent from both shareholders' assemblies.[54] It needs to be in writing, § 293 para. 3 AktG, and is accompanied by extensive reporting and auditing requirements, with § 293a AktG requiring the boards of both parent and subsidiary to draft a report detailing the contract as such, Auditors prepare a detailed report as well, focusing on what will be offered to minority shareholders as stipulated in §§ 293b et seq. AktG. Both reports, as well as the contract itself and the annual financial statements of the last three years must be presented to the shareholders before the vote on the contract, § 293f AktG.

If the vote is successful, the contract must be included in the commercial register of companies, § 294 AktG.

2. Enabling Components

a) Profit Distribution Agreement

The first form of contract exclusively regulates profit distribution. The subsidiary agrees to transfer its entire profit to the parent, § 291 para. 1 sent. 1

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[53] EMMERICH/HABERSACK, *supra* note 22, § 291 AktG marg. no. 3; HOPT, *supra* note 6, 10; MÜLBERT, *supra* note 21, § 291 marg. no. 5 et seq.; MÜLLER, *supra* note 15, Vor § 311 marg. no. 12; R. VEIL, in: Spindler/Stilz, AktG, 3rd ed. 2015, § 291 marg. no. 3.

[54] GRIGOLEIT, *supra* note 15, § 293 marg. no. 1, 9; HOPT, *supra* note 1, 98; KOCH, *supra* note 17, § 293 marg. no. 1, 8; KOPPENSTEINER, *supra* note 21, § 293 marg. no. 2, 28; LANGENBUCHER, *supra* note 21, § 293 marg. no. 1, 24; VEIL, *supra* note 53, § 293 marg. no. 13, 17, 37 et seq.

AktG, or run its business for the account of the parent, § 291 para. 1 sent. 2 AktG. Tax law provides the main reason for concluding profit distribution agreements[55], as the group qualifies for a tax group regulation where a profit distribution agreement has been concluded and carried out for a minimum of five years.[56]

b) Domination Agreement

The second form of contract is more comprehensive. It allows for a full-fledged domination of the subsidiary by the parent company. The board of the parent company is conferred a right to request compliance by §§ 291, 308 AktG, a right which overrules both duties of loyalty and capital maintenance rules, § 57 para. 1 sent. 3 AktG.[57]

According to § 308 AktG, the management of the dependent company must comply with lawful orders of the parent company, even if they are disadvantageous for the subsidiary. It differs from the de facto group in that the subsidiary's board does not have a choice of whether or not to comply with the parent's orders, unless these orders carry a serious risk of insolvency.

3. Protective Components

The far-reaching options of aligning the management of a subsidiary with the parent go hand in hand with strong protection offered to minority shareholders and outside creditors. Under § 302 AktG, the dominating parent company must compensate any loss reflected in the annual financial statement, abiding by capital maintenance rules for the sake of both minority shareholders and creditors.[58] Similarly, §§ 309 et seq. AktG stress the liability of the parent's management for issuing unlawful orders. Minority shareholders may bring a lawsuit, but are only permitted to request payment to the subsidiary, while creditors bringing a lawsuit may claim payment for themselves.

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[55] KOCH, *supra* note 17, § 291 marg. no. 38; HOPT, *supra* note 6, 2; KOPPENSTEINER, *supra* note 21, § 291 marg. no. 4; MÜLBERT, *supra* note 21, § 291 marg. no. 8; LANGENBUCHER, *supra* note 21, § 291 marg. no. 13; VEIL, *supra* note 53, Vor § 291 marg. no. 15 et seq.

[56] ALTMEPPEN, *supra* note 15, § 291 marg. no. 144; EMMERICH/HABERSACK, *supra* note 22, § 291 AktG marg. no. 51a et seq; KOCH, *supra* note 17, § 291 marg. note 38; KOPPENSTEINER, *supra* note 21, § 291 marg. no. 79; LANGENBUCHER, *supra* note 21, § 291 marg. no. 53; VEIL, supra note 53, Vor § 291 marg. no. 17.

[57] ALTMEPPEN, *supra* note 15, § 308 marg. no. 95; EMMERICH/HABERSACK, *supra* note 22, § 291 AktG marg. no. 74 et seq.; SERVATIUS, *supra* note 21, § 308 AktG marg. no. 10, 12; KOCH, *supra* note 17, § 291 marg. no. 36; KOPPENSTEINER, *supra* note 21, § 308 marg. no. 28; LANGENBUCHER, *supra* note 21, § 308 marg. no. 24.

[58] ALTMEPPEN, *supra* note 15, § 302 marg. no. 2; GRIGOLEIT, *supra* note 15, § 302 marg. no.1; H. HIRTE, in: Großkommentar AktG, 4th ed. 2013, § 302 marg. no. 4; KOCH, *supra* note 17, § 302 marg. no. 3; VEIL, *supra* note 53, § 302 marg. no. 3.

a) Minority Shareholders

Minority shareholders profit from different provisions for mandatory relief.[59] § 304 AktG is intended to ensure shareholders have a choice between exiting the subsidiary and staying with it. The rule requires the parent company to offer a fixed yearly payment based on what may have been expected as a dividend payment during the years preceding the contract.[60] Alternatively, the contract may provide for a variable payment based on dividends distributed by the subsidiary to the parent company. For minority shareholders who choose to exit the subsidiary, § 305 AktG requires the contract between parent and subsidiary to include an appraisal right.[61] Obviously, establishing a fair compensation amount raises a number of complex accounting questions.[62]

b) Outside Creditors

Once a contractual group ends, the parent is no longer required to compensate the subsidiary for any losses. Hence, § 303 AktG allows for creditors with outstanding claims to acquire a security. The rule presupposes, that the claim goes back to a situation before the end of the contractual group was made public in the company's register.

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[59] D. SCHENK, in: Bürgers/Körber, AktG, 3rd ed. 2014, § 304 marg. no. 2; EMMERICH/HABERSACK, *supra* note 25, § 21 marg. no. 1; K. HASSELBACH/H. HIRTE, in: Großkommentar AktG, 4th ed. 2013, § 304 marg. no. 4 et seq.; A.-J. PAULSEN, in: Münchener Kommentar zum AktG, 4th ed. 2015, § 304 marg. no. 1; TRÖGER, *supra* note 3, 9 et seq.

[60] SERVATIUS, *supra* note 21, § 304 marg. no. 14 et seq.; KOCH, *supra* note 17, § 304 marg. no. 8; HOPT, *supra* note 1, 99; PAULSEN, *supra* note 59, § 304 marg. no. 75; K. STEPHAN, in: Schmidt/Lutter, AktG, 3rd ed. 2015, § 304 marg. no. 75 et seq.; VEIL, *supra* note 53, § 304 marg. no. 54 et seq.

[61] SERVATIUS, *supra* note 21, § 305 marg. no. 2 et seq.; HASSELBACH/HIRTE, *supra* note 59, § 305 marg. no. 7 et seq.; HOPT, *supra* note 1, 100; KOCH, *supra* note 17, § 305 marg. no. 2 et seq.; KOPPENSTEINER, *supra* note 21, § 305 marg. no. 3; PAULSEN, *supra* note 59, § 305 marg. no. 1.

[62] S. RUIZ DE VARGAS, in: Bürgers/Körber, AktG, 3rd ed. 2014, Anh § 305 marg. no. 1 et seq.; SERVATIUS, *supra* note 21, § 305 marg. no. 13 et seq.; HOPT, *supra* note 1, 100; KOCH, *supra* note 17, § 305 marg. no. 24 et seq.; KOPPENSTEINER, *supra* note 21, § 305 marg. no. 68 et seq.; STEPHAN, *supra* note 60, § 305 marg. no. 47 et seq.

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