The Dualism of One-Tier and Two-Tier Board Systems in Europe

Dr. Carsten Jungmann
LL.M. (Yale), M.Sc. in Finance (Leicester)
Bucerius Law School in Hamburg

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(For references refer to the published article.)
A. Introduction

It is a well-known phenomenon that there are two main sets of legal rules on the supervision of corporate management: one-tier boards and two-tier boards. In the one-tier system the control of managing directors of companies lies in the hand of a separate supervisory board, in the two-tier system it is an additional task of the board itself.

Within Europe, the United Kingdom is a prominent country with a single board system, consisting of executive and non-executive directors; other countries such as Ireland take the same approach. On the other hand, Germany traditionally employs the dualism of a management board and a separate supervisory board. This system is also found in the Netherlands, Austria, Finland and Denmark. While some countries such as Sweden have legal frameworks that cannot be classified as one-tier or two-tier systems, other countries, such as Belgium, Portugal and Spain, allow corporations to choose between the two systems. The same once held true for France, but France has since introduced a third option through which more than one organ can be entrusted with executive supervision. The European legislator also took the approach of creating a mixed system when it created the European Company, the Societas Europaea (SE). According to Article 38 of the Council Regulation (EC) No. 2157/2001 of October 8, 2001 on the Statute for a European company (SE), a SE shall be comprised of "either a supervisory organ and a management organ (two-tier system) or an administrative organ (one-tier system)".

There are strengths and weaknesses of the monistic as well as of the dualistic systems with regard to nearly all aspects of the organisation of a company’s affairs. As Germany and the UK are paradigms of the monistic and the dualistic system, respectively, we will focus on these two countries in the following.

In this course, you will be introduced to the main features of the monistic and the dualistic system. We will then highlight the advantages and disadvantages of each of the systems and will finally try to make recommendations for the improvement of the level of adequate corporate governance in both systems.

B. Forms of supervision of corporate management in the UK and in Germany

For a sound comparison of the two systems, it is important to analyse who exactly is entrusted and empowered with control in both jurisdictions.

I. The German system of corporate control (two-tier model)

According to the German Stock Corporation Act of 1965, it is mandatory for all German stock corporations (Aktiengesellschaften) to have two boards: the management board (Vorstand) and the supervisory board (Aufsichtsrat). The supervisory board members are either shareholder representatives or labour representatives. Simultaneous membership of the management board and the supervisory board is not permitted.

The main tasks of the supervisory board are to appoint and dismiss the members of the management board and to monitor them. The supervisory board also represents the corporation in all affairs concerning the management board, especially by initiating court actions against the board members. In addition, the supervisory board must approve the
annual accounts and can intervene in cases where the company’s interests are seriously affected. For certain extensive and fundamental decisions, the by-laws must impose that authorisation by the supervisory board is required. Finally, the supervisory board also has some "soft functions", such as networking with stakeholders. Notwithstanding these numerous tasks, supervision remains the core function of the supervisory board, whereas all management issues are in principle reserved for the management board, which acts autonomously and is not bound by orders of the shareholders or the supervisory board. As mentioned above, the members of the management board are appointed and can be removed by the supervisory board. The management board does not only manage the company’s affairs, but also sets up long term goals and guidelines. At least in principle, there is a clear separation between the tasks and responsibilities of the two boards. However, case law in the last few years has shown that the monitoring task of the supervisory board has become more and more permanent and future-oriented, as the intended business policy has also to be controlled by the supervisory board. Sec. 5.1.1 of the German Corporate Governance Code expressly clarifies that it is the task of the supervisory board to "advise regularly and supervise the management board in the management of the enterprise" and that it must be "involved in decisions of fundamental importance to the enterprise". Thus, the members of the supervisory board act, to a certain extent, as consultants of the management board which necessitates an ongoing and continuous discussion.

There are, in addition, shareholder control mechanisms, which are often referred to as "voice" and "exit". In small family companies and companies with only a small number of shareholders, the shareholder influence is significant, both practically and theoretically: few shareholders are able to coordinate their activities and act efficiently; in particular, few shareholders can effectively make use of their rights in the general meeting, which the German Stock Corporation Act of 1965 regards as the highest corporate organ. By contrast, in listed and publicly traded companies, which hold the spotlight in the corporate governance debate, investors have only a tiny proportion of the shares and are not in a position to effectively exercise control in the general meeting. Furthermore, monitoring costs exceed the benefit of being able to exert influence and non-monitoring shareholders would gain the same advantages (free-rider problem). Thus, the incentives for shareholders to exercise control are low.

Notwithstanding these general reflections on the role of shareholders in large corporations, we need to make two remarks concerning distinct particularities of the German stock market. The first concerns the ownership structure of large companies. At least traditionally, institutional investors and especially banks have held large proportions of shares in Germany. This was regarded as a major advantage for effective corporate control. However, in Germany as well as in the UK, there is a now general tendency towards a less dispersed ownership. Thus, the first phenomenon observed is becoming less important; at least, it is no longer a German particularity. Secondly, the threat of (hostile) takeovers helps to discipline the management in other jurisdictions, but we have to recognise a lack of hostile public takeover bids in Germany.

Consequently, in Germany, the members of the supervisory board are the predominant monitors of the corporate management. This also holds true in the light of the remaining shareholder control mechanisms, since the means by which the shareholders can
exercise control are different from those that the main bodies for corporate control can use.

II. The British system of corporate control (one-tier model)

In the UK, only one single board exists. All board members, i.e. executive directors as well as non-executive directors, are normally elected by the shareholders. The shareholders also have the power to remove the directors from office (Sec. 168 Companies Act 2008). However, this remedy would be the last resort and is only used in cases of serious misconduct or extreme under-performance. Usually, the board takes decisions to reorganise the management, and the shareholders, as well as the creditors, have only a limited capacity to exercise pressure on the board members and thereby indirectly affect the board composition. An increasing pressure to reorganise the board is a reaction to the financial situation of the company, and demand to remove directors only arises with regard to those who are managing the company’s affairs – the board.

According to legal provisions, it is "the board" that manages the company. Nowadays, however, virtually all boards consist of not only executive directors but also non-executive directors: according to the Combined Code on Corporate Governance (as amended in 2008), it is best practice that half of the board of larger companies should be comprised of non-executive directors. Therefore, the question arises as to how the role of an executive director differs from the role of a non-executive director. Non-executive directors are not employees of the company but rather members of the board and are, accordingly, concerned with managerial problems. It is indeed one of their functions to judge on strategy, key appointments and standards of conduct. The Combined Code meanwhile expressly states in the supporting principles to its Sec. A.1 that non-executive directors "should constructively challenge and help develop proposals on strategy". However, it has become apparent in the corporate governance debate during the last years that there is a tendency towards control becoming their most important task. It was only a logical consequence of this development that not only the Cadbury Code but also the Combined Code refers to this role of non-executive directors. Sec. A.1 of the Combined Code assigns them, as becomes apparent in the supporting principles of this section, with the duty to "scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance". The first studies subsequent to the adoption of the Cadbury Code revealed that the disciplinary function of the board increases if the monitoring role of non-executive directors is strengthened.

It is also apparent that even if managerial power is vested in the board, e.g. by the articles of association, the day-to-day business of the company is managed by individuals, not by the board as a whole, which meets once a month or even less frequently. Thus, most of the tasks required to run the business are executed by senior managers. They do not necessarily need to be board members, but in practice, this is often the case among the most senior members. It is, in any case, not the function of the non-executive directors to get involved in the day-to-day management of the company. In this respect, it is possible to differentiate non-executive directors from executive directors. Nonetheless, in contrast to the two-tier board system, there is no black or white distinction between the functions, neither between the separate organs nor within an organ of the company itself.
III. Groups of persons entrusted with monitoring tasks

This final aspect will be significant to the discussion of the advantages and disadvantages of the British one-tier system. Since the management of the daily business affairs of the company does not fall within the responsibilities of the non-executive directors, it is the role of executive directors in the UK. This distinction is mirrored in Germany with the role of the members of the management board being identical to that of the executive directors, whilst the members of the supervisory board are the counterparts of the non-executive directors.

C. Strengths and weaknesses of the concurring board models

Strengths and weaknesses of a system must always be seen in the context of both business and legal environments. Legal systems develop in accordance with their historical, societal and even cultural roots. This view is not limited to models of corporate governance but is also true with regard to, e.g., accounting standards, taxation principles, etc. In order to reach an enhanced level of corporate control, it is worthwhile to examine the advantages and disadvantages of the two systems. Consequently, a comparison will allow an analysis of the possibilities to improve each system individually as a means of corporate control, by adopting new measures and by systematically eliminating structural weaknesses.

I. Advantages and disadvantages of the two-tier model

This discussion of the advantages and disadvantages of the dualistic system with two separate boards refers to the present state of legal rules applicable to corporate control. The key advantage of the two-tier system, however, needs to be seen in the context of its historic origins.

1. Separation of control and management as its key advantage

Historically, the core idea behind the two-tier model was to strictly separate the controlling institution from the managing institution. When implementing the laws governing the stock corporation in Germany in the late 19th century, it was the legislator’s intention to protect both shareholders and the public interest. This strict separation of control and managerial tasks was regarded as one of the major advantages of the two-tier system, and this argument has also been highlighted in the British discussions on the reform of company law. While this statement still appears to be true in general, one has to observe the impact that case law had in the last ten years on the functions of the supervisory board. As mentioned above, at present, control is not purely backward-oriented but requires an open discussion between the supervisory board and management board and also their close and trustful cooperation. Notwithstanding this development, at least theoretically, conflicts of interests between the members of the two boards should not arise: members of the supervisory board are elected by the shareholders in the general meeting. Accordingly, supervisory board members increase the likelihood of getting re-elected by fulfilling their most important task, i.e. to monitor the management board adequately and thoroughly. At the same time, the members of the management board are elected by the supervisory board and will remain in office only if the company performs well.
In practice, however, the members of the supervisory board are chosen by the management board and are only formally elected at the general meeting. It is unusual for persons to become members of the supervisory board who have not been pre-selected by the management board. This has two consequences: only persons that are "adequate" in the opinion of the management board become elected as members of the supervisory board, and only those who "adequately" control in the eyes of the management board remain in office. In both cases, the definition of "adequacy" by the management board does not necessarily correspond with the shareholders' definition of "adequacy". Consequently, the members of the supervisory board are not completely independent when they exercise control. This becomes strikingly evident in the cases in which members of the management board (often the chairman) switch to the supervisory board (and often become chairman of this organ) after retirement, which was, and sometimes still is, usual in practice.

While the separation of management and control – the key advantage of the two-tier system – somewhat dilutes the independence of the members of the supervisory board, this separation remains a strength with respect to the management board. Each member of the management board has the same task, namely to run the business in a way that allows further development and financial prosperity. In order to perform this task, every information is shared among all board members and is not to the exclusive knowledge of some board members. Accordingly, the decision-making process within the management board is swift and efficient.

2. Structural weaknesses versus problems arising from co-determination

There are also a number of disadvantages to the two-tier system. With regard to Germany, a thorough review must distinguish between those weaknesses derived from the mere fact of having two separate organs of the company (structural weaknesses) and those owed to a German particularity, namely its co-determination statutes. The latter strongly influences the composition of the supervisory board: the circle of eligible persons, the responsibilities and the primary interests of its members, possible expert knowledge requirements, etc. clearly depend upon the co-determination laws. The distinction between structural weaknesses and problems arising from co-determination is not only necessary for a sound analysis of the strengths and weaknesses of the two-tier model, but it also helps to objectively evaluate on the value of the two-tier model and also its potential in countries that are not governed by co-determination laws. For example, even European Companies (SE) based in the UK might opt for the two-tier system. For these companies, only the arguments regarding the structural weaknesses of the two-tier system will be relevant. Finally, the above-mentioned distinction is important for the discussion of potential improvements to the one-tier system which could adopt single features of the two-tier system.

a) Structural weaknesses

The key advantage of the two-tier system, i.e. the independence of the members of the supervisory board due to the separation of the control and management, is at the same time the reason for a number of structural weaknesses. At least traditionally, the members of the supervisory board, by definition, do not make strategic management decisions of their own, and – with the exception that decisions of the management board
need the approval of the supervisory board – they are not involved in the decision-making process at all. They are not informed at the outset, nor are they asked for their opinion or advice. Instead, their role is limited to evaluating measures already taken by the management board. Consequently, the way in which the supervisory board exercises its control is always reactive and never active. This necessarily leads to a decrease of the quality of control: at the outset, there are normally a number of possible solutions to a strategic management problem. In a two-tier system, the supervisory board is restricted to commenting on the chosen solution in hindsight. It might criticise the choice and even go so far as to remove management. However, this does not enhance the current status of the company, but rather only reduces the possibility that the same mistake will be made again. If, on the contrary, the supervisory board had had the opportunity to exert influence on the decision \textit{ex ante}, a better solution may have been found.

The amendments to the German company law provisions by the Control and Transparency in the Corporate Sector Act of 1998 and by the Transparency and Publicity Act of 2002 were a step in the right direction. Since then, it has become an additional task of the management board to inform the supervisory board on intended business policy and corporate planning. As the words "intended" and "planning" indicate, the supervisory board should increase its involvement in strategic decisions. German courts have highlighted this additional tasks and have, as mentioned above, thus initiated the process of transforming the supervisory board from a pure review body to a consultant of the management.

The need for information is another weak point in the two-tier system of control. This stems from the supervisory board’s non-involvement in the decision-making process and the fact that its members are not present at the meetings of the management board. In order to be able to judge on the performance of the management board, the supervisory board needs adequate disclosure of information. However, there is a strong information asymmetry between the two boards, since all information concerning questions of strategy, future projects, business opportunities, budgetary questions, etc. lies in the hands of the management board. The members of the management board are in direct contact with employees and junior management. They obtain all information unaltered and unfiltered. By contrast, the members of the supervisory board receive all their information from the management board. They are not permitted to collect information on their own, and employees are not obligated to report to the supervisory board directly. Thus, the access of the members of the supervisory board to sensitive information is limited.

Theoretically, the situation described above should not contribute to information asymmetry since, according to Sec. 90 of the German Stock Corporation Act of 1965, the management board must regularly report to the supervisory board. This provision was changed by the Control and Transparency in the Corporate Sector Act of 1998, which led to an improvement in the flow of information: disclosure must be comprehensive and punctual, and the reports must contain all information needed to evaluate the work of the management board, meaning that they must include information concerning future projects and strategy. In addition, the management board must not withhold information from members of the supervisory board which is deemed to be delicate.
In reality, however, we must note that the supervisory board would not be able to perform its tasks if the relevant files were not prepared, the information was not processed and the data was not conceptualised prior to the meetings of the supervisory board. This becomes evident if we consider the average working hours of the supervisory board: prior to 1998, it was common for the supervisory board to meet only 3.8 times a year on average; each meeting lasted less than four hours, namely 3.74 hours on average\(^1\). This amounted to a total working time of 14 hours and 13 minutes per year. Since the amendment of the statutory provisions in 1998, it has become mandatory for the supervisory board to meet at least two times in each half of the year. This sets a minimum standard, but cannot be regarded as a major increase in the frequency of meetings. Hence, it is still impossible to reach decisions in such a short time if the members of the supervisory board are not provided with the data that is already processed. Consequently, the members of the supervisory board rely on reports which contain all information concerning the company and the management’s strategy. As these reports are prepared on behalf of the management board, the information is necessarily filtered. The aspects that appear to be important in the eyes of the management board are stressed, while others are de-emphasised or even left out. This has the following consequence: the management board members make decisions based on information which they themselves regard as important. However, a thorough control requires full transparency in order for one to be able to properly evaluate the quality of the management’s decision-making process. In a two-tier system, with its typical flow of information, there is a danger that the supervisory board cannot discover deficiencies due to a lack of information. In evaluating the decisions of the management board, the supervisory board might, consequently, make the same mistake as the management board made. This is not a question of bad faith or that a management board was not willing to provide relevant information. It is rather due to the fact that the management transfers only the information that it relied upon itself.

Furthermore, a meeting frequency of about four times a year confines the supervisory board to its traditional but weak position, in which it exercises mere \textit{ex post} control. More continual monitoring and more frequent meetings are needed in order to adequately process the high amount of data.

\textbf{b) Problems arising from co-determination}

In addition to the structural deficiencies of the two-tier system, there are problems originating solely from the German laws of co-determination. As mentioned above, up to 50\% of the members of the supervisory board are labour representatives. According to the Co-Determination Act of 1976, as amended, one-half of the supervisory board must, in companies with 2,000 or more employees, be composed of labour representatives.

In the supervisory board, the labour representatives and the shareholder representatives have equal rights and duties with the exception that the vote of the chairman, who is never a labour representative, counts twice (casting vote) in the event of a deadlock in the supervisory board. Before turning to the disadvantages of labour co-determination with regard to corporate governance and the ability of the supervisory board to control

\footnote{Klaus J Hopt, ‘The German Two-Tier Board (Aufsichtsrat): A German View on Corporate Governance’ in Klaus J Hopt and Eddy Wymeersch (eds), \textit{Comparative Corporate Governance: Essays and Materials} (Walter de Gruyter, Berlin 1997) 9.}
management, it is worth glancing at the historical roots and the benefits of co-determination. The first laws governing co-determination were reactions to the economically and socially difficult times after the wars in the first half of the twentieth century and reflected on the significant role of the coal and steel industry in Germany at that time. As today's working environment is much more developed and governed by other laws, co-determination does not appear to be as crucial now as it was sixty or eighty years ago. It still has its merits, however, especially as an early warning system for social conflicts, thereby reducing the probability of strikes. Furthermore, management accommodated co-determination, which is capable of shielding companies from hostile takeovers, somewhat gratefully. One must keep all these aspects in mind when evaluating the German two-tier system and when subsequently mentioning the disadvantages of co-determination with respect to corporate governance.

The first of the weaknesses is related to the information asymmetry mentioned above. It is apparent that the shareholder representatives on the supervisory board are reluctant to discuss certain highly confidential issues with labour representatives. In countries with co-determined supervisory boards, this has the practical consequence that certain issues are not discussed with the supervisory board as a whole, although the laws provide for the contrary.

There exists a third shortcoming to the two-tier system governed by co-determination laws: co-determination requirements complicate the introduction of mandatory qualification standards for all members of the supervisory board. The installation of such standards is suggested in the OECD Principles on Corporate Governance of 2004, and recent studies highlight the importance of qualification and experience for the choice of the members of the supervisory board. In contrast, Point 11.1 of the 2005 “Recommendations of the European Commission on the Role of Non-Executive Directors of Listed Companies and on the Committees of the (Supervisory) Board” (hereinafter the 2005 Recommendations of the EU) as well as the German Corporate Governance Code take a rather diffident approach. Sec. 5.4.1 of the German Corporate Governance Code states that members need to have the "required knowledge, abilities and expert experience to properly complete their tasks". At least every individual member of the supervisory board needs to have a certain degree of knowledge, whereas the corresponding provisions of the German Stock Corporation Act of 1965, as interpreted by the courts, only require that the supervisory board as a whole has this level of knowledge.

The introduction of even advanced mandatory qualification standards would certainly not bar shareholders from finding adequately qualified representatives. Such standards would instead be regarded as a hindrance to employees which prevent them from freely choosing their representatives. Without common standards concerning qualification and professional experience, however, it is extremely difficult to ensure the quality of work performed by the members of the supervisory board. The ex post review of decisions by the management board is already a difficult task. It is unlikely, however, that an organ consisting of members with little or no expertise in economics, finance, corporate strategy, etc. would be able to enhance the quality of the decisions made by the highly paid, carefully selected and well-educated members of the management board. Thus, it is even more challenging to involve the supervisory board more deeply in the decision-making process.
c) Other uniquely German characteristics

The consequences of the German co-determination laws and the influence of labour representatives are not the only particularities influencing the standards of corporate governance and the effectiveness of the control by the supervisory board. The tight-knit relationship between investors and lenders also affects the manner in which control is exercised over the company and its managers. The influence of German banks on the composition of the supervisory board is immense. About 12% of the shareholder seats in supervisory boards are taken by members of private banks. At first glance, this number might not appear to be terribly significant. However, this 12% represents only part of the influence that private banks have. Their total influence is derived from the aforementioned seats in the supervisory boards, from bank proxy votes, and – notwithstanding a slight trend to the contrary – from their still significant blocks of shares of the largest German stock corporations.

The role of financial institutions in Germany is certainly not the sole explanation for the quality of corporate control. Neither is it directly linked to the two-tier system. However, any evaluation of the two-tier system as a means of effective corporate governance and control must take this German feature into account. This means that the adoption of this system in other countries, or the introduction of elements of this system by way of converging the one-tier system and the two-tier system, might lead to other results than in Germany.

II. Advantages and disadvantages of the one-tier model

A number of the advantages of the one-tier model correspond with the weaknesses of the two-tier model and vice versa. The one-tier model in the United Kingdom does not face comparable national particularities, the way that the two-tier model in Germany does. Thus, the arguments made in favour of and against the British one-tier model might appear to be more universal than the remarks on Germany’s system of corporate governance. Nevertheless, the following comments refer to the United Kingdom, unless the contrary is explicitly stated.

1. Structural strengths of the one-tier model

It is "the board" that leads and controls the company. Thus, all members of the board are entrusted with the same tasks and are obliged to perform the same duties. Consequently, both the responsibilities of monitoring and strategy-setting are incorporated into the same body. Despite the fact that some members of the board are executive directors, while others are non-executive directors, they all have direct access to the same information. At least in theory, the flow of information is a vast improvement to that of the two-tier model. As the non-executive directors are involved in the decision-making process, they have more incentives to supply themselves with all relevant information, since they cannot argue afterwards that they were limited to an ex post control of decisions made by other persons.

At the same time, the decision-making process is swifter with regard to far-reaching questions. In a two-tier system, there is typically, but not necessarily, the need for the

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management board to receive the approval of the supervisory board. This approval can often be obtained only after a couple of weeks, due to the low frequency of meetings of the supervisory board. By contrast, in the one-tier system, board meetings take place more regularly. This higher frequency of meetings has, simultaneously, an impact on the understanding of the board members of the business, as it increases their knowledge of day-to-day business. Meanwhile, the knowledge of the non-executive directors helps the board as a whole, which demonstrates the potential for better informed decisions in one-tier systems. This holds especially true with regard to strategy formation.

These advantages are certainly typical for the one-tier model with its unitary board. In practice, however, it is doubtful whether the flow of information is as perfect as in theory. It can be observed that the information available to the non-executive directors is prepared by the management. Consequently, non-executive directors face the problems of obtaining independent and unfiltered information that are comparable to those of the members of the supervisory board in the two-tier system. In the two-tier system, this leads to an information asymmetry between the two boards; in the one-tier system, there is an information asymmetry within the board. The non-executive directors might not ask for additional facts, numbers, figures, etc. if they are confronted with the well-informed executive directors in the board meeting, while in the meetings of the supervisory board, all board members face the problem of insufficient or lacking information. A single non-executive director or a group of non-executive directors in a meeting of the board may therefore be reluctant to ask for further information, whereas the members of the supervisory board might, collectively, be less reluctant.

These observations notwithstanding, non-executive directors have, contrary to members of the supervisory board, direct rights to information. This is a clear advantage of the unitary system. In this system it is, in fact, rather more a question of filling the board with capable non-executive directors than a structural problem of guaranteeing an adequate flow of information.

2. Weaknesses of the one-tier model

The separation of control and management proved to be one of the key advantages of the two-tier system. By contrast, the members of the unitary board fulfil both managerial and supervisory roles. Thus, they face a dilemma: they should make decisions and, at the same time, monitor these decisions. While this problem does not exist in the two-tier system due to the inherent formal separation of control and management, it is necessary to obtain this separation artificially in the one-tier system. The mere fact that there are executive and non-executive directors is not sufficient to guarantee the adequate execution of the monitoring role of the board. Non-executive directors are, as some surveys confirm, well aware of their strategic role but less so of their monitoring role. Indeed, there is a need for some board members to be neutral and to concentrate their efforts primarily on the monitoring task. This has led to a further class of board members: within the group of the non-executive directors, only some are deemed independent. Emphasising the importance of having independent directors on the board and narrowing the definition of "independence" were core elements of the debate on the reform of corporate governance in the UK. Independence is deemed to be a necessary precondition for the ability to handle the combination of two tasks in practice. It thus remains a problem of the one-tier system to find ways to guarantee that a certain number
of board members are independent and to name criteria for independence. According to Sec. A.3.1 of the Combined Code, the following criteria are relevant for the determination whether a director can be regarded as being independent:

- if the director has been an employee of the company or group within the last five years;
- if the director has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- if the director has received or receives additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme;
- if the director has close family ties with any of the company’s advisers, directors or senior employees;
- if the director holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- if the director represents a significant shareholder; and
- if the director has served on the board for more than nine years from the date of his first election.

The independent non-executive directors face the dilemma of being colleagues with the other board members but also having to monitor them at the same time. This monitor-colleague-dilemma could be diminished, however, by clarifying the roles and responsibilities of each director. It is mainly the responsibility of the chairman to hold meetings in an environment in which there is a clear understanding of the different tasks of the board members and in which problems and questions can be discussed frankly and openly. In addition, it is the task of the shareholders to find suitable persons to fill the board. The non-executive directors must have a breadth of experience in order to understand the business and the sufficient confidence to hinder the other board members from making mistakes. In addition, shareholders must bear in mind the fact that they need persons on the board that represent their interests. If these requirements are met, it is possible for the independent non-executive directors to simultaneously act as colleagues in matters of strategy-setting and decision-making, as well as supervisors. This double function was traditionally integrated into the one-tier system and it has been, with a focus on non-executive directors, highlighted in the recent debate: non-executive directors participate in setting the corporate strategy and in monitoring the management. If necessary, they are obliged to seek the removal of the executive directors from office.

What remains, however, is the structural weakness of the one-tier system, in which the effectiveness of corporate control depends not only on the personality of the non-executive directors, but foremost on the personality of the chairman. Thus, a minimum formal requirement should be that the chairman is not also the CEO and that he is independent. Both are recommended in Sec. A.2.1 and Sec. A.2.2 of the Combined Code. These requirements are key elements of effective corporate control in the one-tier system, as there is otherwise a danger that too strong an individual, possessing the double title of chairman and CEO, would dominate the board, constraining the board’s monitoring function and restricting the representation of shareholders’ interests.
D. Possible recommendations for the improvement of corporate control

As mentioned in the beginning, it is hardly possible to consider one of the two concurring systems for corporate control as being superior to the other. This is consistent with a view broadly (but not unanimously) shared amongst the academic commentators. The analysis of the advantages and disadvantages of the two systems formed the basis for the following conclusion, which contains recommendations for the improvement of corporate control in both systems. Keeping the limitations due to path dependence in mind, every endeavour should be made to enhance the systems by implementing single features of each that have proved to be an important element of effective monitoring. Consequently, positive elements have to be stressed and weak features have to be abolished. This approach will necessarily lead to a convergence of the systems. However, convergence remains a concept that leads to an enhanced standard as opposed to simply creating minimum standards. Both systems will keep their uniqueness and their fundamental difference: separation of managerial and control functions in the two-tier system and the combination of the two in the one-tier system. Thus, convergence and continuing divergence are not mutually exclusive.

I. Recommendations for the improvement of corporate control in the two-tier system

In countries with two-tier systems of corporate control such as Germany, being a member of the supervisory board was, for many years, considered to be merely an honorary position. Decisions were normally let through on the nod, and there was often a lack of real effort towards effective control. Nonetheless, in the current changing economic environment and with regard to businesses that are becoming ever more international and complex, the time of regarding supervisory boards as social circles to meet old friends and cement old relationships is over. A couple of years ago, it was not uncommon to be a member of more than twenty supervisory boards. The number of mandates is now limited to ten by Sec. 100 of the German Stock Corporation Act of 1965, and being the chairman of a supervisory board counts as holding two seats. Furthermore, the amended German accounting standards provide for the publication of all seats held by members of the supervisory board in supervisory boards of other corporations.

In 2009, the Liberal Party (FDP) introduced a reform bill according to which the maximum number of board seats should be lowered to five. However, this reform approach did not find a majority in the German parliament.

1. Strengthening the position of the chairman of the supervisory board

The introduction of these new rules can be regarded as the first step in the right direction. What is necessary, however, is the strengthening of the chairman's role. He plays the key role in the supervisory board, as he is normally the only member dealing with the management on a more permanent basis. Being the chairman of a supervisory board should therefore become a full-time job, at least with regard to publicly listed corporations. This should be accompanied by an adequate compensation. Nonetheless, the chairman should remain strictly independent. Independence in this sense means, *inter alia*, that the chairman should not have had a business relationship with the company for the three to five years prior to his appointment. Thus, the normal practice of retiring from the management board and switching to the supervisory board as its
chairman should be abolished. Meanwhile, Sec. 5.4.4 of the German Corporate Governance Code contains a similar, though not too rigid, provision. As an accompanying measure, a compulsory upper limit for his term of office should be introduced. After about five years, the danger of the chairman losing his independence becomes too large. Furthermore, a chairman should not hold seats on other supervisory and management boards.

At the same time, the chairman of the supervisory board should have informational rights that go beyond the present status and beyond the rights which the supervisory board are presently allowed. It should be ensured that the chairman has unlimited access to all sources of information. He should also independently gather the information and should not rely on information provided by the management. Proposals of this kind, made with regard to other jurisdictions, have been heavily criticised in Germany. However, this criticism must be seen in the context of the existing German statutory provisions. There is no convincing reason to delay changing these rules.

The advantage of a strong chairman is obvious: within a short time, he will gain a thorough knowledge of the corporation. Even if his term of office is limited, and he is not eligible for re-appointment, he has a strong incentive to fulfil his tasks thoroughly: as he is appointed by the shareholders and not by the management board, it is important for him to build a reputation. If he becomes renowned for his work as a monitor he is likely to be appointed as chairman in another company. Thus, being the chairman of a supervisory board would become a profession in its own rights.

2. Professionalising the role of the other members of the supervisory board

The roles of the other members of the supervisory board also need to become more professionalised. As their task is clearly defined and limited to the control of the company, it is not necessary for them to have the same degree of independence as the non-executive directors on the British board. Nonetheless, it is a step into the right direction that Sec. 5.4.2 of the German Corporate Governance Code refers to an "adequate" number of independent members of the supervisory board. Unless a conflict of interests becomes apparent, the other members also do not have to be as independent as the chairman. On the contrary, it might be an advantage for the supervisory board as a whole if these members have special expertise and experience due to a former position in the company or due to former or present jobs in the same sector of the economy.

It is necessary to further increase the frequency of meetings. Nothing hinders the supervisory board from meeting on a monthly basis. This would have a number of positive consequences: even though being a normal member of the supervisory board would not become a full-time job, work load and time pressure would prevent individuals from holding too many seats in supervisory boards. Thus, it is not necessary to further reduce the maximum number of seats by law. At the same time, monthly meetings would allow the supervisory board to monitor management on a more continual basis. This is of crucial importance with regard to the involvement of the supervisory board in strategic or fundamental decisions by the management board. If the list of decisions requiring the approval of the supervisory board grows, it will become increasingly necessary for the supervisory board to react in appropriate time.
Some exceptions notwithstanding, the German Stock Corporation Act of 1965 allows for the formation of committees, and Sec. 5.3 of the German Corporate Governance Code expressly recommends such formations. Nevertheless, German corporations still do not make regular use of this right. Audit committees, personnel committees, finance committees, etc. should be set up in large companies. Committees allow for the utilisation of a number of the above-mentioned advantages, as members gain special expertise in certain areas of the company. Meetings can be organised more easily and meeting times can be flexibly adapted to the company’s needs. As the size of each committee is smaller by definition, the work can be performed more efficiently. However – with the exception of audit committees – there should be no mandatory list of committees for each company. The question of whether to install committees depends upon the nature and size of the company. Some have a high fluctuation of staff, some rely on the highly specialised technical expertise of the decision-makers, some invest and produce in exotic countries and need decision-makers on site, etc. Accordingly, some types of committees appear to be vital for some companies but not for others. To a certain extend, this view is reflected in the approach taken by the 2005 Recommendations of the EU. According to Point 5 of the Recommendations, nomination, remuneration and audit committees should be created within the supervisory board. However, Point 7.1 grants some flexibility in setting up these committees, as it states that companies may group the functions as they see fit and create fewer than three committees. Today, the Recommendations also need to be seen in the light of very recent trends and changes of the German Corporate Governance Code: According to its Sec. 4.2.2 the supervisory board should decide on questions concerning the remuneration of members of the management board in a plenary meeting (and not through committees).

Members of the supervisory board have a demanding and important responsibility. In large corporations, especially in those listed on the stock exchange, numerous anonymous shareholders rely on their work, as the shareholders do not have the ability to efficiently monitor the management themselves. According to Sec. 116 of the German Stock Corporation Act of 1965, members of the supervisory board are held liable to the corporation for any breach of their duties. Recent legislation introduced the possibility for shareholders to take legal action against the members of the supervisory board, however, numerous requirements have to be met. In addition, the action of the shareholders is a derivative action. It would be even more advantageous if the shareholders themselves were able to hold members of the supervisory board responsible for ineffective control of the company. In such a regime, the company would not necessarily have to suffer a loss; the loss suffered by the shareholders would be sufficient. This would mean that a decrease of the share price would be regarded as a loss, and the members of the supervisory board would be liable if such a decrease was due to a failure on their part to properly monitor business operations.

An additional method of increasing the quality of corporate control by the supervisory board would be the introduction of mandatory qualification standards. Such requirements should be applicable for all members of the supervisory board in order to guarantee a uniform level of effectiveness. In any case, diversity of experience and knowledge would be beneficial for the work of the supervisory board. Thus, it is neither necessary nor desirable for the supervisory board to consist solely of experts in business
administration, corporate finance or the like. Expertise in the relevant industrial sector, technical knowledge, access to important external information, good business relations, etc. would also serve as evidence of qualification.

Therefore, the newly introduced Sec. 100(5) of the German Stock Corporation Act of 1965 is a first step in the right direction: According to this provision, at least one independent member of the supervisory board needs to have special expertise in accounting and auditing. It is obvious that only a board consisting of persons who, on the whole, have the expertise to fulfil the necessary level of supervision over the company, can be regarded as an effective means of control.

Qualification standards, in this sense, would also minimise the potential conflicts with co-determination rules. It was already mentioned above that co-determination law might hinder mandatory qualification requirements, and the same might hold true with respect to liability rules. But labour representatives typically have a sound knowledge of the company and can thus help the supervisory board to control management with regard to a number of questions that are unique to that company. The liability of the management might also be restricted to cases of gross negligence. This appears to be consistent with co-determination rules and labour law, according to which no employee is permitted to act recklessly.

3. Involvement of the supervisory board in management decisions

Finally, the supervisory board should become more involved in management decisions. This does not mean that the separation of management and control in the two-tier system should be abolished. Day-to-day management should remain the responsibility of the management board. Indeed, there are very significant differences between the daily responsibility of the members of the management board and the periodic responsibility of the members of the supervisory board to evaluate plans, decisions and results.

The supervisory board should not be completely limited to an ex post control. Consequently, all fundamental decisions – and especially those that set or change the corporate strategy – should require the approval of the supervisory board. This is an expansion of the present statutory provisions and of the rules already existing in the by-laws of some companies, since the current law only requires the by-laws to provide a list of decisions that need approval. This, however, is merely a formal requirement, as the form of the list and its content are not prescribed. The proposed mandatory approval list is more than a mere expansion of the existing legal rules: it should be seen in the context of the above-mentioned professionalisation of the supervisory board as an organ consisting of experts permanently monitoring the company. In such a reformed supervisory board the flow of information is more complete and timely, and due to the higher frequency of meetings, decisions can obtain the necessary approval in a reasonable time.

II. Recommendations for the improvement of corporate control in the one-tier system

Some of the recommendations made with respect to the two-tier system are of equal importance to one-tier systems and need not be repeated. This holds true especially with regard to the installation of committees and liability rules. Subsequently, we will concentrate on the proposed changes that are essential for the unitary board.
It has been stressed that the central issue in each unitary board is, firstly, the lack of separation of management and control and, secondly, as a consequence thereof, the monitor-colleague-dilemma, which the non-executive directors are facing. Hence, the key to successful control of the management of the company is to reduce the potential conflict inherent in this dilemma. As was proposed, particularly in the American literature on corporate governance, this can effectively be done by choosing independent non-executive directors. Thus, the recent reforms in the UK to strengthen the role of independent directors were necessary and essential. While this is a widely accepted view, we should bear in mind that independence does not only have its merits but also its downfalls. There are fewer incentives for a person who had not previously had and did not currently have a relationship to the company to spend an adequate amount of time controlling the company’s affairs. Moreover, it is questionable whether such a person has the relevant knowledge of the particularities of the firm, which is a disadvantage for both tasks.

1. Frequency and duration of board meetings

Information concerning the company is complex. This is true especially with regard to data about long-term trends relating to financial performance, competitive position and organisational structure. Consequently, directors need time to evaluate the information and consider decisions and choices of the past. It is thus worthwhile to further increase the frequency of board meetings and to make board meetings last longer. Monthly board meetings are essential for continual supervision and to give every board member the possibility to promptly ask questions. The emphasis is on the continual possibility of initiating discussions and addressing all areas of concern. Once such a culture of continual supervision has been established, the preparation of board meetings does not require the same amount of time as it does if meetings take place only every third or fourth month. Thus the counter-argument that monthly meetings lead to an inefficient allocation of director’s attention is diluted. At the same time, and in contrast to a minimum frequency, it does not appear to be sensible to postulate a minimum duration of a meeting. Each meeting should last until all issues are discussed. It is then a question of the particular circumstances as to how much time is indeed necessary.

One exception to this last point should be mentioned: at least once per financial year, a board meeting should take place over two or three consecutive days. In the absence of a tight time schedule, but rather with an extended period including coffee breaks, lunches and one or two evenings spent together, thoughts would be shared more openly and frankly, and non-executive directors would have a better chance of getting involved in the work of the board, even if they are not as well prepared as the executive directors. In such a meeting, the long-term corporate strategy should be on the agenda.

2. Meetings of the non-executive directors

Having meetings of the board which last several days is a way of better integrating the non-executive directors into the board. At first glance, it may seem contradictory to also propose that the non-executive directors convene in additional sessions without the management. However, in meetings of this kind, it is again very likely that cohesive bonds develop among the non-executive directors and that questions are discussed that might not be otherwise brought up. They also strengthen the position of the non-executive directors in the next regular board meetings, as the non-executive directors
might feel more competent when convening later with the executive directors. As only questions of corporate control are on the agenda of the exclusive meetings, the monitor-colleague-dilemma is not as apparent as in the board meeting, since the non-executive directors are able to concentrate their efforts solely on questions of control.

3. Composition of the board

The smaller the number of directors, the more likely it is that each director can play an active and vital role. As a rule of thumb, in boards with more than ten or twelve members, at least some directors will feel superfluous and consequently stop preparing board meetings themselves but rather rely on the work of the others. In addition, sufficiently thorough discussions will not take place in groups that are too large. In a board consisting of eight to ten directors in total, there is a sufficient range of viewpoints in the boardroom, that an exchange of thoughts is still possible and that there is enough diversity. Today, diversity has indeed become a key word as the German Corporate Governance Code expressly recommends in Sec. 5.1.2. that diversity should be an important criterion for the composition of the supervisory board.

The Combined Code states in Sec. A.3.2 that "at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent" but does not stipulate a maximum number of seats in total. In some large companies, there might be practical need for six or eight executive directors. It is doubtful whether this legitimises a board consisting of twelve, sixteen or even more persons in total in order to meet the requirement of the Combined Code and whether this could be inconsistent to the supporting principle in Sec. A.3, according to which the board should not be so large as to be unwieldy. In contrast, the 2005 Recommendations of the EU take a more sensible approach, as they forbear from prescribing fixed numbers but refer in Point 4 to a sufficient number of independent non-executive directors that ensures that any material conflict of interest involving directors will be properly dealt with. Indeed, it seems sensible to provide for a flexible rule and to regard a maximum board size as the superior criterion. It should be guaranteed, however, that a minimum number of independent non-executive directors exists, and that they have effective voting rights.