The Politics of Ownership and the Transformation of Corporate Governance in Germany, 1973-1995

by

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John R. Griffin

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ABSTRACT

This dissertation presents the three most important instances of adjustment or attempted adjustment of the rules of corporate governance and ownership in Germany since the early 1970s: the case of privatization and the reorganization of corporate governance in the former East Germany; the rise of Konzernrecht and the management holding; and the (nominally) sweeping reform of the bankruptcy laws. While the first has had disappointing but ambiguous success, the second has been a dramatic success, and the third a dramatic failure. Each supports the two main contentions of the dissertation: that corporate governance and ownership have been transformed, and that this transformation has been anything but orderly. Each also illustrates the prominent causative role played by three factors in that transformation: economic change, the law and its interpretation, and historical precedent.

The large corporation no longer governs, and no longer is governed, in the same way in Germany as 25 years previous. Corporate ownership is differently distributed, is regulated differently, and is organized within the firm differently than before. The twin shocks of reunification and globalization have changed the relationship between capital and the state. At the national level, the system of peaceful coexistence and separate accommodation among different traditions of governance and ownership that had existed since the Kaiserreich has been undermined both by new, confounding governance forms and by a weakened framework of interest-group politics; the active locus of policy-making and dispute resolution has shifted; power and initiative has tilted away from organized capital toward the courts and, in some instances, the state.

Despite this transformation, major difficulties with which the adjustment of ownership rules occurs in the Federal Republic remain.

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# Table of Contents


## Table of Contents

A PRELIMINARY NOTE ON THE POLITICS OF OWNERSHIP

CHAPTER 1

INTRODUCTION

German Organized Capital
- The Classic Arguments
- Contemporary Arguments
- An Alternative

Corporate Ownership Scrutinized
- The Perfect Markets Debate
- Transaction Costs and Property

The Politics of Corporate Governance

The Argument

The Strategy of the Dissertation

CHAPTER 2

CHANGE AND AMBIGUITY IN THE GERMAN SYSTEM OF CORPORATE GOVERNANCE: THE QUANTITATIVE EVIDENCE

Three Views of the German System of Corporate Governance
- Die Macht der Banken
- The Doubters
- The Transformation of Corporate Governance?

Reconciling the Data and Discriminating Among Alternatives
- Ownership & Control: Widely Held vs. Tightly Held AGs
- Debt: Distinguishing Legal Forms

Summary
CHAPTER 3

INVESTMENT AND OWNERSHIP IN A VOLATILE ECONOMY: THE TRANSITION IN EAST GERMANY

Privatization: The Plans

GEMSU: Gleichschaltung of the System?

Failed Expectations: The Banks Balk and the State Reacts

In the Shadow of Uncertainty: Two Examples of Privatization and Governance in the East
   The East German Machine Tool Industry
   Jenoptik GmbH

The Banks’ Limited Role: Three Possible reasons for failed expectations
   Political Barriers to Privatization?
   Wise Caution?
   The Politics of Investment and Property in a Volatile Economy

Summary

CHAPTER 4

THE TRANSFORMATION OF THE MODERN CORPORATION IN GERMANY, PART I: LEGAL TRANSFORMATION

The Modern Origins of Corporate Governance in Germany
   The Laws of Joint-stock Companies
   The GmbH and the Legal Framework of Governance
   Cartels, Control and Production

The Transformation of German Corporate Law
   Conflicts of Principle and the Beginnings of Legislative Paralysis
   Economic Transformation, the Politics of Impediment, and Legal Innovation

CHAPTER 5

THE TRANSFORMATION OF THE MODERN CORPORATION IN GERMANY, PART II: THE BIRTH OF THE MANAGEMENT HOLDING

The Export Economy: From Mass Production to Niche Production

The Export Economy Revisited: Beyond Niche Production

Uncertainty and Innovation: The Birth of the Management Holding

An Illustration: The Case of the German Machine-tool Industry
   Background and Composition of the Industry
A Preliminary Note on the Politics of Ownership

“Property is impossible.” -- Proudhon

This dissertation is about the habits of rule, in two senses. The first is how the state -- including the government, parliament, administrators and the courts -- determines which rules constrain how owners and directors define and fulfill their roles as corporate rulers. The second is how, given those rules, owners and executives actually do so. Both types of government are political.

Obviously the state directly influences and sometimes determines how corporations rule, and how it does so has always been a subject of politics. Government dictates corporate law; it also determines the rules that influence how corporations can organize collectively and articulate their political needs. The search for viable ways to govern a corporation is a search for understanding how the courts, government and regulators will (re-)interpret or adjust the law, as well as how the law can be circumvented, restricted or otherwise manipulated. Successful economic adjustment demands that owners and executives must have constant access to government, and how they rule the corporate sphere is influenced by how they manipulate that public relationship.

Some think that this is where politics ends, and where “private” governance begins. But “private” governance remains public for at least three reasons. The first is substantial: corporations have such great influence over public life that they and their rulers are often indispensable participants to public governing processes. Because of this
influence and of the political origin of the rules that enable it, they are often seen in a
gle of responsibility similar to government. The second is constitutive: how
corporations govern helps determine *how industry organizes politically*, and especially in
the case of democracies, how interests are organized often determines how states can
govern. The third is formal: the *ideas about how to govern well* that animate the
economy often base themselves on models of governance articulated, reproduced, and
even determined by the state and by the political debates animating the state — including
ideas about individual and state sovereignty and the source of private and public power.

It is impossible to imagine corporate ownership, the keystone of what is called
property in the modern capitalist economy, as separate from the political.
Chapter 1

Introduction

The 1980s were a decade in which powerful business and financial interests determined the policy and political agendas of advanced industrial countries. Governments replaced Keyensian policies with more conservative monetary regimes. Capital markets and large corporations internationalized. Employing a rhetoric of “deregulation,” governments found it both more difficult and less desirable to oppose the interests of large corporations and organized business. Labor unions weakened. In Sweden and other Social Democratic strongholds, the 80s marked not only the ascendancy of conservative government and capital, but the undoing of policies and the dismantling of institutions that for years had ensured organized labor near equal footing with organized business in the economy and in government.¹

The 80s were also a time of turmoil for business and finance. Like the decade before, the 80s were a period of economic adjustment and industrial reorganization.² Amidst these challenges, troubling questions arose about the principles that govern the role of capital, as well as about the principles of how capital governs, in economic production: the rules of corporate governance. These questions did not come from labor or labor-sympathizers. Rather, conservative policy makers struggled with uncertainties about the propriety and efficacy of government regulation of financial claims and investor rights. Mainstream economists and theorists debated the nature of capital markets, their
role in economic development and adjustment, and their relation to the law and to the state. Above all -- and the major reason for the controversy in both public and academic spheres -- investors and managers themselves became increasingly divided over their roles, debating their rights and status as they attempted to find new ways to govern corporations. From fights over British privatization to those over the American LBO and board-room activism, issues as basic to capitalism as corporate ownership, corporate control and how these should be defined and preserved became contested within organized capital itself -- ironically, during the very period capital gained newfound influence in politics and in the economy.

To help ascertain the scope and limits to the new-found power of capital, this dissertation examines changes in what many consider to be one of the most well-organized, influential business and finance communities in the world: the German. German capital lies at the heart of the European common market. Its well-organized features and political power are one of the salient continuities in the long and tortured German past. Today, many attribute a significant portion of the Federal Republic’s post-war success and prosperity to big capital’s and big business’ close-knit relationship with the new democratic regime. In fact, whether from a France scrambling to replace the old price-administered system of industrial credit, from a United States trying to strengthen its flagging commercial banking system, or from a Poland and a Czech Republic going through the throes of privatization, calls have consistently come from other nations to mimic “German-style” bank-industry ties and other corporate governance features central to business organization in the “German model” of political economy.
But is the German model of corporate governance surviving the throes of re-unification? Or is it being transformed at the very instant others view it as an endpoint? Does the politics of corporate ownership at this critical juncture rely upon the same post-war relationship between capital and the state? Or are these ways of government also receding as one more ghost that haunts the German past? The argument of the dissertation is that the practices of corporate governance have been transformed both before and after re-unification, and so have the practices of government regulating the relationship between big capital and the state. The most substantial changes have not been revolutionary in the sense of sudden and unforeseen, although certainly re-unification and prolonged economic troubles have exacerbated – and in some cases spawned – them. The system of peaceful coexistence and separate accommodation among different traditions of governance and ownership that had existed since the Kaiserreich has been undermined both by new, confounding governance forms and by a weakened framework of interest-group politics; the active locus of policy-making and dispute resolution has shifted; power and initiative has tilted away from organized capital toward the state.

This chapter introduces both the theoretical and the methodological approaches that the dissertation takes in advancing its argument. First, it reviews the familiar models of German politics and capital, making explicit the arguments and assumptions about the central role of corporate governance institutions in such models. Next, it reviews several contemporary debates about corporate ownership and governance, compares the implications of opposing positions in explaining the transformation of governance
institutions, and justifies an alternative approach taken by the dissertation. Based on this approach, the chapter then lays out the comparative strategy followed to answer the dissertation’s motivating questions – how the institutions of corporate governance are being transformed and, most critically, how German organized capital and the state are coordinating or failing to coordinate these changes.

**German Organized Capital**

Germany has long been considered by many to be the model of business organization, along with its kindred system Japan, in which the institutions of state and capital endow business with the power to act and react in the public’s -- and in its own -- long term interests. From the more statist arguments of Gerschenkron, Shonfield and Zysman to the technology-driven arguments of Chandler, from neo-corporatist models of economic growth and adjustment to the modern models of “coordinated” market capitalism which they helped spawn, scholars have consistently argued that the superior economic and political organization of business is a major well-spring of Germany’s economic strength. If German capitalism is anything, it is organized.

**The Classic Arguments**

The “organized” character of German capital, in the economy and politically, was undoubtedly first popularized by the writings of two scholars who stressed the close relationship between capital and the state: Rudolf Hilferding and Alexander Gerschenkron. Hilferding's 1910 book *Das Finanzkapital (Finance Capital)* advanced the thesis that, by the turn of the century, German capitalism had entered into a phase of very high industrial concentration organized around a system of self-reinforcing
agglomeration of industrial control by high finance (above all among the big Berlin banks). The basis of the system was the rules of ownership and credit, created and enforced by the capitalist state, which enabled the individual financier to gather powerful control rights and then to use them to steer production centrally and overcome the economy’s contradictions, such as the falling rate of profit, which Marx had predicted would lead to the system’s collapse. In essence, competition and the destructive cycles of capitalism forced the search for massive oligopolistic rents and economies from rationalizing production by scale in order for economic stability to be maintained, and these could only be ensured by a system of ever-more concentrated control by owners and those who had the most capital to maintain it: financiers. "... a fully developed credit system is the antithesis of capitalism, and represents organization and control as opposed to anarchy. It has its source in socialism, but has been adapted to capitalist society. At the outset it suddenly opens up for the knights of credit a prodigious vista. The barriers to capitalist production -- private property -- seem to have fallen, and the entire productive power of society appears to be placed at the disposal of the individual."5

To Hilferding, the political organization of business was maintained by one thing, and one thing only: the coercive powers of ownership, ensured by the state. Capitalists’ place in the national economy dictated their interests, but these interests always conflicted across groups; the pressures of competition meant that even within the same group political unity was difficult. Commercial capital, industrial capital, money capital, and finance capital all had opposing interests, and within these groups divisions between industries and sectors proved insurmountable -- were it not for one instrument:
ownership. The law enabled owners to fashion relationships of dependency that could overcome the destabilizing conflicts among capitalists. Industrial capital was thus beholden to finance capital over time for the massive credits it needed to stay afloat, and finance capital from this position could come to dominate boards of directors through share acquisitions and exercise direct control over industrialists. As business further consolidated, it created pressures within banking toward concentration that then enabled larger financiers to swallow smaller ones though similar processes. Hilferding argued that institutions like the credit and stock markets, far from discouraging centralized control, enabled owners to concentrate their resources like never before. The point was that by giving individuals the power to re-allocate and distribute earnings as they wished, the power to hire or fire executives, and the power to take over less powerful investors, the rules of corporate ownership became instruments of hierarchy the big banks used to forge common interests and political ties among otherwise antagonistic capitalists. Actors like industry associations and trade chambers were nothing more than the formal but superficial public vessels for the underlying capitalist groupings organized directly or indirectly by ownership ties. The state maintained the rules of ownership and credit; finance capital maintained political stability in the economy. Ownership was the economic and political glue that held the advanced capitalist state together.

Hilferding’s model of bank-led corporate governance and its central place in the organization and development of the German economy and state has been passed down in various guises to the present day. The main contention of this model – that the universal banks' historical capacity to superintend industrial investment, restructuring and
cartelization has enabled the German state to overcome economic crisis and to promote economic development – was most prominently re-employed fifty years later by Alexander Gerschenkron. Gerschenkron, together with a number of his contemporaries in the 1960s,7 championed the thesis that economic development could be hastened by non-market interventions. Once again it was the big banks, the state, and their close relationship with each other that was key. By themselves, the Berlin banks solved problems like scarce capital, distrust of the market, and high sunk costs that states east of Germany could only overcome with severely authoritarian methods. "The banks refused to tolerate fratricidal struggles among their children. From the vantage point of centralized control, they were at all times quick to perceive profitable opportunities of cartelization and amalgamation of industrial enterprises."8 Together with the state, the banks helped formulate and implement strategies of acquiring and promoting the most important technologies. The modernizing German state, with such an ally, was well-informed and powerfully-endowed to embark on a course of rapidly industrializing the most modern sectors at the time, including chemicals, electrical engineering, steel and mechanical engineering.9

Since the 60s Gerschenkron’s argument that particular features of the corporate governance system sped late-development in Germany was accepted and used as a foundation by theorists with very different views. Take the two competing theses of Alfred Chandler and Andrew Shonfield. The former tied economic development to the compelling logic of technology, claiming that mass-production technology forced the basic organizational and financial features of the modern business enterprise into the
economic life of all nations; and that how well managers mastered the logistical and
financial problems created by these technologies accounted for the relative economic
success of nations. Shonfield, in contrast, saw national democratic traditions –
including public-private boundaries and the procedures and institutions used to determine
them – as the source of performance variation, claiming that the salient feature of rapidly
growing nations after the war was the mixed economy. Both men, for different reasons,
agreed that the superior political and economic organization of German capital –
derunderpinned by a system of corporate governance with features described by
Gerschenkron and Hilferding – fulfilled the most important criteria for rapid and
sustained growth: mastery of technology and logistics or public-private cooperation and
planning, respectively.

Contemporary Arguments

With the onset of economic crisis in the 70s scholars re-employed the same model
of organized capital to explain adjustment to crisis. Neo-corporatist arguments about
economic performance and crisis-management led the pack. These arguments’ primary
thrust was that strong, centralized unions together with the political institutions and
procedures that enabled organized labor to maintain its collective strength and full
participation in wage bargaining enhanced economic performance in the new, volitile
international economy. Though ostensibly focused on tripartite negotiation, neo-
corporatist scholars did not in the rule give much attention to the problems of organized
capital but instead simply echoed Schonfield’s reasoning about the strength of capital and
the key role of the banks. Those who pushed the argument sounded echoes of Hilferding:
the key to the German system was that the banks’ management of economic crisis at least partially shielded the state from direct public responsibility for such crisis. This shielding effect was the object of central political exchange: in return for the political shield, the government maintained a bank-friendly regulatory environment that strengthened banks’ influence over industry, reinforcing the institutions of corporate ownership and control that lay at the heart of the model. In this way the rules of corporate governance helped organize capital just as the rules of unionism helped organize labor. John Zysman amplified these echoes of Hilferding even further by returning attention to the institutions of credit and governance: a critical element of Germany’s successful tripartite negotiation system was banks’ provision of patient capital and active board supervision, underpinned above all by the rules of credit and ownership and how they were regulated by the state. National variation in performance and patterns of adjustment could be traced to variation of these rules and practices.

During the later 80s this thesis came under fire. The implications of neo-corporatist models, which had been based primarily on data from the 70s and early 80s, seemed to be contradicted. States with strong centralized systems of union control and wage-bargaining underperformed those with more decentralized labor institutions and came under political stress to boot. Some of the most outstanding neo-corporatist examples -- above all, the Swedish system -- actually appeared to be substantially dismantled. Some scholars reinterpreted the previous success of neo-corporatist systems together with their post-70s performance variation in terms of organized capital. Though divided over the question whether a fundamental shift in power toward
capital had precipitated neo-corporatism’s troubles or whether the organization of capital had always been the key to the performance of these systems, these scholars agreed that many of the high-performance economies of the 70s as well as those of the 80s belonged to Zysman’s German-style governance and bank-led financial systems.

The most important of these arguments are those of David Soskice. Drawing on Zysman, Soskice and others\textsuperscript{18} have argued that systems with German-style governance institutions extend the time-horizons of business; that lengthened time horizons together with certain meso-level institutions (including unions) and a well-organized business sector encourage long term, collective investments in goods such as high-skill worker training; and that these investment practices, difficult if not impossible to maintain otherwise, help tame destructive wage bargaining cycles -- with the help of a credibly conservative monetary authority -- and are an important basis for superior economic performance. Organized or “coordinated” capitalism, in this view, is not only the sum total of the institutions of labor, capital, and government, but more importantly how these institutions are interlinked or positioned in a type of golden arch of growth and innovation -- the “coordinated market economy.” In the arch of coordinated capitalism, the system of German corporate governance acts as the keystone, monitoring and holding accountable the most powerful actors in the system as a whole. Within these governance institutions, captains of industry and finance can organize themselves to act in their own and in the general economy’s long-term interests.

While drawing on neo-corporatist arguments, Soskice represents an apparent break with previous models of German political economy. An economist, Soskice has
little to say directly about how the political organization of capital is maintained -- only
what its alleged economic effects are. The same applies to the system of corporate
governance. However, his argument does follow previous arguments in emphasizing the
coherence of the national system, the central role of capital in maintaining that coherence,
and the fundament of governance institutions, rules and laws by which capital is
organized and upon which the organization of the greater German economy rests. If
corporate financing and governance institutions and were otherwise, individual
executives' interests could not be guaranteed to correspond to the long-term interests of
the corporation; without long-term investments, corporations' interests would correspond
less with organized labor (the demand for high-skill labor would drop and so would
wages); the system would unravel and conflict would erupt. Seen in this way, corporate
governance institutions help guarantee economic and political stability. The state has
every incentive to maintain them; the implications for the relationship between capital
and the state move in the same direction as the neo-corporatists and Hilferding.

An Alternative

Except for Soskice, both classic and contemporary arguments about German
capitalism focus primarily on the political organization of capital; how the relationship
between capital and the state is defined, reproduced and modified over time; and what
difference this makes in the economy. Despite very different theories of politics, each of
the main arguments converges in its characterization of German capitalism and its
foundations. For each characterizes the German state as a coherent national actor with
enough policy maneuvering room to stabilize or spur the economy. Moreover, each
attributes this to the coherent, national organization of business, economic and political.

Although the mechanics of the relationship between business and the state work differently in each theory -- via class interests, by political exchange, by group struggle over the power to determine rules and shape institutions, or by mutual, rational collaboration -- the common views on the organization of business and the state and the common focus on national politics are enough to produce converging implications.

German capital and the state have every interest in cooperation and possess the instruments and means to ensure this to their mutual benefit and long-lasting stability. As we have seen, these implications hold both for managing economic prosperity and for managing economic crisis.

Despite its prominence, the common vision of German capitalism described above has been seriously challenged by those who question its characterization of both the German national state and German capital. Of these, Gary Herrigel's work stands out most prominently. Herrigel starts with the familiar thesis of correspondence between politics and the division of labor -- the organization of production -- in the economy. However, he immediately departs from familiar arguments by arguing for the primacy of politics in determining the former. Historically, Herrigel advances his argument by showing that at least two major economic traditions ("industrial orders") populate Germany, geographically, economically, and politically, and that these two traditions form obvious political alternatives when it comes to organizing and regulating production. The historical and political roots of each tradition being regional, the implications for the former theories of German capitalism are clear: a single, national
framework of economic and business regulation is by no means a given; neither is the coherence, business or economic, of the business community. So distinct are the alternatives Herrigel reveals that even the very boundaries between the state and economy are differently drawn in each. National economic governance, if it is managed either among corporations privately or in conjunction with the state publicly, might be an extraordinary, or delicate, feat.

Herrigel was not the first to articulate such a view of the German state and its relationship with capital. A related argument is that of David Abraham, who advanced the bold thesis that the collapse of the Weimar Republic was due to problems of cooperation both among different factions of capital and between capital and the state.20 While Abraham’s genealogy of business and its divisions is defined in neo-Marxist terms, much like Hilferding, unlike the latter Abraham did not read capital’s political organization from the economy but took seriously the problems of articulating common interests both within economic groups and across them. In fact, it was precisely the inability to find ways to compromise across a number of business groups wide enough to form a popular coalition that excluded the National Socialists that led to the republic’s demise, according to Abraham. Leaders from the government and business community tried but found their options exhausted because of the difficulties of organizing such different and opposing capitalist groups during times of great economic stress.

Taken together, Herrigel and Abraham’s theses force serious scholars to re-examine the classic and modern arguments about German capitalism reviewed above. The productive relationship between the state and capital cannot be taken for granted. If
a coherent, beneficial system of regulating business and the economy is posited to exist, that system and the arrangements within the business community and government that allowed its emergence and encourage its reproduction must be critically examined, both theoretically and empirically. Above all, the institutions of finance and business, including especially the rules and practices of corporate ownership, must be scrutinized. How strong a "glue" among corporations and capitalists are these rules and practices?

**Corporate Ownership Scrutinized**

Of course to assess the strength of ownership ties in producing cooperation in the business community requires historical analysis, above all to see if the structures of ownership truly match the assertions of Hilferding and those who later drew on his arguments. That is a task begun by the next chapter and continually revisited throughout the dissertation. But evaluating ownership ties also requires a theory of ownership, starting with Proudhon's famous question, "What is property?" What does it mean to own a corporation; who defines ownership; and how are these definitions changed or reproduced over time?

**The Perfect Markets Debate**

Economics once enjoyed a consensus about the subjects of property and ownership, the essence of corporate governance in a capitalist economy. However, in the wake of the controversies mentioned at the beginning of this chapter, and in the wake of a growing and serious interest in institutional transformation, it does so no longer. This consensus entailed an agreement over the relation between financial markets and corporate ownership, over how that relation should be optimally structured, and over the
direction that these institutions develop over time. Two debates in particular have undermined that consensus.

The first such debate was the controversy that grew up out of doubts revolving around one of the central tenets of financial economics, Modigliani and Miller’s perfect markets proposition. In perfect markets, the proposition went, capital structure is irrelevant to the value of the firm; the choice of debt, equity, or other financing instruments has no bearing on actual firm performance. In other words, financial markets’ magnitude and depth should guarantee efficient allocation of funds to firms. Since its publication in 1958, theorists trying to illustrate the M&M Proposition’s validity empirically ran up against the paradox that because any pricing model of the value of a firm (and stock returns) requires an assumption of perfect markets, testing the proposition empirically requires first showing that actual financial markets approach perfection. Showing that capital structure is irrelevant and then implying that financial markets are roughly perfect, frustratingly enough, is impossible.

Amidst successive controversies over the existence of market imperfections, scholars discovered a number of empirical puzzles that pointed to the possibility that the source of market imperfections in financial markets might lie in the non-market foundations of trade and exchange. The first controversy was over tax irregularities and took the familiar form of debates over government intervention in markets. Were the market irregularities that result from taxation profound or insignificant? While some argued that the government’s power to tax made certain dividend policies more profitable than others and created distinct investor clienteles with preferences for certain capital
structures, others countered that the only real meaningful imperfections arose because of erratic exercise of that power, in effect disrupting investor expectations.\textsuperscript{21} Can investor foresight correct for tax distortions, or is government a permanent source of market inefficiencies?

This controversy soon gave way to greater concerns. The existence of information asymmetries, agency costs, and contracting costs demonstrated that even without state intervention, the autonomy of private market participants (whether of managers, of traders, or even of other investors) could create imperfections just as great as those created by a public sovereign.\textsuperscript{24} One need not look farther for such distortions than the basic economic transaction. In the relationship between investor and executive, managers can employ a variety of strategies to build their own empires rather than maximize investor return, and thus cause undervalued equity. Although the market for corporate control (the share market) can in theory correct such distortions, the principle-agent dilemmas at their root pervade the share market as well, acting as no guarantee for efficient corporate investment behavior.\textsuperscript{25} In addition, traders alone can self-deal and create restrictive exchange barriers in financial markets. More seriously, because of information asymmetries or ignorance about them, other investors might trade on “noise,” creating situations in which arbitrage -- the activity that drives prices toward an efficient equilibrium despite sub-optimal trading -- becomes prohibitively risky.\textsuperscript{26} The perfect markets debate had given rise to a growing skepticism. Theoretically, market efficiency could not be assured, even by sophisticated, informed rational investors.
The discussion over the final source of market imperfections, bankruptcy costs, brought the problems of public sovereign and private market actors together. The value lost in court as investors haggle over the future of a bankrupt enterprise, who controls it, and the division of corporate returns, it was observed, is usually so enormous that even a remote chance that a healthy firm might end up in bankruptcy creates high debt premiums and has serious repercussions on its capital structure. Perfect markets seemed to require a regulatory regime invulnerable to individual investors’ acts of circumvention, and yet markets themselves were supposed to represent the only hope of coordinating such strategic behavior virtuously. Can regulation of investor claims minimize bankruptcy losses? Or is the problem be exacerbated by state regulation? Can any actor -- state or investors -- resolve the predicament when the powers to do were its apparent cause? Theoretically, the problem was serious. If exercising full corporate ownership rights remains so difficult during a time investors can call upon the law directly to help them do so, in less formally-adjudicated circumstances (in the court’s shadow) these rights must be vulnerable indeed. Because anticipation of the “exceptional” circumstance of bankruptcy guaranteed that bankruptcy shortcomings adversely affect the “normal,” non-bankruptcy states, private and public sources of market imperfections are directly interconnected. Moreover, it was obvious how they were interconnected: in the problematic of private property. The problems with markets were rooted in the elusiveness of a “robust” ownership regime, even in a capitalist economy.

The debate had reached a new point of departure: if the rights in corporate assets that investors trade remain so vulnerable to infringement, it was easy to see why
imperfections were a permanent feature of markets. Just as government tax and regulatory powers are trespasses upon the cash flows and control rights otherwise guaranteed an individual by her securities claims, so too are managerial discretion and various privileges held by different classes of investors. For instance, not only can the possibility that managers hoard information from stockholders upset market equilibrium, but so too the possibility that stockholders gamble away the securities of debtholders, or the possibility that privileged debt-holders re-negotiate their titles in a way that infringes the claims of scattered junk bond holders. Investor ownership when infringed seemed to create problems, but so too did these powers when left un-infringed. The dilemma was a classic conflict of rights, but *instead of conflict between different rights, the case was of a single, self-conflicting right: the right to ownership*. Ownership claims are the securities that form the basis of financial markets, and yet ownership cannot not be structured efficiently by market solutions. Economic theorists needed an alternative way to model this critical non-market institution.

**Transaction Costs and Property**

Developments in a separate literature about transaction costs and their relation to economic institutions reached similar results. Since Coase first argued that transaction costs create non-market forms of economic organization like the firm or government regulatory arrangements, theorists have been searching for a way to systematize arguments about the origins of transaction costs and their effect on economic organization. In the 60s such a way was found, partly at the instigation of Coase himself: transaction costs originate when property rights remain poorly defined, un-enforced, or
inalienable. Coase’s famous argument about externalities underscores the point: as long as farmers, whose fields remain at risk because of sparks from a passing train, can trade (or bribe) for the right to emit sparks, and as long as that right is clearly defined, exclusive and enforceable, they will do so if it is more efficient for them to possess it, or forego the right if it is more efficient for the railroad to exercise it. Either way, initial allocation of rights does not matter to efficiency, and frictionless trade facilitates the transition to the more efficient state. The job of the state concerned with economic efficiency is to guarantee ownership rights without saying anything about their (re-)allocation. Without such a clearly delineated rights structure, trade would suffer as costs from wrangling in or outside court would prevent the emergence of the more efficient production arrangement.

The basis of the theory was a specific argument about the alternative to exclusive rights and the resulting problem of the commons. Accordingly, a non-exclusive rights structure in effect places resources in a “public realm” where they become the target of appropriation by all. Waste results from the rush to appropriate. Dissipation results because common property fails to motivate self-maximizing agents to consider the costs their additional use imposes on others, and resources are overused. In the famous example, additional cattle graze the commons until the grass is entirely eaten and they all starve.36 Only by defining property rights more precisely and exclusively, enforcing them adequately, and allowing them to be traded, can such dissipation and waste be overcome as resources are taken out of the “public realm” and placed into the hands of responsible individuals.
Throughout the 60s and 70s theorists elaborated this economic theory of property rights, using it to explain, for example, price ceilings, rationing, intra-firm organization, and sundry regulatory structures.\textsuperscript{37} Douglass North,\textsuperscript{38} perhaps more than any other economist, pushed the theory to its extremes by interpreting all of economic history as the march toward a more ideal or “imperial” property rights structure\textsuperscript{39} (i.e. rights precisely defined, thoroughly exclusive and alienable, and completely enforced). Such a structure minimizes transaction costs by maximizing the “individual capturability” of the gains to exchange and thus the raw fuel of economic growth, an individual’s incentive to produce. Property rights over intellectual goods accelerate science and technological growth; those over natural resources and commodities accelerate development of the primary and secondary sectors; and those over private and public savings accelerate capital formation and investment. The state allowing, private parties will find ways to overcome short run distributive problems and institute a stable legal and normative foundation for this property structure. However, insofar as government intervenes in this process and undermines this structure – whatever the cause – societies will be unable to sustain economic growth and eventually fail.

Coase’s transaction cost view fit nicely with Miller’s perfect markets view of capital markets: perfect markets were those markets in which the rights represented by traded securities were perfectly alienable, enforced and defined. As long as some rights remained ill- or un-defined, markets would be incomplete. As long as those rights could not be traded costlessly, markets would be imperfect. If certain rights by their nature conflicted with other rights, making perfect and complete markets impossible, then the
solution should be to combine them. Integration would remove their relation from the flawed market, simultaneously reduce transaction costs, and make the market in which the combined rights traded more perfectly and completely. Olive: Williamson called one variant of this problem “asset specificity”: value from assets like a supplier’s specialized machines for supplying parts to a specific customer was by the nature of these assets simply not 100% capturable by their owners; the ownership “incidents” that the customer held in the asset were, by the nature of technology (asset-specific), simply not capable of being traded. Integration of supplier and customer, or arrangements that approximated it, Williamson argued, would solve the problem (uniting the assets with the aforementioned inalienable ownership incidents). Although Williamson offered intriguing institutional alternatives to simple ownership, the thrust was the same: the counterpart to perfect markets was perfect ownership, and the solution to any inefficient exchange was to approximate more fully this property ideal.

A particularly refined argument that builds on the transaction cost theory is Oliver Hart’s. Hart argues that ownership is the solution to the most general incomplete contracting dilemmas, including the usual bounded rationality assumptions, because residual control rights give actors an alienable instrument that can encourage cooperation even under the most general uncertainties. Proper distribution of ownership rights ensures that actors who are vulnerable to unanticipated contingencies can adjust to them, stabilizing their expectations and thus encouraging their investment in capital, kind, or effort. Improper distribution of ownership rights, in contrast, destabilizes expectations. If an investor lacks the power to capture return on investment, for example, she will
underinvest. If her customer is dependent on timely delivery but lacks the power to prevent her from raising prices for some unanticipated reason, she will underbuy and again, the investor will anticipate this and underinvest. The solution, Hart asserts in a vein recalling Williamson’s asset-specificity analysis, is to bundle ownership rights over production and then share them between the two parties. Following the argument that ownership rights over complementary assets should be bundled and that those over less complementary assets should not, the a-priori ownership distribution among investors — both among firms and within firms — can be calculated mathematically, given the costs and structure of production. A way seemed to be found in which exact ownership distributions, whatever they may be, could be determined.

Unfortunately, the logic of incomplete contracts could be turned against the ownership rights meant to be its solution in a way that rendered the theory much less powerful. This is because although the theory allows for varied ownership distribution, it mandates the absolute conservation of the rights themselves. As the M&M Proposition came under fire, this mandate and the classic transaction cost viewpoint with which it was associated began to suffer. Theorists pointed out that raising the exclusivity of rights brings with it its own coordination costs — the costs of enforcing and of precisely defining those rights. Not only could contracts be incomplete, in the broad sense Hart allows, but so too could ownership rights. Economists showed that as the value of resources rises, not only would the pressure to make them exclusive rise, but so too would the incentive to trespass them, and with it the costs of defining, enforcing, and trading them. Coase himself pointed out that the costs imposed on the courts, the police
and the state bureaucracy, among other non-market institutions, might make changing rights structures not only prohibitive in the short-run, but also in the long-run. More exclusive rights might very well be less efficient -- in fact, says Coase, "the ubiquitous nature of 'externalities' suggests to me that there is a prima facie case against intervention..." (Coase, 1988, p.26). Other transaction-cost economists followed with similar qualifications.

Once such costs and externalities were recognized by theory, the exact point at which a given rights structure would be more efficient if it more fully approximated the ideals of perfect market and imperial ownership became unpredictable, and the transaction cost theory has since suffered under its perceived lack of rigor. By favoring ideal ownership states whose stability and definition could not be guaranteed by primary actors, the theory required second order guarantees of its fundamental elements, effectively externalizing what it could not explain as a problem of "politics." Taken together, the transaction cost theorists and the related and perhaps more refined arguments of Hart had invented a clear way to think about origins of market imperfections and their close link with ownership structure. In this regard, they offer much more powerful tools for analyzing the concerns from the perfect markets debates, for example. But they remained "vulnerable" to politics. Without a solution to politics, neither theory by itself or in combination could predict how governance institutions and the ownership relations that underpin them might transform themselves.
The Politics of Corporate Governance

Economic theories of ownership had become particularly beholden to arguments about the political origins and political nature of economic institutions. For the German case, the problem had come full circle. The classic accounts of the origins and development of German political economy, when scrutinized, all depended on similar conceptions of ownership. And yet the economic debates had shown that the mechanism and form of ownership were no longer givens and had themselves turned to politics for the answer. The problem was vexing, and even those scholars who found ingenious and even radical ways to use this circularity to their benefit in the end fall short because of it, as two of the most prominent and elegant contemporary arguments about the politics of corporate governance – that of John Zysman and Mark Roe – illustrate.⁵⁰

Financial systems, Zysman argues in Governments, Markets, and Growth, are political creations, the outcome of struggles between rival interest groups over competing visions of politics and the political resources to realize them -- resources which include, as an illustration of the reflexive relationship between the state and capital, the elements of financial systems themselves. France’s system of state-led, price-allocated industrial credit -- Zysman’s premiere example -- was itself partially built by the use of credit controls to forge necessary political alliances. When the post-war Planning Commission found itself squeezed between the hostile small business and reluctant state ministries, it used what limited access to credit allocation it had to win over big business. This alliance helped to overcome the skepticism of the Trésor and to institute state-centric financial regulatory reforms. These reforms and the new-found support of the Ministry of Finance, in turn, allowed the Plan to expand the system of price-administered credit allocation and
shape the bureaucracy in a way that conformed to this powerful interventionist instrument. France's peculiar dirigiste financial system was born. In general, Zysman argues that by presenting the state with a limited number of ways to allocate resources among groups, financial systems help determine who makes allocative decisions, what groups benefit from those decisions, what alliances are desirable or possible between groups to capture those benefits, and thus the shape of political interests themselves. The circle is closed when those interests forge institutions to further their own purposes.

Though his focus is the law instead of the state administrative apparatus and economic policy, Mark Roe uses a similar reflexive device in his account of the genesis of America's splintered corporate governance system. Roe, like Zysman, argues that struggles for control over political resources, taken within the context of democratic politics and its historically-derived structure (e.g. federalism in the U.S.), decisively shape how financial institutions are defined, and that the shape of these institutions in turn favors some political groups over others, affecting subsequent political and economic development. Shortly after the turn of the century, Roe illustrates in one of his best examples, industry stumbled upon a strategy that ironically turned the anti-big business ideology of American populism and the workings of a federal regulatory system into the political catalyst for legal reforms. These reforms freed business from policing by its largest shareholders, the big New York insurance companies. On the heels of public outcry over an insurance company scandal, business used a yellow press to fan fears of financial empires and encouraged the New York legislature to pass reforms that prevented insurance companies from owning stock, investment or commercial banking,
or using investments in out-of-state companies to by-pass these rules. The law directly prohibited insurers from “interfering in any way” with the governance of a corporation. Once legislation was passed, business entrapped the New York firms into swallowing the bitter pill by using leverage in smaller states and alliances with Progressive federal attorneys and judges to threaten insurers -- who relied upon uniform regulations to manage costs reasonably -- with worse if they sought out-of-state remedies. Big business managers thus used their economic and social position both to manipulate politicians directly and to influence them indirectly by shaping popular opinion and building a political consensus that made important legal alliances possible. With this political victory big business managers destroyed the most powerful watchdog in its affairs and thus gained enormous autonomy in deciding how to use investment moneys. And of course, this autonomy naturally furthered both business’ economic position and its political leverage, which it used again and again to pacify other potential financial monitors legally.

Roe and Zysman’s accounts complement each other in how they turn the mutually-dependent or even circular relationship between politics and corporate governance into a device for understanding change and development. Corporate ownership and the institutions that determine it are controlled politically, but politics is determined by how corporate actors organize themselves collectively, a direct outcome of corporate ownership institutions. This feedback mechanism means that large consequences can follow small changes. Thus, the initial alliance between big business and the French planning commission could mushroom into a much larger price-
administered system, and big business' incursions into New York insurance law could mushroom into a much larger American system of weak to non-existent outside corporate monitoring. The arguments are subtly but skillfully made, and present one method by which the dilemmas previously discussed might be partially turned to one's advantage.

However, the weakness in economic theory and its dependence on politics also causes several important flaws in Roe and Zysman's arguments. The most obvious such flaw in Zysman's case is the lack of a good model of French business and its interests in particular governance solutions, leading to the question why big business and the French planning commission could agree on price-administered credit to begin with. One possibility is that big corporations didn't have a choice: French administrators could dictate their own terms. Despite corporations' relatively weak political footing immediately after the war, however, the constellation of opposing forces, including divided opinion within the French state over economic policy, makes this possibility highly unlikely. An alternative explanation would be that large corporations could readily integrate the resulting governance practices into their current system of corporate control and into their plans for how that system should develop – and, by implication, those corporations against the new system (mostly small firms) could not. Because Zysman has no economic theory of ownership, he does not lay out the features of such an explanation, and the reader must simply take on faith that large corporations did indeed see such a way forward and that a mechanism existed for them to articulate this vision collectively in a way that made the planning commission alliance a potent one.
Unlike Zysman, Mark Roe does offer a more explicit causal route from the politics of the individual corporate board room to the larger political sphere. Motivated by the law and economics literature’s focus on the conflict of interest between investors and executives of a corporation – the classic principle-agent problem – Roe posits that this gap, reproduced again and again on every corporate board, was wide enough to produce at least two separate capitalist groups or classes (executives and investors), and that the strongest proponents of these groups, the executives of large corporations and those of the powerful insurance companies, would carry the political fight forward for their respective side. Thus, big business squared off against New York insurers. How the fight would work depended on external factors such as how easily the interests of each group could ally with the most powerful political movements. The mechanism of interest generation, reproduction, and articulation, however, are clear.

One problem with Roe’s argument, unlike Zysman’s, is that the principle-agent mechanism, though powerful, is by itself too blunt an instrument for modeling the interests of capital. It is true that these problems, information asymmetries and other dilemmas of corporate ownership all create conflicting interests among executives and owners and should be included as starting points in any political analysis of governance reform. That much the economic debates made clear. But why those dilemmas dominate other ways of organizing the interests of corporate ownership politically (by industry, alternative governance traditions, etc.) is not obvious in Roe’s argument. If the implication is that such alternatives can be reduced to the same basic principle-agent dilemmas, that implication is no where illustrated by the argument.
On a deeper level, principle-agent problems are dependent on the very form of ownership that politics is meant to determine, making the analysis blind to alternative ownership forms. To be convincing, Roe’s argument would have to show why, historically and economically, the peculiar form of ownership that gives rise to serious principle-agent dilemmas was present to begin with. This is not just a question of when to begin the political genealogy. Rather, it hearkens back to the primary economic arguments of Hart and the transaction-cost advocates. The principle-agent dilemma depends on an exclusive, “imperial” conception of ownership and control, for if corporate ownership were structured otherwise, there would be no clear principles and no clear agents. Why American corporate ownership required such a form – if it did so – and thus gave rise to the exacerbated politics Roe describes, is left unanswered. Without the answer, the argument is simply incomplete – for there is no way to judge if those factors were still operating during the time Roe analyses.

One cause of both Roe and Zysman’s shortcomings,\textsuperscript{52} which stem primarily from the lack of a sufficient theory of ownership and thus from an insufficiently-elaborated relationship between organized capital and corporate governance, is the way both scholars model the relationship between politics and the economy. Both argue for the primacy of politics: economics determines what choices are available, but never which choices political actors actually make, thus dropping out of the political story altogether. In Zysman’s account, the existing alternatives of a bank- or broker-led finance system are given by flow of funds arguments, but only open-ended struggles and alliances among political groups determine which specific alternative is chosen and developed. In Roe’s
account, explicit economics enters even less into the picture: groups (investors, executives, etc.) are defined by the existing form of corporate ownership, but no suggestion is made that this form is the outcome of anything but previous political struggles among groups. The politics of corporate ownership is thus characterized as little more than a distributive struggle only indirectly connected to the actual economy.  

Roe and Zysman offer complementary accounts of how struggles over ownership – both over the political clout to allocate rights and resources and over the definition of ownership itself – shape financial institutions, the institutions of corporate governance and their relationship to industry. Each elegantly traces the reflexive relationship between ownership and politics. But to be truly convincing, each argument needs a more robust explanation of how ownership dilemmas at the corporate level get translated into the political organization of capital. Without such an explanation, each argument renders invisible the myriad of organizations, groups and interests that play important political roles in questions of corporate ownership but which are organized around economic concerns other than corporate ownership itself, such as industry associations, commerce chambers and trade councils. Nevertheless, this common shortcoming might be understandable, for it highlights the inadequacies of existing theories of ownership, as even Roe’s use of principle-agent theory illustrates. When it comes to modeling property forms, theories of ownership in their present form are all over-determinate, idealizing a single, “imperial” rights structure. To preserve the primacy of politics in determining the outcomes of ownership struggles, the political account requires an economic theory
ownership that could account on its own terms for more than this single, questionable ideal.

**The Argument**

This dissertation argues that substantial changes have occurred in Germany's system of corporate governance and ownership, but that contrary both to the common models of German consociational government and to models of German organized capital, the politics of this change is complicated, contradictory, arbitrary and fraught with pitfalls and instability. It is anything but orderly and qualifies the common image of the 80s as the decade of capital. The cause of these disorders, the dissertation continues, is a combination of severe economic pressures brought forth by reunification and by globalization together with a structure of different and competing governance traditions that made regulating corporate ownership at the national level by established methods extremely difficult if not, in several cases, impossible. Thus, both the institutions of corporate governance, on the one hand, and those of public governance, on the other hand, have undergone innovation. How stable or desirable the new ways of rule in both private in public spheres remain, the dissertation argues, depends directly on the link established between political groups representing factions within business and finance and the structure of corporate ownership and governance in the economy. This link, the dissertation suggests, is at best a tentative one.

To make its argument, the dissertation challenges the picture of historical continuity and uniformity of large firm governance in Germany as well as common assumptions about ownership and its role in organizing capital politically. Contrary to
this picture, the thesis elaborates several different and competing traditions of corporate governance in German economy. Offering a particular interpretation of transaction cost and property rights theories and building on the work of Gary Harrigel, the dissertation argues that these traditions are possible not only by political fiat, but also by alternative and equally valid ways of organizing production and its governance economically. Reproduced by traditions of law and economic practice, during times of economic stress these alternatives generate conflicts at the national level and, if the tentative link between economic and political dialogue can be maintained long enough, the raw fuel for institutional innovation. The relationship between the political organization of capital in groups and associations and its economic organization within corporations and industry, the dissertation argues, is the key to understanding the politics of corporate ownership in Germany, including how new traditions are born and how old traditions are renewed.

Transaction cost theories and related property rights approaches, it was argued earlier, externalize not only the solution to the problem of stability of ownership institutions, but the solution to the form of ownership institutions as well. The root of this problem is each theory’s tie to the ideal “imperial” rights structure previously described, a tie maintained for two reasons. First, each theory’s focus on efficient rights allocation favors the most alienable and precisely defined rights structure possible and reduces ownership forms to bundles of individually-conserved ownership incidents which must themselves adhere to the norm. Deviations from the norm become by definition political or “second-level” problems, such as enforcement, definition and other related costs. Second, each adheres to the argument that market imperfections arise from
conflicting rights or incidents (such as occurs in asset-specificity or complementarity cases), and that bundling ownership incidents solves such conflicts and remedies the market imperfections in question. For bundling ownership 1) removes resources (incidents) from appropriation by competing actors and places them under the control of a single, rational sovereign, eliminating the waste generated by conflict; and 2) places ownership bundles, by virtue of their coherence and lack of conflicts with other rights, in a market where they can be allocated efficiently. Ownership allocation and form are inseparable. In sum, allocative efficiency and the problem of the commons, given no countervailing forces, push ownership forms in the direction of bundled, imperial rights structures – or, in other words, the sovereign economic actor.\footnote{56} Forces that limit such sovereignty must come from outside the theory.\footnote{57}

If countervailing forces did exist, instead of a single predicted ownership form a range of ownership forms would emerge as theoretical possibilities. Alternative ownership forms would no longer be theoretic deviations, explained with higher order or external givens. Ownership forms in general would no longer be reducible to bundles of absolute incidents. And the role of government would no longer be restricted to limiting economic sovereignty (whether for good or bad).

It is the argument of this dissertation that economic forces do exist that counter the pressures toward bundled rights structures. Revisit first the problem of the commons. In addition to the problems of waste and dissipation that occur when no single sovereign can prevent rights incursion by others and thus overuse of resources, significant positive effects can accrue to common ownership. Some resources actually increase in value, for
example, the more they are used. Take languages, certain ideas and skills as examples. The more craftsmen use a certain skill reservoir, for example, the more that reservoir will be improved with time and the more valuable it will become. Far from enforcing barriers to use, more efficient rights structures would preserve such skills by preventing their capture by single actors so that they can be used as often as possible by the widest range of actors possible. In addition to resources that increase in value with increased generic use, other resources might increase in value with increased selected use. Take general purpose machinery, for example. A corporation that becomes more proficient at producing individual specialized goods the more it produces different types of specialized goods will find that the value of such machinery increases proportional to its diverse use. Instead of integrating customers and suppliers to avoid conflicting ownership incidents arising from complementary assets, the increased value associated with diversity of use would dictate the opposite course of action, avoiding asset integration and exclusive use. Despite the potential for conflicts, waste and hold-ups between customer and supplier, the potential value of increased selected use of assets could act to prevent integration.

In addition to gains from increased generic or specific asset use, other economic forces could act to countervail the allocative efficiency gains from bundled, non-conflicting rights structures. These forces arise from the information-sharing gains that sometimes accrue when actors are forced outside the market to bargain over the distribution and form of ownership or control. Under incomplete contracting, centralizing residual control to one party of a transaction could hinder information sharing between the parties. If the benefits of sharing information outweigh the costs of
haggling, however, then the parties involved will seek an incomplete ownership regime if it can ensure the sharing of such information.\textsuperscript{58} Simply put, the benefits of voice could countervail those of exit in a way that favors unclear or incomplete ownership states.\textsuperscript{59} It might be more efficient for a corporate board, for example, to cede periodically some of its control powers to an executive according to general criteria that require messy but detailed negotiations to evaluate than to retain them but fear the executives are withholding such information.\textsuperscript{60}

To sum up thus far, this dissertation argues against any economically-predetermined ownership forms but rather identifies several countervailing economic pressures that might influence the structure of ownership and governance. In addition to allocative efficiency and the waste and dissipation resulting from conflicting or common rights, economies from increased asset use, both general and specific, and information-sharing gains from forced bargaining all could influence the shape of ownership institutions and the direction of their change. How they do so depends on how corporations and the actors affected by the institutions of corporate governance organize their interests collectively, and how these interests are linked with the political forces that can effect such change.

The link between the private organization of capital in the governance and ownership of corporations and the political organization of capital in business associations, trade chambers and other lobbies is by no means a transparent one, and does not necessarily translate the economic pressures previously discussed into political pressures. Three factors complicate the relationship between the private and public
organization of capital: the law; history, and the economy. The law acts as both a medium of debate and discussion between capital and the state and as a separate, autonomous force that both must reckon with. By history is meant the weight of existing institutions and traditions of governance and business politics in structuring interests and outcomes. The economy, including the structure and practices of production, influences the formation, organization and modification of economic interests and, through experimentation, actual solutions to governance problems.

A major theme of the dissertation is the central place of law in the institutions and practices of corporate ownership and in the politics of their change and conservation. Law specifies the theoretic features of governance institutions, and given well-understood practical considerations law can specify the actual features as well. It is over law and its interpretation that many of the political battles in this dissertation are fought. In addition, law specifies many of the rules of the battles themselves. It is a primary, although not the only, language of ownership politics in that its more articulate speakers are better equipped to succeed in their struggles and objectives. Finally, law can structure ways the institutions of governance develop that are beyond the control of the political actors and economic actors, in ways that are anticipated and – as German history makes abundantly clear – in ways that are not. The demands for both formal and substantive consistency that Germany’s legal system places on governance institutions would act as a simple conservation mechanism were it not for the fractured nature of the business community. Because of the combination of diverging and conflicting governance traditions with
economic stresses, however, the law can act as a major source of tension and a flashpoint for innovation.

A second major theme of the dissertation is the role historical precedent plays in influencing subsequent institutional development and change. The inertia of governance rules and practices that perpetuate principles of ownership long since contradicted by the economic context is one important example. What explains this inertia is not obvious. In fact, what appears as the conservation of outdated institutions is sometimes an exercise in change and experimentation. Which interpretation of tradition is best depends on actors’ procedures for evaluating the performance of governance institutions. When no such procedures are in place, governance institutions will tend to persist unless outside shocks create powerful constituencies for change – and then change can be arbitrary or superficial. If such procedures do exist, then what appears as institutional inertia might be, in addition to well-functioning corporate government, slow or preliminary transformation.

A third major theme of the dissertation is the role that the structure of economic production, and actors’ efforts to re-organize production in the face of economic pressures from events such as globalization and re-unification, plays in structuring the politics of corporate ownership. It is the economy where the traditions of governance are directly lived, evaluated and reproduced. This dissertation primarily examines the exposed or competitive parts of the economy because it is how the German model copes with the economic volatility and competitive stresses that is one of its most interesting features. Besides traditions of governance, the German economy is populated with
variegated traditions of organizing production. The dissertation argues that included in these traditions are alternative ways of governance and organizing ownership. The problem of how to best organize production is a problem of governance and thus of ownership; alternative answers to the former question, whatever their origin, have alternative consequences for the latter question.

To summarize, the argument of the dissertation is that the practices of corporate governance in Germany have been transformed both before and after re-unification, and so have the practices of government regulating the relationship between big capital and the state. Three general factors have played key roles in these changes: legal procedures and interests, historical legacies, and economic changes. The system of peaceful coexistence and separate accommodation among different traditions of governance and ownership that had existed since the Kaiserreich has been undermined both by new, confounding governance forms and by a weakened framework of interest-group politics; the active locus of policy-making and dispute resolution has shifted; power and initiative has tilted away from organized capital toward the state.

It should be clear that the dissertation builds on much of the literature previously discussed but especially that on alternative traditions of production. In recognizing these traditions, together with the alternative ways of organizing politics associated with them, the dissertation takes the lead of Herrigel and other scholars. The aim is to further this work by elaborating the link between the formal governance of corporations and these traditions of politics and economy, and by modeling their renewal and transformation in contemporary politics. This is done by employing the economic arguments previously
introduced in an analysis of the links between the political and economic organization of capital. Such an analysis, the dissertation contends, reveals a much different portrait of the German model of political economy, and especially of the link between capital and the state. Instead of the model of organized capitalism or any of its derivatives, the picture of German capital that emerges is more fractured, weakened and often dysfunctional, on the one hand, and more dynamic and mercurial, on the other hand.

**The Strategy of the Dissertation**

To make its argument, the dissertation must demonstrate two points. The first is that Germany’s system of corporate governance and ownership has indeed changed since the 1980s. The second is that the politics of this transformation illustrate a change in the politics of corporate ownership in general, a key component of the relationship between state and capital at the heart of the German model.

Measuring the transformation of ownership structures in Germany is a notoriously difficult task. Objective quantitative data are rare and as a rule inconclusive. The twin difficulties of political polemics and competitive sensitivities make collecting the types of comprehensive data needed to show real changes in corporate governance and ownership nearly impossible. Nevertheless, because of both keen political interest and growing theoretical appeal, recent attempts to measure the features of Germany’s large-firm governance system and demonstrate differences either with the previous system or popular models of it have been many and superb. What these attempts succeed in demonstrating and what their improvement would require is therefore of immediate concern to the argument here and is the subject of the next chapter.
Because of the difficulties of quantitative analysis and because of the nature of the questions it pursues, this dissertation takes an historical and a comparative strategy to support its main theses. The argument about governance structures can only be made by demonstrating changes in the main institutional linkages between banks and firms, between individual investors and banks, between corporate owners and chief executives, etc. This requires considerable structural analysis of corporate governance institutions, as well as an analysis of the motives and strategies of the primary actors who act on and within those institutions, such as CEOs and board members. In order for the dissertation to be convincing, it must analyze the most important instances of governance reform and demonstrate how these instances have changed the practices and structures of control in question. If possible, it should pick instances that cover a broad ranges of governance institutions and regulatory arenas – but keep the focus of reform on one major object: corporations, including the rules that structure and distribute control over them.

The argument about politics likewise requires a structural and dynamic analysis – of the political relationships that shape the regulation and definition of corporate ownership and governance, and of the strategies and goals of the primary actors who shape those relationships. Such an analysis is also best accomplished with well-chosen, detailed cases of governance reform or attempted reform. As in the case with demonstrating changes in the structural corporate governance, the cases chosen must be important and representative. Unlike the case of demonstrating structural change during one common period (that from the early 70s to the present), the political argument must also rely on comparing successive processes of change across the same period, analyzing
the effect that the changes in private governance structures had on the public governance structures (if any), and visa-versa. The political argument can only be made compellingly once common patterns between the different cases can be compared and contrasted and the historical causes analyzed in each of the chapters – including reunification and globalization – are situated temporally.

Based upon these considerations, the cases chosen for the dissertation are meant both to be comparable in the sense of containing common objects and processes of analysis, and comparable in the sense of one setting the scene or contributing to the events and context of another. In this way the cases are like the chapters of a novel or the acts of a play, each explaining a drama on its own terms but unable to make sense of the action unless seen as a whole in the proper sequence.

The dissertation analyzes three major cases of governance reform: privatization in the new federal states; the creation of a new type of corporation in both East and West; and bankruptcy reform. The roles of the courts, government and ministries, parliament, industry associations and corporations themselves varies among each of the cases, as does the relative success or failure of the reform itself.

The dissertation starts with the case of privatization in the East, not because the reforms and events there started earlier than in the other two cases, but because they came to fruition earlier, and because they had important influences, direct and indirect, on both of the other cases. In the story of the politics of corporate ownership in Germany, the transition in East Germany was to the other, longer-spanning cases of reform like WWII was to the history of Germany in the 20th Century: the defining “exception” that
permanently shaped the rule. The next case analyzed by the dissertation is that of the creation of the management holding, a new type of corporation founded upon new types of rules and interpretations in the law and in the corporate practice. Shaped both by the macro-economic shocks of re-unification and the individual experiments in governance that privatization made possible, the management holding represents the most important German innovation in corporate governance over the last twenty five years. The management holding and re-unification both helped to revive bankruptcy reform and to bring it to a conclusion in 1994 after over fifteen years of arduous politics and debate. Bankruptcy reform, perhaps appropriately, is the dissertation’s last case.

One of the potential weaknesses of the dissertation’s methodological approach is the danger that object of reform, some dimension of corporate governance itself, is so different in each case that the comparisons across cases will be impossible at the micro-economic level, rendering the economic arguments impossible at the level of the firm and therefore leaving the dissertation’s response to the important economic arguments discussed earlier crippled. Without a micro-foundation, moreover, the larger political arguments would be weakened. Especially daunting seems the comparison of the problems of repairing or transforming individual elements of the governance system in the solidly-grounded West with an economically chaotic situation as existed in the former East Germany after 1990. If this comparison cannot be made, then the links between cases would be jeopardized.

To address this concern, the dissertation employs an important strategy. For each case of reform under question, it tracks the effect on and participation of a common
industry, the German machine tool industry. This is especially important in the comparison between privatization in the East and the creation of the management holding in the West. The machine tool industry was chosen for its small size (making research practical), its importance in the economy, its well-documented history, and its central place as a reference point in most work on the German model. Besides allowing the control of many economic variables in the comparison, the single industry thus provides the chance to track the historical development of the German corporate governance system because of the possibility of drawing explicit links between cases.58

Based on the arguments of the dissertation and on the comparative and historical approaches outlined above, the type of research required by the dissertation was multidimensional. A great deal of intensive interviews were required. Tracing the reform process in each case, and especially the actors’ roles in it, required interviews with officials from business and industry associations (including the that of the banks), the relevant ministries, with some politicians (where possible), with legal experts and scholars, and with activists such as members of the two stockholder reform associations and members of the Insolvency Commission discussed in Chapter 6. Many interviews were also conducted with bankers, including many from the big three, but also from the large public banks and some smaller merchant and investment banks. To properly cover the machine tool industry, interviews were required with over 10 CEOs and many more managers and engineers. At each of the firms visited, plant tours supplemented the interviews so that evidence of any changes in work organization could be noted. Moreover, interviews with officials from the different business organizations related to
machine tools were conducted. All told, over one hundred and twenty intensive interviews with bankers, politicians, ministry officials were conducted.

A great deal of library research was also required, for the quantitative, legal and historical dimensions of the dissertation. Archival work was not feasible and, in the opinion of the author, not required. The historical and legal work was done primarily over eight months at the University of Munich. The statistical work primarily involved gathering together all the known sources of data and quantitative analysis on corporate ownership, principally but not exclusively covering the last thirty years. Much of this work – including many of the best pieces – have been done in very recent years, and some was still in progress. Julie Elston organized a conference in the summer of 1994 at the Wissenschaftszentrum Berlin on the German model of bank-based governance that was especially helpful in this regard.

Altogether, the research utilized by the dissertation included over nineteen months of field work in Germany conducted over a time period of three years and including five separate trips. The research on privatization in the former East Germany was done during the summer of 1992, the winter of 1993-94, and the fall and winter of 1994. The research on bankruptcy, corporate board and proxy reform, and the creation of the management holding in the West was performed from the winter of 1994 through the summer of 1995. Separate trips to study bank-firm relationships and the German big banks specifically were taken in the spring and summer of 1994, in addition to work on that subject done during the summer of 1992.
Chapter Two evaluates much of the recent research on German corporate governance and the structure of ownership in the economy, especially among large firms. Chapter Three takes a look at one of the most successful yet controversial instances of governance reform, the case of East German privatization. Its focus is on the bank-firm relationship and the innovations produced in response to the failure of this relationship to function well in the circumstances of the former East German economy. Chapters Four and Five examine the successful creation of a new type of company and a new set of institutions of corporate governance and ownership that go with it: the management holding. Chapter Six analyzes the difficult and failure-ridden bankruptcy reform, begun in the late 70s, that was finally passed in 1994 amidst widespread insider disappointment despite its relative protection from popular controversy or intervention from the public. The reform helps lay bare the troubles seen in the other reforms with the apparatus of interest formation and political negotiation. These troubles, the last chapter explains, are consistent with long-run patterns in the relationship between organized capital and the state that, together with the observed changes in the actual practice of corporate ownership and governance, qualify the familiar models of German capitalism. The chapter goes on to posit an alternative view of the German state and speculates about the meaning this view could have for modern capitalist states in general.
Chapter 2

Change and Ambiguity in the German System of Corporate Governance: The Quantitative Evidence

What are the basic features of the German system of corporate governance? To what extent do quantitative data show that the classic bank-based model still holds, and to what extent not?

Debates in the United States over LBOs, investor activism and the weakness of the U.S. banking system; recent intensification of many German’s long-held suspicions of the power of the banks (Macht der Banken); and observations of changing banks’ behavior in cases of difficult restructuring have all spurred many economists’ recent efforts to measure the basic features of Germany’s corporate governance system quantitatively and with this data evaluate the classic claims about the German model of bank-led governance. A plethora of such studies and analyses have appeared in the last several years, creating as much controversy over corporate governance and ownership outside Germany as within. While some of the most comprehensive analyses purport to disprove the claims, others assert that data show strong proof of the model. The debate is a charged one, both politically and academically.

Unfortunately, collecting data on who owns and controls large corporations is notoriously difficult. Because information about corporate ownership and control is so sensitive politically and competitively, often what data can be collected remain
generalized and ambiguous. Regulatory bodies such as the Monopoly Commission have published excellent figures on the group of largest joint-stock companies as a whole, but failed to move beyond this to a more differentiated view of corporate control – such as grouping by legal form, share volume or type of large shareholder.\textsuperscript{71} It is these ambiguities, the chapter argues, that open the door to widely opposing viewpoints on how the German system of corporate governance works and how it is changing. Sifting through the evidence and comparing data from all available sources reveal a more differentiated, qualified view of the German model of big firm governance. Analysis of certain evidence shows that such refinement is not possible for some features of the model and leads to the recognition of how limited those data truly are, despite perpetual reference in current debate.

\textbf{Three Views of the German System of Corporate Governance}

In the debates over the German bank-based model of corporate governance, scholars commonly stake out one of three standard positions. The first is that the old model of bank-led governance\textsuperscript{72} has always been with Germany and is still largely valid today. The second is that this model was a myth in the past and continues to be a myth. The last position is that there once was a bank-based governance system, but that since the 1970s it has been greatly weakened or antiquated altogether.

\textbf{Die Macht der Banken}

Classic arguments about the power of banks on boards and in the general economy have always been a mainstay of the Left in Germany and continue to remain so today. Investor activist groups like the \textit{Schutzgemeinschaft der Kleinaktionäre}
(Association for the Protection of Shareholders) and the *Deutscher Verein fuer Wertpapierschutz* (German Securities Protection Club), as well as unions aiming to gain full parity representation on co-determined boards, the Social Democratic Party, the Federal Cartel Agency and many liberal economists, have strong ideological and material interests in exposing the supposed tight links between German banks and large corporations, and have ensured that the “power of the banks” be revived periodically in both public and private debate. What quantitative data support their arguments?

Those who argue that the banks exercise significant control in large firm governance have always pointed to the relatively large supervisory board presence of the big banks. One prime piece of evidence Hilferding used to support his thesis of finance capitalism in 1910 was the number of bank representatives on supervisory boards: the top six Berlin banks had a combined total of 751 such seats, the largest bank alone held 221.73 In the 1960s and 1970s, Andrew Shonfield and John Zysman used similar citations (see Table 1).

**Table 1: Bank Representation on Supervisory Boards**

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage/Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of Top 400 Companies:</td>
<td></td>
</tr>
<tr>
<td>Percentage of firms with bankers on Supervisory Boards:</td>
<td>79.5%</td>
</tr>
<tr>
<td>Number of bankers on Supervisory Boards:</td>
<td>570</td>
</tr>
<tr>
<td>Of 1480 Supervisory Board Seats in Top 100 Companies:</td>
<td></td>
</tr>
<tr>
<td>Total number of seats occupied by bankers:</td>
<td>145</td>
</tr>
<tr>
<td>Total number of chairmanships occupied by bankers:</td>
<td>15</td>
</tr>
</tbody>
</table>

In 1977 the Monopoly Commission reported numbers on board composition consistent with the thesis of significant bank presence on boards (see Table 2 and Figure 1). Its study found that of the top 100 firms, 75 had banks on their boards and fully
eleven of those that did not were foreign subsidiaries. A 1995 study critical of bank influence over German industry showed a similar picture (see Table 3). Each of the big universal banks had far more representatives on supervisory boards than any other actor or institution in the economy.

Table 2: Banks' Share of 1024 Total Supervisory Board Seats in Top 100 Companies

<table>
<thead>
<tr>
<th>Type of Bank</th>
<th>Seats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Big Three (Deutsche, Dresdner, Commerzbank) Seats</td>
<td>102</td>
</tr>
<tr>
<td>Regional and Private Bank Seats</td>
<td>57</td>
</tr>
<tr>
<td>Savings Banks Seats</td>
<td>17</td>
</tr>
<tr>
<td>Cooperative Banks Seats</td>
<td>3</td>
</tr>
<tr>
<td>Total Number of Bankers chairing boards</td>
<td>31</td>
</tr>
</tbody>
</table>

Figure 1: Banks' Presence on Supervisory Boards in Top 100 Companies in 1977.

Table 3: Bank Representation on Supervisory Boards in Sample of 110 of 500 Largest Firms in 1990

<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Companies without bankers on supervisory board</td>
<td>18</td>
</tr>
<tr>
<td>Number of companies with one banker on supervisory board</td>
<td>51</td>
</tr>
<tr>
<td>Number of companies with two bankers on supervisory board:</td>
<td>19</td>
</tr>
<tr>
<td>Number of companies with three bankers on supervisory board:</td>
<td>17</td>
</tr>
<tr>
<td>Number of companies with four bankers on supervisory board</td>
<td>5</td>
</tr>
</tbody>
</table>
In addition to the supervisory board numbers, critics of bank power have pointed out the high number of share votes exercised by the banks in large companies. Again, Monopoly Commission data show that of the top 100 companies, the big three banks exercise major blocks of share votes in over 50% of the cases, the majority coming from proxy votes (see Tables 4 and 5).

**Table 4: Bank Control of Equity Votes in Top 100 Companies in 1975, Part I**

<table>
<thead>
<tr>
<th>Size Bracket of AG</th>
<th>Number</th>
<th>Banks Own Vote</th>
<th>Bank Proxy Votes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 10</td>
<td>8</td>
<td>3.56%</td>
<td>63.48%</td>
<td>67.04%</td>
</tr>
<tr>
<td>11 to 25</td>
<td>6</td>
<td>6.10%</td>
<td>48.19%</td>
<td>54.29%</td>
</tr>
<tr>
<td>26 to 50</td>
<td>14</td>
<td>14.65%</td>
<td>25.03%</td>
<td>39.68%</td>
</tr>
<tr>
<td>51 to 100</td>
<td>28</td>
<td>13.52%</td>
<td>29.01%</td>
<td>42.53%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>56</td>
<td>7.28%</td>
<td>49.45%</td>
<td>56.73%</td>
</tr>
</tbody>
</table>

**Table 5: Bank Control of Equity Votes in Top 100 Companies in 1975, Part II**

<table>
<thead>
<tr>
<th>Size Bracket of AG</th>
<th>Number of Companies with Bank-Owned Equity Stakes greater than 5%</th>
<th>Average Percent of Share Votes Held by Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 10</td>
<td>8</td>
<td>59.14%</td>
</tr>
<tr>
<td>11 to 25</td>
<td>6</td>
<td>23.11%</td>
</tr>
<tr>
<td>26 to 50</td>
<td>14</td>
<td>20.39%</td>
</tr>
<tr>
<td>51 to 75</td>
<td>12</td>
<td>25.02%</td>
</tr>
<tr>
<td>75 to 100</td>
<td>16</td>
<td>21.33%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>56</td>
<td>35.87%</td>
</tr>
</tbody>
</table>

Finally, those who argue that German banks still exercise control over large corporations point to correlations of bank control with profitability, or lack of it, to make the point that the model is not simply statistical formalism, but has real consequences in the economy. The most widely cited study suggesting a correlation between bank-led governance and firms' profitability is John Cable's.76 Using weighted least squares (to correct for heteroskedasticity) and a panel of large firm data between 1968 and 1972,
Cable tested four variables for effects on profitability: banks' combined share voting rights, individual banks' presence on the supervisory board, the ratio of bank debt to total liabilities, and the dispersion of nonbank stakeholdings. In three separate equations, Cable found that all four variables were significant in one case, and that the supervisory board and nonbank stakeholding variables were significant in all three cases, although significant only to 10% in the equation with the other significant variables. The implication was that the bank-led system of governance was alive and well in Germany.\(^7\)

Recently, critics of bank control over corporations have mounted similar techniques to argue the opposite thesis, namely that bank control depresses corporate profitability. Perlitz and Seger's 1995 study, for example, found that when measured in several different ways,\(^8\) a group of 52 "low-influenced" firms performed better than 58 firms "highly-influenced" by banks in their sample of 110 large corporations (see Table 6). When crisis-ridden companies were factored out of the data (as these might be precisely the types of companies requiring bank-led governance),\(^9\) the picture did not change (see Table 7). In addition to lower profitability, bank-influenced firms were found to grow more slowly and have less aggressive market performance.

### Table 6: Profitability and Bank Influence Among 110 Large Corporations, 1991 to 1993

*Source: Perlitz & Seger (1995), Table 12, p.21.*

<table>
<thead>
<tr>
<th>Measure</th>
<th>Low Influence (52 companies)</th>
<th>High Influence (58 companies)</th>
<th>2-tailed significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Earnings / Stockholders Equity</td>
<td>7.56%</td>
<td>1.81%</td>
<td>8.10%</td>
</tr>
<tr>
<td>Net Earnings + Interest Expenses / Total Assets</td>
<td>5.21%</td>
<td>4.14%</td>
<td>5.30%</td>
</tr>
<tr>
<td>Net Earnings / Total Assets</td>
<td>3.39%</td>
<td>1.41%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Cash Flow / Total Assets</td>
<td>12.93%</td>
<td>10.01%</td>
<td>0.40%</td>
</tr>
<tr>
<td>Net Earnings / Revenue</td>
<td>2.40%</td>
<td>1.04%</td>
<td>0.60%</td>
</tr>
</tbody>
</table>
Table 7: Profitability and Bank Influence Among 105 Large Corporations, 1991 to 1993, "Crisis-ridden companies" Excluded


<table>
<thead>
<tr>
<th></th>
<th>Low Influence (51 companies)</th>
<th>High Influence (54 companies)</th>
<th>2-tailed significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Earnings / Stockholders Equity</td>
<td>9.43%</td>
<td>6.12%</td>
<td>2.40%</td>
</tr>
<tr>
<td>Net Earnings + Interest Expenses / Total Assets</td>
<td>5.36%</td>
<td>4.59%</td>
<td>11.60%</td>
</tr>
<tr>
<td>Net Earnings / Total Assets</td>
<td>3.60%</td>
<td>1.98%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Cash Flow / Total Assets</td>
<td>13.22%</td>
<td>10.67%</td>
<td>0.70%</td>
</tr>
<tr>
<td>Net Earnings / Revenue</td>
<td>2.60%</td>
<td>1.60%</td>
<td>0.40%</td>
</tr>
</tbody>
</table>

More rigorously performed tests indicate a negative relationship between profitability and bank control. One such test factored the stock market with the analysis, trying to meet the obvious objection that large listed firms were expected to have lower debt levels, higher profitability and higher risk – and that "bank-influenced" firms should thus be expected to be less profitable because of higher debt levels. The results of this test were surprising, and they lend strong ammunition to the critics of bank power (see Table 8). Not only were returns depressed, but risk was increased for firms with higher bank debt ratios – a contradiction of one of the basic principles of stock market valuation.

Table 8: Relationship between Bank Debt to Return and Risk in 416 Large Companies, 1991-1993

*Source: Schmidt (1995), Table 5*

<table>
<thead>
<tr>
<th></th>
<th>Spearman Correlation Coefficients*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bank Debt/Total Assets</td>
</tr>
<tr>
<td>1991</td>
<td></td>
</tr>
<tr>
<td>Mean half-year return on equity</td>
<td>-.1043 (3.3%)</td>
</tr>
<tr>
<td>Standard deviation (Risk) of half-year return</td>
<td>.2022 (1.0%)</td>
</tr>
<tr>
<td>1992</td>
<td></td>
</tr>
<tr>
<td>Mean half-year return on equity</td>
<td>-.1856 (1.0%)</td>
</tr>
<tr>
<td>Standard deviation (Risk) of half-year return</td>
<td>.1554 (1.0%)</td>
</tr>
<tr>
<td>1993</td>
<td></td>
</tr>
<tr>
<td>Mean half-year return on equity</td>
<td>-.1996 (1.0%)</td>
</tr>
<tr>
<td>Standard deviation (Risk) of half-year return</td>
<td>.1718 (1.0%)</td>
</tr>
</tbody>
</table>

*Two-tailed significance in parentheses.*
Perhaps the most thorough test of the relation between bank influence and profitability is that of Robert Chirinko and Julie Elston. They found that after controlling for a myriad of relevant macro-economic and financial variables and measuring the effects of bank debt, risk, and cash flow separately from three independent bank influence variables (level of bank ownership, relative strength of bank ownership scored as one if bank holds a majority or plurality of outstanding shares, and the Perlitz and Seger measure of bank influence), the effects observed by Cable either entirely disappear or are reversed. Ordinary least squares analysis, together with upper and lower bound estimates, revealed absolutely no statistical relationship between profitability and the measures of bank influence based on direct ownership but significant negative effects of Perlitz and Seger’s measure on profitability, seemingly confirming Perlitz and Seger’s results (see Table 9). Moreover, the same analysis confirmed the negative relationship between bank debt and profitability.

**Table 9: Relationship between Bank Influence and Bank Debt to Return on Equity in 270 Companies between 1965 and 1990**

*Source: Chirinko and Elston (1995), Table IX.1.*

<table>
<thead>
<tr>
<th></th>
<th>OLS Coefficient</th>
<th>Significance Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of Bank Ownership*</td>
<td>-0.0939</td>
<td>&gt;25%</td>
</tr>
<tr>
<td>Relative Strength of Bank Ownership*</td>
<td>-0.3075</td>
<td>25%</td>
</tr>
<tr>
<td>Perlitz &amp; Seger's Bank Influence Variable*</td>
<td>-1.35</td>
<td>1%</td>
</tr>
<tr>
<td>Bank Debt**</td>
<td>-7.825</td>
<td>12%</td>
</tr>
<tr>
<td>Share Volatility (Risk)**</td>
<td>-0.9875</td>
<td>7%</td>
</tr>
</tbody>
</table>

*Each Estimated in Separate Equations  **Estimated with Perlitz and Seger Variable*

Believers in the bank-led model of German corporate governance agree that this model exists and point to evidence of supervisory board representation and equity rights control for support. Although German critics and American advocates of the model disagree over the direction of its effect on profitability, the strongest quantitative analyses
from panel data on large German corporations seem to support the former. Despite ambiguities over the issue of profitability, both sides agree that the German model of bank-led governance is strongly supported by existing quantitative evidence, as it has been for years, and that this evidence includes measurable consequences of the model in the economy itself.

**The Doubters**

Recently, a group of scholars began to cast serious doubts on the German model of bank-led governance and on the data that seems to speak for it. They argue not only that the studies on supervisory board representation, proxy voting, and profitability should be qualified, but that additional data on bank debt and ownership point to considerations quite different than the bank-led model of governance would imply. The bottom line of these critics is the idea that there really is nothing extraordinary about large firm governance in Germany.

The data that cast the most serious doubt upon the existence of a bank-led governance system are those on large firms’ sources of finance, especially bank debt. Edwards and Fisher’s 1991 and 1994 analyses lead the way. From Bundesbank flow of funds and capital account data, Edwards and Fisher calculated that between 1950 and 1989, German firms used an average of three to four times internally generated funds for financing investment as they did bank debt. Net of all bank deposits, this figure increases to a remarkably high six to seven times, or an average level of 11.7% (see Tables 10 and 11).
Table 10: Net* Sources of Finance for Investment, Producing Enterprises


<table>
<thead>
<tr>
<th></th>
<th>1950s</th>
<th>1960s</th>
<th>1970s</th>
<th>1980s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internally-generated funds</td>
<td>75.4%</td>
<td>74.1%</td>
<td>71.3%</td>
<td>80.1%</td>
</tr>
<tr>
<td>Provisions for pensions</td>
<td>3.2%</td>
<td>2.0%</td>
<td>4.3%</td>
<td>4.9%</td>
</tr>
<tr>
<td>Capital transfers from government</td>
<td>1.2%</td>
<td>4.0%</td>
<td>7.9%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Bank borrowing</td>
<td>11.8%</td>
<td>13.4%</td>
<td>12.0%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Bonds &amp; Shares</td>
<td>4.2%</td>
<td>3.1%</td>
<td>0.2%</td>
<td>0.4%</td>
</tr>
</tbody>
</table>

*Net of Financial Sources & Investments

Table 11: Gross* Sources of Finance for Investment, Producing Enterprises


<table>
<thead>
<tr>
<th></th>
<th>1950s</th>
<th>1960s</th>
<th>1970s</th>
<th>1980s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internally-generated funds</td>
<td>64.1%</td>
<td>62.6%</td>
<td>55.6%</td>
<td>61.7%</td>
</tr>
<tr>
<td>Provisions for pensions</td>
<td>2.7%</td>
<td>1.7%</td>
<td>3.3%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Capital transfers from government</td>
<td>1.0%</td>
<td>3.4%</td>
<td>6.1%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Bank borrowing</td>
<td>17.5%</td>
<td>19.2%</td>
<td>20.8%</td>
<td>15.7%</td>
</tr>
<tr>
<td>Bonds &amp; Shares</td>
<td>5.3%</td>
<td>4.4%</td>
<td>2.8%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

*Including Financial Sources & Investments

Using OECD accounts data, Edwards and Fisher show that Germany actually has lower corporate debt levels than the United Kingdom – the standard of comparison against which the bank-based governance model is usually set (see Table 12).

Table 12: Comparison of Net and Gross Sources of Finance in Nonfinancial Companies in the UK and Germany, post-1970


<table>
<thead>
<tr>
<th></th>
<th>Net*</th>
<th>Gross</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (1970-1989)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internally-generated funds</td>
<td>76.0%</td>
<td>58.8%</td>
</tr>
<tr>
<td>Bank &amp; insurance loans</td>
<td>11.0%</td>
<td>19.0%</td>
</tr>
<tr>
<td>UK (1970-1987)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internally-generated funds</td>
<td>87.9%</td>
<td>59.9%</td>
</tr>
<tr>
<td>Bank &amp; insurance loans</td>
<td>15.4%</td>
<td>27.2%</td>
</tr>
</tbody>
</table>

*Net of Financial Investments & Assets

Not only do these numbers seriously challenge the notion of close bank-firm ties in the present, but they do so over the entire post-war period. The levels of internal
finance and bank borrowing fluctuate, but show no signs of steady change in any direction. In light of these data, it is hard to accept that a bank-based model of governance in Germany existed at all since the war; when the data set is narrowed to large manufacturing firms, the debt levels in German firms shrink even more (see Table 13).

Table 13: Weighted Avg. Net and Gross Sources of Finance for Investment by Manufacturing AGs, 1971-1985

<table>
<thead>
<tr>
<th>Source</th>
<th>Net*</th>
<th>Gross</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internally generated funds</td>
<td>88.1%</td>
<td>61.9%</td>
</tr>
<tr>
<td>Provisions for pensions</td>
<td>14.7%</td>
<td>10.4%</td>
</tr>
<tr>
<td>Bank loans</td>
<td>-2.7%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Bonds &amp; External equity</td>
<td>10.6%</td>
<td>7.5%</td>
</tr>
</tbody>
</table>

*Net of Financial Investments & Assets

Without the allegedly high debt ties to firms, any model of bank-based governance would be cast into doubt. To make this doubt stick, scholars have attacked the other source of direct financial commitments between banks and firms: ownership ties. Stock ownership in Germany since WWII has been anything but dispersed. Based on a calculation of ownership of underlying corporate assets, the Bundesbank calculates that households have owned less than 30% of corporate equity after the war, and that this number has fallen in recent years (see Table 14).

Table 14: Ownership of Shares Assets
Source: Bundesbank Monthly Reports, 1990

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Households</td>
<td>28.1</td>
<td>29.8</td>
<td>21.1</td>
</tr>
<tr>
<td>Nonfinancial Enterprises</td>
<td>35.7</td>
<td>36.9</td>
<td>43.0</td>
</tr>
<tr>
<td>Banks</td>
<td>7.0</td>
<td>7.6</td>
<td>10.4</td>
</tr>
<tr>
<td>Insurance Enterprises</td>
<td>3.6</td>
<td>4.0</td>
<td>8.8</td>
</tr>
<tr>
<td>Government</td>
<td>13.6</td>
<td>9.3</td>
<td>4.6</td>
</tr>
<tr>
<td>Foreigners</td>
<td>12.0</td>
<td>12.4</td>
<td>12.1</td>
</tr>
</tbody>
</table>
In a study on equity stakes in large German firms, Iber finds that not only do dispersed shareholders own fewer shares in German corporations, but large stakeholders own equity stakes in a very high number of large corporations (see Tables 15 to 17). If anything, this tendency has only been strengthened over time since the war.

**Table 15: Percentage of Listed AGs by Large Shareholders**  

<table>
<thead>
<tr>
<th></th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than 75% Stake</td>
<td>22.1</td>
<td>32.3</td>
<td>38.9</td>
</tr>
<tr>
<td>Between 50% and 75%</td>
<td>33.6</td>
<td>31.1</td>
<td>26.6</td>
</tr>
<tr>
<td>Between 25% and 50%</td>
<td>29.1</td>
<td>29.3</td>
<td>22.9</td>
</tr>
<tr>
<td>Between 1% and 25%</td>
<td>3.2</td>
<td>2.3</td>
<td>5</td>
</tr>
<tr>
<td>Under 1%</td>
<td>12</td>
<td>5</td>
<td>6.6</td>
</tr>
</tbody>
</table>

**Table 16: Percentage of Nominal Equity Value of Listed AGs by Large Shareholders**  

<table>
<thead>
<tr>
<th></th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than 75% Stake</td>
<td>13.6</td>
<td>17.4</td>
<td>17.7</td>
</tr>
<tr>
<td>Between 50% and 75%</td>
<td>26</td>
<td>21.2</td>
<td>20.3</td>
</tr>
<tr>
<td>Between 25% and 50%</td>
<td>21.6</td>
<td>28.7</td>
<td>25.1</td>
</tr>
<tr>
<td>Between 1% and 25%</td>
<td>9.3</td>
<td>9.5</td>
<td>15.4</td>
</tr>
<tr>
<td>Under 1%</td>
<td>29.5</td>
<td>23.3</td>
<td>21.5</td>
</tr>
</tbody>
</table>

**Table 17: Percentage of Market Value of Listed AGs by Large Shareholders**  

<table>
<thead>
<tr>
<th></th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than 75% Stake</td>
<td>13.1</td>
<td>24.3</td>
<td>17.9</td>
</tr>
<tr>
<td>Between 50% and 75%</td>
<td>22.7</td>
<td>19.3</td>
<td>16.9</td>
</tr>
<tr>
<td>Between 25% and 50%</td>
<td>24.7</td>
<td>28.5</td>
<td>32.2</td>
</tr>
<tr>
<td>Between 1% and 25%</td>
<td>11.2</td>
<td>9.2</td>
<td>16.5</td>
</tr>
<tr>
<td>Under 1%</td>
<td>28.3</td>
<td>18.7</td>
<td>16.6</td>
</tr>
</tbody>
</table>

Comparing the market value figures in Table 17 with the nominal equity value in Table 16 and the absolute numbers in Table 15 reveals an additional point: while the very largest, public companies (those with the highest market value) have increased their public or dispersed shareholder pools with time, most AGs have not done so and in fact have done just the reverse – consolidating ownership structures in a way that resulted in the most concentrated equity stakes consistently and rapidly *climbing* since the early
1960s. Despite this broadening of the investor clientele for the largest firms— including market value of shares – the number of small shareholders decreased in every category.

The bottom line is that with the exception of only some of the most prominent large firms, Germany is a land of concentrated corporate ownership. Who owns these stakes?

In Tables 18 through 20, Iber gives the answer, based on data collected by the Bundesbank and the German Statistical Yearbook.

**Table 18: Percentage of Listed AGs by Type of Large Shareholders**


<table>
<thead>
<tr>
<th>Type of Shareholders</th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Families</td>
<td>26.7</td>
<td>23.8</td>
<td>22.6</td>
</tr>
<tr>
<td>Non-financial Enterprises</td>
<td>6.9</td>
<td>11.1</td>
<td>11.3</td>
</tr>
<tr>
<td>Government</td>
<td>8</td>
<td>8.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Foreigners</td>
<td>7.7</td>
<td>9.7</td>
<td>11.3</td>
</tr>
<tr>
<td>Banks</td>
<td>4.3</td>
<td>8.5</td>
<td>8</td>
</tr>
</tbody>
</table>

**Table 19: Percentage of Nominal Equity Value of Listed AGs by Type of Large Shareholders**


<table>
<thead>
<tr>
<th>Type of Shareholders</th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Families</td>
<td>15</td>
<td>8.9</td>
<td>6.9</td>
</tr>
<tr>
<td>Non-financial Enterprises</td>
<td>5.5</td>
<td>7.9</td>
<td>7.1</td>
</tr>
<tr>
<td>Government</td>
<td>10.3</td>
<td>11.3</td>
<td>12.9</td>
</tr>
<tr>
<td>Foreigners</td>
<td>6.6</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Banks</td>
<td>1.6</td>
<td>2.3</td>
<td>2.5</td>
</tr>
</tbody>
</table>

**Table 20: Percentage of Market Value of Listed AGs by Type of Large Shareholders**


<table>
<thead>
<tr>
<th>Type of Shareholders</th>
<th>1963</th>
<th>1973</th>
<th>1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Families</td>
<td>10.2</td>
<td>7.6</td>
<td>6.4</td>
</tr>
<tr>
<td>Non-financial Enterprises</td>
<td>3</td>
<td>7.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Government</td>
<td>11.4</td>
<td>8.7</td>
<td>8.9</td>
</tr>
<tr>
<td>Foreigners</td>
<td>9.1</td>
<td>14.5</td>
<td>9.2</td>
</tr>
<tr>
<td>Banks</td>
<td>1.2</td>
<td>4.5</td>
<td>3.3</td>
</tr>
</tbody>
</table>

These percentages\(^{86}\) show that in addition to the high number of family-owned stakes in the smaller AGs, and the government-owned stakes in companies like the
national railroad and telecommunication firms, banks own a significant but by no means
dominant stake in German corporations when compared with other shareholders, such as
other companies, both foreign and domestic. In fact, in terms of shares’ market value, the
banks own half the equity other German companies do, and less than a forth the amount
when foreign firms and funds are considered. In absolute terms, the banks own a higher
percentage of stakes than market value would indicate (just about a third that of other
corporations and foreigners). Nevertheless, the numbers show that the banks by no
means own a large amount of equity – although when they own it, they tend to own large
stakes.87

The Monopoly Commission data and the Chirinko and Elston study discussed
earlier corroborate the implication of the Iber numbers that banks play relatively minor
roles as actual owners. Tables 4 and 5 show the relatively low levels of bank equity
stakes in the largest 100 firms (although the levels for the middle tier of 100 firms are
higher than average). The Chirinko and Elston study’s two direct bank ownership
variables, when tested against corporate profitability, return as insignificant and wrong-
signed. Together, these data could indicate that the banks invest in equity stakes only
passively for reasons other than playing an active role in corporate governance (see Note
12.) This is exactly the position taken by the National Association of German Banks
about the reasons for banks’ large stakeholdings.

Precisely at this point in the analysis, Edwards and Fisher’s data play a crucial
role; without direct ownership links, the only other motive banks would have to play a
leading role in corporate governance would be through their debt relationships. And yet
the evidence shows that corporations’ debt ties with banks are relatively weak. Armed with these results, Edwards and Fisher, and many other critics, have proceeded to cast doubt on the relevance of the two facts of German bank-firm relations cited most frequently by the *Macht der Banken* position: supervisory board representation and proxy voting rights. Without the financial motivation to actively monitor the large corporations, why would banks do so?

Supervisory board membership is much less conclusive than the classically cited data might suggest. Studies show, for instance, that the relevance of supervisory boards in the governance of large corporations is less than assumed by stockholders and the public at large; most boards meet only the required two times a year, and there is much evidence that managers of the company frequently leave supervisory board members in relative ignorance of the operational details needed to properly monitor performance and assess strategy.\(^8^8\) Detailed analyses of the composition of supervisory boards and their behavior show that as with direct ownership of equity stakes, banks are severely outnumbered on German boards by other corporations (see Table 21), suggesting yet again that the dominant force in large-firm governance in Germany are the large firms themselves.

In addition to the gross composition of supervisory boards, Table 21 reveals the correlation between ownership and supervisory board representation. While less than half of corporate board members do not have ownership ties to the corporations they supervise, fully 69% – over two-thirds – of banks do not. Unlike other corporations, most banks with ownership ties do not hold majority stakes. The evidence thus shows
that bankers are more like consultants – the majority of whom lack ownership ties – than other companies and individuals with strong financial motives to control or direct the governance of the corporations. Using regression analysis of Monopoly Commission data, Edwards and Fisher confirm in their study that direct bank ownership, bank proxy voting, and bank participation on boards are highly uncorrelated. In the case of the Deutsche Bank, coefficients of the former two variables acting on the latter are not significantly different from zero.\textsuperscript{89}

**Table 21: German Supervisory Board Membership of 2068 Seat in Large AGs.**

*Source: Gerum, Steinmann & Fees (1990), Table D-3, p. 48.*

<table>
<thead>
<tr>
<th></th>
<th>158 Firms with Boards of 12 Members</th>
<th>55 Firms with Boards of 16 Members</th>
<th>68 Firms with Boards of 68 Members</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Stockholders</td>
<td>88</td>
<td>17</td>
<td>12</td>
<td>117</td>
</tr>
<tr>
<td>Stockholder Associations</td>
<td>11</td>
<td>8</td>
<td>13</td>
<td>32</td>
</tr>
<tr>
<td>Companies with more than 50% Ownership</td>
<td>138</td>
<td>64</td>
<td>69</td>
<td>271</td>
</tr>
<tr>
<td>Companies with 50% Ownership or Less</td>
<td>74</td>
<td>51</td>
<td>43</td>
<td>168</td>
</tr>
<tr>
<td>Companies without any Ownership</td>
<td>163</td>
<td>75</td>
<td>144</td>
<td>382</td>
</tr>
<tr>
<td>Banks with more than 50% Ownership</td>
<td>5</td>
<td>9</td>
<td>1</td>
<td>15</td>
</tr>
<tr>
<td>Banks with 50% Ownership or Less</td>
<td>34</td>
<td>34</td>
<td>24</td>
<td>92</td>
</tr>
<tr>
<td>Banks without any Ownership</td>
<td>124</td>
<td>38</td>
<td>71</td>
<td>233</td>
</tr>
<tr>
<td>Government Officials with Ownership</td>
<td>24</td>
<td>50</td>
<td>167</td>
<td>241</td>
</tr>
<tr>
<td>Government Officials without Ownership</td>
<td>6</td>
<td>5</td>
<td>20</td>
<td>31</td>
</tr>
<tr>
<td>Foreign Companies</td>
<td>82</td>
<td>19</td>
<td>20</td>
<td>121</td>
</tr>
<tr>
<td>Ex-CEOs</td>
<td>38</td>
<td>22</td>
<td>26</td>
<td>86</td>
</tr>
<tr>
<td>Consultants</td>
<td>161</td>
<td>48</td>
<td>70</td>
<td>279</td>
</tr>
<tr>
<td>TOTAL</td>
<td>948</td>
<td>440</td>
<td>680</td>
<td>2068</td>
</tr>
</tbody>
</table>

Banks’ proxy voting powers, in contrast to their supervisory board roles, are not overshadowed by other forces in the economy, but are undeniably the highest for any single type of institution in the economy. Here, the troubling question for the German model is why proxy voting power is uncorrelated with supervisory board representation and ownership stakes. Although in several corporations – especially the largest and most
prominent – the banks exercise both proxy votes and supervisory board powers, in even a larger number of firms they fail to join the two. Even if they did, moreover, the lack of direct ownership or debt ties to these corporations remains a curious qualification of the model, for such ownership would not only enhance their control powers, but motivate them to be successful in their roles – unless those roles were truly not the type envisioned by believers in the classic bank-based model.

The Transformation of Corporate Governance?

Both the pro- and contra-German model positions view history as a constant, and tend to see the post-war system of German corporate governance in static terms: either bank-based governance exists or it doesn’t. In the wake of recent controversies and in accordance with the growing post-unification popular perception that the German economy has been transformed, for good or not, some now take a third position: that the bank-based model, once present, has declined or disappeared since the onset of slowdown and crisis in the 1970s.90 The primary data used to support this claim are those on large corporations’ self-financing behavior. Edwards and Fisher’s source of funds calculations, according to this view, reveal the weak loan ties between large corporations and banks, but fail to adequately track how these developed over time; their internal financing numbers (recall Tables 10, 11, and 13) are misleading.

Internal financing can be calculated in many ways (see Figure 2).91 Depending on the definition of internal finance, the view of corporations’ relationship with banks changes dramatically. If write-offs (counted as government transfers by Edwards and Fisher) are excluded from the analysis, then self-financing becomes a cyclical
phenomenon and one that relates inversely with the performance of the economy. During crisis periods, large corporations would become more dependent, not less, on outside monies, thereby making the banks stronger. Likewise, if self-financing is calculated in terms of a measure of total assets, then it will also fluctuate cyclically due to price volatility in underlying physical assets. If a base standard of total revenues is used instead, then self-financing numbers tend to flatten over time, because when revenues are low, so are the profits that can be reinvested, and when profits and funds for investment climb, so will revenues.

Figure 2: Self-Financing Monies of All Producing Enterprises
Source: Rossbach (1990), p. 106

The argument of those who see the German model of corporate governance weakening over time is that of the many possible measures mentioned above, only self-financing monies as a percentage of gross investment is the one that counts in terms of the bank-firm relationship. Even if large corporations still carry long-term debt on their
balance sheets, if they decrease their use of bank monies for new investment, then over time their dependency on the banks will also diminish. It would be misleading to discount write-offs and other sources of government finance from the analysis, because these funds are just as important as profits in offsetting the need for bank finance. Measured properly, self-financing data reveal one striking fact: since 1970, corporations have dramatically reduced their need for outside funds in Germany, regardless of the state of the macro-economy. In fact, not only have overall self-financing monies increased, but corporations' overall financial assets have also, despite price volatility and the decrease in total corporate equity associated with inflation and economic downturn (see Figure 3).

**Figure 3: Financial Assets and Liabilities of All Producing Enterprises.**
*Source: Rossbach (1990), p. 102.*

![Figure 3: Financial Assets and Liabilities of All Producing Enterprises](image)

If the data set is narrowed to manufacturing firms, the picture becomes even starker (see Figure 4). Focusing only on net interest payments (the difference between
interest on loans and interest on deposits), the numbers show a dramatic across-the-board
decrease in industry’s use of loan finance, with the notable exception of the declining
steel and coal industries. Because industry’s bank deposits are taken into account, the
numbers are netted. But unlike Edwards and Fisher, they are netted in such a way to
place more weight on loan finance than bank deposits, reflecting the differential in
interest rates as a real corporate cost associated with maintaining the relationship with a
bank.

**Figure 4: Net Interest Payments by Producing Enterprises, by Industry**
*Source: Rossbach (1990), pp. 129-134.*

In addition to debt relations, ownership and supervisory board representation data
strengthen the view that the banks’ role in the governance of large corporations has
decreased over the last 30 years. Regarding the former, the most notable statistic is the
rapid reduction in supervisory board chairmanships controlled by the banks. Comparing
Tables 1 & 2, from the Medley and Monopoly Commission data alone, one can observe a
19% drop (from 179 to 145) of the number of bankers on supervisory boards between the
years of 1975 and 1983 alone. More important, the decrease in the number of supervisory board chairs held by banks dropped a remarkable 50%, from 31 to 15. Comparing Medley’s 1983 figures of 570 bankers in the top 400 firms with Gerum, Steinmann & Fees’ numbers of 340 bankers on the boards of 281 firms, one sees that in the period after this initial drop, the number of bankers on supervisory boards dropped from 1.42 to 1.21 between 1983 and 1990 – another 15% drop. Seen as a whole between 1974 and 1990, then, one observes a significant fall in banks’ supervisory board presence (estimated above 30%) – despite, as Edwards and Fisher pointed out, the lack of individual correlation between bankers’ supervisory board representation and financial or control relationships such as ownership and proxy voting. In addition, one observes a fall in critical supervisory board posts: the chairs.

Finally, since 1970 there have been changes in banks’ ownership of shares and stakeholdings – although the measures here are less comprehensive or convincing. Using Iber’s numbers in Tables 18 to 20, one can calculate that although there was a slight rise in the percentage of nominal equity held by banks, the absolute percentage of firms in which banks held equity stakes and the percentage of share market value of such equity stakes reflect a decrease in bank ownership of corporations by 6% and 27% respectively between 1973 and 1983. In the years thereafter, data on ownership are hard to find. From Bundesbank data and from Edwards and Fishers’ numbers in Tables 10 and 11, one observes an increase in banks’ overall ownership of shares, although these numbers do not say anything about concentrated equity stakes – the relevant figures cited by Iber – and could very well reflect an increase in banks’ dispersed shareholdings. Perhaps more
relevant about changes in overall ownership of shares is the steep increase in corporate share ownership by 17% to almost 50% of all shares between 1960 and 1988. Increased corporate ownership, even if it is dispersed, reflects a strengthening of financial power on the side of firms, and indeed, Iber's data show that much of the increase was in stakeholdings and reflects an even greater increase in financial leverage. From the banks themselves, finally, come data indicating an overall decrease in equity stakes: Ulrich Schroeder, a banker from the Deutsche Bank, claims that between 1976 and 1989 the big banks sold 40 large (i.e., over 10%) industry participations while acquiring only three. By 1989, these banks held stakeholdings of 25% or more in only 2% of the top 500 German companies.92 The Federation of German Banks reports that between 1976 and 1989 the percentage of total nominal capital held by banks in all nonfinancial joint-stock companies (AGs) and private limited companies (GmbHs) dropped by over 50% from 1.3% to 0.6%.93

Taken together, the self-financing, ownership, and control data all point to a significant increase in large firm autonomy since the 1970s -- an increase not expected within the framework of the classic bank-based model, and not explained by the critical arguments of those like Edwards and Fisher. Figures 5 and 6 provide additional indicators of such autonomy: on average, by 1991, large firms used several different banks simultaneously, and openly flaunted the traditional house-bank relationships, if not subverting such relationships altogether by installing their own intra-corporate banks themselves (see Figure 5).94 With such leverage, it is easy to see why they successfully
negotiated debt contracts that, relative to other firms, offered far riskier assets as collateral (see Figure 6).

**Figure 5: Number of Firms with Multiple Bank Relationships**  
*Source: Braun (1991).*

![Bar Chart](chart1.png)

**Figure 6: Number of Loans (Outer Ring) and Share of Loan Volume (Inner Ring) by Type of Collateral**  
*Source: Drukarcky (1985).*

![Pie Chart](chart2.png)
Reconciling the Data and Discriminating Among Alternatives

The three viewpoints introduced previously present themselves in debate as mutually exclusive alternatives: either the German bank-based system of governance exists, or it does not. If it no longer exists, either it once did exist and does no longer, or it never existed in the first place. Yet, each of these viewpoints cites important data in its favor, for which neither alternative has an explanation. The fact remains that the majority of shareholder votes in the top 25 companies are controlled or represented by the banks, despite data that show such control in decline over time for all large companies. The observations that self-financing ratios have increased substantially, and that debt levels have remained both constant and comparatively low since the 1960s, are likewise true, despite quite different and apparently conflicting implications. How does one reconcile the data if the positions they support cannot be reconciled?

The answer lies in discriminating among different types of firms together with different types of governance. When apparent contradictions arise among available data, they do so usually because the data being compared describe different groups of firms – usually a broad group versus one or more subgroups. If care is taken to distinguish among these groups, then not only does the magnitude of the contradictions in evidence recede, but so does the theory in question. Each theory describes different spheres in the world of German corporations. Although to recognize the marked heterogeneity of German governance practices reveals large gaps in existing data that any comprehensive, unambiguous account of the economy would have to bridge, such recognition also makes the politics of corporate governance much more intelligible by identifying the constellation of groups and interests that compete and participate in these politics.
Discerning these groups and how they changed over time reveals the extent of change a corporate governance system can sustain, and uncovers the illusion of stasis and the empirical confusion that sustains this illusion in current debate.

**Ownership & Control: Widely Held vs. Tightly Held AGs**

Which German firms, if any, fall under the aegis of the classic bank-based model of German corporate governance? In their 1995 study, Perлиз and Seger identified two groups of large firms distinguished by various measures of bank influence: direct ownership, proxy voting, and debt levels. Table 22 shows just how many large companies fall into the bank-influenced group according to each of these criteria.\(^{95}\) Within each category, the number is about a fifth, with the exception of proxy voting, where the group of “bank-influenced” companies might reach 30%.

![Table 22: Two Groups of German AGs and their Relative Size](source)

```
<table>
<thead>
<tr>
<th>Percentage of Companies:</th>
<th>All Bank Equity Participations</th>
<th>All Bank Proxy Votes</th>
<th>Total Debt Over Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>none</td>
<td>76%</td>
<td>35%</td>
<td>19%</td>
</tr>
<tr>
<td>&lt;10%</td>
<td>5%</td>
<td>19%</td>
<td>37%</td>
</tr>
<tr>
<td>10% to 24%</td>
<td>9%</td>
<td>15%</td>
<td>22%</td>
</tr>
<tr>
<td>25% to 50%</td>
<td>7%</td>
<td>10%</td>
<td>22%</td>
</tr>
<tr>
<td>&gt;50%</td>
<td>2%</td>
<td>19%</td>
<td></td>
</tr>
</tbody>
</table>
```

The size of the group of firms that meets any one of these criteria, 52%, was noticeably higher than the 20% to 30% figure for any one category, an indication of a considerable lack of correlation between these criteria – an observation already made by
Edwards and Fisher in the previous discussion. However, this lack of correlation has less to do with the weakness of the German model of corporate control than with the reality that most German firms – including large AGs – have few or no public shareholders. Table 23 shows just how few listed companies (those with any public shareholders) and actively traded companies (those with a high number of public shareholders) there are in Germany: the former make up only 21% of joint-stock companies, and the latter only 1.4%. That is, fully 80% of all AGs are without public shareholders, and of the remaining 20% a high number have shares that are unattractive to dispersed public shareholders because of their decreased liquidity.

Table 23: Number of German Firms, 1983  
Source: Deutsche Bundesbank Monthly Reports, Nov. 1984

<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Number of German Firms</td>
<td>~2,000,000</td>
</tr>
<tr>
<td>Private Limited Companies (GmbHs)</td>
<td>~400,000</td>
</tr>
<tr>
<td>Partnerships</td>
<td>~100,000</td>
</tr>
<tr>
<td>Public Limited Liability Companies (AGs):</td>
<td>2,118</td>
</tr>
<tr>
<td>Listed AGs</td>
<td>442</td>
</tr>
<tr>
<td>Actively Traded AGs</td>
<td>~30</td>
</tr>
</tbody>
</table>

The lack of correlation between share ownership and proxy-voting powers illustrates this division between public and nonpublic AGs. For one group, the banks can rely on their proxy-voting powers to maintain their position. Figure 5 shows the level of bank influence in the largest 24 companies with a majority of public shareholders. For this relatively small group of prominent companies, the banks (together with their affiliated companies) represent fully 84% of shareholders in stockholder meetings, where stockholders can exercise control, an undisputedly dominant position. Perlitz and Seger
confirm the relationship between bank proxy-voting power and the percentage of public shares. The equation

\[
\text{total bank proxies} = 1.4\% + 69\% \times \text{number of public shares}
\]

was significant to the 1% level.\textsuperscript{96} Although it is true that large shareholders exist for several large public companies – such as Kuwaiti interests in Daimler Benz – these investors cannot stand up to the power of the banks, illustrated in Figure 8.\textsuperscript{97}

**Figure 8: Shareholder Representation in Stockholder Meetings of Largest 24 AGs with >50% Public Shares.**

In contrast to public companies, large shareholders dominate the much more extensive group of tightly-held joint-stock companies. According to Table 15, fully 55.7% of listed joint-stock companies had majority shareholders in 1963 and *this figure had risen to 65.5% by 1983.* Because this includes companies with large publics and no majority shareholders by definition, the figure is undoubtedly much higher for nonpublic
listed companies. Table 23 demonstrates that the ratio of AGs without a significant shareholding public (one less than 50% of outstanding shares) is under 1/3 if one makes the reasonable assumption that public investors who allow the banks to vote proxy do so for all of their shares. Exclude these firms from the analysis in Table 15, and the number of companies in the remaining group of companies – listed companies with a small or nonexistent public – with a majority of shareholders that climbs to well above 90%. There is no reason to assume a different percentage for unlisted companies.

If the banks wish to maintain influence over governance of any of the large group of closely held AGs, then they must rely on different mechanisms than proxy-voting, and, above all, the direct ownership of shares. Table 18 shows that only a small subgroup of these joint-stock companies are controlled by banks, and, when compared with Tables 19 and 20, that on average these bank-controlled companies are smaller when measured by capitalization. Among listed companies, only 4.3% of large (not majority) shareholders in 1963, and 8% in 1983, were banks. Other private actors rose from 41.3% in 1963 to 45.2% in 1983 – ten times the level of banks in 1963, falling to five times that level in 1983. Although the Monopoly Commission numbers in Table 5 show an even distribution of bank-owned stakeholdings by size in the top 100 companies, CONTROLLING STAKES are owned by the banks in a far smaller group of relatively smaller firms. 98 It is no wonder: mounting the number of shares needed to significantly influence the governance of a firm would be extremely costly, because it would normally require purchasing a majority stake – an extremely risky action. In cases where banks lacked the majority vote, it was likely that another entity held more votes than they did, meaning
that banks were still not the dominant shareholder. This demonstrates that such non-majority stakeholdings might be better viewed as financial investments, not investments in control and influence.99

Over time, the Iber data in Tables 18 to 20 might seem to indicate that the banks have increased the number of large company stakeholdings: the percentages of bank-owned equity seemed to double between 1963 and 1983, no matter how Iber measures them. As mentioned, the ratio of banks as large shareholders to (private) nonbank shareholders has also doubled over the same period. However, the impression that banks have dramatically increased their controlling interests in corporations over the very post-crisis period, as some argue, is misleading. For one, the data in question only stretch to 1983; indeed, between 1973 and 1983 there was a slight drop in the bank numbers. The Iber data cannot confirm whether or not the banks increased their sale of equity stakes in the 1980s or 1990s. More important, the data cannot say whether other stakeholders increased or decreased their own stakes in public corporations. Because the German stock market rose in volume by multiples during the ten years after 1973, such data would be critical in evaluating bank influence in firms today.

Another reason the data in Tables 15 to 20 might appear misleading is that they hide the true distribution of ownership within the firm or across firms. Scores of 8 to 8.5% in Table 18 imply a relatively high degree of bank ownership in at least a small group of firms (8 to 8.5% representing at least 12.8 to 13.8% of the firms with any large shareholders at all). But because the data on type of large shareholders are in no way correlated with those on size of stakeholding, it is impossible to tell the size of the bank
shares. Compared with the Monopoly Commission data from 1978, it might appear that
the stakes are modest – averaging no more than 15%. But again, averages do not reveal
how ownership is actually distributed from firm to firm. Unless most firms were grouped
at the average, it is simply impossible to tell whether the 15% is an average of several
firms with banks as their majority shareholder grouped with a large number of firms
without bank shareholders. Over time, high share turnover could signify a shift from a
bank strategy of a few high stakes to one of many smaller stakes. For example, when the
percentage of listed companies with banks as large shareholders doubles but the
percentage of listed company market value quadruples, as is the case between 1963 and
1973, the change might mean one of two things: either the banks kept old stakes and
bought a whole new set of stakes in larger, more highly valued companies; or they simply
reinvested more money in the stock market but less of it in large equity stakes. Again,
the Iber and Monopoly Commission numbers cannot discriminate sufficiently between
these possibilities.

All the two data sources seem to definitively reveal is that the banks had no large
stakeholdings in fully 92% of the firms sampled in Iber's 1985 data. The implications
of this fact are disturbing. When 92% of listed companies lack banks as stakeholders, it
means that the banks' combined stakes are on average extremely high – too high, in fact.
If one assumes that the average equity level per firm from the Monopoly Commission
data of 11.7% for the entire 100%, subtracting 1% for all the equity owned below the 1%
level that counts in Iber's data as a large shareholder, and then multiplying this number
(10.7%) by the ratio of 11.5 to 1 (92% to 8%) firms without any large bank stakeholdings
at all, we get a figure of well over 100%. This indicates one of two possible conclusions. First, the assumption that the patterns of ownership in the top 100 firms sampled in the Monopoly Commission report would hold for the entire set of nearly 550 listed companies might be false. In other words, the banks held abnormally high stakes in several of the largest corporations when the 11.7% figure was measured by the Monopoly Commission.\textsuperscript{101} Second, the high level of calculated bank ownership might indicate that between 1978 (Monopoly Commission data) and 1985 (Iber data), banks truly did decrease the average level of owned equity (it would have to be by entire multiples to be realistic). Although this might seem to contradict Iber’s data, because he only measures stakeholdings and not absolute equity ownership there is a possibility this is true.

Indeed, the idea that banks began reducing their share ownership in the mid to late 1970s is borne out by other observations, as previously discussed.\textsuperscript{102} These data showing a marked reduction in direct share ownership, especially of stakeholdings over 25%, indicate that this group of bank-influenced firms is indeed shrinking.\textsuperscript{103} It is interesting to note, moreover, that in addition to the size and number of the bank stakeholdings, the relative economic importance has also decreased: the firms in which the banks hold their large stakes are mostly confined to the unexposed sectors, such as retail, wholesale, and construction. This is in marked contrast to the majority of large AGs, which on average derived 28.8% of their revenue in exports when the data were measured in the Monopoly Commission report – a percentage that represents fully 52.5% of the nation’s exports.

To sum up the results of the analysis, the puzzle of the lack of correlation between ownership and proxy-voting powers can be solved by classifying bank-influenced firms
into two distinct groups: one of widely held public firms, most of which fall under considerable bank sway; and another of tightly held companies, a small and decreasing number of which are influenced substantially by the banks. The governance of each group of companies is founded on distinctly divergent principles, as is the way the banks participate in that governance. While the former group of widely held companies include some of the largest and most prominent German firms, most large companies fall into the latter group of companies with large – and usually majority – shareholders.

**Debt: Distinguishing Legal Forms**

The AG, although the quintessential legal type of the large firm, is not the only form that large firms take in Germany. What is more, by whatever dimension one measures the prominence of the AG – number of companies, total revenue, or total capitalization – neither is it the dominant form in the economy as a whole. As later chapters demonstrate, the diversity of legal forms of corporate ownership is a major cause of the political and economic dynamics that spur the development of large-firm governance in Germany. The analysis here, however, turns to another consequence of this variety of forms: the misleading nature of global financial statistics in Germany.

In their analysis of historical trends in German corporate governance, Edwards and Fisher employ Bundesbank flow of funds data to show that since the 1950s, the level of debt, as well as the level of self-financing, among German corporations has remained relatively constant. This implies little change in the bank-firm relationship. But, as Figures 9, 10 and 11 demonstrate, underneath this picture of stasis, dramatic changes occurred in the types of firms and types of governance relationships.
Although the number of AGs, both listed and unlisted, remained relatively constant over the last forty years, the number of private limited companies – the Gesellschaften mit beschränkter Haftung (GmbHs) – increased dramatically. With this increase, the relative size of economic activity and corporate capitalization of the GmbH also increased, forcing down the relative amount of capitalization of all other types of companies and doing the same to percentage of total generated revenue in the economy, with the exception of the AG, which remained relatively constant.
Figure 10: Percent of All Corporations' Capitalization by Legal Form.

Figure 11: Percent of All Corporations' Revenue by Legal Form.

Because the flow of funds data average debt flows and debt levels of all these different types of companies, they are poor indicators of the types of debt relationships normally associated with the German model of bank-led governance (large-firm relationships, as well as Mittelstand relationships) when underlying changes in the relative composition and weight of these alternative forms of enterprise are occurring in
the economy. As a rule, GmbHs are not only smaller, but carry a much higher debt load than AGs. This is due to their much lower capitalization, not only absolutely but relative to their volume of business (see Table 24). Over time, the gap between the capitalization of AGs and GmbHs has increased, although the rate of capitalization per unit revenue has converged because of the rapid reduction in GmbH size (revenue per company).

Moreover, because GmbH shares are not easily tradable – and often not tradable at all – their ownership structure is far less open to outside investors than AGs. These facts result in two separate statistical problems.

**Table 24: Relevant Size and Capitalization of Companies by Legal Form of Enterprise (Normalized Scales)**

*Source: Edwards & Fisher (1994), pp. 77, 80, 84; own calculations.*

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit Capitalization per AG / KGaA</td>
<td>0.510</td>
<td>0.938</td>
<td>1.541</td>
<td>2.718</td>
<td>3.36</td>
</tr>
<tr>
<td>Unit Capitalization per Listed AG / KGaA</td>
<td>1</td>
<td>1.887</td>
<td>3.449</td>
<td>6.345</td>
<td>8.621</td>
</tr>
<tr>
<td>Unit Capitalization per GmbH</td>
<td>0.015</td>
<td>0.029</td>
<td>0.034</td>
<td>0.025</td>
<td>0.029</td>
</tr>
<tr>
<td>Unit Revenue per AG</td>
<td>1</td>
<td>1.271</td>
<td></td>
<td>1.290</td>
<td></td>
</tr>
<tr>
<td>Unit Revenue per GmbH</td>
<td>0.081</td>
<td>0.033</td>
<td>0.010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unit of AG / KGaA Capitalization per Unit Revenue</td>
<td>1</td>
<td>2.378</td>
<td>5.110</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unit of GmbH Capitalization per Unit Revenue</td>
<td>0.361</td>
<td>2.054</td>
<td>5.789</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

First, flow of funds data that show relatively constant debt levels of all enterprises during a period of enormous expansion of the number of GmbHs could easily hide a reduction in debt levels in AGs that is offset by the higher total debt levels attributed to the increasing numbers of GmbHs. The data simply cannot say one way or the other, despite Edwards and Fisher’s attempt to use them in this fashion. Any historical data on debt levels would have to be better targeted at large firms, especially manufacturing firms, in order to validate theses about stasis in debt relations advanced by Edwards,
Fisher, and other economists who argue in their vein. Unfortunately, such specific data is rarely consistent, considering how changes in individual firms complicate panel data, and how global accounts data are measured historically in Germany (by the Bundesbank for the purposes of monetary and regulatory policy).

When Edwards and Fisher narrow their data from the producing sector in general to manufacturing firms in particular, they move from a dynamic data set measured periodically over each decade since the 1960s to one that averages accounts together for the entire period between 1970 and 1985 (see Tables 10, 11 and 13) – falsely conveying the idea that debt levels were low or self-financing levels were high for the entire period in question. Without the focus on manufacturing, however, the data are so diluted by the weight of smaller firms and those in government, service, and other sectors (whose behavior is conceivably far different) that extracting meaningful results about the German model of large firm governance becomes challenged.

Second, ownership data such as those presented by the Federation of German Banks are likewise tainted by the same averaging problem. When the BdB cites the statistic that bank ownership of shares in producing enterprises has fallen by over 50% between in early 1970s and late 1980s, they fail to account for the fact that the amount of equity capital accounted for by GmbHs in which the banks find it very difficult, if not impossible, to invest has risen by nearly 50%, as Figure 9 makes clear. With no filters, the global numbers simply cannot guarantee that ownership levels in the type of medium-sized to large firms in question have truly fallen. The difficulty is compounded by the
types of problems in calculating or inferring bank ownership from other existing data sets, as discussed above.

When distinguished by basic legal types, the broad, stable averages defenders of a thesis of stasis in the German model use to support their position melt away. In their place arises a different history of broad swings in the composition of corporate debtors, together with dramatic changes in the underlying financial character of their relationships with the banks. It is simply impossible to assume that global statistics, such as flow of funds data, can portray even minor aspects of true dynamics of corporate governance in Germany. To do so would require much more refined historical data, differentiated especially by size and legal form, which no one in the debates has yet used and which is very likely unavailable. Tracking corporate debt relationships in a way meaningful to theory is rendered difficult if not impossible by the coarseness of existing data.

**Summary**

Of the classic pillars of the German model of large firm governance – debt, equity (both direct and proxy ownership), and board representation – each statistically plays a major role in shaping the allocation and exercise of corporate control. The bank-led model of governance *does* exist in Germany; however, the model is severely limited by the diversity of actual governance practices in the economy, and, moreover, in important ways has been in decline over the last 25 years. Banks hold most of the control rights for widely held companies. These companies, though stable, are a small but prominent group in the German corporate world. For the more extensive class of closely held corporations, or those without a large shareholding public, the banks hold controlling
shares in only a minor subset of companies, and since the crisis in the 1970s and increased exposure to global markets in the 1980s, this smaller subset has declined in size and prominence in several ways. Banks have sold many of their large stakes. Companies have become far less reliant on outside finance for investment and now use a variety of banks to fill their needs. And those firms owned by the banks are in primarily non-exporting industries and have found their roles diminished as the economy becomes more exposed.

Analysis of the existing evidence on the German model shows how each position in the debate over the German model is right for some part of the German governance system. but wrong in its application to any one “German model.”104 There is no single German model, but rather several different models: one of widely held companies; another of closely held but bank- and outside investor-influenced companies; another of closely held private companies; several more of all of these latter types of companies but in private limited rather than joint-stock form, and so on. The implications of this diversity are not only significant for banks and other investors who participate in the governance of these firms, or for scholars trying to characterize that participation, but for the politics of maintaining and adapting the rules of corporate governance in general. This includes the adjustment of the relationship between organized capital and the state as forces in the economy put the mix of governance forms under stress, as subsequent chapters will demonstrate.

Of course, the data introduced in this chapter offer no means to evaluate how such politics proceeds. Further, they offer no definitive evidence of how corporate control is
actually relegated and exercised in practice, only indications of how it might be. A bank might hold 60% of proxy votes but be unwilling or unable to exercise these rights independently from management. Finally, the existing data offer no way to evaluate the relative influence that factors such as the globalization of markets and production, increased economic volatility, and geo-political shifts such as the reunification of Germany, might have on either the politics of adjustment, or the machinations of actual governance practice and innovation. These questions can only be answered by detailed analysis of the important cases of governance reform – and failed reform – that have marked the German economy over the past several years. That is the task of the remainder of the dissertation.
Chapter 3

Investment and Ownership in a Volatile Economy: The Transition in East Germany

However exceptional, the problem of transition in East Germany has had a lasting impact on the Federal Republic and might have permanently discredited what was once called, by both Germans and non-Germans, the German Model. In order for West Germany to preserve its much-acclaimed institutions, re-unification had to be a rapid and successful *Gleichschaltung* of East German ways, practices and rules. And yet initial popular and expert expectations that such a feat could be accomplished had become dramatically disappointed – despite enormous accomplishments – only a few years after the falling of the wall. This proved especially the case for the transformation of corporate governance and ownership in East Germany, together with the relationship between capital and the state upon which such a transition was predicated.

Though in retrospect the surprising collapse of markets in the East and the unexpected crisis in investing firms' home markets in the West seem to have loomed over an initially promising economic transition like a guillotine, these shocks are not sufficient reasons for the faltered transition. Careful examination of events since 1989 shows that public and private actors' strategies for transforming East Germany into a rapidly-growing market economy failed during the initial economic boom, before the recession came crashing down on the Eastern states' recovery in 1993.
The changes in government and governance practice that resulted from the transition, its disappointments and actors’ efforts to adjust to them have affected every subsequent case of governance reform in the West. It is therefore appropriate that the study of corporate governance reform in Germany start with the case of the East German economic transition.

This chapter outlines the common assumptions held by the German government about the transition and the conditions for its success and describes the policy strategies of the Treuhand and Federal Government that these ideas justified. It analyzes the important relationship between organized capital and the government, including the expectations both had about their respective roles during the economic transition. The chapter then shows how major adjustments of those expectations led to important changes in that relationship. Changes to the institutions of corporate governance and ownership in the East, the chapter argues, resulted both from unanticipated difficulties with privatization in the volatile economic environment there and from adjustments to the political relationship between capital and the state to which they gave rise. The chapter illustrates these findings with the privatization of the machine tool industry and several other cases of corporate creation and restructuring in the East.

**Privatization: The Plans**

From the beginning privatization – the institution of private economic governance – was thought to be the grand key to creating an investment boom in the East and rapidly converting old assets into a modernized capital stock. Regardless of where they stood on issues of the timing of transition, of fiscal and monetary concerns, or even of political
solutions to the East German transition, most participants in the great debate over East Germany and its move away from Realsozialismus agreed that industry would have to be privatized and that, to be efficient, the East German economy would have to be organized with the same relationships that were thought to structure West German markets – above all, those that constituted the West German corporate governance system. In fact, though in large part driven by electoral political considerations, and though these considerations required a break from practices of consultation and iterated improvement or negotiation that had characterized policy formation up until reunification, the ideas that shaped privatization generated remarkably weak opposition from those groups most critical to their successful implementation: business, finance, and the majority of the West and East German electorates.

Re-unification was the act that conceived and gave birth to privatization, and re-unification determined its speed and form. After the falling of the wall, the East German government together with the SED began a rapid and chaotic process of democratization that ended in their own dissolution. On December 1, 1989 the East German parliament passed an amendment dropping the phrase “under leadership of the working class and its Marxist-Leninist Party [the SED]” from the opening definition of the state in the DDR constitution. Proposals were floated for the first time for the restoration of the five federal states that had existed in the DDR prior to 1952. On December 7th the famous Round Table was formed which brought officially-sanctioned groups like the SED and the East German CDU together with groups from the opposition like the Independent Women’s League, the Citizen’s Initiative (Buergerbewegung), and the Gruene Liga in
order to discuss plans for a transition from the old Stalinist system, including a wholly new state constitution. On December 23rd the SED was renamed the PDS after a special party congress from two weeks previous that had resolved to develop a truly democratic socialism. By February 20th, parliament had passed a resolution for free elections for the 18th of March, in which twenty four parties and party-like groups would participate.

Democratization, however differently intended, freed the way for re-unification. Few of the East German groups were in favor of speedy re-unification. However, the openness of the Round Table and of the March elections made it possible for powerful West German groups and actors to exercise their influence over the East German electorate and even over the process of elite transformation. Already on November 28th Helmut Kohl had introduced a 10 point plan for re-unification to the Budestag that had won approval from the CDU and the SPD. With the East German CDU and his own foreign policy forays as platforms, Kohl launched a number of measures designed to seize political initiative and persuade Germans – especially East Germans – of the desirability of rapid re-unification. In February, Kohl’s CDU began its successful campaign to frame the elections as a referendum on re-unification by annexation (Article 23). On the 12th of April, 1990 a coalition agreement was reached among the East German CDU, FDP and SPD calling for the timely re-unification of the DDR with the BRD and the expeditious negotiation of treaties with the BRD that would make social and economic union immediate and forthright. The ball was clearly in Kohl’s court. By May 18th the “Treaty for the Creation of a Monetary, Economic and Social Union” (GEMSU) had been signed,
which went into effect July 1st. It was this treaty that laid the basic parameters governing the privatization.

Bonn's strategy for effecting re-unification relied above all on speed and persuasion of the necessity of speed. While any number of procedures might have been chosen for forming policies affecting re-unification, the government held closely to a practice of unilateral initiatives and minimal consultation with outside groups. Over six weeks before the March election, Kohl announced his intention of negotiating a currency and economic union with the DDR. A week later when Minister President Modrow visited Bonn, Kohl elaborated the offer, and by February 20th a BRD-DDR expert commission had convened to discuss its broad features. Instead of passing laws, Kohl chose to enact treaties which the Bundestag and Bundesrat could only oppose by rejecting in full – a highly unlikely action. Normal parliamentary procedures, including the decentralized and thorough negotiation process in parliamentary committees, ministerial councils and closed and open hearings, were scuttled in favor of direct talks with the fewest number of interlocutors. Party leaders consulted with one another in exclusive meetings. Details of the treaties were penned by small working groups within or between the ministries, and then negotiated only on major points (such as the currency conversion ratio) by senior government officials. Because the expertise and initiative was so clearly held by Bonn, differences between the East German and West German sides became less important to re-unification policies than did differences between the SPD and CDU positions, and even these were limited by the weak position of the SPD in the DDR
government's coalition, which held enough sway to block constitutional amendments but not normal majority votes.

As a critical piece of its overall re-unification strategy, Bonn favored a rapid and complete privatization program and used its political momentum together with its procedural initiative to ensure that such a course was chosen. German industry – including the Federation of German Industry (BDI) and the Federation of German Banks (BdB) – was also in favor of a thorough privatization program but was unsure of the way in which and the speed at which it should be executed. Many executives and financiers were unsure of the costs rapid re-unification, together with rapid privatization, would impose on the economy; in addition, some were fearful of the competitive pressures that might result from introducing large productive capacity in the East into their home markets. But in contrast to other major economic policy initiatives, these fears mattered little to the course of events. Faced with cautious position papers by the BDI and a brewing debate over the costs, speed and terms of reunification that threatened to ally parts of big business with the opposition, the Bonn government acknowledged but did not heed the concerns of big industry and instead sought and found another partner it could use to publicly bolster its position and give it theoretical and ideological coherence to boot: the economist.

In the debate of gradual transition to the market vs. the rapid or “shock” conversion to the market, main-stream economists, both German and foreign, clearly sided with the former. In theory, the "transition" in the East simply meant instituting a new set of market legal codes -- those general "rules of the game" or
Rahmenbedingungen that constrain the economy in an optimal fashion by maximizing the exchange possibilities between individuals. The best way to encourage investment in East Germany would be to adopt West German market rules. Thus, under the rubric of optimal allocation of existing property and adoption of efficient market governance structures, most economists viewed privatization as simply the creation of Western-style ownership forms like the modern joint-stock company and their installation via some type of enlightened bidding process. Janos Kornai, for instance, equated privatization with replacing rules that support bureaucratic hierarchies with those upholding individual rights, private property, free entry and exit, and competition -- what he named "the foundation of market co-ordination forms." The transition process should be a Gleichschaltung of legal structures to new forms that optimize the links between the incentives and performance of both managers and workers by maximizing the ability of individuals to engage in transactions with each other. Anything less than such a Gleichschaltung would misalign incentives and produce inefficiencies.

Privatization thus required creating both bankruptcy procedures and corporate law that would provide the basic legal framework governing corporate ownership. Instituting the joint-stock company and other ownership forms that make managers responsible to owners without due hold-ups, however, would be insufficient for efficient private governance. From the market economics perspective, the necessary counterpart to new forms of firm ownership is a functional capital market. A board of directors or lead management will not maximize firm performance without the watchful eye of investors who, by replacing members, by selling their stock and driving down equity value, by
waging proxy fights, and/or by renegotiating security provisions, can punish the board for poor decisions or reward managers for successful action. Without an efficient capital market, the process of "selection" by which the most able leaders of a firm buy out those less able would be hindered. The auctioning/negotiating process would fail and capital would be allocated inefficiently. Performance and ownership incentives would remain mis-aligned.

Therefore, inasmuch as the efficiency of "private" corporate forms depends upon the character of the capital markets in which they operate, the market economics model necessarily required institutions that properly organize competitive capital markets. In 1990 Jefferey Sachs, whose views the Bonn ministries respected, wrote that the importation of various Western-style financial groups would create the financial institutional structure needed for successful privatization: "Privatization means creating anew the basic institutions of a market financial system, including corporate governance of managers, equity ownership, stock exchanges, and a variety of financial intermediaries, such as pension funds, mutual funds, and investment trusts. Economists debated and continue to debate exactly which financial intermediaries provide the best relationships with firms in East Europe continues to be a much-debated subject. But whether a voucher system, a system of mutual funds, bank-mediated financial markets, or a stock market of widely dispersed share-holders, the thrust of the model was the same: in order to promote investment and motivate management, the state should provide a legal framework that encourages competitive behavior among investors and financial institutions.
On this point the German government had no uncertainties, however, for economists frequently classified the financial institutions of the Federal Republic among the most well-functioning in the world. Interestingly enough, this characterization was made by both advocates of open markets of corporate control and those who viewed such markets as an anathema to economic growth. Both groups praised the German universal bank system, which allows banks to take large equity stakes in corporations and sit on their boards of directors. While advocates of corporate control markets viewed this concentrated shareholding power as a low-cost means to organize owners against errant management (and overcome the free-rider problem that makes such action costly in dispersed markets), those who remained skeptical of take-over gains turn this argument on its head and stress how the banks shield management from short-term fluctuations in the stock market and therefore grant firms the option to enter into systems of long-term contracting. Both groups agreed, however, that the strength of the German banking system lay in its ability to overcome the problems of dispersed ownership that plague countries like the US and Britain while also retaining firms’ independence from political interference.

In fact, as the German government explored economists’ views on privatization, it found that scholars cited the German banking system as a model for newly developing and transition economies. At the time, Sachs wrote:

... the Eastern European countries should create a legal and institutional environment in which financial intermediaries play a more active oversight role than is typical in the United States and United Kingdom... As a first step toward strengthening the hand of the financial intermediaries, the Eastern European economies should aim to develop universal banking, as in Germany and Japan, where commercial banks hold stakes in corporate assets and play active roles in the oversight of enterprises. The new banks
should place representatives on the corporate boards of directors, and strengthen their capacities to participate in the restructurings of troubled firms... As a second step toward strengthening the oversight by financial intermediaries, newly created mutual funds and pension funds should be encouraged to appoint representatives to the boards of directors of enterprises in which they hold shares, and to create the institutional capacity to monitor closely a large number of firms.\textsuperscript{108}

Such characterizations together with the wide-held belief in the big banks’ power historically made them appear well-suited to the tasks of economic reconstruction and development central to the privatization effort. Economists and policy-makers alike imagined that once present in the East, the banks would face problems similar to the ones they were convinced the banks had overcome in the past, including supervising the restructuring of big enterprise, spearheading large-scale investment, and coordinating economic modernization. Had not the banks played a key role in the “shock” transition to the market in 1948 and the economic miracle that followed it? The German government, moreover, was convinced that an alliance with the big three in the East would help deflect political criticism sure to arise out of the social upheavals from large-scale reorganizations. The mitigation of such pressures would allow Bonn to proceed all the more rapidly down the path toward privatization.

In sum, driven by a re-unification strategy of speed and annexation, and bolstered by the views of most economists, the German government set out on a course of economic transition in the soon-to-be new Eastern states by privatizing the East German economy as rapidly and completely as possible. Privatization was to be a \textit{Gleichschaltung} of governance rules and institutions. Three sets of institutions were important to the transition: financial markets and the banks, bankruptcy procedures, and the formal governance procedures themselves. Of these, the role of the banks was
anticipated as the most critical. Although for reasons of expeditiousness industry and the banks had been consulted infrequently and insincerely as the government initially formed its grand strategies for the transition, as economic union neared and the task of privatizing industry loomed closer, Bonn planned to reverse these ways and elicit the active participation and cooperation of finance and big business. What were its strategies for doing so, and how well did they succeed?

**GEMSU: Gleichschaltung of the System?**

The government’s plans to transform the governance system and set the stage for a speedy and successful privatization was twofold. It consisted of a strategy first to place the East German economy under the same legal regime – including the rules and procedures of bankruptcy and corporate government – as existed in the West. Already a central feature of the initial re-unification effort, the government did not welcome and in fact spurned the suggestions of finance and business for accomplishing this part of the transition. In contrast, it encouraged their full participation in its second strategy, which was to transform the financial institutions themselves, together with the actors whom it envisioned would play the key roles of corporate oversight and restructuring once privatization was actively underway.

The first strategy was to change the broad regulatory framework governing corporate ownership and finance. In general, the idea was to simply replace East German company law, banking and bankruptcy codes with the relevant West German laws. Thus, as a first step in March 1990 East Germany passed the Gesetz über die Änderung des Gesetzes über die Staatsbank der DDR, which replaced the Eastern one-tier banking
system with a two-tier organization compatible with the West; this change, it was hoped, would help initiate the desired economy-wide *Gleichschaltung* of financial institutions.\textsuperscript{109}

The old *Staatsbank*’s monopoly on financing domestic industrial firms and the old *Deutsche Aussenhandle Bank*’s monopoly on financing export firms and foreign currency trade were broken. Instead, the field was open for competition between banks for both corporate and consumer clients. On 1 July, three months later, laws introducing the German Economic, Monetary and Social Union (GEMSU) replaced the old Ost-Mark with the West German Mark at rates near 1:1. The liabilities and assets of all firms and private households were transformed into hard currency debts and credits. In Article 2 of the GEMSU agreement both East and West German governments guaranteed all contract, economic, occupational and competitive freedoms and promised to harmonize all laws and rules governing these freedoms.\textsuperscript{110} The foundation of harmonization was laid in August 1990 by the signing of the Unification Treaty: the former DDR would become five *Länder* under the same federal legal code and under the same Basic Law. The same bankruptcy regime would exist in both East and West. The same laws would constitute corporate ownership and the rules of governance on boards in both East and West. Finally, the same rules, institutions, authorities and money simply governed banks in both East and West. As a striking symbol of the change, the *Bundesbank* erected its Eastern Headquarters in the old Central Committee building of the SED (Communist Party) in East Berlin.

Under the surface of this successful transformation, however, the relationship between capital and the government had been strained. On several GEMSU issues
important to the private sector the government had only cursorily acknowledged
proposals and concerns voiced by the BDI, the BdB and other industry organizations.
The most dramatic example, and one which over four years later officials within the BDI
continued to cite as a great step backward in its own relationship with the government,
was the treatment of the Bundesbank over the issue of the conversion ratio for currency
union. Between March and July 1990 a great debate erupted over this ratio. A low
conversion ratio would hurt the savings and purchasing power of Germans in the East but
curb inflation and give firms a stronger balance sheet. A high conversion ratio would do
the opposite. Naturally, as the constitutional authority over monetary policy issues, the
Bundesbank repeatedly attempted to assert prerogative over the issue, seeking
consultations with the government if not a downright mandate to determine the ratio
itself. But the government rejected its overtures and in the end made the decision itself as
part of its treaty negotiations and explicitly apart from any mere policy. To boot, it chose
in favor of a very high 1:1 ratio against the conservative lower ratios suggested by the
bank. To Bundesbank officials and many others in organized industry, the action
displayed not a policy of speed and expeditiousness, but one of political arbitrariness and
wanton disregard toward non-governmental authorities in industry and finance. 111

Nevertheless, as hoped, legal transformation encouraged the rapid move toward
private governance desired by the government – especially the key players, the West
German banks. These banks moved affiliates and branches into East Germany quickly
and massively. Already by July 1990, at the time of the currency union but still five
months away from actual unification, Commerzbank had erected 26 of its own branches
and 12 mobile offices; had hired 460 staff (most West Germans); and had sunk over DM 200 million into its Eastern operations. By the same date Dresdner Bank had set up 35 of its own branches. Deutsche Bank had erected 18 of its own branches and sent over 850 of its West German staff into the new Länder. Other of the large German banks, including the Bayerische Hypotheken- und Wechsel-Bank, the Westdeutsche Landesbank, the Bayerische Vereinsbank, and the Deutsche Gessenschaftsban, also invested large sums in the former DDR. In Berlin the rush into the new Länder was especially intense. While the large, established banks had only to extend branches into the Eastern part of the city, many credit institutes decided to establish their first branches in Berlin after 1989, as Figure 1 demonstrates. One Berlin banker described it as “an invasion.” It was the invasion the government had hoped and planned for.

The second strategy to transform the East German governance system and create the general market parameters for privatization was to privatize the important banks and other financial institutions of the former DDR, placing the much-lauded West German institutions in the key positions early on to oversee and participate in the privatization and restructuring process. Here the ambiguity of straightforward market economics theory became manifest in a type of chicken and egg question: in order to privatize the banks effectively, one needed a efficient financial market -- yet the institutions which made that market were in this case the very object of privatization in the first place. The buyer of the assets in question was thus the only competent judge of the value of those assets; the creation of the conditions for a "transition" to the market economy required the violation of those conditions. Nevertheless, the dilemma posed no problems to the government,
which was interested in winning the confidence and support of the banks. For the sake of speed and favor, the government negotiated directly with the big banks and in the end offered them joint-ventures with and major participations in the old East German banks at extremely favorable prices. The government hoped to transform the East German banking structure instantly by giving West German banks a controlling interest in the old firms, in effect replacing them with their Western counterparts. With the laws and oversight institutions in place, the stage would be set for privatization and the second wave of corporate takeovers – of large, profitable Western firms assuming control of East German industry.

Figure 1: Number of Banks and Bank Offices in Berlin, 1989 to 1991
Source: Landeszentralbank Berlin, Jahresberichte.

![Chart showing number of banks and bank offices in Berlin from 1988 to 1991](chart.png)

The structure of the former DDR banking system made transformation seem formidable. The system’s one-tier nature gave one bank, the Staatsbank Berlin, the power to control the money supply in addition to its monopoly on industrial credits and thus allowed the state, which controlled the Staatsbank, maximum steering capacity.
Like other economic sectors, banking was marked by extreme concentration and a stark division of labor: banks usually offered only one major product and were the official monopoly supplier of that product. Thus, only the Staatsbank Berlin financed domestic industry (with over 80% of all East German credits); only the Deutsche Aussenhandelsbank financed trade in foreign currency; only the Deutsche Handelsbank financed exports and imports that did not require currency exchange; only the Bank für Landwirtschaft und Nahrungsgüterwirtschaft financed agriculture; and only the Sparkassen managed private households’ deposit accounts.113 Fully controlled by the state, each bank allocated loans according to administrative decree and the requirements of the Plan -- not on a profit or risk-related basis. Thus, the banks were more bureaucratic clearinghouses than strategically-thinking businesses. “We made no important decisions ourselves,” said a manager of the former Deutsche Aussenhandelsbank.

Once West German banks had committed themselves to transforming the Eastern system, three broad possibilities presented themselves for rationalizing it along the criteria of risk and profitability. The banks could teach East German personnel the principles of credit allocation in a massive training exercise. Within the existing East German banks experienced West German bankers could replace East German personnel. Or the West German banks could quickly learn the East German business and import it into their own. In practice, all three means were used simultaneously. In March 1990 the Staatsbank, for example, spun off two major corporations, the Deutsche Kreditbank AG (DKB) and the Berliner Stadtbank AG, which received the some DM 123 billion of old industrial credits to DDR combines (Altkredite) under refinancing from the Staatsbank
(still an appendage of the state). The new structure paralleled the West German banking organization. At the behest of the state, the *Deutsche Kreditbank* entered into two "joint ventures" in July 1990: one with *Deutsche Bank (DBK--Deutsche Bank)* and one with *Dresdner Bank (DBK--Dresdner Bank)*. Besides assuming all of the *Deutsche Kreditbank*'s regional offices and most of its personnel, both joint-ventures were given the task of administering the *Altkredite*. In December 1990 the *Deutsche Kreditbank* sold its shares in the *DBK--Deutsche Bank* to *Deutsche Bank*. In June 1991 the *Deutsche Kreditbank* sold its shares in the *DBK--Dresdner Bank* to *Dresdner Bank*. Although the original *Altkredite* remained with the *Staatsbank*, their administration, and all subsequent new financing of the combines, was handed over completely to the two largest West German universal banks. Similar strategies were followed to transform the remaining financial institutions, as outlined by Figure 2.

Despite the comprehensive take-over process, for the system to work many barriers had to be overcome. In order to avoid disorientation and confusion, the East German accounting procedures had to be replaced only slowly by Western methods. The old financial complex had to be mastered quickly by the new West German bankers and a way found to transform it without losing too much information. In addition, the organizational structure of the old bank had to be changed and adapted not only to the organization of the mother institution, but also to the peculiar needs posed by the rapidly-changing East German economy. Thus, the West German institutions had simultaneously to discover the peculiarities of the market and to create organizational resources to sense
and accommodate them. Finally, ways had to be found to bridge the enormous cultural barriers between Eastern and Western bank personnel.

**Figure 2: Schematic Representation of Takeover Process of East German banks, July 1990 to July 1992.**

1. Staatsbank Berlin → 1a. Deutsche Kredit Bank AG (DKB) → 1aa. DKB
   1b. Staatsbank
   1ab. DKB-Dresdner Bank
   1ac. DKB-Deutsche Bank
   1ad. Berliner Stadtbank (BSB) (100% Berliner Bank)
   1b. Staatsbank
   2a. DABA
   2b. DIHB: 60% WestLB, 40% DABA

2. Deutsche Aussenhandelsbank (DABA) → 2a. DABA (WestLB in Supervisory Board) → 4a. GBB
   2b. Deutsche Industrie und Handelsbank (DIHB): 50% WestLB, 50% DABA
   3a. DHB: 69% Bank fuer Gemeinwirtschaft (BfG)

3. Deutsche Handelsbank (DHB) → 3a. DHB: 69% DABA

4. Bank fuer Land- und Nahrungsgueterswirtschaft (BLN) → 5a. Sparkassen
   5b. Deutsche Girozentrale

5. Sparkassen → 4b. 6.4% stake in Deutsche Genossenschaftsbank (DG Bank)
   5a. Sparkassen
   5ba. Deutsche Girozentrale
   5bb. NordLB – MitteldeutscheLB
   5bc. HessischeLB
   5bd. SachsischeLB: 50% Sued-WestLB

Although all of these problems were real (and often frustrating), none posed problems so serious as to derail the merger process. In fact, the innovative capacity of both East and West German bankers has been impressive. *Deutsche Bank* managers claim that the mastery of the old East German *Staatsbank* accounting system and then the creation and installation of a new system took only six months (from March to September, 1990); apparently the resulting computerized accounting system (dvs-system) in many respects outperforms the West German variant, allowing for easier monitoring of accounts and faster money-transfers. “We even improved on the our Western counterparts,” one manager beamed. The reorganization of the *Staatsbank* also proved relatively smooth. Bank managers proudly insist that during the six months before September 1990 they established a very supple network including the *Treuhand* and other important institutions that made available information needed to rationalize the
Staatsbank accounts. This network continued to serve the needs of the bank even after business was transferred to local branches.

Finally, cultural problems, despite their frustratingly stubborn persistence, also proved masterable and in the fact were often a source of inspiration to top and middle bank managers. Although theorizing about the clash between West German and East German organizational culture turned into a growth industry for many West German industrial sociologists, interviews with managers of the largest banks in East Germany consistently demonstrated that the most important problems have been overcome. "They [cultural barriers among the employees] have no meaning any more," said one branch manager. In fact, the most important cooperation barrier to emerge from the dynamics of cultural/social divisions between East and West Germans might have been the one between West German managers in East Germany and West German managers in West Germany. The same branch manager, for example, related how top Frankfurt managers' unfamiliarity with East German ways had created bitter controversy between Frankfurt and Berlin and also between Frankfurt and Potsdam over the banks' marketing strategies in the East.

By early 1991 most observers agreed that the transformation of finance had been a success. Relative to problems looming in other sectors, it had proved smooth and rapid. The new banks had successfully switched from unrestrained dirigisme to a market-oriented credit allocation system. All three big banks sunk enormous sums into building up their own branch network and training East German employees as fast as possible. While retail banks in the DDR offered only two services (small loans and a
standardized savings account), the product offerings of banks in the new Länder one year
after re-unification rivaled that of the West in diversity and sophistication. In fact, the
competition between banks for clients in the East had always been fierce, continuing in
intensity from before 1989.119 The opening of the East presented the big banks with a
precious opportunity to regain market share lost during the 1970s and 1980s by pulling
customers away from the East German savings banks and by aggressively seeking
corporate clients.120

By mid to late 1990 policy makers and many observers felt that the scene had
been set for speedy, efficient privatization. The important Western banks had forged new
relationships with East German players; they could extend their close industrial ties
Eastward. The government hoped they could help graft Eastern combines onto the
Western economy and also help orchestrate an accelerated expansion of West German
industry into the East. Competition between the banks for new market space would speed
the process. In the popular press, West German bankers themselves bragged of their
future role in the privatization process and many economists both within and outside of
the banks predicted a strong recovery in the new Länder by late 1991 and early 1992 as a
result of the successful installation of the Western legal and financial frameworks.121
Given their experience as monitors and active coordinators of West German industry, and
given their ideal placement within the financial institutions of the former DDR, the banks
would add much-needed help to the government’s efforts through the Treuhand to
reorganize the Eastern economy. The transformation of corporate governance as most
Germans in and outside the government envisioned it could proceed.
Failed Expectations: The Banks Balk and the State Reacts

The surprise was that despite well-laid plans the German universal banks failed to play the consequential role expected of them. Although the big banks went rushing to compete for the East's new retail market, they failed to follow the grab for deposits with badly-needed investment monies and played only a background role in cutting privatization deals. Only under agreements with the government that spread most of the risk onto the latter did the banks extend lines of credit to the newly-forming businesses or old combines in the East (see Figure 3). Complaints from both privatized and non-privatized firms mounted. By the summer of 1992 employers organizations and industry and trade chambers, from West and East, joined the outcry. As the government stepped in to fill the void, a rift over privatization policies began to develop within the central industry associations and between them and the bank associations. The remarks of one businessman that “the banks have been the biggest barrier to growth” became common. The government, at first tolerant of the banks’ cautious, unassertive behavior, became increasingly impatient with them even to the point of joining their open critics. In response, the Federation of German Banks made a series of public announcements denouncing these criticisms and defending the banks’ cautious strategy. Although with time sales of firms greatly accelerated, the process of bargaining which had begun before the banks entered the scene was the force behind this success -- and remained substantially unchanged by increased bank participation. The banks' grand entrance into the investment process in the East failed to make the expected difference in the formation of corporate governance institutions.
A closer look at the government’s privatization agency, the Treuhand, and the bargaining process it led among former managers, potential investors and other actors shows just why the banks played such a peripheral role in the East: that process favored institutions that could provide certain information difficult for the big banks to obtain, and the banks were unfit for correcting this difficulty.

**Figure 3: Total Private Bank Lending in the New Federal States**
*Source: Bundesverband deutscher Banken*

Originally created by the Hans Modrow government in early 1990 as a holding organization with legal stewardship over all East German combines and state property, the Treuhand Anstalt became the instrument the government chose to direct the massive privatization effort that began in August 1990 after the signing of the Unification Treaty. Placed under the direct supervision of the government as an extension of the Finance Ministry, the Treuhand was received by Western industry with some controversy and considerable uncertainty. The reasons were clear: despite appearances to the contrary, the Treuhand was really an pure extension of the state and broke with the tradition of para-public institutions that characterizes public policy and economic management in
Germany. Although its governing board included some prominent bankers and industrialists, and although its mandate was to be rid of the enterprises under its supervision, the Treuhand seemed extremely state-centric, born of the regime whose state-centralism was the economic transition’s very object of change. But once again, on this matter the industry associations were not consulted. The government never showed any intention of discussing its decision to adopt the Treuhand as the privatization agency and to integrate it into an existing ministry. The action, ministry officials would later admit, seemed the best one for keeping the controls over numerous subsidy and other programs in one central place so that they could be easily modified or appended as the needs arose. Moreover, the government wished to keep a tight grip on the agency on whom so much of its success rested.

The expectations placed on the Treuhand were indeed steep. It received the legal mandate to privatize as much of its assets as possible (those not critical to the direct functioning of the state), but also sought to maximize the price collected for these assets and incur as little debt as possible. Finally, because the CDU faced strong political pressures, the Treuhand was expected to minimize employment losses and to finish the major privatizations by the 1994 Federal election. Many of the Treuhand’s managers were political appointees (including Birgit Breuel, the longest acting managing director) and realized that their political futures would stand or fall with their success at minimizing the controversy and expense associated with large, non-privatized combines by 1994. Every day a large combine remained in state hands meant that the federal government had to continue to foot the large wage and upkeep bill -- which brought more
tension into a political scene already fraught with controversy over taxes, budget deficits, high interest rates, wage decreases, the *Länderfinanzausgleich*, and other aspects of "the costs of unification." Although the *Treuhand* made a number of tough political decisions, as elections approached it sought to delegate its responsibilities to one or several other non-federal organizations, even creating such organizations where none existed previously. By mid-1994 it had to be out of the political spotlight.\textsuperscript{122}

Meeting these expectations was made more difficult by economic realities. The monetary union required eastern enterprises to integrate into western markets successfully if they were to survive. Yet the most important privatization cases -- those combines upon which entire regional economies depended -- were the most ill-suited for competition in those markets. As a rule, these giant enterprises mass produced goods using highly vertically integrated processes at a time when markets required successful firms to pursue niche strategies and to adopt more horizontal, flexible patterns of organization. Successful sales of these combines could only occur if the *Treuhand* found ways to reorient their production to service special markets attractive to western firms. To identify exactly which enterprises or enterprise pieces might accomplish such reorientation, and to insure that sale of those combines or combine pieces would not fatally disadvantage the viability of remaining assets, the *Treuhand* had to evaluate both possible opportunities on world markets and the precise possibilities of and limits to converting combine assets, including skills, land and machinery, to new uses -- all of which it could never know by itself.
The existing organization of East German industry and the shape of the restructuring problems that grew out of it, then, required the Treuhand to rely on a host of outside actors to evaluate its assets, contact potential investors and put together its deals. Such institutions included investment banks (many foreign), accounting firms, consulting companies, and well-connected West German firms. In addition, in order to minimize the cost of maintaining the combines in ways compatible with both its conversion plans and with the plans of possible investors, the Treuhand was forced to rely on outside managerial expertise -- West German, local East German, and foreign. Thus, the Treuhand hired numerous managers, both as employees and outside consultants to oversee its existing assets. Many Treuhand managers came from prominent West German companies as "managers on loan" and, in addition to overseeing East German management, often acted as deal-makers with their own firms. Finally, the Treuhand created boards of directors for the combines and filled them with West German managers. The end result was a complex network of East and West German managers, consultants, investment banks, accounting firms, buyers, and politicians that made an accelerated pace of information-sharing and deal-making possible.

Of course the government was only too eager to fill the Treuhand with managers and others from private industry and demonstrate the Treuhand's close cooperation with private actors such as outside intermediaries. Such cooperation helped alleviate criticisms of the state's heavy hand and spread responsibility for more difficult privatization decisions. Although some in the media cried foul at the perceived conflict of interest of many enlisted actors, and indeed several scandals were traced back to such
conflicts, the government was willing to pay this price for the added expertise and the benefits of a firmer alliance with big industry at a time when its relationship with financial interests seemed to be deteriorating.

The Treuhand thus relied on a great diversity of institutions besides the big banks to estimate the value of its assets. In fact, officials in the Treuhand's finance arm claim that in most of the important appraisals the big banks played only a minor role. Price Waterhouse and other large accounting firms did most of the balance sheet work. Foreign investment banks, including Goldman Sachs, Wasserstein Perella, and J.P. Morgan among others, did much of the difficult on-site valuations. Consulting firms like Arthur D. Little and McKinsey & Co. also joined these efforts. The reason for hiring these fairly expensive agents is clear: what the Treuhand sold was not assets with some fixed value, as economists' theories of privatization assumed. Rather, the value of old East German firms and firm pieces depended heavily both on the strategic needs of outside investors and how well local assets could adopt themselves to fit those needs. Both, but especially the former, were influenced heavily by these deal-makers. Goldman Sachs not only had the necessary connections to find French and Kuwait buyers for the large chemical combine at Launa (in the new Land Sachsen-Anhalt); it had the talent to help these buyers integrate the combine's assets into complex short- and long-term strategies and build consortia around these strategies. For some of these buyers, Launa meant entering the EC; for others, Launa meant a beachhead in both the German chemical industry and an option for future expansion into Eastern Europe. Investment banks sold East Germany's status as an under-developed region of the EC and thus as an
interesting strategic space for many products. In short, the success of these financial institutions stood or fell with their ability to create attractive strategic value for the product, geographic, or political markets in question: an ability that possibly gave banks with close connections to outsiders an advantage over domestic banks.

Matching production possibilities with the strategic needs of outside investors and managing assets to maintain the most promising possibilities without great expense put a premium not only on knowledge of external markets and investors, but on reliable local knowledge as well. This proved especially so in the context of the relatively “top-heavy” Treuhand deal-making network. Knowing enough about equipment and work organization to adjust production as suppliers and customers changed and new markets replaced old ones; knowing the alternative uses of equipment or which workers or managers could evaluate such uses; and knowing how production layouts could or could not be reorganized if some of their parts were sold off or shut down all made the perspectives of local managers and workers valuable -- especially in the context of highly vertically integrated and conglomerated East German industry. Unfortunately, neither the Treuhand itself, with over 8500 firms and over 4 million workers under its supervision, nor the investment banks, consulting companies and accounting firms doing many of its financial transactions, possessed adequate decentralized information resources in East Germany. To compensate, these and other institutions went to great efforts to collect local data on-site, introducing themselves to local business chambers, economic development associations, and other bodies; the costs of doing so were so high, however, that structural information deficits often remained.
In order to help bridge these deficits, the Treuhand sought ways to organize and enlist local managers and workers. The Treuhand established some twenty three regional branches, formed roundtables that include the Länder, such as the Treuhand Kabinet, and created variegated oversight structures such as Industriepark Gesellschaften, Technologiepark Gesellschaften, and Management Kapital Gesellschaften. To varying degrees, all of these structures encouraged substantial cooperation among the Treuhand, municipalities, local management, and investors. Industry parks, for example, were created to organize actors whose cooperation was necessary to carve up a given combine into salable parts. In the Launa industry park, municipalities held 60%, regional development agencies 10% (these agencies themselves represent interests of municipalities, the State of Sachsen-Anhalt, and private investors), local management 10%, and future investors (represented by the Treuhand) 20% stakes in the industry park. Among other activities, the industry park granted access to public goods such as sewage, water, energy, and other systems; issued licenses and permits, especially for activities that might complicate the environmental cleanup efforts; controlled distribution of basic raw materials such as oxygen, chlorine, nitrogen and hydrogen; streamlined application procedures for subsidies, grants, tax bonuses or credits from any of several public or semi-public sources (including the industry park itself); coordinated production by prohibiting manufacture of competing goods between member firms; and planned efforts to solicit potential investors. Deciding how to perform all of these functions required open discussion of alternative future uses of and thus alternative ways to organize the chemical combine’s existing plants, facilities and jobs. Because of these discussions, the industry park provided an effective device for the Treuhand and prospective investors to
elicit the local information necessary for evaluating prospective investments and to judge the chances of receiving the cooperation necessary to realize those investments.

The value of local cooperation in the privatization and economic reconstruction process was manifest in other ways. One example is the way such cooperation was used to overcome political barriers to the privatization process in the giant industry park in the steel-producing region between Frankfurt/Oder and Eisenhüttenstadt along the Polish-German border. In addition to organizing local councils and boards to govern resources in ways similar to Launa, the Land Brandenburg and the Treuhand bestowed upon those bodies certain powers to enforce rules that helped prevent destructive cross-border price competition in steel (based on cheap Polish labor) and encouraged them to work with local works councils in doing so. The idea was to use local initiative to diffuse a potentially-explosive situation that might have led to a political environment quite hostile to outside investment.125

As another example, take the increasing number of locally-established consulting associations, economic development organizations, “industry centers,” and “technology centers” established with the financial help of the Länder. As the Treuhand gradually receded in importance, these bodies grew ever more active in helping small and medium-sized investors -- many formerly under Treuhand supervision -- find local suppliers and distributors, build relationships with municipal and Land governments, apply for subsidies and other assistance from the Land, Bund and EC, locate good investment sights, and hook up with colleagues who could guide them further along the initial stages of building their business. These various Länder-level bodies were not important to large
investors -- but they did exercise considerable influence over the size, shape, and location of smaller investments. The proliferation of these bodies and the unusual oversight bodies created by the Treuhand clearly illustrate that local actors were empowered by investors' needs for accurate, precise information on all aspects of former and current production possibilities.

The observation that the investment and restructuring process in the East favored financial institutions with strategic ingenuity and/or with links to local groups and institutions might at first glance seem to have placed the big banks, especially the two heirs of the large Staatsbank network, Deutsche Bank & Dresdner Bank, in a privileged position. After all, these banks could combine their knowledge of western industries and markets with a bird's eye view of each combine's financial condition and, in addition, inherited the network of Staatsbank branches (over 200 all told) that appeared to have good connections to local information sources -- and a monopoly on industrial credit in the DDR to boot. But closer inspection reveals otherwise. The type of information kept in the Staatsbank about its industrial "customers" was far less comprehensive and relevant than originally expected. On the liability side, the Staatsbank had kept meticulous records of the prices of Plan-allocated materials and input costs, including wages, and of the precise amounts of foreign currency credit required for imported materials. But on the asset side, the value of firms' stated assets was almost completely arbitrary. Despite several failed reform efforts, credit had never been allocated according to firms' market viability, innovative capacity or strategic dynamism. Workers in the former Staatsbank branches were not trained to investigate firms closely and did not
understand what types of information were relevant to issuing sound industrial credits in a market environment. Where there was no risk to the creditor, there was no incentive to exert effort to get to know the debtor. Thus, to the banks' chagrin, the information network that existed between the *Staatsbank* and the combines was non-functional from the first day of the currency union onward. Until the day the Treuhand officially closed in 1994, the meaning of the 1989 combine balance sheets continued to be a subject of controversy.

For the banks' part, instead of using their newly acquired *Staatsbank* network as an information source independent of third parties, the strategy of the big banks relied far more on building relationships with consulting firms (both subsidiaries and independent firms), contacts with outside accounting firms and connections with foreign investment banks. Bank managers consistently cited their relationships with consulting firms as their most important source of information about East German firms, even when compared to quite close contacts with the *Treuhand* itself. When East German managers brought their business plans to the banks for appraisal, the banks frequently referred the managers to consulting firms. The arrangement worked nicely for all three parties: the firm's managers received training in the market and strategic know-how, the consulting firm received more business, and the bank managers received assurances from the consulting firm about the credit-worthiness and viability of the firm. Thus, whether the case was a management buy-out or buy-in, a spin-off from a *Treuhand* combine, a take-over, the refinancing of an already-privatized firm, or the establishment of a Western plant or
branch in the Eastern market, banks relied on third parties, especially consulting firms, for much of the information needed to assess investments' risk and profitability.

Given the Staatsbank's incompetence, it is likely that the banks' motivation to buy it was not to assume a more active, risky role in the governance of Eastern enterprise, in accordance with policy-makers' intentions. Rather, besides offering a low-cost means to establish their Eastern consumer branch network and to compete with the savings banks for deposit business, the Staatsbank gave the banks a chance to earn a large return in the short-run for refinancing the old combine debts, or Altlasten. At the time of currency union, savings banks held about DM 106.5 billion of credit to the Staatsbank, which in turn had lent the money, and money from other sources including the Deutsche Aussenhandelsbank, the Deutsche Handelsbank, and the Genossenschaftsbank, to the combines via credits allocated by Plan. The value of the savings deposits had to equal that of the industrial credits, or the banking system would collapse. To ensure the balance and meet the liquidity needs of the banks, the Federal Ministry of Finance set up an "Equalization Fund" under the Bundesbank's supervision. On 1 July 1990, the date of the economic, monetary and social union, not only were the savings of East Germans transformed into hard DM deposits, but the credits of Treuhand firms were transformed into hard DM debts (about DM 123 billion total). Refinanced over the Staatsbank, the hard credits administered by the new Deutsche Kreditbank, the DKB-Deutsche Bank and DKB-Dresdner Bank soon required interest due. In addition, many firms needed bridge loans to keep their operations going until they could be privatized. Unable to tell for themselves the optimal size, length, or type of these credits, the Treuhand hired the banks
to evaluate these technicalities. And naturally the two big banks administering the *Altkrediten* provided the needed credits, or Liquidity Funds. They did so, however, only under the full guarantee of payment by the *Treuhand*, the ultimate "owner" of the combines. The banks' first active financing of East German firms, then, entailed no risk.

In the months that followed this lucrative venture, the banks hesitatingly began to assume more risk. A short battle over the ownership of the actual *Altkrediten* ended with their permanent assumption by the *Staatsbank* (100% owned by the federal government) and their sole administration by the new *Deutsche Kreditbank* (also 100% owned by the federal government). The *Treuhand*, feeling intense pressure to minimize the cost of privatization, developed a refinancing system designed to bypass the banks as middlemen and issue debt directly in domestic and international bond markets where possible. By this time, the big banks had begun to provide credits directly to firms and "firm pieces" as they were privatized. These monies, however, were frequently tied to risk-sharing arrangements with the government or with government-owned institutions, like the *Kreditanstalt für Wiederaufbau*, the *Deutsche Ausgleichsbank*, or special *Burgschaftsbanken* (Guarantee Banks). One big bank, for example, estimated that as of July 1992, about 25% of the DM 70 billion in credits to the new *Länder* were guaranteed by the government and over 60% were at least partially financed as part of government investment programs. Of the remaining 40%, an undisclosed but high portion had been issued to "safe" construction projects, real-estate improvement projects, and retail businesses with stable, local markets.
In fact, as the financing squeeze continued in the East, the government dramatically increased its financial help to Eastern firms, privatized or not. Public subsidy and help programs proliferated. Economists calculated that at an average of 250,000 DM per worker, in order for a workforce of 2 million to remain in East Germany (the workforce before 1989 was just over 3 million) a level of some 500 billion DM of yearly investment had to be reached.\textsuperscript{127} With a ramp-up from 1991 to the year 2000 and assuming a convergence of living standards in West and East, the amount of total investment needed was calculated at over 2 trillion DM.\textsuperscript{128} The number was staggering, and it is not surprising that even before the banks were to enter the scene the government had instituted a number of important subsidy programs. But the numbers rose quickly along with doubts over the banks’ contribution to corporate governance and finance. Between July of 1990 and November 1991, for example, the \textit{Treuhand} revised its estimate of the worth of the assets from 800 to 1,000 billion DM to 200 billion DM, which, subtracting liabilities on the assets estimated at 400 billion DM meant revising expectations of winning around ½ a trillion DM on privatization to leaving a deficit of 200 billion DM.\textsuperscript{129} Much of this lost money was spent directly on subsidies and programs aimed at speeding the direct sale of firms. Privatization, meant to extract the state from the governance and finance of industry, had ironically done just the opposite, pulling the state into an increasingly active financing and oversight role. Desperate to stem the tide of the rapid fall in production after currency union (see Figure 4), the government would not wait passively as its key actors failed to play their desired role. Despite a valiant effort, the \textit{Treuhand} just could not find the private, independent corporate owners it so desperately needed to fill the investor and governance roles its mission was to create.
Only after mid-1992 did the big banks begin to assume the credit risk of Eastern corporate clients fully; unfortunately, the results were largely disastrous. Local branches, fearing attenuation of their position by competitors and eager to build their long-term customer base, began the process by financing a substantial number of management buy-outs. Other risky projects followed. Each big bank's inability to distinguish good from bad projects only heightened its fears of loosing substantial market share to the others and accelerated its plunge into the abyss. By the end of 1992 several big bank directors in the East reported net losses since January; all made gloomy prognoses for their future corporate lending business -- in stark contrast to the previous year's of record profit levels.130 “We are writing red figures now,” one bank manager said with chagrin. “Our people’s inability to choose the winners from the losers has spelled disaster.” Although the banks did not make a high number of commitments, their experience in this downward spiral of fear, uncertainty and mounting liabilities reinforced their initial misgivings. Moreover, the economy-wide downturn that began in 1993 increased losses and furthered these misgivings: corporate credit became as tight as ever in the East, as the big banks redoubled their determination to avoid risky projects.

It is true, despite these results, that the banks did play middleman roles superficially similar to the ones envisioned by the government. They did act as information sources to large West German firms seeking business or take-over opportunities in the East. And, when public guarantees were not available for strategically-important projects, the banks actively sought the cooperation of large, cash-rich firms as loan partners in management buy-outs or other ventures, where possible
jealously refusing to build bank consortia to share the business with other banks. But these activities were limited. When the large West German firms invested in the East, they almost always did so with their own internal reserves instead of loan finance. Without the prospect of issuing large credits, the bank's motivation to use their connections with the German giants and to persuade them to invest in the East was relatively low. In addition, the dissemination of information to large, "in-house" firms in the West was really only critical in the rare cases when those firms were not better connected in other ways (directly via the Treuhand or indirectly via consulting firms). In the case of most large deals, like the Launa sale mentioned above, Treuhand "managers on loan" or "hose consulting firms or investment banks putting the deals together Figure 4:

**Figure 4: Index of Production, East German Industry 1990-1991**  
provided far more comprehensive and sensitive information to large Western firms than the banks did. Under these circumstances, it is no wonder that, in stark contrast with policy-makers’ expectations, the banks rarely bought participations in firms -- such investments, bankers insisted by 1993, were the proper activity of equity participation firms, not the banks.\footnote{131}

\textbf{In the Shadow of Uncertainty: Two Examples of Privatization and Governance in the East}

To illustrate the larger story of privatization and to see in detail how the problems of local coordination and innovation in an uncertain economic environment drove the creation and modification of governance forms, take the two prominent examples of the East German machine tool industry and of Jenoptik. The former shows how the Treuhand could muster great financial and expert resources to create a private governance regime for a politically critical industry, but still come away from the case with non-standard and even innovative governance forms. The latter shows how even in a starkly CDU state the government sometimes stepped in to manage corporate governance directly, and how it sought new ways of doing so that could solve the tough economic problems facing industry. Both examples illustrate the difficulties of instituting the bank-led governance regime that key actors initially sought but later rejected.

\textbf{The East German Machine Tool Industry}

Machine tools was one of East Germany’s premier and renown industries. With over 85,000 employed and yearly revenues of over 10 billion Marks, the industry was a chief supplier to the USSR’s most important arms manufacturers. As such, it exported
over 80% of its products, 90% of which went to Soviet block allies. The industry did not reap export revenues directly, however, as these were funneled back from the government selectively in the form of investments granted for specific projects requested by economic planners. Most of the industry was organized into two giant *Kombinats* named the “7th of October” and “Heckert.” Each consisted of several factories spanning a large geographical and an extremely diversified range of mostly unrelated products. With main plants in Berlin, Magdeburg, Leipzig and Chemnitz, the former made turning, drilling, grinding and milling machines, while the latter shared turning, grinding and milling machine production with gear cutting machine production. Each employed close to 30,000 workers. While the creation of the *Kombinats* made large investments in research and development possible that made some DDR products into showcase items in the world machine tool fairs, such as the first ever flexibly integrated gear-cutting system, it also led to radical vertical integration and large mismanaged investments, such as the one in the huge Harlass Foundry. Though its access to world markets was unquestionably broad compared to most other industries, by most other standards the industry demonstrated the typical organization and weakness of the planned economy.

When the *Treuhand Anstalt* began to plan seriously the privatization of enterprise starting in August 1990, it made the successful sale and preservation of the machine tool industry a high priority, setting aside hundreds of millions of marks for the task and promising millions more if they were needed. It immediately hired semi-retired senior executives from major West German firms to advise it and help it plan how the industry should best be divided and subsequently restructured. These individuals also managed
the Kombinats and plants until these were privatized or until additional management was found.

As a first step, already in June many of the old Kombinates had been broken up either into transitional holdings or into wholly independent corporations under the new economic and legal regime. With currency conversion, many factories sought immediate independence from Kombinat oversight or any structure that approximated it. The large NILES machine tool holding of some sixteen separate Treuhand firms that resulted from the breakup of the October 7th combine, for example, was given no more than 50% stake – and normally less than 50% stake – in each of its subsidiaries, which operated mainly under the direction of local management and the Treuhand. The NILES holding itself did not pretend to such activities as R&D planning or joint marketing, let alone rationalization of production, but instead viewed its job as an intermediary between the Treuhand and the subsidiaries as each sought to find its own way in the new market economy.

As local management made proposals for buy-outs, takeovers, and other forms of privatization or restructuring, the Treuhand sought the advice and participation of banks and those West German firms closely allied with the banks on each of the proposals. In fact, as part of the proposals, local management was required to seek outside finance from the banks if no equivalent – as from a full Western buyer, for example – could be found. As the banks had already assumed control of the short-term financing operations, it was hoped these initial contacts would pave the way toward the banks’ expected role in the governance and ownership of the firms as they brought in their contacts from industry to
evaluate and make counter offers to these initial inquiries. But on this count the
*Treuhand* was sorely disappointed. Most of the initial proposals lacked outside investors.
Management buy-outs at extremely low valuations of equity were the overwhelmingly
common form such proposals took. The banks, for their part, usually offered to finance
these deals only on condition of full security by the Treuhand. In effect, the Treuhand
would continue to hold residual liabilities while coalitions of other actors who lacked the
sought experience from the West managed operations and kept the upside for themselves.
This was simply unacceptable.

With the outlook initially bleak, but still believing (until the middle of 1992) that
the machine tool factories had excellent chances for profitability, the Treuhand began an
active solicitation of Western machine tool firms itself, using its experts to help arrange
sales and deals and to more actively restructure production as they saw fit in order to
attract such deals. Plants were closed, as were many parts of production better
outsourced. Accounting firms were hired to help determine initial corporate balances and
the liquidity levels needed to sustain them. State and local governments – such as the city
of Chemnitz, which viewed its chances of prosperity inextricably would up in preserving
its long traditions of excellence in industries such as machine tools – began to negotiate
the closures, relocations, or conservation of plants. Occasionally, as with the case of the
turning and grinding technologies, high-profile consulting firms like McKinsey were
called in to come up with creative privatization concepts.

It was about this time, in mid to late 1991, that the *Treuhand* began to have
successes in privatizing key parts of the industry. It was also about this time that the
 politicization of the privatization process dramatically rose, and with it the efforts of the Treuhand to intervene in the governance of its firms. Take the example of the Union Sächsische Werkzeugmaschinenfabrik in Chemnitz and Gera. The machine tool factories were counted as the second oldest in the entire Federal Republic. Moreover, before 1989 when it still belonged to the Heckert Kombinat, close to 75% of its production had been sold to non-socialist countries, a remarkable achievement. In October 1991 the Treuhand announced it had sold a majority stake of 75% to Schiess AG in Duesseldorf along with a minority stake to Kloeckner & Co. for 12 million DM, with 16 million DM of new investment promised and long-term guarantees of 230 of a previous workforce of 1000. By October of the following year, the workforce had already been reduced to the 230, with over half on short-term work. Promised investments had not been made. As plans to close the Chemnitz plant and consolidate it with the one in Gera became public, the Treuhand announced that it would impose financial penalties on Schiess for reneging on its agreement. Schiess countered that it was deceived at the time of the sale by the Treuhand and filed a suit against it. Amidst the rapid downturn in the machine tool industry in West Germany, Schiess claimed that Union Sächsische WZF has caused the majority of its over 100 million DM loss for 1992. At this point the State of Saxony, under pressure from Chemnitz and believing that prolonging the controversy would kill all chances of the plants’ recovery, demanded that the Treuhand assume responsibility for the Chemnitz plant because of evidence that Schiess intended to shut the plant down at sale and liquidate the land and equipment for a profit. In response, the Treuhand sought to negotiate directly with Metallgesellschaft, Schiess’ parent which had fallen into bankruptcy. The latter sold Schiess to Doerries Scharmann AG which immediately
announced that it would keep the Chemnitz plant but shut down the Gera plant, moving its workforce to Chemnitz. After the Gera management fought the decision, DS announced the sale of the the Gera plant to a Belgium firm, which proceeded to outfit the plant as a producer of high-end boring machines. DS, for its part, integrated the Chemnitz plant into its profitable management holding strategy, doubling its workforce of 75 by 1995.

The example of *Union Saechsische WZF* is only one of many, and by no means the largest or most dramatic illustration of how privatization fueled politicization and much more aggressive tactics on the part of the *Treuhand*. The sale of NILES main plant in Berlin to Fritz Werner; the sale of the *Magdeburger Werkzeugmschinfabrik* to Autania, the holding closely associated with the Rothemberger brothers and the West LB are examples at least as controversial and just as complex as the former. These latter also involved threatened liquidations, multiple transfers of production, and the bankruptcy or threatened bankruptcy of either the parent or subsidiary. Because of the much larger scale of these sales, the *Treuhand* intervened all the more aggressively when the deals threatened to unravel, and learned to quickly dispense with expectations that the banks or any other private actor – with the exception of the large management holdings in the West – would react to coordinate the restructurings and the governance of the machine tool firms in general.

Doerries Scharmann and the management holdings which it typified are discussed in the next chapter in far greater detail. Suffice it to say here that it was the appearance of the management holding concept that stabilized many of the potentially disastrous
privatizations in the machine tool industry. Unlike the sale to traditional firms in which ownership rights over the firm were bundled and control centralized, the management holding spread ownership of the firm between parent and subsidiaries in ways designed to produce interdependence and negotiation over control and enhance specific models of producing and innovating. Control rights, freshly created by the act of privatizing, were immediately blurred or made ambiguous. Take the creation of the Schleifring GbmH as an example. After many of the best plants had been privatized, the Treuhand was left with a number of decent grinding machine producers which had no obvious buyers. Firms in the west which produced similar products were either too small to buy them, or suffered from maladies deemed to disqualify them. Unwilling to close these producers because of their relative quality but unwilling to finance their continued support, the Treuhand asked one of its leading machine tool executives to develop a concept that would make the firms competitive on their own and demonstrate such competitiveness to otherwise uninterested buyers.

The concept developed, the Schleifring GmbH, called for bundling the grinders together into one holding that, unlike the intermediary holdings that replaced the old combines, would actively market, finance and manage the subsidiaries and their products, but unlike classical industry holdings in the West would do so by shifting control rights into each subsidiary as individual profit centers. Each firm would be independently expected to compete on its own terms. As with other independent Treuhand firms each would develop a plan for becoming profitable on its own and be given the operational control necessary to do so conditional upon meeting certain performance criteria which
were periodically renegotiated. But unlike other firms, the management holding would provide an umbrella under which profits could be shared and outside investors like the banks kept at arms length or abandoned altogether. Moreover, innovative ideas could be commonly explored, and production could be rationalized. Finally, if successful, the Schleifring would be large enough to interest potential buyers not yet in the grinding industry, for it would span the complete range of products and therefore maintain not only a dominant position in Germany, but a viable position in the growing international marketplace.

Indeed, the Schleifring was successful in achieving its goals. Bought by the Koerber Group in Hamburg even before it achieved profitability, the governance concept provided a structure under which the ring could integrate the group’s flatbed grinder Blohm into a much more promising competitive position and become the industry’s leader through acquisitions of several small, quality producers in West Germany and abroad. And the model was copied. Whether Dorries Scharmann provided the example to the Schleifring or visa-versa, it is certain that Autania and other buyers of Treuhand firms learned from this model and sought to emulate it structurally if not strategically as well. The management holding became the single most important innovation in the Treuhand’s efforts to privatize its machine tool producers and came to symbolize how it parted with its original intentions and ideas about the creation of private governance in East Germany.
Jenoptik GmbH

Like the experience with the machine too industry, the creation and sale of Jenoptik GmbH also came to symbolize the Treuhand’s break with its original plans for and convictions about privatization, but in a very different way. In contrast with the machine tool industry, however, the privatization of Jenoptik was never a true privatization but instead led to the creation of a major state enterprise in one of the most politically conservative states in the East.

Carl Zeiss Jena was for nearly one hundred years the centerpiece of a vibrant and innovative regional economy in Jena. The Zeiss family foundation, the city, the university and hundreds of small, research oriented firms in optics and precision engineering made the region’s products world renowned for their rigorous quality. Even after the Russians stripped the factories and university in 1948, the economy rebounded quickly and by the early 1970s boasted the home of the Carl Zeiss Jena Combine, one of the DDR’s largest at nearly 70,000 workers and exports of over one thousand separate products reaching over eighty countries in the East and West. The Kombinat, like those in the machine tool industry, had become a key supplier of both technology and products to the most important Soviet arms manufacturers and a popular symbol of East German scientific and industrial prowess. The Treuhand knew from the start that it would have to make special concessions to be sure that Carl Zeiss Jena continued as the region’s premier industrial power.

The Zeiss combine truly encompassed an entire regional economy, and on the very day of GEMSU, July 1, the Treuhand moved to split it into twelve legally distinct
corporations. Of these, however, the primary firm, Jenoptik Carl Zeiss JENA GmbH, continued to employ over 30,000 workers. The Treuhand immediately hired the Boston Consulting Group and the KPMG accounting firm to draw up a strategic concept for its privatization and further break-up. With the closure of markets in the East, including all of the Soviet arms factories, the prognosis looked grim. Action would have to be taken soon to divide the firm into core competencies and expand its niches in Western markets.

To complicate matters, Jenoptik Carl Zeiss JENA had a sister in the West that claimed the same name and many of the same patents as the Jena firm, Carl Zeiss Oberkochen-Heidenheim. The firm had been founded as the subsidiary to a public foundation in Baden-Wuertemburg after the Jena firm’s nationalization in 1948, which the Unification Treaty labeled illegitimate and for which it called for a re-instatement of all lost property. Faced with the potentially devastating prospect of losing the most profitable businesses to Oberkochen while having to maintain many hundreds of loss-making businesses dependent on those businesses but critical to the regional economy, the Treuhand persuaded the State of Thueringen to step in and create a non-profit foundation that could oversee the integration of many of these institutions and firms into the private or public economy.132 What is more, because of the potentially explosive conflict between the state of Thueringen and the state of Baden-Wurttemburg over the Zeiss name, patents and assets, the Treuhand organized negotiations between the two states. The final agreement came on July 16th and called for the creation of a public foundation seated in both Oberkochen and Jena which would collect all the patents in dispute and manage them together with the core businesses of the Jena plants that were
dependent on them. In order to separate these businesses, the old Zeiss Jena GmbH was split into a core business named Carl Zeiss Jena GmbH, 51% of which was owned by Oberkochen. The other 49% was to be held by the remaining firm, named simply Jenoptik GmbH. To help bridge the tension between the states, Baden-Württemberg’s former Minister President Lother Spaeth was chosen to chair Jenoptik’s board.

The task facing Jenoptik was obviously enormous. Left with the bulk of the regional business but missing the profitable optics business and those businesses related to it, the firm had to act quickly to build a competitive core while preserving as many of the unrelated businesses as possible so as not destroy the regional economy. This would require enormous subsidies and a commitment to the public good not normally had in private enterprise. No one thought for a second that institutions such as the banks could offer even part of the answer. Only one solution seemed possible: a public body would have to control the entity. With Thuringen already involved in the negotiations, the Treuhand chose to commit to an enormous level of subsidies – over one billion DM – in return for the Land’s assumption of the ownership rights, its commitment to subsidizing an additional ½ billion DM in investment and other monies, and with these its assumption of the responsibility for privatizing the enterprise and with it restructuring the economy.

But public ownership contained no grand key toward fulfilling these responsibilities. With over 40 million DM in losses each month, even the close to 2 billion DM put aside to help Jenoptik would run out if a viable strategy for profitability was not found. The trick would be to organize privatization and solve the familiar problem of eliciting local cooperation while combining this with expertise in the
possibilities in global markets, just as the Treuhand attempted, but do so within an existing framework of corporate governance, that of Jenoptik GmbH. The strategy required two types of activities, and the structure of governance chosen was designed to accomplish these. On the one hand, Jenoptik had to constantly evaluate its core competencies and then enhance and build on these competencies by determining what they were missing to compete in the global marketplace and then make those additions. On the other hand, it had to determine which activities, however profitable, would not fit into its greater strategy and then seek to spin these firms off at a fair price so as not to incur additional losses that could not be recouped.

Similar to the Treuhand, both of these experience required an enormous system of corporation monitoring, selling and buying that could localize and then harness information about both desirable additions and desirable subtractions based on the research and development occurring in its vital areas of production. Indeed, it was precisely around such a system that the corporation was structured. Instead of a single integrated firm, Jenoptik divided itself into literally hundreds of firms, giving each a legal shell that could collect its assets for sale while setting up a clean accounting system to keep local managers accountable for their profits or losses. (See Figure 5 for a diagram mapping these firms.) For its part, management of the holding was simplified to three areas or divisions with only three senior executives: Infrastructure, which “sold” services to subsidiaries but normally at their option only; Technology, which included Jenoptik Technologie GmbH, the subsidiary housing the firm’s core businesses; and Participations, which oversaw the sale of firms failing to meet the holding’s criteria and
which purchased those deemed strategically critical. It was in the intersection between the latter two areas where the heart and soul of the firm: that is, where the critical strategic decisions were made that would decide the firm’s fate.

Although highest priority for Jenoptik’s many subsidiaries was to reach profitability, followed by finding ways to contribute to the holding’s core areas of production, many of Jenoptik’s member firms initially could not meet these criteria. This meant that alternative criteria had to be sought and negotiated by which to supplement the ratings of performance that determined whether the firms should be sold or liquidated. Though such a system seemed to dilute the whole purpose and intent of privatization, in the context of the case of Jenoptik such a system of negotiation was welcome because by it management was able to learn and put together a great deal of information on production possibilities that it otherwise never would have known -- information critical to deciding some of the key strategic issues it faced. The tradeoff between maintaining a centrally bundled control structure and encouraging such needed communication was a real that fused the strategy and structure of the firm.

During the years following its sale to the state of Thuringen, Jenoptik rapidly reduced its losses despite the severe economic downturn that hit the German economy starting in 1993. Declared a success by most observers, though still in public hands, the firm is another example of how economic and political expedients combined to push the Treuhand and even state and local governments away from their plans and preconceptions about privatization and governance to a more ambiguous – and even outright contradictory – solution that not only excluded banks and traditional actors from principle
roles but, as with the case of machine tools, led to the formation of a highly unusual system of governance within the firm itself.

**The Banks' Limited Role: Three Possible reasons for failed expectations**

The large picture of the big banks' limited participation in industrial investment and restructuring outlined above seems to contradict policy makers' plans as well as historical and economic arguments in their favor. Policy makers and economists had envisioned that, once in place, West German financial institutions would solve precisely those tough problems that characterized the reconstruction. Difficulties between owners and managers -- the type that plague privatization efforts in other former socialist countries -- would be solved by bank-led corporate governance; problems that might develop in the political sphere would be solved by close political arrangements between finance and the state; and through it all the banks could draw on their industrial expertise to orchestrate solutions to the technicalities of restructuring from a centralized vantage point. And yet once in place, the big banks refused equity ownership and withheld industrial credits. The Treuhand together with the government was forced to play a far more activist role and innovate entirely new governance solutions. Why?

In their reflections, German policy-makers and observers offered three different explanations to this puzzle. First, political forces might have undermined the process from without -- politicians willing to pursue short-run electoral gains might have compromised policy-makers' positions. Without the proper legal framework, or Rahmenbedingungen, the banks were thus blocked from investing or participating in the reorganization of industry more fully. Adjustments had to be made. Second, the banks
Figure 5: Jenoptik Intrafirm Organization, October 1994.

Unternehmensgruppe JENOPTIK
einschließlich unmittelbare und mittelbare Beteiligungen

1. Organkreis UST
2. Organkreis KST mit EAV

Organsprecher UST
Organsprecher KST

In Liquidation befindliche Firmen:
- I.V. Tech
- AK Optik, Schweden
- Binder Stahl
- C.G. Keramik, Belgien
- Jenoptik Lasertechnik Steiger
- Jenoptik Lasertechnik Wien
- Jenoptik Lasertechnik Berlin
- Jenoptik Lasertechnik DK

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might have been extremely well-informed and realized that East German industry was in far worse straits that anyone had previously imagined. Acting on this knowledge, they wisely instituted extremely conservative investment policies. Lastly, policy makers' assumptions and convictions about privatization might simply have been in error. When policy makers confronted the difficulties and paradoxes associated with investment in a volatile economic and political environment, they precipitated a series of impromptu adjustments that, accumulating over time, led to important changes both in the relationship between the banks and the state and to the institutions of corporate governance themselves.

**Political Barriers to Privatization?**

Of the three possibilities introduced above, the earliest argument of those wishing to defend initial strategies for privatization was the first -- namely, that political forces seeking their own ends had prevented the models from being properly implemented. The version of this argument most cited has been that politicians or judges from the former DDR encouraged conflicting claims over property and that the resulting uncertainty over property rights produced under-investment in the East, including banks' unwillingness to lend and inability to buy secure equity claims. Around 30% of East German land was confiscated from private individuals by both the Nazi and Communist regimes since 1938; no sooner did Germans see unification as more than a remote possibility than a heated debate broke out over the question of the restoration of this property. Because one of the largest affected groups, those West Germans which had fled from the East, number primarily among conservative voters, and because of the long-
standing anti-Communist traditions in the CDU, Bonn made restitution of property an early priority in the unification process. On June 15, 1990 the governments of East and West Germany issued a Joint Declaration that stated, "Pertaining to the resolution of present questions of ownership, both governments believe that a socially acceptable solution in the interests of different groups is to be had. The security and clear articulation of rights, including property rights, are principles which guide the governments of the DDR and BRD in this resolution. This is the only way that peace over questions of rights can be guaranteed in the future Germany." Article 41 of the Unification Treaty made this declaration into a guiding legal principle. Hundreds of thousands of property claims resulted from the Federal Government's subsequent regulations providing for the restoration of ownership; almost overnight complex legal tangles developed over everything from housing to shares in firms and industrial capital.135

The investment process in the East, critics contend, thus was stalled from the beginning. The restoration movement replaced many owners who have the know-how and experience to use their assets with those, many of whom are children of former owners, who do not and whose abilities to maximize return on the capital were far worse than present Eastern property "users." In other words, the politics of restoration produced a second system of property allocation beside that of the market. Because of the power of the courts, this second, political system often circumvented the efficient market system and prevented the banks from playing their proper role. Moreover, laws designed to bypass the courts were been inadequately enforced due to the East's poor administrative
endowment. Directors at several of the big banks in Potsdam and Berlin, for example, cited troubles with local courts and inadequately outfitted government bureaucracies as major barriers to speeding investment; the large number of claims on property could simply not be processed in time to satisfy interested investors. Even when the laws clearly spoke in favor of an investor, often appeals had to be made to higher, regional courts to overturn "impossible" decisions by local judges set on defending small claim holders against large investors. The long court battles add to confusion, suspend expectations, stall projects, and add additional costs to investment. Some bankers even went so far as to accuse local political and legal authorities of harboring a political interest in perpetuating the blockage of property cases.

The government anticipated these problems, however, and took measures to circumvent them. At the Treuhand's behest, the federal government passed a series of laws in 1990 and 1991 designed to eliminate the relevance of legal claims where industrial investment was at stake. Unlike claims on homes and non-industrial assets, claims on firms or productive property could only be rewarded by government cash paybacks, not actual restoration of the assets in question. Thus, investors in firms were protected from sudden confiscation of their property or compensating claims by former owners. Most importantly, on April 22, 1991 a special Investitionsgesetz was passed that freed state-owned property from legal claims by former owners when that property is connected to private investments that create permanent jobs, a substantial number of new living quarters, or important elements of the economic infrastructure. In addition, the Treuhand and the Federal Economics Ministry, serious about clearing any remaining
legal ambiguities that might stall investment, created special departments of legal experts
designed to troubleshoot property problems with the courts. Berlin and Bonn passed laws
to speed the enforcement of the *Investitionsgesetz*. The most important of these was the
"General Administrative Decree for the Accelerated Processing of Property Claims."
This decree based itself on Article 15 of the Unification Treaty and allowed *Landkreisen*
to speed process property claims which were deemed of special relevance to investment.
Because *Landkreis* administration was frequently lacking in the new Federal states, this
decree gave special powers to the states themselves to clear any legal tangles they feel
block investment. Thus, since 1991 banks and other financial intermediaries with decent
relationships with the *Land* governments and the *Treuhand* had the resources to minimize
enforcement problems of the *Investitionsgesetz* and of other laws designed to cut a path
for investment through the jungle of property claims.

In fact, the argument that uncertain ownership claims stalled bank investment
works more against the thesis that banks should have been a key to facilitating
privatization than for it. The reason why ownership tangles made banks so reluctant to
invest in the East German Economy is that land was the only asset banks had the
confidence to value consistently. Especially in the first phases of privatization -- until the
end of 1991 -- real estate or federal guarantees were the primary collateral banks required
against loans to East German firms, which lacked established markets and whose physical
capital thus bore extremely uncertain value to those lacking intimate knowledge of the
firms. If banks could value the products and services of East German firms more
confidently, then the knotty real estate market would carry less importance. In fact,
several big bank managers claim that the importance of land deeds *is* decreasing with time as they learn to judge the East German markets more accurately.

The problem, as a first step, appears reducible to an information and learning problem: the real reason why banks were so slow to invest in the East was that they did not possess enough information to form competent opinions about the value of firms, markets and assets in the East. This possibility runs exactly counter to the view that the banks would be the key to privatization. In fact, it supports the opposite thesis: only as privatization proceeded and banks gained experience in the associated bargaining processes, learning to rely on different actors and bargaining participants for accurate information about the prospects of different East German firms, did they become more able to invest. Instead of the financial institutions facilitating an efficient sale of assets, the sale of assets actually facilitated the efficient participation of the financial institutions. But before moving on to the full implications of this view, the opposite thesis must be briefly entertained: namely, that banks’ *superior* knowledge was the reason for their hesitancy to invest and play a more active role in reorganizing industry. Could it be that the banks’ caution stemmed from unusually fine insight into firms’ difficulties?

**Wise Caution?**

Today the most popular explanation of the banks’ cautious role in the East is that they simply could see the disaster there before anyone else. Looking backward, there seems nothing special about explaining the banks’ caution -- why invest and go to the expense of helping the *Treuhand* reorganize combines when the prospects of successfully converting industry appeared so bleak? No profitable bank would consider such a course
of action. In light of the way many large investors pulled out of commitments to the Treuhand after claiming that conditions in the East had made their plans nonviable, and in light of the recession that gripped West Germany in 1993, perhaps the banks’ caution was quite enlightened.

This view seems congruent with the experiences of many bank lending officers in the East. From the early days after monetary union onward, these officers steadily complained of the huge mass of unviable business propositions they received from naive prospective entrepreneurs. “Piles and piles of useless plans,” said one such officer, “and every one [of these entrepreneurs] needed to be told personally that they just would not do.... After so many times, being the cause of so much disappointment really gets to you.” Another manager lamented, “That stuff is complete garbage, what they try to sell us [Eastern entrepreneurs seeking loans]. Mist!” He continued to berate many of the management buy-outs that the bank had refused to finance: “These projects don’t even deserve to be named ‘firms’ -- they are completely unsustainable.”

Despite these impressions, the thesis that intimate knowledge with Eastern firms and combines was the reason for the banks’ limited role fails on two grounds. First, it does not conform well with events. The fact that the banks were forced to sift through a large number of nonviable investment projects does not mean that there existed only few opportunities to invest profitably. If this was so, why did banks source out so many prospective investment projects to independent third parties? The use of third party information sources appears especially puzzling if the banks possessed superior knowledge of their investments. Moreover, why the big losses incurred on losing
projects in 1992? If the banks were so well informed, it seems unlikely that they would invest in such projects fearing that their competitors might do so first. In fact, the most likely explanation for this behavior seems to be that the banks were unable to distinguish by themselves the good projects from the bad projects.

Second, and more importantly, it is not plausible that an information advantage would keep the banks out of the investment and negotiation process with the Treuhand. Rather, such an advantage should have encouraged the banks’ participation. Because the Treuhand frequently used large subsidies to pay investors to buy firms, investors could and did make money even on projects whose costs exceeded revenue. Everything was open to negotiation, even the balance sheet of the combines themselves. In short, the system seemed to favor most those actors who possessed good information about industry. Moreover, the Treuhand’s goal to sell its assets quickly, combined with its attempt to involve the banks from the earliest moment possible, made it unlikely that it would drive a bargain too hard for the banks to swallow. Rather, the experience with the liquidity loans and the sale of the Staatsbank showed just the contrary: the Treuhand would prefer to err by paying the banks too much for their co-operation. If there were large potential gains to be made from successfully negotiating agreements between the Treuhand and the banks, and if the open nature of negotiation ensured that informed parties would share in at least some of the gains, then refusing to participate fully in them pointed not to the banks’ prudent caution, but to their fear that not knowing enough about the objects of negotiation -- alternative investment plans -- would disadvantage them.
The Politics of Investment and Property in a Volatile Economy

Rejecting both of the above explanations leads to the argument of the chapter: namely, that the impeded form of financial politics in the East -- characterized by serious risk aversion -- stemmed primarily from problems associated with the creation of investment institutions in a volatile economic and political environment. This volatility lead to abnormally severe information problems in Eastern markets which a centralized administrative apparatus could not overcome. Intermediaries supposed to discover the objective value of assets become burdened with actually creating future market possibilities by rearranging or restructuring the assets they were selling to fit niche strategies of their own construction. As evidenced by the case of privatizing the East German banks themselves, the resulting asset values were often buyer-specific: highly or even exclusively dependent on the strategic interests of individual companies. The same difficulty arose in the two cases of privatization discussed above: problems of incomplete information were caused by the dynamic and uncertain nature of future market possibilities. The chicken and egg problem that confronted the Treuhand in the case of the sale of the Deutsche Kreditbank and the East German banking system thus mirrored itself again and again, less dramatically, in the sale of other firms. The result for outside investors like the big banks was that in some cases hands-on experience with restructuring was the only way to learn to judge investment opportunities for themselves. In other cases, the relevant information was simply not discoverable from the outside and investment was nothing more than a fancy version of blind-man's bluff.

Policy maker’s models and the economists that elaborated them offered a common solution to this problem based on the presumed intimate relation between
ownership and information. Ownership was to be the best way to motivate and enable monitoring. Ownership would establish a hierarchy with the monitor on top. Banks' purchase of shares would give them control rights which would allow imposition of their own representatives on the most intimate bodies of decision-making within the firm. Because of banks' financial means and position at the peak of the economy, this would establish ways for information asymmetries between firms to be overcome and economy-wide coordination to be introduced -- namely, through the existence of a large, centralized common owner. Even in uncertainty, it was thought, "motivating the monitor" would best accomplished by giving it a high stake in monitoring. If the payoffs to monitoring were unknown and highly variable, then the best way to do this would be to cede rights to the monitor: in other words, to give the monitor a substantial equity stake in the firms in question or a substantial cut in the volume of the transaction. The Treuhand did just this in the case of investment banks, offering the banks a cut from 0.5% to 3% depending on the size of the sale in question. In addition, the Treuhand also created Management KGs that designated highly motivated individual owner-monitors to oversee groups of state-owned firms.

Why, then, did the big banks refuse to accept equity positions in Eastern firms? The empirical answer seems to be that, contrary to both of the above models, ownership rights and the hierarchies they establish were not always desirable in the volatile East German economy. For many investment banks, the expected payoff from privatization projects was far less the percentage cut in the project than the value added to the bank's reputation in Europe or a given industry; than the value of acquired learning; or than the
possibility of doing future business in East and West Germany or in Eastern Europe. In short, to intermediaries just as to the buyers they hoped to find, a deal's strategic externalities were often far more important than the deal's immediate pecuniary returns. Ownership rights could sometimes exacerbate unforeseeable negative externalities involved with the individual transactions. J.P. Morgan, for instance, suffered severe loss of reputation when scandals developed from its sale of the newspaper industry to politically dubious groups. Other investment banks balked at taking potentially lucrative projects because of the uncertain reputation effects associated with layoffs and other restructuring measures. In fact, most deals required the Treuhand to carry out layoffs and worker reorganizations before it transferred ownership to private parties for precisely these reasons, as was seen in several examples in the machine tool case. Once transferred, moreover, these rights were often unbundled in favor of a blurred or shared rights structure that encouraged negotiation and thus information sharing between local and central actors.

These uncertain strategic and political externalities help explain why motivating the big banks to monitor East German firms and to participate more closely in their privatizations met with such little success. Bank officials often cited their unwillingness to accept responsibility for the social dislocation that frequently follows privatizations and their associated restructurings as a reason for their hesitancy to play a more prominent role in the East. Such negative publicity caused enormous strategic problems, bankers stressed: not only did it hinder banks' efforts to woo new investors in the East, but it had negative backlash effects on the banks' Western business as well. Obviously,
local community outrage could kill the big banks' deposit business -- which from the beginning was the main attraction of the East. More importantly, heated social controversy could threaten the delicate balancing act banks had to perform between the interests of Eastern management and the Treuhand. Because Eastern firms were still largely uncommitted to any one bank as a "house-bank," the big banks are extremely hesitant to participate in activities that could portray them as heavy-handed interventionists -- especially if they fell into the disfavor of community officials on whose good will local management often depended.

In addition to the observation that property rights often failed to capture the most important pecuniary dimensions of a project -- namely its strategic, learning and reputational values -- experience with the many privatization cases shows that property rights often prevented or held up the information sharing process so necessary to successful restructurings. Property rights created hierarchies of control that left subordinates with incentives to hoard information or shirk. These hierarchies were inimical to the success of numerous restructurings and investments that required local actors with intimate knowledge of combines' production to share their information with intermediaries familiar with external markets and the strategies of outside investors. Both sets of actors had to cooperate to invent investment strategies and form plans for how best to reorganize combine assets to meet those plans. Because the strategies invented frequently formed the most important component of a valuation, if cooperation halted because the control rights of one party induced the other to withhold information, the entire sale process halted also.
Thus, one of the great ironies of East German privatization seems to be that where political externalities were greatest and the needs for reorganization the most poignant, the most successful way the Treuhand "sold" Eastern firms was by creating ownership structures in which residual rights of control were forfeited, shared or hidden: in other words, by creating governance systems that blurred property rights or made them less exclusive and the subject of negotiation. Unorthodox privatization forms like industry parks, the creation of the Schleifring in the machine tool industry, the structure of governance within Jenoptik GmbH and solutions in which ownership rights reverted to the Länder, municipalities or federal government can be seen as just such solutions. Although the Treuhand ultimately retained the deeds to sell to investors and reaped the price (or the cost) of the sales, the rights it ceded to industry parks not only give them substantial influence over the Treuhand, but actually granted them control powers over combine assets so broad and permanent that they must be considered "residual" in the strong sense of ownership rights. By separating ownership from control, or even disposing of exclusive control rights altogether, the Treuhand was able to enlist the cooperation of several important actors in breaking down the information barriers that would otherwise hinder restructuring and investment.

Summary

Despite the government's well-laid plans to give the banks a major role in privatization and the implementation of private economic governance, the struggle over ownership and the uncertainties accompanying extreme economic volatility combined to produce an impeded form of financial politics in East Germany. The big banks' missing
willingness or capability to "monitor" or guide the investment process in the East can be traced to the political volatility of the restructuring process, the banks' refusal to assume the risk of associated negative strategic or political externalities, and their difficulties accessing relevant investment information. Policy makers' assumptions about property and its relation to economic information were questioned by the observed difficulty of creating private ownership rights and actors capable of exercising them under the difficult economic conditions of privatization. In fact, in those situations involving the largest, most important privatizations, policy makers had made exactly the wrong assumption: instead of a clear, centralized ownership structure, often the most workable and attractive solutions was to blur or disguise property rights. Only then could damaging political and social controversy over privatization be deflected from investors and only then did local actors and intermediaries cooperate fully in sharing the information needed to find the best business possibilities.

As expectations that the big banks would use ownership stakes to play an active investment role in the East were disappointed, it became clear to many that the government's expectations had been disappointed. If the banks acted as a political buffer in the West in times of economic crises, they certainly did not do so in the East. On this political level, the experience of privatization had led to a worsening of the relationship between finance and the government. Instead of finance, the government had turned to big business for help with the privatization. But even this relationship must be qualified with the observation that in questions of policy the government turned increasingly toward to big firms directly instead of through the traditionally powerful political bodies
representing them. On this last count, in fact, privatization had left a legacy of only superficial heed, if that, to such organizations’ concerns and suggestions. At times, the government actually spurned their proposals outright. When compared with some of the outstanding examples of cooperation between the Treuhand and industry in finding highly innovative solutions to the governance dilemmas with which they were confronted, these observations stand out even more starkly.

But how exceptional was the legacy of the East? Do the changes in ways of governing firms, as well as in the way the state regulates such governance as part of its broader relationship with big business and finance, have any bearing on developments in West Germany and on other policy matters besides privatization? The dissertation argues a definitive yes to these queries, but to see why one must turn to other cases of corporate ownership and governance reform, cases that preferably span privatization historically. So it is exactly to such a case, that of the creation of the management holding, that the argument turns next.
Chapter 4

The Transformation of the Modern Corporation in Germany, Part I: Legal Transformation

Reunification indisputably changed Germany’s economic and political landscape. In many instances, privatization spurred the development of unconventional property and governance forms as policy makers and private actors learned to overcome unanticipated difficulties in their attempt to make East German industry competitive in world markets. Privatization also bypassed the usual collaborative processes between organized capital and the state. As the government moved to ensure the success of the economic transition, it made little use of formal channels to consult with industry and employer associations, it was not genuine in its solicitations for input from these organizations on key policy issues, and when in doubt it chose to deal with firms individually rather than use the cumbersome apparatus of associational politics.

But how exceptional were these developments? The next two chapters analyses a second event – the emergence of a new form of large firm governance in the West – to support the claim that changes brought about by privatization indicate a longer-term transformation of the relationship between public and private governance. That transformation includes changes to traditions over one hundred years old. Central to it is the revision of central doctrines of the modern corporation, the heart of capitalism in Germany. These changes, the dissertation contends, violate the usual policy-making
practices and patterns of interest mediation, and in so doing challenge the conventional model of German politics and industry.

The transformation in question proceeded in two distinct phases: one legal, the other institutional. Although the two were in practice closely related – and at times indistinguishable – they were each separate and even sequential. The present chapter lays out the argument for the first phase: the transformation of corporate law, especially those rules governing the control and ownership of large corporations in Germany. First, the chapter explains the origins and historical organization of corporate governance institutions in Germany. The principles and rules of governance animating these models and how they have historically organized the links between politics and business are made explicit. Second, the analysis exposes limitations to these principles and the pressures and difficulties of adjustment that have plagued them as the economy changed in the 1960s and 1970s. From these difficulties, the chapter explains the rise of a peculiar politics of impediment, which not only revealed limitations to the traditional collaborative system of government and interest mediation, but provided a launching point for practical strategies and innovation to bypass these difficulties in nontraditional spheres, such as the judicial courts. The innovations made by the courts, the chapter argues, caused a revolution of sorts in company law, along with a major political upheaval within organized business and capital.

**The Modern Origins of Corporate Governance in Germany**

The modern system of large firm governance – and with it Germany’s system of corporate governance in general – was founded primarily during the last third of the 19th
century -- during the same period of nation building during which the Imperial State was erected. Though the contemporary German corporation is the product of a history nearly as turbulent as that of the country as a whole, its main features endured for over one hundred years, with only relatively minor modifications. Those main features are the product of joint-stock company law; the laws of other corporate types; a national legal framework that structures the regulation of corporate governance; and the actual practices of production and finance, including the formation of cartels and collaboration with and oversight by the big banks.

The Laws of Joint-stock Companies

The legal foundations of the modern joint-stock company were laid in Germany, as well as in Britain and the United States, during the last third of the 19th century, and with them were delimited many important rules defining how large corporations would be governed and financed. In the United States this unleashed a great wave of incorporations and new stock issues after the Civil War, while in Germany (mostly in Prussia) the boom in founding joint-stock companies occurred a little less than a decade later between 1870 and 1873, during the first years of the new German Empire. Besides the timing, the German incorporation laws and founder booms shared much in common with their European and American cousins.

The joint-stock company -- a corporate entity granted its own independent legal personage with the right to issue shares -- actually had its origins over three hundred years earlier, in large English trading companies. The first permanent corporation appeared in 1602. But until the "founders' period" beginning in the 1860s, corporate
charters were passed by discrete government acts. Whether in France, the German states, England, or the United States, each individual corporate charter had to be separately negotiated with the government. All kinds of significant restrictions discouraged the formation of corporations and placed them under strict state supervision. These included limits on the corporate lifespan, the nature of the corporation's business dealings, the number and type of its shareholders, its geographic scope, its capital structure, the composition, nature and powers of its organs, and the manner and method of paying dividends and issuing shares. Companies like the South Sea Company, the East India Company, and Friedrich II's Bengal and Oriental Companies were renewed every few years, at which time the government collected fees and bonuses for granting renewal and, in addition, set certain restrictions or limits on the funds it could raise by issuing bonds or shares. These and later companies, like the large 19th century Prussian mining companies and railroads, were granted monopoly or quasi-monopolistic powers with incorporation and charter renewal. Corporations were as schematically and economically diverse as the moods, coalitions, and interests of the governments that created them.

Besides the opportunity to extract rents, close state supervision of incorporation and re-incorporation had good reasons, the foremost being to prevent abuses. The history of early joint-stock companies is full of speculative bubbles, buying manias, market crashes and scandal, which can only be expected during a time when the concept of equity investment was new, the ideas of probability and quantifiable risk foreign, and the uncertainties of the newly incorporated businesses extreme. Spectacular examples include the South Sea Bubble, the Mississippi Bubble, and the East India Company Crash.
of 1782. Because the idea of a legally independent corporate personage was a novelty, and because the bundles of rights granted these corporations were similar to those granted guilds and other groups for hundreds of years, governments could not escape responsibility for these entities. The only sensible way to avoid upsetting its relationships with financiers, but not forego noticeable economic benefits by banning the companies altogether, was to regulate them closely. Many state-imposed restrictions were thus meant to avoid or to quell crises, or in their unwelcome event, to deflect criticism from the government. Requiring all joint-stock companies to be government chartered, periodically renewed, etc., together with the granting of monopoly privileges, limited their number and stabilized both their goods and securities markets.¹⁴⁵

This concessionary system of incorporation was first done away in the U.S. Without a long history of corporate scandals, the well-developed charter negotiation apparatus of England and France, and strong, public financial markets, the American states responded to the growing demand to incorporate by liberalizing the procedure.¹⁴⁶ The first modern, general incorporation laws were passed in New York in 1811 and in Connecticut in 1837.¹⁴⁷ The U.S. laws were true innovations and committed the state to refrain from directly supervising the incorporation process. Private incorporation of any lawful business was encouraged. Instead of laying a corporate charter bare before the eyes of outsiders and justifying it before the legislature, the law called for the charter to be drawn up privately and then filed with a government agent, who would check legal compliance and keep the contents secure. Gone was public debate about the incorporation, and gone was the opportunity to amend the charter as the state saw fit;
instead, the charter assumed the status of a quasi-private contract between the founders, even though it laid down terms of finance and liability clauses that would hold for future investors who had no opportunity to check or negotiate its contents.\textsuperscript{148}

In Germany throughout the 1850s and 1860s, only Bremen and Hamburg had non-concessionary incorporation laws. In 1970, after several U.S. states (among them California, Virginia, and Maryland) and England had followed the Connecticut and New York examples, the First Aktiennovelle was passed in 1870 and a non-concessionary system instituted nationally.\textsuperscript{149} 1870 marked a high point of German national liberalism, a year in which German troops were victorious in Paris and a slew of individual and economic freedoms imported from other countries (primarily England and the U.S.) were passed as law in preparation for the unification of the Empire the following year.\textsuperscript{150} In this euphoria, the authors of the bill explicitly tried to fashion provisions that would be recognized by the world for their liberalism, and so used American and English examples as their basic pattern.\textsuperscript{151} Germany, like the U.S., lacked many of the barriers to generalized corporation which other nations, like France and Britain, had to overcome. Germany had very few joint-stock companies before the 1870s, as well as very small securities markets, and thus lacked experience with scandal and crashes. Popular resistance or mistrust toward the new liberalized process was absent; business itself, of course, welcomed the proposal with fanfare.\textsuperscript{152}

What followed the 1870 law was the first major German incorporation mania, scandal, and Germany's first big corporate crash. Between 1870 and 1873 the corporate structure of German industry was transformed; hundreds of partnerships, “silent
partnerships,” and mining societies changed their corporate form to the AG (Aktiengesellschaft, or joint-stock company). In Prussia, the number of AGs climbed from 200 in 1870 to over 1000 in 1873, but not even half of the newly formed equity survived the 1873 crash, and nearly half of the number of enterprises were liquidated or bankrupt in the very year they were founded.\textsuperscript{153} A widespread reaction against the new corporation formed, as industry and trade chambers, prominent groups of legal experts, banking societies, and labor joined the outcry. Some business groups called for the complete ban of AGs. So intense was this opposition that serious proposals for reform of the 1870s were brought forward already in 1873,\textsuperscript{154} and the liberal parliament debated and passed major revisions to the 1870 law only fourteen years later, as the Second Aktiennovelle of 1884.

The 1884 law instituted many of the key differences with other governance systems. The reforms attempted to protect the stockholder from swindle and deception, and to quell speculation by raising the barriers to found and invest in an AG. Shares could only be denominated in multiples of 1000 RM; a careful state-led review process of the health of the enterprise and the accuracy of its prospectus was instituted; and the corporate founders were made personally liable for any falsehoods and any financial difficulties with the equity issue. All these rules meant, in effect, that only already large and powerful companies or those with the backing of well-financed actors like the banks could venture a stock issue. In contrast to the American, British, and French systems, the power of the banks was instituted at the most fundamental levels of corporate law by making it difficult for companies to obtain equity finance (and with it greater freedom
from debt) without a big bank’s or company’s active participation. These same rules formed barriers to entry that encouraged the formation of an oligopolistic industry structure among the AGs by preventing companies that wished to enjoy the advantages of issuing equity from doing so without first combining with other companies to reach a critical size. The 1884 law specifically stated that the AG was meant to be the legal form of the largest enterprises.

The 1884 law also formally redefined the relationship between the German state and the joint-stock company. While the 1870 law was meant to handcuff the heavy hand of the state in the incorporation process, the 1884 law – after the miserable experience in the 1870s – restructured the governance of the AG so as to allow direct public oversight of the company. The non-concessionary incorporation process was kept, but the supervisory board – and with it the two-tier board system – was born. German law defined separate bodies for stockholders (the supervisory board) and management (the executive board) and forbade the overlap of personnel; in this way the law at least superficially attempted to institute a body that could formally protect the interests of public shareholders. Public officials, semiprivate officials,\textsuperscript{155} major shareholders, and independents could sit on a board (and might be required to in order for a public offering to be approved) and monitor management’s doings without interfering in the day-to-day operations of the company. As the shareholder meeting elected the supervisory board members, the system was introduced as a triumph of balance between self-government and state oversight.\textsuperscript{156}
Nevertheless, the tools given to the supervisory board were insufficient to prevent it from foregoing its nominal task. If shareholders were scattered and weak, the supervisory board could easily become an ill-informed spectator; if large minority or majority ownership blocks existed, the supervisory board assumed the powers of management and led the firm. In practice, the latter was almost always the case, and the board system came to resemble the unitary non-German systems de facto, such as that of the United States, which next to Germany was the other most important rapidly industrializing country. This occurred even more so, because, like the American system, the corporation assumed the role of proxy voting for absent shareholders unless these votes were explicitly lent to other institutions, such as the big banks. As in the United States, the board became a singularly effective instrument for insulating management, promoting corporate mergers and coordinating monopolistic and oligopolistic practices. The stockholders meeting soon became a place for rubber-stamping decisions already made by management, and, as in the American case, the courts became the last and only resort small stockholders could use to protect their interests from management, an endeavor without a high expectation of success.

Despite the popular reaction and the thoroughgoing reforms ostensibly made to differentiate the German joint-stock company from the abuses endemic to its liberal American sibling, much of the AG's structure remained in common with its American cousin. In addition to the converging roles of management, despite the formal differences discussed above, stockholder rights were also defined in similar ways: liability limited to the value of equity; shares fully alienable; governance role limited to the stockholders
meeting, where majority voting applied to most issues and qualified majority voting was required for capital appreciations, dilutions, new share issues, and other activities that affect equity structure; the right to choose management of the corporation; the right to require an accounting from management; and finally the right of minorities to sue management or the corporations for infringing any of these previous rights or carrying out actions against the interest of the corporation. The German AG was built on the same basic foundation as the American corporation, and as a result the same types of stockholder-manager conflicts were instituted with it as Berle and Means described in the U.S.\textsuperscript{161}

In sum, the German joint-stock company was born twice: once as an import from abroad, and again as a re-christened “German” version meant to balance the self-governance principles of the AG with state oversight. The 1870 law introduced many of the fundamental principles of joint-stock company governance from abroad, while the 1884 law instituted such novelties as the two-tier board system and shackled potential entrants into the club of AGs with steep incorporation requirements. In practice, only the latter measures protected public shareholders from scandals and fraud; these provisions did so by severely limiting the number of new incorporations and with them the possibility of new issue chicanery – an obvious instance of “throwing out the baby with the bath water.” The law which was meant to place them in a better position to monitor and oversee the management of the enterprise and its equity capital, however, had resulted in a buildup of powerful interests adept at keeping the public from obtaining precisely such information. The balance between state oversight and self-governance that
drafters of the law meant to be the solution to the serious monitoring problems in the 1870s was kept in form, but in practice was tipped squarely in favor of large, influential investors.

**The GmbH and the Legal Framework of Governance**

When the AG was created in 1870 and then again in 1884, one of its most important principles – as with joint stock companies in other countries – was that financial instruments and liabilities were the central, defining feature of the corporation. Because these came in discrete, inseparable bundles (shares), the boundaries of a corporation, together with the powers of control over it, could, in practice, be sharply delineated. The scope of a company ceased precisely where the financial liabilities of individual investors and the managers acting on their behalf no longer enjoyed legal protection or limit. Where such protection existed, the corporation could act as a distinct personage under the law or juristische Person (JP), with the rights of contract and person as if it were a full-fledged individual.

The advantages to the JP status were not lost to the vast number of non-AG managers and owners who made up most of the German economy. For family firms seeking a device that would provide a trusted dispute resolution process and a mechanism for perpetual succession and inheritance, limited liability together with JP status held promise. Initially, however, passage of limited partnership legislation was not seriously considered as a possibility by the Reich’s myriad of trade and commerce chambers, which acted as focal points for family and craft firm interests. The concept of the limited partnership – or rather, the concept’s early progenitors such as the limited
cooperative – had been a mere political fancy in the decades after 1848. Once discussion of the AG became earnest, the idea of the limited partnership was given merit by some, but again was perceived as politically unworkable. After 1861, instituting a limited partnership required altering not just regional laws, but the national commercial code, an act that would have to come from the government, not parliament. While the Imperial government in Prussia saw common interests with large financiers and industrialists, it was far less receptive to the needs of small businesses. In fact, much of the Imperial government’s impetus behind the 1884 reform had been to restrict use of the new AG rules to only (existing) large enterprise, and to prevent abuses that arose when small enterprise used the new rules nonetheless.

Small enterprise was indeed a separate country to the Prussian suzerainty. The newly forming large enterprises were concentrated not only by industry – in mining, metal-working, ship-building, and other heavy industries – but geographically as well: primarily in the north, especially the Western reaches of Prussia, the Ruhr, Bremen, Berlin, and Hamburg. Indeed, many of the progenitors of the joint-stock company incorporated under the old concessionary system were based in precisely these businesses and locales, including the bergrechtliche Gewekshaft (mining) and the Reederei (ship-building). Industry in Baden, Bavaria, Wuertemberg, the Palatine, and other non-Prussian areas – the Reich’s “periphery,” so to speak – often comprised smaller, family firms and (more rarely) cooperatives, whose interests were removed from the concerns of the Imperial government, just as their ways were often removed from the debates over legal and administrative innovations in Berlin. Although smaller firms also populated
Prussia’s economic landscape, these firms remained outside the concerns and machinations of Reich government.

The initial impetus toward passage of the GmbH (limited partnership) law of 1992 could not and did not come from small and medium-sized businesses, nor from the business chambers that spoke for them in legislative circles. Rather, it was the Reich’s own colonization politics that brought the issue to the fore.\textsuperscript{168} As the Imperial government took a keener interest in overseas expansion -- following the model of England, France, and other colonial powers -- it realized that private and semi-private corporations were the most preferable instruments for pursuing its economic and political ambitions. But while such corporations allowed the government to enlist large private sums and resources to the cause and to pursue objectives in not only its formal colonies, but in rival states’ colonies and non-colonized regions, such corporations were extremely risky and rarely profitable enough to justify the commitments of banks or other large financiers. The AG was at first thought to be a solution to this conundrum – pooling individual investors who could more easily bear the prospect of depressed returns. But as the 1880s drew on, it became obvious that the AG’s governance apparatus prevented state participation in the management of such Koloniegesellschaften (colony companies), as they were then called, despite the desire of both the government and shareholders for such participation.\textsuperscript{169} What was more, the law prevented equity participations by kind or services, including managerial services and other non-pecuniary obligations, deemed essential to Koloniegesellschaft operation by most observers.
As influential groups such as the Deutsche Kolonialverein (German Colonization Association) weighed in on the matter, they not only called for the modification of existing corporate laws or creation of a new type of corporation, but, by virtue of their influence in both government and parliamentary circles, initiated formal processes toward realizing those calls.¹⁷⁰ Between 1885 and 1888, when the first series of pro-colonization laws were passed, these groups and the affiliated attorneys, scholars and lawmakers linked issues like the threatened sale of the Luederitz Koloniegesellschaft of Southwest Africa to English interests with general corporate law reform, arguing that disadvantages of governance were the prime source of difficulties for such financially troubled corporations. The Deutsche Kolonialverein made repeated suggestions to government commissions and parliamentary committees that a new corporate form had to be created to fit the needs of German colony companies. The issue was not merely critical to the over 300 such companies incorporated mostly in Berlin, but was also vital to German national interests.

Once the issue had the attention and interest of the Imperial government, company law reform was quickly made a front-burner issue by practitioners in law and business and their sympathizers in parliament, such as Oechelhauuser, Hammacher, Simon, and Riesser.¹⁷¹ These men argued that the problems with colony companies were symptomatic of larger problems with incorporation law in the German Reich. Not only the colony companies, but many manufacturing firms in the neglected but economically vibrant areas of the Reich were disadvantaged compared to companies in England, because ownership forms such as the limited partnership or limited cooperative did not
yet exist in Germany. The AG law of 1884, despite intentions of the government, had not prevented these smaller companies from using the Aktiengesellschaft form. Desperate for a law that would confer the advantages sought by the reformers, retail and trade partnerships, small craft producers, and even agricultural cooperatives donned the AG habit, however perverse the outcome. Citing figures that showed the average size of the AG still decreasing after 1884, Oechelhaeuser and others argued that a new limited partnership law would “purify” the AG law’s application by offering a more attractive alternative to those not in the club of large manufacturing firms with high capital requirements and fairly transparent production designs. Once the state had passed non-concessionary corporate law, the cat was out of the bag. The only practical way left for it to discriminate in its administration of governance rules in a changing economy was to offer alternate laws for the companies it wished to regulate separately, attracting the “right” companies to the “right” law. Initially considered for reasons of national interest, the “limited liability corporation,” or GmbH, was passed in 1892 to structure the new corporate economy along existing political and economic divisions.

Initially, in 1870, the authors of the First Aktiennovelle did not discuss, and very probably did not intend to fit the rules of the corporation to only a select group of large firms. In the euphoria of national unification, many National Liberals from non-gentry backgrounds without strong Prussian credentials – precisely those who later championed the cause of the GmbH – formed a broad coalition with intimates of the concessionary system. At the time, it appeared that the two worlds of business politics had united in the same spirit on which Rudolf von Delbrueck had drawn as he helped piece together the
national coalition of economic interests for the common commercial code of 1861. But in the wake of the scandals following the 1870 law and especially after the crash of 1873, a schism between big business (especially metal working, mining, and iron) and the more decentralized economy developed that widened so quickly that it was soon impossible to imagine the possibility of mending it.

The causes of the rift were primarily political. In the late 1870s Bismarck embarked on a deliberate policy of splitting the alliance between the National Liberals and the Free Conservatives, seizing issues such as the press laws that would cause more liberal members of the former party to break with the others. The most important issue was protectionism. In the wake of the 1873 crash many industrialists turned to protectionism as a way to stabilize their businesses and business communities. It was in the years following 1873 that the prominent big industry associations were formed as alternatives to the regional trade and industry chambers. Industry associations were formed to catalyze the formation of a consensus among big industrialists on the issue of protectionism, in direct opposition to the chambers, which were dominated by regional business interests that had been the champions of free trade in the drive toward the common commercial code and national Zollverein. Once such organizations as the Centralverband der Industriellen (the precursor of the BdI) had formed, they hardly had need of action. Bismarck immediately seized the moment and approached them. Accepting the Pope’s offer of compromise on the Jesuit issue, Bismarck ended the Kulturkampf, offered cooperation with the Catholic Center Party, and began a pro-protectionism and pro-monopoly drive in the national parliament. The issues drove a
fateful wedge through the National Liberals while forming a large pro-conservative block of Free Conservatives, big Prussian industrialists, Catholics, and many well organized agrarian interests. It was in precisely this context that the 1884 AG law was passed – in an effort not only to restrict the Aktiengesellschaft form to big industry, but to use its rules to consolidate its anti-competitive position in the economy.

The stark formal separation of the GmbH from the AG developed from both a regionally disparate nation and deliberate policy. Geographic and economic dualism between regions organized around either autarchic or decentralized production practices\textsuperscript{180} provided a basis for the rift in the collective organization of business interests that developed in the 1870s and 1880s around the issues of protectionism and monopolization. This rift, in turn, combined with high politics to produce the Imperial government’s focus on large firm interests and disregard for less centralized business concerns. The relative specialization of the AG rules in 1884, and later the GmbH rules in 1992, became both the product of this dualism and a powerful mechanism for its reproduction. The collection of primarily Prussian industrialists, prominent German families, and members of the Imperial and Prussian governments who had participated in the old concessionary system of incorporation combined with the newly formed national industry associations to become the chief negotiating nexus through which the AG rules and regulations were tweaked and adjusted over time.\textsuperscript{181} In contrast, the nexus of interests through which the GmbH law was formed, negotiated, and later adjusted consisted of the trade and commerce chambers, regional business associations, and various outward-looking legal practitioners and scholars.\textsuperscript{182} The economic and regional
split between the AG and GmbH worlds of the economy was one reinforced by differently organized systems of business interest mediation and an open and formal political divide through high politics.

The principles on which the GmbH and AG laws rested not only reflected these economic and political dualisms, but were designed to reproduce them within the same national framework. This was especially true of the new GmbH law, which first introduced the formal division of the modern corporation in Germany. At its heart, the GmbH shared with the AG its most important principles: the juristische Person and the central role of financial instruments to the definition of the company. But how those instruments distinctly defined the company is what made the difference. Unlike AG shares, GmbH shares were not easily tradable. When transferred, they had to be certified by a notary. In addition, the GmbH charter could “personalize” shares with all kinds of special provisions, ascribing them solely to specific individuals, requiring the consent of all other shareholders for any transfer, trade or sale, and even ascribing special or limited powers to specific share issues. These potential stipulations, together with the drastically reduced publicity and reporting requirements, increased the costs of trading GmbH shares high enough to keep them out of all but the most intimate equity markets. Because of this, the GmbH was far less an ideal property form for raising share capital – and with it debt – than the AG.

The very flexibilities that disadvantaged the GmbH by raising outside capital made it a more desirable device for tailoring governance rules to the needs of family firms, owner-managed firms, and the like. The issue of shares could be linked not only
with payment of capital, but with the contribution of services and kind, or the assumption of specific obligations such as that of leases, the rental of land or machinery, or the donation of certain patents. In addition, the actual control powers available to owners could be drastically increased because of the very limited checks between the two governance bodies, the management board (Geschäftsleitung), and the shareholders meeting (Gesellschaftsversammlung). Shareholders could vote, for instance, to limit the powers of the CEO in almost any way imaginable; the same was true, in many circumstances, of the powers of other shareholders. The law provided for a number of default rules, but in the main these could be violated by explicit stipulation of the corporate charter. Finally, the very object of the corporation, and with it the object and value of the shares, could be altered within the GmbH structure. Whereas the AG required the corporation to pursue a profit motive in order to make standardized accountability and publicity criteria possible and with them transparency, the GmbH charter could deviate from this in almost any direction possible. Examples include not only the preservation of family or community interests, but the promotion of certain cultural norms, such as was the case with private foundations, museums, public works, and, most notably, colony companies.

In sum, while the AG was meant to mimic the rules of fair, transparent, public government, the GmbH was meant to provide great flexibility in forming special governance forms made to fit private, family, community, and myriad other needs. This was because the two ownership forms, for the historical reasons discussed above, explicitly targeted two very distinct groups of industrial enterprises. The first group
included the large, more autarchically organized firms in the Prussian North and West. The elaborate governance procedures of the joint-stock company were designed to add legitimacy and inspire public confidence in such enterprises, streamline access to outside finance, and consolidate their hold over their respective industries by erecting substantial barriers to entry against other firms seeking to join their ranks.\(^{186}\) The second group contained a vast number of family firms, start-up and owner-managed firms, craft enterprises, communally organized companies, and cooperative-like ventures especially prevalent in the non-Prussian areas of the Reich and in regions with a decentralized economic organization.\(^{187}\) Although the GmbH was inspired and used by other types of ventures not in German industry, such as the colony companies, it was designed to reinforce this “second economy” by providing companies in it with tools especially adapted to their needs, such as the ability to hone share structures flexibly to family, individual, and community relationships. GmbH rules did not inspire the confidence of outside investors, and thus was not meant to meet the needs of large companies with considerable finance requirements, nor were they meant to. Equity finance and transparency were not high priorities in the decentralized regions as they were in Prussia, the Ruhr, and those areas where firms had to build a whole public infrastructure in addition to an efficient, modern capital stock.\(^{188}\)

**Cartels, Control and Production**

Protectionism and monopolization were the issues that exacerbated the rift between large industry and the trade and commerce chambers in such a way as to produce parallel rifts in high politics, in the formal collective organization of German business,
and in company law. Indeed, the new 1884 AG law acted as a complement to protectionist and monopolistic policies. These practices, in turn, helped to keep the law itself consistent in its practical application and theoretical interpretation. For many large German firms, the organization of production, finance, corporate control and company law all met in anti-competitive practice.

The institutionalization of the AG arrived at the same time as the rise of scale production techniques and practices in many German industries, most especially mining, metal-working, and heavy industry. As pointed out previously, it is no accident that companies which employed these techniques were precisely those that became some of the earliest to incorporate under the joint-stock rules.\(^{189}\) Besides paving the way for raising the equity capital needed for large, sunk investments in specialized machinery and assets and in community infrastructure, the joint-stock company preserved the principle of central, discrete control within clearly delimited firm boundaries, a principle that was key to the implementation of scale production techniques in practice. Importing such techniques into the factory often required rapid and radical conversion of existing production layouts, a conversion that required strong, central control. Companies that could quickly marshal the resources to adopt Thomas-Gilchrist smelting methods, for example, were those that made the largest productivity gains and leapt down the learning curve of the new technology the fastest, lowering marginal and average costs, gaining market share, and with that market share lowering costs still further.\(^{190}\) Stabilizing market share brought with it even greater benefits, enabling the firm to commit to the large costs of implementing the new scale techniques sooner, and so receive an extra boost from
earlier learning. Emerging markets for standardized goods were fragile. Efforts to dampen the huge demand swings from the 1870s onward thus were a natural focus of the large firms, and an obvious way to do so was through anti-competitive arrangements: protecting markets from foreign producers who might undercut home market share, and preventing ruinous price competition among domestic producers who had every incentive to lower prices, perhaps below break-even if the alternative were to watch large sunk costs in equipment and new techniques go un-depreciated.

Collusion, syndication, and monopolization required enhanced central control, for without it industrialists could not have confidence in each others’ price commitments and production quotas – confidence that even with such control was often called into question. The AG ownership form produced just such control. But how did it keep control when its rules were designed to ensure public accountability, to increase publicity, and to protect dispersed shareholders? The answer, as Hilferding correctly pointed out, lay in the resulting market for shares. Unlike all corporate forms before it, and unlike the GmbH form after it, the invention of the AG was a simultaneous invention of an active, liquid market for corporate control. Horizontal and vertical mergers were made far easier as the stock market developed, and with them the act of industrial consolidation. Transparency and liquidity spurred corporate consolidation and integration by allowing outside finance to be harnessed by the process, including capital from banks and other large investors – especially the corporations themselves. Indeed, after 1884, several successive merger waves produced a whole legion of giant, vertically integrated and diversified AGs. From 1887 to 1907, the number of such fully integrated and diversified
firms among the top one hundred German enterprises rose from 13 to 62. Between 1896-1905 these 100 largest firms grew four times in size to a point where they represented 40% of the nation's industrial capital.\textsuperscript{194} The same was occurring in the U.S., where the rise in scale production techniques also combined with a similar corporate laws and a meteoric rise in stock market volume to produce consolidation, integration, and diversification. A comparison of the degree of vertical integration, degree of diversification, and product markets in the top one hundred U.S. and German firms shows matching parallels across the board.\textsuperscript{195} (See Table 1.)

Both the share ownership rules of the AG and the anti-competitive industry structures that grew from them helped determine how financial institutions participated in large firm governance. The need for collusive mechanisms created a demand in Germany for financiers who could stabilize syndicate agreements from positions of influence.\textsuperscript{196} Thus the high number of board seats of the six Berlin banks, which at the turn of the century Hilferding gives at 221, 133, 130, 101, 92, and 74 seats.\textsuperscript{197} Nevertheless, case studies of major bank-associated combines from the 1880s to the Great War show that while the German banks provided long-term finance in the form of rolled-over short-term credit lines, they were primarily interested in provided financial services to client firms and did not exercise controlling influence through large loans.\textsuperscript{198} Unlike today, German equity markets in the early 20\textsuperscript{th} century were extremely active, and companies raised far more equity capital on the markets (see Figure 1).\textsuperscript{199} Rarely did German banks themselves invest in stakeholdings, preferring instead to charge fees for bringing firms onto the Börse -- fees comparable in size and method of calculation to those of the American investment
houses.  When the banks did accumulate industrial shares, it was usually the result of rescue financing packages designed to keep clients afloat in times of misery.  Although German banks structured the system of board participation around a few powerful individuals who served on many boards simultaneously, these individuals were often personally related to their clients and preferred to intervene in their affairs only when needed, such as in order to enforce agreements or understandings with other firms.

Table 1: Comparison of Largest American and German Companies, 1907-1917
Source: Kocka & Siegriest (1979) pp. 86, 89.

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<th>Degree of Diversification*</th>
<th>Presence of Business Integration**</th>
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<tr>
<td></td>
<td>Low</td>
<td>Medium</td>
</tr>
<tr>
<td>U.S.</td>
<td>37%</td>
<td>60%</td>
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<tr>
<td>German</td>
<td>5%</td>
<td>71%</td>
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* Low = subsidiaries within only one product group; medium = 2 to 9 product groups; high = over 10 product groups.
** Includes both backward and forward integration (into suppliers & customers).

Figure 1: New German AGs, The Early Days
Although passage of the 1884 law helped spur anti-competitive arrangements and the financial relationships that helped keep them intact, the law’s application and interpretation by the courts was far more important to their development and to the development of the collective organization of governance in general. So was the court’s interpretation of myriad other laws. When the new company laws were passed, they had unclear ramifications for a series of separate state procedures, policies, and authorities. In tax law, for example, the rules for “enterprise tax” (Koerperschaftsteuer), sales tax, “trade tax” (Gewerbesteuer), “charter tax” (Stempelsteuer), and income tax were worked out separately by various local, regional, and national administrative bodies and the courts. As cartels, "common interest societies" (IGs), syndicates, and other collusive bodies were formed and innovated, the various tax agencies and courts in question reacted piecemeal and inconsistently, creating often arbitrary and conflicting interpretations of the same ownership arrangements, which only after years were coordinated. These rules, however, had enormous impact on how corporate and industry control developed in Germany.

One of the most vexing problems was the interpretation of inter-corporate ownership. To continue the tax example, if the ownership of one corporation by another were interpreted as two separate corporations, double taxation would ensue for any transfer of profits or, say, a dividend payment. While this system dominated most of the Wilhelmine period, in 1902 the Prussian High Administrative Court interpreted such ownership as an administrative relationship between two separate governance bodies — bound by a type of “employee-employer” relationship — within the same overall enterprise, freeing parent-subsidiary concerns from paying the trade tax twice.
Nevertheless, the decision was an exception, and double taxation discouraged the formation of enterprises with multiple legally independent subsidiaries, forcing industrialists to assume legally unitary ownership forms. This circumstance, combined with the high tax assessed on silent reserves at the point of any fusions or mergers, led to the formation of myriad loose price-setting partnerships or syndicates before and during the Great War.

After the war, an explosion of new interpretations and decisions on inter-corporate ownership transformed the tax rules, and with them the forms and practices of large-firm governance. The problem with the Wilhelmine era had been that with the loose structure of the syndicates had come very weak or non-existent enforcement mechanisms. To alleviate the problem, some syndicates -- especially the largest -- formed separate administrative companies (usually, because of its flexibility, a GmbH), whose powers to enforce production agreements among shareholders the courts upheld. As soon as these companies assumed any productive function, such as marketing or distributing, double taxation immediately slapped such arrangements with a high price tag. Between 1920 and 1921, however, following the lead of such decisions as that by the Prussian High Administrative Court of 1902, the Reich Tax Court interpreted the peak administrative company of a Ruhr-area coal syndicate as an employed “organ” of the participating enterprises and freed it from having to pay sales tax on goods it “bought” from the syndicate members in order to control distribution and with it overall coal sales. Similar decisions from other courts and authorities followed in the important areas of income and enterprise taxes. In fact, a whole “body-organ” theory of the enterprise
developed, which interpreted inter-corporate ownership in terms of relationships between organs of the same body.\textsuperscript{209} Under the Aufsichtsrat of a parent, the shareholders meeting and boards of subsidiaries or cartel-companies could operate much as the limbs and organs of a body operated under the direction of the brain. To interpret ownership otherwise would not only compromise the concept of property and owners’ rights of control, but would violate the very integrity of the greater economic enterprise, leading to a body with a degenerate nerve disorder: it was a “sick” economic entity.\textsuperscript{210}

The result of the new body-organ ownership theory applied in the tax code and to the rules of enterprise control (in company law) was a boom of cartels and other more tightly integrated collusive arrangements throughout the 1920s. The number of German cartels and the total output under their control climbed precipitously between 1905 and the 1920s (see Figure 2).\textsuperscript{211} In contrast, large unitary enterprises were penalized even further. As double taxation was lifted, the general tax rates increased. This meant that penalties for liquidating silent reserves climbed, and with them the disincentives to fuse and merge companies. The holding company became the method of choice for creating large combines.\textsuperscript{212} In 1926, for one year in the wake of the great inflation, taxation of liquid reserves was lifted, and a wave of mergers and acquisitions flooded the economy. But in 1927 the wave had subsided with the re-introduction of the previous rules.\textsuperscript{213} Germany had become a land of cartels.
The Transformation of German Corporate Law

The process by which the modern corporation was defined in Germany determined not only the rules and organization of governance, but the political system by which the rules of governance were modified, created, and negotiated. The move from concessionary politics and the AG laws’ far-reaching centralization of ownership powers tilted the AG’s formal balance between the state and private industry squarely in favor of the latter. However, national politics structured how industry participated in the new system. High politics split the collective organization of business, regionally and institutionally. After the Imperial period, a stronger central government replaced the old Prussio-centric federal system, and the courts began to assert themselves by adding new interpretations to the AG and GmbH rules, which strongly shaped large-firm and big-
industry governance. The law that was originally intended to keep the alternative autarchic and decentralized economies separate had to be continually reinvented by the courts in order to respond to developments in those economies. In the case of scale production and large AGs, cartels were the result. The courts opted to leave the powers of central corporate owners intact; the incentives this created in the tax system combined with the need to stabilize newly-emerging standardized markets by coordinating production across existing groups of firms rather than integrate production within one larger firm.

Conflicts of Principle and the Beginnings of Legislative Paralysis

Despite energetic discussion within the legal community, the German courts were never pleased to innovate rules where the legislature failed to provide adequate guidelines. Nevertheless, they were often left with little choice. Under the new democratic regime during the twenties, the government was frequently chaotically managed and weak; major, controversial legislation such as in company and tax law had no chance to be considered. Under these circumstances, it is little wonder that the courts took matters into their own hands and invented doctrines that in effect served as a new section of business code for the modern economy. Inaction was still action, scholars and practitioners alike agreed, for economic developments were compounding problems like the yearly interpretation of inter-corporate ownership.

Remarkably, after decades of upheaval and change, during the 1970s and 1980s, similar problems developed with similar results. After over thirty-five years of stable democratic government, the Federal Republic was regarded by many observers in and
without Germany as a model of consensus-driven politics, a characterization which, as previous sections showed,²¹⁷ was especially made of organized capital’s relationship with the state. Yet during this period the courts were forced to innovate entirely new doctrines that, just as during the chaos and instability of the Weimar days, had a critical impact on rules that determined control within many of the largest and most prominent corporations in the economy. Once again, a crisis of legal ambiguity loomed because the courts perceived that major economic changes had no chance of being addressed and negotiated in the normal legislative process. How did such a crisis develop, and for what reasons?

Not surprisingly, the modern day difficulties originated in the 20s and in the years thereafter. Once again, the problems stemmed from inter-corporate ownership. During the Weimar years, as previously described, the body-organ doctrine had upheld the powers of corporate owners to control subsidiaries as they pleased (according to the usual procedures of stockholder governance). Because for tax and other purposes the state interpreted such ownership arrangements as single enterprises and thus conserved many of the most important advantages of unitary governance, and because fusions and mergers were penalized by the law, a myriad of cartels and cross-ownership arrangements developed instead of large, single integrated firms or monopolies – despite otherwise relatively highly centralized control arrangements.²¹⁸

The difficulty with the body-organ doctrine and the resulting system of both intra-corporate and inter-corporate governance was that the juristische Person, the basic principle that legitimized limited liability and the resulting system of bundled, alienable control rights in the first place, was violated. If the courts allowed corporate owners to
exercise the full extent of their control rights, then the autonomy of the owned company’s boards – and thus the entity of the corporation accorded rights as a separate personage under the law – would be compromised in a way akin to the slavery of individuals. The justification for limited liability, the separate powers of contract, and most of the advantages of incorporation would be lost. To redress the problem, however, by upholding the corporate-owned company as a legally-independent personage whose autonomy could not be so violated, would place drastic restrictions on shares and stockholdings in ways that seemed to take away the fundamental core of ownership rights themselves. The body-organ theories of the courts were meant to solve this dilemma by erasing the troublesome inter-corporate boundaries that caused the fiction of the juristische Person, including the resulting powers of contract and ownership, to be used against itself.\textsuperscript{219}

During the National Socialist years,\textsuperscript{220} the body-organ theory that had developed over the previous 30 years in such an ad hoc and provisional fashion was called into question. The state took a much more aggressive approach toward recognizing and resolving the dilemmas of inter-corporate ownership. For ideological reasons, corporate autonomy was lifted as a norm that, when possible, should not be violated.\textsuperscript{221} The barriers to fusions and mergers were lifted, and cross-shareholdings, though still prevalent, were discouraged.

Already in 1931 a law that encouraged large companies to spin off subsidiaries into separately owned AGs was passed; corporation and charter taxes were lifted for such instances. In 1934 an Umwandlungsgesetz (Company Transformation Law) was passed
that substantially lowered the penalties on hidden or silent reserves at the time of a merger. Although parts of the body-organ doctrine were kept and in fact instituted in sales and other taxes, of greatest significance was a new AG law in 1937 that for the first time formally defined the Konzern (concern or conglomerate), giving a name to the group of cross-owned companies that until then were simply an artifact of interpretation in the law, despite a commanding place in the real economy. The 1937 law held large shareholders liable for interventions in a company that could be shown to be without sound economic reason and against the interests of that company (and not those of the owner!) In addition, it required profit-sharing or control agreements to be approved by a qualified majority of shareholders; gave minority shareholders recourse to sue the corporation if any decision of the shareholders’ meeting was contrary to corporate interests; and limited the type of direction managers or owners of a controlling corporation could give those of its subsidiary. Transparency and publicity standards were increased. Finally, the 1937 law instituted the Fuehrerprinzip (Fuehrer Principle), which upheld the power and autonomy of management from shareholders as a norm the courts had to enforce in order to protect the integrity of the corporation. As a result of this norm, the separation between the supervisory and management boards became not just a formality, but a fact of practice. In the name of corporate autonomy, the 1930s law instituted a series of checks on the powers of corporate ownership in large firms – an irony not lost to scholars who recognize the Nazi period as one of extreme centralization of power in both the government and the economy.
The 1937 law, like the 1884 law, also attempted to purge the group of AGs of all firms that did not truly belong in the large firm economy. This economy, since the 1870s, had been deemed its own separate province and the primary, exclusive object of AG law. In this vein, of the series of new measures perhaps the most important was the raising of the minimum equity capital needed to form or maintain an AG to 500,000 RM. Despite its intentions, the definition of the Konzern, the partial abandonment of the body-organ doctrine of inter-corporate ownership, and the subsequent move from cartels to more unitary enterprises or holding company forms all had far greater impacts on the GmbH – AG divide. In fact, they attenuated that divide. After the 1920s, inter-corporate ownership and the Konzern became permanent features of the economy. In this context, the new value placed on corporate autonomy made mixed-form ownership constructs (such as the ownership of a GmbH by an AG) extremely problematic. It was no longer obvious which set of principles and norms the court should apply to resolve control disputes in each situation: those that guided GmbH governance, or those that framed control procedures in the large AG.\textsuperscript{224}

Neither the courts nor the Nazi government had any real opportunity to resolve the dilemma of mixed ownership. After the 1937 law, the conversion of much of industry under administrative control and national wartime objectives made the question mute.\textsuperscript{225} After the war, however, the question became a serious one. Not only theoretically, but practically as well the ambiguities spelled trouble to the framework by which corporate governance was defined and regulated in Germany.
Ever since the late 19th century, the GmbH structure, in contrast to that of the AG, had reinforced an industrial district or regional economy model of production and limited the types of financial relationships a firm could have with a bank or institutional investor. Because shares were not easily alienable, the GmbH and its related corporate forms prevented financial institutions from participating directly in the organs of corporate control but instead forced them to pursue their monitoring activities through other mechanisms: the traditional arms’ length debtor-creditor relationship, or participation in bodies that governed firms indirectly, such as trade chambers, municipal government, etc.

The tight-knit, secretive nature of small-firm governance favored those institutions with naturally close ties to local and regional communities, such as savings and cooperative banks. Those big banks that wished to compete in corporate finance were encouraged to participate more actively than otherwise in commerce chambers and other community bodies that regulated companies in the familiar model of craft production. The model ran directly counter to that of large firm governance, in which transparency was the norm that guided the system of checks and balances between owners and the boards (supervisory and management) that had become critical to the definition and exercise of ownership.

In the new German democracy after 1945, the question of how to resolve the conflict between AG and GmbH in the Konzern became an extremely troubling issue. How could the two ownership forms be reconciled when each was designed for very different types of companies, each had been negotiated and regulated by different systems of business interest mediation, and each was laced with distinct principles and norms designed to instruct the courts on how to interpret the law so as to preserve the distinction
in the law? Whole economies had grown up based on the separate laws, and despite their prominence, *Konzernen* were not the only form of large enterprise and certainly played only a minor role, if any role, in the more decentralized economic regions. In the circumstances of a new democracy, the courts were absolute in their refusal to rule on the issue. This would be an issue for the legislature to resolve.

Not long on the heels of the currency and balance sheet reforms, and only shortly after negotiation and passage of the new co-determination laws, the German legislature began to debate, and the justice, finance and economics ministries began to propose and discuss a new *Konzern* law. The new bill, in the context of a larger reform of joint-stock company law designed to purge the 1937 law of some of its objectionable language (such as the *Fuehrerprinzip*) but reaffirm many of its principles (such as the autonomy of the *juristische Person*), promised to resolve the conflicts between corporate ownership and autonomy and between the GmbH and AG rules.

After the war, the Federal Republic did indeed go through a type of second *Gruenderzeit*. Much at the instigation of the Allies, but also on their own initiative, Adenauer and Ehrhard’s CDU government pushed through a Cartel Law in the 1950s that set up an independent Cartel Office to enforce bans on anti-competitive practices and organization. The 1950 bill was diluted considerably by the time of its passage in 1957, but the CDU endured controversy and division because of the stiff opposition of the Bdl and big industry during the very time the government was building its political strategy on its role in promoting Germany’s “economic miracle.” Nevertheless, the bill passed, ending the long period of formal tolerance of cartels and private monopolies.
The new *Konzern* and AG law proposed and debated throughout the 1950s and early 1960s followed much the same trajectory as the Cartel Law. Targeted at the same large companies as the co-determination and cartel laws, it is no wonder. At the time it was originally proposed and a draft was presented to the federal cabinet, the AG Novelle intended to declare all inter-corporate control and profit contracts invalid because of their obvious encroachment on corporate autonomy. Although some contracts were probably fair and balanced, the legislature felt that the many dependency contracts that companies were forced by owners to sign despite obvious economic penalties – such as contracts to deliver products to the parent at below value – should be curbed, and the only way to do so when none of the owners or stockholders of a company felt disadvantaged or knowledgeable enough to sue was to give managers their own weapon by banning such contracts outright. After intense opposition to this proposal, the government tried a second provision that would only validate operational directives of owners to management if management had previously signed an explicit control agreement with the owners, which required a qualified majority for approval. This was also watered down past recognition. Finally, the attempt to delineate rules for mixed-ownership forms also ended in ruin. Ruling on the matter would have brought restraints into the inter-corporate ownership rules that would further support the above proposals with principles from GmbH law, and was therefore fought by big business as an unacceptable addition to a law that should only deal with the AG. The final law that passed in 1965 for the first time had a lengthy section on the *Konzern* – but only with reference to AG owning other AGs. Transparency, publicity, and accounting rules were reformed thoroughly – issues that were squarely within the traditional province of AG concerns – but any controversial
topics that involved companies from different walks of the economy had been stripped.
The message from the legislature was that existing ambiguities would simply have to
remain for the time being, and because of political difficulties, their resolution would be
postponed.

**Economic Transformation, the Politics of Impediment, and Legal Innovation**

The postwar years were not the first time an ambiguous legal framework of large
firm governance existed in Germany. During the heyday of the cartel in the early
century, a similar situation developed, as discussed earlier. But in contrast to the 1920s,
the German economy during the 1960s began to change in ways that placed great stress
on the national framework of governance. Germany’s economy became ever more
integrated with European and world markets.\(^{229}\) Since the early 1970s, these changes
accelerated. With integration, many corporations’ strategies of production, and with those
strategies the structure and distribution of control, were transformed – more than once.
Stresses emerged that made the resolution of ambiguities in the law essential to the task
of jurisprudence. If the system of corporate control was to be reproduced by the law, then
the law had to find a way to reproduce and adapt itself to the pressures of practice.

Already in the 1950s the exporting sectors had taken the helm of Germany’s
economic miracle. In the 1960s the levels of exports as a percentage of GDP increased
by nearly one point every two years – about a 6% yearly increase (see Figure 3).
As exports increased, so too did large corporations’ focus on external markets and with that focus a concern to emulate more quickly from abroad what were perceived as superior manufacturing strategies. Mass production techniques pioneered and developed in the U.S. were an outstanding example of this phenomenon in the 1960s and 1970s. Already structured around scale economies in inputs, distribution, marketing, and production itself, the large firm economy and autarchic regions substantially increased their degree of product standardization and with it their support for policies and arrangements that would stabilize domestic and international markets in standardized goods. This was true for a host of product types, including investment and consumer goods, finished and intermediate goods, and non-durable and (especially) durable goods.

What is most notable about the rise of mass production in Germany during the 1960s and early 1970s, however, is how these techniques crossed over and diffused to the
regions with classically decentralized economies. The spread of mass production in these areas had two reasons. First, the series of economic, political and societal institutions that defined each type of economy in Germany were always flexible enough and never determining enough to prevent corporations in those regions from following other types of strategies. The occasional use of the GmbH by large firms in autarchic regions, just as the occasional use of the AG in the more decentralized economy, are obvious examples in the domain of company law. Second, because of its cost emphasis, mass production strategies are highly sensitive to macroeconomic price fluctuations, which require national institutions to tame properly. As mass-production proponents successfully mobilized to organize a national framework to support their strategies, they necessarily focused their efforts on reconciling regions with distinct economic interests and practices. This brought about a type of regional economic fusion in Germany that can be characterized at the national level as a move from accommodation by coexistence to accommodation by collaboration. This was the era of tripartite corporatism, collective bargaining by national industries, and several bank-led consolidations in steel and other big industries. It was also a time when the government attempted Keynesian demand management techniques and experimented with new bodies of national economic advisors and collaboration forums between the Bundesbank, state and national government, and peak associations of employers and employees.

As the economy became more national, along the several dimensions mentioned above, the ambiguity in corporate law left by the failures of the 1965 law became ever less tolerable. The practice of mixing ownership forms drastically accelerated.
companies pursued the simultaneous strategies of integration at home and expansion abroad and thereby put the AG-GmbH constructs under duress from two sides. First, integration meant centralization of operational control. Many conglomerates or Konzernen began pursuing strategies of management consolidation and made ownership ties to subsidiaries and affiliates much more “active.” Second, in the effort to gain presence in important markets abroad, large corporations began a process of founding affiliates and subsidiaries all over the globe. In some ways, the larger markets required more decentralization of corporate-wide operations – along national lines. Strategic information and decisions did not follow this pattern, but marketing, distribution, and administration did.

In contrast to Konzern arrangements in previous eras, those during the 1960s and 1970s required much more interference in the affairs of subsidiaries. It no longer sufficed merely to coordinate prices and output through a central distribution outlet, but let most other operational decisions, including diversifying into related goods, go uncontested. To work properly, mass production required coordination of all inputs and outputs so that standardization in both could push prices down from two directions. Entire product lines were consolidated, for decisions to produce related goods directly affected the viability of main products.\textsuperscript{234}

The implications for company law were serious. Domestic GmbH subsidiaries, once left in relative freedom, became much more dependent on their parents. Because the GmbH was the most popular and cost-effective subsidiary form, this meant that the governance of large parts of Konzernen were organized around dependency relationships.
Legally, such constructs were a monstrosity; for nearly one hundred years, the rules of the GmbH, reproduced in practice by the GmbH-dominated decentralized regions, had upheld the norms of tightly held company autonomy and wide-ranging freedoms to act within the bounds of that autonomy. Now, in broad parts of the economy, the very rules that were supposed to confer great internal flexibility and freedom of governance were being used to undermine the operational autonomy of the company, and with it any semblance of freedom of internal action that was the original object of those rules in the first place.\textsuperscript{335} The courts were pressed with increasingly grievous complaints. What should be done with the Konzern – not the theoretical construct of the pure AG Konzern ruled on in the 1965 law, but the real Konzerna of mixed forms found throughout the economy?

Politics and the national integration of economic regions exacerbated the dilemma. As more companies pursued mass-production strategies from non-autarchic regions, the number of firms accustomed to traditional GmbH governance that were encountering the problems of dependency and large-firm control increased substantially. Legal observers, commentators, and scholars debating the need for a GmbH Konzernrecht cited the first generational turnover in family firm leadership since the war as a source of legitimation crisis for the GmbH.\textsuperscript{336} (See Tables 18 to 20 for evidence on just how dramatically family firm ownership fell during this time for AGs alone.) In this context, many such firms were sold to larger companies or sought new ways of cooperating with them, producing a conflict between governance traditions never before seen in Germany. Regional commerce and industry chambers mobilized in defense of the
GmbH. Commissions were formed, and scholars advised on ways to protect the GmbH in company law.\textsuperscript{237} In the early 1970s, the now SPD government drafted a new GmbH bill that would rule on the mixed-form \textit{Konzern}, promising a solution to the controversial issue originally abandoned by Ehrhart and the CDU government of the 1950s and early 1960s.

Once proposals were made, however, the reform effort polarized organized industry, split regional business coalitions, and threatened to undermine the fragile national framework of economic regulation which the government, labor, and industry wanted so desperately to create. The BdI, as well as big steel, automobiles, and textiles, strongly opposed any law that would curtail inter-corporate ownership rights, labeling such an attempt as anti-market or socialist. Since the 19\textsuperscript{th} century, existing AG-GmbH ownership practices had never been struck down by the courts, the argument went. What economic reasons did the government now have to create a veritable revolution in large-firm governance? The debate was further polarized by the co-determination controversy, in which big industry made similar accusations about proposed changes in company law. But the co-determination debate did more to unite big industry against the 1973/74 GmbH bills than anything else. Still many AGs at the time were not organized around a \textit{Konzern} structure, and really had no strong interests in one direction or the other about the proposed legislation. Cast as sister legislation to the co-determination laws, however, these large companies rallied behind a united front against the proposed bill. Big industry hardened. The original intent of the government, like the 1958 draft of the AG law, was to substantially restrict control and profit contracts between a GmbH and other
companies. By the time it wrote the 1972 draft, and then again a 1973 draft, it had reversed its position, intending to preserve the wide-ranging possibilities of controlling a GmbH and modify them only insofar as questions such as the protection of creditors and minority shareholders were concerned, and only in ways that would integrate the GmbH Konzern more closely with the (much watered-down) 1965 rules on the AG Konzern.²³⁸

Even this largely diluted attempt at a GmbH law failed. Rules that would open the outside company-controlled GmbH to better transparency for the sake of protecting other stakeholders were opposed by big industry and became extremely divisive with the business community. Faced with bromidic reactions from separate business groups and organizations that seemed only to become more volatile by the course of debates in the legal community, the government decided to abandon its attempt at a GmbH Konzern law. The bill failed, and once more the courts were left with major ambiguities in company law that seemed to get worse over time.

In 1980, legal experts, practitioners and much of industry held their breath one more time as a much-needed GmbH Novelle swept through parliament with the promise of modernizing the limited partnership and with it alleviating the problems with mixed ownership that had been building over the previous forty years. Parliament, however, had the experience of the previous decade in mind and did not even attempt a serious discussion of a Konzern law. The divisive politics of such an issue, even without co-determination or cartel laws to exacerbate the conflict, were simply too high a price to pay for legislation that would make governance institutions consistent with themselves and practice, but would be judged harshly by at least one broad industry coalition, if not
more. While the 1980 reform was widely acclaimed as a success within the GmbH economy it affected – clarifying one-man GmbHs, setting a new minimum capitalization standard, and so on – observers despaired at its screaming silence on the mixed-form enterprise.239

With cross-ownership forms and the Konzern itself increasing in number and prominence in the economy, and with so much attention paid to the subject of mixed-ownership forms in legal debate, the courts found it increasingly difficult to accept the government’s lack of action on the issue. Throughout the 1950s and 1960s the High Civil Court had refused to rule on several Konzern issues, declaring that without adequate legal guidelines to decide cases in one direction or the other such rulings would be tantamount to making up new legislation, a move it was loathe to do in a democratic system that was constructed around compromise and the process of coming to agreements precisely on such controversial issues. By the late 1970s its patience had worn thin. In a series of rulings, startling in their degree of creativity and aggressiveness, the courts in essence innovated a whole section of law on Konzernen that, together with the 1965 law, has become a canon that scholars now refer to as Konzernrecht.

At the heart of the new canon was a discussion about the boundaries of the firm and where these should be defined, that is, a debate about the definition of the firm itself. Beginning in 1977,240 the courts made several rulings that equated the firm with simple economic independence. The difficulty was obvious: without the ability to define firms in a way other than by formal incorporation, it would be as equally impossible to adjudicate the many conflicts between the AG and GmbH ownership forms and thus
preserve their integrity as it would be to speak of Konzernen at all. In an important sense, the law had to move beyond corporate form and ownership in order to conserve it. To this end, it was unavoidable that the definition of the firm should be so broad. Since their birth in 1870, corporations had been forbidden to own their own shares (this would obviously undermine ownership from the outset). But what occurs when a subsidiary owns shares of its parent? The 1965 AG law banned this practice for the same obvious reasons, but in so doing implicitly defined the firm in terms of independence of will, not formal ownership form. Even if that subsidiary only had the potential to be controlled by its parent, the law said, it could not own shares – to do so would undermine the claims of the parents’ own shareholders, and with it the integrity of ownership itself. After 1977, the courts applied this principle to an ever wider assortment of company types, including not only cross-shareholdings between the GmbH and AG, but between cooperatives, chartered associations, and charitable foundations; to consortia (including bank consortia that pooled proxy votes); and even to the extreme case of a single individual who holds management responsibilities, oversight functions, or large stakes in more than one company.\textsuperscript{241} To have a body of Konzernrecht that would be at all consistent required its universalization across the entire economy; the new rulings caused a mini legal revolution of sorts. Put another way, what the courts ruled about Konzernen could apply to the most diverse settings; even governmental bodies that could exercise control over other bodies, such as counties over municipalities, were bequeathed the title of firm, and with it responsibility under the developing law of the Konzern.\textsuperscript{242} The hallmark of the modern corporation was the firm’s assumption of the status of a legal personage or individual,
and Konzernrecht's hallmark was the individual's assumption of the status of the firm. Company law had in this important sense come full circle.

As Konzernrecht developed with an expanded definition of the firm, so too did the court’s repertoire of recognized Konzern types. It was not enough simply to identify the Konzern. In order to suit economic practice, different types of firms with different features and rules were defined. Already in the course of the debates over company law reform in the 1960s and 1970s, practitioners and scholars alike had developed a number of such types in the legal literature. These categories the courts simply lifted into law as the occasion warranted. Included were the “Vertragskonzern” (contract combine), “qualifizierte Konzern” (qualified combine), “faktische Konzern” (de facto combine), and the “qualifizierte faktische Konzern” (qualified de facto combine). None of these were previously defined in the law. Some were old ideas which, though undefined, were still addressed by the legislature, such as the case of the contract combine and the rulings on control and profit-sharing contracts in the 1965 law. Some were invented only very recently and amounted to true innovations by the courts. This is the case with perhaps the most important type, the qualified de facto combine.

Beginning in 1986, the High Civil Court made a series of rulings that called into existence the qualifizierte faktishe Konzern in the case of the subordinate GmbH. While in the AG Konzern (a combine in which one AG owns the whole or part of another) dependency and thus a qualified combine could be identified in a straightforward fashion with the existence of a controlling ownership stake or outright control contracts, in the case of the GmbH the matter was far less clear. The rules and practice of
governance for the GmbH allowed myriad ways a shareholder could assume control of a corporation with or without having what appeared to be a controlling share. In addition, shareholder agreements and shareholding levels were much less transparent in the GmbH. The courts therefore ruled that a qualified de facto combine is said to exist when a *continuous and comprehensive*\(^{246}\) pattern of direction from a shareholder (or anyone, for that matter) to a manager could be shown. In such a case, the violation of company interests was *presumed* to be the case, and the shareholder, company, or individual in question had to be held liable for the actions of the dependent company.

In presuming the violation of the dependent company’s interests and therefore autonomy, the courts openly equated the firm with independent will – and hence the individual with the firm. It was not long after the initial rulings, in 1991 and 1992, that the court made the controversial decision that a single individual who exercises continuous and comprehensive direction over the affairs of the company could also be held liable in the fashion of the qualified de facto combine. The difficulty with this decision was not only that it directly violated an European Union directive calling for the preservation of the single-person limited partnership (or limited sole proprietorship),\(^{247}\) but that it violated the 1980 GmbH law and much of the tradition of the GmbH which purposefully sought to uphold such an ownership form. The ruling would in essence completely undermine a major use and practice of incorporation throughout the more decentralized economy. Since the 1991 decisions, the court has repeatedly sought to qualify its own definition of the qualified de facto concern, ruling that continuous and comprehensive direction was an indication only of dependency, not the definition of
dependency itself. But which other criteria such an indication would fulfill was left open.

The rulings on the qualified de facto GmbH combine embroiled companies, scholars, judges and attorneys in one of the most controversial legal debates since the founders period in the 19th century. On some issues, such as the one-man GmbH, industry found itself united in opposition to the rulings. On several other issues, opinion was split. The protection of dependent GmbHs was a high priority not only for the decentralized economy, including all of its small craft firms, family firms, and other companies that over the last twenty years had grown closer to larger firms through the processes described above, but to creditors, minority and individual shareholders as well. Many large companies and their legal advocates complained vigorously. Some combines noticeably abstained, apparently fearing the internal disunity that would result from taking a stand one way or another. The whole of industry seemed to be plunged into a state of continuous and comprehensive strife.
Chapter 5

The Transformation of the Modern Corporation in Germany, Part II: The Birth of the Management Holding

The dramatic changes in company law described in the previous chapter – including the transformation of the rules of intercorporate ownership, the wholesale innovation of new legal doctrines basic to the definition of the modern corporation, and the definition of entirely new types of companies (most noticeably, the qualified de facto GmbH combine) – did not necessarily require an accompanying transformation of actual governance practice. By itself the law is no determinant of behavior. This is true especially of laws that attempt to govern leaders and captains of industry who are used to making their own rules in their own mini-states and corporate empires.

A famed example is the GmbH & Co. KG, a corporate form innovated neither by the government, the legislature, nor by the courts, but by managers and entrepreneurs from Bavaria in 1912. The limited liability granted by the state for GmbHs and AGs was to come with its price: taxation of profits or income of the corporation itself before income is distributed to investors, who are taxed once again separately. Persons who manage and invest in unincorporated companies, in contrast, do not enjoy the protection of the juristische Person, but do not see business’ money taxed before they receive their distribution; corporate owners could not have their cake and eat it too. But shortly before the first world war, a group of wily businessmen from Germany’s decentralized economic
regions figured out how to do just that. Relying on the unincorporated
*Kommanditgesellschaft* (KG) form, in which some investors (the *Kommanditisten*) could enjoy limited liability as long as at least one of them (the *Komplementaer*) assumed all liability, they founded a GmbH that, as a *juristische Person* with full rights of contract and ownership, they made the *Komplementaer* of a KG\(^{251}\) (see Figure 1). They were both the *Kommanditisten* as shareholders and *Komplementaer* as managers, but while the overall company was not taxed, the investors enjoyed protection from the liability of the *Komplementaer* as shareholders of the GmbH. Unable to rule against such a construct without damaging the contract and ownership privileges of the GmbH, the courts, at an impasse, had to allow the invention and its accompanying subterfuge of corporate tax law. After several failed attempts to ban the elegant contrivance,\(^{252}\) the legislature finally dealt with the “problem” in the 1980 GmbH reform by allowing similar privileges for less complicated GmbH constructs, hoping that the GmbH & Co. KG would disappear with the uniqueness of its advantages. It did not.

*Figure 1: The GmbH & Co. KG*

![Diagram of GmbH & Co. KG structure](image-url)
As the GmbH & Co. KG shows, managers and owners have their own motives and can marshal the necessary resources to interpret, bend, and otherwise act on the law as they best see fit. There is nothing natural or simple about the legal rules and doctrines that compose corporate law and the framework of governance, as the courts well know, and as their actions since the 1970s well illustrate. On the contrary, these rules are open to manipulations and subterfuges by actors who have the requisite resources. Large-firm owners and managers, if anyone, control such resources and have never displayed a lack of initiative in this regard – the cartel revolution at the turn of the century and such doctrines as the body-organ are obvious cases in point.

However, the law does not always have to be a laggard to economic change and private initiative, especially when the corridors of influence by which big industry affects the law’s formation and interpretation are blocked so that no obvious mechanism exists to organize that influence, let alone consensus about its purpose. When such is the case, as the previous chapter argues was true for a great deal of the postwar period, then only the coincidence of the new legal doctrines with economic troubles that induce the participation and cooperation of industry will bring about lasting institutional reform.

The present chapter argues that increasingly volatile and competitive international trade markets were the catalyst that compelled the interests of business and the innovations of the law to indeed coincide. No form of negotiation, political debate, or collaboration brought about this union – adjustment in this important case was a true coincidence. The result was the birth of a new type of large corporation in Germany, one with new governance procedures and practices that promised to further redefine the
conventional relationship between organized capital and the German state. The chapter ends by illustrating the arguments with the case of the post-1990 adjustment of the machine-tool industry, continuing one of the main examples introduced in Chapter 3.

**The Export Economy: From Mass Production to Niche Production**

Germany’s two largely autonomous economic orders, the decentralized and the autarchic, endowed the country not only with fissures and controversies within its national framework of economic regulation, but with increased flexibility and enhanced capacity to respond and adapt to external economic shocks. Integration of these orders and a strengthening of national unity helped German companies overcome barriers to implementing such competitive strategies as mass production, but also limited company response to shocks and changes in world markets.

Mass production, the previous chapter argued, involved precisely such a nationalization of economic policy and coordinating mechanisms. The centralization of wage-setting into a Concerted Action program, the turn to macroeconomic demand management and counter-cyclical policies, and the widespread fusion of smaller craft firms into larger diversified Konzernen, all contributed toward national integration. The structure of corporate governance changed as well. Between 1969 and 1970 large German corporations underwent a major merger boom, rationalizing their divisions and subsidiaries along functional lines: sales, development, distribution, purchases, legal, engineering and research, etc.²⁵³ Each department was organized with a national focus. Many product-based or regionally based subsidiaries were subsumed or broken up by the new functional divisions. Executives hoped to expand scale economies in each of these
areas, and so the firm was organized to remove any jurisdictional conflicts that could hinder the realization of that goal.

Rationalization by functional divisions went hand in hand with conglomeration and a diversification strategy into unrelated products, a strategy that itself grew out of international expansion and the formation of multi-national businesses. Because firms purposefully limited product lines, they became exposed to higher cyclical risks. Popular strategies of offsetting these risks were through diversification into unrelated businesses and expansion into other national markets. Large firms gained greater scale economies by exploiting their national base to embark upon world-product strategies. To do so they would found national divisions which would be subsumed into the larger functional divisions if growth so warranted. This was the era of the Volkswagen world car, and when Daimler Benz aggressively acquired, founded or participated in scores of companies all over the world. It was the time of Kloeckner-Humboldt-Deutz’ first large-scale cooperation with large foreign firms, such as Fiat. It was also the period when Mannesmann placed its core steel-working plants into a single subsidiary, acquired giants such as Rexroth and Demag, and began its worldwide expansion into hydraulics, measurement and instrumentation, and data management.

Contrary to such indications, however, large German firms’ forays into mass production strategies never truly matured, and the attempt at national economic integration was never fully successful. While union structures underwent far-reaching centralization and wage bargaining patterns became more national, industry remained as divided as ever – and perhaps became even more so. Employer organizations had fewer
difficulties and even might be said to have succeeded in uniting capital at the national bargaining table, ignoring the mutinies that occurred during some of the more vicious strikes.\textsuperscript{255} And industry associations themselves succeeded at uniting their ranks in opposition to Social Democratic and organized labor goals of achieving a parity-based system of co-determination. But when it came to questions of determining how to reconcile their own opposing principles of governance and ownership, as the previous chapter showed, organized industry failed.

Within many larger firms, the push to rationalize control along nationally based functional lines also met with hindrances. Families sold their GmbHs to larger corporations,\textsuperscript{256} and as previous competitors sought to unite forces, clashes between local and central managers became more frequent.\textsuperscript{257} Corporate integration was not easy, especially between managers and owners with very different methods and conceptions of governance. The initially unintended result was sometimes a larger company with more uncoordinated and decentralized administrative units that operated much in the same tradition of large, decentralized firms from earlier years. More frequently, compromises were reached that resulted in truly confused governance forms, not only mixed formally between the GmbH and AG, but mixed administratively as well: conglomerates would consist of both separate functional and separate product or regional divisions and subsidiaries.\textsuperscript{258} However perverse, the large corporation became a microcosm of fractures pervading the spheres of organized industry and politics.

Whether caused by limitations at the corporate or the national level, as German exports expanded with the growth of global markets, the capacity of large firms to sustain
mass production strategies did not. In fact, it diminished. At a national level, price and financial volatility increased beginning in the late 1970s, and demand management and counter-cyclical macro-strategies were abandoned. At the corporate level, conglomereration, multi-nationalization and corporate rationalization by administrative function required even greater outlays for overhead and administration and thus diminished scale economies. Inventory systems became far less manageable. New entrants into international export markets depressed profit margins. Under these conditions, strategies that targeted markets for high-end, custom-built niche goods emerged as dominant among many German firms, both large and small.

To be successful, niche production strategies, in marked contrast to those of mass production, required more decentralized organizations to be successful. This was true both for individual firms and for state and community administrative structures. By definition, niche production meant realizing greater economies of scope. Manufacturing smaller batches of precisely honed goods, or even groups of related but unique goods, required reliance on general-purpose machinery and the generalist skills of the craftsman, and necessitated the broad increase in the discretion of those who directly managed and produce the goods in question. This discretion was needed both to decide between alternative solutions to the unique problems of unique orders, and to seek out and collaborate with those who might know what those alternative solutions were – activities that qualified the skilled generalist highly. Germany’s craft traditions, which had always flourished in its more decentralized regions, endowed industry with precisely these resources.
Niche production also required a reorientation or redefinition of the division of governance within the firm. The large decentralized firms created with the conglomeration and merger waves of the 1970s seemed nearly as well-suited to manage the task of realizing scope economies as the networks of smaller firms in the decentralized economic regions. In fact, many of the more autonomous subunits of large decentralized firms were structured around networks of suppliers and joint-ventures that mimicked the forms of interfirm collaboration observed to be so successful in *Mittelstand* districts. Functional divisions, in contrast, could not provide this type of local focus around products and regional specialties. A division of governance that required the central administrative unit to adjudicate between many separate units every time there was a coordination problem between design and materials, or between marketing and distribution, for example, would hopelessly paralyze a niche-product strategy. Institutions such as works councils helped craftsmen collaborate with management on a plant wide basis and thus ameliorate such conflicts. But even if preserved formally, many large firms abandoned functional management divisions de facto in favor of product-oriented divisions or subsidiaries. Thus the perversity of mixed corporate structures, much like the fissures at the level of national politics, provided an obvious scaffolding upon which to base new strategies for adjustment in international markets.

When mass production strategies began to falter, together with the system of national concertation on which they were to be based, German large firms found themselves turning to an obvious alternative. Not only the famed *Mittlestand* from regions such as *Baden-Wuerttemberg*, but many larger corporations in traditionally
autarchic regions became extremely successful at exploiting custom-good export markets beginning in the 1970s and then accelerating throughout the 1980s. A good indicator of the general shift to more decentralized production arrangements, both in terms of the flourishing of small and medium-sized firms and in terms of the decentralization of large Konzernen, is the dramatically accelerated growth of the GmbH economy during the period. (See the reproduction of Figure 9 in Chapter 2 below, and refer to the corresponding discussion there.)

At the level of shareholder ownership, the decentralization of administrative functions had immediate consequences. As discussed in Chapter 2, noncorporate ownership of industrial stakes declined – both for private individuals and families, on the one hand, and for the big banks, on the other. With that decline in stake ownership, debt levels and interest payments of large corporations declined as well. Intercorporate ownership rose. While the rise of intercorporate ownership and the decline of family ownership resulted directly from the conglomereration and merger wave that was partially responsible for creating many of the large decentralized firms in the first place, the decline in bank ownership and control almost certainly resulted from the changes in corporate structure discussed here. Because banks monitored companies at their head offices – through supervisory boards, shareholder meetings and central corporate finance offices – their understanding of the firms they controlled declined with the corresponding decline in administrative oversight and control functions of the central corporate office. Not wishing to risk maintaining controlling stakes in companies whose prospects they
could not easily comprehend, they divested as best they could⁶⁵ – or simply did not aggressively maintain control in corporations whose ownership was contested by others.

**Figure 2: Number of Companies by Legal Form**  
*Source: Statistisches Jahrbuch, selected years.*

In fact, throughout the 1980s, the big banks pursued strategies of gaining market share among smaller and medium-sized firms in the more decentralized economic regions, recognizing the importance and profitability of this area of the economy. Many of the banks themselves decentralized operations and sought to cooperate more extensively with regional trade chambers and other institutions intimate with the regional economies.⁶⁶ They perceived, rightly, that competitors in the savings and regional giro bank sectors were benefiting from their business with small to medium sized businesses in the decentralized economy and, moreover, that it was these competitors’ ties to local economic networks and governments that gave them an advantage in those businesses.⁶⁷
By the late 1980s, large German industry had gone through a ten-to-fifteen year transformation from mass production to niche-production strategies. However individual scholars characterize the German economy during the 1980s, almost all agree that it benefited from the traditions of craft production and of decentralized regional economies. They also agree that the exploitation of scope economies and the pursuit of niche export markets were key strategies to corporations’ and the country’s economic strength. The argument here is that these strategies and the traditions that helped realize them had a profound impact on the way corporate control was defined both between managers and shareholders and within large enterprise itself. As the next section argues, that distribution of control was just as robust and just as fragile as the success of the niche production strategies with which it corresponded. When these strategies were threatened, decentralized large-firm governance offered major dilemmas to corporate leaders. This time, however, the solutions were far from obvious; no existing economic traditions provided an obvious way forward. It was this impasse, plus the twin shocks of reunification and recession, that provided the impetus for some industrialists to experiment with using the court’s legal innovations to create a new type of large corporation, one that represented a true institutional break from past corporate traditions.

The Export Economy Revisited: Beyond Niche Production

At the end of 1990, industrial production in Germany had reached a level nearly 25% higher than that of 1985. By the middle of 1993, that level had dropped to only 10% the 1985 level.268 The German economy, starting in 1991, slid into its worst postwar recession.
The post-1991 recession had many causes. These sprang from primarily two main sources: the increased globalization of markets and reunification. The latter threw akilter monetary, fiscal and tax policies. Reunification overheated the West German economy in 1990 following the massive demand boom created by the combination of a high East-West Mark exchange rate and economic union. It caused a skirmish between the state and the Bundesbank and resulted in higher inflation and then a severe monetary contraction. And it led to ever-increasing state fiscal transfers that provided a massive drag on financial markets. Globalization accentuated the crisis and determined the economy's response to it. The post-1990 worldwide economic downturn reduced the size of export markets vital to sustained German growth and gave the country -- though delayed for a year -- yet another demand shock at the very time reunification made its absorption particularly difficult. The integration of worldwide currency and securities markets exacerbated the country's fiscal and monetary difficulties. What is more, German companies' competitiveness abroad declined with new entrants into high-quality and custom-good markets from countries like Japan and Italy. Export markets crowded at the very time domestic markets faltered. Formerly exclusive German product niches disappeared.

Even before the downturn in growth, exports began to decline. A comparison of Figure 3 with Figure 4 shows that while real GDP dipped only once, and not until 1993, exports contracted twice, in 1991 and 1993, and experienced their first big drop in 1990, the year before the global contraction. That year the German economy grew by 5.7% in real terms. Moreover, the decline occurred in key industries, including mechanical
engineering, chemicals, and automobiles. In the former and latter cases, the most immediate cause was foreign penetration of markets previously dominated by the Germans. The Germans themselves were well aware of this threat. In 1990, industry associations in automobiles and mechanical engineering formed commissions to study foreign competition and its perceived superiority to the structure of German manufacturing. The commissions brought in panels of experts to study how corporations, especially large corporations, should be restructured more competitively, both in Germany and abroad. Exporters were plainly troubled.

**Figure 3: Real GDP in Germany**


Increased competition in international markets brought pressures to change in two key parts of the corporation. The first was at the level of the shop floor and the organization of work. As custom goods manufacturers encountered equally skilled competitors, they found that quality was no longer the only important competitive dimension. Cost became equally important. Unfortunately, the traditional alternatives that had initially given the Germans an advantage in this regard no longer indicated a
clear way forward. More important than either cost or quality, however, was time. In specialty production, faster product turnaround meant not only savings to customers that could be passed on to producers, but direct savings to the producers in the form of lower inventory costs and higher utilization rates.

Figure 4: Average Annual Growth Rate of Exports, Selected Countries

Further, a jump on the competition in newly developing product or manufacturing technologies translated into enormous advantages, allowing a company to travel down the learning curve sooner and thus at any moment of time not only realize higher scale economies and lower costs than the competition, but enjoy major advantages in expertise that could translate into a permanent lead in the race to increase scope economies.

New forms of inventory-less, continuous improvement and just-in-time production were the result of these pressures. These demanded that the discretion of workers and of peripheral units of the company be increased even more than
previously. Without inventories, mistakes cost a company far more than previously as whole production lines could be stalled. Without the discretion to react flexibly to correcting such mistakes and an infrastructure of collaboration to learn from them so as to not repeat them and related mistakes, such costs would never be minimized, and the firm would quickly fail. Discretion and collaboration, in turn, required yet further increases in worker autonomy and generalist skills. If a firm could manage such increases, it could speed its rate of innovation, decrease its inventory and down-time costs, and collapse considerably its time to market, gaining needed advantages over the competition.

When Germany first turned to niche production, craft traditions, together with the ways of GmbH governance, provided a natural resource on which to base the needed increases in worker and manager discretion and the accompanying need to decentralize administrative tasks. But as firms attempted to adopt the production strategies mentioned above, these traditions no longer provided the needed resources. In fact, the hierarchies and skill ladders that structured the craft world now created real barriers to adjustment, even though the economic changes requiring those adjustments were nothing more than the intensification of those changes that first made craftsmen the key to competitive success.

At the core of continuous-improvement production schemes was the product team, a group of workers organized in somewhat ad hoc fashion both to draft solutions to general production orders and to push innovative ideas into early and intermediate stages of actualization. The very purpose of teams was to cooperate across traditional boundaries between crafts and skills in the achievement of these aims. Teams were
expected to organize themselves along criteria they themselves set according to the needs they judged fitting for their projects. By eliminating the relevance of predefined skill grades to the mechanisms of shop floor governance, teams threatened the identity and authority of master craftsmen. Such teamwork produced daunting jurisdictional conflicts all through the craft system of skill definition and reproduction.\textsuperscript{275} When these traditionally authoritative figures turned to institutions such as works councils for re-enforcement, the result could paralyze adjustment at the shop floor.

Teamwork also further redefined the relationships between managers and workers. In addition to solving technical problems, teams were often designated profit centers within the firm. This meant that not only workers with traditionally separate skills, but the sales, accounting and other experts collaborated with team members to further collapse the time from design to market. Knowledge of marketing and distribution costs and the skills of calculating cash requirements and expected return could help workers focus only on economically viable solutions from the start, eliminating much of time and effort spent on ideas that would later be rejected by management. What is more, if pegged to appropriate incentive schemes, profit centers could spur workers and designers to improve costs even when such costs already fell within allocated budgets. Finally, manager participation in the teams themselves allowed them to actively monitor their progress in ways previously impossible. All this meant that skills and tasks that were the traditional province of managers -- like those that were the traditional province of other craftsmen -- were taught and shared with all the members of a team. With the adoption of new work practices, the distinction between managers
and workers was collapsing. (See Figure 5 for a listing of several additional work dimensions affected by teamwork.)

Figure 5: Translation of Chart in VDW/VDMA and IG Metall, “Gruppenarbeit – Chancen fuer den Maschinenbau,” March 1993, p.30.

<table>
<thead>
<tr>
<th>What is new about Teamwork?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>-- Differences between Teamwork and previous work organization:</strong></td>
</tr>
<tr>
<td>OLD WORK PRACTICES</td>
</tr>
<tr>
<td>Quality assurance performed by specialists</td>
</tr>
<tr>
<td>Machine upkeep performed by Repair Dept.</td>
</tr>
<tr>
<td>Monitoring of parts performed by Logistics Dept.</td>
</tr>
<tr>
<td>Work tasks set by Production Dept.</td>
</tr>
<tr>
<td>Rationalization by Production Dept. planner</td>
</tr>
<tr>
<td>Work times predetermined</td>
</tr>
<tr>
<td>Formal training sites and labs</td>
</tr>
</tbody>
</table>

Unlike the case of work organization, the changes to the manager-worker relationship did not result in jurisdictional conflicts between managers and workers. However, the authority of managers was affected. Workers organized in profit centers and teams now judged their own and others’ performance on criteria such as residual income, profitability and strategic importance. Management increasingly had to justify their decisions in the new language – and when they could not, nasty fights developed between management and labor. These disputes in turn caused divisions within management itself. Third parties, such as consultants, often called in to recommend decisions that could no longer be resolved between such divisions, deepened the distrust of workers on the shop floor.276 All this made adjustment to new production forms
extremely difficult, for the very goal of adjustment seemed to generate barriers to its own realization.

In addition to changes in the organization of work, heightened competition in global export markets put the organization and generation of corporate strategy under stress. The increasing scope, competitiveness, and volatility of the international marketplace not only placed a premium on plant workers’ and managers’ ability to learn, innovate, and realize scope economies in production, but also on top managers’ ability to learn from market changes and react quicker and wiser to momentary market opportunities. The economies in time that were the object of continuous improvement and inventory-less production strategies were even more important in strategic maneuverings in the global marketplace. First movers could gain lasting advantages in the struggle to define standards in emerging technologies and markets. Thus, the long-term importance of recognizing and acting on market opportunities could be enormous but often could be assessed properly only in light of diverse technical and market developments in the widest geographical scope. Thus the push to internationalize not just distribution and marketing, but research, design, and production itself. If collecting and processing such information were delayed, opportunities could not only be ceded to competitors but improperly assessed for months or more because of out-dated or misleading information. The challenge was to create an organization with both global and local reach, in which global decisions could be taken with local acumen. Strategic competence had to be devolved throughout the organization so that relevant information could be recognized faster, while proper incentives had to be found so that the periphery
would communicate its insights and generate an informed, centralized consensus. In this way the uncertainties of the international marketplace could be managed and mastered.

Before the globalization of markets, traditional corporate governance models – for both the AG band GmbH – had performed in a similar fashion, but within national boundaries. The big bank governance umbrella that spanned large German firms in most industries undisputedly centralized information on productive capacity and price of inputs in a manner that allowed the banks to lead difficult consolidations by identifying and favoring more productive facilities. Cartels functioned in a similar manner. However, unlike this regime, success in modern competitive markets required the communication of information on innovative possibilities that a central monitor detached from local development teams, managers and workers – even if it were granted the technical competence to understand such sources – might never know, or never know it didn’t know. Simultaneously, because new work practices demanded a localized, discursive process of assessing and reassessing goals, progress, work and how that work should be organized, vertical communication became far more difficult, rendering ineffective the traditional instruments of monitoring inside an organization. This was true not only in the ways previously explained, but also because of the autonomous nature of team cooperation itself. The fact that scope economies depended precisely on workers’ and teams’ freedom to decide who was the best strategic interlocutor on any given project, the stable information links with supervisors that previously had made the assessment of progress and opportunities at the shop floor so self-apparent. In other words, changes to the terms of competition changed the terms of successful monitoring of such competition;
and altering these terms quickly produced stresses and limitations within the old structures of governance. In the 1990s, large German corporations found themselves in a truly crisis-ridden world: cyclically, politically, competitively, and structurally.

*Uncertainty and Innovation: The Birth of the Management Holding*

The economic conditions described in the previous section and the legal changes explained in the previous chapter – together with the climate of uncertainty created by the economic adventures of reunification – formed a crisis-laden context in the 1990s that led to a great deal of experimentation and innovation with corporate ownership. Large companies transformed their control and work structures in a variety of ways that led to entirely new forms of governance. One of these was the management holding, a *Konzern* form not only with unique microinstitutional features, but with unique macro-institutional implications. The new corporate form was the outcome of a true transformation of the large German corporation.

Between 1985 and 1992, the High Civil Court had made rulings on intercorporate ownership that upheld the autonomy and independence of partially owned and even fully owned GmbH subsidiaries of large corporations. Because most subsidiaries were indeed in the GmbH form, these rulings affected every major German *Konzern*, whether privately or publically owned. However, in practice the new rules did not necessarily increase the actual independence and autonomy of Konzern subsidiaries. In fact, there was every reason to suppose that the initial rulings on the qualified de facto *Konzern* would have precisely the opposite effect on the economy. Why? Because if the new rules interpreted so many existing parent-subsidiary relationships in terms of the new
**Konzern** type, they would make many **Konzern** parents liable for those subsidiaries.

Once liability existed between the two companies, then the parents would have an obvious economic and financial interest in making the relationship a truly dependent one, most likely forcing the subsidiary to sign heavily one-sided control, profit-drawing and dependency contracts. Minority owners would have every incentive to leave. Thus the ruling meant to protect small companies from infringements on their autonomy by recognizing informal dependency relationships could actually have led to a massive effort to formalize such relationships along even starker lines, removing that autonomy completely. The ruling would act like a self-fulfilling prophecy.

As the economy changed in ways previously described, however, the implications of the new rulings changed also. The decentralization inside many large firms throughout the 1980s worked in precisely the opposite direction. Parent companies of large **Konzernen**, for reasons previously discussed, did not wish to assume full operational control of its subsidiaries – and, in fact, they rarely wished to assume operational control at all. In the United States, pressures to decentralize led to a massive break up of hundreds of large conglomerates created twenty and fifteen years earlier. Huge financial gains were realized as such behemoths were dismembered into smaller, more leveraged companies. In the Federal Republic, stagnant share markets made such a course of action impossible. Because of the costs of selling companies into an illiquid market, large companies kept unrelated subsidiaries but allowed them full operational and even strategic control of their businesses. Without any evidence of “constant and comprehensive” instruction between it and its subsidiaries, a parent could not be held
liable under the new limited de facto combine rulings. Sometimes parents would create holdings within holdings, inserting a subordinate AG over groups of related businesses in an effort to match form with practice. The AG, because of strictly enforced laws preventing managers from acting against the interests of their corporations, did not fall under the new rulings on the qualified de facto Konzern, in fact, legally such a Konzern could not exist at all. More often, however, the Konzern parents simply let subsidiaries operate on their own volition, with little accountability. The very fact that such practices were so common is evidence of the way economic pressures counteracted the incentives set up in the law to define governance in other ways.

So marked were the pressures to decentralize, in fact, that large Konzernen often entirely broke off their close relationships with banks and instituted internal money-drawing systems designed to replace bank services among members of their group. Some, like Metallgesellschaft, went so far as to found their own banks. The center was rapidly changing from the old locus of command-and-control to a new organization in the business of offering cost-effective services to its member firms. Pushed to its limit, such intercorporate ownership had become a combination of passive investment, much like large mutual funds and holdings in the United States, and of contractual business dealings, much like those between suppliers and buyers. In such instances, intercorporate ownership meant little beyond simple formal association.

From the standpoint of corporate accountability, however, these developments were nothing more than a recipe for disaster. Indeed, during a time when monitoring a firm had become difficult for central actors anyway, limiting interaction except in the
case of selling or providing primary services made such vital activities next to impossible. Although other causes – such as those relating to competitiveness or conjunctural problems – most certainly contributed, it was no accident that the 1990s were marked by a slew of the most spectacular large-firm losses and even bankruptcies in memory. *Metallgesellschaft, Bremer Vulkan, Volkswagen, Deutshe Aerospace* of Daimler Benz, *Feldmuehle Nobel* – the list of firms that lost not just millions or tens of millions, but hundreds of millions and even billions yearly, is a long one. Even if the parent were not held liable for its subsidiary’s losses, its equity investment in that subsidiary would be wiped out. In fact, these extremely public disasters led to unprecedented debate and political movement on how to reform large-firm governance, as Chapter 6 demonstrates.

If companies wanted to limit their liabilities for much of the manufacturing process, one option was to outsource a great deal of production and reduce their own size. Here the idea was to use firm boundaries to replace ownership relationships with contracting relationships, finding ways to integrate external producers enough to keep them responsive to precise demands and specifications and enough to provide them with whatever tools they might need to realize those demands, but to do so in a way that clearly left them accountable to themselves and their own shareholders. In fact, the outsourcing strategy became an extremely successful strategy for some companies, providing them ways around many of the barriers to continuous innovation practices that had been their goal all along.
A tradeoff faced those who pursued the outsourcing strategy. On the one hand, if the final assembler or main contractor wished to protect itself fully from the financial difficulties and liabilities of its suppliers, it was forced to maintain true arms-length relationships with them. Just as with the case of the qualified de facto combine, it could not engage in close collaborative relationships, or the courts would interpret its long-term contracts in terms of dependency and hold the final assembler liable for any defects in or damages caused by those suppliers. If an assembler opted for this approach to its supplier network, then just-in-time production was a much less predictable affair because the assembler would have a far less easier time monitoring performance until defects caused production to grind to a halt and result in high downtime costs. To ameliorate such costs, the assembler would have an incentive to carry more inventory; this in turn would reduce the compulsion to learn – not to mention the ability to communicate with its supplier network.

If, on the other hand, the final assembler or main contractor wished to collaborate with its suppliers more closely, both helping them integrate their products more closely and in less time with the final product, and benefiting from the information learned from the supplier in the process of such collaboration, then the assembler was often held liable by the courts for the mistakes of the supplier. If supplier products were co-designed by the assembler or by other suppliers introduced and coordinated by the assembler, then how could the courts hold only that supplier liable for its mistakes? They could not. The price of collaboration was liability. Just as in the case of control within large decentralized firms, however, some of the most successful assemblers – most noticeably
BMW – built up large, collaborative supplier networks nonetheless, assuming the higher risks for the sake of the extremely high scope economies and savings in turnaround and development time such relationships afforded, not to mention the increased speed of innovation and the additional economies of scale and scope associated with such manufacturing virtuosity.

Unlike the case of the decentralized Konzern, however, the assembler model of just-in-time production had a built-in mechanism for monitoring its supplier network. The problems of governance, earlier sections argued, had arisen from difficulties in assessing past performance and performance opportunities centrally; at the same time formulating better-aimed global strategies had become far more important. In order to increase the rate of improvement of both products and processes, companies had modulated production, devolved design, development and financial autonomy to local units, and devised benchmarking and other schemes for assessing performance that rendered the old central control systems obsolete. At the same time, the information demanded of central managers had become richer and more detailed if they were to match the volatile conditions of markets by formulating strategy with more agility and precision. It goes without saying that if companies could not master the situation, their owners and creditors would be unable to do the same – and the task of monitoring investment would be thwarted.

The solution to the conundrum was to build the monitoring relationship around existing trade and production relationships, just as the latter types of assemblers did in the case of their suppliers. Large, central assemblers could assume many of the monitoring
roles of the banks for their smaller, decentralized suppliers. Such customers already acted as major creditors to these firms. As part of their relationship with such assemblers, supplier firms also engaged in intimate discussions of strategy, development and pricing. In fact, many of the most successful assemblers, having developed joint-engineering and co-development relationships with their suppliers, and having contracted out production of modules and products once considered to be their core competencies, gathered precisely the information about industry standards, innovations, and pricing needed to monitor suppliers in the process of their supplier network coordination activities. In such instances, the supplier-customer relationship seemed a natural monitoring surrogate to the traditional creditor-debtor relationship – one that could inform firms when and how they needed to adjust their production to stay competitive. In fact, assemblers who maintained collaborative relationships with their suppliers were far more willing to lend to liquidity-strapped suppliers than those that did not.

In the late 1980s and early 90s, some large Konzernen, seeking a way out of the severe monitoring problems observed in other German enterprises, and reacting to the court’s definition of the qualified de facto combine, experimented with a new way to organize interfirm governance inside the Konzern that more closely resembled the assembler models of production. The goal was to remove the liability between parent and subsidiary but preserve the monitoring relationship that other, radically decentralized companies had failed to retain.

The organization they created, the management holding, was unique. The idea that made the new corporation unique, and thus the idea that defined the construct, was
the stark separation of strategy formation (the exclusive domain of the parent) from operations – the exclusive domain of the subsidiary. If this separation was credibly maintained, the courts appeared to rule,280 then the resulting Konzern would not fall into the qualified de facto class. Instead, it would enjoy enough autonomy to be deemed liable for its own business; it would truly be its own corporation. But guaranteeing that separation was the trick, and only the beginning of the true innovations in governance. Unlike the traditional Konzern, management holding subsidiaries would be structured to remain autonomous companies, not travel down a path of progressively more integration until fusion with the parent. The parent could not hold any type of Weisungsrecht, or right to direct or advise, its subsidiary. It could not engage in traditional board politics, so as to interlink boards in ways that would guarantee control. And it had to limit its directives to management to only infrequent occurrences. To commit to such policies, it sometimes signed control contracts that explicitly limited parent interference into operations except in certain extraordinary circumstances.

The stated powers to determine corporate strategy were also used as a guarantee of noninterference in operations. To be credible, most Konzern parents disengaged themselves from all operations of all its divisions; the result was the “spin-off” and incorporation of those divisions, such as legal, accounting, data and personnel services, that had always been lodged with the heads of large firms. All operational businesses had to be separately incorporated. Left in the center was a much smaller, pure strategic entity, controlling such activities as acquisitions, overall technological development, and corporate finance, but not much more (See Figure 6). Without such separation, the
division between operations and strategy could be too easily blurred, and with it the formal firm boundaries so critical to the management holding structure.

**Figure 6: Structure of a Management Holding**

![Diagram of a Management Holding]

The separation of strategy from operations not only limited the liability of the parent, it gave the parent the necessary tools and focus to monitor its subsidiaries more actively, and thus overcame the problem of the traditional large, decentralized enterprise. Ownership was the key. Obviously, that a parent could fire the CEO of its subsidiary as its majority owner did not solve the monitoring problem. What did solve the problem was the natural tension that arose between the strategic and operational competencies of each side, the resulting negotiations over how control would be (re-)apportioned, and the parent’s insight gained therefrom.

In the context of production methods that demanded collaboration among sales, design and production specialists, any separation between a firm’s operational and strategic control functions was bound to be artificial. But exactly how could never be predetermined. For example, if developing a new product one way seemed expensive but held the potential to open a whole new export segment, then in order to assess that
method properly, not only would teams need knowledge of export markets and their future prospects for development in general, but they would need to know how those prospects might fit in to the overall strategy of the firm in general – or vice-versa. As separate profit centers, subsidiaries had every incentive to enhance their strategic value through their operations, but to do so they required the participation of the management holding’s parent – as well as, possibly, the participation of other subsidiaries. What form exactly that participation would take depended on the manufacturing projects in question.

In the process of its active participation and consultation (not simple direction) in matters of its subsidiaries, management holding parents would learn enough about their operations to properly assess their value and performance. In this way they could monitor the Konzern more thoroughly than normal shareholders – just as an assembler monitors its suppliers in the process of collaboration. The difference between the assembler and the management holding, however, is obvious: in the place of an interest in building a common product, the parent and subsidiary of a management holding have an interest in building a common strategy. (For this reason, the management holding must be composed of subsidiaries which share some obvious strategic interests.) Just as in the case of the assembler, the management holding parent does not normally add key individual additions to the final (strategic) product. Much more, it orchestrates or coordinates the assembly of the different subsidiaries’ additions to that final strategy. Its job is to facilitate collaboration and order cooperation among its parts. Because of the need to build a common strategic whole, it uses the instruments of ownership – continuously renegotiated around a formal strategy/operation division of control that
practice itself challenges – to accomplish this end. Just as the supplier uses the
ingstruments of contract – continuously renegotiated around a formal supplier/buyer
division of interest which practice itself challenges – to accomplish its end.

In 1986, the first public mention of the management holding ownership form
occurred in an article in a well-known journal on corporate organization. Although the
idea did not get much immediate attention, similar formulations appeared in subsequent
articles, and then in 1989 and 1990 the idea was picked up by several prestigious strategy
consultants, first by Faber Castel and shortly thereafter by Roland Berger (among others),
and quickly propagated throughout industry. The timing was extremely propitious. The
courts were just issuing key rulings on the GmbH Konzern forms, and controversy about
these was thick in the air. Roland Berger itself subsequently became chief consultants in
several well-known cases of corporate restructuring and recommended the adoption of the
structure in those cases. Business periodicals and newspapers, including the
Handelsblatt, Management Magazine and Wirtschaftswoche, reported on the new
corporation. Conferences were held on the subject. Many large corporations that
had not previously experimented with similar ideas then took up the form, converting
intracorporate divisions into legally independent companies, eliminating intercorporate
hierarchies and restricting the scope of the corporate parent to strategic activities. Some
of these experiments occurred in the East, led not only by the Treuhand (Chapter 3
discusses these) but by other large corporate investors as well. East Germany thus
provided a natural arena in which to test such ideas, likely accelerating the adoption of
the management holding form markedly.
Since that time, the new corporate form has spread throughout all of German industry. One scholar reported that by the end of 1990, 46% of the 50 largest enterprises had actively restructured their governance along the management holding model. In the same article, he listed a breakdown of a sample of 46 out of 93 management holdings by industry, reproduced in Figure 7 below.

**Figure 7: Breakdown of Management Holdings by Industry**

Because of more liberal definitions of the management holding, these figures overestimate the true extent of the management holding in German industry. Nevertheless, its occurrence is relatively high even if the definition is restricted to the principles and structures discussed above. Within a period of less than ten years, the management holding had joined the ranks of the traditional AG, the integrated *Konzern*, and the GmbH as another widespread and important form of corporate ownership – one
explicitly structured after legal principles and rules that were no product of legislation but rather one of judicial innovation.

**An Illustration: The Case of the German Machine-tool Industry**

The best way to illustrate the birth and role of the management holding in the German economy is by reference to one of Germany's vital export industries, one at the center of industrial production, of the traditional model of that production, and one that played a major role in the invention and propagation of the management holding itself: the machine-tool industry.

**Background and Composition of the Industry**

The machine-tool industry is one of the key craft industries in the German economy. If one breaks down machine-tool firms by size and location throughout the Federal Republic, the picture that emerges, unsurprisingly, is one dominated by small to medium-sized firms and the decentralized regions. A glance at a breakdown of its structure by size of firm, shown in Figure 8, shows that an unusually high amount of production is concentrated in medium-sized firms (shown in the figure as the 250-500 and 500 to 1000 employee bands). This is the classic German Mittelstand, those craft-based firms lauded by most observers both within and outside of Germany for their competitiveness and importance in the country's export economy.

The industry reflects a high regional distribution: three federal states dominate over 80% of machine-tool production, employment, and composition by number of firms. The first is Baden-Württemberg, a classic industrial district and the finest example of a
decentralized industrial order in all of Germany.\textsuperscript{285} Another is Bavaria, which has historically been an example of an autarchic region, although in recent years other production practices have made their home in the fiercely independent state. Finally, there is North-Rhein Westphalia, the largest German state and historically an amalgamation of several different areas, including the more economically decentralized Rheinland and the big industry (autarchic) areas of the Ruhr and former Prussia. It is not surprising, given the critical craft component to machine-tool production, that of these three states, Bavaria lags the others in all categories, Baden-Wurthemburg dominates the industry, and North-Rhein Westphalia falls somewhere between.

\textbf{Figure 8: Structure of German Machine Tool Industry by Firm Size, Year-End 1992}  
\textit{Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.}
Figure 9: German Machine Tool Industry by States, 1993
Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.

A further confirmation of the argument that the machine-tool industry is a regionally based industry founded on craft production and heavily skewed, though not exclusively so, in favor of the decentralized economy, is the data on corporate ownership form. Table 1 breaks down this data further by the three important machine-tool producing states.

The results are highly consistent with the arguments in Chapter 5 that correlate the GmbH and its permutations with the decentralized regions, and the AG with traditions of control in the more autarchic regions. Thus, despite the role that craft traditions play throughout Germany in this important industry, the ownership divide is clearly preserved across the economy.
Table 1: Regional Comparison of German Machine-tool Industry, 1990

<table>
<thead>
<tr>
<th>Employees</th>
<th>B-W</th>
<th>NRW</th>
<th>Bav</th>
</tr>
</thead>
<tbody>
<tr>
<td>GmbHs</td>
<td>63%</td>
<td>46%</td>
<td>13%</td>
</tr>
<tr>
<td>AG</td>
<td>6%</td>
<td>30%</td>
<td>59%</td>
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<tr>
<td>GmbH &amp; Co</td>
<td>20%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>GmbH &amp; Co KG</td>
<td>10%</td>
<td>5%</td>
<td>25%</td>
</tr>
<tr>
<td>KG</td>
<td>0%</td>
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<table>
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<th>Bav</th>
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<tr>
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<td>49%</td>
<td>45%</td>
<td>11%</td>
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<tr>
<td>AG</td>
<td>6%</td>
<td>27%</td>
<td>74%</td>
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<tr>
<td>GmbH &amp; Co</td>
<td>36%</td>
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<td>0%</td>
</tr>
<tr>
<td>GmbH &amp; Co KG</td>
<td>8%</td>
<td>3%</td>
<td>15%</td>
</tr>
<tr>
<td>KG</td>
<td>0%</td>
<td>7%</td>
<td>0%</td>
</tr>
<tr>
<td>TOTAL (In Millions of DM)</td>
<td>6,043</td>
<td>1,666</td>
<td>2,485</td>
</tr>
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</table>

Figure 10: Important Machine Tool Industry Ratios 1990
An interesting addendum to the observed correlation between ownership form and region is shown in Table 1, which depicts the correlation between ownership form and scale economies. The average size of the AG is noticeably larger, both in terms of total workforce and in terms of total revenue, than that of the GmbH or any of its variants. However, the efficiency of scale economies (roughly measured in revenue per employee), even during a peak year in which industry capacity was at an all time high of 95%, was mixed at best, coming in as the median of the group. In fact, in view of the fact that the vast majority of machine-tool firms are organized in the GmbH and GmbH & Co. forms, production organized by scale might even be said to be less efficient than the alternatives. The AG number is indeed less the industry average (201,371 DM per employee), although not by much.

The Post 1990 Crisis

German machine-tool exports have traditionally, and unsurprisingly, led the world. Table 2 shows that until 1991, Germany consistently led the world in exports, maintaining at least one quarter of the entire share of world machine-tool exports. These exports accounted for between half and two-thirds of the industry’s entire machine-tool production. It is not surprising, moreover, that just about half of these exports went to other European countries. Not only was Germany a close neighbor to these economies, but Europe as a whole consistently represented the most important export market in the world – just over 60% of total world exports. Nevertheless, the figures also mean that about 50% of German exports, and therefore about one-third of total industry production, were sent beyond Europe to the United States, Japan, the (former) Soviet states, and
developing countries such as China. The industry was therefore not only the world’s strongest, but it was extremely dependent on maintaining its position as the world’s strongest machine-tool exporter.

**Table 2: Worldwide Machine-tool Exports.**

Sources: *American Machinist* and *Verein Deutscher Werkzeugmaschinenfabriken e.V.*

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<th></th>
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<tbody>
<tr>
<td>Germany</td>
<td>30.6%</td>
<td>25.6%</td>
<td>26.5%</td>
</tr>
<tr>
<td>Japan</td>
<td>3.5%</td>
<td>13.3%</td>
<td>20.7%</td>
</tr>
<tr>
<td>USA</td>
<td>11.7%</td>
<td>6.9%</td>
<td>5.7%</td>
</tr>
<tr>
<td>West Europe</td>
<td>64.0%</td>
<td>59.1%</td>
<td>62.0%</td>
</tr>
<tr>
<td>Germany as % of West Europe</td>
<td>47.8%</td>
<td>43.9%</td>
<td>42.7%</td>
</tr>
</tbody>
</table>

**Table 3: Worldwide Machine-tool Sales.**

Sources: *American Machinist* and *Verein Deutscher Werkzeugmaschinenfabriken e.V.*

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<tbody>
<tr>
<td>Germany</td>
<td>12.2%</td>
<td>10.2%</td>
<td>17.3%</td>
</tr>
<tr>
<td>Japan</td>
<td>16.1%</td>
<td>10.1%</td>
<td>22.1%</td>
</tr>
<tr>
<td>USA</td>
<td>17.3%</td>
<td>21.3%</td>
<td>10.1%</td>
</tr>
<tr>
<td>West Europe</td>
<td>34.0%</td>
<td>30.2%</td>
<td>42.2%</td>
</tr>
<tr>
<td>Germany as % of West Europe</td>
<td>35.7%</td>
<td>33.8%</td>
<td>41.0%</td>
</tr>
</tbody>
</table>

**Table 4: National as Percentage of World Machine-tool Production.**

Sources: *American Machinist* and *Verein Deutscher Werkzeugmaschinenfabriken e.V.*

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<tbody>
<tr>
<td>Germany as % of West Europe</td>
<td>51.4%</td>
<td>50.0%</td>
<td>55.9%</td>
</tr>
<tr>
<td>West Europe as % of World</td>
<td>41.1%</td>
<td>40.4%</td>
<td>47.3%</td>
</tr>
<tr>
<td>Germany as % of World</td>
<td>19.0%</td>
<td>17.6%</td>
<td>22.3%</td>
</tr>
<tr>
<td>Japan as % of World</td>
<td>14.2%</td>
<td>14.3%</td>
<td>28.4%</td>
</tr>
<tr>
<td>USA as % of World</td>
<td>18.5%</td>
<td>18.0%</td>
<td>6.7%</td>
</tr>
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In the 1990s, disaster struck the industry. Production fell off at an astounding rate (see Figure 13). So did employment (See Figure 14). It was easily the worst downturn in the industry’s long and prestigious history.
Figure 11: German Machine Tool Production, 1976-1993
Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.

Figure 12: Post-1990 Machine Tool Employment in West Germany (excluding East)
Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.

At first glance, the causes of the downturn seemed obvious. Tables 5 and 6 show that between 1990 and 1993, German home markets for machine tools collapsed by
nearly 50%, yet home producers’ share of that market remained steady at around 60%.
Likewise, although export shares dropped gradually between 1990 and 1992, they did not fall off at nearly the same rate as overall production. Capacity utilization did fall at the same rate. Machine tools, by their very nature as capital intensive investment goods, are a highly cyclical industry. Moreover, Germany’s position as the leader in custom-built and small-batch products put it in a segment of the industry particularly vulnerable to demand fluctuations. The data seemed to show that the crisis in the industry was a classic, albeit an extremely vicious, result of worldwide recession, together with all the negative peculiarities associated with reunification and Germany’s own protracted economic crisis at home.

**Table 5: Post-1990 Machine Tool Production in Germany**
*Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.*

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<tr>
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<tbody>
<tr>
<td>Total Production</td>
<td>16425</td>
<td>17235</td>
<td>14159</td>
<td>10709</td>
</tr>
<tr>
<td>Exports</td>
<td>9447</td>
<td>9828</td>
<td>8507</td>
<td>6946</td>
</tr>
<tr>
<td>Inland Sales</td>
<td>6977</td>
<td>7407</td>
<td>5652</td>
<td>3760</td>
</tr>
<tr>
<td>Total Inland Demand</td>
<td>11375</td>
<td>12273</td>
<td>9486</td>
<td>6367</td>
</tr>
</tbody>
</table>

**Table 6: Post-1990 Machine Tool Production in Germany, Selected Ratios**
*Source: Verein Deutscher Werkzeugmaschinenfabriken e.V.*

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<tbody>
<tr>
<td>Percentage Inland Sales of Total Demand</td>
<td>61.3%</td>
<td>60.4%</td>
<td>59.6%</td>
<td>59.1%</td>
</tr>
<tr>
<td>Percentage Exports of Total World Market</td>
<td>23.3%</td>
<td>22.3%</td>
<td>20.0%</td>
<td>23.0%</td>
</tr>
<tr>
<td>Capacity Utilization</td>
<td>95.0%</td>
<td>89.7%</td>
<td>81.5%</td>
<td>70.7%</td>
</tr>
</tbody>
</table>

Surprisingly, however, very few industry analysts shared this interpretation.

Instead of a conjunctural crisis, the Association of German Machine-tool Producers (VDW), the Association of German Machinery and Equipment Producers (VDMA), observers from the press, analysts from I.G. Metall, and many CEOs and managers of
machine-tool firms themselves labeled the crisis the industry’s worst *structural* crisis of the postwar period.

The numbers were misleading. After reunification, the industry added a large chunk of capacity in the East, which artificially enlarged statistics on export share. In 1993, machine-tool producers met an exceptional export order from China, which again artificially raised the numbers. By comparison to exports to historically key countries, the Germans were actually losing ground, and losing it quite rapidly (see Figure 13). The most important customer segment, European countries, made up less and less of the overall export share at a time in which that share was dropping (albeit gradually) year by year. The Germans were being threatened in their most important markets. And they knew it.

**Figure 13: German Machine Tool Export Structure**
Source: *Verein Deutscher Werkzeugmaschinenfabriken e.V.*
Japanese Competition: the Politics of Adjustment in World Markets

In 1990, a handful of leading machine-tool manufacturers, under the sponsorship of the "Economic Rationalization Committee" (RKW) and in collaboration with representatives from several large-firm works councils, I.G. Metall and some academics, launched a formal study of Japanese machine-tool makers, their corporate strategies, methods of manufacturing, work organization and ownership structures. Headed by Drs. Leibinger and Kammueller from Trumpf GmbH & Co., who held top positions in several of the most important Baden-Wuertemburg industry groups, the crew visited Japanese machine-tool plants, interviewed over twenty top machine-tool executives there, and then spent a year of analysis, defining what German machine-tool firms needed to change in order to become more competitive with the Japanese.

What the RKW group saw and perceived in their own markets — already in 1990 — were not only the short-term problems with new foreign competitors from the East. They recognized the long-term trends at work as well. As Table 1 shows, the Japanese had risen extremely rapidly as respected machine-tool producers, quickly surpassing the Americans in the 1970s and then steadily building out their share of world exports until, in the 20 years since 1970, they had increased that share to over 20%. If these trends continued — and the troubles the Germans had in markets close to home suggested they might — then it appeared that Germany might become a victim to Japanese competition just as the Americans had. "What makes the Japanese machine-tool producers so strong? Why can they keep building up their competitive position in the German market, after they already wrestled to the ground the once technologically and competitively superior machine-tool industry of the United States?" In their 156-page published
report,\textsuperscript{287} entitled "Factors of Success in the Japanese Machine Tool Industry," the RKW group repeatedly cited incursions into the highest quality machine-tool segments as evidence that Japanese corporations had indeed begun this process.

Of the many differences cited between Japanese and German machine-tool firms, one of the most prominent was that between the dynamic flexibility of Japanese work practices and the less innovative and hardened ways of the German craftsman.\textsuperscript{288} "Simple is beautiful" and "Object-orientation, not function-orientation" were key phrases the report used to explain how project teams were the key to Japanese success. Complicated and flawed design processes, together with worries and bickering over job jurisdictions, were holding German firms back from mimicking the Japanese, and then, on the basis of its superior skill pool, beating the Japanese at their own game. Module production designs were an important way German engineering could move production processes closer to these goals, the report suggested, and thereby realize the greater scope and scale economies inherent in the continuous improvement systems of Japanese manufacturing.

In many ways the German report used the foil of Japanese success to argue for changes already recognized as possible improvements throughout the industry: abandoning craft-based skill hierarchies in favor of flat, multi-task teams, for example, had already been recognized by the major industry associations and unions as a necessary step toward more productive, innovative work practices. Indeed, both had published pamphlets and held seminars and local presentations on ways in which old rules could be bent into these new directions. The RKW report simply gave these efforts more legitimacy and added to them a sense of urgency.
In other ways the German report offered entirely new recommendations as to how industry should learn from the Japanese and properly respond to their late entrance into niche markets formally dominated by the Germans. The most important of these was the recommendation for consolidation and interfirm cooperation. Though both industries were similarly structured by firm size (see Figure 14), there was a major difference among the largest firms, which were the most important exporting firms. The strongest German exporters, the RKW report argued, were simply too small to compete head to head with Japanese machine-tool companies. Especially among the largest of firms, Japanese companies were twice as large as or even larger than their German counterparts (see Figures 15).

**Figure 14: Industry Structure by Firm Size, in Percent of Total Firms, 1990**

*Source: Broedner and Schultetus (1992).*
How did this matter, when German firms organized around scale were not necessarily as efficient as their *Mittelstand* counterparts? In two ways. The first was a continuation of arguments about module production: the greater size of the firm meant not only greater scale economies in the manufacture of modules (and, indirectly, end products), but if size included not just a bulging workforce but more numerous subunits, scope economies as well. Far more important than this, however, was the advantage in strategic maneuvering room that size advantages gave Japanese firms in the international marketplace. Japanese firms could – and did – offer large worldwide customers whole ranges of related products at once. This afforded the Japanese many benefits: they could more easily and flexibly make additional deals with multinational customers with diverse needs; they gained obvious economies in marketing; they could offer superior services and maintenance contracts; and (importantly) they could keep abreast of all developments in related product spheres and thus accelerate the rate of learning and improvement due to
spillover from one technical variation to another. Larger firms offered customers who
didn’t know exactly what they needed far richer advice on the possibilities. Finally,
because of their much more acute strategic sense, firms that produced a broader product
range could react quicker in the international marketplace and thus gain first-mover
advantages in key developing technologies, such as robotics and numerical controllers.

The RKW report pointed out that while large size was important, so was the
smaller size and the corresponding GmbH governance form that sustained much of the
system of flexible production. The preservation of such flexibility was vital. Japanese
firms used large supplier networks and flat combine governance to retain both large-firm
and small-firm advantages. In the German context, the answer to these concerns was to
adopt a flexible Konzern-like structure that allowed smaller German producers to band
together in ways that preserved their autonomy but allowed them to act as one strategic
unit. Traditional craft district institutions, for obvious reasons, failed to provide such an
infrastructure. One obvious way forward, although it was not mentioned directly in the
studies at the time, was the management holding.

The Emergence of the Management Holding

Of course, not all agreed with the conclusions and recommendations of the RKW
group. The VDW and VDMA launched their own separate studies on Japan and the
current crisis and came to less poignant conclusions. I.G. Metall did the same. But
once the cat was out of the bag and the post-1990 downturn had been publicly interpreted
by respected leaders from capital, labor and the academy as a deep structural crisis, most
of industry began to take serious steps toward restructuring both the organization of
production and the organization of management and governance. Roland Berger, the 
prestigious strategy consultant mentioned earlier, worked closely with several large 
machine-tool producers to help them get out of major financial troubles and eventually 
adopt a management holding structure. Other producers did the same on their own 
initiative. One firm in Moenchen Gladbach served as a model to many others: having 
adopted a management holding structure early on in 1990, its sales had boomed, and 
earnings had stayed in double-digits during the entire 1991-1994 downturn.

The management holding allowed machine-tool makers to do more than simply 
band together and realize strategic advantages in the international marketplace. It also 
helped alleviate the types of problems with work reorganization alluded to earlier. One 
negative way it did so was to remove levels of hierarchy in labor representation, breaking 
up large firms that formerly required codetermined boards and various other high-level 
odies of worker representation into smaller, legally independent units that did not. The 
smaller the firm in which a worker operated, the less room seemed to exist for throwing 
up barriers to projects the firm required done expeditiously just to exist. More important 
than the formal institutions, therefore, was heightened competitive pressure in former 
divisions that were now incorporated; such pressures brought management to heel and 
moved labor into much closer contact with management in the everyday operations of the 
firm. As one punching machine maker from Baden demonstrated, both parties found it 
much more difficult to escape justifying their actions in the terms of the criteria worked 
out on the ground floor for completing or exploring projects. Though it could not take 
the place of institutions like the works councils, the dual training system, and official job
certificates that made a noticeable difference in perpetuating or ameliorating conflicts on the shop floor, the management holding did help firms overcome some of the workplace barriers to adopting more open, team-like work organization.

The management holding also helped accelerate the rate of technology transfer among its subunits and innovate more module-oriented designs such as the RKW group had recommended. One maker of polishing and grinding machines that joined such a combine, for example, reduced the number of parts in its main series of flexible machining centers by over 35% because collaboration with other subsidiaries revealed ways to modulate some key systems and ways to simply cut parts and features that in the experience of the others had been unnecessary on the market. These savings, plus the freedom to move production of machines best manufactured by other subsidiaries without any financial penalty, subsequently allowed the firm to focus more on its core competencies and reallocate its resources toward developing those machines. If they could succeed, one manager related, the company could "sell" the new improvement to other members of the group with now similar designs and modules, receiving credit from the parent for an important combine-wide advance and with it the advantages of collaborating more closely with the parent in its marketing and developing planning.

Finally, the management holding gave machine-tool firms important tools in the struggle for financial relief. One of the major spurs toward forming the Konzernen in the 1990s, in fact, was another flood of family firm sales due to yet another generational turnover in machine tools. This created a type of internal market for firms looking to find ways to break their debt relations with banks and sell out to larger firms. In this context,
the tax and profit retention advantages created by recent court rulings proved to be powerful incentives for smaller firms to pool resources and join Konzernen organized as management holdings. Profit-sharing contracts allowed firms to offset profits and write off any losses, while the firm-of-firms structure of the Konzern gave it a way to retain a high percentage of earnings by doing so at each lower level before doing so once again at the level of the parent – leaving only a fraction of money to be taxed and distributed to the shareholders as dividends. The company was set up in such a way to give the firm far greater control over its resources but allowed investors attempting to monitor the corporation from the outside far less a chance to do so. It is no surprise, therefore, that the occasion of the creation of a management holding was also usually an occasion for banks to get out of their investments. Indeed, this is precisely the reason the much-troubled Deckel-Maho AG joined with Gildemeister AG to create such a Konzern after near bankruptcy in 1994. The management holding thus acted as an intra-firm replacement of a monitoring and control system formerly centered on external investor relations, such as those with the big banks.

By the end of 1995, every single one of the top eight German machine-tool producers had become a management holding. Not every firm was profitable. And not every Konzern that appeared like a management holding on the outside actually acted like one strategically and operationally. To every observer, however, the transformation of the industry had been thorough and comprehensive.
Summary

Pressures stemming from an increasingly competitive, volatile global marketplace produced stresses in the traditional German variants of the modern corporation – the joint stock company (AG) and the limited liability company (GmbH) – and the systems of production with which they are classically associated. These stresses were both economic and political in nature. In the first case, pressures to move toward ever more open, flexible forms of production made old managerial control hierarchies more obsolete and the task of monitoring performance much more challenging. This was true for both large AGs and smaller GmbHs, both autarchically organized production and decentralized production organized along craft principles. As a consequence, the ownership relationships around which traditional forms of monitoring were organized were questioned and redefined. Efforts to create new forms of governance, both in response to these internal changes and in an effort to meet the strategic demands of the international marketplace, led to a reexamination of old rules of governance and ownership. The long and tortuous process of political and legal debate that began even before the war, as explained in Chapter 4, was accelerated. The classical traditions of corporate ownership upon which were founded the formal structure of the law, the collective organization of business, and the political system of those traditions’ own regulation and reproduction, collided.

In the midst of this collision – in reaction both to the novelties of the courts and to the uncertainties of the new economic environment – private innovation produced an experiment in governance which some dubbed *the management holding*. First identified by academics and management consultants, and then soon spread by the same in
combination with the press as well, the idea of the management holding seemed to give a formal structure to practices and relationships already partially in place. Above all, it provided a simple method for ownership to be conceptualized and for control to be allocated and then (re)adjusted, a method that offered modern corporations a way forward around the impasse between decentralized production and the demands of monitoring and maintaining accountability. In fact, not only did it provide a way around such an impasse, but when applied to the problems of adjustment in the machine-tool industry, it actually helped firms adopt new production strategies that promised to speed up processes that transformed traditional craft relationships which had previously been so difficult for firms to overcome.

The management holding, not unlike the confusion that preceded it, confounded traditional distinctions in the law and in politics. A corporation was both a GmbH and an AG, not only in form but in practice. The structure used the courts’ newly intended balance between the rules of autonomy and flexibility found in the GmbH and the more formal governance procedures of the AG (usually the parent). Patterned in the law and practice on the principles of supplier relationships of large assemblers, the management holding broke down traditional firm boundaries by dividing ownership not discretely by shares but figuratively by function: asserting an artificial distinction between strategy and operations that necessitated the periodic redefinition of control. Finally, the historical divisions between autarchic and decentralized industrial orders were challenged as well. Within the management holding, decentralized methods of production – in fact, as the case of the machine-tool industry illustrated, methods even more flexible and open than
those found in the traditional craft system – could be, and often were intended to be, integrated into a single large corporation that as a whole acted and was governed after more autarchic principles. Not surprisingly, such Konzernen often had member firms actively involved in both regional trade chamber politics at the regional level and in big industry associations at the national level, organizations that traditionally represented colliding political viewpoints. The birth of the management holding was thus the birth of a truly novel form of corporation, one that did not fit easily into the existing system of ownership and politics.

Nevertheless, the management holding by no means replaced other governance traditions, nor did it immediately undermine the system of their representation and reproduction on the political level. If the surveys cited earlier are any indication, at least half of all large firms – and probably a significant percentage higher – would not fall under the special mixed ownership regime of the management holding. Moreover, among large sections of the craft economy, the GmbH still functions quite well as a common vehicle of governance. However, the new type of corporation did represent a major reinterpretation of company law, a primary vehicle by which separate traditions of governance were maintained and distinguished in Germany. And it openly confounded many of the economic institutions that distinguished the two types of corporate economies in Germany, including co-determination rules in the large firm and craft principles of work organization in the smaller firms. Where these points of attenuation of the old German model might lead – politically and economically – is a subject for the last chapter and conclusion of this dissertation.
Chapter 6

The Bankruptcy of Bankruptcy

In 1975, Dr. Kilger, a widely respected legal scholar, gave a speech entitled “The Bankruptcy of Bankruptcy” at the annual Conference of German Jurists. Kilger publicly highlighted the consensus developed among practitioners and academic observers that the bankruptcy procedure had become grossly inadequate. After the talk, members of the government and legislature began serious consideration of a reform, and in 1978 an official commission formed to draft a comprehensive reform of the bankruptcy and insolvency laws. At the time, very few doubted that such a reform would occur; however, the actual reform did not pass into law until sixteen years later, and then only after considerable controversy over the question whether a reform should be passed at all. Many were dissatisfied with the law. Indeed, the new Insolvenzrecht, despite being one of the longest, most complicated and technical documents produced by the Bundestag, was widely viewed as a masterful, formal creation with little practical significance. Why had Kilger’s speech been so well received, and what caused the reversal of fortunes for bankruptcy reform by 1994?

Liquidation, not Reorganization: The German Bankruptcy System

The Reichstag debated the first German bankruptcy law in 1872, two years after the new AG law. In fact, the explicit intent of the bill was to adjust bankruptcy procedures to the new corporate economy and the ownership rules that undergirded it. It replaced the punitive view of bankruptcy – designed to punish individual debtors according to moral judgments of the reasons for default – with a positive view, one
adjusted to the fact that many owners, not one, would typically default with a corporation, and that these shareholders often were not morally culpable for the firm’s actions or misfortunes. The bill also added a composition procedure to avoid liquidations. This latter procedure was rejected. Instead, in 1877 – after the first wave of stock scandals – a pure liquidation procedure was passed. It was this same law that was still in place when Kilger made his famous speech in 1975, and it was this same law that the 1994 *Insolvenzrecht* finally replaced.

The 1877 Bankruptcy Law (*Konkursverordnung*, or KO) was designed for one major purpose: to assist creditors in their efforts to recover their assets from a bankrupt individual or company according to common rules of fairness and equity. During bankruptcy, ownership of the firm reverts from shareholders to creditors; the bankruptcy procedure thus becomes a governance procedure for a firm in default. Just as in the case of the liquid corporation, that governance procedure is supposed to be a private one supervised by the state. Accordingly, the law stipulates that the bankrupt firm be supervised by a private receiver, appointed by a creditors’ committee, whom the courts oversee (see Figure 1). Ideally, the creditors work out their own plan of governance, including how a firm should be liquidated or reorganized. In practice, however, the receiver does the valuation of the firm and settles conflicts among the claimants, deciding how assets should be distributed. Creditors may appeal, but they must pay for court costs if their appeal is rejected.²⁹⁴
Despite the KO’s focus on the self-governance of private creditors, the law left plenty room for the state to have an active hand in the procedure – once again a reflection of the public-private balance sought in the AG law. The KO not only defined the procedure of governance, it defined the owners (creditors), as well as their respective rights. It also ordered the priority of their claims according to what, at the time, most
observers felt was fair and just. Thus the law ordered unpaid workers as the first priority because of their relative weakness vis-à-vis and lack of information about the firm itself. Following similar reasoning, it put unpaid social insurance funds second after workers; the fiscus third; churches, schools, doctors, and pharmacists fourth; and funds it owed all other (unsecured) creditors, including financial institutions, last. Within these separate groups, the principle of equality was to hold, and no worker received a privilege above another worker, just as no creditor was to receive special privileges either.

Besides those explicitly defined by the law, one other class of creditors remained: secured creditors. The 1877 law specifically deemed all rights individually contracted to other parties as untouchable by the receiver; these were deemed prior to bankruptcy and therefore did not require a bankruptcy procedure to realize. The receiver simply excluded secured property from the estate. If a bank secured a loan with the land upon which a firm rested, for example it was considered the sole owner of this land in the event of default, whether the bankruptcy procedure was instituted or not. Any ruling otherwise would have brought the basics of private ownership into question, the drafters of the 1877 law felt. The bankruptcy procedure was simply to assist creditors whose claims automatically conflicted – unsecured creditors – in the exercise of their rights. The whole idea of a secured claim was that it granted exclusive (nonconflicting) rights over some asset of the estate.

Though passed after the first big wave of joint-stock incorporations, the 1877 law's principles of fairness were based on conceptions of the firm completely outdated thirty years later. At the time, debt ratios were far lower, and wages, taxes, and
social insurance payments made up a relatively small fraction of total revenues.³⁹⁸

Schools were often private, and churches did not yet collect their funds through taxes. Most important, because land values were relatively cheap and because lending practices were as of yet relatively unsophisticated, the practice of securing credits was an exception. Corporations were large and expected to be even larger after the revisions to the 1870 AG law were passed, but the GmbH law had not yet provided a path for small firms to incorporate easily. Thus, while non-bank claims made up a relatively small part of the general creditors’ pie, this pie was a far smaller pie compared to the size of the firm as a whole.³⁹⁹ The viability of the firm itself did not seem to be a valid issue, given these circumstances, and so composition proceedings were removed from the bill in favor of a procedure that would help creditors recover in the event of default.

As the economy changed and the national framework of corporate law was defined and put into place, however, the same procedure on paper changed into a very different procedure in practice. Banks became easily the most powerful creditor constituency. Not only did bank lending increase as the corporate economy flourished, so too did their position within the supervisory and stockholder boards. Consolidations and developments in the system of production itself made them among the most powerful investors (see Chapter 4). Banks became much better informed of a firm’s viability and could renegotiate their claims vis-a-vis other claimants at opportune moments. Finally, banks secured an increasing fraction of their loans, developing an elaborate system of liens against land, movables, accounts receivable, and other objects of value.³⁸⁰ The extended use of liens enhanced banks’ leverage over a firm not only in times of
insolvency, but in times of prosperity as well.\textsuperscript{301} Banks staked out the top spot on the creditor ladder and put themselves in a position so that they could respond far more adeptly to bankruptcy or the threat of bankruptcy. As powerful economic actors among the politically favored large-firm economy, banks became close allies of the Imperial government,\textsuperscript{302} which under the 1871 constitution held sole power to initiate all legislation. For this reason, despite significant changes to the economy and the radical reshuffling of the procedure in practice, changes to the bankruptcy system were rarely considered and never brought forward. A composition procedure (\textit{Vergleichsordnung}) was later passed in 1935 – in response to the rash of liquidations during the depression years after 1929; but impossibly compressed time scales for composing and then approving a reorganization plan left bank power intact (see Figures 1 and 2). A 1938 attempt to reform the 1935 bill was quashed.

During the postwar years, the economic position of the banks during insolvency only increased. So too did the position of the group with first priority in bankruptcy: workers. After the 1948 currency reform, wages increased between 1 to 5% faster than productivity in Germany, averaging about 6 \( \frac{1}{2} \)\% per annum.\textsuperscript{303} The size of workers' bankruptcy claims grew relative to others. Because the high percentage of secured debt meant a small ratio of recovered funds for general creditors, the amount of worker wages lost during bankruptcy increased as well, in direct proportion to the rise of wages. The DGB took notice of these changes, and organized labor began lobbying for a reform that would alleviate the problem. Because the original law so clearly favored workers over other creditors, labor could argue quite rightly that the dependent position of the worker
was being exploited by far more powerful creditors who had found ways to subvert workers’ true claims.

**Figure 2: Comparison of Bankruptcy Procedures, Selected Countries.**

<table>
<thead>
<tr>
<th>Filing Procedure</th>
<th>Who controls insolvent Firm?</th>
<th>Stay of execution against secured claims?</th>
<th>Do new loans receive priority?</th>
<th>Method of Adoption of Reorganization Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Managers have 120 days to file reorganization plan (Ch.11); 3 creditors can file involuntary plan. Court adjudicates.</td>
<td>Managers (under Chapter 11) or receiver (under Chapter 7)</td>
<td>YES</td>
<td>NO</td>
<td>By majority vote (2/3 by value) of each creditor class, including old equity holders.</td>
</tr>
<tr>
<td>U.K. Directors must file immediately; floating lien holders &amp; others permitted to file involuntary plan.</td>
<td>Receiver appointed by floating lien creditors</td>
<td>YES</td>
<td>YES</td>
<td>Receiver decides, and decision must be ratified by majority vote (by value) of all creditors.</td>
</tr>
<tr>
<td>France Managers file, starting a 6 to 18 month “period of observation.”</td>
<td>Court-appointed receiver</td>
<td>YES</td>
<td>YES</td>
<td>Court-appointed receiver decides.</td>
</tr>
<tr>
<td>Germany Managers must file reorganization plan within 3 weeks of insolvency, to be approved by creditors. Any creditor can file involuntary plan.</td>
<td>Receiver appointed by court and approved by majority of creditors (by value).</td>
<td>NO</td>
<td>NO</td>
<td>35% of claims, 40% if after one year, must be paid for approval. A majority of unsecured creditors by claim value must approve.</td>
</tr>
</tbody>
</table>

In 1972, a law was passed that required the negotiation of a social welfare package in the event of mass layoffs and recognized the ensuing claims either as a general debt or as a
debt of first priority. A 1974 law required firms to keep a fund to pay wages lost due to bankruptcy in the first three months (*Konkursausfallgeld*). Unlike other claims, unpaid wages between 6 and 12 months old were not demoted from the first priority. Universally opposed by employer, industry, and bank associations, all these changes were accepted by the legislature because of a conducive political environment. Conservatives, liberals and social democrats alike perceived that fairness and adherence to the original intent of the law warranted the adjustment of bankruptcy rules.

Compared to other European and the U.S. bankruptcy laws, the German law – in the context of the modern economy – grants big, secured creditors (the banks) the most control over the firm (see Figure 2). Enhanced worker rights, therefore, were most vehemently opposed by the banks. Despite this incursion, however, it was not the new position of workers that brought the issue of bankruptcy reform to a head in the 1970s. Rather, as the next section shows, it was the inability of banks themselves to prevent a rapidly accelerating volume of bankruptcies. Pushed to the limit of restraint, banks attempting to salvage corporate viability found that as the economy worsened, keeping firms out of bankruptcy was becoming well nigh impossible. The procedure almost guaranteed liquidation, and most participants in the process were unsatisfied with the results. For the first time, a public outcry arose which made lawmakers generally aware of the non-viability of existing rules, and of the general dissatisfaction of all claimants involved with the feature. The law was deemed unfeasible by both Social Democrats and Christian Democrats alike. All parties agreed that some form of reform was needed.
*Economic Crisis*

In 1972, the number of bankruptcy proceedings was 4,575. By 1975 it had more than doubled to 9,195. Between 1975 and 1978, when the Insolvency Commission was officially formed, hundreds of articles in journals, newspapers, and books appeared suggesting possible reforms of the 1877 law.\(^\text{304}\)

What caused the rising numbers of bankruptcies was hard to determine. The numbers probably had multiple causes;\(^\text{305}\) among these were falling profit margins (thus less room for financial maneuver), a higher debt ratio among GmbHs, low equity ratios, more volatile macroeconomic conditions, higher numbers of lenders per firm, and a steady rise in new GmbHs (with a corresponding rise in entrepreneurial misadventures). Undoubtedly, however, difficulties associated with the existing bankruptcy regime were among the contributing factors, and instead of mitigating the other causes they exacerbated them.

Regardless of the causes in the rising numbers of bankruptcies, as the previous section makes clear, most parties were dissatisfied with the existing law. The major problems with the procedure were that it was inefficient, scarcely satisfying many claims, with only few exceptions; and it was economically destructive,\(^\text{306}\) resulting in a very high number of liquidations. A study conducted between 1976 and 1977 of over 250 bankruptcy courts, 300 receivers, 200 banks, 1000 employees of bankrupt firms, and numerous other sources\(^\text{307}\) found that on average,
1. Secured claims consumed fully 87% of the bankrupt estate's assets: 20% of these go
to suppliers, 11% go to handicraft and other service providers, 3% go to tax
authorities, and most of the rest (66%) go to banks.

2. Not counting the distribution of secured claims, only 30 to 35% of remaining funds
were actually distributed to creditors, because of high court and administrative costs.
The extremely low amount of funds left after secured claims were satisfied was
partially to blame – leaving a proportionally lower percentage residual after additional
court costs.

3. Bank claims made up 38% of all claims. Yet among completed liquidations, banks
realized fully 79% of all their outstanding debts, compared with 64% for suppliers,
11% for the tax authorities, and 14% for all others. If bankruptcy had accorded each
creditor equally, each would have received 46% of its original claims.

4. Among secured creditors, those with claims on movables lost on average only 22% of
their claim. Those with land and property lost 34%, and those who secured their
claims with corporate monies (accounts receivable, etc.) lost fully 50%.

Figures 3, 4, and 5 show how some of the problems mentioned above reached
extraordinarily high proportions over time. Figures 3 and 4 illustrate how the incentive to
liquidate firms rather than reorganize them drastically increased as the problems
described above intensified. By the mid 1980s, less than 1% of all bankruptcies were
administered under the 1935 composition procedure – by far the lowest figure among the
United States, France, Germany and the United Kingdom. This increased to less than a
third of one percent by the end of the decade – the very time when bankruptcies were
increasing by thousands each year. Banks were accused by many of liquidating firms prematurely to avoid anticipated losses. Unions were accused of pressing their newly-won rights so hard that a firm had no room to maneuver to develop a reorganization plan. In any event, the reality was that firms entering liquidity crises had little chance of surviving.

Figure 5 shows that given the liquidations, the chances creditors had to recover any claim at all decreased steadily over time. By the mid 1980s, only 20% of bankruptcy cases could proceed far enough to grant general creditors some proportion of their lost monies. Fully 80% of cases could not even get that far. Thus overall, less than 3% of general debt was actually recovered in bankruptcy.\(^{308}\)

**Figure 3: Reorganizations as Percentage of Total Bankruptcies, 1950-1990**
*Source: Statistisches Jahrbuch, selected years.*
Figure 4: Reorganizations as a Percentage of All Bankruptcies, 1977-1990
Source: Statistisches Jahrbuch, selected years.

Figure 5: German Bankruptcies, 1950-1990
Source: Statistisches Jahrbuch, selected years.
All these facts meant that except for the best-secured creditors, bankruptcies resulted in extraordinarily high losses in Germany, losses not only of debts to creditors, but because of the rare occurrence of reorganizations, losses of jobs and domestic product. Even though banks could realize 79% of their claims in cases that went through to final distribution, they realized far less than this in practice because only 1/5 of cases did so. This meant that over time parties such as suppliers, providers of services, and other claimants – all of whom realized a far lesser fraction of their claims than the banks – could count on recovering very little if anything from bankrupt firms.

**The Politics of Impediment Revisited**

That Kilmar should proclaim the bankruptcy of bankruptcy in 1975 was not happenstance. In 1974, a single event precipitated the worst bankruptcy crisis in German history: the Herstatt Bank collapsed, with losses of nearly 800 billion DM, a total value of nearly ten times the bank’s equity capital.\(^{309}\) A liquidation crisis threatened the entire economy if the bank could not remain afloat,\(^{310}\) yet the courts were left with a Vergleichsordnung that on numerous counts would make reorganization of the firm impossible. Faced with such a catastrophe, the courts allowed numerous violations of existing law in order to keep the firm from being destroyed. Deadlines that disqualified the estate from reorganization were missed by over five times the allotted time. Extraordinary settlements were reached with smaller lenders which openly violated not just the letter but the intention of the law as well. Instead of treating these creditors equally, all claims under 200,000 DM (over 140 million DM altogether) were paid 100%
from Federal Association of German Banks funds and the Gerling family – despite clear evidence that fraud and mismanagement were to blame for the losses.\textsuperscript{311}

Unlike the case of \textit{Konzernrecht}, the courts’ actions exceeded mere innovation but extended to open and willful violation of the law. The message was obvious: existing bankruptcy law simply had to be reformed if smaller but no less significant crises – at least from the standpoint of affected parties, the main object of the law – were to be avoided. The high number of unsatisfactory liquidations was becoming unbearable even to the banks. To this end, the full bearing of German parliamentary institutions were brought to bear on the problem.

When the Hans Jochen Vogel, then head of the Ministry of Justice, formed the Insolvency Commission in 1978, its members included recognized experts with affiliations from all the affected parties: the banks, industry (including interests of both insolvent enterprises and their suppliers), workers, receivers, attorneys, and scholars. Each party had unique interests and a high stake in the reform. Suggestions for the reform were entertained from all over: the professional literature, the popular media, and especially the parties themselves. However, the emphasis of the commission was placed on producing a bill that would be largely agreeable to most parties, and would accurately reflect the needs of a modern corporate economy.

These priorities proved to be unreachable. The public positions of the respective parties proved a very poor guide. On the one hand, business associations were openly divided over the new law. While the BDI took an initially hard ideological stand against changing the rules of private ownership,\textsuperscript{312} its member associations, as well as those
industry associations outside its scope, remained more ambivalent, recognizing that the interests of suppliers and firm managers might be strengthened considerably if the high numbers of liquidations, and especially liquidations with insufficient funds to pay any general creditors, were reduced. The Federal Association of German Banks, whose members openly had the most to lose with any reshuffling of rights of procedures, welcomed the discussion and initially refrained from publicly criticizing the commission. In fact, some bankers, including Dr. Heinsius on the commission itself, were noticeably attracted to the prospect of reducing the high losses incurred during insolvencies through a feasible reorganization procedure. Even large Konzernen themselves found their interests confused: they were at once managers with the interests of the debtor firm, prominent equity holders in other firms, and very often lead creditors of their own subsidiaries or even of unrelated businesses.

On the other hand, the DGB, I.G. Metall and representatives of labor were also ambivalent about changes in the law. Labor had only recently won enhanced rights and priorities in the bankruptcy procedure. Social insurance funds, with which labor sympathized, had also won recent decisions by the court and legislature. All these could be endangered by reform. Yet labor recognized the high cost of administration and the high percentage of secured debt as obstacles that threatened its interests and at least paid some lip service to the possibility of a rational reorganization law that might spare jobs and spur the economy.

In addition to somewhat ambivalent but tense interest-group politics, the commission also had to contend with a confusion of reform suggestions from the
academic community. The storm of debate unleashed previous to 1978 intensified, and it became simply impossible for the commission to come to any consensus either from outside experts or from the affected parties on a new law. The debates raised sweeping issues with far-reaching ideological and practical implications. These included the desirability of secured credit or a stay of execution on secured claims;\textsuperscript{313} the desirability of priorities among general creditors;\textsuperscript{314} and the initiation problem in bankruptcy and the question of the receiver's powers to contest individual claims.\textsuperscript{315} Because it was viewed as a general reform, debate among members of the legal community, both scholars and practitioners, provided no clear way forward.

Under these circumstances, the members of the Commission had a choice: either they could pretend to come up with a bill that defined and then balanced the chaos of competing interests, which might or might not address the serious dysfunctions of the current law, or they could rely on their academic acumen and strike out on their own paths, proposing a bold initiative that might gain wide acclaim in the legal community, and thus carry considerable momentum into the government and Bundestag hearings that would be held on their reports. Unsurprisingly, they chose the latter course.

Throughout the seven years it took to discuss, formulate, and circulate its initial report on a bankruptcy reform, the Insolvenzkommission took a comprehensive view of similar reforms abroad, including the U.S. law. Both Britain and France adopted bankruptcy reform in 1985, while the U.S. had adopted its Chapter 11 Bankruptcy Code in 1978. The Commission made trips to these countries to discuss possible proposals with their counterparts. Chapter 11 (in the U.S.) was especially appealing to the
Commission, and it based much of its initial proposal on this model of reorganization law.\textsuperscript{316} The American bankruptcy law was a unitary procedure, unlike the German system of two laws, one passed over fifty years behind the other, in which it was very difficult to switch procedures after a case had already begun consideration. As a rule, it viewed bankruptcy not as a creditor’s bargain that needed simple enforcement,\textsuperscript{317} but as a disaster whose fixing needed close supervision by the state.\textsuperscript{318} Accordingly, its rules gave managers of firms in default far more leniency and allowed the courts much greater freedom in restructuring creditors’ claims than any other European law, with the possible exception of France.\textsuperscript{319} Moreover, the high degree of voluntary filings\textsuperscript{320} and the much higher likelihood of corporate reorganization\textsuperscript{321} were outcomes the commission wanted to emulate.

When the commission advanced its proposal in 1985, it made special mention of the American law and garnered reports from American scholars to supplement its findings. The proposal was for the entire 1877 KO and the 1935 Vergleichordnung to be replaced by a new \textit{InsolvenzOrdnung} (InsO). The InsO would be a unitary procedure, such as the American, for both liquidations and reorganizations. Like the American, it would specifically include as a goal the salvage of going businesses whenever possible.\textsuperscript{322} The proposal contained major differences with the American model, including much higher majority requirements for adoption of a reorganization plan,\textsuperscript{323} much strengthened powers of creditors and the receiver over the debtor, the rejection of cramdowns, and the abandonment of strict judicial scrutiny of the reorganization plan. Moreover, many of the features of the old KO were conserved, including the creditor committee’s power to
appoint a receiver or trustee, the stockholder meetings' power to approve or reject amendments to the corporate charter, and the rejection of a reorganization filing by management without initial approval by at least some creditors and the courts. Nevertheless, in important ways the plan revolutionized German bankruptcy practice and adhered to openly American ways. The structure of the law was obviously taken from the American law. The proposal rejected minimum payments to creditors as a requirement for reorganization. Despite enhanced appeal provisions, it rejected "best interest of creditor" clauses. It provided an immediate stay of execution against secured credits after filing, and even dared to allow credits secured by personal property to be included in the debt restructuring. In short, all agreed that the commission's proposal would represent a significant departure from the previous bankruptcy regime.

Despite the participation of business and lender interests on the commission during the seven long years it took to hash out a proposal, once the Insolvenzkommission report was presented to the Justice ministry for consideration, it became the target of immediate attacks by conservatives, who included on their side bankers and representatives from industry. Since the commission first formed in 1978, the SPD no longer controlled the government, or the Justice ministry. Instead, the CDU and FDP, both much more sensitive about attacks from industry and capital, now ran the reform process. Although prominent bankers and scholars with noted pro-business reputations endorsed the commission's report, opposition from those fearing the changes would open the door to further encroachment of ownership powers labeled the plan an attempt at social engineering (Sozialpolitik), a designation that undermined the ability of the
government to defend it. Anxious to appease the critics, the ministry asked for a second
draft, submitted one year later in 1986. Following repeated complaints from these
same critics, the commission was dissolved.

The dissolution of Insolvenzkommission opened the door to even more attacks on
the new InsO proposal. Critics of the plan were irked at the inclusion of workers at the
same level of status as secured creditors: in the plan, both groups required an 80% super-
majority to approve a reorganization plan, and worker representatives on supervisory
boards were given seats on the Creditor Oversight Committee. Although protections
were written in the bill which excluded real property claims from modification, and
although creditors with secured rights in personal property were required to be
compensated by at least 50% of their claims’ value, the bill was labeled a setback for
property rights in German law and an attempt to further labor’s long-standing goal of
absolute parity in co-determination. Liberals who had initially expressed admiration for
the proposal found themselves backtracking. Following proposals by conservative
members of the Budestag’s Legal Committee that would have further eroded worker’s
rights to extra-wage benefits by allowing these to be stricken by the receiver, the DGB
replied with a hotly written rejection of the existing proposal. Lines had been drawn
between the traditional parties of conflict in the economy, and behind these fronts, ranks
hardened. Reform of the Bankruptcy Code, though still an official parliamentary task,
fell into an indefinite period of debate.
**Reunification and the Liquidation of an Entire Economy**

The government could not shake the public outcry over the ever-growing number of insolvencies\(^{326}\) and the rapidly increasing losses\(^{327}\) because of the coordination problems of the procedure. But neither could it organize a consensus among the affected parties, especially among businessmen and bankers, and thus it fell mercy to a privately initiated polarization of the conflict along historically passionate lines. Bankruptcy reform might not ever have passed at all, had it not been for one event: unification. Before the parties to the reform process had a chance to realize what had happened, legal experts and bankruptcy scholars had plotted with the government to create a special bankruptcy law for the former East Germany. This law, which contained many provisions and suggestions in the original draft, proved highly effective even in the very challenging circumstances of mass bankruptcy and the peculiar Treuhand agency’s leading role in reorganizing former East German combines.

As discussed in Chapter 3, the government had lost no time in activating a reorganization and privatization strategy for the East German economy, even when it meant rolling over well-established procedures of consultation between the state and business associations, trade unions, and other groups in the polity who were traditionally consulted about major policy proposals and certainly about major legislative changes. The government simply had too much at stake and time was too short to bother with the usual parliamentary protocols. More important, there existed a wide parliamentary and societal consensus on the expediency of action and an initially far-reaching lack of resistance in the East to West German attempts to reorganize the economy efficiently – both based on common assumptions about the West German model, its basis, and its
transferability to the East. This consensus and corresponding lack of resistance allowed the government to use extraordinary procedures and bypass holdup points that normally gave tried and true interests their say on pertinent issues.

The *Gesamtvollstreckungsverordnung* (roughly translated as General Execution Order, hereafter abbreviated GVVO), passed in 1990, was one very prominent and important example of the peculiar dynamic reunification brought to politics.\(^{328}\) It was passed not by the West German Bundestag, but by the East German Volkskammer on June 6, 1990 – four weeks before GEMSU. The Kohl government, which at the time was intimately involved with negotiating the terms of monetary and economic union, had a close hand in the formulation of the new law, just as it did with the Treuhand Law (*Gesetz zur Privatisierung und Reorganisation des volkseigenen Vermögens*) of June 17\(^{th}\). Although it did not draft the bill itself, it provided assistance and recommended to the East German government the services of several prominent West German bankruptcy scholars. Given the situation at the time, it can be said with some certainty that if Bonn had objected to parts of the *GVVO*, which was to operate in East Germany after GEMSU, the bill would have been amended accordingly.

The *Gesamtvollstreckungsverordnung* was built on a similar but primitive law from 1975 that itself was an adaptation of the 1877 Bankruptcy Law inherited by the DDR. Although the 1877 bankruptcy law, together with the 1935 composition law, was technically in force until the 1975 law, for obvious reasons (state control of the credit institutions, the plan economy, etc.) it did not function like the West German system and was rarely used. In 1990, however, the East German legislature and the West German
experts they had called upon faced an entirely different situation: not only would
bankruptcy be needed in the new market economy, but the law would have to fit well
with the existing system in the West and with the reformed Western system that was
anticipated in the near future. Moreover, the new law would have to address the needs of
the many formerly state-run firms that were anticipated to undergo some form of
liquidation before, during, or after privatization. Although the East Germans did not yet
comprehend just how great the number of firms in liquidation and privatization would be,
they did know that the law would form an important and actively used part of the new
economic framework they were negotiating at the time.

The GVVO therefore adhered to the basic KO structure but added many changes
to the law proposed for the case of the KO and initially embraced before the reform was
stymied by conservative opponents. Bankruptcy experts from both the East and West
regarded it as a type of experiment. For example, the law adhered to the usual procedure
for the appointment of receivers, including the rejection of cases without sufficient funds
to cover administrative costs. But receivers were supposed to be independent of both the
insolvent enterprise and the creditors. Although they were to report to the creditors
committee, they were to offer only information on their doings, not an accounting. For
that, the courts were solely responsible.

The most important differences with the KO were as follows: 1) enhanced powers
of the receiver to challenge any claims made near the time of insolvency; 2) two-tiered
priority system that only gave administrative costs, court costs, and the previous six
months wages the highest priority; all other claims received the equal service, including
taxes, bank debts, and other worker benefits; 3) the power of the receiver, with the approval of the court, to dismiss employees; and, 4) broad staying power against the claims of general creditors and, after the GVVO Amendment of July 25th, against secured claims as well if the purpose of the said stay was financial rehabilitation. This latter goal was deemed feasible only if a powerful creditor (such as the Treuhand) would guarantee funding during the period, and the availability of the general stay of execution would end on 30 June 1991 – after a one-year experiment during the time it was deemed most critically needed.

To West German bankruptcy scholars and experts who had been disappointed at the lack of progress made by the KO reform during the previous ten years, the new GVVO in the East proved to be an object of admiration. Articles appeared praising the law for its simplicity and functionality. The law became an open experiment on provisions that had only been contemplated by reformers in the West, but had had no chance of getting past the vehement protests of the affected groups: the power to fire workers and order a stay of execution against secured debt fell into this category.

As it turned out, the viability of such experiments was never fully tested. Although the law was to remain in force until the West German bankruptcy reform would take effect, it was rarely evoked. This is because of the far-reaching powers of the Treuhand and the Treuhand’s intention to keep firms from being liquidated or, if they had to be dissolved, the Treuhand’s desire to keep the proceedings as frictionless and private as possible – hardly the effect of a public bankruptcy procedure.
Take the typical example of the former VEB Giesserei und Maschinenbau “Max Matern.” In April 1990 its “parent,” the VEB-Kombinat Schiffsbau, ordered it to incorporate. That month it officially announced its intention to become a corporation; on July 1, it did so according to the provisions of the Truehand Law. The new “Giesserei und Maschinenbau T. GmbH,” as it was called thereafter, reported shareholder equity of 27 million DDR Marks on June 30th, which was then set at 27 million DM at its shareholder meeting in January 1991. However, the firm could not reach break-even. Its previous customers – mainly shipbuilding yards and diesel motor manufacturers in the former DDR – could not be replaced rapidly enough to prevent the skyrocketing of average costs with very little volume. Few new major customers were found to reverse the cost structure. In 1991, the firm’s revenue was only 27% of the 1990 level. By December 1991, the firm had laid off 626 out of the original 1,900 workers from June 30th 1990 and moved 817 of the remaining workers to special ”Kurzarbeit Null” status, which required much lower outlays because of government support. Nevertheless, at the January 6, 1992 shareholders meeting, the decision was met to liquidate the firm.

The sole owner, the DMS AG, entered into a control contract with the firm before the currency union. Though the GmbH was never profitable, as its sole owner and creditor it refrained from filing for liquidation; because the GVVO, like the KÖ, required not only managers to file for bankruptcy within 3 weeks of insolvency, but required that at least one creditor affirm the application, the DMS AG could perpetually postpone the GmbH’s liquidation at its discretion, as long as bills to customers, suppliers, and other potential creditors were paid. In June 1991, the DMS AG negotiated a deal with the
Treuhand whereby the latter agreed to assume ownership of the firm as if it had owned the firm since July 1990 by assuming all liabilities and making the control contract invalid after that date. In any other circumstance, the firm would still have had to be liquidated under the GVVO. But because the firm was now controlled by the Treuhand, and officially had been in its control for the entire period since declaring its opening balance in June 1990, it was never officially insolvent. The 27 million DM in equity capital, an estimated figure from the firm’s days with the shipbuilding combine, never represented any actual funds, and the “deficit” that normally would have meant insolvency was subsumed under the special features of “Treuhandunternehmen” (Treuhand corporations.) These entities were regarded by the law as lacking an official balance sheet until the time of privatization, or until the time the Treuhand designated one at its discretion.

To make up the deficit in equity capital (between actual capital on hand and the capital it had declared in June 1990), a Treuhandunternehmen could apply for special equalization funds. However, the Treuhand was under no obligation to pay them, and did not. As a Treuhandunternehmen, the Giesserei und Maschinenbau T. GmbH was just like a highly dependent subsidiary of a Konzern: although it retained all the organs of governance as if it were a normal firm, from the standpoint of control and liability, it was considered to be part of the Treuhand itself. Thus, the Treuhand had absolute control over the GmbH – a type of “super-owner” that controlled governance in a state that blended insolvency and solvency into one. When the Treuhand decided to liquidate the firm, because it had never officially been insolvent in the first place, it could avoid the
GVVO procedure and simply designate the company as a *Liquidationsgesellschaft* ("corporation in liquidation") whose "business" was its own efficient liquidation. This allowed the Treuhand, not the courts, to stay in control of the company, and thus gave it tremendous flexibility in deciding when and how the firm should be wound up. The Giesserei und Maschinenbau T. GmbH thus was partially liquidated, and partially bought out by management at a later date — all without the potentially strangling addition of bankruptcy rules to encumber the process.

As the case of the Giesserei und Maschinenbau T. GmbH well illustrates, the government invented several devices to bypass the East German bankruptcy procedure — and often did so, despite its greater flexibility to reorganize instead of liquidate insolvent firms. Regardless whether the law in the former East Germany was used extensively or not, its effect on the reform debates in the West was catalytic. So was the performance of the Treuhand, which successfully managed thousands of corporations in liquidation in the East. Once the GVVO had gone into effect and observers saw that few problems resulted from the procedure, naysayers to the Western reform were put on the defensive. By the terms of the Unification Treaty, the bankruptcy law would not be replaced until a time when the law itself designated. That time was the anticipated all-German reform itself. Because reform opponents were in no position to mount a legislative drive to overrule the previous arrangements (by passing a special addendum to the GVVO, for example), the only way to end the GVVO experiment in the East — along with undesirable liquidation procedures such as the general stay of execution — was to pass the stalled all-German bill. Caught in this no-win situation, the reform opposition softened. The East German bill
had paved the way, both intellectually and politically, for the long-anticipated bankruptcy reform to be finally negotiated and passed.

*The Conflict Resolved? Formal Innovation and Institutional Petrification*

With reunification, the bankruptcy reform was back on the agenda. In 1988, the ministry of justice published its first “draft for discussion” of a new insolvency law; one year later, a slightly modified version of this draft was published, this time as a formal recommendation that a bill be sent on to the government. After extremely contentious debate, the next year the cabinet sent a legislative draft along to members of the parliament for analysis and comment. On the basis of these comments, in late 1991 the government sent a final modified version to the Bundestag’s Legal Committee with the intention to finally push through the legislation. After two years of debate and the addition of a long “introductory law” to the main bill, the reform passed in July 1994. Though it was not to take effect until 1999, five years later, the 1994 reform appeared to mark a major change in German bankruptcy law. In reality, however, dissatisfaction with the new law was extremely high, and many onlookers regarded it as a gross failure of government.

Reunification gave the government a much wider window for passing the new law. Difficulties with privatization had created a rift between Bonn and finance that made the ministries much less sympathetic to the concerns of the banks (see Chapter 3). Organized business, which earlier had hardened its position against the bill for ideological reasons, found itself bypassed in several directions as the government grew ever more accustomed to negotiating directly with large firms. And large firms
themselves were ambivalent about the new bill – finding themselves, as previously stated, on many sides of the issue at once. Industry chambers and smaller business interests, for obvious reasons, supported a more feasible reorganization procedure. While at the time the peak national bank association, industry association, employers organization, insurers association, and trade chambers cooperated on other issues of company law reform, they could do so no longer on the issue of bankruptcy. As the critics of the bill were put on the defensive for reasons discussed in the previous section, the prospects of passing a reform increased dramatically. The ministry of justice, with the Kohl government at its side, was heartened.

A sign of the new possibilities for reform, ironically, was the formation of a formal group of critics of the new bill made up of many professional receivers, some academics, and a few bankruptcy experts from some of the larger banks. This group, known as the Ravenbrucher Kreis, argued that the government’s bill was simply too large and too radical. Seeking every opportunity to publish its opposition in both the popular but especially the expert press, the Ravenbrucher Kreis symbolized the decreased influence of those interests that backed it to halt the momentum of the reform. Its debate with the justice ministry after the 1992 bill was put forward turned into a larger debate over the need for a “large” bankruptcy reform or a “small” bankruptcy reform; once again, the reform effort was nearly derailed altogether.

The Kreis employed clever tactics to try to sway the direction of discussion in academic circles, which once more strengthened their influence as the government sought guidance with the reform. The sheer mass of words the bill represented was one
launching point for its criticism: the new bill was over 1,000 pages long, one of the longest in German legislative history. Capitalizing on this point, the Kreis argued that the GVVO should indeed be considered as a model for reform, just as many had called for, because it was only 24 short sections (in about as many pages) long – a masterpiece of simplicity. The GVVO was designed to complement the KO, and the Kreis argued that the old 1877 KO, having stood as the longest lasting piece of company legislation in German history, should be preserved as a legislative masterpiece. Another argument was that the proposed bill was too “American,” and therefore too lenient on debtors, allowing them to escape justice by evoking the powers of the state to block owners’ rights. Yet another argument was that by preserving the restrictions on firing workers and the high burden of negotiating a social welfare package, the new bill would cement in some of the major handicaps to efficient liquidations and some of the important obstacles to reorganization. Finally, the Gravenbrucher Kreis argued that the lower hurdles for opening a bankruptcy proceeding, meant to lower the costs of the proceeding and decrease the number of cases that never reached the point of distribution, would hinder private workouts before bankruptcy. The aim of most of these points was political; together, these arguments reflected an obvious attempt to revive the old anti-reform coalition between business and finance.

But the days of that coalition had ended. In a 1992 reply to the Kreis, the justice ministry labeled the attacks as “one-sided formulations from the perspective of entrenched bankruptcy administrators.” Citing the high rate (over 75%) of cases rejected by the courts because of the high costs of administration, the ministry labeled the
Kreis’ arguments as self-serving and economically destructive. Now confident of the sway it had over the formal interests who participated in the usual legislative system of committees and negotiation, the government was concerned about the possibility of aggravating old opposition to the bill and chastised the Kreis for its politics:

It is regrettable that the Gravenbrucher Kreis is waging public polemics against the government’s bill for an insolvency reform, instead of seeking substantive dialogue with the government and parliament and using the important experience of bankruptcy receivers and administrators to propose concrete improvements to the bill…. The federal ministry of justice is always ready for such a dialogue. 332

Unfortunately, the confidence displayed by the justice ministry in 1992 was overblown and premature. Although the active opposition from finance and big industry had subsided after 1990, the support of these groups was not forthcoming. Without a consensus among affected groups, major changes, such as the inclusion of more than a limited part of secured rights in the procedure, had to be ruled out. Government by fiat was weak government. Moreover, the alliance between the banks and big industry might have been broken, just as the cooperation between finance and the government, but that did not remove the several points of influence each group or members of each group could exercise as the legislation ran through passage. Organized capital was simply disorganized – it had not signed off on the bill.

The result of the peculiar lack of strong opposition but also lack of consensus was that when the bill reached the Bundesrat for final approval, many states opposed it and a
veto was threatened – not because of the opposition of the SPD, which controlled the 
Bundesrat, but because the issue, shielded from popular interest by its extreme technical 
nature, had become an object of local holdups. The Federal Association of German 
Banks, the BdI, the Federal Association of German Insurers, some smaller industry 
associations, and individual banks and companies still concerned with the law had won 
the ear of some state legislatures. To prevent a last-minute defeat, some of the bill’s more 
powerful provisions were watered down with additional guarantees, such as the addition 
of a special exception for credits secured by movable property, which prevented simple 
stakes of execution for these claims. (These claims, in contrast to the KO, were 
nevertheless subject to revaluation by the receiver.) As a consequence, many viewed 
what passed as half-hearted, ineffective, and overly complicated.

The 1994 Insolvenzordung (InsO) allowed creditors the possibility to negotiate a 
reorganization in the creditors’ meeting, effectively unifying workouts and liquidations 
into one procedure; dramatically lower the requirements of initiating bankruptcy 
proceedings by requiring that a firm only be able to meet the first three months of court or 
administration costs; and require secured creditors to deduct some valuation and 
procedural costs from their receipts. Beyond these changes, however, most of the 
innovations were formal. The language of the bill was modernized. The procedure was 
given a two-track, unitary structure. The regulations that granted receivers their powers 
were updated, and the oversight powers of the courts were strengthened. Whole new 
sections on work rules, employee benefits and rights, and the social welfare plan were 
added, which simply formalized existing rulings and law already in practice. And
provisions were added that concentrated the actual jurisdictional structure of bankruptcy administration, eliminating redundancies in the hopes of eventually building more expert bankruptcy courts.

Most of these reforms, however, were anticipated to have little impact on real bankruptcy outcomes. Lowering the barriers to filing still did not eliminate the costs that would eventually be incurred as the process proceeded. Many argued that without changing that cost structure, or without speeding the process, the result would simply be a dramatic rise in opened proceedings that had to be shut prematurely – simply increasing the workload of administrators, attorneys, and courts. Providing for a two-track law might increase the ease with which cases could be transferred from liquidation to reorganization and back again, but this would not have a noticeable effect on the number of reorganizations unless the actual financial barriers were in some way reduced – such as the huge burden of worker and secured claims. Worker provisions were of course now negotiable, but their protection went largely untouched. Simply putting the parties in the same room did not mean they would change negotiating tactics. The enhanced power of the receiver to value claims independently – barring an extremely liberal interpretation of these rules – was not enough to force down holdups. In short, most parties shared the carefully phrased commentary voiced by an employer association circular to its members:

The question unfortunately remains if the practical aims of the law could have been [better] met through a selective reform of the existing KO, for the legislature has [instead] chosen a comprehensive reform. The long list of small improvements… should be recognized. Nevertheless, despite all the last minute
changes, ... the work remains a comprehensive and complicated opus, so that
difficulties with applying it in practice are not to be underestimated.\textsuperscript{333}

Perhaps, however, the commentary of the Gravenbrucher Kreis in one of the
leading professional journals would be more fitting:

Even the experienced speed reader would have to spend several days in
cloister to read through the text (about 1,000 pages of tightly spaced machine
print) once from beginning to end. But this is not all! The next "present" of the
reformers is the Introduction Law, which promises more than one hundred further
sections of several hundred paragraphs and even more pages of commentary. It is
verily the titanic work of a century, that will busy the profession [for years] and
threatens to overrun the legislature. For obviously the Justice ministry is banking
on the expectation that the Bundestag will let the whole thing pass (steamroll?)
through during this coming legislature period, just to be rid of it.\textsuperscript{334}

Summary

The new Bankruptcy Law of 1994 has yet to be implemented, so it is hard to
judge its performance. However, the history and causes of the reform are a telling case of
the difficulties that beset the political regulation of corporate governance in Germany.
Without question, a major reform of the existing law was needed. The data on the rising
costs and dysfunctionality of the procedure were clear. A procedure created for one type
of economy and successfully modified for later circumstances led to dire problems
starting in the early 1970s, at the onset of economic slowdown and crisis. Difficult cases
forced the courts to innovate, but unlike the case with Konzernrecht, those innovations
involved the outright and unseemly violation of existing law. The government had to
take action.
Yet while all parties recognized and called for the reform, the government found it extremely difficult to achieve consensus on the required changes. This proved so especially among business and finance. The peak organizations of employers, big and small industry, banks, and insurance, which frequently cooperated with the government in formulating smaller issues of company reform, could not do so in this important instance. On the contrary, unable to formulate their interests, they became susceptible to polemics which opponents of the reform used to nearly scuttle it. Only reunification, and with it the government’s chance to break normal patterns of collaboration and set out more freely on its own, brought the issue back to the table. Due to the decentralized nature of the German legislative process, however, the lack of central cooperation from business and finance proved debilitating. The government could not threaten long-standing rights of the parties without risking an organized attack. Worse still, various rogue interests were able to negotiate last-minute changes to the law which weakened what few real changes the law had provided. Despite years of effort, the reform passed in 1994 was a momentous technical accomplishment with little practical bite.
Chapter 7

Conclusion: The Politics of Corporate Ownership

The large corporation no longer governs, and no longer is governed, in the same way in Germany as 25 years previous. Corporate ownership is differently distributed, is regulated differently, and is organized within the firm differently than before. The twin shocks of reunification and globalization have changed the relationship between capital and the state. What has stayed the same, however, is the difficulty with which the adjustment of ownership rules occurs in the Federal Republic.

This dissertation has presented the three most important instances of adjustment or attempted adjustment of the rules of corporate governance and ownership in Germany since the early 1970s: the case of privatization and the reorganization of corporate governance in the former East Germany; the rise of Konzernrecht and the management holding; and the (nominally) sweeping reform of the bankruptcy laws. While the first has had disappointing but ambiguous success, the second has been a dramatic success, and the third a dramatic failure. Each supports the two main contentions of the dissertation: that corporate governance and ownership have been transformed, and that this transformation has been anything but orderly. Each also illustrates the prominent causative role played by three factors in that transformation: economic change, the law and its interpretation, and historical precedent.
The German Model Reconsidered

This dissertation is not the first to challenge the long- and widely-held German model of political economy, nor will it be the last – nor does it pretend to be. Rather, the dissertation stakes out one part of that model deemed extremely important in today’s economy: the relationship between capital and the state, as seen through the lens of corporate governance. As the first chapter showed, the literature has long held that Germany is one of the premier examples of a system of organized capital, in both the economic and political spheres. This characterization can undoubtedly be traced back to Rudolf Hilferding’s seminal work Finance Capital, which provided a model not only of Germany, but of “advanced capitalism” and the tight connection between corporate ownership and the state that can be possible in the modern economy. At the center of Hilferding’s analysis, as with that of every member of its long intellectual legacy, is the bank-based system of corporate ownership and control.

While providing an important qualification to this model, the dissertation affirms its applicability to the German economy throughout much of Germany is history – especially from the period after the development of the modern corporation in the late 19th century to the early postwar years. However, beginning in the early 1970s, this model came under strain and was transformed. Its change can be viewed in two ways. As Chapter 2 showed, corporations lowered their dependence on debt and external financing, increased their own stakeholdings while banks decreased their own, and limited their public shareholdings and with them the number of bank-held proxy votes. Other corporations replaced the banks as the most frequent type of supervisory board member. At the same time, the correlation between banks’ power over corporations and publicly
held shares did not disappear: banks remained closely involved in the governance and control of a core group of prominent, widely held companies. However, if the data are to be trusted, the size of this group gradually decreased during the 1970s and 1980s to the point that it became the exception rather than the rule.

The second way the transformation of large-firm governance can be viewed is from the perspective of the many companies that had undergone the changes. It is in this case that the creation of the management holding and the transformation of the legal rules that govern mixed ownership forms – *Konzernen* – come to bear. While the quantitative evidence shows that many large firms increased their share ownership, it does not say how or why they did so. The successive trends toward conglomerate, the large decentralized combine, and then the management holding provide an answer. Chapters 4 and 5 explain each stage of this transformation and show how changes in the organization of production, changes in the relation between different industrial orders or traditions of governance, and changes in the way the law was interpreted by the courts all contributed toward prodding the innovation of these corporate forms and then stabilizing them once they were invented or adopted. By the time the management holding had been created in the early 1990s, the definition of the corporation itself had been largely replaced. The old system of bank-based control, for most large firms, had been replaced by the new rules of intercorporate ownership.

In addition to the transformation of large corporate governance in Germany, this dissertation takes issue with another, arguably more central piece of the Hilferding-based model: the role of ownership in organizing business and providing the state with some
modicum of control over the corporate economy. Even during the heyday of cartels and classical finance capitalism, this dissertation contends that the German economy was really a mélange of distinct traditions of ownership and governance that at best co-existed without significant conflict or admixture. There was no one German model, but several. In such a world, the separation of economies, or "industrial orders," was the very premise upon which the regulation of corporate control existed. At worst, when pressures in international markets drove corporations to mix these traditions into single, giant entities meant to stay mixed (and not integrate, which was the old presumption of the body-organ doctrine), the system of ownership actually confounded what clear channels of state control and regulation existed. Worse still, the system of organized business interests that provided the state with collective business partners with which it could negotiate at all was predicated upon the very same system of ownership. That the German government developed close relationships with individual banks and large corporations, therefore, was a sign more of the weakness of this system of politics than of its strength.

The rules of ownership functioned not as a mechanism of exercising national economic control, but of reproducing divisions within the economy that made it extremely difficult if not impossible to control or regulate the corporate economy from a central location. Ownership was a divisive instrument of national politics, not a unifying instrument. In fact, it was precisely this attempt to unify these traditions of ownership that led to the confounding of some of the most basic rules of the modern corporation in Germany, and thus to the transformation of the system of corporate control that Hilferding had first observed when he wrote Finance Capital.
The Politics of Ownership: The Mechanisms of Change

The cases of the dissertation all illustrate the important role of three major sources of change to Germany's "system" of corporate governance and ownership: economic, legal, and historical.

Economic Pressures, Volatility and Uncertainty

Economic theory broadly predicts that if history is efficient, then ownership rights – and the incidents of control that accompany them – will be bundled over time so as to minimize conflicts among incidents and make them alienable or tradable. In fact, unsurprisingly, this process defines a market. While this argument is valid if one accepts the usefulness of markets, it can be counterbalanced by the idea introduced in the dissertation\textsuperscript{335} that bundling rights can actually create inefficiencies, especially when the free flow or learning of skills and information creates considerable economic benefit. Thus, while political considerations such as the ones outlined in the previous and following sections might work against the bundling of ownership into structures such as the bank-based governance system Hilferding modeled, economic forces might do the same. Although under some conditions such forces may be determining, because they can offset or counter each other, they are in no way predetermined.

The examples of privatization in the East and the reorganization of the machine tool industry in the East and West illustrate the argument well. In the latter case, both the integrated firm, which controls much of production from the center, and the GmbH economy or industrial district, in which production is divided among many smaller but tightly held corporations, rely on models of bundled ownership in practice.\textsuperscript{336} While in
the integrated firm this can lead to the petrification of scope economies due to
information hoarding and the lack of a broad client or supplier base from which to learn,
in the small firm model, bundled ownership rights can lead to entrenchment behind
traditional definitions of specialty\textsuperscript{137} and a lack of strategic coordination – also leading to
a loss of potential scope (and, because of the strategic hindrance, scale) economies. If, in
contrast to these models, a way is found to make the exercise (not possession) of
ownership rights contingent on information sharing between the right parties, then not
only can such problems be overcome, but ownership structure can be harnessed to
produce economic gain. This is exactly the design of the management holding. Within
such companies in the machine tool industry, ownership rights – though held formally by
the parent – became perpetually negotiable through the constant discussion about how to
divide strategic and operational control. These negotiations were in turn structured
around designs for module production that relied on continual collaboration among
separate subsidiaries to deepen existing scope and scale economies. The negotiations
also formed the basis for realizing marketing economies in international markets and,
obviously, gains from enhanced strategic prowess.

The case of privatization showed similar principles at work. In the former East
Germany, privatization was best accomplished if an Eastern concern could offer strategic
advantages to potential investors. Once again, the problem became how best to organize
local actors to provide them with incentives to share what they knew about their former
combine’s capabilities with global actors who could match those capabilities to strategic
needs, or invent new strategies altogether based upon what was learned. The way
forward was not to create a hierarchical ownership structure that placed local actors, former managers, etc., in a subordinate position. Rather, the Treuhand, firms such as Jenoptik, and others invented sundry corporate structures that blurred or made ambiguous exactly those ownership rights whose eventual creation was the whole object of privatization. In fact, in the East German machine tool industry, executives, consultants and the Treuhand itself turned to the management holding as exactly such a structure.

Even bankruptcy reform provides a good example of the argument here, namely that economic forces can work both to bundle/define and to unbundle/blur ownership rights. The case, however, is a negative example. In the discussion over bankruptcy reform, as Chapter 6 showed, large firms and big banks found themselves apprehensive but uncertain of the direction reform should proceed. Secured creditor rights – the closest thing to protected/bundled property rights in a bankruptcy because of their non-negotiability in the post 1877 procedure – seemed to be a major obstacle to initiating a reorganization instead of a liquidation, and yet it was unclear whether modifying or qualifying them would make the procedure less efficient or not. With no clear economic pressures, the reform's success became purely political, and this is why it fell into such a morass; unable to organize capital and provide clear leadership, the government was held hostage to those who polemicized the issue. Only reunification, and with it the dual changes of a new, innovative bankruptcy regime in the East, and the relative centralization of the policy-making process broke the impasse – even then, it did so incompletely; the government could still only pass a watered-down (although formally formidable) reform. Even the finest scholars debated to no clear resolution the economic
effects of alternative bankruptcy regimes. Although the bankruptcy situation was becoming far more wasteful every year, the participants to reform were ultimately unsure of the reasons.

The case of bankruptcy reform, when compared to the previous two, also illustrates just how economic forces can “determine” institutional outcomes. Perhaps there was a point at which it was more efficient to pool secured creditors with the rest of claimants and exercise a stay of execution against all claims, and perhaps there was an ideal point at which the length of this stay should have settled. But the Germans never found these points. In fact, in view of the wide range of procedures in Britain, France, the United States and Germany, it is questionable whether such a point could ever have been found. So it was not that the parties involved were not seriously concerned about the economic effects of the bankruptcy procedure – they were simply unsure of them. In contrast, while it took prodding from the law and desperate tactics of adjustment to the worst downturn in the industry’s history for Germany’s leading machine tool makers to hit upon and try out the management holding, once they found the structure they quickly realized its economic potential. Everyone who could stand to benefit from doing so spread the word, and soon all the most important companies had adopted the new ownership form. Technically, economic forces did not determine the institutional outcome by themselves – the latter required legal and learning dynamics to be realized – but they were the main justification that actors took in seeking to experiment and then decisively change existing governance institutions. And, arguably, they were what stabilized the outcome once it had occurred.
Law as Force of Change and Medium of Institutional Renewal

As the example of bankruptcy reminds, yet another source of change—and stability—of the structure of corporate ownership in Germany is the law. The law helps reproduce the practices of governance over time, and it can play a major role in changing those practices. The law creates incentives for management and owners to both adhere to established traditions of governance and to challenge them.

It was legal innovation in the 1870s and 1880s that created the modern corporation and with it the most important alternative ways to govern and control companies. The formal rules of the joint-stock company quickly made old governance forms obsolete and formed a foundation for modern stock markets, for the system of cartels and bank-led governance, and for the conflicts and debates over governance within and outside the corporation. It is arguable, moreover, that the new laws on joint-stock companies created a sea-change in the relationship between business and the state. In fact, that was one of the major purposes of the 1870 law, and again of the 1884 law that supplemented it. The concessionary system of politics and incorporation was done away. Individual companies were no longer the subject of open debate nor were they the objects of micromanagement by the government. More important, once the state let the corporation loose, a diversity of corporate governance practice began that the state could no longer control. The national politics of corporate ownership became fractured. Indeed, it is one of the dissertation’s major implications that this process of fracture lies at the very essence of modern ownership in advanced industrial countries and, more poetically put, is the condition of economic modernity itself.
After the 1970s, the innovations of the court redefined the rules of the corporation and in so doing had a major influence over how the practices of governance changed over the last twenty-five years. Even many of the less momentous changes, from the body-organ doctrine of the early century to the Fuehrerprinzip of the 1930s, and the relaxation of double taxation after the war, had noticeable effects on the way managers and owners arranged relations of power within and between corporations. As with the early joint-stock company laws, these changes not only transformed aspects – or even whole methods – of corporate control and ownership, but they helped stabilize those aspects as well. Cartels, for example, faced dire problems in keeping members in check. Were it not for rules of the court that not only allowed their formation but (building on the tradition of the GmbH) allowed them to use very customizable governance rules, and then appeal to the law for their enforcement, if necessary, then undoubtedly many cartels would have never held together for as long as they did. In the modern day, it seems certain that in addition to strong economic incentives, one of the main reasons the management holding is so stable and widespread is the tax and liability incentives which the courts have created to keep the otherwise precarious separation of strategic from operational control intact. In fact, many companies that appear as full-functioning management holdings from the outside but do not realize the economic gains from a well-functioning division of labor on the inside nevertheless remain in that form precisely because of the legal framework that encourages them to do so.

Yet as with the case of economic forces, the law is no determinant of institutional change or stability by itself – at least in no intentional way. The example of the GmbH &
Co. KG that leads the discussion in Chapter 5 is a perfect case in point. Here, a formal corporate type was invented by business people, neither by the courts nor by the government. The law can thus become the subject of manipulation by the very actors it purports to regulate, and in so becoming lose any predetermining effect. In this way it can also lose its determining effect, as actors respond to other sources of change and mold existing institutions to their needs. The management holding is a perfect case in point: this form of corporation is not defined as such in the law, but rather the creation of those seeking to avoid the scope of companies explicitly defined by the court, namely the qualified, de-facto Konzern. Although the author was unable to interview the judges who invented this type of combine, it is fairly certain that those judges did not have a clear idea of the type of company that would develop as a result of their rulings. To do so, they would have had to understand more about future economic development than was probable, and their legal reasoning would have been deceptive. No, the courts were more concerned about consistency in the law and how that could be preserved given the economic changes they were observing. Instead of responding to the intentions of the law, companies responded to the perceived economic advantages in adopting the management holding structure and fit the tax and liability incentives around these. In this way the law and economy interacted to produce the new governance institutions.

Of course, legal changes are not always caused by the law itself. The law can be the object of politics as well. The creation of the joint-stock company in Germany – contrary to the theses of many economists and economic historians – is a good illustration. The 1870 AG law was not just a fine legal innovation. In fact, large parts of
the law were actually borrowed from abroad. Economic pressures undoubtedly played an important role in bringing the joint-stock company to Germany, for the National Liberal Party, which championed the law, represented precisely the elements of the bourgeoisie for whom the AG would be a great boon. More important, however, were the political considerations behind the law's passage. Besides feeding their own constituents, the National Liberals viewed the law as a major foundation stone in the new nation and an example to the world of Germany's liberal, forward-looking economy. These were the reasons the American and British laws appealed to the Germans to import so much of their content. In 1884, of course, the tides were turned against such sentiment, an explicitly "German" version of the AG was passed that replaced many of the more liberal provisions with high barriers to entry for potential corporations, set up an oversight organ within the company designed to show the presence of the state in governance, and helped usher in a new day of cartels by cementing the existing position of large companies in their markets. But once again, politics was behind these changes; Bismarck had shifted his alliances and was trying to use the law (successfully, in fact) to split the National Liberal Party and shake out its allies.

As the example of Bismarck shows, corporate law was a major device used in national politics. This was true both for nation building and for defining distinct national variants of economy. The examples from the previous paragraph illustrate the latter case. The 1884 "German" variant of the joint-stock company, however, was designed explicitly to be just that -- a variant -- and in important ways kept much in common with the 1870 law and thus with the laws on joint-stock companies in other countries. The basic
conflicts within the corporation, for example, were the same types of conflicts that arose in corporations in the United States and in other economically advanced countries. The central example, of course, is the stockholder-manager conflict, which is driven by basic features of the joint-stock company, such as the limits placed on convening and leading shareholder meetings, on stockholder appeals, on management's divulgence of sensitive information, etc. It is for this reason, namely that national variants of the corporation were understood precisely as such, that the German law contained within itself the seeds of its own alternatives – especially the American alternative. In this sense the law served not just as a device by which to perpetuate certain institutional arrangements, but as a mechanism to preserve the collective memory of other, non-German corporate variants. It should therefore be no surprise that in recent years the Germans have passed distinctly American-patterned reforms – such as the bankruptcy procedure and the reforms to be introduced shortly – for both countries' laws were in some sense siblings in the same family, and at least in the German case, they preserved the recognition of kinship.

In the case of the law's role in nation-building, it was the creation of distinct legal codes for different traditions of corporate governance in different regional economies that brought business interests from these separate regions under the same national regulatory umbrella, and in an important sense united the national economy. Corporate law was made in Berlin, and the different types of corporate interests, though separate, all directed their attention toward the same parliamentary committees, government ministries, and national courts. Nevertheless, Germany remained a fractured nation, and the system of collective representation of these interests was built on the same distinction as was the
law itself. When the law no longer provided a clear mechanism to regulate these interests, business associations and trade chambers found themselves paralyzed as well. 

In this sense, the law contributed to the weakness of the regulation system of corporate governance precisely because it kept that system a national one. Companies, whether regionally, cross-regionally, or internationally based, were at the mercy of the national courts.

The Lessons of History: Traditions of Governance and Politics

Why should fitting the rules of corporate control and ownership to the needs of capital be so difficult for a state founded on principles of cooperation with capital, for a state held up as a model by many of precisely such public-private collaboration, and during the rule of a conservative government, which has every interest in pleasing the business and finance communities? The dissertation provides an answer: history. Specifically, the fractured nature of business’ interests is a historical outcome of the development of the German state and economy, and these divisions have made it very difficult for the state to determine what the interests of business are and to respond to them – at least with regard to the issue of corporate governance. If one excluded the courts from the definition of the state, then at critical points in time the state has been entirely helpless to respond to capital’s need to adjust the rules of governance to modern conditions.

The argument that the divisions within capital hindered a rational adjustment mechanism explicitly builds on Gary Herrigel’s work of distinguishing alternative "industrial orders," or coherent alternatives of defining production, its public and
private governance, and the boundaries between the state and the economy in Germany. These industrial orders, Herrigel shows, are built on alternative ways of defining work and the division of labor in competitive economies. This dissertation’s argument is that in addition to work organization with its links to corporate governance (broadly defined) and the state, links exist between the organization of work and production on the one hand, and the rules of corporate control, ownership, and investment (corporate governance narrowly defined) on the other hand. What is more, these links are reinforced by the correlation between corporate governance (narrowly defined) and the structure of corporate law, which in turn affects the collective organization of business politically.

Of course, there have always been exceptions to the rule. Many famous examples of GmbHs in “autarchic” industrial regions exist, as do examples of AGs in openly decentralized regions. The sections on the development of the AG and GmbH in Chapter 4 explain the link between formal structures and production in detail, but suffice it to say that these exceptions will always exist because of the peculiarities of ownership that abound in most companies – such as the interests of families in preserving control over large, autarchic corporations, certain corporations’ relationships with foundations, and other nontraditional “owners,” etc. Moreover, the use of the GmbH in all parts of the economy is not surprising, because the ownership form was specifically designed to be as widely adaptable and flexible as possible. What matters more to the dissertation is the general correspondence of one legal structure to a particular type of regional economy or way of producing, and on this count what evidence has been tested is overwhelmingly positive. (See Table 1 in Chapter 5 for the evidence in the machine tool industry.) In
sum, formal rules are just that – nothing more, nothing less; by themselves they do not
determine behavior. An individual firm adopting a certain legal form can be like a boy
who picks up a seashell along the shoreline: he can take it or leave it for many reasons,
whether he hears the music inside or not.

What remains apparent from the three cases of governance reform introduced by
the dissertation is that history, through the medium of law and the precedent of nation-
building, provides an explanation for why in this system – held up by most as an
exemplar of state-business cooperation – the adjustment of rules concerning the rule of
managers and owners according to their own needs might be so difficult. The national
system of governance was founded in a way and reproduced through a medium that made
its future adjustment extremely difficult and confused the very system that was supposed
to articulate how that adjustment should occur. The German capitalist state was built on
contradiction.

*The Semi-Sovereign State Revisited*

To some, this dissertation might have argued what those familiar with German
politics and history already know. Germany never has been a “unified” nation.
Religious, lingual, regional, economic, and ideological divisions have always plagued the
country. The question for scholars attempting to generalize about Germany has always
been “Which Germany?” This is the question Herrigel’s work poses to those touting a
“German Model” of economic relations: “Which Model?”

Perhaps the most brilliant attempt to answer these questions for the Federal
Republic is that of Peter Katzenstein, who argues that the success of the new democratic
German state is founded on a cooperative federalist constitutional structure, on large, centrist political parties, and especially on para-public institutions that bridge public and private spheres and bring diverse interests together to collaborate on important policy issues. These institutions, Katzenstein continues, have always acted as a brake against big policy initiatives or radical political ambitions. Together with the parties, and especially in the context of Germany’s particular federalist system, such institutions have harnessed rather than antagonized the great diversity of social, economic, and political life in Germany, and resulted in a stable regime very good at enlightened, but incremental adjustment. Thus the “semi-sovereign” state. Big cases of adjustment, such as the three analyzed by the dissertation, could simply be the kinds of instances in which the German system fails – not because of the divisions it must overcome, but because the institutional machinery of politics does not match the challenge at hand.

This objection misses the deeper message of the dissertation.

In Katzenstein’s model, para-public institutions and the system of federalism work because of the way centralized interests interact with decentralized government to produce consensus about policy and politics. Radical change is halted because each of these elements resists such change, and together the elements can brake it. This is not the model of adjustment observed at work in the cases of the dissertation. On the contrary, as repeated earlier, the creation of Konzernrecht and the reform of bankruptcy show central attempts to regulate fractured interests. The policy-making machinery in Katzenstein’s model was used, but – at least in the case of governance reform – it could not organize the interests of capital in the way required for the model to work properly.
The result of this type of dysfunction was that the role of the German state in the
development of company law and bankruptcy has been arbitrary. The very inclusive
policy-making process that normally leads to outcomes well suited to the problems at
hand, even if based on compromises no party is entirely happy with, simply could not
work. Instead, the courts had to rule where the government and parliament could not.
Because of the explicitly civil law tradition in Germany, the courts were extremely
reluctant to do so, and in fact did so only when they lacked confidence that the
government would at least attempt a reform of pertinent issues. As a result, there was no
good reason why any of its rulings would provide anything but an arbitrary map to the
future. The law’s role in guiding German companies to the management-holding solution
was little more than coincidence, and certainly no recipe for adjustment.

The case of East Germany presents the negative result of this failure of
government. Reunification presented the government with unprecedented opportunities
to bypass normal policy-making procedures. At times, policy was decided in small
circles composed of major party leaders. At times it was decided solely by the
government through such devices as the Reunification Treaty, the negotiations over
economic, monetary, and social union, and the formation of “super” agencies, such as the
Treuhand. The government now had the freedom to forge ahead with new solutions to
the tough privatization problems after its fallout with the big banks; and the government
encouraged a bankruptcy reform in the East that spurred the development of the long-
awaited reform in the West. And thus, when the cooperation of private actors was not
forthcoming, the government turned to massive subsidy and adjustment outlays that to
this day still account for a great deal of the economic stability in the region, as well as for
difficulties Germany is having in meeting currency and budget targets whose violation in
former years was simply unthinkable. In sum, only a much more centralized government,
in the circumstances of extraordinary parliamentary consensus about the priorities to
convert East German institutions into their counterparts in the West, and to do so quickly,
created the room for maneuver necessary to reform the institutions of governance in an
economically fitting way.

The conclusion, then, is not that Katzenstein’s model of policy-making and
adjustment is wrong, but that it is limited. When it comes to regulating how capital
adjusts the rules by which it governs in the economy, the state is in a very different
circumstance than when it must arbitrate between employers and workers, for example, or
among students and professors. The semi-sovereign state does not earn its name due to
the way it can harness diverse interests from the economy and society into a decentralized
policy-making process that blurs the public and private, but rather because of the way
deep and abiding fractures within capital paralyze its actions and prevent any but the most
(economically) arbitrary outcomes.

A final illustration of the dilemma is the 1994-1995 attempt at a comprehensive
supervisory board reform. After several huge corporate disasters, including the
bankruptcy of one of the largest Konzernen in the economy, it became obvious to all
observers – including the public, shareholders, business, scholars, and legal experts – that
the supervisory board system was not performing its proper oversight role effectively.
The SPD was the first to act. It promulgated a bill in the Bundestag to strike the
provision for proxy voting, create qualifications for supervisory board members and auditors, require the board to meet more frequently, and strengthen shareholders’ rights to demand information from both the management and the supervisory board. Unsurprisingly, the bill was rejected by the ruling coalition. But what was surprising was the adoption of the issue in the post-election coalition agreement among the CDU, CSU, and FDP. The agreement promised that the government would seek to circumscribe bank powers on boards by limiting proxy voting; raising standards for board accountability to shareholders; and limiting the number of supervisory board seats per individual. It was the first time a conservative government had ever declared such intentions and committed to them so explicitly and so publicly.

By the middle of the next legislative period, however, all chances at such a comprehensive reform had been killed. The justice ministry circulated inquiries among the banks, companies, industry associations, and the trade and commerce chambers, seeking advice on how best to structure a reform. The response was telling. Although most were in favor of some type of reform, on all the crucial details there was widespread and passionate disagreement. Groups like the banks vowed to fight tooth and nail any reform of proxy voting rules; large Konzernen opposed efforts to restrict supervisory board membership; and smaller companies especially opposed attempts to “open” sensitive company information to the outside public. Yet each of these groups favored other ways to reform the supervisory board, and concurred with the urgency of the need to do so, citing the benefit a good reform might bring to their own governance practices. Once again the justice ministry faced a chaotic and obviously uphill battle if it was to
formulate a draft of legislation, even for discussion, that had any bite at all. By the late summer of 1995, the government had as quietly as possible downgraded the goals of the much-touted supervisory board reform and slowed the process of consultation and drafting proposals to a crawl.

Reflexive Politics: Toward the Possibility of Self-Governance?

The problem of adjustment is an old one in politics and engages a central principle of government, namely, that the best government is the most fitting government. If a government does not respond to the needs of its subjects, it will be deemed unjust. But how to determine what rules are proper? And how to make this determination in a shifting and unpredictable world?

Modern liberal democracies have answered this question with the idea that the most fitting government is one that helps individuals govern themselves. In fact, this is one of the central justifications for ownership in the liberal, or capitalist, economy: that it removes the state from decisions over how to use assets to their best use and guarantees that those who know best and have the most immediate interest in that best use have the power to use or deploy those assets as they see fit. The idea of ownership is premised on self-governance.

In fact, this justification for ownership is precisely the same one on which the modern corporation was founded: the new, non-concessionary system of incorporation was really the extension of the idea of self-governance and ownership in the capitalist economy. It freed the corporation from under the thumb of the government, allowing individuals to write their own charters, run their chosen businesses, and solicit their own
investors as they saw fit, not as the state saw fit. Modern capitalism was founded on the idea of self-governance. The modern corporation was and is, in a very important sense, a state within a state.

But how corporate ownership determines the method of control over the firm is another matter altogether. The firm is not a single object or piece of property. Behind the fiction of the legal personage (*juristische Person*) are workers, managers, and all those involved in the apparatus of production itself. The firm includes physical assets and myriad relationships built around those assets. Who will control what part of the production process, and how, is entirely unclear a priori. It is a question both for the state to answer, insofar as it first defines ownership and thus the rules that govern it generally, as well as for the owners and executives of the corporation itself, who lay down just how control should be allocated or defined vis-à-vis that general regulatory framework. The challenge of modern capitalism, then, is to adjust those rules of ownership properly.

This dissertation questions seriously whether within a national framework like Germany's this challenge can be met. The implications are far-reaching. Germany is known for its collaborative style of government, and for the close relationship between business interests and the state. And yet the diversity of governance forms and needs -- developed precisely from the system of incorporation that defines modern corporate ownership -- prevents it from doing so, except in an arbitrary and accidental fashion. If the German political system cannot adjust these rules in a fitting and timely way, what modern nation-state can? At the national level, the regulation of corporate governance appears to be governed by chaos and happenstance. Perhaps this is because the legal
solutions imposed at this level are too universal to fit the needs of the modern corporation's diversity of forms.

Yet neither is the dissertation optimistic about such solutions as regional ones. It was in precisely Baden Wuerttemberg, a premier example of the industrial district and close regional cooperation between economic interests and the state, where the German machine tool industry was hardest hit and where many smaller firms were sold into larger groups of companies from all over Germany and, for that matter, Europe and the world because of the perceived advantages of cross-regional and even nonregional governance arrangements. The GmbH economy, structured around small craft and family firms, simply did not provide the ability to develop some types of desirable relationships with other companies and gain the strategic and operational advantages of such alliances. Again, the barrier was the structure of corporate ownership and control.

The only contemporary example of a successful system of self-governance discussed by the dissertation is that of the management holding; yet the rules that govern it are the mainly unintended product of judicial interventions in a fashion that, when created, had no direct connection with the economic needs of individual companies. The management holding is thus a successful private adaptation to the results of arbitrary public governance. Perhaps this is the recipe. Perhaps the recipe is that there is no recipe, and that the modern capitalist state, built on contradiction, can never shake its crisis of adjustment.
Endnotes

Chapter 1


6 Hilferding went so far as to assert that "taking possession of six large Berlin banks would mean taking possession of the most important spheres of large scale industry." Hilferding (1981), p.368.


8 Gerschenkron (1962), p.15


The basic property-rights argument has been elaborated by North whose new theory argues that costly information, by upsetting stable expectations, foils efforts to measure asset value, places resources in a public realm and thus creates additional transaction costs: “As a generalization, the more easily others can affect the income flow from someone’s assets without bearing the full costs of their action, the lower is the value of that asset. As a result, the maximization of an asset’s value involves the ownership structure in which those parties who can influence the variability of particular attributes become residual claimants over those attributes. In effect they are then responsible for their actions and have an incentive to maximize the potential gains from exchange. The rights to an asset generating a flow of services are usually easy to assure when the flow can be easily measured, because it is easy to impose a charge commensurate with a level of service. Therefore, when a flow is known and constant, it is easy to assure rights. If the flow varies but is predictable, rights are still easy to assure. When the flow of income from an asset can be affected by the exchange parities, assigning ownership becomes more problematic. When the income stream is variable and not fully predictable, it is costly to determine whether the flow is what it should be in that particular case. In such an instance, both parities will try to capture some part of the contestable income stream.” (North, 1990, p.31)


39 A legal specification of the “imperial view of property,” together with a list of problems with the same, can be found in Munzer’s (1990) *Theory of Property*. Munzer defines the imperial ownership structure, as envisioned by theorists, as “the full constellation of Hohfeldian elements, correlative and opposites; the specification of standard incidents of ownership and related but less powerful interests; and the catalog of things, both tangible and intangible, that are the subjects of these incidents.” Particularly important incidents include the right to transfer, control, consume, destroy, and capture all profit from an asset.


41 The addition of seeming non-ownership-related institutional arrangements such as hostage exchange seems to be one of Williamson’s main contributions, but as argued above these arrangements simply approximate the ideal ownership regime without formally reaching it. As such perhaps Williamson should be reconsidered for proposing a more explicit definition of ownership that allows an economic approximation of an otherwise problematic legal relationship. The ownership ideal of absolute enforcement includes punishment by exclusion from an asset, supposedly inflicting costs much higher on the party in question than simple conformity to the wishes of the owner would entail, thus approximating the loss of any security or hostage.

42 Hart would probably object to inclusion in the group of transaction-costs economists. However, transaction cost theorists have been intimate with questions of ownership since Coase, and have even defined transaction costs in terms of property, as the argument has shown. For this reason they are really far more related than they often admit in the literature.


47 With this admission, not even the problem of the commons argument, which lay at the base of the transaction cost theory, was safe. Although it is true that additional users of common resources do not take into account the costs they impose on others at the margin, they do take average costs into consideration. Thus, letting cattle graze in the commons might very well not lead to overgrazing and starvation. Additional farmers who would otherwise let their cattle graze the commons might assess the situation and realize that doing so is not worth the effort. In fact, given the difficulties described above, the commons
might be an efficient grazing arrangement. A-priori it was impossible to tell if common resource arrangements are inferior.


51 An unsurprising difference given that, in contrast to Zysman, Roe wrote his work after many of the debates described above.


53 Zysman’s argument, in contrast to Roe’s, does contain real economic implications if one sides with the view that the top-down modernization program, dependent on the French system of credit allocation, was the best course for the economy.


In close parallel with these results, Grey has argued that the modern multiplicity of ways ownership incidents are defined and distributed has spelled an end to classic ownership and its relevance to politics and the economy. Yet the fact that ownership structures are no longer convergent does not mean that they are irrelevant. See Thomas Grey (1980), "The Disintegration of Property," in Pennock and Chapman, eds., NOMOS XXII: Property. Also, Pierre-Joseph Proudhon, What Is Property?, Cambridge Texts in the

57 Indeed, in this way the argument for bundled rights is tightly related with the normative thrust of economic arguments. Once attenuated, much of this bite would be taken out of such arguments. To take a prominent example, Coase’s modern criticism of Pigouian policy prescriptions, as well as his suspicion of recommendations that the state correct “market externalities,” rests precisely on his observation that no entity -- not even a state -- can exercise or even possess imperial ownership rights without incurring excessively prohibitive costs. See Coase (1989), “The Lighthouse of Economics.”

In close parallel with these results, Grey has argued that the modern multiplicity of ways ownership incidents are defined and distributed has spelled an end to classic ownership and its relevance to politics and the economy. Yet the fact that ownership structures are no longer convergent does not mean that they are irrelevant. See Thomas Grey (1980), “The Disintegration of Property,” in Pennock and Chapman, eds., NOMOS XXII: Property. Also, Pierre-Joseph Proudhon, What Is Property?, Cambridge Texts in the History of Political Thought, ed. Raymond Geuss and Quentin Skinner (Cambridge: Cambridge University Press, 1994).

Finally, as the above arguments imply or state, the challenge of individual sovereignty is also a challenge of state sovereignty, again linking the political and economic arguments. For an excellent argument in favor of the utility of state sovereignty as the central category of politics, see Carl Schmitt, Political Theology: Four Chapters on the Concept of Sovereignty, Studies in Contemporary German Social Thought, ed. Thomas McCarthy (Cambridge: M.I.T. Press, 1985). For more on the sovereignty of property and political philosophy, see Jonathan Wolff, Robert Nozick: Property, Justice and the Minimal State, (Stanford: Stanford University Press, 1991). For classic criticism of property because of its reliance on the sovereignty idea, see Pierre-Joseph Proudhon, What Is Property?, Cambridge Texts in the History of Political Thought, ed. Raymond Geuss and Quentin Skinner (Cambridge: Cambridge University Press, 1994).


59 Albert Herschman, Voice & Loyalty. The tradeoff between clear, delimited rules and unclear or complex rules in property law in general is a rough analogy to the point made here – the latter forcing information exchange in a way that, given the latitude of judges, can lead to more satisfying outcomes. See Carol Rose, “Crystals and Mud in Property Law,” Stanford Law Review 40 (1988): 577-610.

60 In making this argument, I refer back to the Hayekian notion of market efficiency and from whence it arises. Allocative efficiency, Hayek explains, arises because when individual actors buy goods they can draw on a host of information contained in prices that would be too costly to process consciously but which left unknown but present allows them to make the right allocative decisions. Allocative efficiency is thus explained in terms of of the market’s ability to collect and generate collective knowledge. This is the same explanation the dissertation employs for non-market ownership institutions. See Friedrich A. Hayek, The Constitution of Liberty (London: University of Chicago Press, 1960), pp.22-25.


63 A group of theorists closely attuned to this concern are the school of French economic sociologists and political scientists that includes Alain Desrosieres, Luc Boltanski, Francis Chatteauraynaud and Robert Salais. For an overview, see Peter Wager, “Dispute, Uncertainty and Institution in Recent French Debates,” *The Journal of Political Philosophy* 2 (1992): 270-289.


68 Of course, one case makes controlling for industry-specific variables impossible. However, doing the research for additional industries would have added years to the already long period of field research necessary to make the arguments, and would have been impracticable.

69 Because of the sensitivity of many of these discussions, especially those in the private sector, promises of anonymity had to be made; this compounded the already difficult problem of verifying the accounts. The only good ways of doing so was thorough preparation and corroboration from other interviews. Appendix A displays the complete list of interviews, including both specific names and, where circumstances require, general titles of all the interlocutors.

70 Little of this could have been accomplished without the generous financial support of the Alexander von Humboldt Foundation, the Center for European Studies at Harvard, the Wissenschafts Zentrum Berlin, and the Center for Law and Economics at Columbia University.

**Chapter 2**

71 Formed in the 70s to measure bank influence in relation to anti-competitive practices, the Monopoly Commission saw its mandate in terms of diagnosing a social problem affecting the whole economy, not singling out any individual firms or small group of firms. Because it could speak in stronger terms by not associating single corporations with its arguments, it rarely did so – avoiding any individual confrontations. See Monopolkommission (1973/75, 1976, 1976/77, 1978/79), *Hauptgutachten* (Baden-Baden: Nomos

72 For a discussion on the features of this model, see Chapter 1.


75 Manfred Perlitz and Frank Seger, “Regarding the Particular Role of Universal Banks in German Corporate Governance,” Mimeo (University of Mannheim, 1995).


77 For qualifications (some severe), see the discussion of Edwards and Fisher (1995) below.

78 The first, net earnings over stockholders equity, is the most valid but is not 5% significant. Of the remaining measures, the fourth (cash flow / total assets) is more a measure of financial strength than profitability.

79 Of the five companies excluded, only one came from non-bank influenced companies. Crisis companies were defined as having a net earnings / stockholders equity ratio of at least two standard deviations below the mean.

80 Actually, the relationship between bank debt and risk/profitability is not so straightforward, for at some point the risk of bankruptcy and/or lower cash flow would be expected to increase risk and with it (in a well-functioning stock market) return or profitability.

81 As the previous note alludes, risk and return should be correlated in any sufficiently liquid securities market. The contradiction here not only indicates a lack of liquidity in the German stock market, but an effect of bank debt on return so negative that the point of increasing risk referred to in the previous note must begin at comparably low levels of debt.


83 Jeremy Edwards and Klaus Fisher, *Banks, Finance and Investment in Germany* (New York: Cambridge University Press, 1994). Edwards and Fisher’s analyses include the most comprehensive collection of quantitative data on the German bank-based model of governance and should be the starting point of anyone interested in pursuing the subject.

84 Calculating ownership of underlying assets instead of nominal capital, markei equity, or bokk value is necessary in Germany due to high levels of “hidden” reserves and undervaluation of assets in standard accounting conventions.


86 The percentages include all companies, even those without large stakeholders, which is the reason why they do not add up to 100%.

87 A conclusion not only born by comparing Table 6 with Table 8, but drawn by incentives of existing tax laws as well, which encourage those that can afford it to own large stakes instead of dispersed shares in order to avoid double taxation of dividends and appreciation.


Perlitz and Seger define bank-influenced firms as those with 25% of liabilities owed to banks, with a banker as chairman of the supervisory board, or with over 50% of shareholders represented by bankers. In Chart 2a I extend the definition to include all firms whose banks own at least 10% of outstanding shares (a stakeholder).

Perlitz and Seger, p.20.


This indicates that the banks do not aim to control firms with the majority of their stakeholdings, but to rather use them as investment vehicles – in no doubt taking advantage of tax breaks for such stakeholdings.

This, indeed, is the view the banks themselves propagate. It also suggests that perhaps the German model of governance has been converging toward the institutional investor model that troubles observers in the U.S. who criticize the passivity of large mutual and pension funds.

The comparable number from Perlitz and Seger’s (1995) sample of 110 listed companies is 76%.

Because the Monopoly Commission does not report levels of equity, this implication is not verifiable.

See the discussion of share ownership at the end of the previous section “The Transformation of Corporate Governance.”


In addition to explaining how each side in current debates might be partially correct, the analysis also explains where the popular momentum behind topics such as the “Power of the Banks” comes from in Germany despite their far reduced role: from the relative public prominence of the small group of firms where the banks do exercise their control. This observation will be revisited again in Chapter 5 and plays an important role in the political dynamics of actual attempts to legally reform big firm governance.

Chapter 3


Lipton and Sachs, "Privatization in Eastern Europe: The Case of Poland," p.319. Sachs' contentions have not been ignored. Indeed, these and similar arguments have led to Polish efforts to copy the broad characteristics of German-style universal banking. Those East European countries that have failed to reform their financial systems in accordance with the German model of bank-based financial markets have received sharp criticism from outside scholars and policy-makers. See, for instance, Jenny Corbett and Colin Mayer, "Financial Reform in Eastern Europe: Progress with the Wrong Model," CEPR Discussion Paper No. 603 (Sept. 1991). From the market economics perspective, if West German financial institutions could simply be moved to the East and given a chance to participate in the privatization process there, then the investment problems of the transition should be largely overcome.


111 Statements by Pohl and Bundesbank in paper.

112 See Deutscher Sparkassen- und Giroverband e.V., Ostdeutsche Wirtschaft im Wandel: Bestandsaufnahme und Perspektiven eines Aufholprozesses (Stuttgart: Deutscher Sparkassenverlag, 1992), p.79 for these figures and others.

113 The big three had separate sister organizations in Berlin, a remainder from the allies' post-war attempt to dissolve the large private banks into many smaller regional banks. In addition, West German development banks also were divided along the Berlin axis: the Kreditanstalt für Wiederaufbau is responsible for all of Germany except Berlin, for example, where the Berliner Industrie Bank is the active federal development bank. This structure mirrored the special political status of the city of West Berlin in the Federal Republic.

114 See, for example, Georg Assmann, Klaus Backhaus, and Joerg Hilder, eds., Deutsch - Deutsch Unternehmen: Ein Unternehmenskulturelles Anpassungsproblem (Stuttgart: C.E. Poeschel, 1991).


116 The point is argued well in Deutscher Sparkassen- und Giroverband e.V., Ostdeutsche Wirtschaft im Wandel, pp.77-88.

117 Deutsche Bank, for instance, invested over DM 9 billion, or over 50% of its consolidated capital and reserves. Commerzbank and Dresdner Bank have invested similar ratios in the East.


119 The news media has not been slow to realize this. See "Strained relations among West Germany's big banks," The Economist 316, no. 7670 (Sept. 1, 1990), pp.67-68. "Breaking with Big Brother: Wherein the famous German Ordnung has given way to chaos as East meets West," Finance Week 160, no. 5 (March 5, 1991), pp.46-47.

120 See "Meeting of the ways: With reunification now seemingly inevitable, German banks are leading the way in transplanting the market economy to the east," The Banker 140, no. 771 (May 1990) for provocative, self-glorifying quotes from economists and bankers from all three of Germany's big banks.

121 The Treuhand Anstalt's announced closing of its main operations by 1994 appears to be well on track. Already it has closed most of its regional offices -- several of which were shut down by mid-1992. See the June 1992 interviews with Birgit Breul in "Schlussverkauf" and "Nachruf total egal," Wirtschaftswoche 46, no. 27 (June 19, 1992): 21-24, 37-38.

122 See accounts of scandals in papers, etc.

123 I am indebted to Mark Jolf and Hanno Schmidt for many of the details of the privatization of Chemie AG at Launa and Bitterfeld. See Mark Jolf and Hanno Schmidt-Gothan, "Privatization in the Former German Democratic Republic: Changing Institutional Roles in the Governance and Sale of Industrial Assets." M.S. Thesis, Sloan School of Management, M.I.T., 1992. For a series of case studies of large privatizations which includes the Bitterfeld example, see Die Wirtschaft, Kombinate: was aus ihnen geworden ist (Berlin: Verlag Die Wirtschaft GmbH, 1993).

In the new Länder, three important institutions were developed to cover loan risk with guarantees in situations where the banks remain unwilling to carry this risk themselves: the Länder Burgschafsfanken (for loans up to DM 1 million), the Berliner Industrie Bank (for loans from DM 1 million to 20 million), and the Treuarbeit AG (for loans over DM 20 million). In all three cases, the government carries between 80% and 100% of the credit risk with guarantees.


Jan Priewe and Rudolf Hickel, Der Preis der Einheit: Bilanz und Perspektiven der deutschen Vereinigung (Frankfurt/Main, 1991).


Deutsche Bank AG's 1990 profit rise, for example, was about 10% in 1990, and 20% in 1991. 1991 net income rose over 32% and net income per share rose by 29% -- a record high. See the Deutsche Bank's Annual Reports for 1990, 1991 and 1992.

Ulrich Schroeder, "The relationship between banks and industry in Germany -- a model for privatization in Eastern Europe?" paper presented at the seminar "Privatization in Eastern Europe," World Institute for Development Economics Research, Helsinki, May 1991. Schroeder, a manager at Deutsche Bank, concludes that it is "not very likely that West German banks will become major and permanent shareholders of East German companies. An appropriate instrument that can be used are the so-called company participation corporations."

Many of these institutions, such as museums, were not true firms however vital they remained to the identity and functioning of the local economy and had to be integrated into other frameworks such as the non-profit foundation in order to continue.


For a complete collection of all related laws and treaties governing the restoration of property from 15 June 1990 through 1991, as well as a detailed legal discussion of the same, see Gerhard Fieberg and Harald Reichenbach, Vermoegensgesetz. For a discussion of the history behind such laws, see Dieter Feddersen, "GDR Emigres and Property Rights," Politics and Society 23, no. 1 (1991): 47-61.


Chapter 4

The classic discussion of the political and state-building history during this period, and the one that this chapter follows where appropriate, is found in Gordon Craig, Germany 1866-1945 (New York: Oxford University Press, 1978), pp.1-247.


A good discussion of this period can be found in Helmut Boehme, Deutschlands Weg zur Grossmacht: Studien zum Verhaeltnis von Wirtschaft und Staat wahrend der Reichsgruenderzeit 1848-1881 (Koeln, 1966).
Part and parcel with these restrictions, of course, were the special privileges granted only select investors in these companies. For the United States, see Ronald Seavoy, The Origins of the American Business Corporation, 1784-1855: Broadening the Concept of Public Service During Industrialization (Westport: Greenwood Press, 1982); Edwin Dodd, American Business Corporations until 1860 (Cambridge, Harvard University Press, 1954). For Germany see H. Blumberg, "Die Finanzierung der Neugründungen und Erweiterungen von Industriebetrieben in Form der Aktiengesellschaften wahrend der fuenzfziger Jahre des neunzehnten Jahrhunderts in Deutschland, am Beispiel der preussischen Verhältnisse erläutert," in H. Mottek, ed., Studien zur Geschichte der Industriellen Revolution in Deutschland (Berlin, 1960), pp.165-208.


See references in Note 142, and especially Boehme (1966).

See Seavoy (1982) and Dodd (1954). Other reasons why the concessionary system was first abandoned in the U.S. might include its different boundaries between private and public life, the states' desire to compete for business, and/or political usurpation of authority by management (as Berle and Means argue).


England passed the Companies Law in 1862. Also note that the view that the financing requirements of railroads required the birth of the modern joint-stock company is seriously qualified by this account. There was nothing novel about the rapid growth of pressures to incorporate the railroads in the early to middle 19th Century. In England, the earliest industrializer, overseas trading companies, canal companies, mining companies and many other corporations had almost always been founded during relatively short boom periods or manias: in the seven years after the Glorious Revolution over 100 new trading companies were founded; the same number of incorporations occurred in 2 short months before the Bubble Act of 1720; and these numbers were far surpassed during the canal mania from 1791-94 and the years 1823-25, when over 600 incorporations were filed for breweries, insurance companies and many other types of businesses -- less than 20% of which survived the 1825 Crash. Instead, what was novel about the railroad mania was the view purported by the English state that it could no longer supervise the incorporation process. See Kindelberger (1993), pp.191-193.


Friedrich (1979).

See Koberg (1996), p.15 Note 27, which lists the percentage of newly incorporated Prussian AGs liquidated or bankrupt between 1871 and 1875. In 1873 there were 162 new incorporations but 67 liquidations and 9 bankruptcies. By the following year only 30 new AGs were formed, but fully 19 were liquidated or went bankrupt.

These were proposed by the deputy Lasker and many members of the Prussian parliament. See Schubert Werner, Die Entstehung des Aktiengesetzes von 1884, in W. Schubert and P. Hommelhoff, "Hundert Jahre modernes Aktienrecht," Zeitschrift fuer Unternehmens- und Gesellschaftsrecht Special Issue 4 (1985), pp.1ff.
These included many local bankers, for example, who often occupied prominent community positions and thus were seen as more accountable to public (investor) interests.


In a unitary system the board of directors included chief executives and major shareholders in one body (the board of directors), disfavoring scattered shareholders who often had no good representatives.

See Spindler (1993), pp.96-160 for examples from the steel, electrical and chemical industries.

Spindler (1993), pp.54-61. See also Klaus Brondic, *Die Aktionaersklage* (Berlin, 1988).

Again, see Spindler (1993), pp.310ff.

See Peter Koberg, *Die Entstehung der GmbH in Deutschland und Frankreich unter Beruecksichtigung der Entwicklung des deutschen und franzosischen Gesellschaftsrechts* (Koeln: Otto Schmidt, 1992), pp.35-153. Koberg’s discussion is the best available on the origins of the GmbH, for he lays out the position papers of over twenty smaller industry and trade chambers, which assumed the job of representing family firm and small firm interests.


See the previous discussion on the origins of the AG.

On the origins of these industries in the Ruhr and the formation of the bank-led model of governance, see O. Jeidel, *Das Verhaeltnis der deutschen Grossbanken zur Industrie mit besonderer Beruecksichtigung der Eisenindustrie* (Leipzig, 1905).


Koberg (1992), pp.32ff.

See the debates documented in Koberg (1992), pp.62ff.

Ibid.


Koberg (1992)’s own figures, p. 21 Note 47, confirm this tendency starting in 1870.

This was explicitly mentioned in the AG debates in conjunction with the heightened publicity requirements of the new corporation. Transparency would not only increase the pool of potential investors – which increase, after all, was one of the prime purposes of the new ownership form – but reduce the likelihood that the relatively severe publicity laws would compromise the AG’s business.

By comparison, New York had enacted a limited partnership law in 1822, while England – despite arrangements that gave companies a de-facto limited partnership status – did not enact such a law until 1907. France waited until 1925 to pass its law creating the SARL.

Craig (1978), pp.64-66, 89-90. See also Boehme (1966) and Blumber (1960).
Craig (1978), pp.99ff., follows many other authors in describing this occurrence as the basis for the “feudalization of the middle class.” David Blackbourn and and Geoff Eley, in the The Peculiarities of German History (Oxford: Oxford University Press, 1983) quite successfully disputed this claim. But however characterized, the rift between heavy industry and the more decentralized economy was a real one.

178 Interestingly, this included the idea that tariff funds could be used to fund the social welfare provisions that some industrialists saw as a vital component to their expansion plans. See Craig (1978), p.88.
180 Herrigel (1996), pp.19ff. and Map 1, p.468 sets out many of the geographic boundaries, while his discussion in Chapters 2 and 3 set out the conceptual and historical distinctions between the autarchic and decentralized economies.
181 See references in Note 179 for more details about the nexus of interests in question here. The famous “marriage of iron and rye” referred to more than simply a protectionist conspiracy between big industry and landed interests – it also referred to the mixing of social worlds, which combined in the various loci of elite politics in question.
182 Again, nowhere is this nexus better described than in Kober (1992).
184 Co-determination law has since linked certain governance bodies to size as well as form. The supervisory board is not necessary for corporations of below 500 employees, although one could be created by the charter or shareholder agreement. Likewise, a Beirat, or “management council,” was also optional.
185 Of course, the management’s contracting powers with outside parties on behalf of the corporation could not be arbitrarily modified by the shareholders, for this would cause chaos with outsiders who lacked the ability to monitor the workings of shareholder decisions. However, unlike the AG stockholders, GmbH shareholders could vote to hold management liable to the corporation for any improper contracts with outside parties.
186 Eberhard Duelfer, Die Aktienunternehmung (Goettingen: Vandenhoeck & Ruprecht, 1962), pp.30-34.
188 Herrigel (1996), pp.84ff.
190 This race to adopt the new technologies is described well in David S. Landes, The Unbound Prometheus (Cambridge: Cambridge University Press, 1969), pp. 124-230, and is a major theme in the Gerschenkron-related literature about industrialization that developed in the 1960s. See also Wilfred Feldenkirchen, Die Eisen- und Stahlindustrie des Ruhrgebiets, 1879-1914: Wachstum, Finanzierung und Struktur ihrer Grossunternehmen (Wiesbaden: Franz Steiner, 1982).
191 It is no accident that cyclical swings and great troughs or slowdowns characterize the period of emergence of standardized goods markets in the late 19th century. See R. Spree, Die Wachstumszyklen der deutschen Wirtschaft, 1840-1880 (Berlin, 1977).
193 Whether an economy-wide ownership hierarchy developed and the banks stood at its pinnacle, as Hilferding suggests, is less important here than the fact that ownership could be far more centralized under
the AG rules than previously or under alternative governance regimes. See Volker Wellhoener (1990) for evidence that mitigates Hilferding’s views.


195 These parallels contrasted sharply with other nations’ corporate structures, like those of Britain, for example, where industrial corporations remained far smaller, less diversified and less integrated. See Kocka and Siegrist (1979), pp.86, 88. See also data on British companies in Chandler (1990), Appendix B.1. and Appendix A.


201 Chandler (1990), p.81.

202 This was the case, for example, with Deutsche Bank’s Georg von Siemens, the cousin of Werner Siemens, whom Kindelberger calls a “central figure in the formative years of the bank’s history.” See Kindelberger (1993), p.125. Many if not most of the German great bank board representatives were, as their American counterparts, men from finance, whose experience with industry was slight, with the exception of the railroads, until the great period of cartel formation and mergers got underway starting in the 1880s. In fact, gaining that industrial experience was precisely the problem most German bankers faced at that time, as they followed strategies of exiting government and real estate finance in favor of industry or -- poorly in comparison with their British competitors -- commerce.

203 See Spindler’s discussion and listed references in Spindler (1993), pp.7-14.


206 Ibid. Notice that such a disincentive only became strong once large corporations had been intact long enough to build up such reserves. In the thirty years following the creation of the AG in 1870 mergers and fusions were extremely common, as these silent reserves were as yet small or insignificant. For literature on the mergers and fusions, see Kocka and Siegrist (1979); also of interest, Joachim Kahl, Aufbau und Finanzierung der deutschen Grosskonzerne (Dissertation, University of Wuerzburg, 1940).


213 Ibid.
214 Most noticeably apparent in the Reichsfinanzhof’s development of the body organ theory.
215 The courts had difficulties legitimizing such episodes within the Continental tradition of jurisprudence; this was especially true of the democratic years during the 20s and after 1945.
216 See Eberhard Kolb’s comments on the period of “relative stabilization” of the least chaotic years, in which he concurs with other observers who characterize the period as a “republic of instability” or a “history of failure.” Kolb, The Weimarer Republic, Translated by P.S. Falla (London: Unwin Hyman, 1988), p.66.
217 See the Chapter 1 discussion under the title “German Organized Capital.”
218 See Spindler (1993), pp.35-40 and his examples from the electronics, steel, coal, banking and other industries.
219 See references in Note 210.
220 For the Nazi economy and its effects on corporate and industrial structure, see C. Hettelheim, Die deutsche Wirtschaft unter dem Nationalsozialismus (Munich, 1974); Gerhard Mollin, Montankonzerne und “Drittes Reich”: Der Gegensatz zwischen Monopoldindustrie und Befehlswirtschaft in der deutschen Ruestung und Expansion 1936-1944 (Goettingen: Vandenhoeck & Ruprecht, 1988).
224 Emmerich and Sonnenschein (1993), pp.8-10.
227 In the case of company law, then, the Nazi time represented a true revolution.
228 For the difficulties of Adenauer and Erhart in confronting industry on cartel issues, ee Katzenstein (1987), pp.88ff.
229 See discussion of export economy below.
230 For an excellent account of the rise of mass production techniques in Germany, see Herrigel (1996), pp.262-275. See also Piore and Sabel (1984), pp.19-49, 142-150.
232 Ibid.
234 See literature in Note 230.
237 Ibid. See Ihde’s (1973) extensive bibliography for a list of contributors to the debates.
238 Ihde (1973).
239 Emmerich and Sonnenschein comment as follows on the 1980 law: “With the GmbH Novelle of 1980 the legislature decided once and for all to avoid attempting to regulate GmbH Konzernrecht.” (Emmerich and Sonnenschein (1993), p.9).
240 The landmark case was the Veba/Gelsenberg decisions (see Entscheidungen des Bundesgerichtshofs in Zivilsachen 69 (1977):337ff.) The 1937 AG law also made reference to firm’s independence of will, but
did so in an extremely restrictive fashion, recognizing it only when proven by the actions of a parent, owner or some other outside agent to be deficient.

243 See discussion in Emmerich and Sonnenschein (1993), pp.50-59, including a discussion about the Treuhand Anstalt.

244 This remarkable result has been downplayed in practice because traditionally public law took priority in principle and interpretation over private law in Germany. Where administrative code did not dictate an outcome, this line of reasoning went, Konzernecht has been applied. However, in recent years this doctrine of precedence has been challenged by the assertion of the idea of the Rechtsstaat, or State of Law. Under the spirit of the Basic Law, even public organizations must submit to the rules of its citizens, the argument goes. Whenever the state is simply involved with private ownership forms — as it is frequently with the GmbH form, it should submit to the rules of Konzernecht just as readily as the private citizen. For the relevant discussion and literature review, see Emmerich and Sonnenschein (1993), pp.51ff.

245 Again, see Ihde (1973) and the referenced works.

246 The Vertragskonzern was an idea that had been discussed since cartel law first became a major focus of debate in the 1920s.


248 Were it not continuous and comprehensive, then directives could be isolated and thus the dominant shareholder could be held liable for only those directives or actions just as she would be in any case of forcing a company to act against its own best interests.


251 Of course, this strife is meant with regard only to the subject of the dissertation, namely, corporate governance reform. Co-determination and ideological issues over ownership, for example, still united most of industry along other axes.

Chapter 5


253 For an early article explaining the innovation, see Fechtthum, "Die GmbH als Komplementär einer Kommanditgesellschaft, in Juristische Woche (1923): 227ff.


258 See Chapter 2, Table 19.
257 Rolf Buehner, Der Erfolg von Unternehmenszusammenschlüssen in der Bundesrepublik Deutschland (Stuttgart, 1990).
263 Note that a decline in ownership stakes does not necessarily equate with a decline in ownership shares. As corporate profits increased during the 80s, one might expect external share ownership to rise. Indeed, this is what the data in Chapter 2 show.
264 See Chapter 2.
266 Sabel, Griffin and Deeg (1993).
270 See, for example, the discussion of the machine-tool industry later in the chapter.
273 Gary Herrigel and Charles Sabel, "Craft Production in Crisis: Industrial Restructuring in Germany During the 1990s."
278 The moment owners’ directives became "continuous and comprehensive" enough to fall into the definition of the qualified de facto combine, the rules of governance calling for a separation of powers between the supervisory board and the management board would be blatantly violated and the directives would be rendered invalid.
283 For example, the conference in Wiesbaden from April 22 to 23, 1991, entitled "Die Holding als Instrument der Strategischen Planung."

Buehner does not always adhere to the strict legal and institutional separation of strategy from operations, counting several combines without this characteristic as “mixed” or “atypical” management holdings.

For an excellent mapping of industrial orders geographically and historically, see Herrigel (1995), pp.34ff., 468-472.


Examples of the large number of other Japanese-German work practices comparisons include: Christian Deutschmann, Die japanische Aufwertungskrise – Lehren fuer die Arbeitsmarktpolitik (Berlin: 1987.) M. Imai, Der Schlüssel zum Erfolg der Japaner im Wettbewerb (Munich, 1991).


The law requires that about half an AG’s earnings be rolled over into retentions before dividends, and the multi-layered structure of a Konzern makes this ratio much higher.

These included Doerries Scharmann, Schuler Pressen, Trumpf, Thyssen Maschinenbau, Pittler, Doerries Scharmann, Mueller-Weingarten, and Deckel Maho.

This is especially true of the Autania Group, which seems to act more as a liquidation holding for chronically-troubled and state-owned firms than anything else.

Chapter 6


This is true for all litigation: the loser pays the costs of both parties in Germany – a fact meant to discourage frivolous law suits.

These with the idea that an entrepreneur who falls into bad health and needs to be administered to will still be able to get required service.

Luetge (1966) and Hahn (1881).

Income taxes, for example, never exceeded 6%.


Ibid.

The development of the secured loans is a natural result of increasing a firm’s debt levels and its number of creditors, for each vies for a higher priority of payment as the risk of loss in the event of default increases. Because of the privileged position of secured credits, not only will initial lenders seek to establish liens on the best property first, but subsequent lenders seek liens on anything of value remaining in the order of its desirability, leading to the system of secured credit mentioned.

Second lenders will be discouraged from investing in a firm if another lender has already staked out the most desirable liens, as those lenders will be dependent on the first’s discretion over when to liquidate a firm in default and be in a more vulnerable position in the event of liquidation. With competition so or discouraged, this power of the first mover obviously translates into considerable leverage vis-a-vis the firm itself.

This was true for periods after the Empire as well. For the Nazi period. see Kurt Gossweiler, “Die Rolle der Grossbanken im Imperialismus, in Gossweiler, ed., Aufsatzes zum Faschismus (Berlin, 1986), pp.199-229. For the post-war period, see E. Czichon, Der Bankier und die Macht: Hermann Josef Abs in der deutschen Politik (Cologne, 1970).


For a list of such articles, see Hess and Goetsch (1993), pp.XII-XXVI.
See Axel Goesche, *Insolvenzen und wirtschaftlicher Wandel: Eine wirtschaftsgeschichtliche Analyse der Konkurse und Vergleiche im Siegerland 1951-1980* (Stuttgart: Franz Steiner Verlag, 1985). This study analyzes all corporate bankruptcies in one small area of Germany over thirty years and comes up with a long catalogue of causes, among them those mentioned here.


See Gesner, et. al. (1978).


The threat was to both the Gerling Group, Germany’s number three insurance group, and to the trustworthiness of German banks in general.


This could appear puzzling to some, and indeed, it does to many within industry itself who saw that a less doctrinaire stance might benefit managers and corporations if an American-style Chapter 11 provision was passed in the new law. From interviews in 1994 and 1995, the hard line is probably best explained by the individual personalities who headed the BDI Department of Legal Affairs.


Heinze (1985), and others.


The French law was modeled on Chapter 11 as well. Whether its provisions for a generous “waiting period” and its explicit norm of saving distressed firms are more effective at prodding re-organization than the American law, however, is not yet clear. See Blanchard, “Das franzoesische Insolvenzverfahren und die Stellung der Glaeubiger in Frankreich,” *Zeitschrift für Konkurs, Treuhand- und Schiedsgerichtswesen* (1983):247-263. Also, Michelle White, “The Costs of Corporate Bankruptcy: A U.S.-European Comparison,” Center for Economic Studies, University of Munich, Working Paper No. 48 (October 1993.)


The ratio of Chapter 11 re-organizations to Chapter 7 liquidations for businesses was 13.24%. in 1981. The corresponding ratio for the German case or Vergleichsordnungen over total insolvencies was 0.92%.

See *Statistical Abstracts of the United States, 1982-1983*, p.533. Although the 20 to 40% rate of success of Chapter 11 re-organization procedures might cast a shadow on the high U.S. ratio, this still leaves a successful re-organization rate over 400% more successful in the U.S. than the simple use of the corresponding re-organization procedure in Germany.

The proposal was that 80% of secured creditors, 80% of affected workers, and 60% of general creditors be required to approve a re-organization plan. These high barriers were the reason judicial scrutiny of the plan was abandoned by the proposal.

Deutsches Rechtsministerium (1986).


Though between 1986 and 1991 the number of insolvencies actually decreased (see Figure 5), between 1991 and 1995 the numbers shot back up to record levels at record rates, over doubling in those five years to about 23,000 cases.

In 1988, for example, the total losses to creditors due to bankruptcies exceeded 6 billion DM, nearly double the 1980 figure. Moreover, in the space between 1960 and 1980, the amount lost had accelerated even fast, by over ten times, from 284 million DM to 3.1 billion DM. See Statistische Bundesamt, Statistisches Jahrbuch 1990, p.152.


This example is rendered in exquisite detail by Harald Hess in Rechtsfragen der Liquidation von Treuhandunternehmen: Abwicklung, Geschäftsförderung, Unternehmenskauf, Haftung des Liquidators (Cologne: Verlag Kommunidationsforum, 1993).


Ibid.


Chapter 7

See Chapter 1, pp.25ff for the detailed argument complete with examples.

It is true that the division of labor in an industrial district is a far cry from a market – and even uses para-public devices to blend out traditional distinctions made in markets. But it is also true that this model of production relies on the private autonomy of the individual craft or family firm, as ensured by the rules of the GmbH.

Assuming that such lines are frequently drawn along small firm boundaries – which, in Germany, they usually are.

Of course, this diversity of ways to govern companies already existed. The argument here, however, is about incorporated companies and the legal personage (juristische Person), not about companies in general.

This dissertation takes a conscious decision not to use the term industrial order, but rather use the terms alternative economies, traditions of production, etc. to signify certain aspects of the more general term employed by Herrigel (and others).

This is Brigitta Young’s thesis of the Fraktionsstaat. Young argues that the German state has become far more centralized as a result of reunification, as evidenced in numerous changes of venue from larger, more open parliamentary committees to smaller ones made up only of the parties with Fraktion status,
which the parties have defined and continue to adjust themselves—outside the stipulation of the Basic Law. The changes have effects not only policy making, but the goals and strategies of political movements as well. See, for instance, Brigitta Young, "The Impenetrable German Fraktionsstaat and Feminist Politics," paper presented at the 92nd annual meeting of the American Political Science Association, San Francisco, August 28 to September 1, 1996.
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