Brigitte Haar

# Shareholder Wealth vs. Stakeholder interests? Evidence from Code Compliance under the German Corporate Governance Code

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House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt am Main

Tel. +49 69 798 34006 | Fax +49 69 798 33910
info@safe-frankfurt.de | www.safe-frankfurt.de

## Non-Technical Summary

The alignment of shareholder wealth and stakeholder interests has been at the center of self-regulation resulting from corporate governance codes increasing in number ever since the turn of the century. The implementation of corporate governance codes in Europe is based on companies' obligation to motivate non-compliance, i.e. explain any deviation from code recommendations. According to the legislators' intent disclosure under the comply or explain principle is supposed to serve as a self-enforcing regulatory capital market-based mechanism.

Since there is no unambiguous evidence of the actual functioning of this market-based enforcement, the paper aims to explore what is driving code compliance and the underlying legitimacy of corporate governance codes. Rules that motivate corporate behavior, but do not greatly affect corporations' material interests can then shed a light on motives that go beyond shareholder wealth maximization to include stakeholder interests.

In order to identify these motives rate of compliance of distinct provisions of the German Corporate Governance Code are analyzed. At the example of the recommendation of incentive pay for supervisory board members it is shown that case law and the legal discussion enter into corporations' decisions whether to comply to a high degree. In the case of severance pay caps outrage constraints seem to be decisive and form the basis for a pressure how to explain non-compliance. This opens the view further to highlight the importance of stakeholder and group interests at the example of compliance with the recommendation of age limits for supervisory board members. Overall the evidence highlights the amalgam of motivations that may play an important role for corporations' motivation to comply or not to comply with corporate governance codes which are, by no means, limited to shareholder wealth.

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# Shareholder Wealth vs. Stakeholder interests?

# Evidence from Code Compliance under the German Corporate Governance Code

**Brigitte Haar**♦

Abstract: In order to better differentiate the drivers of corporations' actions, in particular shareholder wealth and stakeholder interests, the paper explores the significance of the comply or explain-principle and its underlying enforcement mechanisms more generally. Against this background, compliance rates with specific provisions may shed a light on companies' reasons for following the code. An analysis of these rates at the example of distinct provisions of the German Corporate Governance Code is therefore entered into. In light of the current corporate governance debate and the legitimacy problems that are raised, among the code provisions that exemplify these questions very well are those regulating incentive pay, severance pay caps, and age limits for supervisory board members. Their analysis will lay a basis for an answer to the question about what motivates companies to comply with the code. The motivation then paves the way to arrive at a further specification of the determinants of the regulatory evolution of the Code and the range of stakeholders and their concerns that enter into it.

Keywords: corporate governance codes, soft law, stakeholder, shareholder wealth, market enforcement, German corporate governance, supervisory board, incentive pay, severance pay caps, age limits

JEL Classification: G38, K20, M12, M14, M52

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## 1. Introduction

Mandatory comply or explain is one of the principal ideas underlying the implementation of corporate governance codes in Europe.[i] It combines flexibility and voluntariness of compliance with code recommendations with an obligation to explain any deviation from code recommendations. In Germany, the legislature clearly aimed to instil investor trust in German corporate governance rules, through disclosure when providing for comply or explain in the German Stock Corporation Act 2002 (Leyens 2016).

Even so, as the EU Commission pointed out in a 2011 Green Paper entitled 'The EU corporate governance framework', despite the success of the comply or explain principle, improvement and greater clarity are needed when it comes to the explanations given by companies when they deviate.[ii] This observation was reinforced by a 2014 Commission Recommendation on the quality of corporate governance reporting.[iii] At the same time, this need for greater specificity has been accompanied by calls for the development of a 'culture of departure from code recommendations', in order to enhance flexibility and ensure that compliance is tailored to each company's individual needs. These two demands raise the important question of what is driving code compliance and the underlying legitimacy of corporate governance codes. Who are companies' explanations addressed to: potential shareholders, investors or stakeholders in general? Turning our attention to which rules motivate corporate behaviour without affecting corporations' material interests could open the door to extending the analysis beyond shareholder wealth maximization to include stakeholder interests.

## 2. Comply or Explain as the basis of corporate governance codes

### (a) Diffusion and nature of corporate governance codes

The idea of corporate governance codes, as it is understood today, did not take hold before the early 1990s. That was when the Cadbury Committee, named for its chairperson Sir Adrian Cadbury, came up with recommendations on corporate governance best practices in the UK (*Cadbury Report* 1992). The Cadbury Report not only began the development of good conduct codes in the UK, notably the Combined Code 1998, 2003, 2006 and 2008, and its

successor the UK Corporate Governance Code 2010, 2012, and 2014 (Mallin 2016, 27-44), it also paved the way for the emergence of corporate governance codes across Europe.

Under the influence of the Cadbury Code, other EU Member States developed similar corporate governance codes (Clarke 2007, 175-79; Wymeersch 2008, 66-72; Zattoni and Cuomo 2008, 6-7), such as the French Code de gouvernement d'entreprise des sociétés cotées, the Swedish Code of Corporate Governance of 2004, the Austrian Code of Corporate Governance of 2002, and the Swiss Code of Best Practice for Corporate Governance. This chapter focuses on the German Corporate Governance Code of 2002 ("German Code"), as drafted by the German Government Commission on the German Corporate Governance Code, set up in September 2001 following a proposal by an earlier government commission, named the Baums Commission for its chairman.

The Cadbury Code can also be seen as the starting point of the comply or explain principle (*Cadbury Report* 1992, 1.3). As corporate governance codes were developed in continental European states, adoption of the comply or explain principle spread, despite considerable structural differences between these countries, for example with regard to ownership structures, institutional shareholdings and legal framework.

## (b) Compliance

### (i) Extent

Even when looking only at a small sample of Member States, the different declared levels of compliance across countries are notable (Seidl 2007, 3-4). A rough overview indicates a compliance rate of above 90 per cent for the largest listed companies in the Netherlands, Belgium, Italy, Spain, and Germany (Wymeersch 2008, 95-8; RiskMetrics Group 2009, 88-97). For German DAX-listed companies, for example, extensive data published by the Berlin Centre of Corporate Governance, indicates a compliance rate of 96.1 per cent for DAX-listed and MDAX-listed companies in 2016 (DAX: 97.5 per cent, MDAX: 95.2 per cent) with the recommendations of the German Code (Beyenbach et al, 2016, 1, 4).

### (ii) Compliance – Enforcement by Markets

#### A. Concept of the German Corporate Governance Code

In light of these fairly high compliance rates, the question quite naturally arises as to the reasons and pressures that lead to compliance with the code. While observation of the Combined Code is a compulsory element of the Financial Conduct Authority Listing Rules in the UK, the comply or explain principle is integrated differently in the German legal framework. Upon the adoption of the German Code by the Cromme Commission in February 2002, the German legislature amended the German Stock Corporation Act by inserting s 161, which states:

> The Management and Executive Boards of the listed company declare every year that they have complied and will comply with the recommendations of the "Governmental Commission German Corporate Governance Code" […] or declare which recommendations they have not or will not comply with. This declaration must be made available to the shareholders on a permanent basis.

By looking at this indirect method of enforcement, one can see the more general implementation mechanism that underlies the German Code. In trying to instil confidence, amongst both present and future shareholders, in the corporate governance of German listed companies, the German Code focuses on international global capital markets and investors (Wackerbarth 2005, 696). Since the beginning of the corporate governance debate in the mid-90s, and becoming even more apparent with the takeover of Mannesmann by Vodafone, the comply or explain regime under the code was designed to make the corporate governance standards and practices of German corporations clear to investors. Assuming causation between corporate governance and market success, when the German Code came into force, the chairman of the German Government Commission on the Code, Gerhard Cromme, stated that capital markets would punish companies that did not follow the code (Cromme 2001). This assumption, and the incentive mechanism that resulted, seems to have been confirmed by subsequent compliance with the code by a large majority of German companies.

## B. Contract-based corporate theory as a parallel – markets and underlying decision-making process

In light of this market-oriented regulatory approach, at first instance a parallel to the contract-based theory in US corporate law doctrine does not seem to be too farfetched. In both cases an important focus is on the alignment of management and shareholder interests. Under

a contractarian approach, financial instruments such as stocks and bonds are looked at as a contractual solution to the principal-agent conflict - that is, the divergence of management and shareholder interests. This results in the notion of the 'nexus of contracts' model of the corporation, which highlights the primacy of contract over state legislation (Jensen and Meckling 1976). According to this concept, purchasers of securities are protected by efficient capital markets. Therefore the capital markets come into play not only as determinants of the fair price for the underlying contractual terms, but also as the most important standard of corporate law. Thus the claim for normative application of corporate law results from the intermediary effect of capital markets.

Such an approach quite naturally begs the question of what role remains for the legislature, whose intervention may seem unnecessary in light of the regulatory function of the capital market and the binding force of party agreements. Nevertheless, there is still a task to be performed by the legislature, a market-enhancing role it can play in the law of corporate governance. Even under the traditional view of the law, as it stands, default rules are supposed to fill gaps and provide standards.[iv] These functions differ from the economic approach of gap filling in one fundamental respect: instead of simply implementing capital market standards, the legislature sets its own.

Comparing comply or explain with the contract-based view of corporate law raises the question of how far the parallel reaches, and to what extent corporate governance codes can be looked at as default rules. Just like corporate law under the contractarian view, the recommendations of corporate governance codes could be included in the corporate law and be provided to the corporation to draft the corporate contract. Under both regulatory techniques, the pressure of the capital market is supposed to provide for optimal corporate governance rules. There is, however, one remaining fundamental difference that results from the implementation of the code using the comply or explain principle (MacNeil and Li 2006, 493). It is that directors have the greatest influence on compliance or noncompliance with the code, whereas the question of what corporate law to pick falls to the founding shareholders at the time of incorporation. Despite this difference, the link between private law-making of so-called soft law and legislated law is so small, that it seems appropriate to characterize the former as a hybrid regulatory instrument, even though the self-regulatory component prevails (Weiss 2011, 131). This becomes apparent from the pure opt-in character of the code, as opposed to the opt-out regime of corporate law rules from the contractarian perspective. The code provides for a standard that need not be met for a corporation to do business, whereas

corporate law provides for legal rules as a necessary infrastructure for market participants to form a corporation as a stand-alone market player (Bachmann 2013, 79).

The hybridity of corporate governance codes also shows itself in the way these codes can be changed and revised without necessary legislative interference. The adoption of the comply or explain principle demonstrates that the legislature is aware of a need for rules, without having a clear notion of what these rules should look like, so that the field of corporate governance develops into an experimental site for regulatory ideas (Windbichler 2009, 29). Despite the resulting advantage of greater flexibility and adaptability, there is no denying the fact that at the same time, this may bring about an opaque political decision-making process that may be captured by interest groups (MacNeil and Li 2006, 493).

### C. Empirical evidence

Despite these rather fundamental differences between the nexus of contracts concept and the comply or explain principle, the German Code is also focused on international global capital markets and investors, trying to motivate potential shareholders to invest in German listed companies (Wackerbarth 2005, 696). Assuming a causality exists between corporate governance and market success, one would expect empirical evidence of a positive correlation between governance measures, disclosure and code compliance on the one hand, and market return on the other. This assumption indeed underlies the legislature's motivation,[v] as seen in the initial statement of Chairman Cromme that whoever did not follow the code would be punished by the capital market, and it is still found frequently in current German corporate law scholarship (Habersack 2012, E27). At the same time, scepticism as to capital market pressure towards compliance seems to be increasing in more recent German literature (Bachmann 2013, 81; Böcking et al. 2012, 618; Spindler 2011, 1009; Weiss 2011, 115-6).

In summary, the overall outcome of empirical research on the relationship between disclosure and code compliance and performance or market return is unclear. The evidence is mixed, indicating a positive effect in general or in individual countries such as Switzerland or Spain (Del Brio et al. 2006; Beiner et al. 2006; Fernández-Rodrígez at al. 2004), or no effect of code compliance (Alves and Mendes 2006; de Jong et al. 2005). One study of FTSE 100 companies not complying with the Combined Code in the UK even indicated a negative effect of compliance on financial performance – in other words, investors seem willing to tolerate noncompliance when financial performance is sufficiently good (MacNeil and Li 2006). Therefore, overall evidence for a strict relationship between code compliance and

performance does not seem conclusive, even though individual measures may have a positive effect (Wymeersch 2008, 90).

In empirical studies on the actual link between compliance with the German Code and market success, the inconsistent picture described above repeats itself.[vi] Looking at the methodological problems raised in these studies, this seems hardly surprising. For example, it is impossible to exclude overarching factors that are related to governance and thus have an influence on the correlation between code compliance and performance, so that the problem of reverse causation cannot be eliminated (Mura 2007; Bhagat and Bolton 2008; Lehn et al. 2007). In addition, looking at the number of recommendations entering into governance aggregates such as ratings or codices whose correlation with performance is examined makes the difficulty even more evident (Prigge 2012, 6). Furthermore, specific company characteristics such as firm size will have an influence on this correlation (Fernández-Rodrígez et al. 2004). Looking at the studies in more detail, one additionally finds that different performance measures are used, data at times dates back to 2005, and only compliance with recommendations, but not with suggestions (which are also important components of the German Code), is included, so that statements on the correlation between compliance and performance are necessarily incomplete (Graf and Stiglbauer 2007; Stiglbauer 2010, 62-3).

### (iii) Compliance based on economic, social, and normative motivations

In light of this ambiguous evidence of the link between compliance and performance, it stands to reason to look for motivations for compliance other than pure efficiency (Bénabou and Tirole 2011; Meyer and Rowan 1977; Aguilera and Cuervo-Cazurra 2004; Zattoni and Cuomo 2008). According to research in the field of sociology of law and regulation, there are three general motives that can explain companies' compliance with regulations, namely economic, social and normative motivations. Especially in the case of agency enforcement of environmental or health and safety regulations, these motivations have emerged as fundamental for compliance.[vii] Similarly, this kind of literature would predict a high degree of compliance with the German Code, partly relying on the idea of market enforcement by way of the comply or explain principle. One factor is surely the aforementioned economic basis of compliance. In light of shareholder interest in good corporate governance practices, higher cost of capital in the case of noncompliance with the Code may result, even though the

empirical evidence is ambiguous (Drobetz, Schillhofer and Zimmermann 2004; Goncharov, Werner and Zimmermann 2006; Bassen 2006).[viii]

At the same time, more recent studies of compliance rates indicate the need for differentiation, finding higher compliance in firms with dispersed share ownership, thus pointing at a substitutive effect of code compliance vis-à-vis high agency costs and limited external ownership control (Jahn et al. 2011). Based on these findings, later studies suggest the need for a more differentiated approach and a closer analysis of the explanations of noncompliance, implying that well-reasoned noncompliance will lead to better corporate governance in specific cases (Böcking et al. 2012, 619-25). According to another closer analysis of the explanations of noncompliance, there seems to be consistent empirical evidence that comparably high noncompliance rates among companies listed in the General Standard, as opposed to DAX-listed companies, are not mainly based on the firm-specific situation of those companies, but instead on their disagreement with the general regulatory purposes and suitability of the respective recommendations. Thus the companies listed in the General Standard appear to feel under less pressure to comply, and the Code is therefore less effective in this segment (Von Werder et al. 2011, 502). Going beyond a market-based analysis, a 2012 survey of chairmen of the management and supervisory boards of all companies listed in Frankfurt, including 25 DAX-listed, 32 MDAX-listed, 9 TecDAX-listed, 25 SDAX-listed companies, and 38 more companies listed on the Prime Standard and another 36 listed on the General Standard, shows that at that time, 41 per cent of the companies did feel pressure to comply. That pressure, however, seemingly did not so much emanate from equity holders, who were perceived as only the third most important driver of compliance. More important were proxy advisors, who ranked first, and the media, who were second (Von Werder and Bartz 2012, 872).

## 3. Compliance patterns between the market and the law

In light of the increasing criticism of the German Code, the survey of 2012 just mentioned raises the question of how the executives interviewed in the survey assessed the usefulness, the relevance and the effectiveness of all the recommendations and suggestions (Von Werder and Bartz 2012, 873-7). If 50 per cent, or more, of interviewees rated a recommendation as negative, the recommendation is considered relatively or mainly un-useful, respectively (Von Werder and Bartz 2012, 873-874). In addition, a differentiation is made among the useful recommendations, according to the number of interviewees making a

more or less negative evaluation. This ultimately leads to the further classification of these recommendations as problematic or even highly problematic, if a significant number of interviewees rated the recommendation as not useful. Under efficiency considerations, these recommendations call for further analysis. The results could also pave the way for further insights into companies' compliance patterns. If, according to this data, certain recommendations are complied with despite the negative assessments made of them by the executives surveyed, or despite being evaluated as problematic, compliance cannot be exclusively and directly based on market considerations, because these regulations are apparently not looked upon as suitable to improve the quality of the company's corporate governance. Therefore, it is worthwhile to take a closer look at some examples of discrepancies between compliance and assessments.

### (a) Low compliance, problematic recommendations, and the law: incentive pay for supervisory board members

One of the recommendations that received the most negative assessments in the survey mentioned above is recommendation 5.4.6 of the German Code of 2011, providing that supervisory board members shall receive incentive pay alongside a fixed compensation. In 2011, only 68 per cent of DAX-listed companies complied with this recommendation. Following a change in the recommendation, which now calls for the alignment of incentive pay with the sustainable development of the company, without prescribing the structure of incentive pay as such, the compliance rate increased to 72.7 per cent of DAX-listed companies in 2014, and 75 per cent in 2015 (Von Werder and Bartz 2014, 909; Von Werder and Turkali 2015, 1362). Therefore, there seems to be no direct capital market enforcement of the Code at work with regard to incentive pay for supervisory board members.

This is even more surprising, because the support for stock option pay in the German Code has been in line with the general development of incentive pay for executives in general. It is true that stock options are much less common among German companies than they are among US companies. Compared with the situation before 1998, when an amendment to the German Stock Corporation Act made stock option pay more attractive, and thanks to subsequent changes in the tax regime, stock option pay in Germany has increased significantly in the first decade of this century and been used as an important incentive for management (Cheffins 2001, 511-3; Haar 2012, 491). This growing use of stock option pay has however been limited to the compensation of the management board, even though the

German Code has also explicitly provided for performance-based compensation for supervisory board members.

This raises the question of the reasons for noncompliance, in light of the code, the presumed capital market performance pointing in the other direction, and the closely related shareholder interest in wealth maximization. Looking at the remarkable changes in corporate governance practice in Germany and its strengthened capital market orientation, it does not seem plausible any more to simply attribute this low compliance rate to cultural factors and labour opposition.[ix] Instead, there may be incentives that are directed not so much towards the outside capital market, but towards the inside negotiation process of the company. These incentives would, however, support the opposite argument, relying on potential board control and managerial power over compensation agreements and norms of reciprocity and similarity that constrain board members from scrutinizing executive compensation awards, and therefore argue for the use of stock option pay in the compensation agreements for supervisory board members (Kahan 2001, 1892).[x]

Therefore there have to be reasons even stronger than these incentives working in the opposite direction, against such use. One oft-cited argument against stock option pay is the 'outrage constraint'. This ultimately relies on reputational constraints on directors that may prevent them from awarding overly generous compensation. Especially in the aftermath of the financial crisis, stock option pay has become increasingly unpopular among the general public in Germany.

### (i) Legal framework under the German Stock Corporation Act

It seems questionable, however, whether such reputational constraints would actually entirely eliminate the above-mentioned incentives to comply, and thus whether there may not be separate reasons for the high rate of noncompliance. Looking at the regulation of executive pay in the German Stock Corporation Act, one finds further and stronger reasons for noncompliance. It is true that incentive pay is explicitly provided for, but only with regard to members of the management board, in ss 87(1) and (2) and ss 192 and 193(2)(4). As far as supervisory board members are concerned, s 113(3) of the German Stock Corporation Act simply states that the profit share is calculated according to the balance sheet profit, thus assuming the legality of variable pay for supervisory board members (Spindler 2015a, note 39). However, this does not include any type of variable pay, let alone stock options. Section 192(2)(3) of the German Stock Corporation Act does not explicitly refer to supervisory board

members as being entitled to exercise stock options. This was a formal argument that the Federal Court of Justice (Bundesgerichtshof) referred to among others in its important *Mobilcom* decision of 2004.[xi] In its main reasoning, the court points out that granting stock options to supervisory board members may lead to parallel incentives for both management board and supervisory board members, and could therefore jeopardize effective monitoring (*Mobilcom*, [126]; Habersack 2004, 725-6; Peltzer 2004, 510-1). This argument is based on fear of the inefficient risk management that might result from parallel interests of the management board and the supervisory board in running excessive risks (Von Rosen and Kramarsch 2003, 25). This incompatibility is not limited to stock-based compensation, however, but may be present in any case where pay is tied to annual profit (Hoffmann-Becking 2005, 179). Therefore the problems of stock options do not necessarily exclude variable compensation for supervisory board members, as provided for in Recommendation 5.4.6 of the German Code, if this pay takes into account different long-term incentives.

**(ii) Compliance against the background of the law until 2006**

Against this background, the low compliance rate for this recommendation does not necessarily reflect any market enforcement of the German Code, but is in line with the legal development. The *Mobilcom* decision led to a decrease in compliance in 2006. Thus a controversial and unclear legal discussion undermined more straightforward capital market-based enforcement of the Code. Instead, this discussion has left its mark on the subsequent version of the Code, as amended in 2012. The recommendation now limits itself to how to structure performance-based pay for supervisory board members, leaving it to companies whether they choose to grant such pay to begin with. Thus the German Stock Corporation Act has exerted an influence on the Code in more than one respect. First, the ambiguity of stock option grants under current corporate law is now reflected by the Code, which does not prescribe performance-based pay but rather leaves companies to choose whether to include such pay in their compensation agreements with supervisory board members. In addition, important normative assumptions of the German Stock Corporation Act can be expected to radiate into the German Code by way of interpretation, in light of Recommendation 5.4.6 para. 2 sent. 2, which prescribes that any incentive pay for supervisory board members shall be oriented towards the sustainable development of the company. This notion of sustainable development is the underlying guideline of the regulation of executive compensation in s

87(1) sent. 2 of the German Stock Corporation Act, which was amended in 2009 in the aftermath of the financial crisis (Haar 2012).

### (iii) The interaction between compliance and the law in the aftermath of the recent financial crisis

This amendment was not only motivated by concern about a 'fairness gap' between directors' pay and that of rank and file employees (Seibert 2010). In fact, the legal debate was kicked off by the question of whether short-term incentive-based compensation had actually exacerbated the financial crisis. As a result, this debate subsequently centred on how to eliminate share options which incentivised managers to undertake excessive risk in pursuit of short-lived increases in share prices, rather than sustainable growth of the company's business (Seibert 2010, 959). The key provision of the rules on executive pay in s 87(1) of the German Stock Corporation Act prescribes that 'the compensation structure has to be aimed toward a sustainable development of the company's business ... [and] therefore variable components should have a long-term basis for assessment'.

Considering the interpretative value of the rules on executive pay in s 87 for different kinds of pay components granted to members of the management board, the legislature's assessment of the priority of sustainable and long-term business success serves as an important aid in interpretation of the general interests of a corporation as the underlying principle of corporate law. It is this notion of sustainable development that carries over to the German Code. At the same time, it is important to note that sustainability was first used as a term in corporate law in the very first version of the German Corporate Governance Code in 2002, referring for example to the responsibility of the management board 'to increase the sustainable value of the enterprise'.[xii]

Looking at the overall diffusion of the notion of sustainability throughout corporate law and its use in the German Stock Corporation Act and the German Code, one has to conclude that in the case of compensation of supervisory board members, there has been a close interaction between these two regulatory systems. Given the low compliance with the recommendation on incentive pay for supervisory board members and the underlying driving force of the legal development, the law - rather than capital markets - seems to be the determinant of companies' compliance with the German Code. The sharp decline in compliance at the time of the decision of the Federal Court of Justice (ruling that stock option pay for supervisory board members violates the German Stock Corporation Act) reveals that

without this clarification, noncompliance along the lines of prevailing cultural values and labour opposition could not by itself explain such a distinct development.[xiii] Along the same lines, in 2015 only 75 per cent of DAX-listed companies and 65.2 per cent of MDAX-listed companies complied with the second sentence in paragraph 2 of Recommendation 5.4.6 on the structure of incentive pay for supervisory board members, which seems to be the least popular provision of the Code (Von Werder and Turkali 2015, 1362). Since its application requires a corporation to grant incentive pay to its supervisory board members, this compliance pattern seems to suggest the legal restrictions applying to granting incentive pay to supervisory board members are the main determining factors behind compliance with the Code.

Against this background of legal regulation, which goes hand in hand with consideration of sustainability concerns, it seems as if noncompliance with the recommendation of stock option pay for supervisory board members cannot simply be based on a meta-law norm of legal obedience (McAdams and Rasmusen 2007, 1589). In the case of corporations, compliance with the norm of legal obedience is often driven by reputational concerns, which may at the fundamental level be regarded as an equivalent to shareholder wealth maximization (Bhattacharya and Sen 2004; Brown and Dacin 1997; Fombrun and Shanley 1990). Thus one may think of the non-grant of stock option pay to supervisory board members, and hence noncompliance with the respective recommendation of the Code, as driven mainly by normative concerns, without however excluding shareholder wealth.

### (b) Low compliance with unproblematic recommendations: the recommendation on severance pay caps

It may be surprising that another recommendation of the German Code touching on executive compensation is characterized by a very different compliance pattern. Paragraph 4 of Recommendation 4.2.3 prescribes severance pay caps that 'do not exceed the value of two years' compensation (severance pay cap) and compensate no more than the remaining term of the employment contract. In case of a termination 'for a serious cause for which the Management Board member is responsible, no payments are made to the Management Board member'. The assessments of this recommendation diverge. The inclusion of severance pay caps as such is deemed appropriate and useful in the survey described above, without too many contrary opinions (Von Werder and Bartz 2012, 876).

On the other hand, there was incisive criticism against the version of theban on severance pay caps as provided for by the Code since 2007, because of the question of how to adjust it to the framework of German corporate law and the individual employment contract (Bachmann 2016, note 1020; Lutter 2009). That was why the recommendation was amended in 2012, so that subsequently an explicit distinction is made between termination for good cause and mutual termination of the contract. Until this amendment in 2012, private practice therefore relied on alternative contractual arrangements having equivalent outcomes, and from that perspective there was no obstacle to compliance. This may be the reason why the above-mentioned survey did not find too negative an assessment for caps after all. At the same time, in light of these considerations in support of the appropriateness of severance pay caps, the relatively low compliance rate, increasing from 84.6 per cent in 2010 to only 87 per cent in 2015 notwithstanding the amendment, is striking (Talaulicar 2011, 277; Von Werder and Turkali 2015, 1361).

**(i) Reverse pressure how to motivate noncompliance in declarations of compliance**

A closer look at the declarations of compliance issued before 28 February 2011 under s 161 of the German Stock Corporation Act by 78 out of 80 DAX and MDAX-listed companies (97.5 per cent) may provide some indication why companies could afford not to comply and why they did not do so.[xiv] Twenty-three of these declarations, nine of them issued by DAX-listed companies, refer to paragraph 4 of Recommendation 4.2.3, stating reasons for at least partial noncompliance. Out of those DAX-listed companies, four of them complied and included severance pay caps in their management compensation agreements. More interesting are the reasons given by the remaining six DAX-listed companies for not including caps in their executive compensation agreements. All of these declarations of compliance (Adidas AG, Fresenius AG, Metro AG, SAP AG, Henkel AG & Co KGaA) cite more or less explicitly the limited duration of the underlying contracts as a reason why it is not practical to implement this recommendation, or refer to other reasons cited in the literature as common and therefore acceptable arguments against severance pay caps (Dörrwächter and Trafkowski 2007, 848-9; Von Werder, Pissarczyk and Böhme 2013, 500). This way of implementing the comply or explain principle is at odds with its initial logic, because it turns the code of best practice into a ‘one-size-fits-all approach to noncompliance’ (Hooghiemstra and van Ees 2011, 481).

If companies prefer not to comply, by not including severance pay caps in their compensation agreements, in order to be more flexible in their choice of how to structure their incentive pay, they have to consider whether such noncompliance will be accepted by shareholders and the public (MacNeil and Li 2006; Seidl 2007). Therefore the capital market pressure to comply, initially perceived as the most important enforcement mechanism of the Code, is replaced by the pressure of how to explain noncompliance. Since companies do not know whether the relevant parties will accept their underlying motivation for noncompliance, it is reasonable that they look to similarly situated peers, thus trying to increase the legitimacy of their noncompliance (Haunschild and Miner 1997; Lieberman and Asabe 2006; Seidl 2007). As a consequence, parallelism between explanations and noncompliance can be expected among similar companies. (Brunsson 2000).

### (ii) Empirical evidence

On the empirical side, this pattern of compliance has been put to the test using data for 126 listed Dutch firms, which indeed indicates uniformity in adopting standards of good governance (Hooghiemstra and van Ees 2011). When it comes to German companies' declarations of compliance with paragraph 4 of Recommendation 4.2.3 on severance pay caps, the same phenomenon seems to hold. This is not just demonstrated by the highly visible DAX-listed companies, which issue similar explanations for noncompliance. The explanations of noncompliance from MDAX-listed companies, such as Aareal Bank AG, Puma AG, and Stada Arzneimittel AG, are characterized by diverse individual reasons given, making reference to the individual circumstances of each firm.[xv] Hence, the theory that peer pressure leads to uniform explanations for noncompliance is illustrated the other way round as well. When companies' visibility is low, they do not face as much pressure to issue generally accepted reasons for noncompliance.

This pattern of declarations among distinctive sets of firms also suggests possible reasons for additional pressure on visible companies towards uniformity. This need will become clear when they look to their peers for further justification indicating an additional pressure for them to prove the legitimacy of their noncompliance (Lieberman and Asaba 2006; Seidl 2007). Absent legal and economic motivations to comply, other sanctions come into play in driving companies' compliance with the German Code. Looking at when paragraph 4 of Recommendation 4.2.3 was enacted, in 14 June 2007, the general background of this provision becomes clear. Starting with the recent financial crisis in 2007, the German

spirit of the times – the so-called zeitgeist – has been instilled with considerable public distrust towards the corporate and financial world. Thus, in light of the lack of a convincing economic rationale, according to the above-cited survey (von Werder and Bartz 2012), the provision for severance pay caps in Recommendation 4.2.3 can be plausibly seen as reflecting an 'outrage constraint' upon executive pay without performance (Bebchuk, Fried and Walker 2002, 786-7). In addition, there have been spectacular cases of abuse of fixed-term employment contracts and their termination, resulting in the payment of enormously high amounts of severance pay to executives, causing a great public outcry. This motivation also seems to follow from the change of compliance patterns observable after a notable change to this provision in 2012, when the commission further specified that no severance pay may be paid in case of termination 'for a serious cause for which the management board member is responsible'. Subsequently this recommendation has been considered as generally accepted, and has been complied with by 92 per cent of the DAX-listed companies in 2014 (von Werder and Bartz 2014, 909). Thus the pressure to provide for severance pay caps has apparently increased, resulting from an outrage constraint upon what top executives can pay themselves without eliciting public or media pressure (Bebchuk et al. 2002, 786-7). With reputational concerns explaining companies' compliance patterns, yet another ingredient enters the interaction between compliance, the law and economics: social motivations, which open the door for the consideration of corporate stakeholders other than shareholders.

### (c) Low compliance with problematic recommendations

Social motivations and reputational concerns are also involved in another field, touched upon by a recommendation whose efficiency is rated rather low by the executives interviewed in the survey cited above (von Werder and Bartz 2012, 876). That is paragraph 2, sent. 2 of Recommendation 5.4.1 , which provides that:

> The Supervisory Board shall specify concrete objectives regarding its composition which, whilst considering the specifics of the enterprise, take into account the international activities of the enterprise, potential conflicts of interest, the number of independent Supervisory Board members within the meaning of number 5.4.2, an age limit to be specified for the members of the Supervisory Board and diversity. These concrete objectives shall, in particular, stipulate an appropriate degree of female representation. (German Code of May 15, 2012)

The part of this provision where compliance rate is strikingly low is the recommendation of an age limit for supervisory board members. In 2013, 2014 and 2015, this was complied with by a relatively low 85.2 per cent, 88 per cent, and 82.6 per cent of DAX-listed companies respectively (von Werder and Bartz 2013, 889; von Werder and Bartz 2014, 910; von Werder and Turkali 2015, 1362). In addition to the evidence from the above-mentioned survey, there is empirical evidence indicating that capital markets value deviation from this recommendation positively, taking the age of a supervisory board member as an indicator of his or her experience and knowledge (Bassen et al. 2009, 394). By contrast, the age limit recommendation is based on the assumption that performance decreases with age. This approach is also reflected by the keyword 'professionalization', which has been the name of the game for the supervisory board for quite a while now, and as such has also been called for in the 2011 Green Paper on the EU corporate governance framework (European Commission 2011, 3) and increasingly adopted across corporate governance systems (European Commission 2011, 3; Davies et al 2013, 17-28).

At the same time, an empirical study established that amongst supervisory boards of DAX-listed companies, persons aged between 51 and 70 are represented to an above average degree of 74 per cent (Board Academy 2011, 16). The number of supervisory board members aged between 41 and 50 and 31 and 40 in these companies is significantly low, at 19 per cent and 3 per cent respectively. This explains the call to recruit younger people for the supervisory board. The German Code, however, while implying decreasing performance levels with increasing age, allows the supervisory board to make decisions on specific age limits, without laying down any instructions.

Another way to take into account such concerns would be regular checks by the board of whether supervisory board members meet the necessary standards. Such checks would require, as a necessary incident, the possibility to fire board members if the requisite performance could no longer be expected. Such a practice is not in line with the high standard for the dismissal of supervisory board members under s 103 of the German Stock Corporation Act, which requires a serious cause, such as a gross breach of duty, incompetence or a permanent serious conflict of interest (Spindler 2015b, § 103 notes 33-36). At the 69th German Jurists Forum in September 2012, a proposal for regular evaluation and check of the supervisory board by third parties, as is common in board performance evaluations in the UK, was clearly rejected (69th German Jurists Forum Munich 2012, s 15). Overall, the approach of the German Code, in having corporations establish age limits for supervisory board members,

so as to ensure monitoring quality and professionalism in the daily work of the supervisory board, is not reflected in the German Stock Corporation Act, nor is it in line with the common understanding of the German legal community involved in corporate and financial law.

Thus the compliance rate of above 80 per cent, and even close to 90 per cent, of DAX-listed companies (compared with an average of 59.3 per cent to 63.9 per cent between 2013 and 2015 overall) with this age limit recommendation seems surprising. In light of the ambiguous pressure in both directions, such as the capital market pointing against an age limit on the one hand, and social values associated with youth and perceived higher performance supported by wider society on the other, there may be internal stakeholders additionally pushing in the direction of compliance.

First, the supervisory board members themselves may be interested to leave the company through a well-ordered procedure, regulated by a clear age limit, instead of making their departure dependent on an observable decline in performance. In addition to other plausible reasons for an age limit such as the prevention of ‘blindness’ to organizational deficiencies[xvi], by setting an age limit, the supervisory board vouches for the effectiveness of the insider reward system (Langevoort 2001, 808). Though it is true that insiders no longer move from the management board to the supervisory board as often as they used to, in light of the cooling off period of two years adopted by amendment of the German Stock Corporation Act in 2009,[xvii] an age limit will still enhance incentives. Along these lines, paragraph 2 of Recommendation 5.4.1 of the German Code has recently been further amended, to the effect that ‘a regular limit of length of membership [shall] be specified’. Thus the law follows the Code when it comes to strengthening the sustainable legitimacy of its recommendations.

## 4. Conclusion – The case for compliance with the Code

The key drivers of the interplay between corporate behaviour and legal evolution have become apparent in the preceding analysis in different ways, and can be summarized by way of a conclusion.

In the case of the incentive pay for supervisory board members recommended under s 5.4.6 of the German Code, the determinant of compliance was the evolution of the pertinent case law. Later on, legally binding regulation has proved to be the guideline for the Code. Ultimately, this may result in reputational concerns relating to the publicity that results from violating regulatory requirements (May 2004).

Analysis of the compliance patterns relating to severance pay caps indicated another consequence flowing from firms' attempts to avoid reputational harm, which applied especially to the highly visible DAX-listed companies. Namely, there was a striking uniformity in the explanations for noncompliance. At the bottom of this peer pressure to comply with noncompliance lies the reputation at stake in this provision, that also reflects the general public interest, giving effect to an outrage constraint.

Since the debate on age limits for supervisory board members and the professionalization of the board is very up to date and at the same time controversial, companies could establish themselves at the forefront of the current political discussion and its opinion leaders. But judging from compliance rates, this rationale does not seem to push strongly enough towards compliance as to outweigh other factors that may enter into companies' decision-making, such as the performance-enhancing experience contributed by older board members. This complex mixture of effects hints at the different economic, social and cognitive implications that may play out in favour of compliance, but not as distinctly as for reputational concerns. These alternative motivations for compliance (and thus bases for the legitimacy of the Code) may result from insider and group interests. They overlap with the publicly endorsed discourse on high performance capacity of young people and declining performance levels with older age, calling into question a purely capital market-based shareholder value model of code compliance. At times, this may arguably require a legislative nudge and designate the responsibility of the legislature and the limits of the legitimacy of the Code (Thaler and Sunstein 2008).

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[i] Council Directive 78/660/EEC, art 46a(1)(b), as amended by Directive 2006/46/EC, art 1(7).
[ii] Commission, 'The EU corporate governance framework' (Green Paper) 18-19.
[iii] Commission Recommendation 2014/208/EU.
[iv] For the gap-filling function see Basedow 2016, note 21; this standard-setting in default rules is explicitly provided for in Sect. 307 para. 2 No. 1 of the German Civil Code; for an exemplary decision confer the Bundesgerichtshof (BGH, German Federal Supreme Court), Feb. 17, 1964, BGHZ 41, 151, 154.
[v] Entwurf eines Gesetzes zur weiteren Reform des Aktien- und Bilanzrechts, 21.
[vi] For a positive influence correlation between compliance and performance see Drobetz et al. 2004, 5-25; Goncharov et al. 2006; only a weak correlation found by Bassen 2006; no correlation found in Bassen et al. 2009; positive correlation for companies with dispersed ownership in Jahn et al. 2010; Rapp and Wolff 2012; for a summary of the existing studies on the German Corporate Governance Code cf. M. Stiglbauer 2011, 61-71.
[vii] On compliance with regard to enforcement in the area of health and safety see Ko et al 2010, 48-70; for reasons why corporate environmental measures may go beyond compliance see Gunningham et al. 2004, 307-41; on the predominance of economic factors for environmental regulations in highly competitive markets see Thornton et al. 2008; for motivations for compliance with environmental as well as social regulations see May 2004; on the role of normative and social motivations for compliance with agro-environmental regulations see Winter and May 2001.

[viii] See in detail above; for a positive influence correlation between compliance and performance see W. Drobetz et al. 2004; Goncharov et al. *2006;* only a weak correlation found by Bassen 2006.
[ix] For this reasoning in 2001 see for example Kahan, who at the same time points out the increasing importance of options, 149 U.Pa. L. Rev. 1869, 1890.
[x] For the ‘managerial power-hypothesis cf. Bebchuk/Walker; Bebchuk/Fried/Walker, 69 U. Chi. L. Rev. 751 (2002); for noms of reciprocity in this context also Kahan, 149 U. Pa. L. Rev. 1869, 1892 (2001).
[xi] *Mobilcom AG* (2004) BGHZ 158, 122 at [126].
[xii] See the second sentence of s 4.1.1 of the German Stock Corporation Act as of 2002.
[xiii] In fact, the abruptness of this change in compliance indicates that there is not a norm at work that might freeze the behavior in place as has been proposed with regard to the effect of social noms as distinct from law (McAdams/Rasmusen 2007, p. 1589).
[xiv] For an overview of these explanations and a detailed analysis see Rapp and Wolff 2011, Appendix [Anlage].
[xv] For the pertinent declarations with regard to recommendation 4.2.3. para. 4 issued by Aareal Bank AG, SGL Carbon AG, Puma AG, Stada Arzneimittel AG see M. Rapp and M. Wolff 2011, Appendix [Anlage]. A similar conclusion can be drawn from the data on individual reasonings in the context of particular recommendations generated in v. Werder, Böhme and Pissarczyk 2011, p. 499.
[xvi] This is the main reason given for the recent amendment of para. 2 recommendation 5.4.1 of the Code that now provided for the limitation of duration of supervisory board membership.
[xvii] German Stock Corporation Act, s 100(2) no. 4.

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| | | |
|---|---|---|
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