

## What Is the Relation Between the Corporate Governance and The Shareholders in Germany? – A Brief Literary Overview\*

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### Abstract

Sustained corporate scandals are not in the interests of the shareholders. Corporate governance structures are supposed to reduce agency problems. The impression arises that the role of the shareholder(s) within corporate governance are too ambitious. Thus, the research question arises, what is the relation between corporate governance and its shareholder(s) in Germany. To find answer, this article follows the methodology of the formal-analytical research strategy with the simple and more or less abstract describing of problem structures (cp. Grochla, 1978, p. 85) by presenting the challenges of corporate governance and its economic scandals in the recent years and analyzes the role of the shareholder(s). This strategy is complemented by the secondary research method. The findings are that corporate governance is still supposed to reduce the agency problems and it requests national-specific setup due to legal reasons, e.g. in Germany. The activist shareholder, derived from the monistic system, is challenged by the dualistic corporate constitution of the German stock corporation with delineation of competencies of the management board, supervisory board and shareholders' meeting as well as shareholder activism tries to demonstrate impact, form or change management decisions. Furthermore, the pursuit of shareholder value is assumed to be the major driver of shareholder activism, beside the alignment of executive compensation with shareholder interests and an efficient market for corporate control that can be tied up to the shareholders' interests. Also, working corporate governance can lead to the impacts of achieving and maintaining competitive advantages and long-term growth in corporate value.

**Keywords:** Corporate Governance, Shareholder, Corporate Value, Reporting,

### Introduction

The separation of ownership and control in stock listed corporates is a key aspect, the so-called principal-agent relationship between the shareholders and the top-management, whereat shareholders, in particularly of large stock listed corporates, do not directly control strategic and operational management decisions (cp. Jensen and Meckling, 1976, p. 305ff.; Hoffmann and Fieseler, 2021, p. 3f.; Fama, 1980, p. 288ff.). Against the background of the so-called accounting scandals and corporates crises in the beginning of the last millennium, for instance Enron (cp. Badruldeen, 2020, no page; Hoje, J. et al., 2021, p. 96ff.; Liu, S. et al., 2021, p. 1ff.; Rashid, 2021, p. 62ff.), WorldCom (cp. Fairchild, 2019, p. 3ff.; Kaplan, 2021, p. 34), Parmalat, ComROAD and Tyco (cp. Hansch, 2021, p. 1f.), as well as the financial and economic crisis of the last years and its impacts on the corporates, like for instance Hypo Real Estate, Lehman Brothers (cp. Rashid, 2021, p. 62; Olbrys, J., no year, no page) and Wirecard (cp. Hansch, J., 2021, p. 1; Hoje, J. et al., 2021, p. 96ff.; Teichmann et al., 2023, no page), it is increasingly referred to the meaning of current,

relevant and reliable respectively credible information and request its stronger use for the monitoring and controlling of corporates (cp. Marten et al., 2020, p. 42). Associated with this is the requirement of an adequate corporate publication and therewith the question, how stakeholders become additionally informed respectively in another form informed because this way a better corporate monitoring shall be pursued (cp. Marten et al., 2020, p. 42).

Structures of corporate governance are supposed to reduce the agency problems by providing shareholders with continuous, transparent and effective options for influencing the management's actions (cp. Hoffmann and Fieseler, 2021, p. 4). Agency conflicts are recognized particularly critical referring to management's (inadequate) incentives to enhance the shareholder value (cp. Karpoff, 2001, p. 1ff.; Hoffmann and Fieseler, 2021, p. 4). Jensen (cp. Jensen, 2003, p. 1ff.; Hoffmann and Fieseler, 2021, p. 4) authors that the isolation of top-management from the shareholders' interests are not compatible with the efficiency striving and the shareholder value orientation. Cases of serious agency conflicts can also be regarded as a failure of established corporate governance structures, as those failed to balance the interests of management and shareholders (cp. Hoffmann and Fieseler, 2021, p. 4; Kahan and Rock, 2007, p. 1021ff.).

Following this introduction, the next section describes corporate governance and its meaning, succeeded by national requirement of a corporate governance. Subsequently, the objectives as well as the impacts are presented, followed by researching the closeness of the shareholder and corporate value to the corporate governance. The next section disclosure of information deals with the revealed information – the corporate governance reporting and highlights its significance – before the literary review is concluded.

## **Description of Corporate Governance**

The literature provides some definitions of corporate governance. One of the first definition is from Cadbury who designates corporate governance as the system that directs and controls corporates which describes the regulatory framework of corporate governance for the direction and targets of a corporate as well as its instruments for monitoring them (cp. Heinen, 2019, p. 14) and states later that corporate deals with keeping the balance between objectives of economic and social as well as between the objectives of individual and communal (Cadbury, 2000, p. 4). The definition of Shleifer and Vishny describes corporate governance as approaches, whereat finance providers secure themselves their own return on investment, which represent a financial focus (cp. Hansch, 2021, p. 3; Heinen, 2019, p. 14). Tirole (cp. Tirole, 2001, p. 4; Heinen, 2019, p. 14) authors that corporate governance is characterized as the institutions form which brings or coerce the management to internalize the stakeholders' weal as the traditional shareholder value approach is too narrow to define corporate governance.

According to the Organisation for Economic Co-operation and Development (OECD) a corporate with effective corporate governance should provide the management organs the right incentives so they act in the shareholders' interests, plus they should have effective control mechanism and use the corporate's resources efficiently as well (cp. Heinen, 2019, p. 14). End of the 20th century the aforementioned upcoming corporate scandals contributed to a stronger meaning of corporate governance in the practice and the OECD developed internationally applicable guidelines for good corporate governance, the OECD Principles of Corporate Governance in 1999, which were updated in 2015 (cp. OECD, 2015, p. 3; Heinen, 2019, p. 15; Welge and Eulerich, 2021, p. 137f.).<sup>1</sup> The revised principles of corporate governance from 2015 are introduced in six chapters which are "I) Ensuring the basis for an effective corporate governance framework; II) The rights and equitable treatment of shareholders and key ownership functions; III) Institutional investors, stock markets, and other intermediaries; IV) The role of stakeholders; V) Disclosure and transparency; and VI) The responsibilities of the board." (OECD, 2015, p. 11).

The next section emphasizes the need of a country-specific corporate governance as well as when and how the development started in Germany.

## **National Requirement of a Corporate Governance**

The framework conditions for an effective corporate governance are defined, among other issues, in form of legal and regulatory principles by the specific national legislations (cp. Brunner-Kirchmair, 2019, p. 68). A country-specific consideration of corporate governance systems is nevertheless unavoidable because of national differences (cp. Heinen, 2019, p. 15), legal form (cp. Hopt and Leyens, 2019, p. 939ff.; Hansch, 2021, p. 3) as well as for local political reasons to gain the trust of international investors (cp. Mondello, 2022, p. 48). In recent years, many countries have developed corporate governance codes which summarize the country-specific legal and regulatory frameworks (cp. Brunner-Kirchmair, 2019, p. 68).<sup>2</sup> The principles do not target on specified regulations for national legislation and the principles are not binding, however, the principles try to identify goals and propose different ways to reach them (cp. OECD, 2015, p. 11). Rules can consist of statutory regulations, comply or explain regulations or recommendations

(cp. OECD, 2015, p. 13; Brunner-Kirchmair, 2019, p. 68). From an international, cross-national perspective, the OECD's principles of corporate governance should be mentioned, too, as this framework addresses political decision-makers and is intended to support them in establishing national legal and regulatory foundations (cp. Brunner-Kirchmair, 2019, p. 69). In parallel, there are also the corporate governance principles drawn up by the non-profit organization International Corporate Governance Network which are intended to support corporate (on a voluntary / advisory basis) (cp. Brunner-Kirchmair, 2019, p. 69).

In 2002 the first German Corporate Governance Code by the Government Commission on German Corporate Governance was published with one objective, among others, to depict the German corporate governance situation (cp. Heinen, 2019, p. 15).<sup>3</sup> The German code was anchored in law (especially in the German Commercial Code and the Stock Corporation Act) by the Transparency and Disclosure Act on January 1st 2003 (cp. Welge and Eulerich, 2021, p. 162). The German code is only directed at stock listed corporates and corporates with access to the capital market with context of Section 161 (1) of the German Stock Corporation Act and that this code only refers to German corporates can be taken from the less transparent goal of the code in the preamble, Paragraph 3, Sentences 2 and 3, which leads to an unequal treatment of foreign corporates stock listed in Germany under capital market law (cp. Hopt and Leyens, 2019, p. 939).

In Germany it is based on a comply or explain principle so that corporates have to justify any deviation from the guidelines recommended therein (cp. Welge and Eulerich, 2021, p. 163; Hansch, 2021, p. 169), and this obligation to comment on the German Corporate Governance Code was established by law under Section 161 of the German Stock Corporation Act (cp.

Freidank 2019, p. 168) as a result of the Transparency and Disclosure Act that came in to force in July 2002 (cp. Heinen, 2019, p. 15). For instance, the code recommends that the financial reporting of German corporates be based on the international true and fair view principle which is against the background that in complement to the principles of proper accounting, investors (and especially those from the Anglo-Saxon area) have been familiar with this principle for years (cp. Welge and Eulerich, 2021, p. 162).

After the introduction of the legal requirements, this article continues to present the objectives and the effects of a corporate governance.

## **What Does Corporate Governance Carry Out?**

The objectives of corporate governance contain the prevention of the investing public interest, preserve the trust in the corporate and improve the worldwide image as a reliable financial center, facilitate accountability and transparency, offer flexibility by the enforcement of rights and duties of diverse corporate, enable the directors' board and their members but also recognize the need for the directors' independence at the same time as well as orientation of the remuneration in compliance with the long-run interest and transparency and the increasing significance of the board referring to the management of risk (cp. Younis, 2021, p. 68). Furthermore, the goal of corporate governance is to support by developing an environment of confidence, transparency and accountability needed in order to promote long-run investment, stability in finance as well as integrity of business, therewith boosting stout growth plus more including societies (cp. OECD, 2015, p. 7).<sup>4</sup> Good corporate governance pays off for the corporate and its shareholders (cp. Mondello, 2022, p. 49), assures success of business growth, reducing of mismanagement, corruption, wastages and risk control, efficiency of processes due to procedures are leaned out and congruent, apparentness for failures and sunk costs, so strong corporate governance receive their investor's trust and consequently, the corporate can raise capital effectively and efficiently (cp. Younis, 2021, p. 67).

For the understanding of the relation between the corporate governance and the shareholder(s), the next sub-sections research first for the shareholder within the corporate governance, second for the meaning of the shareholder activism and third, elected studies underline the corporate governance's contribution to the corporate value.

## **Closeness of the Shareholder and Corporate Value to the Corporate Governance**

### ***Shareholders Within the Corporate Governance***

In response to a lack of the management monitoring disclosed in the aftermath of the financial crisis, the European lawmakers intend to involve shareholders more closely in the corporate governance as part of the shareholder rights directive (cp. Hauber, 2020, p. 33). Thereby it is pursued the guiding principle that the effective and sustainable shareholders' involvement is both the cornerstone of a corporate governance system of control and balance between the bodies and stakeholders of stock listed corporates and also an instrument for improving the corporate's performance (cp. Hauber, 2020, p. 33f.). The idea of strengthening the shareholder as a pillar of corporate governance was adopted by the European Union from the British Stewardship Code (cp. Freitag, 2014, p. 649; Hauber, 2020, p.

34; Wilsing, 2012, p. 293ff.). However, the role of an activist shareholder who cooperates with and at the same time controls the management, is derived from the monistic system of corporate governance (cp. Hauber, 2020, p. 34; Wilsing, 2012, p. 292). In the dualistic corporate constitution of the German stock corporation, on the other hand, the competencies of the management board, supervisory board and shareholders' meeting are clearly delineated (cp. Hauber, 2020, p. 34; Wilsing, 2012, p. 292ff.). An activist shareholder threatens of colliding with, among others, the management power of the management board under Section 76 I of German Stock Corporation Act, the supervisory function of the supervisory board under Section 111 I of Stock Corporation Act and the principle of equal treatment of shareholders under Section 53a of Stock Corporation Act (cp.

Bundesamt für Justiz, 2023, p. 1; Bundesamt für Justiz, 2023a, p. 1f.; Bundesamt für Justiz, 2023b, p. 1; Dejure, 2023, p. 1; Dejure, 2023a, p. 1ff.; Dejure, 2023b, p. 1f.; Hauber, 2020, p. 34). Against this background of development, it is to expect that the pressure on institutional investors to exercise voting rights from the shares held in trust by them will further increase continuously (cp. Hauber, 2020, p. 34).

The next sub-section describes the shareholder activism and the potential mechanisms by which management decisions can be tied up to the interests of the shareholders.

### ***Meaning of Shareholder Activism***

Shareholder activism, is the attempt by shareholders to influence, to form or change management decisions, can take place within the framework of an established corporate governance structure like for instance through interventions at the annual general meeting, but also beyond this like for instance by threatening or exerting pressure in public communications (cp. Hoffmann and Fieseler, 2021, p. 3). Briggs (cp. Briggs, 2007, p. 681ff.; Hoffmann and Fieseler, 2021, p. 3) authors that shareholder activism introduces a so-called balance-of-power politics into a corporate's corporate governance that is in the context of an activist intervention, a power struggle breaks out between different actors, especially between the board and the shareholders. In the finance-literature the pursuit of shareholder value is assumed to be the main driver of shareholder activism (cp. Becht, 2008, p. 3093ff.; Brav et al., 2008, p. 1729ff.; Del Guercio and Hawkins, 1999, p. 293ff.; Hoffmann and Fieseler, 2021, p. 4; Karpoff et al., 1996, p. 365ff.). From this point of view, shareholder activism is one of three possible mechanisms by which management decisions can be tied up to the shareholders' interests. The other two mechanisms are the alignment of executive compensation with shareholder interests and an efficient market for corporate control (cp. Hoffmann and Fieseler, 2021, p. 4).

Close to the shareholder (value) is the corporate value. The impact of the corporate governance on the corporate value is pointed out with two empirical studies in the following sub-section.

### ***The Contribution of the Corporate Governance to Corporate Value from Elected Studies***

Empirical studies demonstrate that effective corporate governance has a positive effect on corporate evaluation (cp. Heinen, 2019, p. 15). For instance, Drobetz, Schillhofer and Zimmermann (cp. Drobetz et al., 2004, p. 291; Heinen, 2019, p. 15) apply a corporate governance rating for German corporates to verify a strong positive correlation between the hallmark of corporate-level corporate governance and corporate value. International studies have come to the same result, for instance Gompers, Ishii und Metrick indicate in their study that in the 1990s corporate governance of a corporate was strongly correlated with the stock return and corporate value (cp. Gompers et al., 2001, p. 1ff.; Gompers et al., 2003, p. 107ff.; Heinen, 2019, p. 15). This was demonstrated by the establishment of a governance-index, which depicts the individual influence of shareholders and was applied to 1,500 large corporates, so a corporate in which shareholders have comparatively more rights, among others, has a higher corporate value, higher profits and lower capital expenditures (cp. Gompers, 2001, p. 1ff.; Gompers, 2003, p. 107ff.; Heinen, 2019, p. 15). A corporate in which shareholders hold, among others, more rights compared to other corporates, result in a higher corporate value, higher earnings and less investments (cp. Gompers, 2001, p. 1ff.; Gompers, 2003, p. 107ff.; Heinen, 2019, p. 15).

The subsequent section presents the disclosed information – the reporting which provides insights of the business management and the effects of such a reporting.

### **Disclosure of Information**

The requirements for a good corporate governance have grown considerably, that is why the kind of corporate's management communication with investors, issuers, institutions like stock exchanges and national banks, rating

agencies and auditors, financial analysts, research institutes, financial intermediaries like banks, journalists and information service

(cp. Repke, 2007, p. 4) becomes increasingly significant (cp. Laier, 2011, p. 149). Due to the enormous market transparency and the associated global investment opportunities for investors, corporates are forced to convince the capital market of their management capabilities (cp. Laier, 2011, p. 149). Stock listed corporates should therefore establish a targeted communication beside the value-oriented steering in order to support the price calculation on the capital market (cp. Günther and Beyer, 2001, p. 1623; Laier, 2011, p. 149). Credible reporting is a decisive way to gain terrain when it concerns building, maintaining and enhancing confidence and reputation (cp. Laier, 2011, p. 149). A significant topic of the reporting is corporate governance - many corporates explicitly covenant themselves to openness, transparency, credibility as well as trust, which are the major pillars of a sustainable corporate model (cp. Volkart and Lamprecht, 2003, p. 139). The simplification of corporate governance reporting is expressed by the elimination of the coexistence of the corporate governance report (cp. Welge and Eulerich, 2021, p. 157) and the corporate governance statement in the management report (cp. Hopt and Leyens, 2019, p. 990f.; Welge and Eulerich, 2021, p. 157). According to the principle 22, the corporate governance statement serves as a central reporting element which is accompanied by the removal of the sample table on the executive board compensation and is due to the amendment of the German Stock Corporation Act by the aforementioned shareholder rights directive, as Section 162 of German Stock Corporation Act requests a meaningful compensation report (cp. Welge and Eulerich, 2021, p. 157). The key formal objective of the current revision also included the streamlining of the entire code as well as the transparency and traceability of the standards (cp. Hopt and Leyens, 2019, p. 938; Welge and Eulerich, 2021, p. 157).

In addition to the general presentation of the committee structure, amendments to the specific composition should be addressed, too, as this information enables an assessment of the corporate's management as well as in supplement, the reasons for the amendments should be explained (cp. Zülch and Gebhardt, 2021, p. 15). In parallel to the basic compensation, the variable compensation and its influencing factors as well as the pension expenses should also be considered here (cp. Zülch and Gebhardt, 2021, p. 15). The linking of the corporate steering with the compensation of the management board and the supervisory board provides the report reader an idea of how the management identifies themselves with the corporate and with the help of strategy indicators as performance-related compensation components, an incentive can be created in case of doubt to implement the declared corporate strategy (cp. Zülch and Gebhardt, 2021, p. 15).

Reporting shows corporate's governance effectiveness as it offers transparency of information for shareholders and stakeholders (cp. Krismiaji and Surifah, 2020, p. 192). High-quality publication is linked with a strong corporate governance as well as in general the extent of publication raises when corporates implement the International Financial Reporting Standards and corporates with high-quality corporate governance further reinforce the financial information publication quality (cp. Krismiaji and Surifah, 2020, p. 192f.). In 1999, Whitehead and Millstein state in their report and recommendations that publication and transparency have turned into the first trademark of good governance which is looked to by the investors (cp. Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 1999, p. 1071; Eccles et al., 2001, p. 242).

The last section concludes the literary results.

## **Conclusion**

The accounting scandals of various corporates in the recent years have brought up the topic of corporate governance in the foreground. The need for disclosure of corporate information including additionally further information is unbroken, whereby it should supposed to monitor a decrease of agency problems. Serious agency conflicts can be recognize as a failure of established structures of corporate governance because those missed to balance the interests of management and shareholders. A corporate with effective corporate governance should offer the management organs the right incentives so they operate in the shareholders' interests as well as they should have effective control mechanism and apply the corporate's resources efficiently, too. In 2015, the OECD updated its recommended principals for a good governance as lessons learned from the increased cross-border ownership, the global financial crisis, the amendment of the way which stock markets work and the aftereffect of an extended and more complex investment sequence from the saving of household to the investments of a corporate.

The framework conditions for an adequate corporate governance are specified among others in form of legal as well as regulatory principles by the particular national legislations. A country-specific consideration of the systems of corporate governance are necessary due to national variances, legal forms and local political reasons to obtain the trust of international investors. The principles of the OECD for a corporate governance provide a framework which addresses to political decision-makers and is intended to support them in establishing national legal and regulatory foundations. One target of the German corporate governance example, anchored in law by the Transparency and Disclosure Act, is to represent the actual situation of corporate governance at stock listed corporates. The German code is only directed at stock listed corporates and corporates with access to the capital market with context of the

German Stock Corporate Act and that this code only refers to German corporates can be taken from the less transparent goal of the code in the preamble, which leads to an unequal treatment of foreign corporates stock listed in Germany under capital market law. In Germany the corporates follow the principle of comply or explain so that corporates have to justify any deviation from the guidelines recommended therein.

Good corporate governance pays off for the corporate and its shareholders, assures success of business growth, reducing of mismanagement, corruption, wastages and risk control, efficiency of processes due to procedures are leaned out and congruent, apparentness for failures and sunk costs, so strong corporate governance receive their investor's trust and consequently, the corporate can raise capital effectively and efficiently. The involvement of shareholders more closely in the corporate governance has come to the point that the role of an activist shareholder, who cooperates with and at the same time controls the management, is derived from the monistic system of corporate governance, however, in the dualistic corporate constitution of the German stock corporation, on the other hand, the competencies of the management board, supervisory board and shareholders' meeting are clearly delineated. This leads to expected pressure on institutional investors to exercise voting rights from the shares held in trust by them will further increase continuously.

Under shareholder activism is to understand the try to impact, form or amend management decisions, that is within the framework of an established corporate governance structure, e.g. interventions at annual general meeting, threatening or exerting pressure in public communications. Shareholder activism is a so-called balance-of-power politics into a corporate's corporate governance which is in the context of an activist intervention, where a power struggle breaks out between various actors, particularly between the board and the shareholders. Three potential mechanisms by which management decisions can be tied up to the shareholders' interests are shareholder activism, alignment of executive compensation with shareholder interests and an efficient market for corporate control. Two elected empirical studies have demonstrated that effective corporate governance has a positive effect on corporate evaluation that underlines the contribution of corporate governance to the corporate value.

In the course of the requested, increased transparency and global investment opportunities for investors, corporates are recommended to structure a targeted communication beside the value-oriented steering in order to support the price calculation on the capital market. The effectiveness of a corporate's governance is to find in its activities and hence, reporting, in which it seems to remain that disclosure and transparency are the top trademark of good governance which is looked to by investors. Furthermore, this way corporate governance can also contribute to achieve and maintain competitive advantages.

<sup>1</sup> Reasons why for the update were the lessons learned from the raised cross-border ownership, the global financial crisis, the amendment of the way which stock markets work and the aftereffect of an extended and more complex investment sequence from the saving of household to the investments of a corporate (cp. OECD, 2015, p. 7).

<sup>2</sup> The establishment of a code in a country was often driven by crises, scandals or corporate collapses which increased the motivation to promote transparency and accountability and strengthen confidence in the capital markets (cp. Brunner-Kirchmair, 2019, p. 68, footnote 474).

<sup>3</sup> An overview about existing corporate governance codes worldwide can be found on the homepage of the European Corporate Governance Institute, a Brussels-based non-profit organization (cp. Brunner-Kirchmair, 2019, p. 69, footnote 486).

<sup>4</sup> The study by Wimelda and Chandra further elaborate the corporate governance with its mechanism which can be divided into internal and external mechanism of corporate governance (cp. Wimelda and Chandra, 2018, p. 46ff.; Younis, 2021, p. 70ff.; Welge and Eulerich, 2021, p. 74ff.). This article will not further discuss the mechanism of corporate governance.

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