Foreign Financial Investments in German Firms - Some Legal and Policy Issues

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I. Introduction

1.

In my following remarks I will focus on a difference which we find in German law as well as in other legislations, the difference between entrepreneurial investments among firms and merely financial investments. Whereas our law of groups of companies of "Konzernrecht" contains quite an elaborated set of rules, the rules governing financial investments, especially cross-border financial investments, seems to be somewhat underdeveloped.

2.

Let me start with some general remarks about entrepreneurial and merely financial investments. This differentiation does not refer to the *object* of the investment (real assets, incorporeal assets, financial assets) but on its *purpose.* To be sure, if a car producer acquires a controlling block of shares in a tyre producing Company the purpose of this investment is also a "financial" one in the end: This investment aims, like "merely financial" investments do, at generating the highest possible outcome for the investing firm. However, crucial differences between entrepreneurial and "merely financial" investments remain. In our example the investor is interested in the first line in the *product* of the firm in which he has invested; it is a necessary part for his own production. The respective firm invests into a supplier of goods which he needs for his own activity; he invests "backwards". An example for a "forward investment" would be the acquisition of a stake in a foreign marketing Company. In other cases of

entrepreneurial investment the investor may be interested in getting or securing his access to raw materials, overcoming market entry barriers in a foreign environment, gaining from joint production (economies of scale or economies of scope), from the skills of the acquired firm's well-trained workforce, and the like.

In contrast to cases of "entrepreneurial" investment we observe also "merely financial" investments not only by private investors or financial institutions but also by firms or entrepreneurs. In such a case the investor is not interested in the products, assets, skills or other advantages which might flow from his investment to his own (other) firm or firms. He does not intend to support or bolster another entrepreneurial activity by his investment but is simply interested in getting the highest possible return in terms of dividends, interests or gains in the prize of the shares held by him.

This distinction leads us to a first Observation concerning the investment and control patterns of these two different kinds of investments. Investment as well as control patterns differ in cases of entrepreneurial and merely financial investments.

II. Investment and control patterns

1.

The ***entrepreneurial investor*** will typically tend to shape the contract or to acquire a participation such that he will reach his goal (make the firm in which he has invested to supply him with the goods, Services or knowledge for which he was looking; abstain from competition and so on). If the entrepreneurial investment consists in the acquisition of an equity stake in a Company' this will typically mean that the investor either acquires a controlling block of shares or, at least, an influential (blocking) minority position as a smaller portion does not give him the means to pursue his goals. As the entrepreneurial investor will try to reach these goals, he will normally tend to control the firm in which he has invested, and exercize his rights as a shareholder actively.

2.

Patterns of investment and control look different in ***merely financial investments.*** Whether the "financial investor" will buy an equity stake in a firm as well as the size of such a participation will depend on the expected return and the assumed riskiness of the investment (the own preferences of the investor - risk aversion or risk neutrality - and portfolio deliberations like diversification etc.)[2]. That may mean and actually very often means that the stake which the financial investor acquires is too small to control the firm in which he has invested, and to exercize his rights as a shareholder actively. I will get back to this problem later.

III. The law governing entrepreneurial and financial equity investments in firms

Entrepreneurial and financial equity investments in firms lead to different questions, and to different solutions.

1.

The ***entrepreneurial investor*** may, for instance, have incentive to exploit business opportunities of one firm for the benefit of another in which he holds a larger stake. Or he may ask management of one firm for deals with his other firm(s) that are not at arm's length, and there may be more opportunities for such detrimental deals or better possibilities to hide them for an entrepreneurial than for a merely financial investor. German corporate law therefore contains quite a detailled and thorough body of rules that are exclusively applicable on entrepreneurial investments or "groups of companies" ("Konzernrecht")[3]. To be sure, the point of reference of these rules is not the entrepreneurial purpose of the investment or the subjective intent of the investor. These rules are applicable if one enterprise is able - by virtue of its participation or otherwise - to exercise a controlling influence on another enterprise, whether or not the specific dangers for outside shareholders and creditors of the controlled (or the controlling firms) are likely to materialize. These rules are also applicable on foreign

entrepreneurial investments in German companies, and some of these rules apply on German investments abroad, too[4].

2.

Merely financial, non-entrepreneurial Investments are, however, subject to the general rules of Company law, be these domestic or foreign investments in a German Company. It seems, however, that this part of our Company law is somewhat unprepared vis-a-vis the growing importance of foreign financial investments in German Stocks, and it is to this development and some consequences for future reform that I turn to in the following.

IV. Foreign institutional investments in German stock corporations

1.

With the growth of foreign institutional investors, especially pension and investment funds, and the internationalization of the securities markets, European as well as institutional investors from overseas have acquired substantial blocks of stock of the major German corporations. In the following I try first to describe this development a bit more in detail. Then I point at some problems which these investors face and put some policy questions.

In 1992 there were (of more than 2 million firms in Germany) about 3,000 stock corporations[5]; of these only 665 are quoted on a stock exchange[6], and of these 665 about 80 are widely held and traded[7]. However, most of these corporations with widely distributed ownership are among the 100 largest firms in Germany[8], and foreign institutionals have picked their "blue chips" like Siemens, Deutsche Bank or Daimler-Benz from this group.

The ever increasing importance and rapid development of foreign institutional investment in German stock corporations has been described and analyzed with respect to its various policy implications several times

recently[9]. Let us just have a look at one - presumably typical[10] - example, the development in Siemens Aktiengesellschaft.

In 1973, of a share capital of DM 1,3 bn, about 29 % of all shares were held by foreigners including institutional investors like insurance companies, investment and pension funds, and banks; the (about 1,000) foreign institutionals alone held about 4,5 % of all shares. In 1986, foreigners already held more than 43 % of all shares (of a share capital of DM 2,4 bn)[11]. This latter number was corroborated by a sociological study with numbers as of Oct. Ist, 1990[12]. According to this study institutionals held at least 35 % of all shares of Siemens in 1990; among them foreign institutional investors with about 18 % of Siemens stock capital. All foreign investments in German shares ran up to DM 5,7 bn in 1980 whereas the total amount in 1991 was approximately DM 15,6 bn[13].

At the same time, the presence of shareholders at the shareholders meetings fell significantly: In 1975, 72,1 % of all shares of Siemens were represented whereas this number fell to 50,30 % in 1992. The numbers for other firms show a similar or an even more dramatical decrease: BASF 1975: 65,9 %/1992: 52,28 %; Bayer 1975: 64,9 %/1992: 49,67 %; Thyssen 1975: 84,0 %/1992: 68,4 %; Deutsche Bank 1975: 63,3 %/1992: 45,8 %[14].

2.

Apparently the increasing passivity of shareholders is correlated with the increase of foreign investments. What are the reasons for this pattern, and what are the drawbacks of this development?

At first sight not the recent low presence at shareholders meetings of our publicly held corporations but the former high presence needs to be explained. For this seems to contradict the common Observation of collective action problems in corporations with dispersed shareholders. It is not rational for a single shareholder holding a small fraction of a company's stock to engage in disciplining management (collect information, taking part in general meetings, vote, or even sue management for misbehavior) if the

gross benefits of his or her activity are lower than its costs. To put it more correctly: if the costs of these activities are such that the gains from alternative courses of action (holding shares but not attempting to discipline management, selling shares and investing in some other investment) are greater than the gains to the shareholder from disciplining management[15]. So how can the formerly high numbers of presence at the shareholders meetings of German publicly held corporations be explained? The explanation lies in the German depositary voting system. Shares are usually deposited with banks, and these banks are given a proxy to vote the deposited shares at shareholders meetings[16]. These proxies which are given to a few depot institutions lead to scale economies in monitoring.

Why then do foreign investors not as well give proxies to depot institutions, at least not to the extent to which German investors do so? It would be interesting to interview the managers of these institutions or funds and ask them for their motives. Here are some presumed answers:

> It is a general policy of our fund or house to remain passive, not to spend money on monitoring ourselves managements of the companies in which we have invested, but to rely on "free-riding" on the efforts of other investors instead. If we don't like the shares of a Company anymore we follow the "Wall Street rule" and choose the "exit" rather than the "voice" option[17].
>
> The interests of the depot institutions and shareholders may diverge substantially; hence these institutions have to be supervised themselves. This "control of controllers" creates higher information and monitoring costs for a foreign than for a domestic investor.
>
> If an investor does not hold an account with a German credit institution or a foreign institution which is subject to the respective rules for German credit institutions he even cannot be sure to receive the invitations, information or other notices from his Company. The institution with which he has deposited his shares might not be obliged to transmit to the beneficial owners the material which it receives from the company[18], and it might not be obliged to vote its client's shares at shareholders meetings at their demand according

to the rules with which a domestic credit institution has to comply[19].

Voting at least large blocks of shares of a company oneself is no alternative: Statutes of German companies mostly require that the shareholder deposit his or her shares for a certain period of time before and during the general meeting with a credit institution[20]. This creates new costs and may harnper the sale of the shares during this period. In single cases the certificate of a foreign institution that shares have been deposited with them might not suffice and not be accepted as a legitimation.

Direct cooperation of several institutional investors like, e. g., by concluding agreements about the repeal of antitakeover provisions, the question whether or not to tender the shares to a bidder, to agree to structural changes of the Company etc., is not only costly but almost impossible because holdings of stock have, according to German Company law, only to be disclosed if such a holding comprises more than 25 % of all shares of a stock corporation, and if this participation is held by another enterprise[21]. That means that information about who the other shareholders are can only be obtained if these hold large blocks. The Company itself does not have this information, either, as shares are mostly non-registered bearer shares. The only way to get into contact with the other shareholders is via the depot banks which can pass on communications to their clients but are only obliged to do so in limited cases[22].

3.

Before we think about improvements and policy recommendations we should first recall shortly the arguments why improvements seem necessary, why shareholders passivity is detrimental to the individual shareholders themselves as well as for the Company.

In principle, lack of control of management means agency costs for the shareholders; these agency costs might then be - but are not necessarily -

lowered by other control devices like, e. g., pressure on management from competition on the product markets with the ensuing threat of bankruptcy and loss of management's positions. Choosing "exit" in contrast to the "voice" option is not a perfect solution for a shareholder as selling means suffering the low price that attaches to the shares of a poorly performing firm. Apart from that, the holdings of institutional investors may be so large that sales may be taken as a negative signal by the market and hence have too great an impact on the stock price of the portfolio as to serve as a disciplining instrument[23]. Free-riding on the efforts of other shareholders will only help if these others do not choose to take the same approach but have incentive themselves to monitor. That is very likely not the case in a publicly held corporation with widely dispersed small shareholdings. The foreign institutional investors could, of course, try to rely on that their interests will be safeguarded by the domestic depot banks. However, these agents may pursue own interests. To exclude conflicts of interests in exercizing the depositary votes at their discretion these institutions should be given instructions how to vote. And their efforts should be monitored by competitive pressure from other competing institutions or alternative proposals of independent groups of shareholders in the shareholders meetings.

V. Policy consequences

Which steps should be taken?

1.

Communication among shareholders should be made easier in order to overcome the collective action problem (high information and monitoring costs for small shareholders), to create an alternative to the use of the depositary voting system and thus reduce the scope of discretion of the depositary institutions.

The current draft of a federal law which is to transform and implement the rules of the "transparency directive" of the EC[24]

(Entwurf "Zweites Finanzmarktförderungsgesetz" as of June 29, 1993) provides that a shareholder whose holding surmounts five percent (or certain higher thresholds) has to give the Company due notice thereof. That means in the case of, e. g., Siemens Aktiengesellschaft with a stock capital of DM 2,638 bn that a shareholder has to hold shares with a nominal value of more than DM 131,9 million before he has to give notice of his holding to the Company and before the other shareholders can get into contact with him. This threshold seems too high and should be lowered.

As an additional means to promote communication among shareholders the law should provide that names and addresses of non-objecting shareholders be furnished from the depositary institutions to the issuing Company and from it to any shareholder on his or her demand who then may communicate directly with such shareholders.

Furthermore, the companies should be obliged to pass to any shareholder on his or her demand a list of all persons and institutions that have exercized votes at the previous shareholders meeting in its own name or in the name of "whom the vote concerns".

Lastly, legislation should ensure that managements of companies accept also certificates of foreign credit institutions or investment firms (at least of the EC member states and such states where the firm's stock is listed and traded on a stock exchange) that shares have been deposited with them as a legitimation for shareholders to be admitted to shareholders meetings.

2.

There are quite some more points to be thought of if we want to lure and obtain foreign capital investments in our large firms. Some reforms are under way, like the insider and the transparency legislation, others will have to be discussed further, like the repeal of restrictions of voting rights, a convincing framework of rules governing hostile takeovers, the improvement of the

internal governance structure of our large corporations and others. Transnational investments and cooperation can still be improved.

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1 The text does not, of course, deal with the question why an entrepreneurial investor chooses an (equity) investment rather than concluding a contract. For a theoretical discussion of this question see Jean Tirole, The Theory of Industrial Organization (1989), at 16 ff.; Paul Milgrom/John Roberts, Economics, Organization and Management (1992), Part I.

2 On financial investments see, e. g., Richard Brealey/Stewart Myers, Principles of Corporate Finance, 3rd ed. 1988; Thomas Copeland/J. Fred Weston, Financial Theory and Corporate Policy, 3rd ed. 1988.

3 For a description and analysis in English cf. Ulrich Immenga, Company Systems and Affiliation, in: Int'l Encyclopedia of Comparative Law, Vol. XIII, Business and Private Organizations (ed. A. Conard), chapter 7 (1985).

4 Details in Bernhard Großfeld, In: J. von Staudinger’s Kommentar zum Bürgerlichen Gesetzbuch, EGBGB, 12. Aufl. 1984, n. 389 ff.; Carsten-Thomas Ebenroth, Münchener Kommentar zum Bürgerlichen Gesetzbuch, Vol. 7, 2nd ed. 1990, at 543 ff.

5 Number as of May 31, 1992: 3,052. Source: Hansen, Die Aktiengesellschaft (1993), AG-Report, at R 64.

6 Source: Handelsblatt, Jan. 29/30, 1993, at p. 39.

7 More than 50 % widely held: 80 companies; more than 75 % of stock widely held: 38 companies (Source: Saling, Aktienführer, 86. ed. 1993 [numbers as of Sept. 19921; Commerzbank [ed.], Wer gehört zu wem?, A guide to capital links in German companies, 17. ed. 1991).

8 Cf. the list of the largest 100 firms in: Bundestag-Drucksache 11/7582 p. 176 ff. and the list of German firms and the structure of their ownership in: Commerzbank (ed.), Wer gehört zu wem (N. 7).

9 Cf. the articles of Richard Buxbaum, Mark Roe and Friedrich Kübler in: Theodor Baums/Richard Buxbaum/Klaus Hopt (eds.), Institutional Investors and Corporate Governance (1993); furthermore Uwe H. Schneider, Auf dem Weg in den Pensionskassenkorporatismus?, Die Aktiengesellschaft (1990), at 317 ff.

10 Cf. also Schneider (N. 9), at 319 f.

11 Data according to Günter Henn, Handbuch des Aktienrechts, 4. ed. 1991, at 763.

12 Siemens AG (ed.), Aktionärsstruktur der Siemens AG (1990).

13 Source: “Auftragsstimmrecht der Banken sollte nach Meinung der deutschen Industrie nicht in Frage gesteilt werden”, Handelsblatt, August 2nd, 1993, at p. 3.

14 Handelsblatt, supra (N. 13); cf. also Schneider (N. 9), at 321 f.

15 For a detailled description and analysis of the collective action problem see Edward Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Georgetown L.J. (1991), at 447, 453 ff.

16 Detailled description with empirical data in Theodor Baums, Takeovers vs. Institutions in Corporate Governance in Germany, in: Prentice/Holland (eds.), Contemporary Issues in Corporate Governance (1993), 151 ff.; cf. also Johannes Köndgen, Duties of Banks in Voting Their Clients' Stock, in: Baums/Buxbaum/Hopt (supra N. 9).

17 See generally A. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).

18 For the actual state of the law cf. Wolfgang Zöllner, Kölner Kommentar zum Aktiengesetz (1984) § 128 note 4.

19 For the actual state cf. again Zöllner (supra N. 18) § 128 at n. 4; § 135 n. 7, 102.

20 Cf. § 123 Aktiengesetz (Stock Corporation Act).

21 §§ 20, 160 (1) (8) Aktiengesetz. The “transparency directive" of the EC (“Council Directive of 12 December 1988, 88/627 EEC, OJ L. 348, 17.12.1988, 62 - 65) has not yet been implemented in Germany. Cf. now, however, the draft of a transformation law (“Zweites Finanzmarktförderungsgesetz”) of June 29, 1993. - According to § 285 Nr. 11 HGB (German Commercial Code) corporations have to disclose holdings in other firms of more than 20 % of the capital of such firms.

22 Cf. § 128 Aktiengesetz.

23 For the increasing activism of institutional investors in corporate governance issues in the U.S. which seems to be caused by these reasons cf. Martin Dickson, “Crusaders in the Capitalist Cause”, Financial Times, March 17, 1993, at p. 15.

24 See N. 21, supra.