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The relevance of long-term interests in the decision-making processes of company directors in the UK, Delaware and Germany: a critical evaluation

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Declaration

I confirm that this thesis has been composed by me, that the work contained in this thesis is my own, and has not been submitted for any other degree or professional qualification.

Katarzyna Chałaczkiewicz-Ładna
Old College, The University of Edinburgh
6 June 2016

Abstract

This thesis explores the extent to which the law in the UK, Delaware and Germany imposes an obligation on directors of solvent public companies to take into account the long-term consequences of their decisions while establishing the content and scope of long-termism in these three legal systems. It adopts a comparative methodology with the aim of determining whether the approaches taken in the chosen jurisdictions regarding both the parameters of long-termism and its legal sources and forms are radically different or very similar. It is also scrutinised here if it can be stated with any certainty that the approach taken in any particular jurisdiction regarding long-termism is 'better' for the protection of a company's interests.

This thesis makes four original contributions. Firstly, it conducts a comprehensive, comparative study on the relevance of long-term considerations. The concept of long-termism is analysed in the contexts of current legislation, case law, soft law, academic literature, and incentives that encourage long-termism decision-making. Secondly, hard law in the UK, Delaware and Germany does not currently offer much guidance regarding the content and scope of long-termism. A key original contribution made by this research draws on the academic literature and performs a gap-filling exercise by identifying examples of long-term decision-making in these jurisdictions, as well as examples of decision-making and conduct that is not long-term in nature. In the gap-filling exercise, case studies are presented in the context of (i) the contemporary shareholder v. stakeholder debate in corporate governance scholarship and (ii) the relevance of the share ownership structure of the company. These two important debates are used as variables to cast light on the ambit of the notion of long-termism, and the structural differences and similarities between the corporate governance systems and concepts of long-termism in the UK, Delaware and Germany. Thirdly, this thesis identifies specific and concrete factual examples of the incentives that the legal systems in the UK, Delaware and Germany do or could provide to encourage long-term managerial decision-making. Finally, it will make a positive contribution to the ongoing 'convergence v. divergence' debate, as the thesis has the scope to offer insights into whether the law on the duties of directors is converging in different legal systems particularly in the specific context of what is meant by long-term decision-making by such directors.

Lay summary

This thesis examines the extent to which the law in the UK, Delaware and Germany imposes the obligation on directors of public solvent companies to take into account the long-term consequences of their decisions and whether the approaches taken in the chosen jurisdictions differ. An analysis is offered as to whether the legal and practical frameworks enable, encourage or make it very difficult for directors to pursue long-termism in these legal systems. An essential part of this research is identifying the content and scope of long-termism.

The belief that short-term stock market trading undermines corporate decision making at the top has long been part of the corporate governance discourse and policymaking. Especially after the recent financial crisis, a discussion on the relevance of long-term value has flourished, as insufficient attention to long-term concerns by businesses is often cited as one of the causes of the global financial crisis and of the financial scandals involving, among others, Enron and WorldCom.

Chapter I. Introduction

1. The underlying problem

1.1 Introductory remarks

Consideration of the relevance of the long-term and short-term consequences of corporate decision-making has flourished subsequent to the economic crisis of 2008, which has often been portrayed as a debate about good v. bad corporate governance. The crisis was attributed, among other things, to an overemphasis on short-term shareholder value[1] (also referred to as 'pervasive short-term thinking'[2] or 'myopia'[3]), whereby the long-term concerns and consequences were overlooked by businesses.[4] Numerous articles, studies and reports were written, generating widespread debate about the ways in which short-term and long-term thinking impact upon corporate performance and the functioning of equity markets.[5] The overriding purpose of the research in this thesis is to contribute towards the scholarship on long-term v. short-term considerations.

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[1] Jingchen Zhao, 'Promoting More Socially Responsible Corporations through UK Company Law after the 2008 Financial Crisis: The Turning of the Crisis Compass' (2011) 22(9) ICCLR 275, 276, 281.

[2] Sheila Bair, 'Lessons of the Financial Crisis: The Dangers of Short-Termism' (Harvard Law School Forum on Corporate Governance and Financial Regulation, 4 July 2011) <http://blogs.law.harvard.edu/corpgov/2011/07/04/lessons-of-the-financial-crisis-the-dangers-of-short-termism/> accessed 11 February 2014.

[3] Lynne Dallas, 'Short-termism, the Financial Crisis and Corporate Governance' (2011) 37 JCorpL 265, 268.

[4] Shuangge Wen, 'The Magnitude of Shareholder Value as the Overriding Objective in the UK: The Post-crisis Perspective' (2011) 26(7) JIBLR 325, 326; Andrew Keay, 'The Global Financial Crisis: Risk, Shareholder Pressure and Short-termism in Financial Institutions. Does Enlightened Shareholder Value Offer a Panacea?' (Centre for Business Law and Practice School of Law, University of Leeds, Working Paper 2011) 10 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1839305> accessed 11 February 2014; Dallas, 'Short-termism' 268.

[5] See e.g. *The Kay Review of the UK Equity Markets and Long-Term Decision Making* (Final Report, July 2012) <http://www.bis.gov.uk/kayreview> accessed 2 July 2014; Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management* (9 September 2009) <http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/overcome_short_state0909_0.pdf > accessed 15 July 2014; Lucian Bebchuk and Jesse Fried, 'Paying for Long-Term Performance' (2010) 158 UPaLR 1915; Chartered Financial Analyst (CFA) Institute (Matthew Orsagh), *Visionary Board Leadership Stewardship for the Long Term* (2012) <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2012.n3.1> accessed 4 May 2015; Martin Lipton, Steven Rosenblum and Karessa Cain, 'Some thoughts for Boards of Directors in 2012' (Wachtell, Lipton, Rosen & Katz 2011) 2 <http://www.wlrk.com/files/2012/somethoughtsforboardsofdirectorsin2012.pdf> accessed 13 February 2014; David Gow, 'Learning German Long-termism' (5 December 2011) <http://www.policy-network.net/pno_detail.aspx?ID=4102&title=Learning-German-long-termism> accessed 25 April 2014.

This introductory Chapter is divided into three parts. Part 1 briefly discusses the relevance, prevalence and characteristics of both short-term and long-term considerations. Part 1 also specifies that long-term interests in the decision-making processes of company directors are under scrutiny in this thesis. Part 2 examines the objectives of this research by explaining the choice of jurisdictions and methodology applied. This part also outlines the research questions and original contribution that will be posed and offered. Finally, Part 3 outlines the organisation of this thesis and contains a synopsis of its chapters. A brief description of the concepts of short-termism and long-termism will now be offered.

1.2 The phenomenon of short-termism

Short-termism generally refers to a tendency to overvalue short-term rewards and gains (e.g. seeking to maximise quarterly earnings) which leads to an under-appreciation of long-term value creation, long-term strategies[6] and investments with a long-term payback, for example, in research, marketing or advertising.[7] It is apparent from the literature that only excessive short-termism, that is, short-termism pursued at the expense of long-term success or stability, is perceived to be problematic.[8]

The nature and sources of short-termism can be difficult to grasp. In the UK, for example, respondents to the Department for Business Innovation & Skills ('BIS'), Consultation Paper 'A Long-term Focus for Corporate Britain' commonly thought that short-termism exists in UK equity markets; however, they struggled to provide evidence of its scale and consequences.[9] Short-termism can be approached and perceived from different angles. It undeniably relates to the behaviour of various stakeholders: 'it is system-wide, with contributions by and interdependency among corporate managers, boards, investment

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[6] Kevin Laverty, 'Managerial Myopia or Systemic Short-termism? The Importance of Managerial Systems in Valuing the Long Term' (2004) 42 ManageDecis 949, 949; CFA Institute Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics (Dean Krehmeyer and Matthew Orsagh), *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value* (2006) 4 <http://www.npr.org/documents/2006/jul/shortterm2006.pdf> accessed 30 March 2015.

[7] Malcolm Salter, 'How Short-Termism Invites Corruption…And What to Do About It' (Working Paper 12-094, Harvard Business School and Edmund J Safra Centre for Ethics Harvard University 12.04.2012) 3 <http://www.hbs.edu/faculty/Publication%20Files/12-094_8260785f-0417-45d1-8abc-0afe86f87eaa.pdf> accessed 25 April 2014.

[8] Dallas, 'Short-termism' 268; CFA, *Breaking the Short-Term Cycle* 4. However, there is also the opinion that 'the notion of pervasive short-term investing is a figment of their opponents' imagination.' Emeka Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2012) 100 KyLJ 531, 534.

[9] BIS, *Summary of Responses: A Long-Term Focus for Corporate Britain* (March 2011) para 5 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207536/11-797-summary-responses-long-term-focus-corporate-britain.pdf> accessed 6 February 2014.

advisers, providers of capital, and government.'[10] It can also be caused by different and sometimes contradictory factors that involve a lack of investment or hyperactivity:

> Short-termism in business may be characterised both as a tendency to under-investment, whether in physical assets or in intangibles such as product development, employee skills and reputation with customers, and as hyperactive behaviour by executives whose corporate strategy focuses on restructuring, financial re-engineering or mergers and acquisitions at the expense of developing the fundamental operational capabilities of the business.[11]

It is worth asking why company leaders focus on short-term results when there is evidence that they prevent long-term benefits. The simplest answer is viability. Keay notes that:

> [I]f executive directors look to the long term they may feel that they are not likely to gain the praise and the benefits from enriching the company as their tenure is usually not very long, and by the time that the company benefits from a long-term strategy they will not be in the job.[12]

According to Bair: '[p]art of our tendency toward short-termism appears to be biological' and she argues that '[s]hort-termism also grows out of the institutional rules that govern our behaviour.'[13] The Kay Review adds that it is 'the natural human tendency to make decisions in search of immediate gratification at the expense of future returns: decisions which we subsequently regret.'[14] Can thus directors be blamed for their myopic behaviour?

1.3 Long-termism an effective weapon against short-termism?

Somewhat paradoxically, the expansion of short-termism in corporate governance practices and the financial markets has recently generated an opposing notion, contributing to interest in the development and diffusion of long-term thinking. The content and scope of this notion is also unclear and depends on many factors. First, the meaning of 'long-termism' varies depending on who is asking whether a decision or the conduct of a corporation is 'long-term' in nature, e.g. whether an investor, director, auditor, etc. Clearly, a decision, which is not a form of long-term decision-making, is likely to be an example of short-termism (that is, a tendency to consider far-sighted considerations and interests). But it does not tell us much about the parameters of long-termism.

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[10] Aspen Institute, *Overcoming Short-termism* 3.
[11] Kay Review 10.
[12] Andrew Keay, 'Getting to Grips with the Shareholder Value Theory in Corporate Law' (2010) 39 CLWR 358, 373. Writer's annotations throughout this thesis are shown in square brackets.
[13] Bair, 'Lessons of the Financial Crisis.'
[14] Kay Review para 1.1.

Nevertheless, the paradigm of long-term thinking is very powerful and it appears to be widely supported – at least in theory. According to Parkinson, the poor performance of companies in the UK in the 1990s was caused by 'a failure to cultivate long-term, co-operative relationships with employees and relationships in the supply chain of the kind that have just been described.'[15] The adoption of 'standards of conduct and behaviour that favour trust and good business in the long-term' has been put forward as one way of tackling corporate governance and financial markets problems.[16] For instance, the Aspen Institute notes the key role of long-term thinking:

> We believe that short-term objectives have eroded faith in corporations continuing to be the foundation of the American free enterprise system, which has been, in turn, the foundation of our economy. Restoring that faith critically requires restoring a long-term focus for boards, managers, and most particularly, shareholders — if not voluntarily, then by appropriate regulation.[17]

The concept of a 'visionary director' – a director that together with a visionary board is a necessary requirement for the promotion of the long-term benefit of all stakeholders – was created in the CFA 2012 report.[18] One of the most significant contributions to the discussion on long-termism is the 2012 report by Professor Kay – 'The Kay Review of the UK Equity Markets and Long-Term Decision Making'– where activity in UK equity markets and its impact on the long-term performance and governance of UK quoted companies was reviewed. The report highlights the need for boards and investors to take a longer view in order to 'support sustainable long-term value creation by British companies.' [19] The report's conclusion was that: 'short-termism is a problem in UK equity markets, and that the principal causes are the decline of trust and the misalignment of incentives throughout the equity investment chain.'[20] Long-termism is also promoted at the European level. The European Commission advocates the long-term financing of the European economy in order to foster economic growth.[21] Further, the European Commission is planning changes to the Shareholder Rights Directive to encourage long-term shareholder engagement and the

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[15] John Parkinson, 'Inclusive Company Law' in J de Lacy (ed), *The Reform of United Kingdom Company Law* (Cavendish 2002) 46-47.
[16] See e.g. Catherine Pedamon, 'Corporate Social Responsibility: A New Approach to Promoting Integrity and Responsibility' (2010) 31(6) CoLaw 172, 180.
[17] Aspen Institute, *Overcoming Short-termism* 2.
[18] CFA Institute, *Visionary Board Leadership Stewardship for the Long Term* 1.
[19] Kay Review 9.
[20] ibid.
[21] For papers that have been already published see <http://ec.europa.eu/finance/general-policy/financing-growth/long-term/index_en.htm> accessed 4 May 2015.

overarching aim of this project is 'to contribute to the long-term sustainability of EU companies.'[22]

The debate about long-term v. short-term considerations is ongoing and it is not difficult to find palpable tensions between long-term and short-term goals. Notwithstanding some of the evident benefits of long-termism; e.g. long-term projects and investments are arguably less risky, more sustainable and inclusive – 'factors like negative climate and environmental effects can be taken into account to a larger extent.'[23] Undeniably, long-termism should be encouraged sensibly, as it might cause damage in some instances. The Kay Review warns about detrimental consequences to companies of bad long-term managerial decisions.[24] Long-termism 'is not to be preferred just for its own sake if it yields poorer returns and wastes resources.'[25] Roe also argues that there is evidence of undervaluing but also *overvaluing* long-term value and one example of the latter are bubbles in technology and other new industries (e.g. the dot.com bubble).[26] Furthermore, there is a noticeable – and arguably justified – hostility towards the concept of long-termism resulting from the lack of certainty regarding its parameters. Respondents to the Review on 'A Long-Term Focus for Corporate Britain,' for example, commented on 'a lack of evidence that a more long-term approach would lead to better performance of the economy.'[27]

On the other hand, excessive short-termism might be harmful to a company. It seems clear that in some cases a short-term approach is beneficial and necessary for the corporation. Strand points out that short-termism can undoubtedly be a problem 'for the individual corporation, shareholder, or manager;' however, there is no evidence that this is 'a problem for the entire market' or that 'the negative effects of short-termism are worse than other types of distortions.'[28] Roe notes that the fact that economic life has become more short-term ought to be taken into consideration.[29] Duruigbo also claims that 'short-term

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[22] Proposal from April 2014, for a Directive of the European Parliament and the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (henceforth: 'New Shareholder Rights Directive') 2.

[23] Therese Strand, 'Re-thinking Short-termism and the Role of Patient Capital In Europe: Perspectives on the New Shareholder Rights Directive' (2014) 22 and the literature cited there <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2516844> accessed 14 January 2015.

[24] Kay Review 10.

[25] Mark Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' (2013) 68 Bus Law 978, 981.

[26] Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' 980. [emphasis in original]

[27] BIS, *Summary of Responses* para 44.

[28] Strand, 'Re-thinking Short-termism' 14, 22.

[29] Mark Roe, 'Corporate Short-Termism in the Fiscal Cliff's Shadow' (Harvard Law School Forum on Corporate Governance & Financial Regulation 20 December 2012)

investors provide much-needed liquidity and stability to the markets' [30] and several respondees to the BIS Consultation on 'A Long-Term Focus for Corporate Britain' mentioned that 'a short-term focus was not necessarily a bad thing – especially at a time of crisis.'[31]

Finally, there are observations that short-termism is unjustly blamed for all the mishaps in the corporate governance[32] and that 'the evidence that financial markets are excessively short-term is widely believed but not proven.'[33] According to Roe, an evaluation of the American economy from a system-wide perspective does not show that short-term tendencies are prevalent, although some corporations undeniably adopt a short-term focus. [34] Duruigbo even indicates that: '[t]he issue of short-termism has acquired sufficient currency that it has become easy, if not convenient, to attribute a host of corporate actions to the dominance of short–term thinking.'[35] In light of this brief discussion on the scope of the short-termism v. long-termism debate, the relevant aspects of this debate that form the subject of this research will now be outlined.

1.4 The notions of long-termism, short-termism and the current research

The scrutiny of the relevance of long-termism in the decision-making processes of public solvent companies is restricted in this thesis to the following jurisdictions: the UK, Delaware and Germany. An analysis is offered as to whether the legal and practical frameworks enable, encourage or make it very difficult for directors to pursue long-termism in these legal systems. An essential part of this research is to identify the content and scope of long-termism. Other aspects of the debate on the consideration of long-term and short-term interests will be analysed only if relevant in the context of directors' decision-making. This thesis does not consider the differences between the individual myopic or long-term acts, on the one hand, and institutional short-termism or systemic long-termism on the other. Moreover, this thesis does not analyse what came first: short-termist behaviour or the regulatory incentives that encourage it.

Because every company is different and every board operates in a unique environment, there is naturally no formula for the 'ideal' time horizon of decision-making; i.e. whether long-term, short-term decisions or any particular combination of both is the best

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<http://blogs.law.harvard.edu/corpgov/2012/12/20/corporate-short-termism-in-the-fiscal-cliffs-shadow/#more-37897> accessed 13 February 2014.
[30] Duruigbo, 'Tackling Shareholder Short-Termism' 534.
[31] BIS, *Summary of Responses,* para 12.
[32] Strand, 'Re-thinking Short-termism' 9, 10.
[33] Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' 1005.
[34] ibid 979-80.
[35] Duruigbo, 'Tackling Shareholder Short-Termism' 532.

for companies. Nevertheless, a few statements should be made at this point. Three observations can be made without any fear of controversy. First, it is almost indisputable that focusing only on short-term goals is detrimental for the company, even if it brings substantial immediate profits, since concentrating 'on short-term considerations damages the ability (…) [of companies] to sustain superior long-term performance.'[36] According to Mitchell, '[t]he problem of short-term managerial focus in American corporations is caused in large part by the legal and practical pressures on directors and managers to look exclusively to the interests of stockholders, resulting in managerial obsession with current profitability and stock price.'[37] This argument is applicable to any corporation in any jurisdiction.

Secondly, this thesis argues that consideration of long-term interests during decision-making processes is beneficial for the company and focusing the attention of directors on lengthening this time horizon is an indication of good corporate governance, as paying attention also to long-term factors and goals makes decision-making less risky, more stable, coherent and balanced. Taking into account the two points made above, it seems that balancing between both long-term and short-term considerations is required during the decision-making process: one cannot exist without the other. Some eminent commentators also share this opinion. For example, Gower notes that 'the directors should balance a long term view against the short term interests (…)' [38] and Keay advises that '[i]n maximizing for long-term value, directors should aim to balance seeking opportunities to make profits now with opportunities to make profits in the future.'[39]

On balance, having regard not only to the short-term but also long-term factors is a characteristic of holistic decision-making. At the same time, it is a challenge to assess whether long-term or short-term decisions and conduct are unequivocally good or bad for companies when viewed in the abstract. However, this thesis focuses solely on encouraging long-term decision-making. In order to underline its importance, the relevance and parameters of long-termism are scrutinised. Having drawn this rough picture of the debate on the relevant time horizons for decision-making, the objectives of this research will now be explained in greater detail.

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[36] Committee for Economic Development (CED), *Built to Last: Focusing Corporations on Long-Term Performance, A Statement by the Research and Policy Committee of the CED* (2007) 1 <https://www.ced.org/pdf/Built-to-Last.pdf> accessed 21 July 2015.
[37] Lawrence Mitchell, 'A Critical Look at Corporate Governance' (1992) 45 VandLRev 1263, 1283.
[38] Laurence Gower, 'Corporate Control: The Battle for the Berkeley' (1955) 68 HarvLRev 1176, 1185.
[39] Keay, 'Getting to Grips with the Shareholder Value Theory' 375; see similarly John Nesbitt, 'The Role of Short-Termism in Financial Market Crises' (2009) 19(4) AustrAccountRev 314, 317; Deryn Fisher, 'The Enlightened Shareholder - Leaving Stakeholders in the Dark: Will Section 172 (1) of the Companies Act 2006 make Directors Consider the Impact of their Decisions on Third Parties' (2009) ICCLR 10, 12.

2. Thesis objectives

2.1 Research questions

The main objective of this project is to examine how the concept of long-termism is approached and what its content and scope is in the UK, Delaware and Germany. Conducting the research from this narrow perspective enables a close exploration of long-termism to be made and renders the research exact, precise, and accurate. Adopting this as the scope of this thesis will enable similarities or conceptual differences between the jurisdictions to be identified, and will enable the jurisdictions to learn from the experience of the others.[40] It should be stressed, that the subject of this thesis is not to suggest a legal transplant from one jurisdiction to another. This thesis focuses on three main research questions:

1. First, are the approaches taken in the chosen jurisdictions regarding the content and scope of long-termism radically different or very similar?

2. Secondly, to what extent do the legal sources and forms of long-termism differ in these jurisdictions? Is there any evidence of convergence in the respective approaches, or are they sufficiently divergent to warrant the conclusion that they are wholly diverse?

3. Following on from this, the thesis examines if it could be stated with any certainty that the approach taken in any particular jurisdiction is 'better' for the protection of a company's interests.

Each of these research questions will be answered by analysing the law of the three aforementioned jurisdictions. These answers play a crucial role in formulating and developing original contribution made by this thesis.[41]

2.2 Methodology

The research questions outlined above indicate that this thesis is comparative in character. It is important to explain briefly the nature of comparative law. Zweigert and Kötz accurately grasp its spirit: '[t]he words suggest an intellectual activity with law as its object and

[40] Dannemann notes that 'learning between legal systems is the principal aim of comparative enquiries which look abroad in order to solve a problem at home,' although it is admitted that not all comparative studies are interested in learning from other systems. Gerhard Dannemann, 'Similarities or Differences?' in Mathias Reimann and Reinhard Zimmermann, *The Oxford Handbook of Comparative Law* (OUP 2006) 417.
[41] Original contribution is discussed in para 2.4 below.

comparison as its process. (…) "[C]omparative law" is the comparison of the different legal systems of the world.'[42] Comparative law is also perceived as a 'knowledge generator,' i.e. dialectic between the domestic and foreign body of law.[43] Moreover, Örücü points out that '[i]n comparative law research, the obvious method is comparison, that is, juxtaposing, contrasting and comparing.'[44] Comparison is an ideal tool, not only for getting a deeper knowledge of the law of a particular or various jurisdictions, but the juxtaposition of different solutions allows us to put them into a broader perspective and context, which in turn results in a more thorough and comprehensive understanding of the law in general. Grossfeld expresses this perfectly by stating that: '[f]or me the greatest value of comparative law lies in the deeper insight it gives into the phenomenon of law itself.'[45]

In spite of the undeniable merits of comparative law, problems emerge when choosing an appropriate method for comparison. The methodology must be carefully selected since '[t]he application of a proper method suitable for a specific piece of research is generally a prerequisite for success in any area of study.'[46] There is no agreement among scholars on how to conduct comparisons. The approaches include 'traditional approach,'[47] 'functional method,'[48] or 'common core studies.'[49] Taking into account the different approaches to comparative methodology, the subject of this thesis and all the constraints related to comparative studies, the functional method has been chosen, as it emphasises that institutions that actually have a similar function must be compared and not the ones that seem similar on the surface. The founders of this method – Zweigert and Kötz – indicate that '[t]he basic methodological principle of all comparative law is that of *functionality*' adding that '[i]ncomparables cannot usefully be compared, and in law the only things which are

[42] Konrad Zweigert and Hein Kötz, *An Introduction to Comparative Law* (Tony Weir tr, 3rd edn, OUP 1998) 2.
[43] Geoffrey Samuel, *An Introdcution to Comparatice Law Theory and Method* (Hart Publishing 2014) 11. The author also suggests the other approach to comperative law at 12-13.
[44] Esin Örücü, 'Methodology of Comparative Law' in Jan Smits (ed), *Elgar Encyclopedia of Comparative Law* (2nd edn, Edward Elgar 2012) 565.
[45] Bernhard Grossfeld, *The Strength and Weakness of Comparative Law* (Tony Weir tr, OUP 1990) 115.
[46] Örücü, *Methodology of Comparative Law* 566.
[47] Known also as a 'black letter' comparison, it 'engages in comparative law through the "law as a rule" approach.' Esin Örücü, 'Developing Comparative Law' in Esin Örücü and David Nelken (eds), *Comparative Law: A Handbook* (Hart Publishing 2007) 49.
[48] Zweigert and Kötz, *An Introduction to Comparative Law* 32ff. See the discussion below. Note also that Michaels, for example, distinguishes at least seven different concepts of functionalism. Ralf Michaels, 'Functional Method of Comparative Law' in Mathias Reimann and Reinhard Zimmermann, *The Oxford Handbook of Comparative Law* (OUP 2006) 344ff.
[49] The aim of this approach is to describe 'commonalities among legal systems hidden below apparent differences.' Ugo Mattei, Teemu Ruskola and Antonio Gidi, *Schlesinger's Comparative Law: Cases, Text, Materials* (7th edn, Foundation Press 2009) 98.

comparable are those which fulfil the same function.'[50] However, the functional method has a disadvantage for this research in that it arguably concentrates too much attention on the similarities between legal systems. 'The legal system of every society faces essentially the same problems, and solves these problems by quite different means though very often with similar results,' [51] consequently it almost amounts to a *praesumptio similitudinis*, a presumption that the practical results are similar.[52]

The authors of the functional method clearly intend the presumption of similarity to have a limited scope of application since it applies only to the 'unpolitical' parts of private law, excluding 'the topics which are heavily impressed by moral views or value' (like family or succession law).[53] Still there is no agreement in the literature about whether the legal systems actually face the same problems and the practical results are the same in the end. The functional approach is heavily criticised by Michaels who points out that it is 'only one of several approaches towards microcomparison,'[54] i.e. that there is more than one functional method, not all functional methods are actually 'functional' and not all its supporters actually follow it. [55] De Cruz acknowledges the general relevance of the functional method, but also notes that 'it is too much of a generalisation to suggest that there should be a presumption that the practical results will invariably be the same in every, or even most, legal system.'[56] Despite these critiques, the functional approach is still significant for harmonisation and unification projects, such as the European Union.[57]

Leaving aside these disputes, it is stressed that the functional method is not useful if it is the only approach employed. This research focuses on evaluating the concept of long-termism considering both similarities and differences, rather than concentrating only on emphasising similarities. This is necessary and is the most reasonable approach, which allows identifying the examples of divergence or convergence between the legal systems. This research might conclude that the three jurisdictions apply similar solutions; however, the presumption of similarity is not the aim of this study. Some researchers focus solely on

[50] Zweigert and Kötz, *An Introduction to Comparative Law* 34 [emphasis in original].
[51] ibid 34.
[52] ibid 40 [emphasis in original].
[53] ibid.
[54] Michaels, 'Functional Method of Comparative Law' 341.
[55] ibid 342.
[56] Peter de Cruz, *Comparative Law in a Changing World* (3rd edn, Routledge-Cavendish 2007) 239.
[57] Örücü, *Developing Comparative Law* 51; Dannemann*, Similarities or Differences?* 388-89. Further, Adams and Heirbaut underline that '[i]deas of functionality and of functional equivalence (still) play a preminent role in comtemporary comparative scholarship.' Maurice Adams and Dirk Heirbaut, 'Prolegomena to the Method and Culture of Comparatoce Law' in Maurice Adams and Dirk Heirbaut (eds), *The Methods and Culture of Comparative Law. Essays in Honour of Mark Van Hoecke* (Hart Publishing 2014) 8-9.

differences between legal systems when describing the method of comparative law.[58] Legrand – one of the most prominent representatives of the 'priority of difference' approach – remarks that '[u]ltimately, all linguistic, social and cultural activity is grounded in differential thinking, if only because of the originary and irreducible distance between word and object, between self and other. But difference is polymorphous and need not be apprehended as divisive and impoverishing.'[59] This narrow approach is not of much help for this research.

Few scholars promote the study of both similarities and differences;[60] however, currently it is far from clear whether the construction of similarities and differences is the method itself or a modified version of the functional method. Jansen notes that '[t]he core of comparative knowledge consists in a structured system of similarities and differences of the objects compared.'[61] Dannemann points out that 'it is often the right mixture of difference and similarity which makes comparative enquiries particularly attractive.[62] To conclude, the proper balance between a functional method and looking for similarities and differences[63] is considered the best approach for this study and the techniques employed will adequately and effectively fulfil the aims of this thesis. Having clarified the comparative methodology employed in this thesis, in the next section the reasoning behind the choice of the specific jurisdictions will be considered.

2.3 Jurisdictions under review

UK, German and Delaware law are compared in this research since 'long-termism' is a dynamic concept in each of them in different ways and at different levels. The topic is particularly well-discussed in the Anglo-American literature. The UK has been chosen because the Companies Act 2006[64] introduced a duty enjoining directors to promote the success of the company.[65] This provision is ambiguous and unclear because it consists of a complex amalgam of a standard of conduct and a standard of review. A need has arisen to examine to what extent the law imposes on directors an obligation to account for the long-

[58] See the summary of the main theories: Dannemann, *Similarities or Differences?* 389ff.
[59] Pierre Legrand, 'The Same and the Different' in Pierre Legrand and Roderick Munday, *Comparative Legal Studies: Traditions and Transition* (CUP 2003) 241.
[60] Dannemann, *Similarities or Differences?* 384ff; Nils Jansen, 'Comparative Law and Comparative Knowledge' in Mathias Reimann and Reinhard Zimmermann, *The Oxford Handbook of Comparative Law* (OUP, 2006) 305ff.
[61] ibid 336.
[62] Dannemann, *Similarities or Differences?* 419.
[63] The approach applied in this research resembles the one formulated by Reitz. John Reitz, 'How to do Comparative Law' (1998) 46 Am JCompL 617, 620.
[64] Companies Act 2006 c 46 (henceforth: 'CA 2006').
[65] s 172 CA 2006.

term consequences of their decisions. Delaware law was selected as a proxy for US law since it is a leading common law jurisdiction in the US – 66% of all Fortune 500[66] companies and more than 50% of companies whose securities trade on the main exchanges, e.g. the NYSE or Nasdaq[67] are incorporated in Delaware. Bainbridge justifies the study of Delaware law since it provides a substantial amount of cases that 'allows questions to be answered with confidence,' boasts a separate court, the Court of Chancery to adjudicate corporate disputes, and the professionalism and expertise of the judges in the jurisdiction.[68] Long-termism is not a component of the directors' duties in Delaware but there is a rich discussion on the long-term considerations in the literature and the notion is debated to some extent in the case law. Delaware law is the focal point of the research in this thesis on the US; however, reference is sometimes made to US federal law or to important debates in the American academic literature. Furthermore, since German law is one of the leading European jurisdictions, the aim is to examine if any guidance on the parameters of long-termism can be taken from the duty of a company director to demonstrate due diligence and duty of loyalty (*Treupflicht*). The role the long-term decision-making plays in this jurisdiction will also be scrutinised. Similarly to the position in Delaware, German law does not discuss long-termism in the context of directors' duties. However, the remuneration structure of the management board in the German listed company 'shall be aimed at the company's sustainable development'[69] and according to the German Corporate Governance Code, the company should be managed 'with the objective of sustainable creation of value.'[70] Owing to the fact that Germany is traditionally portrayed as a stakeholder value jurisdiction – it is believed to have an 'in-built tendency to long-termism.'[71]

The three jurisdictions have been chosen not only because they are influential, but also because they are very attractive from a comparative perspective. The study of these systems will allow not only a better understanding of the notion of long-termism during the decision-making processes in these jurisdictions, but will also cast some light on the

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[66] The list of the US top 500 closely held and public companies.
[67] DLA Piper, 'Delaware Corporate Law and Litigation: What Happened in 2014 and What it means for You in 2015' (12 January 2015) 3 <https://www.dlapiper.com/~/media/Files/Insights/Publications/2015/01/FINAL20142015AnnualDelawareCorporateLitigationReview.pdf> accessed 7 May 2015.
[68] Stephen Bainbridge, *Corporate Law* (2nd edn, Foundation Press 2009) 9.
[69] § 87 (1) 2 *Aktiengesetz* (Stock Corporation Act), as of 6 September 1965 (BGBl I, 1089) (henceforth: 'AktG'). Translation as at 1 December 2011, by Norton Rose <http://www.nortonrose.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf> accessed 14 May 2015. (The translation of the AktG prepared by Norton Rose is used in this thesis, unless provided otherwise).
[70] § 4.1.1 German Corporate Governance Code, as amended on 5 May 2015 with decisions from the plenary meeting of 5 May 2015 (*Deutscher Corporate Governance Kodex*) (henceforth: 'Kodex').
[71] John Plender, 'Giving People a Stake In the Future' (1998) 31 LongRangePlann 211, 211.

management of the companies in general and identify any patterns in that respect. Broader, general debates in comparative company law (e.g. the discussion on the differences regarding the board structure, the role of case and soft law, division of power within the company and shareholder activism) will be scrutinised within the context of the UK, Delaware and German law.

There are some substantial dissimilarities between UK and Delaware law, on the one hand, and German law, on the other – which have the potential to affect the parameters of long-termism. UK and Delaware law belong to the common law tradition with a well-developed body of case law, whilst Germany inherited the civil law tradition – the legal culture of which is to rely on code-based regulation.[72] It is still vigorously debated whether judge-made law in common law jurisdictions is more efficient (due to more independent and less formalised judicial systems) than code-based systems.[73] On the other hand, the division between civil and common law is arguably currently eroding. For example, '[i]n the area of company law, German courts clearly break the mould of robotic obedience to the law's letter that uninformed commentators on contemporary [c]ivil [l]aw would impose' [74] and this area of law is developing now considerably in Germany through judicial decisions.[75] It has also been noted that 'today both civil and common law regulate and codify'[76] company law. For instance, in the area of company law in Delaware the Delaware General Corporation Law ('DGCL')[77] is the leading source and in the UK, the Companies Act 2006 is the relevant statutory source, which is the most detailed legislation regarding company law among the jurisdictions under review. The introduction of the Kodex is an indication of civil law adopting some common law modes. From this perspective, it will be interesting to observe whether the current research on the relevance of long-term considerations confirms to the traditional preconceptions about common and civil law systems.

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[72] The 'legal origins' theorists believe, for instance, that legal families – especially civil and common law systems – differ markedly, and that common law countries offer much better investor protection (both shareholders and creditors) – see e.g. and others, 'Law and Finance' (1998) 106 JPolitEcon 1113; Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, 'The Economic Consequences of Legal Origins' (2008) 46 JEL 285. These studies have been extremely influential. However, there have been also many critiques of the methodology applied and the conclusions reached through it. See e.g. Udo Braendle, 'Shareholder Protection in the USA and Germany - "Law and Finance" Revisited' (2006) 7 GLJ 257; Holger Spamann, 'The "Antidirector Rights Index" Revisited' (2010) 23 Rev Finance Stud 468; Priya Lele and Mathias Siems, 'Shareholder Protection – A Leximetric Approach' (2007) 7 JCLS 17.

[73] La Porta, Lopez-de-Silanes and Shleifer, 'Economic Consequences' 298.

[74] Andreas Cahn and David Donald, *Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany the UK and the USA* (CUP 2010) 15.

[75] ibid.

[76] Mark Roe, 'Legal Origins, Politics and Modern Stock Markets' (2006) 120 HarvLR 460, 475.

[77] Title 8, ch 1 Delaware Code.

Apart from the general common and civil law division, there are also other differences; e.g. in the board structure (Germany has a two-tier board structure whereas the US and the UK have single boards)[78] and the share ownership structure of the large publicly listed limited corporations in each of these jurisdictions. Traditionally, Germany is perceived to have an 'insider' corporate governance system – where share ownership is concentrated in the hands of families, banks, etc. with identifiable controlling shareholders, while the UK and US are generally characteristic of 'outsider' corporate governance systems; with more widely dispersed shares.[79] The differences in the share ownership structure are the source of different 'agency problems' or 'agency costs,' For instance, Germany suffers mostly from 'horizontal' agency problems between majority and minority shareholders and the UK and US experience 'vertical' problems between managers and shareholders as a class.[80]

This study not only points out the similarities and differences between the UK and Delaware on the one hand and Germany on the other, it also compares both common law jurisdictions regarding the parameters of long-termism and identifies different attitudes towards this concept in the UK and Delaware. Finally, the role of the UK as a linking jurisdiction between Germany and Delaware is scrutinised: '[a]s a jurisdiction with a [c]ommon [l]aw system that has significantly influenced US law, and as a member state of the European Union that, like Germany, must implement EU directives and obey EU regulations and ECJ decisions (…).'[81]

A final point to be made in this section is to note that comparative research offers challenges. The concerns relating to the choice of the appropriate methodology and the difficulty in ensuring that the subject of the research is comparable were mentioned above. Linguistic,[82] terminological, and cultural differences between the jurisdictions had to be overcome to complete the research. The dearth of primary sources regarding the actual parameters of what is meant by long-term interests during decision-making, made it necessary to study the general directors duties to reflect on the content and scope of long-termism and to look beyond the formal legal rules to extra-legal sources such as soft law and

[78] The board structure is analysed in Chapter II below.

[79] William Bratton and Joseph McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' in Joseph McCahery and others, *Corporate Governance Regimes, Convergence and Diversity* (OUP 2002) 26; Mark Roe, 'Some Differences in the Corporation Structure in Germany, Japan, and the United States' (1993) 102 Yale LJ 1927, 1936. See Chapter V s 1.2 below for a more detailed analysis of share ownership structure in the jurisdictions under review.

[80] John Armour, Henry Hansmann and Reinier Kraakman 'Agency Problems and Legal Strategies' in Reinier Kraakman and others, *The Anatomy of Corporate Law* (2nd edn, OUP 2009) 36; Mark Roe, 'The Institutions of Corporate Governance' in Claude Ménard and Mary Shirley (eds), *Handbook of New Institutional Economics* (Springer 2008) 372-375.

[81] Cahn and Donald, *Comparative Company Law* 19.

[82] Örücü expressed her concerns regarding problems with translation. Esin Örücü, *The Enigma of Comparative Law: Variations on a Theme for the Twenty-first Century* (Martinus Nijhoff 2004) 164ff.

secondary academic literature. After identifying the research aims, methodology and jurisdictions under review, the critical element, i.e. the original contribution of these studies will now be scrutinised.

2.4 Original contribution

The original contribution made by this thesis is fourfold:

1. First, the thesis performs a gap-filling exercise. The hard law in the UK, Delaware and Germany does not currently offer much guidance regarding the content and scope of long-term managerial decision-making. This thesis draws on existing academic literature in order to identify specific and factual examples of long-termism, as well as exampes of decision-making and conduct that is not long-term in nature. In the gap-filling exercise, case studies are presented in the context of (i) the contemporary shareholder v. stakeholder debate in corporate governance scholarship and (ii) the relevance of the share ownership structure of the company. These two important debates are used as variables to cast light on the ambit of the notion of long-termism and the structural differences and similarities between the corporate governance systems and corporate cultural conditions in each of these jurisdcitions. Due to these differences not all of the specific examples will hold in each legal system e.g. some will apply in the UK and Delaware, but not necessarily Germany and vice versa.

2. Secondly, this research conducts a comprehensive comparative study on the relevance of long-term considerations during the decision-making processes of the directors/managers of solvent public companies in the UK, Delaware and Germany, i.e. publicly owned companies whose shares are listed on the relevant stock exchange. The current state of affairs is critically assessed and some reforms are proposed. This research presents long-termism in a holistic way: the legislation, case law and soft law are analysed in detail, scholars' interpretation of long-term decision-making in the academic literature is scrutinised and finally incentives that encourage long-termism are presented.

3. Thirdly, this thesis identifies specific and concrete factual examples of the incentives that the legal systems in the UK, Delaware and Germany do or could provide to encourage long-term managerial decision-making. Notably, these incentives are tailored to the differing legal families, overarching corporate objectives, share ownership structures, corporate governance and corporate cultural condictions in each of the three jurisdcitions.

4. Last but not least, this thesis intends to make a positive contribution to the ongoing 'convergence v. divergence' debate. The thesis has the scope to offer insights into

whether and to what extent the law on the duties of directors is converging (formally or functionally) in different legal systems, particularly in the specific context of what is meant by 'long-term' decision-making by such directors/managers.

Recent scholarship shows that there is no agreement as to whether divergence or convergence is happening among European and American corporations. In a very influential article, entitled 'The End of History for Corporate Law,' Kraakman and Hansmann recognised convergence as a dominant factor. They believe that there are 'forces pressing toward international convergence on a relatively uniform standard model of corporate law. Those forces include the internal logic of efficiency, competition, interest group pressure, imitation, and the need for compatibility.'[83] Ultimately, they argue that the Anglo-American shareholder-orientated model of the corporation has triumphed over other models and that the legal systems of the world will converge to this model.[84]

The article by Kraakman and Hansmann has provoked immense discussion and a sharp critique.[85] The hegemony of Anglo-American corporate governance appears to be dubious in the current economic climate. For instance, recent scandals in leading US corporations, including Enron, WorldCom, Tyco and Adelphia, have affected the convergence debate and have revealed important corporate governance problems. Arguably, these scandals prevented the US model from claiming the prize as the 'best in show.'[86] Further, many commentators have argued that there are inherent differences in the corporate law rules across the legal systems and that 'path dependence' presents a formidable obstacle to any convergence. This theory argues there are differences between the corporate governance systems, because of historical, political and social events and these differences are likely to persist in the future.[87]

Whether the business corporations in all of the jurisdictions under review have a fundamentally similar set of legal characteristics and face a similar set of legal problems will be explored in order to determine whether convergence or divergence is taking place in the studied areas. The thesis will also assess whether any of the national corporate governance

[83] Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 Geo LJ 439, 453.
[84] ibid 468.
[85] Branson notes that this paper is 'a chauvinistic statement of the Americanocentric convergence thesis.' Douglas Branson, 'The Very Uncertain Prospect of "Global" Convergence in Corporate Governance' (2001) 34 CornellInt LJ 321, 330-31.
[86] Jeffrey Gordon and Mark Roe in Jeffrey Gordon and Mark Roe (eds), *Convergence and Persistence in Corporate Governance* (CUP 2004) 5.
[87] Lucian Bebchuk and Mark Roe, 'A Theory of Path Dependence in Corporate Ownership and Governance' in Gordon and Roe (eds), *Convergence and Persistence in Corporate Governance* 69ff. In this chapter, the authors show 'that there are significant sources of path dependence in a country's patterns of corporate ownership structure.'

systems under review possess any relative competitive advantages, as will whether it is reasonable for the systems to converge. Whether formal (the increased similarity of the legislative structure) or functional convergence (the existence of legal frameworks that serve similar functions) is taking place, or is more likely to happen in the near future will be studied. Gilson describes functional and formal convergence in the following manner:

> [F]unctional *convergence,* when existing governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; *formal convergence,* when an effective response requires legislative action to alter the basic structure of existing governance institutions (…).[88]

Finally, differences in ownership structures and corporate objectives will be analysed in relation to the divergence theory to determine if differences still exist between Germany on the one hand, and Delaware and the UK on the other and whether they affect the nature of long-termism.

3. Organisation of this thesis

In order to provide an answer to the research questions, the thesis is structured as follows. Chapter II has an introductory character and provides background knowledge on the role and structure of the board of directors (in the UK and Delaware) and management board (in Germany) in public companies. A clear understanding of the national frameworks is vital for the success of this comparative research. Chapter III evaluates the primary sources; i.e.: the legislation, case law and corporate governance codes in order to put the notion of long-term decision-making into a legal context. It ascertains, firstly, whether the long-term interests in the decision-making processes of company directors are relevant in circumstances where a company is solvent. Secondly, Chapter III seeks to establish the content, nature and breadth of long-term decision-making according to the primary sources. It begins with an analysis of some key corporate law concepts: the position of a director as a fiduciary, the role of standards in directors' duties and it also sets out directors' duties in the UK, Delaware and Germany. Subsequently, Chapter III draws on these notions and scrutinises long-term decision-making in the context of directors' duties, case law and corporate governance codes. This discussion is followed by comparative conclusions.

Together with Chapter IV, Chapter V carries out the research on the relevance and content of long-termism according to the secondary sources of law (i.e. the academic

[88] Ronald Gilson, 'Globalizing Corporate Governance: Convergence of Form and Function' (2001) 49 AmJCompL 329, 356.[emphasis in original]

literature). First of all, the approaches and views of commentators on the role of long-termism are underlined. However, these chapters centre upon an examination of the parameters of long-termism through the prism of the practical case studies – i.e. it performs a gap-filling exercise. These case studies are presented in the context of two important debates: shareholder v. stakeholder theories and a discussion of the relevance of the predominant share ownership structure of companies in the jurisdictions under review. This invocation of specific fact patterns is undertaken in order to examine whether a specific decision is an instance of short- or long-termism in the UK, Delaware and Germany, i.e. to furnish concrete examples of long-term decision-making. This analysis is followed by comparative conclusions on the gap-filling exercise. In Chapter VI, the focus will shift to the incentives that might serve to foster long-term decision-making in the UK, Delaware and Germany. It is critical to examine some important factors and mechanisms that currently incentivise, or could potentially incentivise managerial long-term decision-making in the future. Incentives are an effective way of encouraging long-termism, as the system of incentives makes directors personally interested in achieving the long-term goals. In Chapter VI, four of the most topical incentives are outlined and critically assessed: executive remuneration, quarterly reporting, the board's tenure and finally shareholders' influence on the board's decision-making. Chapter VII draws on the approach of this thesis and scrutinises the arguments for the convergence and divergence between the legal systems with regard to long-term decision-making. Finally, it suggests some developments with regard to the future of long-termism.

Chapter II. The board of directors and the management board – structure and role

1. Introduction

As outlined in Chapter I, this thesis analyses the extent to which long-term considerations are relevant in the decision-making processes of company directors in public solvent companies in the UK, Delaware and Germany with a view to supplying specific examples of long-term conduct. Before discussing the notion of long-termism in detail, this chapter provides some background information on the company laws of the three jurisdictions compared in this thesis. It examines the role and structure of the board of directors in public companies (also considering publicly traded companies),[89] which gives useful insights and a broader context into the discussion on long-termism. This chapter discusses the structure and role of board of directors in the UK, Germany and Delaware. It sets out the relevant law in the three jurisdictions under review, analyses who can be a director in each legal system, and what the structure and composition of the board should be. It then scrutinises the appointment and removal of directors and considers the role that the board plays in the company. This chapter also briefly evaluates the division of power between the board and shareholders.[90]

2. The United Kingdom

2.1. The structure and composition of the board of directors

In the UK, companies are divided into private and public.[91] A public company is:

> [A] company limited by shares or limited by guarantee and having a share capital (…) whose certificate of incorporation states that it is a public company, and (…) in relation to which the requirements of this Act, or the former Companies Acts, as to registration or re-registration as a public company have been complied with on or after the relevant date.[92]

[89] Companies whose securities are traded on a public market.
[90] The different aspects of the debate on the division of powers within the company are discussed in more detail further in this thesis. Chapter III evaluates directors' duties. Chapter III and IV analyse the corporate objectives in the jurisdictions under review and Chapter V discusses share ownership structure of the companies in different legal systems and the conflicts that it generates.
[91] s 4 CA 2006.
[92] s 4 (2) ibid.

The Companies Act 2006 is the main statute that regulates companies in the UK. Companies are additionally regulated by: the Companies Act 1985,[93] the Financial Services and Markets Act 2000,[94] the Insolvency Act 1986,[95] common law rules, European legislation, the Financial Conduct Authority's Listing Rules,[96] the City Code on Takeovers and Mergers,[97] and the UK Corporate Governance Code.[98] Unlike private companies, public companies are permitted to offer or allot shares or securities to the public.[99] The CA 2006 specifies that '[a] public company must have at least two directors'[100] and at least one director who is a natural person.[101] However, '[t]his requirement is met if the office of director is held by a natural person as a corporation sole or otherwise by virtue of an office.'[102] The CA 2006 fails to define the term 'director,' stating only that it 'includes any person occupying the position of director, by whatever name called.'[103] What 'occupying the position of a director' means is not defined.

Traditionally, the UK has a one-tier board system. The Companies Act 2006 does not explicitly sanction the unitary board (but it refers to a 'board of directors' on various occasions)[104] and only the UK Code – whose applicability is limited – describes the board as 'unitary.'[105] The UK Code is applicable to a listed company incorporated in the UK.[106] The Listing Rules of the Financial Conduct Authority require such a company to supply a statement detailing whether a company has complied or failed to comply with the provisions set out in the UK Code.[107] The statement regarding compliance or reasons for non-

[93] Companies Act 1985 c 6.
[94] Financial Services and Markets ('FSMA') Act 2000 c 8.
[95] Insolvency Act 1986 c 45.
[96] United Kingdom Listing Authority listing rules are available at: <https://fshandbook.info/FS/html/FCA/LR> accessed on 26 August 2015.
[97] The City Code on Takeovers and Mergers is available at: <http://www.thetakeoverpanel.org.uk/the-code/download-code> accessed on 26 August 2015.
[98] The UK Corporate Governance Code (the 'UK Code') September 2014, Financial Reporting Council (FRC), available at: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf> accessed on 26 August 2015.
[99] s 755 (1) CA 2006.
[100] s 154 (2) ibid.
[101] s 155 (1) ibid. Note that s 87 of the Small Business, Enterprise and Employment Act 2015 c 26 specifies that every director must be a natural person (with some limited exceptions). This provision is scheduled to come into force in October 2016. See: <https://www.gov.uk/government/news/the-small-business-enterprise-and-employment-bill-is-coming> (accessed on 26 August 2015).
[102] s 155 (2) CA 2006.
[103] s 250 ibid.
[104] For example, ss 414, 414D, 419, 422, 433, 445 ibid.
[105] A.4 Main Principle UK Code.
[106] A company admitted to the 'official list' (s 74 FSMA), which is maintained by the Financial Conduct Authority and trading on the main market of the London Stock Exchange.
[107] The Financial Conduct Authority (FCA), Listing Rules, r 9.8.6(5).

compliance must be included in the director's report.[108] The UK Code is thus 'soft law' and operates on a 'comply or explain' basis.

The one-tier board system means that one body fulfils both the managerial and supervisory functions in the UK. There is no employee representation on the board. The UK Code provides that directors can be divided into executive directors (with managing duties) and non-executive directors (NEDs) (with supervisory functions).[109] The Code discusses the composition of the board in detail.[110] Therefore, even though according to the Code the board has a unitary character, directors fulfil different roles. The company employs executive directors full-time, and they are responsible for the day-to-day conduct of the company's business.[111] NEDs, on the other hand, perform a controlling and advisory role. They do not hold full-time posts 'and are not commissioned with the task of overseeing the daily operations of the company.'[112] NEDs 'should constructively challenge and help develop proposals on strategy.'[113] The UK Code describes their role further:

> Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.[114]

The chief executive officer ('CEO') and the chairman are the most prominent directors in the company. The CEO 'has overall responsibility for the management of the company's affairs'[115] and '[t]he chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.'[116] The UK Code underlines that '[t]he roles of chairman and chief executive should not be exercised by the same individual.'[117] In the same vein, Clarke points out that in the UK the role of the CEO and the chairman is usually

[108] s 419A CA 2006.
[109] See e.g. Principles A3, A4, B1 UK Code.
[110] B1 ibid.
[111] Andrew Keay, *Directors' Duties* (2nd edn, Jordan Publishing 2014) 10.
[112] ibid.
[113] A.4 Main Principle UK Code.
[114] A.4 Supporting Principle ibid.
[115] Keay, *Directors' Duties* 10.
[116] A. 3 Main Principle UK Code.
[117] A.2.1 ibid.

separated.[118] Having discussed briefly the role of the board of directors, the appointment, removal of directors and structure and composition of the board will now be scrutinised.

2.2. The appointment and removal of directors

Little detail can be found in the CA 2006 regarding the appointment of directors. The Act discusses the minimum age for appointment[119] and section 160 (1) of the CA 2006 articulates that the appointment of directors of a public company must be voted on individually. The UK Code requires only 'a formal, rigorous and transparent procedure for the appointment of new directors to the board.'[120] Hence, the articles of association mainly deal with the appointment of directors and leave a lot of freedom in that respect. Section 18 (1) of the CA 2006 states that '[a] company must have articles of association[121] prescribing regulations for the company.' The articles of association of a public company are based on the Model Articles for Public Companies,[122] except to the extent that the latter are modified or disapplied by the company.[123] The Model Articles describe two methods of appointing directors. Namely, '[a]ny person who is willing to act as a director, and is permitted by law to do so, may be appointed a director (…) by ordinary resolution,[124] (…) or by a decision of the directors.'[125] Naturally, due to the possibility of amending the articles, the appointment of directors can proceed differently. In comparison to the appointment, the CA 2006 provides a mandatory provision regarding the removal of a director. The position of a director in the UK is relatively weak, as '[a] company may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding

[118] Thomas Clarke, *International Corporate Governance: A Comparative Approach* (Routledge 2007) 48.
[119] ss 157-159 CA 2006.
[120] B.2 Main Principle UK Code.
[121] The articles of association are part of a company's constitution (Part 3 CA 2006). According to ss 17 and 257 CA 2006 references in the Acts to a company's constitution include: the articles of association; resolutions and agreements affecting the company's constitution specified in s 29 CA 2006; any resolution or other decision taken in accordance with the constitution; and any decision by the members of the company or a class of members that is treated by virtue of any enactment or rule of law as equivalent to a decision by the company.
[122] Model Articles for Public Companies are listed in the Schedule 3 to the Companies (Model Articles) Regulations 2008 (for public companies incorporated on or after 28 April 2013) (SI 2008/3229) (henceforth: 'Model Articles').
[123] s 20; s 21 (1) CA 2006 states that '[a] company may amend its articles by special resolution.'
[124] According to s 282 (1) CA 2006 '[a]n ordinary resolution of the members (or of a class of members) of a company means a resolution that is passed by a simple majority.'
[125] art 20 Model Articles.

anything in any agreement between it and him.' [126] There is no reason why the articles should not include another ground for removal.[127]

2.3 The role of board of directors

The CA 2006 does not provide much detail about the role of the board of directors. Directors' functions are dispersed throughout the Companies Act and the duties are set out in ss 171-177. The role of the board of directors is to manage and run the company and to make decisions in relation to its strategic operations. This role can be derived from the Model Articles (which can be changed). According to article 3: 'subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company.'[128] Articles 5 and 6 allow the directors 'to delegate any of the powers which are conferred on them under the articles of association,' 'to such person or committee (…) as they think fit.'[129] The UK Code confirms the leading role of the board in managing the company: '[e]very company should be headed by an effective board which is collectively responsible for the long-term success of the company.'[130] The function of the board is further described:

> The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.(…)[131]

Apart from this general function, the UK Code describes the more detailed tasks of the board: holding regular meetings to discharge its duties effectively,[132] preparing an annual report that identifies e.g. the chairman, deputy chairman or CEO,[133] and arranging 'appropriate insurance cover in respect of legal action against its directors.' [134]

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[126] s 168 (1) CA 2006; s 169 discusses a director's right to protest against removal.
[127] Similarly, Paul Davies, Sarah Worthington and Eva Micheler, *Gower and Davies' Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 410.
[128] art 3 Model Articles.
[129] arts 5 and 6 ibid.
[130] A1 Main Principle UK Code.
[131] A1 ibid.
[132] A1.1 ibid.
[133] A1.2 ibid.
[134] A1.3 ibid.

2.4. The balance of power between the board and shareholders

In the UK, the power in the company is divided between the board and shareholders.[135] Although power in the company is divided between directors and shareholders, and the former manage the business, the latter are believed to hold the primacy, in the sense that they are residual claimants and retain ultimate decision-making authority, in the areas that generate conflict of interests.[136] Certainly, the board of directors plays a central role in the company. The board is responsible for running the company and its daily management and without a doubt, it is 'the most important decision-making body within the company.'[137] It performs a number of mandatory functions, which cannot be transferred to shareholders. Davies et al. divide these mandatory functions into two areas: 'the production of the annual accounts and the regular administration of the company.'[138] Nevertheless, the board's management authority is belived to be only derivative of the shareholders' governance authority – on which the UK company law is conceptually built.[139]

Shareholders in the UK 'possess an arsenal of governance powers'[140] and shareholder power 'remains the true heart of the UK conception of the Corporation.'[141] Altohough not engaged in a day-to-day running of the company, particularly the large institutional shareholders are called 'stewards' of the companies in which they invest – which suggests they are expected to actually oversee management of the company.[142] To start with the key power of the shareholders, they have some decision-making powers in the company. The Model Articles state that '[t]he members may, by special resolution,[143] direct the directors to take, or refrain from taking, specified action.[144] As outlined above, section 21 of the CA 2006 entitles a company to amend its articles by special resolution. Therefore, members have a legal right to change or even to remove article 3 of the Model Articles, which gives wide powers to the board of directors (conversely, the board might be given more power). This provision gives shareholders 'very direct power over the content of the corporation's core governance arrangements.'[145] Secondly, members representing 5% of

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[135] *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2KB 113, 134 (Greer LJ).
[136] See the discussion in Daniel Attenborough, 'The Vacuous Concept of Shareholder Voting Rights' (2013) 14(2) EBOR 147, 163.
[137] Davies, Worthington and Micheler, *Gower and Davies' Principles* 383.
[138] ibid 395.
[139] Christopher Bruner, *Corporate Governance in the Common-Law World: The Political Foundations of Shareholder Power* (CUP 2013) 29.
[140] ibid.
[141] ibid 31.
[142] ibid,
[143] s 283 (1) CA 2006 provides that a special resolution is 'a resolution passed by a majority of not less than 75%' of the shareholders.
[144] art 4(1) Model Articles.
[145] Bruner, *Corporate Governance in the Common-Law World* 29.

capital have the right to request general meeting.[146] Further, shareholders have the power to remove a director by ordinary resolution.[147] As it was underlined above,[148] it means that the position of a director is relatively weak.[149] Davies et al. state that '[t]hat can be a powerful inducement to the directors to follow the line of action preffered by the shareholders.'[150] The Companies Act also gives examples of situations where shareholder approval of the board's proposed decisions is necessary. For instance, where the decision is likely to have an impact upon the shareholders' rights: alterations to the class rights attached to shares;[151] alteration of the type of company;[152] decisions to allot and issue shares;[153] or to disapply pre-emption rights on the allotment and issue of shares.[154]

Nevertheless, there is an on-going discussion about the actual leading role of shareholders in the UK and the benefits of their engagement in the company. Considering, for instance, the traditionally dispersed share ownership structure of listed public companies in the UK,[155] the paramount role of the shareholders' is somewhat debatable. Cheffins notes that '[i]n Britain shareholders have traditionally taken a "hands off" approach to corporate governance and refrained from exercising active control over publicly quoted companies.'[156] Attenborough underlines that costs from voting exceed gains and 'therefore, shareholders tend to be "rationally apathetic."'[157]

The introduction of the Stewardship Code,[158] which aims to encourage engagement between institutional investors and companies, and improve the effectiveness of companies, confirms that shareholder activism is advocated in the UK. The Stewardship Code promotes the long-term success of the company; it sets out good practice recommendations for institutional investors and works on 'comply or explain' basis.[159] However, there is currently

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[146] s 303, 304 CA 2006.
[147] s 168 (1) CA 2006.
[148] Chapter II para 2.2.
[149] However, Keay points out that obrtaining majority to remove directors in the private company may be possible, it might be more difficult in the public company. As a consequence, directors are rarely removed from public companies. Keay, *Directors' Duties* 71.
[150] Davies, Worthington and Micheler, *Gower and Davies' Principles* 390.
[151] s 630ff CA 2006.
[152] s 90 ibid.
[153] s 549 ibid.
[154] s 569 ibid.
[155] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 26. See Chapter V s 1.2 for a more detailed analysis of share ownership structure in the jurisdictions under review.
[156] Brian Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73(6) ModLRev 1004, 1004-05.
[157] Attenborough, 'Vacuous Concept' 164.
[158] UK Stewardship Code, Financial Reporting Council (September 2012) <http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> accessed 13 May 2015.
[159] UK Stewardship Code 1.

no consensus regarding the effectiveness of this Code.[160] For instance, opponents of the Stewardship Code argue that it is likely to be an ineffective tool in promoting increased shareholder engagement doe to increasing fragmentation of ownership and due to the high level of foreign investement, resulting in less than one-third of the shares in UK quoted companies suggests adoption of the Code.[161]

3. Germany

3.1. The structure and composition of the board of directors

German law provides several types of legal entities including the *Aktiengesellschaft* (AG). The word *Aktiengesellschaft* is translated in this thesis as 'public limited company'; in the past, the trend was to refer to these corporations as 'joint stock corporations.'[162]

The AG is subject to mandatory regulations, which are included in various legal acts. The *Aktiengesetz* establishes a comprehensive regulation of public limited companies that is mandatory unless provided otherwise.[163] The articles of association may contain different provisions, if it is permitted by the AktG and 'additional provisions, except as to matters that are conclusively dealt with in the Act.'[164] The AktG also incorporates provisions of the Commercial Code (*Handelsgesetzbuch*). The law relating to public companies also includes case law and a number of laws, relevant to accounting, mergers and co-determination, rules on takeovers and securities regulation, and the Kodex. The management board and supervisory board of a listed company and corporations with capital market access (pursuant to § 161 (1) 2 AktG) should annually declare whether the company complies with the recommendations issued by the Kodex.[165] Companies that are not focused on the capital markets are also recommended to respect the Kodex.[166] It should be borne in mind that compliance with the Kodex is voluntary and operates on a 'comply or explain' basis but deviations from it must be justified.[167] Apart from the sources listed above, legal scholarship plays an important role in Germany. Doralt notes that:

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[160] For the detailed discussion on shareholder activism, see Chapter VI s 5 below.
[161] Cheffins, 'The Stewardship Code's Achilles' Heel' 1024, 1025.
[162] Jean du Plessis and others, 'An Overview of German Business or Enterprise Law and the One-Tier and Two-Tier Board Systems Contrasted' in Jean du Plessis and others (eds), *German Corporate Governance in International and European Context* (2nd edn, Springer 2012) 5.
[163] § 23 (5) 1 AktG.
[164] § 23 (5) 1, 2 ibid.
[165] § 161 (1) 1, 2 ibid.
[166] Kodex 2.
[167] Kodex 2.

> Legal scholarship has established a very direct and strong influence on practice in Germany. This special status and authority of some academics is one of the reasons for which, up to today, an argument found in a publication will often be followed be a footnote quoting only an academic publication as a reference for the accurateness of the statement advanced in the text. [168]

The public limited company is a corporation that 'constitutes a separate legal entity' and '[l]iability to creditors with respect to obligations of the company (…) [is] limited to the company's assets.'[169] The AG 'shall have a capital divided into shares'[170] and 'the share capital shall be denominated in euro.'[171] The AG may be admitted for trading on the stock exchange:[172] the main stock exchange in Germany is the Frankfurter Stock Exchange. The AG assigns the administration of the company to two bodies: the management board (*Vorstand*) and the supervisory board (*Aufsichtsrat*);[173] thus, two kinds of directors can be identified: supervisory and managing directors. In order to separate the *Vorstand* and the *Aufsichtsrat* from each other, a single person cannot be a member of both boards.[174] The supervisory board; however, may fill vacancies in the management board with its own members for up to one year, during which time they may not serve on the supervisory board.[175]

3.2. The appointment and removal of directors

Companies that have a share capital greater than three million euros generally have management boards comprising 'not less than two persons, unless the articles provide that it is to comprise one person.'[176] According to the AktG, the management board should have one or more members.[177] The Kodex points out that the board 'shall be comprised of several persons.'[178] There is also a requirement that '[o]nly a natural person with full legal capacity may be a member of the management board.'[179] If it comprises at least two members, the

[168] Walter Doralt, 'Regulating Directors' Duties, their Enforcement and the Business Judgment Rule' in Walter Doralt and Olivier Deshayes (eds), *Reforming the Law of Obligations and Company Law: Studies in French and German Law,* Collection Trans Europe Experts vol 8 (Societe de legislation compare 2013) 121, fn 3.
[169] § 1 (1) 1, 2 AktG.
[170] § 1 (2) ibid.
[171] § 6 ibid.
[172] § 3 (2) ibid.
[173] AktG Division Four: pts 1-2.
[174] § 105 (1) 1 AktG.
[175] § 105 (2) ibid.
[176] § 76 (2) 1, 2 ibid.
[177] § 76 (2) 1 ibid.
[178] § 4.2.1 Kodex.
[179] § 76 (3) 1 AktG.

management board might have a chairperson.[180] The Kodex notes that the management board of listed AGs should have a spokesperson or chairperson.[181] The AktG does not offer guidance regarding the chairperson's legal status. The rules concerning the function and authority of the chairperson are to be found in the articles of association and/or the management board's rules of procedure; according to Dryander and Riehmer the chairman is usually responsible for representing the company in public, coordinating its work with the supervisory board and chairing board meetings.[182]

The supervisory board appoints members of the management board 'for a period not exceeding five years' and the appointments may be renewed or the term of office extended for up to five years.[183] As an effect of the employees' right of co-determination – a distinctive feature of German corporate law – certain companies are required to appoint a labour director (*Arbeitsdirector*); that is, a management board member responsible for personnel matters.[184] The supervisory board 'may revoke the appointment of a member of the management board (…) for cause' (*ein wichtiger Grund*).[185] Some of the grounds justifying removal are listed in the *Aktiengesetz* (naturally there might also be other grounds for removal); e.g. a gross breach of duty, inability to manage the company properly, or a vote of no confidence by the shareholders' meeting.[186]

The supervisory board, on the other hand, is composed of non-executive directors and consists of three or more members,[187] including 'an adequate number of independent members.'[188] The AktG sets also the upper limit of members of the supervisory board for companies with different share capital.[189] Importantly, the employees' right of co-determination also affects the composition of the supervisory board in large companies.[190] The shareholders elect the members of the supervisory board at the general meeting, 'unless they are to be appointed to the supervisory board or elected as representatives of the employees pursuant' to the co-determination rules.[191] If a public limited company employs

[180] § 84 (2) ibid.
[181] § 4.2.1 Kodex.
[182] Christof von Dryander and Klaus Riehmer (eds), *Being a Board Member in Germany: A Manual for English-Speaking Members of Management Boards and Supervisory Boards of German AG, GmbH and SE* (German Law Publishers 2011) 10.
[183] § 84 (1) 1, 2 AktG.
[184] § 33 Mitbestimmungsgesetz (Co-Determination Act), 4 Mai 1976 (BGBl I, 1153), § 13 Montan-Mitbestimmungsgesetz (Coal, Iron and Steel Co-determination Act) 21 Mai 1951 (BGBl I, 347) in connection with § 76 (2) 3, § 84 (4) AktG.
[185] § 84 (3) 1 AktG.
[186] § 84 (3) 2 ibid.
[187] § 95, 1, 2 ibid.
[188] § 5.4.2 Kodex. This provision also specifies what is meant by 'independent.'
[189] § 95, 4 AktG.
[190] § 95, 5 ibid.
[191] § 101 (1) 1 ibid.

more than 500 employees in Germany, pursuant to § 1 (1) 1 of the One Third Participation Act,[192] one third of the supervisory board must consist of employee representatives. According to the same provision, companies that were incorporated before 10 August 1994 and are not family owned should also have one third employee representation on the board even if they have less than 500 employees. If the AG has more than 2000 employees, the Co-Determination Act requires half of the supervisory board to be employee representatives.[193] According to § 4 Coal, Iron and Steel Co-determination Act, the supervisory board of companies with more than 1000 employees in the coal, iron and steel industries must consist of eleven members (five are elected by the shareholders' meeting, five by the employees and one – the neutral member – is elected through mediation).

3.3 The role of the boards

According to the AktG, '[t]he management board shall have direct responsibility for the management of the company.'[194] The management board is clearly the most important administrative organ of the corporation, constituting the sole body authorised to conduct business in the name and on behalf of the company.[195] Würdinger perceives the management of the company as 'a wide concept' since:

> It comprises carrying on the kind of business specified in the statutes of the company; it includes, further, the organisation of production and the preparation and execution of long-term planning for that purpose, and therefore takes in the whole of the trading, investment and earnings policy of the company.[196]

In terms of the role of the management board, the *Aktiengesetz* distinguishes between external power to represent the company and internal management of the corporation: § 77 AktG confers on the management board the authority to manage the company and the act stipulates that the *Vorstand* 'shall represent the company in and out of court.'[197] The authority to represent the company vis-à-vis third parties may not be restricted, but it is possible to restrict the management's board authority to manage the company.[198] The Kodex also lists the tasks and responsibilities of the management board: '[t]he Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus

[192] Drittelbeteiligungsgesetz (One Third Participation Act), 18 Mai 2004 (BGBl I, 974).
[193] The detailed rules are to be found in § 7 Co-Determination Act.
[194] § 76 (1) AktG.
[195] von Dryander, Riehmer, *Being a Board Member in Germany* 3; Bernhard Grossfeld, 'Management and Control of Marketable Share Companies' in *International Encyclopaedia of Comparative Law*, vol. XIII, ch 4 (Mohr Siebeck and Martinus Nijhoff 1998) 6.
[196] Hans Würdinger, *German Company Law* (Robert Pennigton ed, Oyez Publishing 1975) 45.
[197] § 78 (1) AktG.
[198] § 82 ibid.

taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.'[199] The main duty of the supervisory board is to supervise the management board[200] and they 'may inspect and examine the books and records of the company as well as the assets of the company, in particular cash, securities and merchandise.' [201] The supervision consists mainly of 'a retrospective control of the conduct of business and the manner, in which the management board is performing its duties,' but in addition, the supervisory board also monitors future decisions, 'in particular corporate planning, and the filling of managerial positions.'[202] The Kodex lays down further the tasks and responsibilities of the supervisory board: '[t]he task of the Supervisory Board is to advise regularly and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise.'[203]

The management board, at least in theory, manages the company independently of instructions from the supervisory board. As according to the AktG, '[m]anagement responsibilities may not be conferred on the supervisory board.'[204] In practice, the powers of the management board might be restricted, as 'the articles [of association] or the supervisory board have to determine that specific types of transactions may be entered into only with the consent of the supervisory board.'[205] If the supervisory board refuses to grant consent, the management board may request that a shareholders' meeting approve transactions.[206] The supervisory board may decide to control in this way the management of the company. Wirth and others point out that '[t]hese catalogues of measures requiring supervisory board consent are important in practice.'[207]

3.4. The balance of power between the board and shareholders

The current section deals with the division of power between the management board and shareholders. The shareholders' meeting is a third body – next to the management and supervisory board – involved in the running of the company. This involvement is mainly indirect and reduces influence over the management board. Crucially, the division of power within the company depends on the actual structure of the company. In Germany,

[199] § 4.1.1 Kodex.
[200] § 111(1) 1 AktG.
[201] § 111(2) 1 ibid.
[202] Gerhard Wirth, Michael Arnold, Ralf Morshäuser, Mark Greene *Corporate Law in Germany* (2nd edn, CH Beck 2010) 121.
[203] § 5.1.1 Kodex.
[204] § 111(4) 1 AktG.
[205] § 111(4) 2 ibid.
[206] § 111(4) 3-5 ibid.
[207] Wirth and others, *Corporate Law in Germany* 122.

traditionally perceived as a concentrated ownership jurisdiction,[208] a majority shareholder can influence the composition of the management board, as shareholders appoint the supervisory board who then appoint the management board.[209]

Apart from the influence of the share ownership structure on the management of the company, shareholders are – to some extent – also directly engaged in the running of the company. The shareholders' meeting adopts and amends the articles of association,[210] appoints members of the supervisory board,[211] makes decisions regarding dividend distribution,[212] and appoints the auditor.[213] Not only the legislation, but also the case law imposes powers upon shareholders. The '*Holzmüller doctrine*' is a good example.[214] This doctrine provides that the management board must obtain consent from the shareholders' meeting 'where material structural measures within a company have significant economic impact on the company's business.'[215] The literature points out that approval is required e.g. in the case of disposal of important subsidiaries.[216] Thus, the 'inherent powers of the general meeting'[217] are very limited. The management board must still carefully analyse whether to present the matter to the shareholders' meeting, even if this is not explicitly required. This thesis will turn now to the review of the board of directors in Delaware.

4. Delaware

4.1. The structure and composition of the board of directors

The DGCL is the main statute governing corporate law in Delaware.[218] The sections of the Delaware Code that pertain to corporations are: Corporation Franchise Tax,[219] Professional

[208] Roe, 'Some Differences in the Corporation Structure' 1936. See Chapter V s 1.2 for a more detailed analysis of share ownership structure in the jurisdictions under review.
[209] Wirth and others, *Corporate Law in Germany* 99. Naturally (as Wirth and others also argue at the same page) the management board would have 'an extraordinarily strong position' in the company with dispersed ownership – which is also possible in Germany, as '[t]he members of the supervisory board are nominated *de facto* (not *de jure*) by the management board and then elected by the general meeting.' [emphasis in original]
[210] § 2, § 23, § 119 (1) 5 AktG.
[211] § 119 (1) 1 ibid.
[212] § 119 (1) 2 ibid.
[213] § 119 (1) 4 ibid.
[214] Based on the following Federal Supreme Court (*Bundesgerichtshof*) cases: Holzmüller, II ZR 174/80 and Gelatine, II ZR 154/02, 155/02 – in the latter case the 'Holzmüller doctrine' was narrowed down.
[215] Wirth and others, *Corporate Law in Germany* 135.
[216] von Dryander and Riehmer, *Being a Board Member in Germany* 40.
[217] Jean du Plessis and Ingo Saenger, 'The General Meeting and the Management Board as Company Organs' in Jean du Plessis and others (eds), *German Corporate Governance in International and European Context* 76.
[218] Title 8, ch 1 Delaware Code.

Service Corporations,[220] Banking,[221] and Commerce and Trade.[222] Importantly, the case law developed over the years by the Court of Chancery and the Delaware Supreme Court has been extremely influential in the field of company law. In addition, there are many more federal and state statutes and regulations that must be observed in managing a corporation: e.g. securities law; the Public Company Accounting Reform and Investor Protection Act of 2002[223]; listing requirements; employment laws; and corporate governance principles.

Close corporations (also referred to as 'closely held corporations') and public corporations ('publicly held corporations') are the main categories of business corporations in the US.[224] The former tend to be smaller than the latter;[225] the critical difference between these two types of corporations consists in the fact that a close corporation 'shall make no offering of any of its stock of any class which would constitute a "public offering" within the meaning of the United States Securities Act of 1933 [15 U.S.C. § 77a et seq.] (…).'[226] An initial public offering (IPO) – selling of securities to investors – takes place on the primary market. Subsequently, these securities are traded on the secondary markets such as the NYSE or the NASDAQ system. [227]

Delaware law neither defines the term 'director' nor provides for the mandatory representation of employees on the board. What can be found in the DGCL regarding the board of directors is the provision that:

> The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors (…).[228]

Like the UK, but in contrast to Germany, Delaware has a one-tier board system. The DGCL does not expressly describe the system as unitary; instead, it refers to the 'board of directors'

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[219] Title 8, ch 5 ibid.
[220] Title 8, ch 6 ibid.
[221] Title 5 ibid.
[222] Title 6 ibid.
[223] (henceforth: 'Sarbanes-Oxley Act') Pub L 107–204, 116 Stat 745, enacted 30 July 2002.
[224] Stephen Bainbridge, *Corporate Law* 7.
[225] ibid.
[226] § 342 (a) (3) DGCL.
[227] Bainbridge, *Corporate Law* 7.
[228] § 141 (b) DGCL.

rather than 'boards of directors' on several occasions.[229] In principle, the board is obliged to act collectively and '[t]he vote of the majority of the directors present at a meeting at which a quorum is present' is necessary 'unless the certificate of incorporation or the bylaws shall require a vote of a greater number.'[230] The CEO and the chairman are among the most important officers on the board and typically these roles are combined:[231] '(…) [the] chief executive officer is responsible for the daily management of the business, the chairperson of the board is generally responsible for managing the affairs of the board.'[232]

Although Delaware has a one-tier board system, executive and supervisory functions can be distinguished among the board members. The listing rules of the national securities exchanges such as the NYSE and the NASDAQ require the presence of 'independent directors;' according to the NYSE Listed Company Manual: '[l]isted companies must have a majority of independent directors.'[233] This Manual establishes a detailed independence test in s 303A.02 and among others: '[n]o director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).'[234]

4.2. The appointment and removal of directors

Directors are elected to hold office by the corporation's stockholders at an annual stockholders meeting or by written consent of the stockholders under the conditions specified by law.[235] A majority of the votes elects directors unless the constitutional documents specify otherwise.[236] Under the DGCL, '[a]ny director or the entire board of directors may be removed, with or without cause,' providing a majority of the shares supports removal.[237] This provision also underlines the instances where removal without cause is not possible. Having discussed briefly the organisation of the corporation in general, the role of the board and division of power will now be discussed.

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[229] § 141-144 ibid.
[230] § 141 (b) ibid.
[231] Clarke, *International Corporate Governance* 48.
[232] Christopher Forrester and Celeste Ferber, *Fiduciary Duties and other Responsibilities of Corporate Directors and Officers* (5th edn, Morrison & Foerster LLP, RR Donnelley Global Capital Markets 2012) 4.
[233] § 303A.01 NYSE Listed Company Manual <http://nysemanual.nyse.com/lcm/> accessed 15 September 2015.
[234] § 303A.02 (a) (i) ibid.
[235] § 211(b) DGCL.
[236] § 216 (3) ibid.
[237] § 141 (k) ibid.

4.3 The role of the board

The DGCL describes the role of the board succinctly: '[t]he business and affairs of every corporation (…) shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.'[238] Hence, in principle the board is responsible for the management of the corporation. As the legislation allows the board to manage the corporation not only personally, but also 'under the direction of a board of directors,' the board is able to delegate the management of the company to officers. Such delegation is considered to be common.[239] The officers are elected pursuant to s 142 DGCL – this provision gives corporations great flexibility in determining the officers' actual level of power.[240] As the officers are responsible for the actual daily management of the corporation, the main function of the board is to monitor the officers; but they are also responsible for providing officers with advice, guidance, disciplining them and for broad policy-making in the corporation.[241] Despite the delegation of powers, clearly the board rather than the officers are responsible for the management of the corporation.

4.4. The balance of power between the board and shareholders

As pointed out above, the DGCL states in § 141 (a) that '[t]he business and affairs of every corporation (…) shall be managed by or under the direction of a board of directors (…).' Thus, decision-making in Delaware is left almost entirely to the board of directors; leaving for stockholders only 'the election of directors and approval of the charter or bylaw amendments, mergers, sales of substantially all of the corporation's assets, and voluntary dissolution.'[242] Moreover, 'only the election of directors and amending the bylaws do not require the board approval before shareholder action is possible.'[243] Delaware is traditionally considered to be a jurisdiction which embraces director primacy : this means that power within the company is divided between the directors and stockholders in a way which favours the former over the latter. This feeds into the on-going discussion in the American literature on the proper allocation of powers between directors and stockholders. The most prominent debate is between Bebchuk (advocate of the shareholder empowerment concept) and Bainbridge (opponent of increasing shareholder powers).[244] Bainbridge – by far the most

[238] § 141 (a) ibid.
[239] Bainbridge, *Corporate Law* 73; Forrester and Ferber, *Fiduciary Duties* 1.
[240] Forrester and Ferber, *Fiduciary Duties* 2.
[241] Bainbridge, *Corporate Law* 73.
[242] ibid 72.
[243] ibid.
[244] For the detailed debate on shareholder activism in the US see Chapter VI s 5.2.3 below.

active supporter of director primacy[245] theorises that 'the power and right to exercise decision making fiat is vested neither in the shareholders nor the managers, but in the board of directors.'[246] Rejecting a stand that 'shareholders are entitled to either direct or indirect decision making control,' shareholder wealth maximisation is accepted as the proper corporate decision making norm.'[247] Bebchuk, on the other hand, challenges 'the basic allocation of power between boards and shareholders in publicly traded companies with dispersed ownership' under American corporate law[248] and advances proposals designed to increase shareholder powers in the corporation.[249] Bebchuk particularly presents the case for strengthening shareholders rights to replace directors and to provide shareholders with the powers 'to change the governance arrangements in the company's rule book by changing the corporate charter or the company's state of incorporation.'[250]

The aim of this chapter has been to give some background on the role and structure of boards of directors in the legal systems under review. Chapter III seeks to interpret legislation, case law and soft law, to ascertain, whether long-term interests in the decision-making processes of company directors are relevant in circumstances where a company is solvent and analyses the content and scope of that notion.

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[245] See the following articles by Stephen Bainbridge: 'Director v Shareholder Primacy in the Convergence Debate' (2002) 16 Transnat'lLaw 45; 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 NwULR 547; 'Response, Director Primacy and Shareholder Disempowerment' (2006) 119 HarvLRev 1735; 'The Case for Limited Voting Rights' (2006) 53 UCLALawRev 601; 'Director Primacy' (UCLA School of Law, Law-Econ Research Paper No. 10-06 2010, unpublished). See also: Harry Hutchison, 'Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm' (2005) 36 LoyUChiLJ 1111, 1194. The author points out that although the concept of director primacy is not expressly articulated in Delaware law, the statutory provisions and the case law (e.g. the *Unocal/Revlon/Unitrin* cases) confirm that directors retain authority in the corporation and in fact control it, which precludes exogenous events or shareholder action from determining corporate decision-making.

[246] Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' 605.

[247] ibid 563.

[248] Lucian Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 HarvLRev 833.

[249] ibid; Lucian Bebchuk, 'Reply: Letting Shareholders Set the Rules' (2006) 119 HarvLRev 1784; Lucian Bebchuk, 'The Myth that Insulating Boards Serves Long-Term Value' (2013) 113 ColumLRev 1637.

[250] Bebchuk 'Reply: Letting Shareholders Set the Rules' 1784-85.

Chapter III: Long-termism' in directors duties – the current legal framework

1. Introduction

The objective of this chapter is to explore the extent to which the law in the UK, Delaware and Germany imposes duties of general application on the directors of solvent public companies to consider the long-term consequences of their decisions. Secondly, this chapter seeks to interpret the parameters of long-termism in these jurisdictions, i.e. its content, nature and scope. In order to achieve these aims, the treatment of long-term interests in the decision-making processes of company directors will be conducted by analysing the formal primary sources in place in these countries, i.e. legislation, court decisions and soft law. As such, this chapter concentrates only on an analysis of black letter law to explain how the primary sources in the jurisdictions under review express and understand long-termism. Therefore, commentaries from academics about this notion are not included here: they are presented in Chapters IV and V below.

Only solvent companies are analysed in this thesis. There is greater scope for conflicts of interest to complicate matters, which can give rise to difficult questions and exercises of directorial judgment in a company that is subject to a takeover bid or is nearing insolvency. It is assumed in this research that the board of directors (or management board) is responsible for decision-making in the company. This thesis does not discuss the division of powers in the company between directors and managers (or officers). When it is used, the term 'manager' is taken to denote a member of the board of directors (in the UK or Delaware) or member of the management board (in Germany); i.e. a person responsible for the running of the company. Moreover, the term 'director' is used to describe board members in all jurisdictions. Decision-making procedures (quorum, voting, etc.) are not scrutinised here.

This chapter is structured as follows. Some introductory remarks are offered: the position of a director as a fiduciary is explained and the role of standards as a way of expressing managerial discretion is examined. This chapter next briefly describes directors' duties in the UK, Delaware and Germany. Then the place of long-termism in the current legal framework is explored. The discussion here is divided into three parts: long-termism and directors' duties (where legislation and where appropriate court cases on general directors' duties are evaluated); long-termism according to the case law; and the notion of long-termism in the non-binding codes of best practice. Each part considers the relevance and parameters of long-term decision making in the three jurisdictions and offers some

preliminary conclusions. In the final section, a comparative summary about the notion of long-termism in the legislation, case & soft law is provided.

2. Setting the scene

To facilitate a discussion on the content and scope of long-termism in the present legal framework, a few points must be addressed. This section explains why directors and members of management boards are considered to be fiduciaries in the legal systems under review. Thereafter, the concept of a fiduciary is linked with the notion of 'standards' as a mode of expressing managerial discretionary powers. A brief introduction to directors' duties in the UK, Germany and Delaware is also presented.

2.1 The director as a fiduciary

As outlined in Chapter II above, the board of directors in the UK and Delaware or the management board in Germany is the principal organ responsible for running a company. Therefore, members of these boards have a fiduciary relationship with the company.[251] Fiduciary relations can generally be described as situations in which 'one party hires the other's knowledge and expertise'[252] or where 'one person holds or controls property that in Equity belongs to another.'[253] Traditionally, these relations involve 'trust, confidence and loyalty.'[254] Fiduciary law originated in the common law courts of Chancery, which dealt with matters relating to breach of trust and confidence. The law of trusts stems from this branch of equity.[255] Davies et al. note that the concept of trust was applied to directors of incorporated companies by analogy, as the assets were held by the company (being a separate legal person), rather than vested in the trustees themselves.[256] Fiduciary relations were narrowly interpreted by the Court of Chancery and included: 'trustees, guardians, executors, receivers, agents, attorneys, corporate directors or officers, partners, and joint adventurers.'[257]

The institution of the fiduciary is also present in civil law jurisdictions and it can be traced back to Roman law,[258] but the fiduciary position of directors is less emphasised outside of common law legal systems.[259] Nevertheless, according to Zimmermann:[260]

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[251] Davies, Worthington and Micheler, *Gower and Davies' Principles* 525.
[252] Frank Easterbrook and Daniel Fischel, 'Contract and Fiduciary Law' (1993) 36 JL&Econ 425, 426.
[253] Remus Valsan, *Understanding Fiduciary Duties: Conflict of Interest and Proper Exercise of Judgment in Private Law* (unpublished PhD thesis, 2012) 16 and the literature cited there.
[254] ibid 12-16.
[255] Len Sealy, 'Fiduciary Relationships' (1962) CambLJ 69, 69.
[256] Davies, Worthington and Micheler, *Gower and Davies' Principles* 525.
[257] Valsan, *Understanding Fiduciary Duties* 16 and the literature cited there.
[258] Klaus Hopt and Marcus Roth, in *Aktiengesetz Grosskommentar* (4th edn, De Gruyter Recht 2005) § 116 mn. 176 (my translation). It should be noted that common law has also used Roman law to

> Roman law provided for certain situations where one party acted for another not as an agent but in his own right. This was the concept of trusteeship: the trustee held a right in somebody else's interest; on account of the fiduciary relationship he was bound, however, to safeguard these interests of the beneficiary. Fiducia fits into this category (be it cum creditore or cum amico contracta).[261]

The lack of the concept of trust, which was developed in Anglo-Saxon law and applied to corporations, is mentioned as a 'major handicap' for German and other continental company laws.[262] The duties of directors in civil law legal systems developed separately under company law, sometimes referring to general civil law agency principles that are considered less strict than those applicable under the English law of trusts.[263] Nevertheless, German commentators sometimes use the analogy of trusteeship (*Treuhandschaft*) in the context of directors' duties.[264] Fleischer notes that the legal vocabulary is limited and confusing and German lawyers use the term '*Treuhänder*' whilst referring to both trustees and fiduciaries.[265]

2.2 Standards as a mode of expressing managerial discretion

Discretion is believed to be 'universally recognized as an essential aspect of fiduciary relationships'[266] and it 'implies the possibility of choice, which in turn calls for the exercise of judgment.'[267] Smith and Lee argue that the discretion of a fiduciary is a space for

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describe fiduciary responsibilities – see e.g. the House of Lords' judgment delivered in a significant Scottish appeal case: *York Buildings Company v Mackenzie* (1795) 8 Brown PC 42 at 63 ('The ground on which the disability or disqualification rests [i.e. the rule against self-dealing], is no other than that principle which dictates that a person cannot be both judge and party.'); followed by *Aberdeen Railway Co v Blaikie* (1854) 1 Macq 461.

[259] Carsten Gerner-Beuerle and Edmund-Philipp Schuster, 'Mapping Directors' Duties: Strategies and Trends in the EU' in Hanne Birkmose, Mette Neville and Karsten Engsig Sorensen (eds), *Boards of Directors in European Companies: Reshaping and Harmonising Their Organisation and Duties* (Kluwer Law International 2013) 23.

[260] Reinhard Zimmerman, *The Law of Obligations: Roman Foundations of the Civilian Tradition* (OUP 1996) 50.

[261] Gai. II, 60 [footnote in original].

[262] Klaus Hopt, 'Self-Dealing and Use of Corporate Opportunity and Information: Regulating Directors' Conflicts of Interest' in Klaus Hopt and Gunther Teubner, *Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility* (Walter de Gruyter 1985) 295.

[263] Klaus Hopt, 'Conflict of Interest, Secrecy and Insider Information of Directors: A Comparative Analysis' (ECGI Working Paper Series in Law, Working Paper No 208/2013 April 2013) 2 <http://ssrn.com/abstract=2178152> accessed 2 May 2014.

[264] Mads Andenas and Frank Wooldridge, *European Comparative Company Law* (CUP 2009) 271.

[265] Holger Fleischer, 'The Responsibility of the Management and of the Board and Its Enforcement' in Guido Ferrarini, Klaus Hopt, Jaap Winter and Eddy Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (OUP 2004) 378.

[266] D Gordon Smith and Jordan C Lee, 'Fiduciary Discretion' (2014) 75 OhioStLJ 609, 610.

[267] ibid.

decision-making left after taking account of: fiduciary duties, regulatory and contractual constraints.[268] Thus, directors as fiduciaries enjoy freedom in managing companies, assuming that they fulfil all obligations imposed by law and any contract concluded with the company. In this thesis, the key directors' duties, i.e.: the duty of loyalty and the duty of care command our specific attention. This is crucial in order to understand the scope and extent of a director's obligation to exercise long-term judgment. The duty of care and duty of loyalty are two classic legal categories where the law in all three jurisdictions under review applies 'standards' – in order to allow managerial discretion – as opposed to legal rules. Directors' duties are generally expressed as standards rather than legal rules.

General rules and standards (sometimes also called principles) are considered to be the main instruments of social control.[269] A rule in a strict sense can be defined as '[t]he most precise form of authoritative general direction.'[270] This term is used also more broadly to indicate 'a legal proposition of any kind.'[271] One of the advantages of rules is that they create legal certainty and should be straightforward in application. This advantage of rules is also their key shortcoming: since they are static and inflexible, they are not easily adaptable to changing circumstances. Moreover, rules per se have a limited application, as it is not possible to regulate all aspects of reality. Cahn and David also notice that the clarity of rules' parameters means they can be easily evaded.[272] There are three categories of legal rules. These are permissive ('may') rules, presumptive ('may waive') rules and mandatory ('must' or 'must not') rules.[273]

Many legal commands cannot feasibly be cast in the form of a rule and more general approaches to regulation – referred to as standards – are sometimes chosen instead:

> Sometimes the sphere to be legally controlled is recognised from the start as one in which the features of individual cases will vary so much in socially important but unpredictable respects, that uniform rules to be applied from case to case without further official direction cannot usefully be framed by the legislature in advance. Accordingly, to regulate such a sphere the legislature sets up very general standards and then delegates to an administrative, rule-making body acquainted with the varying types of case, the task of fashioning rules adapted to their special needs.[274]

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[268] ibid 612-13.
[269] H L A Hart, *The Concept of Law* (3rd edn, OUP 2012) 124.
[270] Henry M Hart and Albert Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* (Foundation Press 1994) 139.
[271] ibid.
[272] Cahn and Donald, *Comparative Company Law* 332.
[273] Brian Cheffins, *Company Law: Theory, Structure and Operation* (OUP 1997) 217.
[274] Hart, *Concept of Law* 131.

Bearing in mind the main disadvantage of rules – which is their inflexibility – obligations set in more general terms may be more effective.[275] Standards are flexible, have an open-textured character, are adaptable and can change over time with changing attitudes. In sum, they do not need to be replaced very frequently. The price to pay for the openness of standards is a lack of clarity regarding their meaning. Examples of standards are found in the literature, e.g. legal commands enjoining legal persons to exercise good faith, due care, fairness, or reasonableness.[276]

Standards can be divided into standards of conduct and standards of review.[277] A standard of conduct is a legal command addressed to a particular person, for example, to a director of a company and 'states how an actor should conduct a given activity or play a given role.'[278] A standard of review meanwhile is a legal command addressed to the court and it 'states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.'[279]

Both rule-based and standard-based regulatory techniques come with advantages and disadvantages. This is because they are created to fulfil different aims:

> In fact all systems, compromise between two social needs: the need for certain rules which can, over great areas of conduct, safely be applied by private individuals to themselves without fresh official guidance or weighing up of social issues, and the need to leave open, for later settlement by an informed, official choice, issues which can only be properly appreciated and settled when they arise in a concrete case.[280]

Kaplow argues that the only distinction between rules and standards is the time of their interpretation: rules acquire their content before and standards after, individuals act.[281] This also affects the difference in costs between rules and standards. The former are generally more costly to create and the latter are more costly for the individuals and courts to interpret.[282]

Cooter and Freedman rightly observe that the beneficiaries of fiduciary relationships would ideally see rules rather than standards used for establishing the framework of how the

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[275] David Kershaw, *Company Law in Context: Text and Materials* (2nd edn, OUP 2012) 313.
[276] Duncan Kennedy, 'Form and Substance in Private Law Adjudication' (1976) 89 HarvLRev 1685, 1688.
[277] There is considerable discussion in the literature regarding whether the standards of conduct and review can be conflated. See e.g. Melvin Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' (1993) 62 FordhamLRev 437.
[278] ibid 437.
[279] ibid.
[280] Hart, *The Concept of Law* 130.
[281] Louis Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 DukeLJ 557, 560.
[282] ibid 557.

fiduciary should manage the assets in the beneficiary's best interests.[283] Nevertheless, directors' duties are better expressed as standards, as they allow effective, flexible, and innovative management of the company. Risk and uncertainty are an inevitable part of asset management; hence, it is difficult to predict the prospective behaviour of the fiduciary.[284] Standards are more adjustable and can be easily adapted to the specific case, to the local circumstances and customs. It is also in fact cheaper to use open-ended measures, as the law does not need to be changed as frequently. The duty of care and duty of loyalty in the company law of the UK, Germany and Delaware are expressed mainly as open-textured standards of conduct and review. Still, rules are occasionally used 'to reinforce standards if the possibility of breach is high, or to reduce legal uncertainty.'[285]

2.3 Introduction to directors' duties

2.3.1 The UK

In the UK, the duties of directors were traditionally regulated under the common law. However, the UK recently decided to codify this area of law. The Law Commission and the Scottish Law Commission considered the advantages and disadvantages of codifying the duties of directors under the general law in a Joint Consultation Paper published in 1998.[286] The Law Commissions subsequently proposed a statutory statement of the duties owed by directors to their companies under general law.[287] The Company Law Review Steering Group (CLRSG) subsequently carried out a comprehensive review of company law, and directors' duties in particular.[288] The CLRSG published several Consultation Documents,[289]

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[283] Robert Cooter and Bradley Freedman, 'The Fiduciary Relationship: Its Economic Character and Legal Consequences' (1991) 66 NYULRev 1045, 1046.
[284] ibid 1046-47.
[285] Cahn and Donald, *Comparative Company Law* 333. All of the jurisdictions provide rules for approving transactions in which directors have direct or indirect personal interests.
[286] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Commission CP No 153; Scottish Law Commission DP No 105, 1998). The codification of directors' duties was also extensively analysed in the literature, e.g.: Lady Justice Arden DBE, 'Companies Act 2006 (UK): A New Approach to Directors' Duties' (2007) ALJ 162; Fraser Dobbie, 'Codification of Directors' Duties: An Act to Follow?' (2008) 11 TrinityCLRev 1; Andrey Keay, 'Enlightened shareholder value, the reform of the duties of company directors and the corporate objective' (2006) LMCLQ 335.
[287] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Commission No 261 and Scottish Law Commission No 173, 1999), Cm 4436.
[288] For detailed information on the process for the review of company law and the bodies responsible for the review see Department of Trade and Industry (DTI), *Modern Company Law for a Competitive Economy* (March 1998) paras 1.3, 7.2-7.4.
[289] E.g. CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (DTI Ferbruary1999); CLRSG, *Modern Company Law for a Competitive Economy: Developing the*

and the Final Report recommended the codification of directors' duties.[290] As a result, the Companies Act 2006 was enacted and the general directors' duties are currently laid down in sections 171-177 of this Act. In the UK, directors' duties are traditionally divided into fiduciary duties and duties of care, skill and diligence.[291] The former require honesty and loyalty (and are commonly referred to as constituting an overarching duty of loyalty) and the latter involve competence and are generally based on the principles of the law of negligence.[292] The CA 2006 describes various fiduciary duties including the duty to act within powers,[293] the duty to exercise independent judgment, [294] the duty to avoid conflicts of interest, [295] the duty not to accept benefits from third parties, [296] and the duty to declare interest in proposed transactions or arrangements. [297] Most importantly for the discussion here, a key fiduciary duty – to act with good faith in the best interest of the company, is regulated in section 172 CA 2006 – and expressed in the UK as a duty to promote the success of the company which requires good faith of directors. [298] The duty of care is expressed in section 174 CA 2006. This provision imposes a mixed objective-subjective test. A director must not only exercise 'reasonable care, skill and diligence,'[299] but also a standard of skill, care and diligence that this particular director[300] and all directors must comply with.[301]

The CA 2006 does not provide exhaustive regulation of directors' duties and despite the codification, the common law principles established earlier still play a vital role in this area of law. To illustrate the complex nature of the current position regarding directors' duties, section 170(3) CA 2006 stipulates that the general duties are 'based on certain common law principles' and 'have effect in place of those rules and principles,' so in fact the

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Framework (DTI March 2000); CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure,* (DTI November 2000).

[290] CLRSG, *Modern Company Law for a Competitive Economy: The Final Report* (Vols I and II, DTI 2001). See especially vol I para 3.9.

[291] Keay, *Directors' Duties* 2. S 178 (2) CA 2006 distinguishes between the fiduciary duties and a duty to exercise reasonable care, skill and diligence. However, Chapter 2 CA 2006 does not make any specific reference to any duties being fiduciary in nature. See in the same vein: Parker Hood, 'Directors' Duties under the Companies Act 2006: Clarity or Confusion?' (2013) 13 (1) JCLS 1, 7 and the literature cited there.

[292] Keay, *Directors' Duties* 2; Davies, Worthington and Micheler, *Gower and Davies' Principles* 517-18.

[293] s 171 CA 2006.

[294] s 173 ibid.

[295] s 175 ibid.

[296] s 176 ibid.

[297] s 177 ibid.

[298] This provision is analysed in detail in section 3.1.1 below.

[299] s 174(1) CA 2006.

[300] s 174(2)(b) ibid.

[301] s 174(2)(a) ibid.

new duties replace the common law principles on which they are based. This principle was emphasised in the recent case of *Eastford Ltd v Gillespie,* where Lord Hodge states that 'the statutory statements replace such of the common law rules as have been subjected to statutory formulation.'[302] However, according to section 170(4) CA 2006, the existing case law on the common law directors' duties remains in principle relevant to the interpretation of the statutory duties since '[t]he general duties shall be interpreted and applied in the same way as common law rules and equitable principles.'[303] Secondly, this provision stipulates that 'regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general law.'[304] The aim of the second part of this subsection is to enable the courts to consider 'developments in the equivalent common law duties applying to trustees and agents.'[305] According to Lord Hodge, the aim of section 170(4) is as follows:

> This subsection seeks to address the challenge which the law commissions and the company law review had identified, namely of avoiding the danger that a statutory statement of general duties would make the law inflexible and incapable of development by judges to deal with changing commercial circumstances. [306]

2.3.2 Delaware

Directors' duties in Delaware are grounded in the common law and are established and clarified by the Delaware courts. The DGCL contains just one rule regarding the duty of loyalty, namely the regulation of conflicted interest transactions between the company and directors or officers.[307] The division of directors' duties in American legal literature is not straightforward and is hotly debated. In contrast to UK law, the duties of care and duty of loyalty are traditionally treated as fiduciary duties in the US. This view clearly stems from the case law. In the *Technicolor* case, for example, Justice Horsey notes: '[the d]uty of care and duty of loyalty are the traditional hallmarks of a fiduciary who endeavors to act in the service of a corporation and its stockholders.(…) Each of these duties is of equal and

[302] *Eastford Ltd v Gillespie* [2010] CSOH 132, [13] (Lord Hodge).
[303] s 170(4) CA 2006.
[304] s 170(4) ibid.
[305] Davies, Worthington and Micheler, *Gower and Davies' Principles* 504 citing HL Debs 6 February 2006, vol 678, col 244 (Grand Committee), Lord Goldsmith.
[306] *Eastford Ltd v Gillespie* [2010] CSOH 132, [13] (Lord Hodge).
[307] s 144 DGCL.

independent significance.'[308] The view that the duty of care is a fiduciary duty is supported in the literature,[309] but there are also dissenting voices.[310]

Pursuant to the duty of loyalty: 'a director is asked to act towards the corporation in the good faith belief that her actions are in the corporation's best interest.'[311] In *Technicolor* '[e]ssentially, the duty of loyalty mandates that the best interests of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.'[312] The duty of loyalty was explained in more detail in *Guth v Loft*:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[313]

The duty of care requires that 'directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances.'[314] The concept of good faith is sometimes defined as a separate duty in Delaware, which clearly distinguishes this jurisdiction from the others under review.

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[308] *Cede & Co v Technicolor, Inc* 634 A.2d 345 (Del. 1993) (henceforth: *Technicolor)* 367 (Justice Horsey).
[309] Tamar Frankel, 'Fiduciary Duties as Default Rules' (1995) 74 OrLRev 1209, 1210.
[310] Smith and Lee, 'Fiduciary Discretion' 622, fn 61.
[311] *Stone v Ritter* 911 A.2d 362 (Del.2006) 370 (Justice Holland) citing *Guttman v Huang,* 823 A.2d 492 (Del Ch 2003) 506 (fn 34). The duty of loyalty was also discussed in the following articles:
Martin Gelter, 'The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance' (2009) 50 HarvILJ 129, 144-145; Nadelle Grossman, 'Turning A Short-term Fling Into A Long-term Commitment: Board Duties in a New Era' 43 (2010) UMich.JLReform 905, 941-943; Randy Holland, Delaware Directors' Fiduciary Duties: The Focus on Loyalty (2009) 11 (3) UPaJBusL675.
[312] *Technicolor* 361 (Justice Horsey) citing *Pogostin v Rice,* 480 A.2d 619 (Del Supr 1984) 624; *Aronson v Lewis* 473 A.2d 805, 2 EXC 28 (Del 1984) 812.
[313] *Guth v Loft* 23 Del Ch 5 A.2d 503 (Del 1939) 510 (Chief Justice Layton).
[314] *Graham v Allis-Chalmers Mfg Co* 188 A.2d (Del.1963) 125, 130 (Justice Wolcott). For more discussion on duty of care see: Gelter, 'The Dark Side of Shareholder Influence' 145-146; Bainbridge, *Corporate Law* 96; David Rosenberg, 'Making sense of good faith in Delaware corporate fiduciary law: a contractorian approach' (2004) 29 DelJCorpL 491.

Technicolor identifies a 'triad' of fiduciary duties: good faith, loyalty, or due care.[315] The concept of a triad of fiduciary duties was revoked in *Stone v Ritter:*

> [A]lthough good faith may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.[316]

Furthermore, *Guttman v Huang* clearly identifies good faith only with the duty of loyalty: '[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.'[317]

2.3.3 Germany

As far as German law is concerned, the members of the management and supervisory boards are required to adhere to the standards of due care and loyalty. Equivalent to the position under UK law, in Germany only the duty of loyalty is perceived as a fiduciary duty (*die treuhänderische Pflicht*). The AktG sets out the duty of care and some elements of the duty of loyalty in § 88, § 93 and § 116 AktG. However, the general concepts of the duty of care and the duty of loyalty are not explained in detail in the AktG. Traditionally, the directors' duties are not regularly invoked or enforced in Germany. According to Doralt, this is why there are not many cases that could help to describe directors' duties and this is the reason why legal scholarship has become the persuasive authority in this field.[318] Only very recently, the German Federal Supreme Court[319] stressed in the landmark decision *ARAG v Garmenbeck* that there is a principal obligation of the supervisory board to examine whether the company has any claim for damages against members of the management board. What is more, the supervisory board can be held responsible if it does not pursue a possible claim.[320]

The duty of care requires the members of the management and supervisory boards to be 'diligent and prudent managers' (*ordentliche und gewissenhafte Geschäftsleiter*).[321] The

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[315] *Technicolor* 361.
[316] *Stone v Ritter* 370.
[317] *Guttman v Huang,* 823 A.2d 492, (Del. Ch. 2003), 506, fn 34 (Vice Chancellor Strine); approved and cited by *Stone v Ritter* 370.
[318] Doralt, 'Regulating Directors' Duties: Their Enforcement and the Business Judgment Rule' 121.
[319] Der Bundesgerichtshof (henceforth: 'BGH').
[320] BGH, 21.04. 1997 (*ARAG v Garmenbeck*) – II ZR 175/95 – BGHZ 135, 244.
[321] § 93 (1) 1, § 116 AktG.

term ‘diligent and prudent managers’ was adopted in the 1937 Stock Corporation Act.[322] Members of both boards are therefore required to ‘devote sufficient time, care and diligence’ whilst acting on behalf of the corporation and managing it.[323] This is an objective standard. A detailed description of a prudent and conscientious manager, that could cover all individual cases, or that could be suitable for different business sectors, is not provided. Each board member must possess the ability and the knowledge, necessary to fulfil the requirments of a particular post.[324] Hence, the scope of the duty of care is not absolute since it depends on specific situations .[325] The courts, therefore, have attempted to provide some guidance on the duty of care. For example, the Bochum District Court (*Landgericht Bochum*) remarked in one case that ‘the due care has been breached as the member of the management board started business relation with the economically unstable corporation without the required precaution, and thus clearly exposed the company to concrete harm.’ [326] Further, the Darmstadt District Court (*Landgericht Darmstadt*) has stated that:

> The duty of care comprises especially of the obligation that follows from the executive function of the management board, i.e.: the management board or the individual board members must fulfil the internal and external obligations of the corporation, in order to keep the company going and to meet different interests directed to it.[327]

The duty of loyalty, in comparison, is more difficult to grasp under German law as it is not clearly defined in the AktG, but established through ananalysis of the case law. The BGH, for instance, provides that ‘this is a well-recognised principle of the civil law that somebody who is in charge of the assets of another party should act exclusively and without restrictions in the interest of the assets’ owner.’[328] Furthermore, in a case from 1967 the court noted that the members of the management board owe loyalty to the company and are subject to prohibition of competition.[329] Certainly, the duty of loyalty must be understood as one that is broader than the principle of good faith, which provides that: ‘[a]n obligor has a duty to

[322] § 84(1)1 AktG 1937 Gesetz über Aktiengesellschaften und Kommanditgesellschaften auf Aktien, 30 January 1937 (RGBl I, 107).
[323] Gerner-Beuerle and Schuster, ‘Mapping Directors’ Duties’ 14.
[324] Kerstin Schnabel and Oliver Lücke, in Oliver Lücke and Bernhard Schaub (eds), ‘Beck’sches Mandatshandbuch Vorstand der AG’ (2nd edn CH Beck 2010) 216 and the literature cited there (my translation).
[325] ibid 217.
[326] LG Bochum 27.6.1989, 12 O 133/88, ZIP 1989, 1557, 1560, 1561 (my translation).
[327] LG Darmstadt 6.05. 1986, 14 O 328/85, AG 1987, 218, 220 (my translation).
[328] BGHSt 21.12.05 – 3StR 470/04 - BGHSt 50, 331, 338, 339 (my translation).
[329] BGH 9.11. 1967 – II ZR 64/67 – BGHZ 49, 30, 31; this case considers a limited liability company (my translation).

perform according to the requirements of good faith, taking customary practice into consideration.'[330]

The AktG merely describes some general characteristics of the duty of loyalty. First, the members of the management and supervisory boards 'shall not disclose confidential information and secrets of the company, in particular trade and business secrets, which have become known to the members of the management board as a result of their service on the management board.'[331] The AktG also sets out that members of the management board may not compete with the company.[332] According to § 88(1)1 AktG, '[a]bsent the consent of the supervisory board, members of the management board may neither engage in any trade nor enter into any transaction in the company's line of business on their own behalf or on behalf of others.' Having discussed the fundamental concepts related to directors' decision-making, attention can now be focused on the consideration of long-term interests in the law. The relevance and parameters of this notion in the light of directors' duties will be analysed first.

3. The concept of long-termism in the context of directors' duties: An analysis based on legislation and relevant case law

Legislation is the starting point in analysing the notion of long-term interests in the decision-making processes of directors. It seems natural to start research by establishing whether and how the legislator in the UK, Delaware and Germany considers this notion and how it is expressed, if at all in the three jurisdictions. Long-termism is not always directly formulated in the jurisdictions under scrutiny. Thus, the duty of loyalty and care (evaluated through both the legislation and case law) are used as the legal tools for extracting its parameters. The concepts of loyalty and due care are present and dynamic in all three legal systems. This enables a meaningful, coherent, and consistent comparison to be undertaken and also implies that conclusions will be easier to interpret despite the differences between the jurisdictions. This section discusses the influence of broad discretionary powers on the duty of loyalty in the context of long-term decision-making and the connection between the duty of care and the business judgment rule and long-termism.

3.1 Directors' broad discretionary powers, duty of loyalty and long-termism

This section poses a question of links between a duty of loyalty, i.e. a duty to act in good faith in the best interest of the company and without furthering private interests, directors'

[330] § 242 Bürgerliches Gesetzbuch (BGB) (German Civil Code), 24 August 1896 (RGBl S 195).
[331] § 93(1) 3, § 116 AktG.
[332] § 88 AktG.

broad discretionary powers and the consideration of the long-term factors in the decision-making processes. It particularly analyses all the essential provisions for establishing the relevance of long-term considerations and the content and scope of this notion. The position in the UK, Delaware and Germany is analysed in turn. The analysis closes with comparative conclusions.

3.1.1 The UK

3.1.1.1. Long-term interests in the UK before section 172 CA 2006

This analysis of the long-term considerations in the UK law is concentrated on section 172 CA 2006 – the duty to promote the success of the company. Before scrutinising the current law, it is worth evaluating the UK's previous stand on long-termism. The present duty to act loyally towards the company and to promote its success, although without an obvious predecessor, is linked to the common law duty to act bona fide in the best interests of the company.[333] The thrust of the concept to concentrate on the best interests of the company was reflected in *Hutton v West Cork Railway*: '[t]he law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.'[334] In the same vein, Lord Denning stated that the duty of directors was 'to do their best to promote its business and to act with complete good faith towards it.'[335] Moreover, according to *Re Smith & Fawcett,* directors were supposed to 'exercise their discretion bona fide in what they consider – not what a court may consider – is in the interests of the company, and not for any collateral purpose.'[336] Under the common law, the directors enjoyed considerable discretionary powers whilst acting on behalf of the company, assuming naturally that they were acting in the best interest of this company. Although it was not particularly outlined in case law, directors in principle were not forbidden from considering the long-term consequences of their decisions before the enactment of the CA 2006.

3.1.1.2. The consideration of long-term interests under section 172(1) CA 2006

Section 172(1) CA 2006

[333] Keay, *Directors' Duties* 117.
[334] *Hutton v West Cork Railway* (1883) 23 Ch D 645, 673 (LJ Bowen).
[335] *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324, 367 (Lord Denning).
[336] *Re Smith & Fawcett* [1942] Ch 304, 306 (Lord Greene M R).

The central duty of loyalty currently finds its expression in section 172 CA 2006. This is perceived by many as one of the most controversial sections of the CA 2006.[337] It generated an enormous amount of debate during the consultation process and when the Companies Bill was going through the UK Parliament whilst being regarded as one of the most important clauses.[338] This thesis concentrates exclusively on for profit and solvent corporations, so only section 172(1) CA 2006 is scrutinised here. According to section 172(1):

> A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to–
> (a) the likely consequences of any decision in the long term,
> (b) the interests of the company's employees,
> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the environment,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly as between members of the company.

To whom are duties owed?

Various factors that a director must consider during the decision-making process are listed in this provision and long-term interests are among them. It is clear that based on section 172(1) the paramount task of the directors of solvent companies is to 'promote the success of the company for the benefit of its members as a whole.' The courts have interpreted the phrase 'members as a whole' as present and future members.[339] Keay also believes that 'members as a whole' could embrace future shareholders, leaving directors with a potentially difficult task of balancing the interests of present and future shareholders. [340] Alcock, hovewer, underlines that during the codification process the CLRSG was resistant in including future members, 'preferring the argument that current company value was determined by prospective revenue generation.'[341]

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[337] Hood, 'Directors' Duties' 15; Arden, 'Companies Act 2006 (UK): A New Approach to Directors' Duties'; Keay, *Directors' Duties* 117.
[338] See e.g. HL Company Law Reform Bill Deb 6 February 2006, col 252 (Lord Freeman) and the subsequent debate <http://www.publications.parliament.uk/pa/ld200506/ldhansrd/vo060206/text/60206-28.htm> accessed 13 November 2013.
[339] *Gaiman v National Association for Mental Health* [1971] Ch, 330; *Brady v Brady* (1987) 3 BCC 535, 552.
[340] Keay, 'The Global Financial Crisis' 26.
[341] Alistair Alcock, 'An accidental change to directors' duties?' (2009) 30 CoLaw 362, 367.

It should be pointed out that section 172(1) – underlining 'members as a whole' – seems to contradict section 170(1) CA 2006. However, the latter leaves no doubts that the general duties are 'owed by a director of a company to the company.' Lord Cullen emphasises this point in *Dawson International Plc v Coats Patons Inc*:

> I see no good reason why it should be supposed that directors are, in general, under a fiduciary duty to shareholders, and in particular current shareholders with respect to the disposal of their shares in the most advantageous way. The directors are not normally the agents of the current shareholders. They are not normally entrusted with the management of their shares. The cases and other authorities to which I was referred do not seem to me to establish any such fiduciary duty.[342]

In practice, section 170(1) means that directors' duties are generally owed to the company – and not to individual shareholders or employees.[343] The above comments and section 172(1) in particular imply that fiduciary duties are owed to the company itself but are actually for the benefit of shareholders. [344]

Relevance of long-term interests based on section 172(1)

In the first instance, directors should focus on promoting the success of the company for the benefit of its members and only subsequently are they entitled to take into account any other factors – long-term interests among them.[345] As section 172(1) reads: 'in doing so [i.e. promoting the success of the company for the benefit of its members as a whole, directors] have regard (amongst other matters) to [factors listed].' This wording supports the contention that the directors' primary obligation is to focus on enhancing the shareholders' interests and profits. The long-term perspective is not associated directly with the success of the company and has only a secondary importance.

The above analysis suggests that it is evident that CA 2006 expresses shareholder primacy (also known as shareholder value maximisation or shareholder value approach); even though, section 172(1) is known as 'enlightened shareholder value' (ESV). [346] It must be acknowledged that s. 172 CA 2006 underlines the importance of non-sharehoolders'

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[342] *Dawson International Plc v Coats Patons Inc (No 1)* 1988 SLT 854, 861. See also: *Sharp v Blank* [2015] EWHC 3220 (Ch). The court underlined in this case that: '[a]lthough the directors had a duty to provide the shareholders with sufficient information to enable them to make an informed choice about the acquisition, they did not owe any wider fiduciary duties because no special relationship existed and they had not undertaken to act for the shareholders in any more extended sense.'

[343] See also: Davies, Worthington and Micheler, *Gower and Davies' Principles* 506.

[344] In the same vein: Hood, 'Directors' Duties' 15-21.

[345] s 172 (1) (a) CA 2006.

[346] CA 2006, c 46, Explanatory Notes, Commentary on s 172 subs 325. <http://www.legislation.gov.uk/ukpga/2006/46/notes/division/6/2> accessed 29 May 2015.

interests and among other things it emphasises long-term considerations. However, in practice, the ESV cannot be distinguished from shareholder primacy and the approach adopted in s. 172 CA 2006 is simply another version of the shareholder primacy. Currently, the consideration of non-shareholders' interests is of secondary importance and is subordninated to the interests of shareholders – confirming the supremacy of shareholders' interests. Also, Lynch underlines that there is very little difference between the current position and the previous duty at common law – as in both cases the shareholders take centre stage. [347] Perhaps the only difference is that the ESV contains a specific encouragement to think about other interests, if they are beneficial for shareholders. [348]

Not only the paramount importance of shareholders' interests, but also other factors, cast doubt on the actual relevance of long-term interests in the decision making processes. Section 172(1) postulates that directors must merely 'have regard to' 'the likely consequences of any decision in the long term.' The word 'must' used in the first part of this section does not apply to the second part of this provision. The phrase 'have regard to' suggests that directors are only required to pay attention and merely consider the long-term consequences of their decisions. Although the Explanatory Notes indicate that '[i]t will not be sufficient to pay lip service to the factors,'[349] there are no legal means to force a director to actually acknowledge the long term consequences of their decisions, assuming that he acts in accordance with his legal duties.[350]

The wording of the provision, also found in the Explanatory Notes to the CA 2006, provides that a list of factors can be considered during the decision-making process, which is 'not exhaustive,' and at the same time the Notes underline that the list 'highlights areas of particular importance which reflect wider expectations of responsible business behaviour (…).'[351] This is how the legislator tries to inspire directors to consider the listed factors. It is striking how ineffective this encouragement really is. As this list is not exhaustive, directors are free not to consider these issues and take into account others. The 'likely consequences of any decision in the long term' is merely one of the supplementary elements or factors that directors ought to consider, and not a mandatory obligation.

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[347] Elaine Lynch, 'Section 172: A Ground-breaking Reform of Director's Duties, or the Emperor's New Clothes?' (2012) 33(7) CoLaw 196, 201-203. However, Ahern presents the opposite view. She argues that the ESV 'clearly went beyond the pre-existing law by requiring the long term interests of the company to be taken into account as well as a range of other interests.' Deirdre Ahern, 'Directors' Duties, Dry Ink and the Accessibility Agenda' (2012) 128(Jan) LQR. 114, 132.

[348] Chapter IV below addresses comprehensively the corporate objectives in the jurisdictions under review, where these concepts are analysed in detail. See especially: Chapter IV s 4.

[349] CA 2006, *Explanatory Notes* 328.

[350] Based on ibid.

[351] CA 2006, *Explanatory Notes* 326.

Therefore, although s. 172 CA 2006 adopted the ESV and expressly encourages long-term decision-making, the current wording of this provision indicates that directors can also have regard to the likely consequences of any decision in the short-term if this will help to promote the success of the company for the benefit of its members as a whole. The conclusion can be reached that instead of presenting an optional list of what factors ought to be included during decision-making, it would be more beneficial to inform directors what they must not do, for instance, concentrate exclusively on short-term interest (although this option is also quite simplistic). A better-developed framework of what is meant by good decision-making is clearly needed. The framework could work on the basis of a 'bank of good decision-making' where successful decisions, put in the context and including the analysis of decision-making process, would be available.

Finally, section 172(1) shows that directors have broad discretionary powers and standards are a common way to express directors' duties. If he acts 'in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole,' the director's duty is fulfilled and there is no breach. It is a matter for the director's good faith judgment,[352] so de facto a subjective decision, to decide what is in the best interest of the company and whether long-term consequences of decisions should be considered. As pointed out above, directors' broad discretionary powers have many advantages. Often directors have to consider various, often conflicting factors whilst taking a decision for the company and without discretion the management of the company would be impossible. However, the subjectivity of this duty jeopardises the importance of long-term considerations even further.

A conclusion emerges that the list created in section 172(1), of which long-termism is one element, can be treated only as a non-mandatory guideline or assistance created by the legislator to help directors during the decision-making processes. It would be very difficult to prove that the duty of a director to promote the success of the company in terms of section 172 CA 2006 has been breached on the basis that a director has failed to consider long-term parameters. Thus, even though the legislator encourages long-term thinking, it is questionable whether long-termism in its current form can play any significant role in practice.

Meaning of long-termism according to the CA 2006

[352] CA 2006, *Explanatory Notes* 327. *Richmond Pharmacology Ltd v Chester Overseas Ltd* [2014] EWHC 2692 (Ch) para 66-68 (Stephen Jourdan QC) confirms that the test in s 172 is a subjective one.

The relevance of long-termism is debatable and the meaning of the concept in the context of section 172(1) is unclear. Neither the CA 2006 nor its Explanatory Notes explain what should be understood by 'the likely consequences of any decision in the long-term.' The legislator has left to the directors the subjective decision on what long-termism means in specific situations. Thus, not only the duty to promote the success of the company itself, but also the notion of long-termism is expressed as a standard rather than a rule. Long-termism is not fixed; it varies by sector and by company, and by the nature of the business. Flexibility is definitely an advantage of long-termism, as long-term factors in the IT and food industries, for example, will differ. The lack of any precise definition, or at least some guidance as to what is meant by it, makes the parameters of long-termism difficult to grasp.

The strategic report – a way to enforce long-term decision-making?

The disclosure requirements of the companies have been recently increased.[353] According to the amended CA 2006, 'the directors of a company[354] must prepare a strategic report for each financial year of the company.'[355] Failure to prepare this report constitutes a criminal offence.[356] The aim of the strategic report is to enforce the duty to promote the success of the company, as section 414C (1) CA 2006 explicitly notes that '[t]he purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (…).' Thus, the provisions of the strategic report strengthen the role of section 172 in general.

More importantly, several aspects of the report are particularly relevant in the context of the long-term decision-making. To start with, each report must contain 'a fair review of the company's business' and 'a description of the principal risks and uncertainties facing the company.'[357] Secondly, the review must include the development and the position of the company's business during and at the end of the financial year.[358] Further, the requirements for a quoted company[359] are particularly extensive and long-term focused. The report of a quoted company must include: 'the main trends and factors likely to affect the future development, performance and position of the company's business' and information

[353] Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013/1970.
[354] Except a small company: ss 414A (2) and 414B CA 2006.
[355] s 414A(1) CA 2006.
[356] s 414A(5)-(6) CA 2006.
[357] s 414C(2) CA 2006.
[358] s 414C(3) CA 2006.
[359] Under s 385 (2) CA 2006, a 'quoted company' is a company whose equity share capital has been included in the official list in accordance with the provisions of Part 6 of the FSMA Act 2000, or is officially listed in an EEA State, or is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq.

about ‘environmental matters,’ ‘the company’s employees’ and ‘social, community and human rights issues,’ to an extent necessary for an understanding of the development, performance or position of the company’s business.[360] Also, the report of a quoted company must include a description of the company’s strategy and business model and a breakdown showing at the end of the financial year, the number of persons of each sex who were directors, senior managers and employees of the company.[361]

To conclude, this enhanced, integrated reporting is likely to be costly for the company and also raises questions about the effectiveness and quality of the strategic report. However, on the whole, the more transparent and detailed corporate reporting is likely to be beneficial for the company and for the functioning of the capital markets in general (e.g. through the detailed valuation of securities). Moreover, it is hoped that the aspects of the report listed above and especially the reference to ‘the main trends and factors likely to affect the future development, performance and position of the company's business’ in particular, encourages consideration of the relevant long-term factors. The practical relevance of the report and especially its influence on long-term thinking has yet to be determined.

3.1.2 Delaware

There is no statutory provision similar to section 172(1) CA 2006 that would directly relate to the relevance of ‘the likely consequences of any decision in the long term’ in Delaware law. Nor does the DGCL offer any guidance of what factors directors should consider in their decision-making processes. The only provision which considers the role and function of the company directors is § 141 DGCL – outlined in Chapter II above: ‘[t]he business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation (…).’[362] All managerial powers in Delaware are derived in principle from this section. Importantly, this provision read together with the duty of loyalty, that is the obligation to act with good faith in the best interest of the corporation, clearly indicates that the board in Delaware has broad decision-making powers. This implies that it is up to the board to decide on what is in the corporation’s best interest – assuming that they adhere to their duties. They can therefore decide to take into account the long-term consequences of a decision. Long-termism is not an explicit component of directors’ duties in Delaware, but it is not excluded since there is no provision that would ban the board from

[360] s 414C(7) CA 2006.
[361] s 414C(8) CA 2006.
[362] § 141 (a) DGCL.

considering long-term factors. However, long-term factors can only be taken into account if consideration of these factors is beneficial for shareholders. Although directors' duties are in general owed to the company,[363] there is no doubt that shareholders are the main beneficiaries of directors' duties in Delaware.

Delaware case law confirms that a company should be managed for the benefit of its shareholders: '[e]ssentially, the duty of loyalty mandates that the best interests of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.'[364] The paramount importance of the shareholders' interests was affirmed in the case law. For example, in *Malone v Brincat*[365] it was provided that: '[t]he board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners'[366] and that '[a]ccordingly, fiduciary duties are imposed on the directors of Delaware corporations to regulate their conduct when they discharge that function.'[367] Delaware is commonly perceived as a great supporter of the shareholder primacy theory, i.e. the theory that a corporation's main objective is to maximise shareholder value.[368] Therefore, combining the board's broad discretionary powers with the shareholder value primacy unequivocally suggests that long-term factors can be considered in Delaware if they are beneficial for shareholders. Legislation neither encourages nor prohibits considering long-term factors directly nor does it provide any guidance on the meaning of long-termism.

3.1.3 Germany

Broad discretionary powers and long-termism

German law does not offer guidance on what managers of the AG should consider in the decision-making processes. As with the law of Delaware, German law does not contain a provision similar to section 172 CA 2006 where the relevance of long-termism is directly emphasised. Nevertheless, similar to the position in the two other jurisdictions, the management board – a key decision-making body in the AktG – enjoys broad discretionary powers. To illustrate this point, according to § 76(1) AktG: '[t]he management board shall have direct responsibility for the management of the company (*Der Vorstand hat unter*

[363] *Stone v Ritter* 370; *Guttman v Huang* 506, fn 34.
[364] *Technicolor* 361 citing *Pogostin v Rice* 480 A.2d 619 (Del Supr 1984) 624; *Aronson v Lewis* 473 A.2d 805, 2 EXC 28 (Del 1984) 812.
[365] *Malone v Brincat,* 722 A.2d 5 (Del 1998) 9-10 (Justice Holland).
[366] Interestingly, § 141(a) DGCL is cited as an authority for this statement.
[367] Citing *Mills Acquisition Co v Macmillan, Inc* 559 A.2d 1261 (Del. 1989), 1280.
[368] For the discussion on corporate objective, see Chapter IV below, especially s 4.

eigener Verantwortung die Gesellschaft zu leiten).'[369] This translation is very literal and it is argued that the translation offered by Schall and others – which underlines that the management board is vested with 'wide powers of discretion' (*unter eigener Verantwortung*)[370] – is more accurate. The BGH also highlights that the management board has wide powers whilst acting on behalf of the company: 'the management board must be given the wide range of free discretion that is essential for the operation of a business.'[371] Interpreting § 76(1) AktG in the context of duty of loyalty,[372] a duty to 'act exclusively and without restrictions in the interest of the assets' owner'[373] and assuming that it fulfils its duties, the management board is free to consider long-term implications of any decision. Similar to the position in the two other legal systems, there is nothing in the legislation that would prevent the management board from furthering long-term goals.

To whom are the duties owed?

In Germany, the duties are owed directly to the company, as members of both boards are appointed to serve 'the interest of the enterprise' (*Unternehmensinteresse*). The notion of 'the interest of the enterprise' was developed by the courts.[374] The BGH[375] considered the claim of the members of the supervisory board against the management board in 1988. This case involved conflicts of interests between shareholders and employees and it was decided that it should be resolved 'in view of the paramount interest of the corporation.'[376] Very little can be found in the case law on the actual substance of 'the interest of the enterprise.' In contrast to the UK and Delaware, Germany is traditionally perceived as embracing the stakeholder value theory. Not only the interests of shareholders but also those of other stakeholders such as employees and creditors are important in pursuing the 'interest of the enterprise.'[377] Therefore, during the decision-making process, the management board is neither entitled nor obliged to consider only the interests of the shareholders.[378] This suggests

[369] Translation of the AktG after the Norton Rose Group (translation as at 1 December 2011).
[370] Alexander Schall, Lilian Miles and Simon Goulding, 'Promoting an Inclusive Approach on the Part of Directors: The UK and German Positions' (2006) 6 JCorpLStud 299, 308.
[371] *ARAG v Garmenbeck* 244, 253.
[372] According to Spindler, the duty of care and duty of loyalty should be interpreted taking into consideration § 76 (1) AktG. See Gerald Spindler, in Wulf Goette, Mathias Habersack and Susanne Kalss (eds), *Münchner Kommentar Aktiengesetz* (4th edn, CH Beck/Franz Vahlen 2014) § 93 mn. 22 (my translation).
[373] See above BGHSt 21.12.05 – 3StR 470/04 - BGHSt 50, 331, 338, 339 (my translation).
[374] BGH 25.02. 1982 – II ZR 174/80 – BGHZ 83, 122, 134; BGH, 12.03. 1990 – II ZR 179/89 – BGHZ 110, 323, 334 (my translation).
[375] BGH 28.11. 1988 – II ZR 57/88 – BGHZ 106, 54 (my translation).
[376] ibid 65.
[377] Chapter IV s 4.1.3 contains a detailed analysis of a stakeholder value theory and the interest of the enterprise.
[378] Uwe Hüffer, *Aktiengesetz* (10th edn, CH Beck 2012) § 76 mn. 12 (my translation).

that the management board is not limited to considering long-term factors beneficial for shareholders only.

Continued existence and profitability of the corporation

The interpretation of the general duties indicates that there is a place for long-term factors to be taken into account during the decision-making process in Germany. The managers' discretionary powers are limited, among other things, by a duty to ensure the continued existence of the corporation[379] and the management board is also obliged to report on the profitability of the company.[380] The former provides that: '[t]he management board shall take suitable measures, in particular surveillance measures, to ensure that developments threatening the continuation of the company are detected early.' The latter provision states that '[t]he management board shall report to the supervisory board, on the profitability of the company and in particular the return on equity.' Thus, decisions of the management board are beneficial if they serve the continued existence of the corporation. The first provision is of general application and aims at detecting any risks that threaten the existence of the company. Hence, it can also arguably be interpreted as a duty to consider the long-term consequences of any decision. A lack thereof jeopardises the continued existence of a company. The continued existence of the company depends on its profitability so it is crucial that the company generates profits. It is worth underlining that § 90(1)2 AktG is quite general and requires the management board to report on profitability but it does not require that the company actually makes a profit. These two provisions have the potential to promote the relevance of long-term interests in the decision making processes in Germany, as they stress the future development of the company. Unfortunately, the meaning of 'profitability' or 'continued existence' is not clarified by the law and it is doubtful whether any explicit obligation with regard to long-termism can be derived from these two provisions.

Remuneration of managers and long-termism?

Section 87 AktG encompasses principles governing remuneration of members of the management board.[381] This provision contains detailed rules regarding the managers' remuneration and it provides that the supervisory board determines 'the aggregate remuneration of any member of the management board.'[382] The supervisory board also has a duty to 'ensure that such aggregate remuneration bears a reasonable relationship to the duties

[379] § 91(2) AktG.
[380] § 90(1) 2 AktG.
[381] Director's remuneration (and in this context also § 87 AktG) is discussed further in Chapter VI s 2.2 below as an incentive for long-term decision-making.
[382] § 87(1)1 AktG.

and performance of such member as well as the condition of the company and that it does not exceed standard remuneration without any particular reasons.'[383] Thus, the role of the supervisory board is to ensure that executive remuneration is not excessive. Further, and importantly for the purposes of this thesis, according to the AktG '[t]he remuneration system of listed companies shall be aimed at the company's sustainable development (*nachhaltige Unternehmensentwicklung*).'[384] The subsequent provision adds that '[t]he calculation basis of variable remuneration components in the listed company should therefore be several years long (...).'[385] It is argued that these two provisions, the guidelines on determining the levels of remuneration, are critical for encouraging forward thinking during decision-making processes in public German companies. Both sections – § 87(1) 2 and § 87(1)3 AktG are new developments and the term 'sustainability' was only introduced into the legislation in 2009.[386] These rules were adopted as a consequence of criticism of executive remuneration schemes during the recent financial crisis and they are designed to set the remuneration of board members based on the financial condition of the company they are running. [387]

Neither the legislation nor the Explanatory Notes to the Act[388] elaborate on the terms 'sustainable development' or 'several years.'[389] Hence, it must be decided on a case-by-case basis how to understand the sustainable development of the company and without doubt, there is an element of discretion in this respect. These provisions clearly encourage members of the management board of listed companies to concentrate on the company's 'sustainable development' – or using the translation of the author of this thesis: 'lasting increase in value' – as their remuneration depends on it. Additionally, this section is addressed to the members of the supervisory board, because they are in charge of determining the aggregate remuneration of the management board. Thus, members of both boards are well placed to contribute to the company's 'sustainable development.' Do these legal provisions say anything at all about the actual content of the expression 'sustainable development'? It is argued that they do. Although it does not elaborate on the parameters of sustainable development, § 87 AktG seeks to connect the managers' remuneration with the future

[383] § 87(1)1 AktG.
[384] § 87(1)2 AktG. The term '*nachhaltige Unternehmensentwicklung'* can also be arguably translated as 'lasting increase in value of the company.'
[385] § 87(1)3 AktG.
[386] § 87(1)2, 3 AktG were added by the Gesetz zur Angemessenheit der Vorstandsvergütung (VorstAG), 31 July 2009 (BGBl I, 09, 2509).
[387] von Dryander and Riehmer , *Being a Board Member in Germany* 23.
[388] Explanatory Notes, Beschlussempfehlung und Bericht des Rechtsausschusses, 17.06.2009, BT-Drucks 16/13433
<http://dip21.bundestag.de/dip21/btd/16/134/1613433.pdf> accessed 16 May 2014.
[389] For the commentators' views on the terms 'sustainable development' and 'several years' see accordingly: Chapter IV s 2.4 and Chapter VI s 2.2 below.

development of the company. It also implies that the management board cannot concentrate only on short-term goals and must take into account long-term factors by analysing the potential long-term consequences of their decisions. Remuneration is a powerful tool and cannot be underestimated. Therefore it is opined that § 87 AktG will encourage a more future orientated management of companies.

An additional question is whether the requirement to concentrate on sustainable development will actually play any role in practice. On the whole, it is up to management boards to consider long or short-term goals and for supervisory boards to shape executive remuneration with sustainable development in mind. § 87 (1) 2 and 3 AktG are only recommendatory provisions and they do not have any mandatory status. They state that the remuneration system of listed companies 'shall be aimed at sustainable development' and 'the calculation basis of variable remuneration components should therefore be several years long.' Consequently, there are no means of obliging the management board to consider sustainable development or take a perspective of several years.

Relevance and meaning of long-termism according to the AktG

As in the two other jurisdictions, the management board in Germany enjoys broad discretionary powers so it is free to take into account the long-term consequences of its decisions. The main difficulty with analysing the AktG in the context of this thesis is that it does not use the term 'long-term' (*langfristig*). Therefore, at first sight, it seems that consideration of long-term factors does not play any role in this jurisdiction. This assumption is certainly incorrect. The terms used in the AktG, namely 'continued existence of the corporation' and 'sustainable development of the company' are functionally equivalent to long-termism since they refer to future orientated and responsible decision-making. Regarding the content and scope of these notions in practice, the legislation does not give much guidance.

3.1.4 Conclusions

The comparative discussion in this section shows that, assuming directors are acting in good faith in the best interest of the company, the discretionary powers that they have in each of the three jurisdictions under review are sufficiently broad to enable them to consider long-term interests during decision-making. Delaware stops at this stage – the board has leeway to consider long-term factors but they are not positively encouraged to do so – but the two other legal systems go further. Without the CA 2006, the position in the UK would not differ much from Delaware, as the analysis in section 3.1.1.1 above demonstrated. The introduction of

section 172(1) CA 2006 gave a statutory footing to 'the likely consequences of any decision in the long-term.' Among the legal systems under comparison, only the UK provides the board with some guidance, as to what they should consider in the decision-making processes. The CA 2006 undeniably encourages directors to pay attention to long-term factors. However, it remains to be seen whether the factors listed in section 172(1) CA 2006 (and long-term considerations among them) will play any actual role in practice, as this provision does not impose a mandatory obligation on directors to inject long-term thinking into their decision-making processes. The position in Germany resembles that in the UK. Although there is no specific obligation to have regard to long-term factors, the remuneration system of listed companies and a duty to ensure the continued existence of a company underlines the importance of forward thinking. This section also highlighted the functional equivalence of the legal terms used in the UK and Germany. In sum, there is nothing in principle to prevent directors from considering the long-terms consequences of their decisions. Nevertheless, the fact that long-term decision-making is allowed is not necessarily a sufficient way of promoting it, as clearly the board might choose to concentrate on short-term factors.

Neither the AktG nor CA 2006 contain definitions or any indications of the actual content of 'sustainable development,' 'continued existence,'or 'long-termism.' Nonetheless, the conclusion arises that these notions are very flexible, since they constitute standards and open-ended measures that require further interpretations to obtain their meaning. The duty of care and the business judgment rule will now be considered in the context of long-termism.

3.2 Duty of care, business judgment rule and long-termism

3.2.1 Introduction

The duty of care – the other key directors' duty – lies at the heart of the discussion in this section. It is analysed here how the requirement to act with due care affects business decisions and why, in principle, the courts decide not to assess directors' honest but imprudent business decisions (known as business judgment rule). Subsequently, this section scrutinises how the duty of care and especially business judgment rule influence the notion of long-term decision-making. In discussing these issues, this section will now consider the law in the UK, Delaware and Germany and UK. Finally, it will offer some concluding remarks.

3.2.2 The UK

In the UK, the duty of care requires a director to 'exercise reasonable care, skill and diligence.'[390] This provision imposes a mixed objective-subjective test. As the care skill and diligence must be 'exercised by a reasonable diligent person' – which implies – 'the general knowledge, skill and experience' of a person in the directors' position (objective test) and the general knowledge, skill and experience of this particular director (subjective test).[391] Hence, despite the objective part, in practice the discharge of duty of care will differ from case to case, due to different skills of each director.[392] The Explanatory Notes explain clearly the standard of care that is expected from diectors, underlining that if they act in good faith – using their business judgment – they will not be liable for a breach of duty:

> (…) [T]he duty [of care] does not require a director to do more than good faith and the duty to exercise reasonable care, skill and diligence would require, nor would it be possible for a director acting in good faith to be held liable for a process failure which would not have affected his decision as to which course of action would best promote the success of the company.[393]

The Explanatory Notes also indicate that, although not directly implemented, the idea of court non-interference with business judgments undoubtedly exists in the UK:

> The decision as to what will promote the success of the company, and what constitutes such success, is one for the director's good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith.[394]

Already the Law Commission and the Scottish Law Commission recommended against introducing a business judgment rule into statute.[395] The Commissions argued that this duty is not necessary since:

> The courts currently do not judge directors with the wisdom of hindsight and do not 'second-guess' directors on commercial matters. There is nothing to suggest that this long-established judicial approach would not apply. It would in any event be difficult to formulate a business judgment principle without either narrowing it or making it too rigid.[396]

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[390] s 174(1) CA 2006.
[391] s 174(2) CA 2006.
[392] Davies, Worthington and Micheler, *Gower and Davies' Principles* 520.
[393] CA 2006, *Explanatory Notes* 328.
[394] CA 2006, *Explanatory Notes* 327.
[395] Law Commission and Scottish Law Commission, *Company Directors: Regulating Conflicts of Interest and Formulating a Statement of Duties* (Cm 4436, 1999) pt 5.
[396] ibid 5.28.

Therefore, it is evident that the business judgment rule operates in the UK, but on an indirect basis. The conclusion arises that in the case of an alleged breach of the duty of care, the courts are unlikely to evaluate whether any long-term factors were taken into consideration, as they are unlikely to 'second-guess' directors' business decisions.

3.2.3 Delaware

In Delaware, the duty of care requires that directors fulfil their responsibilities in good faith with the care of an ordinarily prudent person.[397] According to *Smith v Van Gorkom* directors should be informed 'of all material information reasonably available to them' before making a business decision.[398] It is worth highlighting that in Delaware business decisions are protected by the business judgment rule. This rule was described in *Sinclair Oil Corp v Levien:*

> A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.[399]

In *Aronson v Lewis*, the business judgment rule was interpreted as: 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'[400] *Smith v Van Gorkom* stated that '[t]he business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors.'[401] Delaware courts are generally keen to protect the board's freedom in managing the company. *Technicolor* affirmed that: '[t]he rule operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation' [402] and the *Disney* case underlines that 'courts are ill equipped to engage in *post hoc* substantive review of business decisions.'[403]

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[397] *Graham v Allis-Chalmers Mfg Co* 130.
[398] *Smith v Van Gorkom* 488 A.2d 858 (Del 1985) 872 (Justice Horsey) citing *Kaplan v Centex Corporation* 284 A.2d 119 (Del Ch 1971) 124.
[399] *Sinclair Oil Corp. v Levien* 280 A.2d 717 (Del 1971) 720 (Chief Justice Wolcott).
[400] *Aronson v Lewis* 473 A.2d 805, 2 EXC 28 (Del 1984) 812 (Justice Moore).
[401] *Smith v Van Gorkom* 872 (Justice Horsey); citing*: Zapata Corp v Maldonado* 430 A.2d 779 (Del Supr 1981) 782.
[402] *Technicolor* 360 [citation omitted].
[403] *Re Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del Ch 2005) 107 (Chancellor Chandler) [emphasis in original].

The *Disney* case emphasises how the business judgment rule works in practice for the benefit of directors.[404] It explains that the presumption of the business judgment rule 'applies when there is no evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment on the part of the directors.'[405] The onus then shifts to the plaintiff to rebut this presumption by demonstrating a breach of any fiduciary duty. Rebuttal results in shifting the burden of proof to the defendants. An analysis of the *Disney* case also shows that the business judgment rule can be relied upon in the case of a possible breach of the duty of care but not the duty of loyalty.

In Delaware, the business judgment rule protects all good faith decisions taken with due care in the best interest of the company. Therefore, in the cases that do not involve a breach of the duty of loyalty – when there is no conflict of interest – the courts are unlikely to intervene even if a given decision is unsuccessful. It has also been argued that the chances of challenging a decision that is subject to the business judgment rule are 'exceedingly slim.'[406] This implies that absent a managerial conflict of interests, long-termism is unlikely even to be on the court's agenda. The business judgment rule thus questions the importance of any consideration of long-term factors, since the courts are generally reluctant to review business decisions.

3.2.4 Germany

Turning now to Germany, the duty of care requires members of the management to employ the care of 'diligent and prudent managers' (*ordentliche und gewissenhafte Geschäftsleiter*).[407] As with the position in Delaware, the operation of the business judgment rule in Germany insulates members of the management board of the AktG from liability for breaches of the duty of care. The BGH developed the business judgment rule in Germany. In the leading case of *ARAG v Garmenbeck*, the court stated that:

> [T]he management board must be given the wide range of free discretion that is essential for the operation of a business. In addition to consciously running business risks, this generally also includes the danger of bad decisions and incorrect evaluations, to which every businessman – regardless of how responsible – is subject.[408]

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[404] *Re Walt Disney Company Derivative Litigation* 107-10.
[405] ibid 108 [citation omitted].
[406] Claire Hill and Brett McDonnell, 'Fiduciary Duties: The Emerging Jurisprudence' in Claire Hill and Brett McDonnell (eds), *Research Handbook on the Economics of Corporate Law* (Edward Elgar 2012) 135 citing Bernard Black, Brian Cheffins and Michael Klausner, 'Outside Director Liability' (2006) 58 StanLRev 1055.
[407] § 93(1)1 AktG.
[408] *ARAG v Garmenbeck* 244, 253.

Only subsequently, in 2005, was this rule set out in the AktG. The Act directs that:

> [Members of the management board] shall not be deemed to have violated the aforementioned duty [of care] if, at the time of taking the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company [*zum Wohle der Gesellschaft*].[409]

The AktG clearly articulates that the business judgment rule can only be referred to in case of breach of the duty of care and not the duty of loyalty or any other provision of law, since only the former is directly mentioned in § 93(1)2 AktG.[410]

In accordance with the judgment of the Regional Court in Hamburg from 1995 that predates the business judgment rule, the term 'benefit of the company' indicates that 'the management board whilst taking decisions on behalf of the company should concentrate especially on the continued existence of the company and its lasting profitability.'[411] Furthermore, according to the Explanatory Notes to the Act[412] that introduced the business judgment rule into legislation:

> The action is in any case considered to be for the 'benefit of the company',if it serves the long-term strengthening of profits and competiveness of the enterprise and its products or services. (...) This is therefore not about the ex post determined well-being of the company (...). To the contrary, the director is required to consider in good faith the interest of the company, when he is making the decision. This decision should be free from conflict of interests, external influences and direct self-interests. The director should also be impartial and independent.[413]

The BGH describes the business judgment rule on several occasions, referring only generally or indirectly to terms like the 'benefit of the company' or 'lasting profitability.' In the context of the business judgment rule, it was argued in a judgment of 2007 that 'the manager

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[409] § 93(1)2 AktG. Note that based on § 116 AktG, the business judgment rule is also applicable to the supervisory board. Furthermore the business judgment rule is also to be found in § 3.8 of the Kodex: '[i]n the case of business decisions an infringement of duty is not present if the member of the Management Board or Supervisory Board could reasonably believe, based on appropriate information, that he/she was acting in the best interest of the company (Business Judgment Rule).'

[410] Similarly Roth: '[i]n general, violations against the law, articles of association, decisions of the general meeting or the duty of loyalty are excluded from the business discretion.' Marcus Roth, 'Das unternehmerische Ermessen des Vorstands' (2004) BB 1066, 1068 (my translation).

[411] OLG Hamm, 10.5. 1995, 8U 59/94, AG 1995, 512, 514 (my translation).

[412] Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrecht (UMAG) 22 September 2005 (BGBl 2005 I, 2802).

[413] Bundesrat, Gesetzentwurf der Regierung – UMAG, 7 January 2005, Drucksache 3/05, 19-20 <http://www.gesmat.bundesgerichtshof.de/gesetzesmaterialien/15_wp/umag/0003_2D05,property=Dokument.pdf> accessed 12 May 2014 (my translation).

of the private limited company exercises its entrepreneurial discretion only if he establishes diligently the basis of his decisions' and he is also required 'to take into consideration all available sources of information, both factual and legal and on that basis assess diligently all advantages and disadvantages of possible solutions.'[414] Thus, this case implies indirectly that the long-term consequences of a decision should be also considered, which reasoning is also applicable to a public company. Similarly in 2008, the BGH in a case regarding a cooperative bank (*Genossenschaftsbank*) [415] it was stated only generally that 'the management board exercises its entrepreneurial discretion only if it diligently establishes the basis of its decisions and considers carefully all arguments pro and contra.'[416]

The business judgment rule in Germany undoubtedly limits the scope of the duty of care. Like the position in Delaware, bad and unsuccessful business decisions are unlikely to be litigated. However, this rule seems to be weaker in Germany for two reasons at least. First, in comparison with Delaware, the threshold of protection for directors is lower under German law. Delaware law creates a presumption in favour of directors, whereas in Germany the members of the management 'shall bear the burden of proof in the event of a dispute as to whether or not they have employed the care of a diligent and conscientious manager.'[417] Secondly, the rule is more general and therefore easier to refer to by directors in Delaware as they 'only' need to act 'on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' In Germany, on the other hand, in order to rely on the business judgment rule, members of the management must show not only that they were acting with 'adequate information for the benefit of the company.' But also that they were concentrating 'on the lasting profitability of the corporation' or in other words, that they were aiming at 'the long-term strengthening of profits and competiveness of the enterprise and its products or services.'

Overall, the exact role of the business judgment rule is unclear.[418] The rule clearly limits the application of the duty of care in Germany and confirms that the management board has broad decision-making powers. Consequently, they are left with the discretion to consider the long-term consequences of their decisions, or not, as the case may be. At the same time, the board's members are unlikely to be held responsible if they decide not to take into account long-term factors, assuming that they act on an informed basis for the benefit of the

[414] BGH, 14.07.2007 – II ZR 202/07 – BB 2008, 2390 (my translation).
[415] In Germany, cooperatives are regulated by the Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften, 16 October 2006 (BGBl I, 642, 660).
[416] BGH 3.11.2008 - II ZR 236/07 – BB 2009, 465 (my translation).
[417] § 93(2) 2; see also § 116 AktG.
[418] See similarly Doralt, 'Regulating Directors' Duties: Their Enforcement and the Business Judgment Rule' 122. Doralt notes that the rule – being a legal transplant from US case law – is criticised in Germany for its lack of clarity and vagueness.

company. Thus, BGH judgments on the application of the business judgment rule are awaited. It is anticipated that the case law and perhaps commentators will explain how the rule should work in practice and what the relevance of the long-term factors really is. A further explanation in § 93(1) 2 AktG is critical. Although the expression the 'benefit of the corporation' is identified by some with the future and the long-term profitability of the company, the literal interpretation does not imply that. There is also a danger that the business judgment rule could be interpreted more broadly and used by managers as a means of evading liability.

3.2.5 Conclusions

To summarise, the foregoing discussion implies that the business judgment rule (which constitutes part of the duty of care) is present in Delaware and Germany and indirectly relevant in the UK. The presence of the business judgment rule undermines the importance of long-term considerations in managerial decision-making processes. The rule shields directors' operational good-faith decisions from judicial review. The author of this thesis agrees with Fleisher that a very strict duty of care would be counter-productive, as directors could be reluctant to take risky decisions.[419] However, the business judgment rule is far too lenient. It makes the duty of care toothless and arguably gives too much freedom to directors and managers while discouraging them from considering long-term factors in their decision-making.

4. Parameters of long-termism according to the case law

4.1 Introduction

The section above illustrated how the notion of long-termism is perceived in the light of legislation and the two core directors' duties. The current section analyses long-termism in the context of the case law, with a view to understanding this concept, its content and relevance, since the legislation does not offer much guidance in understanding it. The UK, Delaware and German case law are presented in turn. This section then offers comparative conclusions on the parameters of long-termism in the light of the most significant court cases.

[419] Holger Fleischer, 'Die "Business Judgment Rule" im Spiegel von Rechtsvergleichung und Rechtsökonomie' in R Wank and others (eds), *Festschrift für Herbert Wiedemann zum 70 Geburtstag* (CH Beck 2002) 830 (my translation).

4.2 The UK

Taking into account the amount of attention that it received before and after its enactment, the scant degree of consideration of section 172 CA in the case law might seem unexpected. Unfortunately, the case law is not of great assistance regarding the interpretation of the concept of long-termism: so far, there have been few cases on the duty to promote the success of the company, let alone on long-termism. This state of affairs stems from judicial reluctance to interfere in management of companies. This hesitancy existed before the CA and continues to this day. *Howard Smith Ltd v Ampol Petroleum Ltd* – a case from 1974 – stated that:

> [I]t would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, on such a question, if bona fide arrived at. There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at. [420]

Re Southern Countries Fresh Foods Ltd – a case decided under the CA 2006 – confirms that it is a task for the directors and not for the court to decide what constitutes the best interest of the company. The case also stresses the subjectivity of the duty to promote the success of the company and instances where it might be breached:

> In relation to acting in the best interests of a company, the directors' fiduciary duty is to exercise the powers conferred on them 'bona fide in what they consider – not what a court may consider – is in the interests of the company', thus the test, both under the general law and under CA 2006, is a subjective one. The question is whether the director honestly believed that his act or omission was in the interests of the company. The court does not consider that the duty is broken simply because, in the court's opinion, the particular exercise of the power was not to promote the success of the company, although it is accepted that a breach will have occurred if it is established that the relevant exercise of the power is one which could not be considered by any reasonable director to be in the interests of the company. (…) This subjective approach does not however, entitle a director to breach the "no-profit" rule and the "no-conflict" rule simply because he thinks it is in the interests of the company to do so. Nor in my judgement, is it necessarily the case that there can, in cases of conflict, be no unfair prejudice simply because the director believes his conduct to be justified.[421]

[420] *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 832 (Lord Wilberforce).
[421] *Re Southern Countries Fresh Foods Ltd* [2008] EWHC 2810 (Ch) para 53 (Mr Justice Warren).

Section 172(1) CA 2006 has thus far been mentioned specifically in the context of the application for permission to bring judicial review proceedings and shareholder's remedies, e.g. 'unfair prejudice' petitions[422] and derivative (shareholder) actions on behalf of the company.[423] In *The Queen on the Application of People and Planet v HM Treasury*[424] the claimant action group applied 'for permission to bring judicial review proceedings in relation to the policy adopted by [the defendant –] HM Treasury for handling its investment in Royal Bank of Scotland (…).'[425] In this significant case on government administration, as to section 172 CA 2006 it was stated that 'that decisions regarding the management of RBS will be matters for the judgment of the directors of RBS' who also need to have regard 'to environmental and human rights considerations in accordance with the (…) duty under section 172.'[426] Consideration of long-term factors was not discussed.

Few cases concerning the petition for an order under section 994 CA 2006 refer to section 172. In the Scottish case *Re West Coast Capital (Lios) Ltd,*[427] Lord Glennie discusses sections 171 and 172 only generally without referring to the notion of long-termism: '[t]here was no equivalent in the earlier Companies Acts, but these sections appear to little more than set out the pre-existing law on the subject.'[428] *Re Southern Counties Fresh Foods Ltd*[429] is another case where a petition for an unfair prejudice was presented. As outlined above, the case discusses in general the duty to promote the success of the company but nothing can be found on long-termism. The section under review is also considered in *Martin Shepherd v Michael Roy Williamson and Phoenix Contracts (Leicester) Limited.*[430] This case only briefly mentions section 172 CA 2006 in the context of the claim under section 994 CA 2006.[431] Neither the duty to promote the success of the company nor long-termism was discussed in any detail. The case merely restates that: '[t]he decision as to what promotes the success of the Company within section 172(1) is one for a director's subjective judgment, exercised in good faith (…).'[432]

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[422] s 994 CA 2006ff.
[423] In England and Wales referred to as 'derivative claims' (s 260 CA 2006ff) and in Scotland as 'derivative proceedings' (s 265 CA 2006ff).
[424] *The Queen on the Application of People and Planet v HM Treasury* [2009] EWHC 3020 (Admin) (Mr Justice Sales).
[425] ibid para 1.
[426] ibid para 35.
[427] *Re West Coast Capital (Lios) Ltd* [2008] CSOH 72.
[428] ibid para. 21 (Lord Glennie). Goddard does not agree with Lord Glennie that ss 171-172 CA 2006 are only a restatement of the pre-existing law. See: Robert Goddard, 'Directors' duties' (2008) 12(3) EdinLRev 468, 471-471.
[429] *Re Southern Countries Fresh Foods Ltd* [2008] EWHC 2810 (Ch).
[430] *Martin Shepherd v Michael Roy Williamson and Phoenix Contracts (Leicester) Limited* [2010] EWHC 2375 (Ch).
[431] ibid paras 33, 95, 96, 103, 104 (Mrs Justice Proudman).
[432] ibid para 104.

Finally, section 172 is important in the context of derivative actions by shareholders on behalf of the company. According to section 263(2) (a) CA 2006: permission (or leave) necessary to continue a derivative claim 'must be refused if the court is satisfied that a person acting in accordance with section 172 (…) would not seek to continue the claim.'[433] Section 263(3)(b) provides that '[i]n considering whether to give permission (or leave) the court must take into account in particular the importance that a person acting in accordance with section 172 (…) would attach to continuing it.'[434] *Iesini v Westrip Holdings*[435] does not discuss the relevance of long-term factors or considerations. This case notes that in most cases courts will not challenge directors' subjective judgments: '[t]he weighing of all these considerations [i.e. factors which a director acting in accordance with section 172 would consider included] was essentially a commercial decision, which the court was ill-equipped to take, except in a clear case.'[436] In the following cases section 172 CA is also cited in the context of derivative claims and the need to act fairly between members of the company is scrutinised but unfortunately, there is no analysis of long-termism: *Kiani v Cooper,*[437] *Parry v Barrtlett*,[438] *Phillips v Fryer,*[439] *Re Singh Brothers Contractors (North West) Ltd*[440] and *Cullen Investments Ltd v Brown.*[441] Furthermore, *Re Coroin Ltd*[442] hardly mentions section 172 CA 2006 at all, stating that '[t]hat [the] duty could give rise to an obligation on directors to disclose to the company matters of which they were aware.'[443]

In sum, there are a very few cases in the UK that consider section 172 CA 2006 and unfortunately, these provide no guidance about the meaning of long-termism. The lack of cases that interpret section 172 CA is principally a product of the subjective character of the duty to promote the success of the company. It is difficult to challenge a particular decision if a director claims that he was acting in good faith in the best interest of the company. Secondly, as mentioned above, courts are unwilling to get involved in the management of the companies, second-guessing directors' decisions, or deciding what constitutes the best interest of the company. It is hard to disagree with this approach. Judges are not necessarily able or trained to assess business decisions from different fields and industries and without doubt, in general, it is much easier to evaluate and criticise the decision *ex post facto* than to

[433] See accordingly s 268 (1) (a) CA 2006 applicable in Scotland.
[434] See accordingly s 268 (2) (b) CA 2006 applicable in Scotland.
[435] *Iesini v Westrip Holdings* [2010] BCC 420.
[436] ibid 421 (Lewison).
[437] *Kiani v Cooper* [2010] BCC 463.
[438] *Parry v Barrtlett* [2011] EWHC 3146 (Ch).
[439] *Phillips v Fryer* [2013] BCC 176 (Ch D).
[440] *Re Singh Brothers Contractors (North West) Ltd.* [2013] EWHC 2138 (Ch) (Ch D (Manchester)).
[441] *Cullen Investments Ltd v Brown* [2015] EWHC 473 (Ch).
[442] *Re Coroin Ltd.* [2012] EWHC 2343 (Ch) (Ch D (Companies Ct)).
[443] ibid para 550 (Honourable Mr Justice David Richards).

make it. The review of business decisions by the courts would also be counter-productive by discouraging directors from taking difficult or risky decisions.

Furthermore, as established in section 3.1.1 above, there is no enforceable duty to consider 'the likely consequences of any decision in the long term.' Therefore, the shortage of judgments that would interpret the parameters of long-termism and section 172 CA 2006 in its current form is not surprising. Court decisions clarifying the duty set out in section 172 CA 2006 are greatly needed. For the time being, the degree of speculation regarding this section only rises and the most it can be hoped for is an obiter dictum analysis of long-termism.

4.3 Delaware

Shareholder value maximisation is clearly the primary corporate objective in Delaware.[444] Knowing that the interests of shareholders are paramount for the board during decision-making, the question arises about the relevance of long-term considerations in solvent public companies according to pronouncements in the case law. Unfortunately, the relevant decision-making time horizon is discussed extremely rarely, especially with regard to solvent companies.

In *Katz v. Oak* [445] a class action was brought by the plaintiff who was the owner of long-term debt securities issued by the defendant – to prevent the defendant from completing an exchange offer. Securities holders were offered cash or stock for the debt securities. The securities holders' application for a preliminary injunction was denied. The importance of this case, for the purposes of this thesis, consists in the judicial commentary on directors' duties in general. It not only confirms the paramount importance of the shareholders' interest in the company (even if directors owe a contractual duty to debt holders). Crucially, it also emphasises the importance of maximising long-term shareholders' interests, even if it is detrimental to other parties:

> It is the obligation of directors to attempt, within the law, to maximise the long-run interests of the corporation's stockholders; that they may sometimes do so 'at the expense' of others (even assuming that a transaction which one may refuse to enter into can meaningfully be said to be at his expense) does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders.[446]

[444] See s 3.1.2 above.
[445] *Katz v Oak Indus Inc* 508 A.2d 873 (Del Ch 1986).
[446] ibid 879 (Chancellor Allen). [citation omitted]

A second case that discusses the relevant investment horizon is *Paramount Communications Inc v Time Inc*.[447] This was a takeover case so not actually relevant in the context of solvent companies. However, some general comments made in the case are in fact applicable to all corporations:

> [W]e think it [is] unwise to place undue emphasis upon long-term versus short-term corporate strategy. Two key predicates underpin our analysis. First, Delaware law imposes on a board of directors the duty to manage the business and affairs of the corporation. *8 Del. C. § 141(a)*. This broad mandate includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability. Thus, the question of 'long-term' versus 'short-term' values is largely irrelevant because directors, generally, are obliged to charter a course for a corporation which is in its best interest without regard to a fixed investment horizon. Second, absent a limited set of circumstances as defined under *Revlon*, a board of directors, while always required to act in an informed manner, is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover. [448]

This case confirms that directors enjoy broad discretion in defining corporate objectives. They can decide to concentrate on long-term or short-term decision-making. It also suggests that because of the broad directors' decision-making powers, the decisions' time horizon is not a controversial issue in Delaware and hence not discussed particularly often by the courts. *Paramount Communications* also clearly stipulates that directors of any companies – even in the context of takeovers – are not obliged to concentrate on short-term shareholder value. Thus, clearly, directors of a solvent company might choose to pursue long-term shareholder value, but the long-term approach is not the only acceptable investment horizon. More cases would be advantageous to strengthen and promote long-term shareholder maximisation (and indicate how to interpret it), as currently long-termism is hardly mentioned in the case law. Taking into account the above analysis, it is doubtful that the courts in Delaware will decide to promote and define long-termism actively.

4.4 Germany

With its modest amount of case law on the time horizon of managerial decision-making in the AG, Germany does not differ much from two other jurisdictions under review. Although there is no judgment that concentrates on this issue specifically, the courts' stand can be picked out from various cases. Despite this, it is argued below that an emphasis on the long-term considerations is the strongest in German case law. To start with, the judgment of the

[447] *Paramount Communications Inc v Time Inc.* 571 A. 2d 1140 (Del 1989).
[448] ibid 1150 (Justice Horsey). [citation omitted, emphasis in original].

Regional Court in Hamburg from 1995 discusses managerial broad discretionary powers that stem from § 76(1) AktG:

> The general principle on management of the company from § 76(1) AktG provides that the management board should consider properly and according to its own discretion interests of shareholders, employees and the public interest, however whilst considering these interests, the management board should concentrate especially on the continued existence of the company and its lasting profitability.[449]

The judgment points out that managerial powers are limited by a duty to concentrate on the continued existence and lasting profitability of the company. As discussed in section 3.1.3 above, the AktG requires from the management board only that it ensures the continued existence of the corporation[450] and prepares the report on the profitability of the company.[451] The Act does not mention any obligation to concentrate on the lasting profitability of the company. The definition of lasting profitability is nowhere to be found in the case law but the implication is that it goes beyond short-term profits or short-term existence of the company. Concentrating on lasting profitability means that the management board ought to consider the long-term consequences of their decisions, think about development of the company in the future and not only about the here and now.

Secondly, the implementation of § 87 (1) 2 AktG in 2009 – which provides that '[t]he remuneration system of listed companies shall be aimed at the company's sustainable development' – raised hopes that the courts would explain what sustainable development means in the company law context. However, judgments are still awaited. Before the enactment of the provision mentioned above, it was possible (but not required) for all corporations and not only the listed ones to consider the lasting sustainable development of the company when shaping the remuneration of the management board.[452] The Düsseldorf District Court (*Düsseldorf Landesgericht*), for example, pointed out in 2004 that 'in shaping the remuneration of the management board not only the financial or economic situation should be taken into consideration, but the overall business position and especially future possible losses, the autonomy of the corporation, [and] its future existence as a subsidiary.'[453] Thüsing notes that this judgment started the discussion about the reform of

[449] OLG Hamm, 10.5. 1995, 8U 59/94, AG 1995, 512, 514 – where the court refers to the commentary by Hüffer (my translation).
[450] § 91(2) AktG.
[451] § 90(1) 2 AktG.
[452] Spindler, *Münchner Kommentar Aktiengesetz* § 87 mn 74.
[453] LG Düsseldorf, 22.07.2004 – XIV 5/04, NJW 2004, 3275, 3278 (my translation).

executive remuneration structures in Germany.[454] The importance of this judgment cannot be underestimated. It is hoped that the courts will refer to it whilst interpreting the 'sustainable development' of the company. The Düsseldorf District Court clearly states that the remuneration of the management board must take into account future development of the company and have a holistic character while considering various factors beyond the financial position of the company.

German case law suggests that management boards in Germany can also consider and fulfil cultural, social, and civic aims. There are few criminal cases on that issue since pursuing these aims might lead to abuses of power and constitute a breach of § 266 StGB (Criminal Code) on embezzlement and breach of trust. Importantly, these issues are analysed by commentators in the context of § 76 AktG on the management of the company.[455] The fact that the courts in Germany permit companies to take decisions, which support cultural, social and civic aims is interpreted in this thesis as a sign of backing for long-term investments. These aims do not produce financial benefits or any immediate profits; however, besides doing good in society, supporting them can be profitable for the company in the longer-run as ways of promoting and advertising the company or building its prestige or reputation. In a prominent judgment from 6 December 2001, the BGH states that in the case of an abuse of trust by the management board, not all financial contributions supporting art, science, social services or sport constitute a breach of § 266 StGB.[456] The BGH stipulates that:

> Part of the duty of the management board is to act as a prudent and diligent manager and to support non-financial goals, with the view to improving the social acceptance of the corporation and to present the corporation as a 'good corporate citizen' and through this activity, improve its financial position.[457]

This case clearly points out that, although acceptable, supporting non-financial aims cannot be an aim in itself. Non-financial goals are only admissible if they benefit the company's financial situation. The court emphasises that the board is responsible for balancing different interests during its decision-making and it acknowledges the legality of pursuing non-financial goals (under certain circumstances): 'the management board acting as a prudent and diligent manager should decide how much should be spent on social aims, what

[454] Gregor Thüsing, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' AG 2009, 517, 517 (my translation).
[455] See for instance: Spindler, *Münchner Kommentar Aktiengesetz* § vor 76 mn 49.
[456] BGH, 06.12.01 – 1StR 215/01 – BGHSt 47, 187 (my translation).
[457] ibid 195.

investments from ethical reasons should be avoided and which supported.'[458] It is also noteworthy that the law does not provide any guidance to companies on how to contribute towards the purpose of the enterprise.[459] The financial and not-for-profit goals are not perceived as contradictory but complementary and it is emphasised that companies also use sponsorship of cultural and sporting events for advertising purposes, without economic justification.[460]

In another case concerning embezzlement and abuse of trust, the BGH provided some guidelines regarding the support of non-financial goals. It noted that the management board does not possess unlimited liberty to contribute towards cultural, social and civic aims. The management board should act, first of all, in the interests of the enterprise, ensuring that any disposal of company's assets is consistent with the duty of loyalty.[461] The Federal Constitutional Court in a judgment of 1979 confirms that the enterprise interest is a binding guiding principle.[462]

4.5 Conclusions

Overall, long-termism is rarely discussed in the case law of the UK, Delaware and Germany. More case law is both needed and awaited. In the UK, the courts stress that it is the board's task to assess the company's best interests. The codification of directors' duties and the inclusion of the consideration of long-term factors in section 172(1) CA 2006 has generated a few court cases on the duty to promote the success of the company. However, in the UK, the case law does not assist in developing a specific understanding of what constitutes long-termism and it seems that this will remain the situation in the future. In Delaware, the respect that the courts afford to the board's broad discretionary powers is particularly evident. The board's powers undeniably encompass the possibility of taking into account the long-term consequences of decisions. Having said that, the courts are generally reluctant to comment on decisions' time horizons. Moreover, in Germany, the courts respect the board's broad discretionary powers, but the possibility of considering long-term or short-term factors is discussed here in greater detail and the relevance of long-term considerations is most visible in this jurisdiction. Still, it remains to be seen how (if at all) the courts in Germany will interpret sustainable development in value of the company. It is anticipated that the approach adopted in 2004 by the Düsseldorf District Court will be pursued. Having discussed long-

[458] ibid.
[459] ibid 194.
[460] ibid.
[461] BGHSt 21.12.05 – 3StR 470/04 - BGHSt 50, 331, 338, 339 (my translation).
[462] BVerGE 50, 290, 374; s*imilarly* BGH 29.01.1962 – II ZR 1/61, BGHZ 36, 296, 306, 310 (my translation).

termism in the context of the relevant case law, the final issue to be analysed in this chapter will be addressed now, namely the extent to which consideration of long-term factors are deemed relevant in codes of best practice in place in the UK, Germany and Delaware.

5. 'Soft law' and the relevance of long-term interests

5.1 Introduction

This section will review the impact of codes containing non-binding, best practice statements regarding the governance of the company in promoting long-term considerations during decision-making. This section analyses whether long-termism is present in the codes in the UK, Germany and US and if this is the case, whether these instruments have any potential to enhance the importance of long-termism.

5.2 The UK

Introduction

As emphasised in Chapter II section 2.1 above, the UK Code is applicable to listed companies and operates on a 'comply or explain' basis, constituting a form of 'soft law.'[463] It consists of main and supporting principles and also code provisions. The role of the Code is to set out good practice in corporate governance.[464] The long-term approach plays an important role in the UK Code. It is underlined on several occasions, in the context of a general discussion of the purpose of corporate governance, the central role of the board and the importance of regulating executive directors' remuneration. These issues are analysed in turn.

The purpose of corporate governance, the role of the board and long-termism

Importantly, the UK Code starts with the statement that '[t]he purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can

[463] For a more in depth analysis of the UK Code see e.g.: Andrew Keay, 'Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight?' (2014) 34(2) LegStudies 279; John Roberts, 'Between the Letter and the Spirit: Defensive and Extensive Modes of Compliance with the UK Code of Corporate Governance,' in: Thomas Clarke and Douglas Branson, *The SAGE Handbook of Corporate Governance* (Thousand Oaks, Calif.: SAGE, 2012) 196-217; John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment,' in: Alessio Pacces (ed), *The Law and Economics of Corporate Governance: Changing Perspectives* (Cheltenham: Edward Elgar, 2010) 213-258.

[464] Financial Reporting Council <http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance.aspx> accessed 10 June 2015.

deliver the long-term success of the company.'[465] The long-term success of the company is clearly the driving force behind the entire Code. The Main Principle on the role of the board states that '[e]very company should be headed by an effective board which is collectively responsible for the long-term success of the company.'[466] Not only is long-termism explicitly mentioned in the Code, also it is provided that 'the long-term success of the company' is the key objective for the board. This all serves to promote the importance of long-term factors in the decision-making of management of the company.

The duty to act for the long-term success of the company is addressed directly to the board of directors and they are collectively responsible for the long-term success of the company. According to the Code, the directors are not merely asked to 'have regard to the likely consequences of any decision in the long-term,' as this is the case in section 172(1) CA 2006, but they are responsible for actually achieving the long-term success of the company. 'Long-term success' is interpreted broadly – it means something different in every given situation or context. Therefore, it is justifiable that it is formulated as a standard, but it is argued here that its meaning is insufficiently explained in the UK Code.

Only the Supporting Principles cast some light on what the board ought to do in order to achieve the paramount aim of the long-term success of the company:

> The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.
>
> All directors must act in what they consider to be the best interests of the company, consistent with their statutory duties. (For directors of UK incorporated companies, these duties are set out in the Sections 170 to 177 of the Companies Act 2006.)[467]

All of these factors contribute towards the emergence of responsible, forward looking corporate management. The future and long-term development of the company depends on: diligent risk assessment, establishing the company's aims and objective in a careful but visionary way, and respecting the company's values and standards.

The Supporting Principles further underline the importance of the general duties codified in the CA 2006. At first sight, this might be considered unnecessary, as they refer to

[465] UK Code 1.
[466] A.1 Main Principle UK Code.
[467] A.1 Supporting Principles UK Code.

the provisions on directors' duties that ought to be well known. But, it is actually advantageous that the UK Code emphasises the importance of these duties, despite the fact that, the exact relationship between the A.1 Principle and section 172(1) CA 2006 is not clearcut here. On the one hand, the UK Code is phrased more strongly – 'the board is responsible for the long-term success of the company.' The long-term success of the company is not an option (as is the case in section 172(1) CA 2006), rather, an imperative. On the other hand, it is significant that the UK Code operates on a 'comply or explain' basis and the board might choose not to comply with these provisions.

Executive remuneration and the long-term success of the company

The executive remuneration is discussed in the UK Code.[468] The Code recommends that the remuneration of executive directors be linked to the company's long-term success: '[e]xecutive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.'[469] This provision promotes performance-related remuneration and constitutes an important tool in incentivising long-term thinking.[470]

The implications of emphasising long-termism in the UK Code

The author of this thesis approves this emphasis on the long-term success of the company in the UK Code. Notwithstanding its soft law character, it is expected that the UK Code will help to instil long-term thinking into managerial decision-making. Both the CA 2006 and the UK Code show that the corporate board in the UK is encouraged to focus on long-term, rather than short-term factors. The question remains whether this is enough? It is argued in this thesis that such mere encouragement is insufficient to make boards pay closer attention to long-term considerations.

A critique must be expressed of provision A.1 on the role of the board and especially the established approach of including general terms such as the 'long-term success of the company' in the UK Code. After studying the Main and the Supporting Principles of provision A.1, the question arises as to whether the former (which states that the board is responsible for the long-term success of the company) or the latter (which indicates what

[468] See chapter VI para 2.3 regarding the reform of the executive remuneration in the UK, including the Kay Review proposals and the position regarding remuneration in the 2012 and 2014 Codes. See also: FRC, *Developments in Corporate Governance and Stewardship 2014 and 2015 (Annual Reports)* (January 2015 and 2016) for some additional information on executive remuneration.
[469] D.1 Main Principle UK Code.
[470] For the discussion on the role of executive remuneration in incentivising long-termism in the UK and the wording of this provision in the 2012 UK Code, see Chapter VI s 2.3 below.

actually is required from the board) is more successful in acknowledging the importance of long-termism. Both are arguably essential, but the Supporting Principles are actually more valuable. The Supporting Principles give some context to the idea of the 'long-term success of the company' and this is what directors really need for the effective and efficient management of the company. More guidance of this sort is needed to transform the notion of long-term thinking from a general corporate objective into an effective working concept. It is argued here that this guidance should be incorporated into the subsequent edition of the UK Code.

Determining the long-term success of a company is extremely complex. Clearly, more publicity on the importance of directors' long-term thinking would help to develop this concept in the UK. The directors of companies who achieved or worked towards establishing long-term success should be praised and encouraged to share their ideas and successful strategies. Their successful solutions could be described on government websites, in journal articles, or included in the publications of the Institute of Directors such as 'The Effective Board'[471] or 'The Director's Handbook.'[472]

5.3 Germany

In the same vein as UK law, Germany has created only one code on corporate governance. This is the Kodex's principles for a non-binding code of best conduct.[473] This 'presents essential statutory regulations for the management and supervision (governance) of German listed companies and contains internationally and nationally recognized standards for good and responsible governance.'[474] From the outset, the Kodex underlines the importance of the corporation's sustainable development, but only in a general manner, without any guidance on the meaning of this notion. To start with, it states that the company's main objective is the 'continued existence of the enterprise and its sustainable creation of value.' [475] Secondly, it is underlined that the role of the Kodex is only to 'clarify' the obligations of both boards: '[the Kodex] clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise).'[476]

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[471] Neville Bain and Roger Barker, *The Effective Board: Building Individual and Board Success* (Institute of Directors 2010).
[472] Martin Webster (ed), *The Director's Handbook Revised Edition: Your Duties, Responsibilities and Liabilities* (3rd edn, Institute of Directors and Pinsent Masons LLP 2010).
[473] See Chapter II section 3.1 above.
[474] Kodex 1.
[475] ibid.
[476] ibid.

The objective of the sustainable creation of value is also pinpointed in the context of the management board's tasks and responsibilities: '[t]he Management Board is responsible for independently managing the enterprise in the interest of the enterprise, thus taking into account the interests of the shareholders, its employees and other stakeholders, with the objective of sustainable creation of value.'[477] Hence, according to this provision, the management board is obliged to pursue the interest of the enterprise – identified here with the interests of shareholders, employees and other stakeholders[478] and the sustainable creation of value is the paramount, but broad aim. Finally, the Kodex refers to sustainability with regard to remuneration: the compensation of both the management and supervisory board members must 'be oriented toward sustainable growth of the enterprise.'[479]

Overall, the need for the corporation's sustainable development is clearly visible in the Kodex. Sustainability is discussed on several occasions and expressed as 'sustainable creation of value' and 'sustainable growth.' It is evident that the Kodex uses this notion to emphasise the need for well-balanced, holistic and forward-looking development and management of the corporation. However, in order to enhance the importance of the corporation's sustainable development, it is arguable that the management board needs more detailed guiadance regarding the corporate objective.

5.4 Delaware

Introduction

In contrast with the position in the UK and Germany where corporate governance principles are found in one code, the US does not have a single national code of corporate governance.[480] The codes exist, only 'the process of developing standards is decentralized,'[481] but they do not operate on a 'comply or explain' basis. The US has a number of codes of best practice, guidelines, and handbooks.[482] Only three sets of guidelines

[477] § 4.1.1 Kodex.
[478] For more discussion on the concept of 'the interest of the enterprise' (*Unternehemeninteresse)* see Chapter III s 3.1.3 above and Chapter IV s 4.41.3 below.
[479] § 4.2.3 and 5.4.6 Kodex. The executive remuneration pursuant to § 87 AktG is discussed in s 3.1.3 above. Chapter VI s 2.2 discusses remuneration as an incentive towards long-term decision-making.
[480] For a detailed analysis of the corporate governance standards in the US see Nolan Haskovec, 'Codes of Corporate Governance: A Review' (2012) Millstein Center for Corporate Governance and Performance Working Paper <http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/Codes%20of%20Corporate%20Governance_Yale_053112.pdf> accessed 11 June 2015.
[481] ibid 20.
[482] Aguilera and Cuervo-Cazurra note that in 2008 in the US there were 25 codes: Ruth Aguilera and Alvaro Cuervo-Cazurra, 'Codes of Good Governance' (2009) 17(3) CG 376, 378, 380. The authors also state at 382 that in the US one code was implemented as legislation: the US Sarbanes-Oxley Act

will be evaluated here: the 'American Law Institute Principles of Corporate Governance,'[483] the 'Report of the New York Stock Exchange Commission on Corporate Governance,'[484] and the 'Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies.'[485]

ALI Principles

The ALI Principles, published in 1994, are highly influential[486] and offer a detailed and thorough analysis of corporate governance practices and rules. The American Law Institute explains the role and structure of the Principles as:

> The product of 15 years of development and preparation, the Institute's first comprehensive treatment of corporate law examines the duties and responsibilities of directors and officers of business corporations to both the corporations and their shareholders. Intended both to clarify and improve existing law, this work combines cogent analysis of current legal requirements with carefully articulated recommendations for the clarifications or changes that it concludes are appropriate (…).[487]

For the purposes of this research, § 2.01 of the ALI Principles is of paramount importance. It provides that in general a corporation 'should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.'[488] This objective is referred to as 'the economic objective.'[489]

However, § 2.01(b) states that '[E]ven if corporate profit and shareholder gain are not thereby enhanced, the corporation is allowed to take into account other factors.' These include ethical considerations, support for public welfare, and other social purposes. The ALI Principles underline that fulfilment of both provisions is 'consistent with economic self-

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of 2002 – '[a]n Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.'

[483] American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (American Law Institute Publishers 1994) (henceforth: 'ALI Principles').

[484] Report of the New York Stock Exchange Commission on Corporate Governance (23 September 2010) (henceforth: 'NYSE Report') <http://www.ecgi.org/codes/documents/nyse_cgreport_23sep2010_en.pdf> accessed 11 June 2015.

[485] National Association of Corporate Directors, *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* (2011) (henceforth: 'Key Agreed Principles') <https://www.nacdonline.org/files/PDF/KEY%20AGREED%20PRINCIPLES%202011.pdf> accessed 12 June 2015.

[486] Minor Myers, 'Corporate Reform Movements and Corporate Law: Lessons from the ALI's Principles of Corporate Governance' <http://moritzlaw.osu.edu/events/mslsc/myers.pdf> accessed 11 June 2015.

[487] American Law Institute: <http://www.ali.org/index.cfm?fuseaction=publications.ppage&node_id=88> accessed 11 June 2015/.

[488] § 2.01(a) ALI Principles.

[489] ALI Principles 57.

interest' of the corporation.[490] It is also noted that these two provisions are not in contradiction and that long-run profitability and long-term shareholder value should be the key corporate objectives:

> [T]he principle embodied in Subsection (a) – that the objective of the corporation is to conduct business activities with a view to enhancing corporate profit and shareholder gain – does not mean that the objective of the corporation must be to realize corporate profit and shareholder gain in the short run. Indeed, the contrary is true: long-run profitability and shareholder gain are at the core of the economic objective. Activity that entails a short-term cost to achieve an appropriately greater long-run profit is therefore not a departure from the economic objective. An orientation toward lawful, ethical and public-spirited activity will normally fall within this description.[491]

Long-run profitability and shareholder gain, as advocated by the ALI Principles, are very beneficial for Delaware corporations since they distract the board's attention from short-term profit maximisation. Section 2.01 is praiseworthy as it promotes balanced and responsible management. Unfortunately, there have been no signs yet of this provision being followed in Delaware. Nevertheless, its application is strongly recommended.

NYSE Report

The recent Report of the NYSE Commission on Corporate Governance, the review of the corporate governance principles that was launched in response to the recent financial crisis,[492] and discusses topics including the role and scope of the director's authority and management's responsibility for governance.[493] Crucially, the NYSE Report supports the stand on corporate objective of long-run profitability and shareholder gain taken in the ALI Principles. The main thrust of the NYSE Report is presented in its first Principle: '[t]he board's fundamental objective should be to build long-term sustainable growth in shareholder value for the corporation, and the board is accountable to shareholders for its performance in achieving this objective.'[494] The interests of other stakeholders should be also taken into consideration but it is clearly stipulated that in the case of any conflicts of interests, the interests of shareholders are paramount.[495]

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[490] ALI Principles 57.
[491] ibid.
[492] NYSE Report 2.
[493] ibid.
[494] ibid.
[495] ibid 25.

Long-term sustainable growth in shareholder value is treated as an overarching objective of the corporation and is referred to on numerous occasions.[496] It is worth pointing out that the Report mentions not only 'long-term shareholder value' but 'long-term sustainable growth in shareholder value.' The latter implies more than only paying attention to shareholder value maximisation. However, no explanation about the content of these concepts is offered. Various factors were listed as necessary components for the objective of long-term sustainable growth in shareholder value. First, the board is obliged to pursue this aim subject to its fiduciary duties,[497] which implies avoiding 'excessive risk-taking for the sake of short-term increases in stock price performance.' [498] The board and management are encouraged to create compensation plans that encourage 'long-term value creation.' [499] Further, the necessity of establishing 'relationships with a core base of long-term oriented investors' is underlined since they should 'understand the corporation's long-term strategy.'[500] Shareholders are also asked to hold a board accountable for achieving long-term sustainable growth in shareholder value.[501] Importantly, the NYSE Report emphasises that all stakeholders including employees, customers, and vendors 'have critical interests in the long-term success of the corporation.'[502] Finally, the Report acknowledges that directors face 'increasing pressure to take actions that are primarily intended to increase stock price in the short term.'[503]

The most important conclusion of the NYSE Report is that the main corporate actors (boards, management and shareholders) should work together towards long-term sustainable growth in shareholder value, due to their interdependence and inter-relatedness.[504] The Report rightly acknowledges that 'it is unrealistic to expect boards and/or management to adopt policies that look to generate long-term economic wealth for shareholders when shareholders are focused primarily on quarterly results and short-term stock price maximization.'[505]

Key Agreed Principles

[496] ibid 2, 25, 27.
[497] ibid 2.
[498] ibid.
[499] ibid.
[500] ibid.
[501] ibid.
[502] ibid 24.
[503] ibid 17.
[504] ibid 25.
[505] ibid.

The Key Agreed Principles were created to 'strengthen corporate governance' and in general, '[b]oards are encouraged to use them in thinking through and tailoring their own governance structures and practices to meet the needs of their respective companies.'[506] In the same vein as the two documents discussed above, the Key Agreed Principles pursue long-term shareholder value creation. Although the interests of other stakeholders must be accounted for, the creation of the long-term shareholder value has paramount importance. Principle I notes that '[t]he board's fiduciary objective is long-term value creation for the corporation; governance form and process should follow.'[507] At the same time, it is also observed that:

> In responding to the pressures facing the corporation, the board must understand the diverse interests of stakeholders and investors, and consider competing demands and pressures as necessary and appropriate while ensuring that the corporation is positioned to create the long-term value that all shareholders have an interest in as a unified body.[508]

Summary

Akin to the position in the two other jurisdictions, the provisions in the corporate governance guidelines are not mandatory. Moreover, the lack of an overarching code in the US diminishes their significance in practice and their impact is difficult to evaluate. Nevertheless, it is positive that all the guidelines presented here clearly encourage long-term, and not short-term, shareholder values as a key corporate objective.

5.5 Conclusions

The most important conclusion derived from this analysis is that all three jurisdictions' codes suggest that directors when taking decisions on behalf of companies should account for long-term consequences. The notion of long-term decision-making is most prevalent across jurisdictions in the context of the applicable soft law. For example, the UK, US and Germany have introduced best practice principles which promote long-termism. The amount of material on long-termism in the codes illustrates the welcome popularity of this notion. However, the actual role of these non-mandatory instruments in promoting long-term decision-making is difficult to assess, especially in the US, where the best practice guidelines do not function on a 'comply or explain' basis.

The notion of 'long-termism' is certainly present in the codes of each of these legal systems. But this is the only obvious feature that connects them. For instance, the language they use to express long-termism differs. In the UK Code it is the 'long-term success of the

[506] *Key Agreed Principles* 2.
[507] ibid 4.
[508] ibid.

company,' in Germany the 'sustainable creation of value' or 'sustainable growth' and in the US 'long run profitability and shareholder gain,' 'long-term sustainable growth in shareholder value' and 'long-term shareholder value.' Without specific examples or detailed explanations, it is difficult to determine whether these terms have analogous meanings. There is also a difference between jurisdictions with regard to which group within the corporation actually benefits from the long-term approach. In the US and UK, these are clearly shareholders. For example, the American codes analysed in this chapter refer directly to long-term shareholder value. Whilst the UK Code is more enigmatic inasmuch as it mentions only the long-term success of the company, section 172(1) of the CA 2006 unequivocally states that the shareholders' interests are paramount. This position can be contrasted with the approach adopted in Germany where the Kodex clearly stipulates that the sustainable creation of value should benefit the whole enterprise and not only shareholders.

An analysis of the comparative material suggests that each of the jurisdictions have failed to give substance and content to the meaning of long-termism. Two important exceptions must be pointed out, namely the A.1 Supporting Principle of the UK Code and § 2.01 (and the comments that follow) of the ALI Principles. Only these two provisions offer more than a vague and general statement that the board is obliged to pursue long-term goals. The concept of the long-term success of the company will mean something different in every given situation and therefore is indefinable. More direction is definitely needed, in order to move from the stage of talking about long-termism to actually pursuing it.

6. Summary: The notion of long-termism and the law

The relevance of long-termism

From a comparative perspective, the analysis of the legislation, case law and soft law offers the following insights. On a general level, legal systems do not appear to be fundamentally different: the notion of considering the long-term consequences during decision-making is present in all three legal systems under review. A long-term approach is encouraged over a short-term one in the legislation, case law, and corporate governance codes. However, the relevance of long-termism differs in each of the jurisdictions and is expressed in slightly different ways.

Managers have broad discretionary powers in Delaware, Germany and the UK. They are not bound to any particular time-frame whilst acting in the best interest of the corporation (even in the UK – which is the only jurisdiction that encourages directors to consider the long-term consequences of their decisions through directors' duties). In practice, this

approach gives managers in all these jurisdictions leeway to take into account the long-term consequences of their decisions.

The three studied legal systems express long-termism differently. With regard to the UK, giving the statutory footing to 'the likely consequences of any decision in the long-term' is praiseworthy. It definitely adds importance to the notion. However, its actual role in practice is difficult to determine, as having regard to long-term factors is not mandatory. Furthermore, case law does not help to define the role of long-termism in the UK. The courts are reluctant to interfere in managerial decision-making.[509] Finally, the UK Code highlights the importance of running the company for its long-term success and shaping the executive remuneration with a view of such success (de facto the long-term success of shareholders).

In Delaware, on the other hand, long-termism is not a component of the statutory duties. Broad discretionary powers allow directors to focus on shareholder value. In Delaware, various best practice guidelines most actively promote long-term shareholder value but their influence is unclear. German legislation does not contain a specific obligation to regard long-term factors during decision-making as a part of directors' duties, but among the jurisdictions under review, it is unique in fostering long-term decision-making in the clearest way. To start with, the remuneration system of listed companies is focused on the company's sustainable development. Moreover, managerial discretion in this jurisdiction is limited by an obligation to ensure the continued existence of a company and its profitability. The Kodex emphasises the importance of the sustainable creation of value and sustainable growth whilst running the company and this growth is one of the factors considered when determining the remuneration of boards. Thus, these factors imply the necessity of long-term goals. Both in the AktG and in the Kodex, sustainability should serve the interests of various company's stakeholders and not only shareholders – as is the case in the UK and Delaware. Not many cases considering decision-making time horizon exist in Germany. However, the relevance of forward thinking is arguably most visible in the German judgments.

The above analysis shows that confusion over terminology exists in this area. Legislation, case law, and corporate governance codes in these jurisdictions use different terms to describe forward decision-making. Although, as proved in this chapter, these terms have functionally equivalent meanings (as they all are about future orientated, reasonable decision-making), because of a deficiency in sources, it is not certain what they actually

[509] See: *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 832 (Lord Wilberforce); *Re Southern Countries Fresh Foods Ltd* [2008] EWHC 2810 (Ch) para 53 (Mr Justice Warren); *The Queen on the Application of People and Planet v HM Treasury* [2009] EWHC 3020, para 35 (Admin) (Mr Justice Sales).

mean in practice. Overall, the current approach is insufficient to promote long-term decision-making. There should be stronger encouragement from legislators and the judiciary for companies to concentrate on long-term factors.

Content and scope of long-termism

The existence of broad managerial discretionary powers in the legal systems under scrutiny means that it is only the managers who are really responsible for defining the long-term success of the company. The UK, Delaware and Germany require that directors act in accordance with the standards established by the duty of care and duty of loyalty. This chapter has sought to demonstrate that the language of long-termism is cast as a standard rather than as a clear rule. Therefore, it is unsurprising that statutory provisions, case law, and soft law in these jurisdictions do not properly determine the parameters of long-termism *ex ante*: the content, nature and breadth of what constitutes 'long-term' decision-making and behaviour on the part of management is deferred to an adjudicator to draw up at a later date. The notable exceptions are A.1 Supporting Principles UK Code, § 2.01 ALI Principles and the Düsseldorf District Court judgment from 2004. These act as variables that provide boards with at least some, modest guidance. The first identifies the role of strategic aims, the company's values, and entrepreneurial leadership in risk assessment. The second discusses in more detail the role of non-financial factors in achieving long-term shareholder value. The last is a pioneering judgment on shaping the management's remuneration with particular consideration given to the company's long-term growth and development. Overall, however, all three of the legal systems must achieve greater clarity about the interpretation of long-termism and offer instructions for the managers on how to make corporate decisions if they are to truly enhance forward thinking during decision-making.

The analysis conducted in this chapter gives rise to the conclusion that the concept of long-term/sustainable decision-making lacks a clear substance in the law and 'soft law' of the UK, Delaware and Germany; it is very flexible, vague and open-textured. As such, the consequences of long-termism operating as a legal standard can be observed. Long-termism's flexibility allows the law in these three jurisdictions to be conceptualised broadly. This in turn enables managers to tailor the notion of long-termism to their specific needs. The open-endedness of long-termism comes at a price though. Since there are no rules that can help managers to interpret long-term decision-making, and standards are by their nature fluid, the content and scope of these standards will have to be established by the courts in the UK, Delaware and Germany *ex post facto*, thus reducing the signalling potential of the command *ex ante*. Long-termism depends heavily on the subsequent interpretation by either

directors or courts. Clearly, in each of the legal systems under review, the judiciary is reluctant to intervene to second-guess the board's broad discretionary powers, notwithstanding that their intervention could be much needed in certain cases. Since the concept of long-termism is thriving in corporate governance codes after the financial crisis, to enhance the long-term approach, the jurisdictions must include more practical guidance and examples of long-term decision-making into their codes. To overcome the existing deadlock regarding the parameters of long-termism, Chapters IV and V below will present practical case studies drawn from the academic literature in order to compare the content, nature, and scope of the standard of long-term decision-making in the three jurisdictions.

Chapter IV. Long-termism in directors' duties according to secondary sources: a critique. The role of the shareholder v. stakeholder debate in determining the content of long-termism

1. Introduction

Chapter III reviewed the response in primary legislation and soft law to issues related to the long-termism of company directors in solvent companies. As stated there, all jurisdictions in principle encourage long-termism in some shape or form; however, they do not offer much guidance on how the role of long-term interests in the decision-making processes of company directors should be understood. The question remains how to measure the time horizon of directors' decisions – is a week, a month, a quarter or a year perceived as long-term? Long-termism is an open-ended construct by its very nature; it requires further interpretation if it is to be meaningful. Therefore, the next two chapters centre upon an examination of the secondary legal sources, i.e. the academic literature, and whether it can cast any light on the parameters and the underlying purpose of the notion of long-termism in its current incarnation.

To start with, section 2 summarises commentators' views on managerial long-term decision-making in order to illustrate the crucial role of academic writers in developing this concept. This section constitutes an essential link between Chapter III ― where the primary legislation and soft law were reviewed ― and sections 3-5 of this Chapter IV and Chapter V ― where a gap-filling exercise is conducted to identify the parameters of long-termism. Further, section 3 highlights the underlying purpose of the gap-filling exercise that will follow in Chapter IV and Chapter V. It demonstrates that the 'shareholder v. stakeholder' debate and the 'share ownership structure of public corporations' in each jurisdiction will be used as two separate variables to cast light on the structural differences and similarities between the corporate governance systems and describe the content and breadth of the concept of long-termism in the UK, Delaware and Germany. These two variables serve as useful analytical tools in identifying the parameters of long-termism and an explanation will be provided as to why that is the case. In this gap-filling exercise, the case studies identify country-specific examples of long-term and short-term decision-making in the three jurisdictions and are intended to contribute to building up the normative theory of long-termism. These case studies are taken from the secondary academic literature, the Kay Review or the BIS Report on 'A Long-term Focus for Corporate Britain – Summary of

Responses.' In light of the prevailing share ownership structure and the orientation of that legal system towards the stakeholder or shareholder primary theories, each of the case studies serves to: (i) furnish a practical example of the content and scope of long-termism, and (ii) identify whether a specific decision is an instance of short- or rather long-termism, how likely it is that that kind of decision would be taken in a given jurisdiction and whether it is likely to constitute a lawful activity.

Section 4 of Chapter IV examines the relevance of the shareholder primacy and stakeholder theory in relation to the content and scope of long-termism and case studies are derived from this variable in section 5 of Chapter IV to provide examples of long- and short-termism.

In the next chapter, the case studies will be presented and the impact of share ownership structures within the parameters of long-termism will be discussed. Further, comparative conclusions regarding both instruments, i.e. the shareholder v. stakeholder debate and share ownership structure will be provided.

Of course, the approach adopted here and in the following chapter is not without its limitations. Due to differences between the jurisdictions in corporate objective and share ownership structure of the corporations, not all of the presented examples will hold in every jurisdiction. As such, the kinds of country-specific decisions, which are held to amount to examples of long-term conduct, may vary as a result of the diverse corporate governance systems, legal families and commercial cultures present in each of the jurisdictions under review. This will be addressed and pointed out throughout the course of the discussion in sections 3, 4 and 5 of this Chapter and Chapter V. What is more, the main drawback associated with the case studies is the inherent subjectivity of the notion of long-termism: it is almost impossible to arrive at final conclusions regarding the content of this notion. The main objective of this thesis is to overcome this obstacle and present a well-developed conception of long-term decision-making.

2. Commentators' views on the role of long-termism: a summary

2.1. Introduction

The objective of this section is to discuss the function of long-termism within the current legal frameworks of the UK, Delaware and Germany, and to summarise the main views of academic and practitioner commentators on long-term decision-making in the legal systems under scrutiny. The position in the UK, Delaware and Germany will be presented in turn.

2.2. The UK

The debate on long-term decision-making in the UK concentrates on s. 172 CA 2006. The provisions of the UK Code on long-termism have not been the subject of the academic discussion so far. The views of UK commentators on the role of long-termism in the day-to-day management of a company range from critical to moderately favourable. First, the consideration of factors listed in s. 172 (1) CA 2006, such as the likely consequences of any decision in the long-term, is clearly of secondary importance, as the paramount objective of the director according to s. 172 (1) CA 2006 is to promote the success of the company for the benefit of its members as a whole. On this point, Lynch accurately notes that the element of subjectivity inherent within s. 172 CA 2006 renders it meaningless,[510] as it would be very difficult for the court to second-guess a director's reasoning and to establish whether or not he or she was promoting the success of the company. It is pertinent to note that consideration of other factors, such as long-term issues, is even more problematic, since the appropriate scheme for analysing these factors has neither been established nor considered in any detail by the courts.[511] Therefore, the author of this thesis agrees with Lynch that s. 172 CA 2006 can be perceived only as a tool for educating directors on how the corporation ought to be managed.[512]

Furthermore, opponents of the current regulation argue that the fundamental problem with the practical effectiveness of s. 172 CA 2006 would seem to be that its terms are not enforceable by non-shareholding stakeholders.[513] Hence, the importance of long-termism is also diminished since only shareholders are entitled to verify whether directors have pursued long-term horizons. Despite some positive comments, a recent report by Collison et al. constitutes an important critique of the notion of ESV adopted by UK corporate law, which finds its main expression in s. 172 CA. In 'Shareholder Primacy in UK Corporate Law: An Exploration of Rationale and Evidence,' fifteen individuals were interviewed, most of whom were directly involved in the Company Law Review.[514] It was argued that s. 172 CA 2006

[510] Lynch, 'Section 172' 201.
[511] Ahern, 'Directors' Duties, Dry Ink and the Accessibility Agenda' 132. At the same time the author mentions *the Queen on the Application of People and Planet v HM Treasury* [2009] EWHC 3020 (Admin) and the commentary thereupon by Stephen Copp ('S.172 of the Companies Act 2006 Fails People and Planet?'(2010) 31(12) CoLaw 406.) In turn, Lynch referring to the *Re West Coast Capital (Lios) Ltd* [2008] CSOH 72 doubts whether s. 172 CA will be discussed in courts: 'it seems that s.172 really is nothing more than a restatement of the previous law, and deserves the almost dismissive judicial treatment that it has received.' Lynch, *Section 172* 202.[citation omitted]
[512] Lynch, *Section 172*, 202 and the literature cited there.
[513] Andrew Keay, 'Moving Towards Stakeholderism? Enlightened Shareholder Value, Constituency Statutes and More: Much Ado About Little?' (2011) 22 (1) EBLR 1, 33-36; Dobbie, 'Codification of Directors' Duties: An Act to Follow?' 18-19.
[514] David Collison et al., *Shareholder Primacy in UK Corporate Law: An Exploration of Rationale and Evidence,* (Research report 125, the Association of Chartered Certified Accountants 2011)

'elicited the strongest negative response among all the answers provided; some 9 of the 13 interviewees expressed dissatisfaction with the wording in the Act.' [515] In the opinion of one interviewee, 'the new wording in section 172 made directors' duties more shareholder-orientated' whilst the others added that s. 172 'increased the emphasis of directors' duties on short-term shareholder interests,' and that it 'would lead directors to focus on optimising share price and, as a consequence, shareholder value.'[516]

Some commentators have argued that long-termism could have some actual role to play in practice if s. 172 CA 2006 is interpreted appropriately and directors are convinced that it is actually worthwhile to consider long-term factors. According to this view, the key argument should be that a proper application of s. 172 CA 2006 might effectively minimise the risks of litigation. In this vein, Cerioni suggests that insulation from litigation and liability might be possible if the long-term consequences of decisions were fully analysed and thus all non-shareholders' interests listed in the provision were taken into consideration; i.e. 'internalise' the requirements of s. 172(1) CA 2006.[517] This point is also underlined by Loughrey et al.: 'rational boards should realise that adopting a long-term inclusive approach on a defensible evidence base and using objective performance criteria will make it very difficult for shareholders to establish that section 172 has been breached.'[518] Moreover, it is pointed out that consideration by directors of the factors listed in this section cannot be treated 'as a complication in their decision making and a box ticking exercise, but as a strategic advise on how to make their choices undisputable and catch this opportunity by taking the strategic management perspective.'[519] Undeniably, the arguments presented above are compelling. The efforts of such commentators to transform long-termism into an effective working concept and offer some practical guidance on how to enhance long-termism in the UK are salutary and could serve as a starting point for the discussion on improvement of section 172.

However, s. 172 CA 2006 can make decision-making a more bureaucratic and lengthy process as all the factors have to be taken into consideration. On the other hand, some commentators contend that also taking into account the perspective of other stakeholders could lead, among other things, 'to better-informed assessments of the long-

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<http://www.accaglobal.com/content/dam/acca/global/PDF-technical/business-law/rr-125-001.pdf> accessed 22 November 2013.

[515] ibid 34.

[516] ibid.

[517] Luca Cerioni, 'The Success of the Company in s. 172(1) of the UK Companies Act 2006: Towards an 'Enlightened Directors' Primacy?' (2008) 4 OLR 1, 17.

[518] Joan Loughrey, Andrew Keay and Luca Cerioni, 'Legal Practitioners, Enlightened Shareholder Value and the Shaping of Corporate Governance' (2008) 8 (1) JCorpLStud 79, 110.

[519] Cerioni, 'Success of the Company' 28.

term consequences of decisions.'[520] As argued in Chapter III,[521] s. 172 CA does not compel directors to adopt a long-term perspective, but it is a step in the right direction towards more balanced and well-thought-out decision-making. Still, the most important positive consequence of the current wording of s. 172 CA 2006 is that it explicitly highlights the relevance of long-term consequences in the decision-making process. This is an exceptional position among the jurisdictions under review. Many commentators in the UK have stressed the significance of this notion and the Director's Handbook produced by the Institute of Directors provides just one example. The Handbook, described by its authors as a practical guide and a source of best practice for company directors in the UK, notes that:

> Promoting a long-term investment culture was a key objective of the government in introducing the Companies Act 2006. Some companies may find themselves with share registers made up of hedge funds and active value investors who look only for short-term returns. Despite that, the relevance of the long view is something a board is required to consider.[522]

It was suggested in 'The Effective Board,' the sister publication to the Handbook, that 'directors need to balance often competing or conflicting demands, as the board must be sensitive to short-term issues but must remember that its overriding goal is the creation of long-term value.' [523] Moreover, analysing the codification process of directors' duties suggests that the overall aim was to embed a culture of long-termism in the UK. In the White Paper of 2005, the Government stipulated that one of the aims of the legislative changes was to enhance 'shareholder engagement and a long-term investment culture.'[524] It was submitted that decisions should 'be made based on the longer-term view and not just immediate returns.'[525] Clearly short-term considerations are not eliminated, as promoting the success of the company for the ultimate benefit of its shareholders 'can only be achieved by taking due account of both the long-term and short-term, and by considering wider factors such as employees, effects on the environment, suppliers and customers.[526]

In the draft Companies Bill, the clause providing for the duty to promote the success of the company for the benefit of its members identified 'the likely consequences of any decision in

[520] ibid.
[521] See: Chapter III s 3.1.1.
[522] Webster (ed), *The Director's Handbook,* xiii – xv, 28.
[523] Bain and Barker, *The Effective Board* 31.
[524] White Paper, Company Law Reform (March 2005) Cm 6456, 5.
<http://www.bis.gov.uk/files/file13958.pdf> accessed 12 November 2013.
[525] ibid 5.
[526] ibid.

both long and short term.'[527] The UK Government argued strongly that an ESV culture 'is most likely to drive long-term company performance and maximise overall competitiveness and wealth and welfare for all.'[528] However, contrary to the expectations of the UK Government, the recent 'Kay Review of the Equity Markets and Long-Term Decision-Making' confirms firmly that more needs to be done to encourage the 'creation of long-term value in companies.'[529] Unfortunately, there is no evidence so far that this aim has been achieved.

To sum up, the analysis of the academic literature indicates that there is no agreement regarding the overarching purpose of pursuing the objective of long-termism in the UK. In principle, the commentators tend to agree that the fact that long-termism is explicitly mentioned in the legislation suggests the importance of forward thinking for corporations. Unfortunately, at the same time the dominant view is that the aim of long-termism does not go beyond pointing out the significance of long-term considerations in the decision-making processes. The analysis in Chapter III has shown that since there are currently no mechanisms in place for the enforcement of the concept and it lacks content and scope, this will have to change if long-termism is to have any practical significance in the future. At the very least, the amount of discussion on long-term interests in the academic literature has at least two positive consequences. First, it clearly shows and spreads interest in the notion of long-term thinking. Secondly, and more importantly this discussion is used in the subsequent sections to facilitate the debate on the actual content and scope of long-termism.

2.3. Delaware

The idea of long-termism is not articulated in the DGCL, mention of it is scant in the case law, at the same time the soft law instruments clearly encourage long-term shareholder values as a key corporate objective. In this context, it is surprising to note that the discussion in the secondary academic literature on the relevance of long- and short-term considerations in the US and Delaware in particular is thriving. The main thread that runs through the American law and economics literature is the emphasis on the significance of long-term orientated shareholder value. The rich discussion on long-termism that has taken place in Delaware indicates that it is (or ought to be) an important feature of this legal system. To illustrate that point, Mitchell stresses that the maximisation of the short-term stock price and

[527] ibid 90.
[528] ibid 20.
[529] Kay Review 12.

the avoidance of long-term accountability is a characteristic of the American corporation.[530] He adds at the same time that long-termism should be promoted: '[g]ood behavior *is* good business, but the rewards of good behavior lie largely in the long run. And who knows quite how long that is?'[531] Furthermore, according to Hansmann and Kraakman, it is obvious that an increase in long-term shareholder value is an indisputably valid corporate objective: '[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.'[532]

As such, more and more commentators argue that a consensus has emerged that corporate law should aim to increase long-term shareholder value. Dallas, for instance, notes that '[i]t is desirable for the economy as a whole to encourage long-term investments.'[533] In their summary of recommendations, the CFA Institute suggests reforming earnings guidance practices, developing incentives that are structured to achieve long-term strategic and value-creation goals, and promoting the education of all market participants about the benefits of long-term thinking and the costs of short-term thinking.[534] Moreover, Lipton et al. observe that: '[t]the need for boardroom resolve and commitment to long-term growth is critical not only for companies, but also for the vitality and competitiveness of American businesses in the global economy.'[535] Others criticise shareholder value for over-concentration on short-term gains at the cost of long-term development.[536]

On balance, these comments express various recommendations on what form the law ought to take. They describe the objectives of the model corporation and there is an emphasis on (the undefined) long-term goals as part of this objective. The only thing that can be said for certain is that some commentators encourage boards of directors to consider the long-term implications of their decisions. However, it is difficult to estimate whether this will be taken seriously by directors in practice. The criticism that is levelled in this thesis is that the current discussion seems to be mainly theoretical. The discussion in Chapter III above[537] shows that Delaware law chooses not to interfere into decision-making time horizon. Although the objective of maximising long-term shareholder value is outlined in the case law, there are arguably too few cases to enhance long-term decision-making in practice.

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[530] Lawrence Mitchell, *Corporate Irresponsibility: America's Newest Export* (Yale University Press 2001) 52.
[531] ibid. [emphasis in original]
[532] Hansmann and Kraakman, 'End of History for Corporate Law' 439.
[533] Dallas, 'Short-termism' 276.
[534] CFA Institute, *Breaking the Short-Term Cycle* 1.
[535] Lipton, Rosenblum and Cain, 'Some Thoughts for Boards of Directors in 2012' 1.
[536] See eg: Martin Gelter, 'Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debate in a Comparative Light' (2011) 7 NYUJLB 641, 659-660 and the literature cited.
[537] See especially Chapter III s 4.3.

2.4. Germany

The academic literature on German law suggests that long-termism is embedded within the German system of corporate governance, despite the lack of provisions similar to s. 172 CA 2006. The debate in Germany is generally focused on a new provision on remuneration (which underlines the aim of sustainable development of the company)[538] and provisions on profitability report [539] in the context of a duty to ensure continued existence of the corporation. [540] The Kodex is not really analysed in the literature in the context of sustainability.

To start with, Roth emphasises that, at the level of the company, long-termism has traditionally been the focus of German company law.[541] He notes that the AktG supports long-term thinking, as the remuneration of the management board in a listed company is aimed at the sustainable development of the company; on the other hand, he also accurately notes that the role of this new provision in practice is yet to be asserted.[542] Importantly, the academic literature provides some assistance with interpretation of the term 'sustainable development' in the context of remuneration. The following interpretations were presented: first of all, it implies that remuneration cannot be shaped in the manner that encourages the management board to breach their duties.[543]

Secondly, in the literature, sustainability is connected to using resources in a sustainable way. This term comes from forestry and is popular in environmental law: it is described as a method of using resources in a way that their regeneration capacity is preserved.[544] Bauer and Arnold state that this meaning could be also applicable to the AktG – as the supervisory and management boards maintain the corporation, and must not jeopardise its existence by means of irresponsible risks, withdrawal of capital or distribution of profits.[545] According to Wagner, this phrase implies a form of evolution that satisfies the needs of the current generation, without risking that future generations will not be able to satisfy their needs. [546] Therefore, Wagner notes that this meaning could be also applied to §

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[538] § 87(1) AktG.
[539] § 90 (1) 2 AktG.
[540] § 91 (2) AktG
[541] Marcus Roth, 'Corporate boards in Germany' in Paul Davies and others (eds.), *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (OUP 2013) 361 and the literature cited there.
[542] ibid.
[543] Hans-Joachim Mertens, 'Vorstandsvergütung in börsennotierten Aktiengesellschaften Bemerkungen zu § 87 Abs.1 Satz 2 und 3 AktG' AG 2011, 57, 57 (my translation).
[544] Jobst-Hubertus Bauer, Christian Arnold, 'Festsetzung und Herabserzung der Verstandsvergütung nach dem VorstAG' AG 2009, 717, 719 (my translation).
[545] ibid.
[546] Jens Wagner, 'Nachhaltige Unternehmensentwicklung als Ziel der Vorstandsvergütung. Eine Annäherung an den Nachhaltigkeitsbegriff in § 87 Abs. 1 AktG' AG 2010, 774, 776. (my translation)

87 AktG, as its aim is to secure the continued existence and lasting sustainability of a German corporation.[547] Finally, Fleischer suggests that sustainable development in business management is associated with ecological reorientation and adjustment of the corporation.[548]

Further, sustainability is perceived as a term that is the opposite of short-termism.[549] Commentators have negatively defined it as 'sustainable development could mean prohibition of the remuneration structure that encourages the management board to concentrate – contrary to their duties – on short-term profits, at the expense of future company's development.'[550] Such a short-term approach has been vividly expressed in the literature as 'a flash in the pan' (*Strohfeuer*).[551] In addition, Hüffer adds that sustainability requires the remuneration structure to be focused on the 'long-term, cross-period success.'[552]

Finally, there are also voices arguing that sustainability is connected to the 'interest of the enterprise'[553] and should be understood as a lasting profitability of the corporation – in line with § 91 (2) AktG.[554] In this vein: 'sustainable development should involve promoting incentives focused on long-term and lasting increase in value of the enterprise, for instance bonuses could be shaped based on the development of the company during few years rather than one year period.'[555]

German law recognises the duty to ensure the continued existence of the corporation and the profitability report that the management board is obliged to prepare based on § 90 (1) 2 AktG is instrumental in that respect. It is noteworthy that commentators unanimously agree that this duty to ensure continued existence of the corporation underlines the obligation of the board to ensure 'lasting profitability' of the corporation, although that lasting profitability is not expressly articulated in the AktG. Fleischer notes that the management board has 'a minimum goal to ensure the continued existence and the lasting profitability of the enterprise.'[556] Hüffer argues that 'management board's discretionary powers are limited by

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[547] ibid.
[548] Holger Fleischer, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' NZG 21/2009, 801, 802-803. (my translation)
[549] Thüsing, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' 520.
[550] Mertens, 'Vorstandsvergütung' 58; Wagner, 'Nachhaltige Unternehmensentwicklung' 76; Bauer, Arnold, 'Festsetzung und Herabserzung der Verstandsvergütung' 719.
[551] Mertens, 'Vorstandsvergütung' 58. In the same vein*:* Bauer, Arnold, 'Festsetzung und Herabserzung der Verstandsvergütung' 719.
[552] Hüffer, *Aktiengesetz* § 87 mn. 4c.
[553] Wagner, 'Nachhaltige Unternehmensentwicklung' 776.
[554] Spindler, *Münchner Kommentar Aktiengesetz* § 87 mn 75.
[555] Jürgen van Kann, Norbert Fischbach, in: Jürgen van Kann (ed), *Vorstand der AG, Führungsaufgaben, Rechtspflichten und Corporate Governance* (Erich Schmidt Verlag 2012) 173 (my translation).
[556] Holger Fleischer, in: Gerald Spindler, Eberhard Stilz (eds.), *Kommentar zum Aktiengesetz* (2nd edn, C.H. Beck 2010) § 76 mn. 26. (my translation)

the duty of ensuring the lasting profitability and continued existence of the corporation.'[557] Moreover, Spindler underlines that 'the management board should protect the continued existence of the corporation and take into consideration the lasting profitability of the corporation, sometimes also described as the preservation of the enterprise or as an appropriate realisation of profits, but not profit maximisation.'[558] Spindler derives the concept of lasting profitability from an obligation to ensure the continued existence of the corporation, as according to the author, such continued existence depends on lasting profitability; pointing out at the same time that 'apart from the obvious cases, it is hard to state precisely what the meaning of this concept really is.'[559]

The discussion immediately above illustrates three important points. First, the role of the academic literature in Germany in framing a better understanding of the presented notions is critical. Secondly, the amount of interpretations of the term 'sustainable development' suggests that there is no consensus about its actual meaning. Each interpretation concerns the future-orientated management of the company, but neither offers a clear indication of what should be done to achieve this aim. Finally, legal scholarship in Germany has created a notion of lasting profitability to underline the point that the management board should concentrate on profit-making rather than profit maximisation as its aim. To sum up, it is contended that Roth is correct to state that each of these provisions enhance 'the accountability of companies for the benefit of society as a whole.'[560] Moreover, the notion of future-orientated and longer-lasting management is extensively underlined in the German literature and is clearly more evident than in the UK or Delaware literature. However, even if it is at the heart of decision-making in Germany, the content and scope of long-termism remains unclear.

2.5. Interim conclusion

In sum, the purpose of long-termism in the jurisdictions under review is to encourage forward thinking by directors, which in turn contributes towards more responsible decision-making. It is pertinent to note that commentators are more successful in underlining the importance of long-term decision-making than the primary sources of legislation or case law. Nevertheless, the effectiveness of long-termism in practice remains questionable owing to the lack of content and scope afforded by the concept. Therefore, to identify and sketch out the parameters of long-termism in the UK, Delaware and Germany, practical examples of

[557] Hüffer, *Aktiengesetz* § 76 mn. 14.
[558] Spindler, *Münchner Kommentar Aktiengesetz* § 76 mn. 69.
[559] ibid.
[560] Roth, 'Corporate Boards in Germany' 361.

long- and short-termism will be presented by reference to both the primary and secondary sources. First, however, the objective of the gap-filling exercise pursued in this Chapter and Chapter V will be explained and the ideas of the shareholder primacy and stakeholder theories duly described.

3. Gap-filling exercise

Long-termism is an intensely subjective concept and is subject to many factors, such as the size of the company, its objectives, industrial sector, etc. The aim of section 5 in this Chapter and Chapter V is to build up a normative theory and to conduct a normative gap-filling exercise, in order to develop the taxonomy of long-termism in the jurisdictions under review. This objective will be pursued by adopting case studies, which will be used to determine what long-termism means. Such case studies furnish practical examples of long- and short-termism while allowing the interrelationships between corporate governance mechanisms to be stressed and identified. Two instruments have been chosen from which these case studies are then derived, and these function to provide examples of long- and short-termism in the UK, Germany and Delaware. These are:

> (1) the shareholder v. stakeholder debate, which centres upon an examination of the question of to whom directors owe their duties, i.e. only to the shareholders in terms of the former theory, or to the non-member stakeholders as well, according to the stakeholder value theory; and
>
> (2) the predominant share ownership structure of public corporations in the jurisdictions under review. Publicly traded corporations have either a concentrated or a dispersed ownership structure and as a consequence these differences will affect how the board acts, the structure and orientation of its company law, and to whom it is accountable.

Of course, other factors also serve to influence the concept of long-termism and can be identified. However, the idea is to limit the drawing out of the case studies to the two variables listed above at (1) and (2), which function as auxiliary aids to assist in identifying examples of long-term decision-making in these three jurisdictions. It is submitted that these tools can be used as proxies that emphasise the structural differences in the corporate governance systems in the UK, Delaware and Germany.

Before progressing any further, it is beneficial to say a little more about the two tools at (1) and (2) above, which it must be stressed are inter-related, rather than parallel. With regard to (1), according to the shareholder primacy theory, the main goal of the corporation is to maximise shareholder value, whilst adherents of the stakeholder theory argue that the interests of all stakeholders (i.e. employees, customers, suppliers, and social and cultural goals) and not only shareholders should be taken into consideration during the decision-making processes of directors. Ascertaining the objectives of the corporation and determining whose interests are paramount is fundamental, as this inevitably influences our understanding of long-term decision-making. The time horizon of decision-making can be established only subsequently, when it is clear whose interests should prevail through the medium of corporate action. Secondly, as for feature (2) above, suffice to say at this stage that it is generally accepted that different systems of share ownership structure give rise to distinct agency problems and tensions within a corporation during the decision-making process.[561] Dispersed share ownership jurisdictions – which are characteristic of common law countries – suffer from 'vertical' agency costs between management and shareholders as a class, whilst in a concentrated shareholding structure, which is principally observed in civil law countries, the main agency conflict is mostly 'horizontal' – between majority and minority shareholders.[562] Different ownership structures thus have a bearing on the company's goals, the constitutional division of power within the company and the nature, content and orientation of their corporate laws, since they affect the pressures brought to bear on the decision-making processes of the directors or managers in such corporations. This, in turn, enables contrasting examples of long-termism or short-termism to be identified within that contextual framework.

The argument unfolds as follows. Section 4 discusses the characteristics of both the shareholder primacy and the stakeholder theories. It focuses on how these theories help us to map the nature, content and scope of the long-term norm through the identification of case studies. Section 5 presents a series of case studies to identify examples of long-and short-term decision-making. The case studies are drawn from the secondary academic literature or from reports, e.g.: the Kay Review and the BIS Report 'A long-term focus for corporate Britain – Summary of Responses.' Each case study starts with a brief introduction on the origins and relevance of a particular scenario. Solutions within particular jurisdictions are then presented and it is stated whether a particular decision is an example of long- or short-ermism. These are followed by comparative conclusions for each case study.

[561] See: Armour, Hansmann and Kraakmann, 'Agency Problems and Legal Strategies' 36 and the discussion in Chapter V s 1 below.
[562] Roe, 'The Institutions of Corporate Governance' 372-375.

4. Shareholder primacy and stakeholder theory

4.1. Characteristics of both theories

4.1.1. Introduction

Different jurisdictions view the corporation in distinctive ways. Two concepts of the corporation currently predominate.[563] The first treats the corporation as an economic entity whose purpose is to maximise shareholder value and the second perceives it as a social institution having the aim of furthering the interests of the corporation itself within the wider society in which it operates. These are referred to as the shareholder and the stakeholder value approaches, respectively. The former is traditionally identified with Anglo-American jurisdictions and these countries are often caricatured as shareholder primacy systems. On the other hand, one of the most notable representatives of the stakeholder value approach is Germany.

In this thesis, it is argued that the content of long-termism is inevitably linked to the chosen corporate objective, i.e. to the notion of whose interests should prevail in a company. Diverse corporate objectives mean that the company's long- and short-term interests are perceived differently. In a shareholder-orientated jurisdiction, long-termism will be identified with long-term shareholder value (or shareholder value maximisation), whilst in a stakeholder jurisdiction, it will be identified with the interests of various stakeholder groups. These concepts differ fundamentally: long-term orientated shareholder value will not always be beneficial for the corporation at large and long-term orientated stakeholder value might aim to achieve different objectives. Traditionally, the stakeholder value theory has been seen as more long-term focused and the shareholder approach has been accused of having an intrinsic short-term bias. This fosters a debate about whether the stakeholder orientated countries are the ultimate exemplars of long-termism or whether perhaps shareholder-focused jurisdictions simply regard long-termism differently. Whether these distinct corporate objectives influence the parameters of long-termism will be reviewed, as will the common perceptions about the jurisdictions under review, e.g. Germany is generally perceived as more stakeholder-orientated and therefore more long-term focused, whilst the UK and Delaware are treated as rather more shareholder and short-term concentrated.

[563] On the discussion about the two dominant theories see e.g. Sarah Kiarie, 'At Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?' (2006) 17(11) ICCLR 329, 329-333; Andrew Keay, *The Corporate Objective* (Edward Elgar Publishing Limited 2011), chapters 2-3. There are also other concepts, e.g. Keay's entity maximisation and sustainability model. Ibid chapter 4.

However, it should be clarified that it is not the aim of this chapter to determine which of the theories has paramount importance or whether one or the other should take precedence.

4.1.2. The shareholder primacy theory

Position in the US and UK

The dominant theory in Anglo-American jurisdictions has been, certainly since the 1970s, the shareholder primacy theory also known as 'shareholder value' or 'shareholder wealth maximisation.'[564] That should not be taken to mean that the UK and US legal position are equivalent. The shareholder value theory is predominantly perceived as a proper decision-making norm in the US and Delaware in general.[565] The shareholder wealth maximization principle was underlined in 1919 by the Supreme Court of Michigan in *Dodge v. Ford Motor Company*.[566] This case is perceived by some 'as the fountainhead of the corporate law rule that the objective of directors must only be to make profits for shareholders.'[567] The Dodges – minority shareholders of Ford Motor Company – objected to a decision by the board to withhold special dividends, on the ground that the company had made too much money and should share profits with the public. Among other things, the court famously stated that the purpose of the corporation is to make money for the shareholders:

> As we have pointed out, and the proposition does not require argument to sustain it, it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that, if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.[568]

The literature however suggests that not all American commentators agree with the shareholder value primacy. Two prominent professors Dodd and Berle started the debate

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[564] Keay, 'Moving Towards Stakeholderism?' 1-2.
[565] ibid 40 fn 256; Leo Strine Jr, 'Our Continuing Struggle with the Idea that For-profit Corporations Seek Profit' (2012) 47 WakeForestLRev 135, 147 fn 34.
[566] *Dodge v. Ford Motor Co.* 170 NW 668 (Mich 1919).
[567] Alissa Mickels, 'Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe' 32 (2009) HastingsInt'l&CompLRev 271, 286-287 and the literature cited there. There are also views that *Dodge v. Ford Motor Company* is wrongly cited for the proposition that maximizing shareholder wealth is the legal rule, as shareholder wealth maximisation should be rather perceived as a standard of conduct, which suggests that the law does not impose on a board a legal duty to maximise shareholder value. See: Lynn Stout, 'Why We Should Stop Teaching Dodge v. Ford' (2008) 3(1) VaL&BusRev 163.
[568] *Dodge v. Ford Motor Co.* 507 (Ostrander CJ).

about the purpose of the corporation (which is still topical at present).[569] The former argued in favour of 'a view of the business corporation as an economic institution which has a social service as well as a profit-making function,'[570] whereas the latter pointed out that:

> [A]ll powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.[571]

Bainbridge argues that neither the shareholder nor the stakeholder models are fully satisfactory, as regards the ends of corporate governance, i.e. whose interests should prevail in the corporation.[572] Therefore, in his view, the director primacy concept also has influence in Delaware since directors there exercise broad decision-making powers. This thesis argues that the shareholder value theory is currently the leading theory in Delaware and it adopts Bainbridge's view that the director primacy theory embraces shareholder wealth maximisation as the proper corporate decision-making norm, but rejects the notion that shareholders are entitled to either direct or indirect decision-making control. Importantly, directors are primarily responsible for maximising shareholder wealth.[573]

The approach in the US can be contrasted with the position in the UK, which adopted the ESV model. According to the UK Government at the time of enactment of the Companies Act 2006, this model forges a '"third way" that merges elements of the shareholder and the stakeholder approaches.'[574] However, as explained in Chapter III,[575] this description of ESV is rejected in this thesis and it is argued that the approach adopted in section 172 CA 2006 is simply another incarnation of the shareholder primacy theory. This position is rooted in the fact that the interests of the shareholders are paramount, the consideration of non-shareholders' interests is only of secondary importance and is subordinated to the interests of shareholders. Moreover, the other stakeholders listed in s. 172 CA 2006 are not entitled to take any actions against the directors. In the same vein, Attenborough notes that the shareholder value principle encapsulates the corporate objective

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[569] See Strine, 'Our Continuing Struggle' 148-155.
[570] E Merrick Dodd Jr, 'For Whom are Corporate Managers Trustees?' (1932) 45 HarvLRev 1145, 1148.
[571] Adolph Berle Jr, 'Corporate Powers as Powers in Trust' (1931) 44 HarvLRev 1049, 1049. See also: Adolph Berle Jr, 'For Whom are Corporate Managers Trustees: A Note' (1932) 45 HarvLRev 1365.
[572] Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' 550.
[573] ibid and the literature cited there.
[574] See i.e.: Cynthia Williams and John Conley, 'An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct' (2005) 38 CornellIntlLJ 493, 496. This article pre-dates the enactment of the CA 2006; however, it contains the analysis of the ESV proposed by the CLRSG.
[575] See Chapter III s 3.1.1.

in the UK.[576] Moreover, Esser and du Plessis correctly point out that practical importance of section 172 CA is unclear, praising at the same time this provision for being: 'probably the most comprehensive list of matters contained in any modem company-law legislation and probably also the clearest recognition in such legislation of the importance of interests other than those of shareholders.'[577]

Assessment of the concept

One of the main justifications for the shareholder value approach is the theory that '[m]aximising value for shareholders is the right social goal for corporations, because it is equivalent to maximising the overall wealth created by the corporation.'[578] According to the nexus of contracts theory of the firm, the corporation is perceived as an efficient means of contracting relationships:

> The private corporation or firm is simply one form of *legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals.*[579]

Consequently, 'fiduciary duties should flow only to shareholders as residual claimants because the residual claimants have the greatest incentive to maximize the value of a corporation, and therefore place the highest value on the legal protection afforded by fiduciary duties.'[580] Shareholders bear the risk of the success or failure of the company and hence they are entitled to control and run the company for their own benefit.[581] Friedman claims that the company's directors are merely the shareholders' agents, so their sole purpose should be to maximise the shareholders' wealth. Friedman has also been critical of the notion of corporate social responsibility:

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[576] Daniel Attenborough, 'How Directors Should Act when Owing Duties to the Companies' Shareholders: Why we Need to Stop Applying Greenhalgh 2009' (2009) 20(10) ICCLR 339, 345.

[577] Irene-Marie Esser, Jean du Plessis, 'The Stakeholder Debate and Directors' Fiduciary Duties' (2007) 19 SAMercLJ 346, 353.

[578] See a summary of this concept in: Margaret Blair, 'In the Best Interest of the Corporation: Directors' Duties in the Wake of the Global Financial Crisis' in: Thomas Clarke, Douglas Branson (eds), *The SAGE Handbook of Corporate Governance* (SAGE Publications Ltd 2012) 63ff and the literature cited there. The idea that maximising share value is equivalent to maximising the total social value created by a firm has been criticised here by Blair.

[579] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 4 JFinanEcon 305, 311.[emphasis in original]

[580] Jonathan Macey and Geoffrey Miller, 'Corporate Stakeholders: A Contractual Perspective' (1993) 43 UTorontoLJ 401, 402, 403.

[581] Friedrich Kübler, 'Rules of Capital under Pressure of the Securities Markets' in: Klaus Hopt and Eddy Wymeersch (eds.) *Capital Markets and Company Law* (OUP 2003) 103.

> [T]here is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.[582]

The shareholder value approach is often identified as one of the obstacles to a long-term approach, as it is accused of promoting short-termism.[583] This theory has been blamed for the 'fixation on profits for shareholders,' notwithstanding that it does allow managers to consider non-financial interests.[584] Keay points out that although shareholder primacy is orientated to short-term profits, the 'courts have accepted arguments in favour of managers looking to long-term issues.'[585] Keay cited *Shlensky v Wrigley*,[586] a case from Illinois Appellate Court, where the court emphasised 'the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighbourhood from deteriorating.'[587]

Despite the strengths of shareholder value maximisation, their undesirable consequences must also be emphasised: increased financial leverage in order to increase stock market value, alignment of management incentives with shareholder interests and most importantly for the purposes of this thesis, an emphasis on short-term profits over the long-term performance of the company.[588] Clearly, Grant is correct in saying that these problems are not associated with shareholder value itself, but rather with its interpretation and application.[589]

There are some theoretical underpinnings for the short-term orientated, shareholder-maximisation approach. The short-term interpretation of shareholder value gained support

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[582] Milton Friedman, 'A Friedman Doctrine: The Social Responsibility of Business is to Increase its Profits' (New York Times Magazine 13 September 1970) <http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html> accessed 14 July 2015.

[583] See i.e.: Jaco Lok, 'Institutional Logics and Identity Projects' (2010) 53(6) AMJ 1305, 1309; Benedict Sheedy, 'The Importance of Corporate Models, Economic and Jurisprudential Values and the Future of Corporate Law' (2004) 2 DePaulBus&CommLJ 463, 502.

[584] Keay, 'Getting to Grips with the Shareholder Value Theory' 376. See similarly: Wen, 'The Magnitude of Shareholder Value' 332.

[585] Andrew Keay, 'Shareholder Primacy in Corporate Law: Can it survive? Should it survive?' (2010) ECFR 369, 388.

[586] *Shlensky v Wrigley* 237 N.E.2d 776 (Illinois Appellate Court, 1968).

[587] ibid 181 (Sullivan J).

[588] Robert Grant, 'Rescuing Shareholder Value Maximization' (Via Sarfatti 25 01/04/2009) <http://www.viasarfatti25.unibocconi.eu/notizia.php?idArt=2131> accessed 10 February 2014.What is more, Esser and du Plessis present further arguments against shareholder value primacy. It is noted, for instance, that 'the classification of shareholders as "owners" [of the company] is flawed.' Hence, it cannot be argued that the company should be run in the best interest of the shareholders, as the company's owners. See: Esser and du Plessis: 'The Stakeholder Debate and Directors' Fiduciary Duties' 358-359.

[589] Grant, 'Rescuing Shareholder Value Maximization'.

among financial economists based on efficiency – where shareholders are perceived as a group the most incentivised to maximise profits.[590] '[T]he short-term price of stock reflects the present value of the corporation's long-term results,' according to the efficient capital markets theory. Therefore, the distinction between long-term and short-term values does not really exist.[591] However, Sundaram and Inkpen point out that those traditional theories of finance and contracting do not distinguish between long- and short-term shareholder value maximisation: 'by assuming market efficiency, whereby optimality in the long run is simply the result of a series of optimal short-run decisions.'[592] Nevertheless, they argue that if market efficiency is under threat (an example is given of managerial incentives such as stock options that are 'structured to benefit managers from short-horizon share price reactions'); it is questionable whether the long run is simply 'a series of optimal short-run decisions.'[593]

It should be emphasised that the efficient capital markets theory has recently been undermined, as the literature has begun to examine the effects of short-term biases and short-term investment horizons.[594] Crawford argues that 'the large drops and gains in the market' are the blatant evidence that 'the market price of a stock does not necessarily reflect its underlying value.'[595] Dyllick and Hockerts add that 'an obsession with short-term profits is contrary to the spirit of sustainability, which requires the firm to meet the needs of its stakeholders in the future as well as today.'[596]

Overall, the short-term shareholder-maximisation approach is frequently criticised. Fisher correctly points out that the undue focus on immediate profit may not only sacrifice long-term performance but it may also be an unreliable indicator of success.[597] A question arises about whether long-term shareholder value can be distinguished and whether it provokes positive connotations. Jansen notes that for most economists a criterion for evaluating the performance of managers should be the maximisation of the long-term market value of the firm.[598] Others argue that 'the core purpose of corporate governance is

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[590] Wen, 'The Magnitude of Shareholder Value' 332 and the literature cited there.
[591] Martin Lipton and Steven Rosenblum, 'A New System of Corporate Governance: The Quinquennial Election of Directors' (1991) 58 UChiLRev 187, 208 and the literature cited there.
[592] Anant Sundaram and Andrew Inkpen, 'The Corporate Objective Revisited' (2004) 15(3) OrganSci 350, 358.
[593] ibid.
[594] Lipton and Rosenblum, 'A New System of Corporate Governance' 208 and the literature cited there.
[595] Rebecca Crawford, 'Corporate Governance Reform: How to Promote the Long-Term Health and Value of U.S. Corporations' (2009) 5 NYUJL&Bus. 905, 918.
[596] Thomas Dyllick and Kai Hockerts, 'Beyond the Business Case for Corporate Sustainability' (2002) 11 BusStratEnv 130, 132.
[597] Fisher, 'The Enlightened Shareholder - Leaving Stakeholders in the Dark' 14.
[598] Michael Jensen, 'Value Maximization, Stakeholder Theory and the Corporate Objective Function' (2010) 22(1) JACF32, 32. Jensen himself proposes a new corporate objective function, i.e. an enlightened value maximization (also called an enlightened stakeholder theory). ibid 33ff.

essentially to build long-term sustainable growth in corporate and shareholder value.'[599] Rappaport suggests that it is not the concept of shareholder value itself that is problematic, but its misapplication:

> Shareholder value did not fail management; management failed shareholder value. Most CEOs champion the goal of maximizing shareholder value but without embracing the essential determinant of value—risk-adjusted, long-term cash flows. Instead, they are obsessed with Wall Street's earnings-expectations machine and short-term share price.[600]

He also notes that the idea that management's primary responsibility is to maximise long-term shareholder value has been widely accepted in principle but has been imperfectly implemented in practice.[601]

4.1.3. The stakeholder theory

Evaluation of the theory

Stakeholder theory dictates that the interests of all of the various stakeholders in a firm, including the shareholders, should be taken into account during the decision-making process.[602] The definition of the 'stakeholder' is not entirely clear. According to Jensen: '[s]takeholders include all individuals or groups who can substantially affect, or be affected by, the welfare of the firm—a category that includes not only the financial claimholders, but also employees, customers, communities, and government officials.'[603] Freeman, one of the most active supporters of the stakeholder theory famously stated that a stakeholder should be understood as 'any group or individual who can affect or is affected by the achievement of an organization's purpose. For instance, some corporations must count "terrorist groups" as stakeholders.'[604]

The term 'stakeholder' includes all those affected by the activities of the company. It underlines at the same time sustainability and inclusion.[605] Contrary to value maximisation, which has its roots in economics, the stakeholder theory is derived from sociology,

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[599] Lipton, Rosenblum and Cain, 'Some thoughts for Boards of Directors' 1.
[600] Alfred Rappaport, 'The Economics of Short-Term Performance Obsession' (2005) 61(3) FinanAnalJ 65, 72.[citation omitted]
[601] ibid 69.
[602] Jensen, 'Value Maximization' 32.
[603] ibid.
[604] R Edward Freeman, *Strategic Management: A Stakeholder Approach* (Pittman Books Limited 1984) 53.
[605] Kiarie, 'At Crossroads' 329.

organisational behaviour, the politics of special interests and, as Jensen argues, managerial self-interest.[606]

Fisher believes that '[s]takeholder value may directly enhance long-term success by encouraging social responsibility.'[607] Wen points out that currently the common view is that the long-term interests of the company are:

> [I]nextricably linked to stakeholder considerations. Unlike shareholders, who are residual claimants and therefore are the risk-bearers of the company, employees, creditors and other stakeholders normally form their relationship with the company via contracts; and it is in their interests that the company they have contractual relationships with should survive and grow over a long-term period.[608]

The theory that stakeholder value approach is long-term focused does not go unchallenged. For instance, Wen notes that, although the stakeholder approach is identified with long-termism, no justifiable analysis for this assumption is provided.[609] Clearly, non-shareholders among stakeholders do not always appear to be focused on the long-term. They are linked with the company via contracts and arguably they are risk-averse, which may cost the company in terms of its ability to attract new investment and stay competitive in the modern business world.[610] As Wen argues further, the interests of other stakeholders cannot be analysed in isolation from the interests of shareholders, in order not to lose profitable business opportunities.[611] Therefore, the conclusion emerges that in order to achieve long-term results and benefits in stakeholder jurisdictions, the interests of all stakeholders (including shareholders) should be considered.

Overall, the main criticism of the stakeholder theory is that it is not possible to define whose interests should actually be taken into consideration – it is too broad to be of much use. Hence, it is feared that directors use the stakeholder theory as an excuse for bad management. To illustrate that point, Easterbrook and Fischel famously stated that 'a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other.'[612]

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[606] Jensen, 'Value Maximization' 32.
[607] Fisher, 'The Enlightened Shareholder - Leaving Stakeholders in the Dark' 14.
[608] Wen, 'Magnitude of shareholder value' 336. [citation omitted].
[609] Shuangge Wen, *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Direction* (Routledge 2013) 221.
[610] ibid 222 and the literature cited there.
[611] ibid 222.
[612] Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996) 38.

In contrast, the shareholder theory has an advantage in that it is clear whose interests have priority.[613] It is argued in the academic literature that the interests of other stakeholders are not neglected in shareholder-orientated jurisdictions; they are protected by other areas of law, for instance environmental, labour and tax law.[614] Fisch also argues that there is little research that demonstrates any correlation between the consideration of non-shareholders' interests and corporate performance. Importantly, she also notes that 'there is scant evidence that corporate decisions favoring the interests of workers, customers, or the community actually increase the size of the pie.'[615]

The stakeholder theory in Germany

The German corporate governance system is traditionally recognised as being stakeholder oriented.[616] Nevertheless, there is no agreement among German commentators as to whether the stakeholder value approach is indeed the current corporate objective in Germany.[617] Despite mandatory co-determination rules, the AktG no longer explicitly refers to non-shareholder interests, as had been the case under the now repealed § 70 (1) 1937 Stock Corporation Act.[618] As underlined in Chapter III,[619] in Germany the duties are owed to the company and members of both management and supervisory boards are obliged to serve 'the interests of the enterprise' (*Unternehmensinteresse*). This notion is not clear, and hence debate surrounds the corporate objective.

However, there are convincing arguments that the German legal system leans heavily towards the stakeholder theory. Firstly, it is worth highlighting that the Kodex is clear to whom the management board owes their duties. Section 4.1.1 explicitly states that the management board is obliged to act in the interest of the whole enterprise and to take into account the interests of shareholders, employees and other stakeholders with the objective of achieving sustainable creation of value. Secondly, the interpretation of the expression 'interests of the enterprise' suggests that stakeholder theory is expressive of the overaraching corporate objective. Fleischer argues that three meanings of this term can be distinguished.

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[613] Christoph Teichmann, 'ECLR Corporate Governance in Europa' ZGR 2001 645, 648 (my translation).
[614] Klaus Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' in: Andreas Fleckner and Klaus Hopt (eds), *Comparative Corporate Governance: A Functional and International Analysis* (CUP 2013) 41.
[615] Jill Fisch, 'Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy' (2006) 31 JCorpLaw 637, 645 and the literature cited there.
[616] John Plender, 'Giving People a Stake In the Future' 211; see also: Peer Fiss and Edward Zajac, 'The Diffusion of Ideas over Contested Terrain: The (Non)adoption of a Shareholder Value Orientation among German Firms' (2004) 49 AdminSciQuart 501, 503-506.
[617] Hopt, 'Comparative Corporate Governance' 41.
[618] Roth, 'Corporate Boards in Germany' 263, fn 64.
[619] Chapter III s 3.1.3 above.

In the first few years after the *Aktiengesetz* was implemented in 1965, the broad concept of 'the enterprise per se' dominated – i.e. the interests of all stakeholders should be taken into account.[620] In the late 1970s and early 1980s, the debate concentrated on the Co-determination Act from 1976 and its influences on the AktG.[621] Today the stakeholder-orientated approach produces mixed views. Nevertheless, currently, the predominant view seems to be that the management exercises broad decision-making powers and the interests of shareholders (assets), employees (labour), and the general public (public welfare) should be respected. The role of the board is to mitigate the conflicts between these stakeholders without giving priority to any of them and the minimum goal is to ensure the continued existence and lasting profitability of the enterprise.[622]

In passing, it must be noted that there are also views, which hold that the position under UK and German law is quite similar and expresses the ESV principle in both cases.[623] Hopt argues that ESV constitutes a standard of conduct for the management board at the most, as the employees and the other stakeholders in Germany or in the UK cannot enforce their rights. Therefore, the interests of shareholders should be of paramount importance in companies, especially when bearing in mind economic concerns. Shareholders are the ultimate risk bearers, but the interests of other stakeholders are served by other means, e.g. labour law.[624]

Overall, the author of this thesis agrees with Schall, Miles and Goulding that although from 'a purely theoretical perspective' the difference between a German and UK position is not significant (i.e. the language used in both jurisdictions is broad and permissive enough to include the interests of all stakeholders 'while emphasising the overall priority of the interest in (sustainable) profits'), in practice, the position in both these systems differs. Contrary to the priority afforded to stakeholders in Germany, the interests of shareholders are paramount in UK law.[625]

4.1.4. Conclusions

Although they serve as the main explanations of the corporate objectives in the current academic literature, it is far from clear whether the shareholder and stakeholder theories appear in uniform and pure forms in the jurisdictions under review. The debates considered

[620] Fleischer in Spindler, Stilz (eds.), *Kommentar zum Aktiengesetz* § 76 mn. 25.
[621] ibid § 76 mn. 26.
[622] ibid § 76 mn. 26; Hüffer, *Aktiengesetz* § 76 mn. 12.
[623] Klaus Hopt, 'Vergleichende Corporate Governance – Forschung und International Regulierung' ZHR 175 (2011) 444, 477 (my translation); Schall, Miles and Goulding, 'Promoting an Inclusive Approach on the Part of Directors' 310.
[624] Hopt, 'Vergleichende Corporate Governance' 444, 477 (my translation).
[625] Schall, Miles and Goulding, 'Promoting an Inclusive Approach' 310, 311.

in the literature suggest that the divisions are not clearcut and that the various approaches employed are far from unambiguous. In this thesis, the UK and Delaware are perceived as leaning towards the shareholder primacy theory (but with a different degree of intensity) and Germany is regarded as leaning towards stakeholderism. The foregoing discussion underlines the strengths and weakness of both theories and suggests that the nature of long-termism will vary according to whether the system is orientated towards shareholder value or stakeholder theory. In the former, the debate will be determined mostly by the interests of shareholders whilst in the latter the interests of various stakeholder groups will be afforded greater precedence.

Taking into account the discussion immediately above, it appears that in practice Germany differs from the two other jurisdictions, because the management board here is more incentivised to consider other factors and interests. They are encouraged to look at the enterprise in a more holistic way. Overall, despite some voices to the contrary, there is a tendency in the academic literature to assume that Germany, as leaning towards the stakeholder value approach, is more long-term focused in comparison to the UK and Delaware. Hence, the gap-filling exercise conducted in the current and following chapter will assist in determining the extent to which Germany actually prioritises long-term decision-making.

Five case studies will now be presented to elaborate further upon the impact of corporate objectives on the content of long-termism during decision-making processes. The case studies present practical examples of what is, and what is not, long-term decision-making with a justification. Each case study has relevance to the shareholder v. stakeholder debate. An explanation is offered of why a particular decision is an example of long- or short-termism in each jurisdiction, whether it is likely to constitute a lawful activity there, and how likely it is that it will be taken. For short-term decisions and potential breaches of directors' duties, s. 172 CA 2006 and the relevant sections in the other jurisdictions will be considered.[626] Concluding remarks are offered at the end of each case study.

[626] The breach of different directors' duties is not precluded.

5. Examples of long- and short-term decision-making: a series of case studies

5.1 Case Study 1: A focus on share price

5.1.1 Introduction

An emphasis on the share price is commonly identified as a leading example of short-termism in the secondary academic literature.[627] Moreover, some respondents to the BIS consultation 'A long-term focus for corporate Britain' identified 'a focus on short-term measures of company performance such as earnings per share and total shareholder return' as an issue.[628] Hence, this case study draws on this academic literature.[629]

In shareholder primacy jurisdictions, it is generally expected that directors will concentrate on share price maximisation, whereas in stakeholder orientated jurisdictions, this inclination is presumed to be weaker, as in the latter directors cannot focus exclusively on the interests of the shareholders. Therefore, concentration on the share price should be theoretically more widespread in the UK and Delaware than in Germany as it is less likely that it constitutes a breach of a director's duty in the former. Further, the corporate objective of the maximisation of share value suggests that such a decision will be predominantly beneficial for the company's shareholders. Does this mean that a focus on share price constitutes an example of long-term thinking in the Anglo-American jurisdictions? With each of those questions in mind, the discussion turns first to consideration of the position in Delaware law.

5.1.2 Delaware

Concentration on the share price in Delaware reflects the widespread shareholder value principle, as it arguably maximises value for shareholders. Mitchell notes that 'the ethic of stock price maximisation' is not only part of the structure of the American corporation but is also rooted 'in a more fundamental social, political and ethical ideology of radical individualism that dominates American culture.'[630] Hence, in line with this argument a decision to maximise the share price would most likely be supported by shareholders in

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[627] See e.g. Kiarie, 'At Crossroads' 334-335; Cerioni, 'Success of the Company' 3. Moreover, Williamson discusses the effects of the over-emphasis on share price on short-termism in employment relationships – Janet Williamson, 'A Trade Union Congress Perspective on the Company Law Review and Corporate Governance Reform since 1997' (2003) 41 (3) BritJIndBusRelat 511, 513.
[628] BIS, *Summary of Responses* para. 14.
[629] It should be stressed that this case study is linked both to the shareholder v. stakeholder debate and to the ownership structure of the company. However, it is more appropriate to present it in the context of the discussion of corporate objectives since a decision to focus on the share price vividly illustrates the concerns related to the issue of whose interests should prevail in the company.
[630] Mitchell, *Corporate Irresponsibility* 20.

Delaware; from their perspective it can be a justified and profitable decision since it maximises shareholder wealth. There is only one problem; over-emphasis on share price is the embodiment of short-term behaviour.

Whilst a decision to focus on the share price might be profitable for shareholders in the short-term, its longer-term impact is difficult to assess. Moreover, there is no guarantee that such, often myopic, decisions will actually be beneficial for the corporation and shareholders in the future. Does focussing on the short-term impede decision-making in Delaware? Strine's findings support the claim that the law in Delaware does not oblige directors to maximise short-term profits for shareholders, but rather by virtue of a duty of loyalty it does require them 'to pursue a good faith strategy to maximise profits for the shareholders.'[631] As a consequence, directors are not obliged to maximise short-term profits, but at the same time they are not forbidden to do so. Thus, arguably a short-term decision to focus on share price appears to be consistent with the corporate objectives under the company law of Delaware.

Since board members exercise broad decision-making powers in Delaware, is it accurate to say that they are somehow incentivised by other non-legal factors – such as the market – to maximise the corporation's share price? On the one hand, they cannot be forced to do so, especially as shareholders are weak in Delaware and cannot really threaten the board, if their objectives differ (i.e. long-term oriented shareholders and short-term orientated directors and vice versa), unless they are able to gather the majority of the shares and remove the board or director.[632] On the other hand, directors will be personally interested in keeping the share price high. Hu argues aptly that because a poor share price may cause them to be replaced (or not re-elected), board members have an incentive to keep the stock price high, sometimes without analysing whether this will actually promote the success of the company.[633] Hu further argues that managers and directors 'underinvest and that this underinvestment arises from the pressures of a stock market focused on shortrun earnings and of excessive corporate borrowing.'[634] In the same vein, Strine notes that market pressures make the board concentrate on short-term profits rather than on longer-term strategies which can produce 'more durable and more substantial benefits to stockholders, as

[631] Strine 'Our Continuing Struggle'155.
[632] § 141 (k) DGCL.
[633] Henry Hu, 'Risk, Time, and Fiduciary Principles in Corporate Investment' (1990) 38 UCLALRev 277, 332-333. At the same time the author believes that in general managers are not encouraged to undervalue future benefits, as '[l]uckily, the stock market does not appear to be myopic to a gross extent.'
[634] ibid 345-346.

well as society in general.'[635] Thus, it is pertinent to note that not only pressures from shareholders (whether they are effective is a different question) combined with their often short-term involvement in the company, but also market drivers exert pressure on directors to achieve quick results.

At the same time, it is worth stressing that the shareholder primacy orientation in Delaware, with its over-emphasis on short-term profits, such as a focus on share price, is widely criticised in the literature. In this context, it is noted that short-termism can be identified with the managerial obsession with current profitability.[636] Lydenberg emphasises that an excessive focus on short-term profits has various detrimental effects including the misallocation of assets, the dangerous volatility of financial markets and the diversion of productive resources to repairing environmental and social damage.[637] As pointed out above, Dyllick and Hockerts have remarked that an obsession with short-term profits does not chime with a concept of sustainability, which respects the interests of present and future shareholders.[638] As a result, it is not surprising that the pressure to focus on the short-term stock price also presents real challenges to maintaining long-term growth.[639] Blair points out that '[t]he point is not that share price is irrelevant, but that it is overly simplistic - in fact, dangerously so […] – to focus too much attention on share price to the exclusion of other measures of corporate and managerial performance.'[640]

Thus, criticism of the pursuit of short-term shareholder value is quite widespread. Without a doubt, considering factors other than shareholders' immediate profits and an occasional willingness to sacrifice them is an indication of long-term thinking. Although the long-term approach is supported, the mainstream view is that long-termism is only acceptable if it furthers the interests of shareholders. To illustrate this point, Elhauge emphasises the inevitability and desirability of managerial discretion to sacrifice corporate profits while going a step further and advocating the understanding of external interests: sacrificing corporate profits might be in the public interest if doing so increases overall stockholder welfare even when profits are not rising.[641] This view has not gained much popularity. For instance, Strine rejects Elhauge's stakeholder-centred approach, saying '[i]n

[635] Strine, 'Our Continuing Struggle' 155 and the literature cited there.
[636] Mitchell, 'A Critical Look at Corporate Governance' 1283.
[637] Stephen Lydenberg, 'Long-term Investing: A proposal for how to define and implement long-term investing' (Summit on the Future of the Corporation Paper Series on Corporate Design 2007) 47 <http://www.corporation2020.org/pdfs/SummitPaperSeries.pdf> accessed 30 March 2015.
[638] Dyllick and Hockerts, 'Beyond the Business Case for Corporate Sustainability' 132.
[639] Lipton, Rosenblum and Cain, 'Some thoughts for Boards of Directors' 12.
[640] Blair, *In the Best Interest of the Corporation*, 66.
[641] Einer Elhauge, 'Sacrificing Corporate Profits in the Public Interest' (2005) 80 NYULRev 733, 776ff and 868.

this vision, corporate directors are trustees of societal institutions, charged with responsibly balancing the best interests of all of those who are affected by their firms' actions.' [642]

To sum up, Delaware law supplies a strong incentive for directors to take decisions that concentrate solely on the growth of the share price, while considering the diffusion of shareholder value. The recent criticism in the US of this policy does not seem to have changed this. A decision to focus on share price does not appear to constitute an unlawful activity in itself but it can contribute to a possible breach of directors' duties if it is detrimental to the company. The business judgment rule will protect directors if their decisions are not particularly successful since the courts in Delaware are not going to second-guess the decisions of a well-motivated, non-biased fiduciary, if he is acting in good faith. [643]

5.1.3 Germany

A focus solely on share price is most likely to constitute an example of short-term thinking under German law, despite the debates surrounding the meaning of the corporate objective. Management boards have wide decision-making powers according to § 76 (1) AktG. It seems that the board can decide to focus only on share price, especially when it is under the strong influence of the majority shareholder. However, the board is not bound by any instructions from other bodies or shareholders and the majority shareholder is less likely to put short-term pressure on the board – the evidence suggests that shareholders in the blockholding jurisdictions tend to have longer time-horizons.[644] Further, in the prevailing view, shared also by the author of this thesis, plural goals must be decisive for the management board during decision-making. Hence, clearly exercising discretion means properly evaluating the coincidence of the interests of the company and its enterprise.[645] Hüffer perfectly explains this further by stating:

> This is not only the economical demand but also a legal duty, despite all the problems connected to specification of it. This concept corresponds primarily with the interests of the shareholders as investors but it also serves the interests of the employees and public welfare.[646]

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[642] Leo Strine Jr, 'Making it Easier for Directors to "Do the Right Thing"?' (2014) 4 HarvBusLRev 235, 237.
[643] *Smith v. Van Gorkom* 872 (Justice Horsey).
[644] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 27.
[645] Hüffer, *Aktiengesetz* § 76 mn. 12b.
[646] ibid, § 76 mn. 14.

Moreover, in Germany discretionary powers are limited by the duty to ensure the lasting profitability and continued existence of the corporation.[647] In this context, Spindler suggests that it is doubtful whether the concept of lasting profitability means that shareholder value is a binding principle under German law. [648] Therefore, the reasonable realisation of profits rather than profit maxinisation is a principal aim of the board. The management board in Germany is strongly encouraged to have regard to the longer lasting development of the company and therefore, the focus on the share price is not a top priority for the management board in Germany. In other words, German law provides weaker incentives for decisions to focus on the share price. It is the view of this author that thinking only of the share price will usually preclude the lasting profitability of the corporation. This is the case, because concentrating on share price might result in a loosening of focus on the corporation in general, cutting production costs or employee benefits. Focusing on the share price is also in conflict with the concept of the corporate objective in German law. Since there is no ranking of interests, the corporate objective is not solely identified with shareholders' interests.

Further support for this claim is supplied by Baums who explicitly emphasises that under German law: '[t]here is no duty to maximise the value of the shares' and that the interests of various stakeholders must be taken into account.[649] Wagner notes that it is questionable whether sustainable development of the enterprise means an increase in value, in the sense of a steady increase in the value of the enterprise and the growth in the share price.[650] On the one hand, the German *Kodex* contained in the past the objective of increase in the corporation value. However, currently the *Kodex* notes that the board should act with the paramount objective of sustainable creation of value. Further, there is no support in the legislation for any concentration on short-term goals.

Concentrating only on the share price is not consistent with the corporate objective in Germany as it favours the interests of only one group, i.e. the shareholders. Consequently, concentrating on the share price alone is more likely to constitute an example of short-termism under German law, which is more evident than under Delaware and UK law. In jurisdictions leaning towards the stakeholder value approach, there is a greater likelihood that a focus on the company's share price constitutes a breach of directors' duties than in a shareholder orientated country: as such, there is less incentive to take such a decision in Germany. This does not prevent directors from taking such a decision, as it is not illegal in

[647] Spindler, *Münchner Kommentar Aktiengesetz* § 76 mn. 94; Hüffer, *Aktiengesetz* § 76 mn. 14.
[648] Spindler, *Münchner Kommentar Aktiengesetz* § 76 mn. 71.
[649] Theodor Baums, 'Corporate Governance in Germany – System and Current Developments'(Arbeitspapiere Goethe Universität, Frankfurt Am Mein, October 1998) 5 <http://www.jura.uni-frankfurt.de/43029805/paper70.pdf> accessed 5 June 2014.
[650] Wagner, 'Nachhaltige Unternehmensentwicklung' 777.

itself. If taken, such a business decision is protected under the business judgment rule in Germany, but only if the management board can establish that the decision was based on appropriate information and that they were acting in the best interests of the company.[651]

5.1.4 The UK

The concentration by the board of directors in the UK only on share price during the decision-making processes is an example of short-term thinking. Short-termism was famously defined by Grinyer et al. as: 'foregoing economically worthwhile investments with longer-term benefits in order to increase reported earnings for the current period.'[652]

As explained earlier, it is striking how focused the ESV principle adopted in the Companies Act 2006 is on the shareholder value model. A long-term approach (long-term shareholder value), although encouraged by the CA 2006 and promoted in the literature, is not enforceable and directors cannot be compelled to consider the long-term implications of their decisions (although they are encouraged to). The current wording of s. 172 CA 2006 actually enables the director to focus on short-term interests and to maximise the share price at the cost of sacrificing the long-term wealth of the company. [653]

Thus, it is argued that these decisions will be popular with the shareholders if they are profitable for them. The decision to focus solely on the share price, if it maximises shareholder value, is arguably consistent with the corporate objective in the UK where the interests of shareholders are paramount. If these conditions are met, it is likely that short-term decisions will be taken, as UK law affords strong incentives for such a decision. The answer is not that clear however, if there are conflicts of interests between the board and shareholders. In the end directors are responsible for the running of the company and they will take the decision to concentrate on share price or not and it will depend on their management style, goals and the position of shareholders within the company.

The other question is whether concentrating on the share price is really beneficial for shareholders, if it considers only immediate, short-term profits and does not pay enough attention to long-term effects. Without a doubt, it might be profitable for shareholders in the short run, providing them with immediate profits. However, concentrating solely on the share price constitutes an example of short-term thinking in the UK and such decisions are detrimental for shareholders in the longer perspective.

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[651] See eg § 3.8 Kodex.
[652] John Grinyer, Alex Russell and David Collision, 'Evidence of Managerial Short-termism in the UK' (1998) 9 BriJManage 15.
[653] In this vein: Collison et al., *Shareholder Primacy in UK Corporate Law* 34.

Similar to the position in Delaware, this example of short-termism in the UK is not as strong as it is under German law, because arguably the decision to focus on share price is more consistent with the corporate objective in the Anglo-American jurisdictions. This does not constitute an obvious breach of directors' duties in the UK, but it definitely contributes to one, if the decision does not promote the success of the company. UK law does not incorporate the business judgment rule; however, as argued in Chapter III above,[654] only instances of serious mismanagement can be actionable. Hence, the mere fact that a particular decision is unsuccessful is not enough to render a director fiduciary liable in law.

The decision to focus solely on share price has been criticised in the UK literature. In a consultation on 'A Long-Term Focus for Corporate Britain,' some respondents acknowledged problems with the short-term measures of company performance such as earnings per share and total shareholder return.[655] The Kay Review reminds us that directors owe their duties to the company and not to its share price.[656] The Kay Review also describes two companies – ICI and GEC – where decisions were influenced 'by external financial advice and by market perceptions of their activities as reflected in the rating of their stock.' The Review found that '[b]oth companies reacted to weaknesses in their operations by trading in businesses rather than by trading in chemicals or electrical goods.[657] It is hence appropriate to note that these short-term decisions had negative consequences for the companies. As Cerioni aptly points out: '[t]he negative effects caused by the pressure on the maximisation of share prices, *if the maximisation is pursued as a goal on its own*, have already been highlighted by the literature as part of the history of the corporate collapses which marked the start of the new century.'[658] Therefore, clearly an increase in the share price cannot be the objective of the company in itself. This thesis also adopts Cerioni's view that the increase in share price 'can only be significant, over time, as one of the *signals* of the company's long-term increase in values, together with other signals such as the business' growing share in the market, volume of sales etc.'[659]

5.1.5 Conclusions

To sum up, a focus on the company's share price is likely to be an example of lawful managerial conduct in all three jurisdictions. It can only contribute to a breach of directors' duties if the given decision is not taken in the best interests of the company. This case study

[654] Chapter III s 3.2.4 above.
[655] BIS, para. 14.
[656] Kay Review12.
[657] ibid paras. 1.15-1.17.
[658] Cerioni, 'Success of the Company' 3 and the literature cited [emphasis in original].
[659] ibid. [emphasis in original]

confirms that it cannot be argued that any given corporate objective obliges directors to focus on the share price. The corporate objective can rather provide (or not) an opportunity to take such a decision. It is argued here that the shareholder value principle creates much greater scope and justification for directors to focus solely on the maximisation of the share price. Therefore, it is more likely that there is greater incentive for such decisions to be taken in Delaware and in the UK than in Germany.

However, the discussion of this kind of case demonstrates that the sole focus on share price has been criticised in all three jurisdictions. The consensus view seems to be that such decisions constitute examples of short-term thinking. As such, it is argued that these decisions should thus be avoided if a company wants to achieve its long-term goals. A decision to focus on share price constitutes a stronger example of short-termism in Germany since it is not consistent with the corporate objective there. Focus on the share price is also an example of short-termism in jurisdictions leaning towards the shareholder value theory – because, although it is beneficial for shareholders, such decision-amking brings only immediate profits and its further impact on the company is difficult to estimate. Does it undermine the shareholder value principle in these jurisdictions? There is certainly no evidence for that; however, focusing on short-term profits like share price maximisation is clearly criticised.

5.2 Case Study 2: A decision to reduce carbon emissions from a company's plant

5.2.1 Introduction

The foregoing discussion concentrated on a managerial decision to maximise a company's share value. The conclusion was reached that this would likely constitute an example of short-termism. In this scenario, a decision by management to reduce carbon emissions and the relevance of this to long-term or short-term thinking will be considered. This example is taken from a recent article by Blair in which she describes a state of affairs where a board has decided to act aggressively to reduce carbon emission from a company's plant (without specifying what the type of company is).[660]

In order to make this case study more convincing, it is based on the assumption that the hypothetical companies in Delaware, Germany and UK each have the same corporate purpose. That corporate purpose is of a company manufacturing cars where arguably, the

[660] Blair, *In the Best Interest of the Corporation* 71.

carbon footprint is high[661] and owing to that fact, the reduction of carbon emissions is a vital decision.

Reducing carbon emissions suggests consideration of environmental and community interests[662] but a decision to do so might also serve the interests of shareholders. It might also have an impact on the profitability of the company. Certainly, factors other than the shareholders' interests were taken into account during this decision-making process and this is the main justification for introducing this case study. The ability to look beyond the shareholders' interests is in line with the discussion of the shareholder v. stakeholder issue, e.g. this example epitomises the corporate objective debate particularly well; it touches upon conflicts between the shareholders' interests and a broader range of factors. A decision to reduce the carbon emissions from the company's plant is not immediately linked to profit maximisation; it rather suggests some costs for the corporation and/or investment in new technologies. However, if the action is justified and well planned it might be profitable for shareholders and other stakeholders. This indirect link to a possible contribution to the company's wealth is interesting in the context of a debate on corporate objectives. Would a decision to reduce carbon emissions be acceptable in all three jurisdictions? It is worth enquiring how the decision might be perceived and whether it would be evaluated as considering long-term or short-term consequences. The topic of the reduction of carbon emissions in the context of the law of Delaware, Germany and the UK will now be addressed.

5.2.2 Delaware

As far as Delaware law is concerned, the decision described by Blair would likely be lawful, as the board exercises broad decision-making powers and it is entitled to reduce carbon emissions. This can only occur under the condition that this decision is also beneficial for shareholders. Hence, arguably this jurisdiction supplies weak incentives for this kind of decision.

On the whole, Delaware law is quite clear that additional interests can only be pursued when the shareholders' interests are also met. Strine, for example, finds a tendency to consider the interests of other stakeholders to be equal with the interests of shareholders 'a tad naive and tiring.'[663] The decision to reduce carbon emissions appears to be an example of long-term thinking, as it arguably goes beyond the immediate shareholders' profits. The

[661] See e.g.: Mike Berners-Lee, Duncan Clark, 'What's the carbon footprint of …a new car?' (The Guardian, 23.09.2010)
<http://www.theguardian.com/environment/green-living-blog/2010/sep/23/carbon-footprint-new-car> accessed 11 September 2015.
[662] This case study does not scrutinise the environmental law regulations like for instance the Kyoto Protocol.
[663] Strine, 'Making it Easier for Directors' 235.

assumption is made that the decision has been diligently thought-out and the effects of this reduction duly considered.

If it satisfies the interests of the shareholders and it was taken in the best interest of the company, the board's decision to reduce carbon emissions is a lawful activity and should not contribute to a breach of the directors' duties. The business judgment rule appears to protect well-motivated and rational decisions, even if they do not maximise shareholder value.[664] Clearly, this approach allows directors in Delaware to consider aims beyond profit maximisation. Bainbridge agrees that the business judgement rule gives directors leeway to consider other factors. However, he stresses that that is not the purpose of the rule since '[t]he fact that corporate law does not intend to promote corporate social responsibility, but rather merely allows it to exist behind the shield of the business judgment rule becomes significant in – and is confirmed by – cases where the business judgment rule does not apply.'[665]

Thus, the consideration of the interests of other stakeholders or long-term factors cannot stand as a sole justification for a decision. It is permitted, providing the interests of shareholders are satisfied.

Blair asks whether this decision has been taken because it is socially responsible or because 'in the long run, it will be good for shareholders if the company plays a leadership role in developing environmentally sustainable ways to operate?'[666] Importantly, Blair's reasoning focusses on the idea that the merit of this decision goes (or should go) beyond the short-term shareholders' interests and that it should be perceived as a critique of and as an alternative to the short-term nature of the shareholder value maxim. Blair's argument that it might be difficult to establish unequivocally what the justification is, appears to be very convincing, i.e. whether the aim was to pursue shareholder value or the wealth of the whole company. Both of these aims can perhaps be fulfilled concurrently, serving various groups' interests. The crucial point is that this decision can be taken in Delaware if it serves the interests of shareholders and is consistent with the corporate objective. The fact that the reduction of carbon emissions might be beneficial for both the environment and the public in general is a bonus. The reduction of carbon emissions might be beneficial for shareholders in

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[664] Todd Henderson, 'The Shareholder Wealth Maximisation Myth' (Truth on the Market, 27 July 2010) <http://truthonthemarket.com/2010/07/27/the-shareholder-wealth-maximization-myth/> accessed 12 November 2014.

[665] Stephen Bainbridge, 'Al Franken, Shareholder Wealth Maximisation and the Business Judgment Rule' *(*Professor Bainbridge.com 27 July 2010) <http://www.professorbainbridge.com/professorbainbridgecom/2010/07/shareholder-wealth-maximization-and-the-business-judgment-rule.html> accessed 12 November 2014.

[666] Blair, *In the Best Interest of the Corporation* 71.

terms of their leadership role in the environment protection, as Blair describes, but in the longer-term this also yields financial profits. The aim of long-term share value maximisation is self-evident and it seems to be encouraged in Delaware.

5.2.3 Germany

A decision to reduce carbon emissions from a company's plant constitutes a clear example of long-termism in the two other jurisdictions under review. It is likely to be an example of long-termism under German law, which is a jurisdiction leaning towards the stakeholder theory. The decision to reduce carbon emissions is arguably not only taken to promote the immediate interests of shareholders but also considers the interests of other stakeholders as well as long-term consequences. The reduction of the carbon emissions should generally positively influence the company in the long run and thus the decision to do so is socially responsible. Siemens, in its Sustainability Report of 2011, informs that the company reduced carbon dioxide emissions by 22% compared to 2006 when the established target was 20%. Sustainability was articulated as 'our guiding principle [which] creates major business opportunities for our company.'[667] Hence, this is not a hypothetical example but a real decision taken by a German company.

Lücke aptly notes that the management board can take decisions in accordance with its own discretion: 'the role of the management board is to establish the interests of the company while considering the diverging interests of all stakeholders.'[668] As previously noted the discretionary powers of the management board are limited in Germany by the duty of ensuring lasting profitability and the continued existence of the corporation. These are the main points of reference for directors when making decisions. Hüffer argues that the concept of lasting profitability corresponds primarily to the interests of the shareholders as investors and it also serves the interests of the employees and public welfare since the public interest cannot rely on economic entities that are unprofitable in the long-term. Hüffer also distinguishes lasting profitability from short-term profit maximisation.[669] This suggests that lasting profitability is not connected to short-term profits and hence directors are discouraged from concentrating on it. If it contributes to the lasting profitability of the company and goes beyond short-term profits, a decision to reduce carbon emissions is likely to be consistent with the country's corporate objective and will likely be lawful. There is greater incentive for

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[667] Siemens Sustainability Report 2011, (Press release Munich 21 May 2012) <http://www.siemens.com/press/en/pressrelease/?press=/en/pressrelease/2012/corporate/axx20120525.htm> accessed 10 June 2014.

[668] Oliver Lücke in Oliver Lücke and Bernhard Schaub (eds), 'Beck'sches Mandatshandbuch Vorstand der AG' (2nd edn CH Beck 2010) 97. (my translation)

[669] Hüffer, *Aktiengesetz* § 76 mn. 14

such a decision to be taken and it is highly unlikely that it will constitute a breach of directors' duties in Germany. Even if the decision is ultimately unsuccessful, the management board can hide behind the shield of the business judgment rule unless it can be proved that it did not act in the best interests of the company.

Is the position under German law any different from that applicable in the UK and Delaware? The decision-making process in Germany appears to involve a greater degree of balancing of the interests of various stakeholders than is the case in the UK or Delaware. This decision appears to be more natural in Germany than in the other two jurisdictions. This case study demonstrates also that in a stakeholder jurisdiction, at least theoretically, the law provides greater scope for different points of view to be considered, the situation is analysed from different perspectives and the decision is more comprehensive. From this perspective, considering the interests of various stakeholders is in itself a more long-term orientated approach. Further, employees and creditors should support reduction of carbon emissions, as they will generally be orientated towards the prosperous existence of the company (this is not always the case regarding shareholders, as they can sometimes be just traders). Moreover, the majority shareholders are generally more long-term focused because of the likelihood of concentrated share ownership. The perspective is therefore longer, fuller and more far-reaching than if only the interests of shareholders are taken into account. As such, greater incentive exists for this decision to be taken in Germany than in the other jurisdictions, as it appears to be highly consistent with the corporate objective there and constitutes the strongest example of long-termism.

5.2.4 The UK

Under UK law, the given illustration should also provide an example of long-term thinking. The decision to reduce carbon emissions is most likely to be an investment that will contribute in the future development of the company as a whole and not only to an increase in the shareholder value. This decision might be favourable to the enterprise and the various stakeholders listed in s. 172 CA 2006 in the long-run. Before making a decision, the board must scrutinise whether it is beneficial to shareholders as a whole, as this is the paramount objective under the Companies Act 2006. Shareholders' interests are a key concern for directors and directors are accountable only to them, but this decision has also some chance of being consistent with the ESV principle promoted in the Companies Act. Lotz aptly highlights that the ESV in s. 172 CA 2006 was introduced to encourage directors to consider

long-term wealth maximisation strategies rather than pursue short-term financial benefits[670] and Al-Hawamdeh et al. interestingly argue that the success of the company in most cases relates to a long-term increase in the value of the company, for example, long-term enlightened shareholder value.[671]

It is argued in this thesis that the decision to reduce carbon emissions most likely will constitute a lawful activity and if it is considered to increase shareholder value, the law affords incentives for such a decision to be taken. As such, it would be difficult to claim a breach of directors' duties. Further, as far as UK law is concerned, the decision to act to reduce emissions will be encouraged in the literature, insofar as it goes 'beyond routine day-to-day operations'[672] – meaning that it is actually 'a *strategic* decision' which considers, 'by using the available information, the consequences in the long-run of the intended course of action.'[673]

However, at the same time and similar to the position in Delaware, the UK law supplies quite weak incentives for such decision, by emphasising the paramount importance of shareholder interests. In other words, in the UK the incentives for such a decision are weaker in a sense that it depends only on whether it will be beneficial for shareholders, as the other factors are of lesser importance.

5.2.5 Conclusions

The conclusion regarding the nature of such a decision appears to be very similar under these three jurisdictions. The decision to reduce carbon emissions would be permissible under all three jurisdictions and it seems that it takes into account the long-term interests of the company. The background and justification for the decision is slightly different in each jurisdiction though. In Delaware and UK law, the decision is taken primarily because it serves the interests of the shareholders. If it is also beneficial to other stakeholders, it is even better, but this is not an essential condition and rather an additional benefit. Arguably, the decision-making process under German law requires the balancing of different interests. Hence, it is naturally a stronger example of long-termism under German law, as it is more in line with the corporate objective there. These different interests appear to be more equivalent and are not immediately subordinated to the interests of shareholders. This case study shows

[670] Sascha Lotz, 'Directors' Duties with Regard to Creditors in German and UK (Core) Company Law' (2011) 22 (8) ICCLR 264, 266.
[671] Ahmed Al-Hawamdeh and others, 'The Interpretation of the Director's Duty under Section 172 Companies Act 2006: Insights from Complexity Theory' (2013) 4 JBL 417, 419, 432.
[672] Cerioni 'Success of the Company' 4.
[673] ibid. [emphasis in original]

that all three jurisdictions differentiate between long-term and short-term profit maximisation, and that the forward-looking perspective, is advanced over the short-term one.

5.3 Case study 3: Excessive marketing

5.3.1 Introduction

The next issue to be analysed is the time horizon of a decision to concentrate on excessive marketing in the three jurisdictions. Excessive, and therefore, detrimental marketing, could be the outcome where a professional hired by the company is incompetent. In this case, the main claim would be by the company against the third party in charge of the excessive marketing campaign. This case study, however, does not analyse this issue and instead concentrates on a board's decision to over-promote the company. The following analysis is based on the assumption that the hypotherical companies in the UK, Delaware and Germany all have the same corporate purpose. They are deemed to be medium-sized, pharmaceutical companies.

Companies all over the world invest or over-invest in marketing. A decision to do so cannot be identified with specific corporate objectives and a question arises about how this decision fits in with the company's corporate objective and whether it is more likely to be taken in one jurisdiction than another. Obviously, this decision affects shareholders. If the marketing is carried out successfully, they will be the first to see its effects. Marketing will also have an effect on other stakeholders. Whether it is effective or damaging, the company's marketing strategy will certainly have an impact on the stakeholders and the company: not only shareholders but also other stakeholders benefit from marketing or suffer because of it. The excessive marketing scenario is inspired by the following case described in the Kay Review:

> In the 1970s, Glaxo made a successful long-term investment in the development and promotion of Zantac which created a British world leader in pharmaceuticals. In the 1990s, however, the company – in common with other global pharmaceutical companies – appears to have given relatively too much attention to marketing and to the acquisition of other pharmaceutical businesses, and not enough to the fundamental research on which long-term success in this industry depends. The long-term damage resulting from such misdirection was exemplified in the $3bn fine imposed by the US regulatory authorities as this report went to press.[674]

This case shows that too much focus on marketing and the purchasing of other businesses and not enough attention to key research were the reasons for the long-term damage that

[674] Kay Review para. 1.26.

Glaxo suffered. Research is perceived as a positive factor and, according to the Kay Review; it should contribute to long-term success in the industry. This scenario suggests that paying too much attention to marketing was a bad decision since it was destructive for the company and created negative consequences for it. Moreover, the word 'excessive' implies a pejorative connotation, as it means 'too much or too great.'[675]

The other justification for associating excessive marketing negatively comes from online marketing. The survey shows that half of online customers connect to a brand via social network. However, a third of social media users disconnected from these brands subsequently (mostly because of aggressive adverts) and then associate them negatively.[676] The other research underlines that in 1996 the response rate to the online adverts was 7%, whilst in 2012 it decreased to 0.1%.[677] It is argued that this is an effect of the 'digital ad bombardment,' as in 1996 each internet user received 30 advertising messages and in 2012 this number increased to 735. What is more, 66% of customers (both in UK and US) said that they would unsubscribe from a brand's pomotion if they thought that the messages they were receiving were too frequent.[678]

Does excessive marketing always contribute to long-term damage and does it always constitute a short-term decision? Every case and every company is different, so an unequivocal answer is impossible. Naturally, as such, excessive marketing will not always have negative and short-term consequences for a company. For example, provocative and excessive marketing of the photographer Oliviero Toscani made Benetton famous and successful in the eighties.[679] Secondly, it seems that excessive marketing is essential for luxury brands.[680]

On balance, what is the value of a case study on excessive marketing, knowing the contradictory opinions on it? Overall, a decision to invest excessively in marketing is

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[675] The Oxford Dictionary for the Business World (OUP 1993) 283.
[676] See: David Mielach, 'Slow and Steady Wins the (Social Media Marketing) Race' (Business News Daily, 23 March 2012) <http://www.businessnewsdaily.com/2247-social-media-backfire.html> accessed 25 September 2015.
[677] See: Matt Henkes, 'Upstream: Alarming consumer attitudes to excessive marketing' (Marketing Tech, 5 March 2012) <http://www.marketingtechnews.net/news/2012/mar/05/upstream-alarming-consumer-attitudes-excessive-marketing/> accessed 25 September 2015.
[678] ibid.
[679] See: Rosie Tomkins, 'Oliviero Toscani: "There are no shocking pictures, only shocking reality"' (CNN, 19 August 2010) <http://edition.cnn.com/2010/WORLD/europe/08/13/oliviero.toscani/index.html> accessed 25 September 2015.
[680] Especially for new exclusive brands: Mark Ritson, 'Marketing Luxury Brands Q&A' (Branding Strategy Insider, 2 July 2009) <http://www.brandingstrategyinsider.com/2009/07/marketing-luxury-brands-qa.html#.VgqGJpfTpSE> accessed 25 September 2015.

negatively regarded and portrayed as a short-term decision in this thesis, because it concentrates on one factor only. From a company's perspective, sustainable development is key. Hence, over-concentration on one factor, like marketing for instance, is condemned as being too risky for the company. The decision to market excessively is portrayed as a short-term decision both if it aims at immediate profit maximisation by shareholders or if it seeks to achieve goals other than immediate profit maximisation.

Returning now to the scenario presented in the Kay Review, it shows excessive marketing as a risky and unreasonable decision because of the resulting negative consequences. The reasoning presented in the Kay Review, despite its subjectivity in relating to the Glaxo case, constitutes an evaluation that can be used by the boards during the decision-making process in order to avoid destructive decisions. This is applicable to each of the legal systems under review. Clearly, excessive marketing might be the result of a spontaneous, one-off decision or of an erroneous longer-term strategy. According to the Kay Review, bad long-term decisions provide examples of short-termism.[681] The Review explains that short-termism or myopic behaviour can manifest itself in hyperactivity.[682] Excessive marketing – understood as an over-concentration on the issues related to marketing, irrespective of whether it is a one-off decision or a continuous strategy – could be an example of this, as presumably little attention was paid to the capabilities of the underlying business.[683]

The question arises as to why companies decide to promote their products and services excessively. The justifications for such decisions can vary. A lack of funds for the development of new products might be one of the reasons why a company focuses on marketing established products rather than on developing new ones.[684] The Kay Review shows that this can have negative consequences for the company, as it tries to compensate for these weaknesses by frequently reorganising its portfolio. This might damage the company's market position and reduce its value in the longer term.[685] Another reason for excessive marketing might be a conviction that it is actually beneficial for the company and for example used to promote a newly established, developing or failing corporation or perceived as a way of attracting new investments. In the pharmaceutical industry, where competition is high, advertisement of a product is vital. Nevertheless, an excessive focus on marketing is suggestive of a form of myopic behaviour; it is negatively regarded and disapproved of in the academic and secondary literature since risky decisions are not

[681] Kay Review para. 1.24.
[682] ibid. paras. 1.1-1.2.
[683] ibid. para. 1.2.
[684] ibid. para. 1.24.
[685] ibid.

desirable and should be avoided whenever possible. The topic of marketing in the UK, Delaware and Germany is now examined in greater detail, in order to scrutinise whether there are any differences in the perception of excessive marketing in the jurisdictions under review.

5.3.2 The UK and Delaware

Taking into account all of these points, it is rather unlikely that a decision to promote excessive marketing would form part of the content of a long-term principle in any of the jurisdictions under review. Although criticised in the Kay Review, it appears that it is more likely that a decision to market excessively might be taken in shareholder orientated jurisdictions such as the UK and Delaware, than in Germany. Shareholders are arguably less risk-averse than the other stakeholders and therefore more likely to support and approve risky decisions.[686] Excessive marketing is thus more likely to be perceived as a positive or necessary decision for the company, even if its development is not sufficiently balanced or there is not enough money to invest in research or staff. Therefore, arguably there are greater incentives for this decision to be taken in the UK and Delaware.

Despite their superficial similarities, the position under UK and Delaware law is not identical. Delaware leans the most towards shareholder primacy: the interests of only one group will be considered by the powerful boards there. UK law likewise recognises the ultimate interests of shareholders but the interests of other stakeholders are also taken into account, although not enforceable. More consideration (at least in theory) is given to the interests of other stakeholders in comparison with Delaware. Therefore, there are fewer incentives for such a decision to be taken in the UK.

It is reasonable to argue that excessive marketing is a lawful activity in both jurisdictions, although it might contribute to a breach of directors' duties. In the UK, directors can only be sued according to s. 172 CA 2006 if it can be proved that they did not promote the success of the company for the benefit of its members as a whole. In Delaware, even unfavourable directors' decisions are protected by the business judgment rule unless the plaintiff can prove that a director did not act in good faith and in the honest belief that the action taken was in the best interests of the company.[687] This will be extremely challenging.

5.3.3 Germany

In Germany, the interests of various stakeholders should be considered before decisions are taken. Von Dryander et al. are correct in pointing out that the interests of the shareholders,

[686] Wen, *Shareholder Primacy* 222.
[687] *Smith v. Van Gorkom* 872 (Justice Horsey).

the employees and the general public must be considered and that the management must weigh the different interests in case of conflicts.[688] As has been established in the previous case studies, in Germany a decision can be taken only if it serves the continued existence and long-term (or lasting) profitability of the company.[689] At this point, it is essential to underline an important remark made by Hohaus and Weber. These authors correctly argue that a lasting increase in value can be achieved through both long-term and short-term incentives: it is important that in the end, long-term incentives are generated and a lasting increase in value is achieved.[690] Hence, short-term management strategies are naturally also allowed under German law given that they aim towards a subsequent creation of value for the company. Nevertheless, it is unrealistic to expect that the decision to focus excessively on marketing in the case of an average corporation will contribute to the lasting profitability of the company. Moreover, it will be difficult to prove that such a decision balances the interests of various stakeholders, contributes towards consistent development and was taken in the best interests of the company. A decision to focus excessively on marketing is a strong example of short-termism under German law. There are weaker incentives for excessive marketing in Germany and as such, it is less likely that a decision to focus on excessive marketing would be taken there or that it would be encouraged since it is not consistent with the corporate objective. It is not an unlawful activity in itself but it might contribute to a breach of the directors' duties. If the marketing strategy is unsuccessful, the members of the management board will find protection under the business judgment rule unless they did not act in the best interests of the company.

5.3.4 Conclusions

Can it be argued that 'appropriate' marketing (i.e. reasonable and balanced marketing) will be a positive decision for a company in the longer-term? It is extremely hard to distinguish between destructive and favourable marketing and to define what constitutes appropriate marketing. It seems more likely that balanced and well-planned marketing will contribute to the long-term sustainable development of companies in every jurisdiction.

This case study highlights the importance of well-balanced and well-thought-out decision-making and the dangers associated with disproportionate decisions. However, it should also be noted that extreme (and short-term) decisions are not always harmful. Decisions may not always be negatively (or short-term) orientated: the context is important.

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[688] von Dryander and Riehmer, *Being a Board Member in Germany* 39.
[689] ibid.
[690] Benedikt Hohaus and Christopf Weber, in Oliver Lücke and Bernhard Schaub (eds), 'Beck'sches Mandatshandbuch Vorstand der AG' (2nd edn, CH Beck 2010) 448 (my translation).

It is reasonable to assume that the word 'excessive' evokes negative associations. Greater incentives are supplied by the law in the UK and Delaware than in Germany to take a decision that focuses on excessive marketing, but it appears to be a lawful activity in all three jurisdictions and it can only contribute to the breach.

5.4 Case Study 4: A lack of focus on environmental and health and safety issues

5.4.1 Introduction

In case study 3 above, the interrelationship between a decision to focus on excessive marketing and its time horizon was put under scrutiny. The next case study draws its inspiration from the BP oil spill of 20 April 2010 in the Gulf of Mexico, which was connected to inappropriate decision-making and to a lack of focus on environmental and health and safety issues. The BP oil spill case was discussed in the Kay Review,[691] extra-judicially by Strine who is Chancellor of the Delaware Court of Chancery[692] and in the academic literature in Germany.[693]

An examination of different factors that are not immediately linked to profit maximisation is particularly interesting in the context of stakeholder v. shareholder discussions. It illustrates how these debates evaluate the broader factors against the corporate objective. That environmental and health and safety arguments should be of critical importance for corporations or for society as a whole is rarely challenged. This case study also shows how focusing on these factors contributes to the long-term gain and development of the company. The environmental and health and safety issues in the UK, in Delaware and in Germany will now be reviewed.

5.4.2 The UK

Since BP is a British company, the lack of sufficient focus on environmental and health and safety issues will be analysed first from the UK perspective. There is evidence that BP was aware of some safety concerns prior to the accident but these risks were ignored for economic reasons.[694] The Kay Review argued that BP's insufficient concern for

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[691] Kay Review ch 1.
[692] Strine, 'Our Continuing Struggle'136-139.
[693] Nick Lin-Hi and Igor Blumberg, 'The Relationship between Corporate Governance, Global Governance, and Sustainable Profits: Lessons Learned from BP' (2011) 11 (5) CorpGovern InternaJournalBusSoc 571.
[694] Congress of the United States, *Official letter to BP CEO Tony Hayward* (2010) <http://online.wsj.com/public/resources/documents/WSJ-20100614-LetterToHayward.pdf> accessed 24 July 2014.

environmental and health issues and cost pressures contributed to a series of accidents in North America of which the one in the Gulf of Mexico was only the most infamous. Pressures on costs are to blame for BP's lack of attention to safety issues and this contributed to 'major financial and reputational damage to the company.'[695] The spill had many negative consequences. Undeniably, not only did BP suffer direct financial losses, but also damage to its image. The loss of public confidence in oil drilling is also likely to have an impact on BP's long-term success.[696] BP's internal investigation concluded that 'no single cause was responsible for the accident.'[697] Various factors must have contributed to the disaster.[698] The evidence suggests that focussing on short-term profits and disregarding environmental and health and safety issues are among the possible reasons for the disaster.

A link between a focus on environmental, health and safety issues and consideration of long-term consequences during decision-making processes has been made in the secondary literature. For example, Lin-Hi and Blumberg noted that BP arguably had a variety of good corporate governance mechanisms in place and that it had committed itself to sustainable conduct.[699] Thus, the conclusion arises that the oil spill did not happen because of bad governance rules or an absence of rules, but that instead it was a result of an improper incorporation of these rules into the running of the company. [700] It is also the view of this author that corporate sustainability was not safeguarded in BP, in the sense that the company was willing to take excessive risks in order to generate immediate profits, rather than realise sustainable, [701] i.e. long-term profits. Further, Lin-Hi and Blumberg identified consideration of these wider factors (i.e. environmental and health and safety issues) with the sustainable development of the company. They argue that in order '[t]o resolve the tension between short- and long-term objectives, good institutions are required that provide incentives for sustainable behavior without endangering corporations' short-term competitiveness.'[702]

Hence, it is pertinent to note that the BP oil spill case is an example of a short-term decision under UK law, as it has been taken to generate profits and presumably the long-term effects or wider factors were not properly analysed or considered. The corporate objective in the UK requires only consideration of these wider factors. If the factors are duly considered, the directors act lawfully. Section 172 (1) (d) underlines the importance of the 'impact of the

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[695] Kay Review para. 1.22.
[696] Lin-Hi and Blumberg, 'Relationship between Corporate Governance'573.
[697] <http://www.bp.com/en/global/corporate/gulf-of-mexico-restoration/investigations-and-legal-proceedings.html> accessed 22 July 2014.
[698] See i.e. Strine, 'Our Continuing Struggle' 136-139.
[699] Lin- Hi and Blumberg, 'Relationship between Corporate Governance' 573-574.
[700] ibid 574.
[701] ibid.
[702] ibid. 571.

company's operations on the community and the environment,' but the board is only obliged to 'have regard' to these factors. Thus, the paramount importance of the shareholders' interests suggests that UK law might supply reasonably strong incentives for environmental and health and safety issues to be disregarded. A lack of focus on environmental and health and safety issues can contribute to a breach of directors' duties only if there is a failure to comply with any other legal duty imposed on the directors.

It is understandable that a decision to concentrate on environmental issues might have been unpopular with shareholders, as it is quite unlikely that it would produce immediate profits. On balance, the BP oil spill case proves the contrary. This case is presented here to educate stakeholders, inasmuch as it shows that it is indeed in shareholders' interests to recognise environmental and health and safety issues, as otherwise this oversight might generate costs, result in the fauilure of profits to materialise, and potentially diminish shareholder value. Clearly, it is also in the directors' interest – whilst acting in good faith and promoting the success of the company for the benefit of its members as a whole – to consider the factors listed in s. 172 CA 2006, to avoid a breach of this provision.

Overall, the accident in the Gulf of Mexico shows that decisions that undervalue environmental and health and safety issues can have serious, negative consequences for companies. A lack of focus on environmental and health and safety issues is a sign of short-term thinking under UK law and, in the case of BP; it obviously harmed the company's reputation. As such, consideration of such health and safety and environmental factors would likely constitute an example of long-term thinking in the given scenario.

5.4.3 Delaware

Under Delaware law, a lack of consideration of environmental and health and safety issues is likely to be treated as an example of short-termism. Importantly, Strine sees the BP oil spill disaster as one of the main examples of 'the tendency to underestimate the extent to which firms subject to pressures to deliver short-term profits for their stockholders [which] pose a serious risk of generating societally destructive externalities.' [703] Strine claims that this case emphasises 'a natural tendency to pay attention to short-term profits over long-term risks.' [704] In practice, however, it is highly likely that the interests of shareholders rather than the condition of the environment would be of paramount importance in this jurisdiction. In this context, Strine points out correctly that ultimately it is expected that managers are

[703] Strine, 'Our Continuing Struggle' 136.
[704] ibid. 138.

accountable to shareholders regardless of 'community values.'[705] Although it may be negatively regarded in the local communities or in the literature, any decision that fails to consider environmental factors is still likely to be consistent with Delaware's corporate objective (assuming the director can prove that he was acting in the best interests of the corporation). Thus, in Delaware there are greater incentives for the board to disregard environmental and health & safety issues in comparison to two other systems. In contrast to the UK, consideration of the environmental issues is not even articulated in this jurisdiction's legislation.

Moving now to the board's responsibility, directors' decisions are protected in Delaware by the business judgment rule. Obviously, this rule cannot save directors from a finding of a breach of duty if they favour their own personal interests and are not acting in the best interests of the company. Nonetheless, this case scenario shows that a disregard for environmental and health and safety issues can contribute to a breach of directors' duties. A lack of regard for wider factors and concentration on short-term shareholders' profits is to blame for such short-term decisions under Delaware law. It is argued that a change of focus from short-term to long-term shareholder value,[706] apart from consideration of the wider factors (which is not mandatory in Delaware), makes a contribution towards minimising the risk of taking such decisions under Delaware law in the future.

5.4.4 Germany

Although shareholders' interests are vital under German law, its tendency to the safeguard the interests of wider stakeholders affected by corporate conduct means that it would arguably be more reluctant to put environmental and health and safety issues at stake (even if they cannot be the sole point of reference). Hopt has argued consistently that shareholders are the equity investors, and since they take the business risks, their interests should prevail.[707] Therefore, it might be argued that under German law directors might have taken the decision because they wanted to concentrate on profit maximisation for shareholders. In the case of BP, that decision was not really taken in the shareholders' best interests; it was detrimental to them and at the same time it undervalued environmental and health and safety issues. Hopt's argument has also been criticised in the literature as creditors and employees also bear certain risks.[708] There is also a strong line of argument that invokes the concept of

[705] ibid. 145.
[706] As underlined above, Jansen points out that for most economists, one criterion for evaluating performance for managers should be the maximisation of the long-term market value of the firm. Jensen, 'Value Maximization' 32.
[707] Hopt, 'Vergleichende Corporate Governance' 477.
[708] Spindler, *Münchner Kommentar Aktiengesetz* § 76 mn. 72.

the benefit of the corporation: the management board is obliged to pursue the interests of the entire corporation and not individual shareholders and this is confirmed in the *Kodex*.[709] Therefore, the argument under German law is clearly that the undervaluation of environmental and health and safety issues benefits neither the corporation as a whole nor individual stakeholders and it is inconsistent with the corporate objective. Seen from this perspective, the incentives for such a decision to be taken under German law are weaker, as demonstrated by the secondary literature; if this is the case, it would be clearly an example of short-termism, as it concentrates on the shareholders' short-term gains. It is also probable that it might contribute to a breach of directors' duties, if the management board was not acting in the best interests of the company or did not fulfil other duties. This, in turn, would prevent a member of the management board from relying on the business judgment rule to shield him/her from liability.

5.4.5 Conclusions

The BP oil spill case caused public outrage. This analysis indicates that all of the jurisdictions should learn from the BP experience, as accidents can happen anywhere. The hope is that this unfortunate incident will encourage corporations all over the world, not only in the oil industry, to pay more attention to the consequences of their management's decisions and their effects in the longer and shorter term. The most important conclusion is that there is a link between a consideration of broader factors, the consequences of directors' decisions in the long-term and good corporate governance. The reluctance to consider broader factors and concentration only on net profits can be very costly. It pays off to invest in the long-term development and in this case, the lack of focus on environmental and health and safety issues is likely to be an example of short-term thinking, in all jurisdictions and in slightly stronger terms in German law. Although a lack of consideration of environmental and health and safety issues does not itself constitute a breach of directors' duties, it can contribute to this breach considerably.

5.5 Case Study 5: Promotion of cultural, social and civic aims

5.5.1 Introdcution

The final issue to be analysed in this chapter is whether the decision to promote cultural, social and civic aims has a positive or negative (long-term or short-term) impact on a company. This decision differs slightly from the examples described above. Consideration of these aims appears to be even more loosely connected to the contribution to the company's

[709] ibid.

financial growth, making their prioritisation by a company much more controversial. The decision to contribute to any cultural, social or civic aims does not usually bring any immediate profits for the company. Promotion of all these social aims is only possible when the company is doing well and when there are some funds allocated for it. Therefore, the question arises whether it is beneficial for the directors of a company to take such a decision, how great the incentives are for such a decision to be taken in the countries under review and whether both shareholder and stakeholder-orientated jurisdictions are likely to support it.

This case study provokes questions about corporate social responsibility and its role in the decision-making process in the shareholder and stakeholder-focused jurisdictions. The essential point of this analysis is to establish whether the decision to promote cultural, social and civic aims fulfils the company's corporate objective and whether it also assists towards promoting the company's successful long-term development. It is argued that this decision might be beneficial for the company in any jurisdiction, if it supports rational aims and when it is well thought through. The justification for it might be that it is a long-term investment for the company. If it is successful, the investment will generate positive effects for the company and it will improve its image. In this section, the discussion centres on whether any particular corporate objective is more likely to furnish an opportunity to justify such a decision. The legal position in Germany, the UK and Delaware will be analysed in turn.

5.5.2 Germany

This final scenario is inspired by German case law. There is evidence that German law acknowledges the importance of cultural, social and civic aims. As described in Chapter III,[710] there are few cases in Germany that have dealt with this issue and they have provoked this further analysis. The conclusion that follows from them is that a company is also entitled to fulfil cultural, social and civic aims, as financial and not-for-profit goals are not perceived as contradictory but complementary objectives. The ultimate aim of being a 'good corporate citizen,' underlined by the BGH,[711] is to improve the company's financial situation. The German courts have also emphasised the interests of the enterprise as a binding guiding principle for the management board.[712] This suggests that social aims cannot constitute the only justification for the decision since decisions should above all serve the interests of the enterprise. The German commentators appear to share that view. They also argue that the directors' duties are not breached in cases when the board supports social goals.[713] It has

[710] Chapter III s 4.4 above.
[711] BGH, 06.12.01 – 1StR 215/01 – BGHSt 47, 195.
[712] BVerGE 50, 290, 374; s*imilarly* BGH 29.01.1962 – II ZR 1/61, BGHZ 36, 296, 306, 310.
[713] Hüffer, *Aktiengesetz* § 76 mn. 14.

been stressed on many occasions in this thesis that the management board must always act in the best interests of the company and ensure its lasting existence and success.[714] Therefore, clearly, if this condition is fulfilled, the management board is protected by the business judgment rule and it can also promote cultural, social and civic aims. Spindler emphasises that the management board is entitled to shape the company's business according to its own discretion only, however, within the limits of the articles of association.[715] Each public limited company is committed to long-term profit realisation and not profit maximisation, unless it is provided otherwise in the articles of association.[716] It is pertinent to note that supporting broad social aims can contribute towards this long-term profit rule.

The principle of long-term profit realisation is not expressed in the Act. According to Spindler, it follows from § 90 (1) 2 AktG. This section notes that the management board must report to the supervisory board on the profitability of the company. It is argued, moreover, from an economic perspective that the realisation of profits is essential, as the company simply cannot exist without them. The law does not further clarify the meaning of the profits targets. Very few of the directors' duties can be derived from this profit realisation maxim.[717] The company is also entitled to fulfil external aims. Importantly, the profit imperative does not mean that the company cannot be a 'good corporate citizen' and that it cannot contribute to the maintenance and development of the general public wealth through contributions that will diminish the company's profits.[718]

Westermann notes that the management board should consider whether a gratuitous donation that is not identifiable with the company's objectives can bring any possible benefits for the company in general, the general public, the corporate identity and the company's reputation. Usually, the management board will have to justify why the shareholders did not receive the profits to which they would normally be entitled.[719] Being a 'good corporate citizen,' apart from its charitable role, might be beneficial for the company in the longer term. In Germany, assuming the condition that this decision is well thought through, it is highly likely that it will constitute a positive long-term investment, an example of long-term decision-making and that such a decision will not constitute a breach of directors' duties. Hence, clearly the German law incentivises the board to promote cultural, social and civic aims. It is a distinctive feature of the German jurisdiction that, although the

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[714] See also: Wirth and others, *Corporate Law in Germany* 109.
[715] Spindler, *Münchner Kommentar Aktiengesetz* vor § 76 mn. 47.
[716] ibid. vor § 76 mn. 48.
[717] ibid.
[718] ibid. vor § 76 mn. 49.
[719] Harm Westermann, 'Gesellschaftliche Verantwortung des Unternehmens als Gesellschaftsrechtsproblem' ZIP 1990 771, 775 (my translation).

financial situation of a company is without doubt of paramount importance under German law, non-financial goals are also prioritised (maybe only in theory). Such an approach may well lead towards the more balanced development for the company, which is one of the prerequisites of long-term decision-making.

5.5.3 The UK and Delaware

The experience under German law confirms that an altruistic decision might be quite controversial but at the same time justified as a lawful exercise of managerial decision-making. The position in the other two jurisdictions is slightly different. Consideration of cultural, social and civic aims does not attract as many court rulings or generate as lively a discussion in Delaware or in the UK in the context of the directors' duties. The decision to support cultural, social and civic aims can also be taken under UK and Delaware law; however, in these systems incentives for such decisions are weaker and not as obvious as under German law. This is the case as shareholders' interests play a more central place in the UK and Delaware. These reflections bring to mind the notion of corporate social responsibility, and its role under UK and Delaware law.

Traditionally it is argued that under Delaware law corporations should be run in order to maximise shareholder value, for instance, Strine rhetorically asks '[j]ust how long will hedge funds and mutual funds subordinate their desire for returns to the desire of a founder to do good?'[720] If a decision that promotes social, civil and cultural aims does not contribute to shareholder profit maximisation, it is less likely that it will be taken.[721] However, if the decision is beneficial for shareholders, it is more possible to be taken and if taken, most likely it will be an example of long-termism. Hence, Delaware law supplies reasonably weak incentives for such a decision. To illustrate this point, Strine argues that there is no doubt that a corporation may support charities or pay higher wages even if they do not maximise corporate profits immediately. They might be justified, as they are likely to produce greater profits over time.[722] In a similar vein, Eisenberg claims that General Motors benefits in the same way from sponsoring documentaries for public television as it would from 'a conventional corporate commercial' – hence, such use of corporate resources 'can be justified on a straight maximizing basis.'[723] Eisenberg quite frankly states that 'frequently a corporation can earn greater profits by appearing to be philanthropic than by appearing to

[720] Strine, 'Our Continuing Struggle' 151.
[721] See similarly ibid. 152.
[722] ibid. 147 fn 34 and the literature cited there.
[723] Melvin Eisenberg, 'Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, The Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure' (1998) 28 Stetson LRev 1, 14.

maximize.'[724] As such, despite the shareholder value orientation of Delaware law, the promotion of social, cultural or civic aims naturally also constitutes a lawful activity. What is more, the business judgment rule in Delaware generally protects decisions that promote interests other than profit maximisation if such decisions are justified and well thought out.

The position under UK law differs slightly. The ESV principle requires consideration of various factors. At least in theory, the board in the UK is strongly encouraged to consider these broader social aims. Therefore, in comparison with Delaware law, the incentives for the promotion of cultural, social and civic aims in UK law are stronger. Despite that, it is likely that the final result will be similar to the position in Delaware. The cultural, social and civic aims can only be taken into account if they are beneficial for the shareholders. This point is clearly illustrated in the *Parke v Daily News (No. 2)*,[725] a pre-CA 2006 case, where it was held that a company's funds cannot be applied in making ex gratia payments to the company's workers. In general, all transactions must benefit the company, i.e. its shareholders:

> The court will inquire into the motives for such payments and the objectives intended to be achieved, and will uphold their validity if, but only if, the transactions are reasonably incidental to the business of the company at the time, are bona fide, and are done for the benefit and to promote the prosperity of the company, i.e., the general body of shareholders.[726]

Arguably, shareholders will profit from this decision if it enhances the company's corporate reputation. In the case of the promotion of cultural, social and civic aims, that would possibly happen in the longer term. Keay underlines the fact that decisions that increase a company's corporate reputation should be identified as long-term actions.[727] Nevertheless, as it does not generate immediate profits, the UK law supplies weaker incentives for the promotion of social, cultural and civic aims. This decision will be a lawful activity, unless it can be proved that directors were not aiming to promote the company's success.

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[724] ibid 16.
[725] *Parke v Daily News (No. 2)* [1962] Ch 927.
[726] ibid.
[727] Andrew Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' (University of Leeds School of Law, Centre for Business Law and Practice Working Paper 20 August 2010) 26 <http://www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf> accessed 17 February 2015.

5.5.4 Conclusions

Decisions that promote cultural, social and civic aims can be taken in all three jurisdictions, without necessarily generating a breach of directors' duties. However, past experience and the characteristics of German law suggest that it is more probable that they will be taken in this jurisdiction, since the incentives supplied by the law are stronger. If a decision is justified and reasonable it is very likely that it will constitute an example of long-term thinking in all legal systems. The common feature under the three jurisdictions is that social aims cannot constitute the only justification during the decision-making process. A decision must also be economically viable in the sense that it contributes to the company's economic and financial development. The difference between the jurisdictions consists in the extent to which these social aims are considered. Arguably, they are of higher importance under German law than under the two other jurisdictions but the UK's s. 172 CA 2006 explicitly underlines the importance of wider factors in decision making, so it ranks above Delaware law.

Chapter V. Long-termism in directors' duties according to secondary sources: a critique. Share ownership structure and the parameters of long-termism.

1. Ownership structure

1.1. Introduction

Having marshalled the shareholder v. stakeholder debate in Chapter IV as a means of drawing up specific examples of long-term and short-term decision-making, the discussion now turns to an analysis of share ownership structures in companies.[728] The share ownership structure of public corporations will be adopted in order to identify additional examples of such long-term and short-term decision-making. The nature and structure of share ownership of public corporations differs worldwide. Publicly traded corporations traditionally have either concentrated or dispersed patterns of share ownership.[729] Theorists have stressed the differences in ownership and control arrangements between Germany – commonly identified as a concentrated ownership jurisdiction – and the more dispersed ownership structure found in the US and the UK.

Davies et al. observe in the 'Anatomy of Corporate Law' that recently '[t]he correlation between ownership structure and corporate law has been a common theme in the academic literature.'[730] Hopt and Davies argue that the dispersed or concentrated nature of the shareholder body is one of two key factors that will have an influence on the role of the board in public companies, as it affects what the board does and to whom it is accountable.[731]

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[728] The classification of different types of shareholders and the role of institutional shareholders is outside the scope of this chapter. Institutional investors will be scrutinised briefly in Chapter VI s 5 below, as they play a vital role in corporate governance, especially in dispersed ownership jurisdictions and some of them are long-term shareholders. See: Christine Mallin, *Corporate Governance* (4th edn, OUP 2013) 106.

[729] See e.g. the seminal work of Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, Corporate Ownership Around the World (1999) 54(2) JFin 471, 471-472 and the literature cited there; John Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2001) 111(1) YaleLJ 1, 3. Not everybody agrees with this taxonomy: in their report, the OECD notes that dichotomy between concentrated and dispersed share ownership structure might be too simplistic and mixed ownership structure should be also distinguished, see: the OECD, *Corporate Governance Factbook* (2014) 9 <http://www.oecd.org/daf/ca/CorporateGovernanceFactbook.pdf> accessed 4 February 2015.

[730] Paul Davies and others, 'Beyond the Anatomy' in Reinier Kraakman and others, *The Anatomy of Corporate Law* (2nd edn, OUP 2009) 306.

[731] Klaus Hopt and Paul Davies, 'Corporate Boards in Europe – Accountability and Convergence' (2013) 61 Am.JCompL 301, 302-304. The second feature mentioned is the extent to which agency problems of non-shareholder stakeholders are addressed in a given legal system.

This chapter scrutinises whether there is also an interrelationship between ownership structure and the parameters of long-termism.[732] It evaluates how various forms of shareholder ownership influence the time horizon of the board's decision-making. The objective of this chapter is to analyse and contrast the conflicts that arise between directors and shareholders due to the share ownership patterns in place in dispersed ownership jurisdictions and those arising between controlling and minority shareholders in concentrated jurisdictions. This chapter also uses the company's ownership structure in the countries under review as a tool to identify additional practical examples of long- and short-termism. An evaluation of the effectiveness or superiority of different share ownership models lies beyond the scope of this research.

This chapter will first introduce the general background on share ownership structure in the countries under review. Second, it will provide more details to clarify the underpinnings of the agency problem and the link between it and the parameters of long-termism. Subsequently, it will present practical examples of long- and short-termism in the form of case studies, which are derived generally from the theme of share ownership patterns and structures. By introducing the case studies and comparing their practical effects in the UK, Delaware and Germany, this chapter will shed some light on the content of long-termism. The chapter will end with some conclusions on the gap-filling exercise conducted in Chapters IV and V.

1.2 Share ownership structure in the countries under review

Traditionally the common law jurisdictions of the UK and the US are characterised as predominantly dispersed shareholding jurisdictions, which are sometimes also referred to as 'market systems,'[733] 'outsider' or 'arm's length systems.'[734] The continental European civil law jurisdictions, like Germany, are described as concentrated (blockholding) shareholding structures or 'insider' systems.[735] In dispersed ownership jurisdictions, share ownership is highly diffused instead of being concentrated in the hands of families, banks or other firms. Major publicly quoted corporations rarely have a shareholder who is a majority owner in

[732] Helms et al. argue that the propensity to engage in short-termism results among other things from the company's share ownership structure – see: Caitlyn Helms, Mark Fox, Robert Kenagy, 'Corporate short-termism: causes and remedies' (2012) 23(2) ICCLR 45, 49.
[733] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 26.
[734] Brian Cheffins, 'Putting Britain on the Roe Map: The Emergence of the Berle – Means Corporation in the United Kingdom' in Joseph McCahery and others, *Corporate Governance Regimes, Convergence and Diversity* (OUP 2002) 148-149, 151.
[735] Maher and Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' 399; Roe, 'Some Differences' 1936.

these jurisdictions.[736] Other typical features of these systems are: 'strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism.'[737] Large firms in Germany, on the other hand, are held in big voting blocks, with a few institutional shareholders' votes frequently commanding 20% of a firm's stock. Germany's companies have been distinguished as 'insider' systems with large majority shareholders (controlling blockholders) who are able to control and monitor the board.[738] Moreover, concentrated jurisdictions are characterised by: 'weak securities markets, high private benefits of control, and low disclosure and market transparency standards, with only a modest role played by the market for corporate control, but with a possible substitutionary monitoring role played by large banks.'[739]

Some studies suggest that ownership structure patterns are eroding and that they are oversimplified.[740] A recent OECD report, for example, describes Germany as having a 'mixed' rather than concentrated or dispersed ownership structure[741] and claims the country used to be a concentrated ownership jurisdiction but has evolved into being 'quite dualistic with a number of enterprises still under tight control but others now have a broad ownership base.'[742] Despite this, there is still strong evidence that the UK and Delaware should generally be perceived as dispersed and Germany as concentrated ownership jurisdictions. Hopt reports that as of 2003, single shareholders or blockholder coalitions were widespread and corporations without such large shareholders are relatively uncommon in Germany.[743] The OECD Report mentioned above describes the UK and the US as generally dispersed shareholdings.[744] It is also noted that in about 90% of companies listed on the London Stock Exchange, there is no major shareholder owning 25% or more.[745] The empirical study conducted by Gugler et al. confirms this dichotomy. They observe that in Germany the

[736] Cheffins, 'Putting Britain on the Roe Map' 148-149, 151.
[737] Coffee, 'Rise of Dispersed Ownership' 3.
[738] Roe, 'Some Differences' 1936; Maher and Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' 399.
[739] Coffee, 'Rise of Dispersed Ownership' 3.[citation omitted]
[740] See e.g. Davies and others, 'Beyond the Anatomy' 306-307; Roth, 'Corporate Boards in Germany' 257-258. For the analysis of the changes in the German ownership patterns, see e.g. Wolf-Georg Ringe, 'Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG' (University of Oxford Legal Research Paper Series, Paper No XX/2014 June 2014) <http://ssrn.com/abstract=2457431> accessed 2 September 2014.
[741] OECD, *Corporate Governance Factbook* 9.
[742] ibid 10.
[743] Klaus Hopt, 'Corporate Governance in Germany' in: Klaus Hopt and Eddy Wymeersch (eds) *Capital Markets and Company Law* (OUP 2003) 299-300.
[744] OECD, *Corporate Governance Factbook* 11. Cheffins reached the same conclusion. See Brian Cheffins, 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23 (1) OxfordJLegSt 1, 12
[745] OECD, *Corporate Governance Factbook* 11.

mean [746] and the median [747] of the largest shareholders came to 54.01% and 51.72% respectively. In the UK it is 16 % and 11.78 % accordingly. In the US, in general it is 21.89% and 16.83%, whilst when one looks at the 500 largest corporations the result changes – 15.75% and 10.95%.[748] Moreover, Stulz analysed the distribution of insider ownership across 48 countries in 2002. Insider ownership consists of the sum of blocks of shares owned, which may include blocks unrelated to the controlling shareholders. Stulz's data, which is based on the degree to which shares in public corporations are closely held, demonstrates that Germany has substantial insider ownership, unlike the UK and the US where the fraction of market capitalisation by insiders is much lower. In terms of the fraction of firms with family control (and looking at the value-weighted average percentage of closely-held shares held by corporate insiders), in the US the figure was 15.68%, whereas in the UK it was 11%, and 51% in Germany.[749]

1.3 The agency problem and the parameters of long-termism

As noted above, the UK, Delaware and Germany differ regarding the company's share ownership structure. A discussion on share ownership structure is inevitably connected to the debate on separation of ownership and control[750] and to the different distributions of the 'agency problem.' When one party – the agent – is enjoined to act on behalf of another party – the principal – there is the danger that he will act in his own personal interest rather than pursue the interests of the principal.[751] In this context, an agent is identified simply as someone with 'the factual power to make decisions or undertake actions' that affect the principal and there is no formal requirement (although it may exist) for the principal to authorise the agent to act on his behalf – as is the case in the context of the general agency relationship.[752] The efficiency losses that take place in a principal-agent relationship, caused by imperfect monitoring by the principal are called 'agency costs.'[753] The agency problem

[746] The value obtained by dividing the sum of several quantities by their number; an average. <http://www.oxforddictionaries.com/definition/english/mean#mean-2> accessed 9 January 2015.
[747] Denoting or relating to a value or quantity lying at the midpoint of a frequency distribution of observed values or quantities, such that there is an equal probability of falling above or below it- <http://www.oxforddictionaries.com/definition/english/median#median> accessed 9 January 2015.
[748] Klaus Gugler, Dennis Mueller and B Burcin Yurtoglu, 'Corporate Governance and Globalization' (2004) 20 OxfRevEconPol 129, 135.
[749] Rene Stulz, 'The Limits of Financial Globalization' (2005) 60(4) JFinanc 1595, 1603-1605.
[750] Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (New York: Macmillan 1932).
[751] Armour, Hansmann and Kraakmann, 'Agency Problems and Legal Strategies' 35; Jensen, Meckling, 'Theory of the Firm' 308.
[752] Hopt and Davies, 'Corporate Boards in Europe' 304 fn 6.
[753] Thomas Ulen, 'The Coasean Firm in Law and Economics' (1993) 18 JCorpLaw 301, 313.

will be scrutinised here only to the extent that it influences the discussion on the board decision-making time horizon.[754]

The agency problem prevalent in the dispersed common law jurisdictions – like the UK and Delaware – is called a 'vertical' problem. It involves the conflict between the firm's owners, i.e. shareholders as a class and its hired managers. The former are the principals and the latter are the agents. Efficiency reasons suggest conferring extensive powers on the board of directors rather than allocating them to the shareholders. At the same time, there is a danger that this will make the accountability of the board to the shareholders tenuous and problematic and the central problem is whether the board will act in its own personal or shareholders' interests.[755] In a concentrated shareholding structure, like Germany, the agency problem is 'horizontal,' involving a conflict between the owners who possess the majority or controlling interest in the company and the minority or non-controlling owners. The non-controlling owners can be identified as the principals and the controlling owners as the agents. The main agency problem ensures that the interests of the former are prioritised at the expense of the latter.[756]

This brings us to the central issue of this chapter: whether there is a link between the share ownership structure and agency problems in the jurisdictions under scrutiny on the one hand and the content of long-termism in these jurisdictions on the other. There are two observations to be made here. The 'agency problem' theory suggests that managers as an interest group will 'dominate corporate law reform and capital market regulation where shareholders are dispersed and weak, while controlling shareholders (or large blockholders) [will] dominate the law where shareholdings in listed firms are concentrated.'[757] As a consequence, the tensions in play during the decision-making processes adopted by directors will differ according to whether a jurisdiction is an 'outsider' or 'insider' system.

The UK and Delaware jurisdictions suffer from conflicts and misalignment of interests between directors and shareholders. For example, the directors exercise broad-decision making powers and therefore the danger arises that they will pursue their own short-term

[754] Directors of public companies can also become shareholders but this aspect is not analysed here.

[755] Armour, Hansmann and Kraakmann, *Agency Problems and Legal Strategies* 36; Hopt and Davies, 'Corporate Boards in Europe' 303-304; FRC, *Response to the European Commission Green Paper on the EU Corporate Governance Framework* (2011) 28. <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/FRC-response-to-the-Green-Paper-on-the-EU-corporat.pdf > accessed 9 February 2015; Roe, 'The Institutions of Corporate Governance' 372-375.

[756] Armour, Hansmann, Kraakmann, *Agency Problems and Legal Strategies* 36; Hopt and Davies, 'Corporate Boards in Europe' 303-304; D. Mathias Siems and David Cabrelli (eds.), *Comparative Company Law: A Case-Based Approach* (Hart Publishing 2013) 6; Roe, 'The Institutions of Corporate Governance' 372-375.

[757] Davies and others, 'Beyond the Anatomy' 306.

interests rather than the interests of the shareholders. Shareholders in these jurisdictions are weak and dispersed with divergent interests. Strand argues for instance that in the US the main view is that short-termism arises from investors.[758] If investors are short-term orientated, managers will also be incentivised to act in the short-term.[759] On the other hand, if shareholders are long-term focused and directors short-term orientated or the other way round, shareholders might struggle to convince the board to follow their advice. The managerial risk aversion hypothesis, which is based on the agency problem, states that managers will aim to maximise their personal wealth, at times, at the expense of shareholders.[760] Shareholders might exert pressure to oust the board, but they would need the support of other shareholders for such a course of action to succeed. Alternatively, they might leave the company by selling their shares on the open market, which is a much easier option. In the dispersed ownership jurisdictions it is more beneficial for shareholders to be apathetic and sell out, because of the high costs of monitoring management and the existence of collective action problems, i.e. the high costs involved in co-ordinating all of the shareholders to act as a single unit.[761]

In Germany, management boards are strongly influenced by the dominant shareholders who may take advantage of their control to undermine minority shareholders' interests by self-dealing or manipulating the share price. This suggests that in Germany a majority shareholder is most likely to be a major source of short-termism during decision-making, as the board is less powerful. Although they provide a source of short-termism, minority shareholders exert less impact on the decision-making process. It is not claimed here that conflicts between majority and minority shareholders are less harmful, but it is observed that they are less visible in the context of decision-making by the board. The concentration of voting power in a small number of hands means faster intervention in the case of management failure.[762] Large shareholders are therefore in a very good position to influence the decision-making process in a concentrated ownership jurisdiction. It is questionable whether they will promote their own interests, the interests of the other shareholders or the wealth of the company as a whole, and what will be their decision-making time frame is not entirely clear. Shareholders in the blockholding jurisdictions are characterised as having longer time-horizons and this increases the scope of opportunity for

[758] Strand, 'Re-thinking Short-termism' 18 and the literature cited there; See similarly Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' 985-986.
[759] Strand, 'Re-thinking Short-termism' 18.
[760] Ali Fatemi and Carl Luft, 'Corporate Risk Management Costs and Benefits' (2002) 13 GlobalFinancJ 29, 30.
[761] Attenborough, 'Vacuous Concept' 164, Wen, *Shareholder Primacy* 37.
[762] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 27.

the management board to invest for the long-term.[763] Opportunities are usually considered long-term and therefore it is claimed that short-termism cannot arise in the securities markets.[764] However, long-term controlling investors are not without their shortcomings. For instance, long-term investments are often associated with a focus on growth in market share, at the cost of a lower rate of return on equity investment.[765] Moreover, Strand underlines various agency problems that can be created by controlling shareholders.[766] It is difficult to state unambiguously that concentrated ownership jurisdiction is *per se* more long-term focused. The interests of majority shareholders can vary. The decision-making process in a concentrated ownership jurisdiction appears to be aligned more closely with the interests of majority shareholders rather than directors and it is less likely that the particular, short-term interests of directors will prevail. Therefore, it is pertinent to note that the goals pursued by majority shareholders should be uniform, coherent and thereby more long-term orientated. Majority shareholders, being more long-term focused, are less likely to put short-term pressure on the management board.

The second issue to address is whether it is more likely that a board will act on its own and/or short-term interests in concentrated or dispersed ownership jurisdictions. Although it is difficult to generalise and still directors are fiduciaries, they are more powerful in dispersed ownership systems. Therefore, directors in the UK and Delaware might pursue their own interests more often[767] and hence, there is a danger that they will have more opportunities to promote short-term goals there rather than the interests of the company as a whole. In comparison, concentrated shareholders are able to take effective decisions themselves. A management board in a concentrated ownership jurisdiction is a decision-making body and large shareholders can more effectively demand accountability for the decisions taken by it. Therefore, in a concentrated jurisdiction, a key issue is whether these large shareholders are acting in their own interests or whether they are pursuing the interests of the shareholders as a whole.[768] It is not the case that short-termism does not exist in concentrated jurisdictions. Rather, it is argued here that short-termism traditionally arises from internal distortions of the corporation. Strand notes that 'possible explanations that could drive managerial short-termism without shareholder pressure include competition in

[763] ibid.
[764] Strand 'Re-thinking Short-termism' 19 fn 83; Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' 991.
[765] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 27 and fn 12.
[766] Strand, 'Re-thinking Short-termism' 24-25 and the literature cited there.
[767] See similarly: Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 28-29 and Hopt and Davies, 'Corporate Boards in Europe' 303-304.
[768] Hopt and Davies, 'Corporate Boards in Europe' 303-304.

managerial work markets.'[769] Hence, the board is less powerful and it will have fewer options to promote its own short-term interests.

This analysis of agency problems suggests that the tensions arising between shareholders and directors in companies operating in dispersed ownership jurisdictions are more likely to be a source of short-termism during decision-making processes. This is attributable to the misalignment of interests between the diverse interests of shareholders and powerful managers that have the capacity to abuse their power and pursue their own private interests. Short-termism in decision-making is less likely to be a major concern in concentrated jurisdictions. As noted by Strand and Roe, there are alternative sources for short-term managerial behaviour. The main agency problem here lies between the interests of minority and majority shareholders, and majority shareholders appear to be more long-term orientated than dispersed shareholders. The agency problem in concentrated jurisdictions does not affect decision-making directly. However, undeniably, it has an indirect effect as powerful, majority shareholders influence the board significantly.

1.4. Conclusions

As established in Chapter IV above, the prevailing approach or philosophy towards the appropriate corporate objective influences the time horizon of directors' decision-making. The variable of 'share ownership structure' adds another layer to the discussion on the content and scope of long-termism by functioning as a technique to provide specific examples of long-term behaviour and decision-making in the managerial context. It can be used as a means of demonstrating how the interplay of various groups, e.g. majority v. minority shareholders (in Germany) and the board of directors and shareholders as a class (in the UK and Delaware) can influence the decision-making process in the corporations and the content and scope of long-termism.

The theory of agency problems and differing corporate share ownership patterns suggests that decision-making is likely to be more short-term orientated in dispersed ownership jurisdictions and centred more on the long-term in concentrated ownership jurisdictions. The case-based approach adopted in this chapter aims to analyse whether this theoretical analysis correctly predicts reality. The objective of the two case studies presented below is to provide compelling practical examples of short-termism and long-termism, whilst at the same time scrutinising the similarities and differences between the jurisdictions. The structure of the gap-filling exercise is similar to that adopted in Chapter IV above. The origins of the case study and its connections with the debate on share ownership structure of

[769] Strand, 'Re-thinking Short-termism' 19 fn 83.

the company will be presented. Weight will be ascribed to whether a particular decision constitutes an example of long- or short-termism in each jurisdiction and how likely it is that it will be taken. The lawfulness of these decisions will be examined and in the case of short-term decisions and a potential breach of directors' duties, a breach of s. 172 CA 2006 and the relevant sections in the other jurisdictions is assessed.[770] Finally, each case study offers comparative conclusions.

2. Practical examples of long- and short-termism

2.1 Case study 1: A focus on dividend growth

2.1.1 Introduction

This section examines the extent to which boards of directors are involved in the distribution of dividends,[771] and especially whether a decision to focus on dividend growth constitutes an example of long-term or short-term thinking. It also analyses whether a decision to focus on dividend growth is especially aligned with a particular share ownership structure in any given jurisdiction. Does the share ownership structure of a company influence the extent to which dividend distributions will represent an example of short-term or long-term decision-making? Of course, one of the key reasons for investing in a company is to generate income. A decision to focus on dividend growth is pivotal for shareholders, as it suggests financial benefits. Without a doubt, it is also crucial for other stakeholders, the corporation as a whole and its development. The distribution of profits or investment of these profits in research, development or any other purposes determines the company's future.[772] The complexity and legitimacy of profit distribution is often analysed in connection with an assessment of what constitutes the success of the company. Sealy and Worthington argue that success may often mean the long-term increase in financial value of the company; however, it is not clear whether directors should favour, for example, increased dividend rates.[773] The distribution of dividends is mentioned in the context of differentiating between long-term and short-term

[770] The breach of different directors' duties is not precluded.
[771] The rules on dividend distribution in the countries under review are complex and they will not be discussed in detail here.
[772] For the analysis of reasons why companies are actually paying dividends see: Fischer Black, 'The Dividend Puzzle' (1976) 2(2) JPortfolioManage 5; H Kent Baker, Gary Powell and E Theodore Veit, 'Revisiting the Dividend Puzzle: Do all of the Pieces Now Fit?' (2002) 11 RFE 241, 243-247.
[773] Len Sealy and Sarah Worthington, *Cases and Materials in Company Law* (8th edn, OUP 2008) 293-294.

decision-making.[774] Chapman notes that one of the examples of short-termism can be ascribed to the exploitation of 'limited company funds on short-term outgoings, typically dividends and share buybacks.'[775] This case study is derived from these discussions in the academic literature.

The decision to focus on dividend growth is presented in the context of the share ownership structure debate as it illustrates not only difficulties related to the corporate objective but also depicts particularly well the different agency problems which arise within companies in these jurisdictions. This case study concentrates on the tensions within the company among different groups regarding the distribution of dividends. A corporate decision to focus on dividend growth in Delaware, the UK and Germany will now be addressed.

2.1.2 Delaware

Pursuant to the DGCL, the board of directors exercises broad decision-making powers unless the certificate of incorporation of the corporation provides otherwise. Delaware traditionally embraces shareholder primacy combined with director primacy. The director primacy model is explicitly articulated in § 141 (a) (1) DGCL: '[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.' The board has the default powers regarding the declaration and payment of dividends within the limits of the law:

> The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock either: (1) [o]ut of its surplus, (…); or (2) [i]n case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.(…).[776]

The board is entitled to maximise the corporation's dividends, to the extent that they are permitted under law to pay out dividends out of annual profits generated, according to § 170 (a) (1) DGCL. But they are also entitled to pay a dividend out of its net profits when a corporation has made a loss in a particular financial year (§ 170 (a) (2) DGCL), so-called

[774] See i.e.: Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' 23 citing: Eric Orts, 'The Complexity and Legitimacy of Corporate Law' (1993) 50 Wash&LeeLRev 1565, 1592.
[775] John Chapman, 'Time to Tackle UK short-termism' (Financial Times 27 May 2012), <http://www.ft.com/cms/s/0/37b29af4-a594-11e1-a3b4-00144feabdc0.html> accessed 9 March 2015.
[776] § 170 (a) (1), (2) DGCL. See also § 171 – 174 DGCL.

'nimble' dividends.[777] Amongst other things, § 174 DGCL regulates the liability of directors for unlawful distributions of dividends and how such liability might be avoided. Moreover, § 172 DGCL provides a further protection for the directors that are in good faith.

The main agency problem in Delaware occurs between the board of directors and shareholders as a class. Since directors are solely responsible for dividend distribution and shareholders are generally interested in dividend growth, divergent interests might lead to tensions. As established in Chapter IV above, the corporate objective in Delaware is to maximise shareholder wealth. This is also a main principle of corporate finance.[778] Baker et al. underline that academics and corporate managers 'disagree about whether the value of a firm is independent of its dividend policy.'[779] Despite these concerns, it is quite clear that shareholders are interested in dividend growth even if it does not translate into a company's sustainable development or has negative consequences.

Managing for the long term is at the same time often 'antithetical' for the board, as directors 'only have a temporary interest in the company, primarily limited to their time in the job' and they are not rewarded for making long-term plans, as their successors will be likely to benefit from them.[780] Therefore, it is not only the directors' duty to maximise shareholder wealth but it will be usually beneficial for directors to produce immediate profits for shareholders. The board is not only solely responsible for the distribution of dividends, but they also have more space to pursue their own interests. It is likely that directors might choose to focus on dividend growth in Delaware and they are strongly incentivised to do so, although shareholders are weak.

If it is the only or the main justification for a decision, the payment of excessive dividends is likely to constitute an example of short-termism. It is a challenge to determine how much profit directors can distribute and not be accused of short-termism though. For example, the distribution of all annual profits at one extreme end of the spectrum would indicate short-term thinking. Other cases are harder to define and it is almost impossible to state objectively how the dividend should be ascertained, in order to constitute an example of long-termism, apart from saying that such distributions should be balanced and reasonable.

If directors are not willing to increase dividend growth, is it likely that shareholders will put short-term pressure on directors and demand earnings growth? It is quite likely that shareholders will pressurise the board but they might struggle to do so effectively, as the diffused ownership structure means that the shareholders are weak and their interests are less

[777] See also: Stephen Bainbridge, *Corporation Law and Economics* (New York Foundation Press, 2002) 775; see chapter 13 on dividends distribution in Delaware.
[778] Baker, Powell and Veit, 'Revisiting the Dividend Puzzle' 242.
[779] ibid.
[780] Keay, 'The Global Financial Crisis' 24.

coherent, more diverse and particular. Although arguably profit maximisation may unite them eventually, alternatively they can leave the company by selling their shares. Shareholders will also find it difficult to remove a director, unless they can coalesce sufficient shareholder support to command a majority of the shares.[781]

Due to the directors' broad decision-making powers in shaping the dividend distribution in Delaware, abuses that lead to short-term decisions are likely. It is also highly unlikely that focus on dividend growth itself will constitute a breach of directors' duties, if directors are acting in the best interest of the company and they are fulfilling other duties. The business judgment rule suggests that courts are not going to second-guess the decision of a well-motivated and non-conflicted director. Nevertheless, concentration solely on dividend growth has been criticised in the literature. Rappaport notes that '[a] company's value depends on its long-term ability to generate cash to fund value-creating growth and pay dividends to its shareholders.'[782] Greenfield emphasises that a company will be focusing on the short-term when it cuts research and development in order to increase dividends or retains 'earnings temporarily at a cost to the long-term health of the company.'[783] This is a vivid juxtaposition of short-term and long-term decision-making. Moreover, he criticises inflating dividends in the short-term at the cost of the long-term fortunes of the company since 'whatever benefit realized from the short-term dividends will be more than set off by the decline in the stock price brought about by the decline in the real value of the company.'[784]

2.1.3 The UK

The position in the UK differs slightly regarding the distribution of profits. The board of directors does not enjoy such broad decision-making powers as directors under Delaware law regarding dividend distribution. The Companies Act 2006 discusses dividends and their distribution only to a limited extent. According to s. 830, a company may only make a distribution out of profits available for the purpose. A company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.[785] The Act stipulates that a public company may only make a distribution if the amount of its net assets is not less than

[781] § 141 (k) DGCL.
[782] Rappaport, 'The Economics of Short-Term Performance Obsession' 65.
[783] Kent Greenfield, 'The Origins and Costs of Short-Term Management' (2nd Summit on the Future of the Corporation: Restoring the Primacy of the Real EconomyJune 2009) 28 <http://summit2020.org/paper-series.htm> accessed 10 September 2015.
[784] ibid 29.
[785] s 830 (1), (2) CA 2006. Section 829 CA 2006 contains a definition of distribution.

the aggregate of its called-up share capital and undistributable reserves, and if, and to the extent that, the distribution does not reduce the amount of those assets to less than that aggregate.[786] The above creditor protection rules are in line with art. 17 of the Second Company Law Directive that states that distributions below subscribed capital are impermissible.[787] The Companies Act 2006 also states that '[e]xcept in the case of a company entitled to the small companies exemption, the [directors'] report must state the amount (if any) that the directors recommend should be paid by way of dividend.' [788]

The division of power between the board and shareholders regarding distributing dividends is left to be determined by the company's articles of association. Every company in the UK can establish its own procedure regarding the distribution of profits.[789] Thus, in theory, a company can arrange this in any form it likes and the board can be solely responsible. Davies et al. note though that it is unlikely that a board will be left to decide about the profits by itself (except interim dividends). If the articles are silent about the distribution of dividends, then shareholders alone will be responsible.[790] However, companies can decide to incorporate Model Articles. According to these Model Articles, if the shareholders and the board of directors are currently involved in the distribution of dividends, the board plays a substantial role in the process. Importantly, the board initiates a decision on whether a dividend should be declared or profits should be affirmed and invested. The Model Articles state that '[a] dividend must not be declared unless the directors have made a recommendation as to its amount. Such a dividend must not exceed the amount recommended by the directors.'[791] The shareholders' role is to affirm or reject such proposal as according to the articles, they declare the dividend – an ordinary resolution[792] is required – and the directors may decide to pay interim dividends.[793] Further, '[t]he directors may pay at intervals any dividend payable at a fixed rate if it appears to them that the profits available for distribution justify the payment.'[794]

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[786] s 831 (1), (2) CA 2006.
[787] Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent Text with EEA relevance.
[788] s 416 (3) CA 2006.
[789] See also Davies, Worthington and Micheler, *Gower and Davies' Principles* 298.
[790] See also ibid.
[791] Reg. 70 (2) Model Articles.
[792] According to s 282 (1) CA 2006 '[a]n ordinary resolution of the members (or of a class of members) of a company means a resolution that is passed by a simple majority.'
[793] Reg. 70 (1) Model Articles.
[794] Reg. 70 (6) ibid.

The Model Articles allow shareholders by special resolution to 'direct the directors to take, or refrain from taking, specified actions.'[795] As such, with a 75% vote referred to as a special resolution, the shareholders can oblige the directors to declare a dividend, i.e. initiate a proposal themselves to declare a dividend. It is questionable, whether shareholders will be able to exercise their rights effectively due to the dispersed share ownership structure of most listed public limited companies in the UK, e.g. the collective action and co-ordination costs will likely be too high to marshall sufficient support.

Taking into account all of the above, the board in the UK is actively engaged in the actual distribution of dividends and exercises quite broad decision-making powers in that respect. However, the board is not as powerful as in Delaware and shareholders clearly have more influence to shape the board's decision-making. Similar to the position in Delaware, conflicts regarding dividend distribution are likely to arise between these actors. This epitomises the agency problem in dispersed jurisdictions.

In the context of dividend distribution, Davies' et al. opinion must be taken into consideration. The authors argue that 'it is far from clear that there is a real conflict' between the board and shareholders, as:

> If management retains earnings, to invest in good projects, which the market evaluates appropriately, then the company's share price will rise and a shareholder seeking income can sell part of the (now more valuable) shareholding. So, the issue is simply the form of the income: dividend or capital gain.[796]

Without a doubt, the conflicts between the shareholders and the board will not appear in every case and the point made by Davis et al. is not disregarded. However, undeniably tensions between the board and shareholders in some instances are very likely. In particular, the argument put forward by Keay is compelling that long term plans and investments can make directors' performance look 'decidedly average, as the share price might not increase and higher dividends would not be paid as quickly as if short-term plans were implemented.'[797] Therefore, it is the view of this author that in the UK, it might be tempting for the board to focus on dividend growth and produce immediate profits for shareholders – there are strong incentives in place for a decision to be taken to focus on dividend growth in this system. Some directors might however prefer to reinvest the profit.[798] Further, it is highly likely that shareholders will also be interested in dividend distribution. In comparison

[795] Reg. 4 (1) ibid.
[796] See also: Davies, Worthington and Micheler, *Gower and Davies' Principles* 297 and the footnote.
[797] Keay, 'Global Financial Crisis' 24.
[798] Davies, Worthington and Micheler, *Gower and Davies' Principles* 297.

to Delaware, shareholders in the UK might be slightly more successful in putting pressure on the board. Although shareholders are diffuse and traditionally perceived as weak, their influence on dividend distribution is higher in the UK, since they must approve the payment of a dividend by ordinary resolution. The board acting in the name of the company and investing for instance in the development of the company can meet with lack of shareholders' approval if they prefer to receive a large dividend pay-out immediately.[799] According to s. 168 (1) CA 2006, a director can be removed by an ordinary resolution if shareholders are not happy with decisions in relation to dividends. The shareholders' influence on the board will depend on whether the former have at their disposal the required majority or can successfully pressurise the board in a different way. In a dispersed share ownership corporate governance system such as the UK, this is extremely unlikely.

Overall, the directors' paramount duty is to promote the success of the company for the benefit of the members as a whole. Hence, even if the dividend policy is not beneficial for the company, it can contribute to a breach of directors' duties only when it can be proved that the directors were not acting in the best interests of the company and when they are not complying with other duties. Nevertheless, on balance focusing solely on dividend growth should be perceived as an example of short-termism. It is criticised in the UK. Chapman aptly highlights that if the board uses limited company funds to finance the payment of dividends and share buybacks that might constitute a short-termist action.[800] Keay observes that the Shell board acted in the short-term in 2009 when they fired 5000 employees to 'boost the dollar value of the dividend by five per cent (notwithstanding a large decrease in profits).'[801] Keay also clarifies that by drastic cost cutting, short-term results might be achieved which might in turn provide shareholders with good dividends and an enhanced share value. However, in the long-term it might bring adverse consequences to the company.[802] In contrast, a decision to distribute the profits sensibly would be more justified, and is more likely to constitute an example of long-term thinking.

2.1.4 Germany

In Germany, decisions on the appropriation of distributable profits are left to the shareholders.[803] These provisions are mandatory and § 119 (1) 2 AktG notes that the shareholders' meeting shall resolve on all matters including the appropriation of distributable

[799] Stephen Girvin, Sandra Frisby and Alastair Hudson (eds.), C*harlesworth Company Law* (18th edn, Sweet & Maxwell 2010) para. 17-025.
[800] Chapman, 'Time to Tackle UK Short-termism.'
[801] Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' 25.
[802] ibid 23, citing Orts, 'The Complexity and Legitimacy of Corporate Law' 1592.
[803] § 119 (1) 2; § 174 (1) 1 AktG.

profits. This rule is repeated in § 174 (1) 1 AktG which provides that such resolution shall specify in detail the appropriation of distributable profits, including in particular: the amount of distributable profits, the amount to be distributed to shareholders, the amounts to be transferred to profit reserves, any profit carried forward, and any additional expense resulting from such resolution.[804] The Second Company Law Directive prohibits distribution of profits below subscribed capital not only in the UK but also in Germany. Cahn and Donald note that '[t]he law compensates for the greater shareholder freedom by limiting the potential volume of distributions to shareholders through a rigorous regime of capital maintenance rules.'[805] According to the AktG, '[d]ividends may not be paid for as long as the legal reserve and the capital reserve in aggregate do not amount to 10 per cent of the share capital.'[806] Shareholders in Germany have more control over dividend distributions than in the UK or Delaware. Neither the management board nor the supervisory board is involved in deciding on the amount of dividends. However, the management board submits to the supervisory board a proposal regarding how to pay dividends out of distributable profits that is 'intended to be presented to the shareholders' meeting.'[807] The proposal must include, unless circumstances require otherwise, relevant information on dividends, details about transfers to profit reserves, profit carried forward, and distributable profits.[808] Every member of the supervisory board is 'entitled to take cognisance of the documents submitted' by the management board.[809] Further, § 58 (2) 1 AktG provides that the management board and the supervisory board approve the annual financial statements. '[T]hey may transfer amounts not exceeding one half of the annual net profit to other reserves.' The management board is also obliged to supervise the distribution carefully, as according to § 93 (3) 2 AktG the members of the management board are liable for damages if contrary to the AktG 'shareholders are paid interest or dividends.'

According to the current law, the management board in Germany can only suggest how the profit should be distributed and it is able to influence the process to a limited extent. The board's point of view does not have to be considered by the shareholders and its role is definitely weaker in that respect than the board in the UK or Delaware. The fact that the board is accountable extensively to shareholders and closely overseen by the supervisory board means that its impact on the distribution of profits should be concentrated more on the interests of the company as a whole and arguably on the benefits to the majority shareholders.

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[804] § 174 (2) AktG.
[805] Cahn and Donald, *Comparative Company Law* 222.
[806] § 233 (1) 1 AktG.
[807] § 170 (2) 1 ibid.
[808] § 170 (2) 2) ibid.
[809] § 170 (3) 1 ibid..

The majority shareholders are more long-term focused than the shareholders in dispersed jurisdictions, thus the management board in Germany should be also more long-term orientated, as it will be subject to less short-term pressure from shareholders. This confirms the theoretical analysis that Germany suffers from a horizontal agency problem; conflicts are likely to take place between majority and minority shareholders, as they might have different visions regarding profit distribution.

Because the board does not have much impact on the distribution of profits in Germany, this case study is not relevant in the context of managerial long-term decision-making. As such, owing to the marginal role of the management board, it does not contribute towards establishing the parameters of the managerial long-termism in Germany. Nevertheless, at the same time it is evident that at least dividend distribution will not be a source of managerial short-termism in Germany.

2.1.5 Conclusions

A balanced and responsible distribution of profits is likely to constitute a long-term decision that should be more beneficial for the company as a whole. There are compelling reasons to argue that the short-term company seeks to maximise profits and earnings in the near future while disregarding the long term.[810] Hence, concentrating solely on dividend growth is likely to be an example of short-termism. This case study confirms that mechanisms regarding dividend distribution differ in the jurisdictions under review. Focus on the dividend distribution constitutes a clear example of short-termism in the UK and Delaware due to their dispersed ownership structure and the existence of the main agency conflicts between directors/managers and shareholders. In Delaware, directors are solely responsible for dividend distribution and in the UK, both shareholders and directors are involved in the process. In both jurisdcitions, the distribution of dividends inevitably will lead to tensions between directors and shareholders, as a result of different goals and investment perspectives. Although criticised, such decision is likely to be a lawful activity in these systems. In Germany, on the other hand, the management board influences the distribution of dividends only in a very limited way. Hence, the decision on dividend policy is not that important in the context of the board's decision-making or parameters of the long-termism. Majority shareholders play a crucial role here and conflicts between majority v. minority shareholders are the most prominent factors in decision-making about earnings distributions.

[810] See e.g. Greenfield, 'Origins and Costs of Short-Term Management' 28.

2.2 Case study 2: investment in research

2.2.1 Introduction

The first case study shows that focussing solely on dividend growth is likely to constitute an example of short-termism, at least in dispersed ownership jurisdictions. This is often contrasted with a decision to invest in research and development, which will be the subject of the current case study:

> Shareholder value focuses on short-term benefits and sacrifices long-term gains that could result from investing in research. It results in undue focus on share price, which is an unreliable and unpredictable means of assessing a company's performance or sustainability. Share prices can be manipulated or affected by factors unrelated to performance, e.g. share prices can rise in good economic times even when the particular company is in financial difficulties. Share prices in this case can overvalue a company's worth. Likewise, the share prices can drop when a company has chosen to invest in new technology or research which, though causing a slump in the short term, is bound to realise huge benefits in the future.[811]

The decision to focus on research differs a lot from the first case study as it discusses discretionary expenses and it centres less on the company's immediate financial growth. This is commonly supported in the literature and generally identified with long-term considerations and long-term investment. Naturally, decisions could turn out to be successful or unsuccessful. To illustrate that, Greenfield points out that cuts in research and development might be justified in certain situations 'when the company needs to satisfy some short-term financial obligation;' but, in general they will be detrimental to the company in the long-term.[812] Interestingly, Jackson and Petraki argue that managers can be said to have a long-term orientation if they choose to invest in research and development of the company. On the other hand, the authors also note that it can be also 'inherently risky in the sense that future benefits are uncertain' and although research and development is a common and useful proxy of a long-term orientation this is an incomplete measure as 'other long-term drivers of value may not be picked up.' [813]

In any case, a lack of immediate profits is likely to be the reason behind a lower popularity of this decision among shareholders – especially when their profits are decreasing – and also the boards might be reluctant to take them. The study recently carried out in the

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[811] Kiarie, 'At Crossroads' 334.
[812] Greenfield, 'Origins and Costs of Short-Term Management' 28-29.
[813] See: Gregory Jackson, Anastasia Petraki, 'Understanding Short-Termism: the Role of Corporate Governance,' (Glasshouse Forum 2011) 18 <http://www.sofi-goettingen.de/fileadmin/Textarchiv/WIP2/Praesentationen/jackson-petraki_short-termism.pdf> accessed 23 February 2015.

US where more than 400 executives were surveyed and interviewed suggests that managers are likely to take economic actions that have negative long-term consequences in order to meet short-term earnings targets.[814] Almost 80% of the respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance etc. if the company might come in below the desired earnings target.[815] It was admitted in the report that the managers face 'a constant tension between the short-term and long-term objects of the firm.'[816] The Kay Review suggests that there is a decline in the UK in investment in research and development as a percentage of GDP since 1992. Comparatively, the US is the leader and Germany is the runner-up. [817]

This case study looks at the connection between a decision to invest in research and the share ownership structure of the company and whether it is more likely for this decision to be taken in one jurisdiction or another. Directors in the UK and Delaware enjoy wide discretionary powers and they will be mainly responsible for deciding to invest in research. Whilst in Germany the management board is usually more dependent on shareholders and the latter will play an important role in deciding whether the investment in research should be carried out. The topic of investment in research in Germany, the UK and Delaware will now be analysed in greater detail.

2.2.2 Germany

A number of incentives exist for a managerial decision to invest in research to be treated favourably under German law. Such conduct appears to be consistent with the corporate objective in this jurisdiction – assuming that the research is reasonable, it focuses on the lasting creation of value and it serves the interests of shareholders, employees and the general public. If this is the case, it will constitute a strong example of long-termism and would be encouraged in the academic literature. Secondly, if the management board is acting in the best interests of the company and is not breaching other duties, the decision is unlikely to constitute a breach of directors' duties or contribute to the breach even if it is unsuccessful in the end. The board will be also protected by the business judgment rule.

Further, it is worth noting that the 'time preference conflict' (*Zeitpräferenzkonflikt*) arises also in Germany between top management and shareholders as they often pursue different goals – Kräkel notes that 'younger top managers have a strong preference for the present and they prefer short-term investments as they have just bought a house or got

[814] John Graham, Campbell Harvey and Shiva Rajgopal, 'The Economic Implications of Corporate Financial Reporting' (2005) 40 JAccountEcon 3, 4.
[815] ibid 31, 32, 33, 35, 40.
[816] ibid 35.
[817] Kay Review para. 1.8 and fig 2.

married.'[818] Clearly, the management board can invest in research or decide against it, even if the majority shareholders oppose it. The board enjoys wide decision-making powers, which means that it is not bound by any instructions from the other bodies or shareholders,[819] as without wide decision-making powers, the management of the company would not be possible.[820] At the same time, they are obliged to evaluate individual interests during decision-making and weigh them against connected risks.[821] Furthermore, the board might be personally incentivised to invest in research. Their remuneration depends on the lasting development of the enterprise.[822] Berger presents a compelling argument that 'such structure of remuneration is believed to prevent refraining from the long-term investments in research and development (or education of employees) and focusing on the short-term high profits that involve high risk.'[823]

The Higher Regional Court (*Frankfurt Oberlandesgericht*) acknowledged in a recent ruling that broad decision-making powers entitle the management board to take decisions that happen to be contrary to the interests of the majority shareholders.[824] This judgment has been criticised in the literature, as it is not certain whether it actually allows for shareholder value or prioritises the interests of the enterprise.[825] Kort argues that the essential point of this judgment is that it distinguishes between the interests of the enterprise and shareholders.[826]

Nevertheless, it is likely that the majority shareholders will influence the decisions taken by the board in this concentrated jurisdiction and the interests of minority shareholders are likely to be marginalised. Wirth et al. argue convincingly that the management board does not have the power to withstand the strong influence of majority shareholders. The majority shareholders influence indirectly the composition of the management board – they choose the members of the supervisory board, which in turn selects the members of the management board.[827] Although it is not responsible for the management of the company, in

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[818] Matthias Kräkel, *Organisation und Management* (3rd edn, Mohr Siebeck 2007) 280-281. (my translation)
[819] Hüffer, *Aktiengesetz* § 76 mn. 10.
[820] BGH, 23.06.1997 – II ZR 132/93 – BGHZ 136, 133, 140. (my translation)
[821] *ARAG v Garmenbeck* 244, 253; BGH, 4.07.1977 – II ZR 150/75 – BGHZ, 69, 207, 213; BGH, 14.01.1980 – II ZR 218/78, BGH NJW 1980, 1630, 1629; Spindler, *Münchner Kommentar Aktiengesetz* § 93 mn. 54.
[822] § 87 (1) 2 AktG.
[823] Andreas Berger, *Vorstandsvergütung: Die Vergütungsproblematik als logische Konsequenz des geltenden Aktienrechts und die Folgen für die Ausgestaltung der Regelungen* (Nomos 2012) 116 (my translation).
[824] OLG Frankfurt 17.8.11 – 13 U 100/10, CCZ 2012, 236, 238 (my translation).
[825] Michael Kort, 'Vorstandshandeln im Spannungsverhältnis zwischen Unternehmensinteresse und Aktionärsinteresse' AG 2012, 605, 607 (my translation).
[826] Kort, 'Vorstandshandeln' 605, 608.
[827] Wirth and others, *Corporate Law in Germany* 99.

practice the shareholders' meeting influences its running. The management board must obtain the approval of the shareholders on many occasions and this reduces its autonomy. It is worth underlining though that shareholders in Germany are not entitled to remove a member of the management board, as according to § 84 (3) 1 AktG, this is within the competence of the supervisory board only.[828]

Fleisher notes that directors might feel incentivised 'to take advantage of their superior information and to misappropriate corporate resources' on the ground that direct monitoring of the directors by the shareholders is often prohibitively costly.[829] Naturally, the foregoing argument applies to all three jurisdictions under scrutiny. This tendency is more visible in the UK and especially in Delaware, due to the stronger position of the board in these jurisdictions, in comparison with Germany. As a consequence, the management board in Germany, due to its less active role, has fewer opportunities to promote its own interests.

Majority shareholders are likely to be the key body in deciding on investing in research. This confirms the distribution of the agency problem in concentrated jurisdictions; however, in accordance with the corporate objective of companies under German law, the other stakeholders' interests must be also considered. The crucial question in the present context is whether the powerful majority shareholders would be interested in investing in research. The interests of the majority shareholders will not always be identical to the interests of the enterprise as a whole. It appears that they will be more convergent and consistent with them than the interests of dispersed, individual shareholders. The majority shareholders should be more interested in the company's sustainable development and balanced growth. Hence, it is more likely that they will present a vision of the corporation that is more integrated and therefore long-term focused. This vision should also embrace investment in research. Helm et al. argue further that private companies have a longer-term focus and one possible explanation for this is that they are 'more hands-on and know the business intimately.'[830] It is contended in this thesis that this is also the case regarding blockholding corporations in Germany. The majority shareholders are usually involved in the running of the company and they understand the relationships within and outside the company well. They should be able to avoid unrealistic and irrational short-term decisions and contribute towards the company's ongoing, long-term development. The majority

[828] § 84 (3) AktG provides that the supervisory board may revoke the appointment 'for cause' and also notes that one of the grounds justifying the removal could be a vote of no confidence by the shareholders' meeting. However, clearly this provision does not oblige the supervisory board to act upon shareholders' request to remove a director.
[829] Fleischer, 'The Responsibility of the Management and of the Board and Its Enforcement' 379 and the literature cited there.
[830] Helms, Fox and Kenagy, 'Corporate Short-termism' 49.

shareholders will tend to consider the bigger picture, and look at not only the short-term but also long-term gains and perspectives.

2.2.3 The UK

Many commentators in the UK encourage boards to invest in research, pointing out that it is likely to contribute to the long-term success of the company. According to Parkinson, '[l]ong term profitability may depend on investing in research and development, capital equipment, and training.'[831] Further, Keay identifies scrimping on research and development as possible examples of short-termism.[832] One of the 'Good Practice Statements for Company Directors' suggested by the Kay Review provides that:

> Company Directors should acknowledge that long-term value creation in the interests of shareholders is best served by strategies which focus on investing appropriately to deliver sustainable performance rather than treating the business as a portfolio of financial interests.[833]

As explained in Chapter IV above,[834] the Kay Review argues that 'not enough [attention] to the fundamental research on which long-term success in this industry depends'[835] was one of the causes for the failure of Glaxo – a global pharmaceutical company.

Investment in research is traditionally perceived as a long-term decision in the UK. Naturally, it can also have detrimental effects for the company and some companies plough significant resources into research and development, the motive behind that investment may very well be rooted in short-term considerations. In the UK, there are slightly fewer incentives for such a decision than under German law. UK boards enjoy broad decision-making powers on how to promote the interests (and success) of the company and will also play a key role in deciding about investment in research and development. In comparison to Germany, the board has more opportunities to pursue their own interests, owing to the dispersed nature of the shareholder body. Naturally, the main role of the board is to fulfil the corporate objective and ensure the protection of shareholders' interests. It is questionable whether dispersed and diffuse shareholders will effectively put pressure on the board, if the latter wants to pursue different goals. Diffuse shareholders tend to be rather passive and weak in corporate governance and exercise their powers via the 'exit' choice and other

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[831] John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Clarendon Press 1993) 90.
[832] Keay, 'The Duty to Promote the Success of the Company: Is it Fit for Purpose?' 23.
[833] Kay Review 59.
[834] See Chapter IV s 5.3.1 above.
[835] ibid. para 1.26.

market forces.[836] Although investment in research is a recognised long-term approach, it might not be popular among shareholders if it does not generate immediate profits. Cerioni notes accurately that a 'higher amount of investments in environmental friendly technologies, may risk leading to a lower amount of after tax profits and to a lower amount of dividends for shareholders.'[837]

Overall, the tensions regarding any possible investments in research will arise in the UK between the board and shareholders and it is argued that in this system the board's approach towards investment in research is in the end crucial. How likely is that the boards will support the long-term development path of the company? Undeniably, some will be interested in pursuing this goal. However, it appears that in general, the board will be more interested in short-term investments and short-term profits, as this is clear evidence that they are successful managers and it makes their performance look better in the eyes of shareholders. If directors decide to invest in research or development, their decision will be most likely lawful. Dispersed shareholders that oppose investment in research might struggle to pressurise the board. As long as directors act in the best interest of the company and they do not breach any of their legal duties, the courts are unlikely to investigate *ex post facto* the substance of a business decision such as investment in reserach that turns out to be unsuccessful and unprofitable.

2.2.4 Delaware

In the US, investment in research has mostly positive connotations and it is believed that in general it contributes towards the long-term success of companies. According to Strine, the paramount objective for the for-profit corporation is 'the generation of durable wealth for its stockholders through fundamentally sound economic activity' and long-term endeavours like investment in research and development are one of the prerequisites for building durable wealth.[838] Undeniably, some research investments can be unsuccessful.

One of the main arguments against short-termism is that it 'discourages investments that offer a long-term payback, such as in research and development, marketing and advertising.'[839] It has not only detrimental consequences for the company itself but also for the whole industry.[840] Laverty contrasts decisions that concentrate on short-term gains (maximising quarterly profits) with long-term strategies, like for instance investment in basic

[836] Wen, *Shareholder Primacy* 37.
[837] Cerioni, 'Success of the Company' 9-10.
[838] Leo Strine Jr, 'One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?' (2010) 66 BusLaw 1, 2-3.
[839] Salter, 'How Short-Termism Invites Corruption' 3.
[840] Helms, Fox and Kenagy, 'Corporate Short-termism' 53-54 and the literature cited there.

research.[841] Decisions to invest in research and development are certainly one of the elements of the ideal board and should be actively promoted. In Lipton's view, the board of a major public company is not only obliged to fulfil its legal duties but also to follow 'the aspirational "best practices" that have come to have almost as much influence on board and company behavior.'[842] One of the aspects of these best practices is to 'work with management to encourage entrepreneurship, appropriate risk taking, and investment to promote the long-term success of the company (despite the constant pressures for short-term performance).'[843]

The decision to invest in research is likely to constitute an example of long-termism in Delaware as its objective goes beyond short-term profit maximisation. The solution under Delaware law mirrors to a great extent the position under the UK law, with the main agency conflicts arising between the board and the shareholders as a whole. Like the UK, Delaware has a dispersed ownership structure and also mostly the board will be mainly responsible there for determining whether the company will invest in research. As argued in Chapter II above,[844] the board in Delaware enjoys an even stronger position than in the UK.[845] Thus, it will depend even more heavily on the board whether a long-term strategy as an investment in research will be pursued and shareholders in Delaware will find it harder than in the UK to pressurise the board to act in their interests, if directors are not willing to pursue their goals.

In conclusion, is it likely that the board in Delaware will invest in research? The Kay Review suggests that investment in research is actually thriving in the US.[846] Still, it might be difficult for the board to stand the short-term profits pressure, especially taking into account its corporate objective. The board of directors that exercises broad decision-making powers and is obliged to contribute to the shareholders' profit maximisation might find it tempting and personally beneficial to promote decisions that give short-term profit rather than those which are long-term investments. As underlined in the study by Graham et al. mentioned above,[847] there is a danger that investment in research and development will not be very popular in Delaware, because it does not bring immediate financial benefits to the

[841] Laverty, 'Managerial Myopia or Systemic Short-termism?' 949.
[842] Martin Lipton, 'The Spotlight on Boards' The Harvard Law SchoolForum on Corporate Governance and Financial Regulation 8 September 2014) <http://blogs.law.harvard.edu/corpgov/2014/09/08/the-spotlight-on-boards-2/#more-65569> accessed 9 September 2014.
[843] ibid.
[844] See Chapter II s 4.4.
[845] § 141 (k) DGCL.
[846] Kay Review para. 1.8.
[847] Graham, Harvey and Rajgopal, 'Economic Implications of Corporate Financial Reporting' 4.

shareholders. There are no legal tools that can force directors to invest in a 'research project that is promising, but costly, and will require a decade to show positive bottom line results':

> So what is a director to do? Under the view that directors should act solely in the interests of shareholders, what would give the directors the right, the obligation, or the flexibility to act in the interests of the long-term undiversified shareholder instead of the arbitrageur or the diversified shareholder? The answer is clear - nothing.[848]

The incentives in Delaware to invest in research are average, at the most. If the board decides to invest in research, it seems unlikely that such a decision will be challenged based on a breach of directors' duties; of course, this is assuming that the board acts in the best interests of the company and they do not breach the no-conflict and no-profit rules. The business judgment rule will protect well-meaning and rational decisions even if they do not maximise shareholder value and the investment turns out unsuccessful. The plaintiff will have to prove that one of the applicable duties was breached.

2.2.5 Conclusions

This case study underlines that a decision to invest in research is generally positively associated with long-termism, is likely to be a lawful activity and constitutes an example of long-termism in all three systems. In light of the share ownership patterns of the company in each of the three jurisdictions, it seems that there are much greater incentives for such a decision to be made in a concentrated, rather than a dispersed, ownership jurisdiction. It constitutes a stronger and a more vivid example of long-termism under German law due to the important role of the generally longer-term orientated majority shareholder in the decision-making process. In contrast, the board of directors – which is the body that is legally responsible for investment in research in the UK and Delaware – is in general more short-term focused.

3. Conclusions regarding the gap-filling exercise

3.1 Introduction

It is now possible to piece together a better account of the content and nature of long-termism. The case studies were presented in Chapters IV and V to identify country-specific

[848] Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statues and Formulation of Director Duties' (1991) 21 StetsonLRev 163, 176.

examples of both long-term and short-term decision-making. The case studies were drawn from two significant issues in corporate law and corporate governance scholarship, namely from the literature on the shareholder v. stakeholder theory debate and the secondary sources that address the relevance of the share ownership structure of a jurisdiction. This thesis links the concept of long termism with the corporate objective and the agency problems within companies in these jurisdictions. The aim was to scrutinise these debates separately to identify and emphasise their influence on long-termism. This concluding section is structured as follows. First, the table that summarises and illustrates the case studies and their findings is presented and its structure is explained. This is followed by comparative comments on the parameters of long-termism. Finally, some general comments on the notion of long-termism will be presented.

3.2 The table

The analysis of the orientation of the seven case studies can be illustrated in a simple table:

Country/ jurisdiction	**Long-term or short-term decision**	**Does it constitute a lawful activity or contribute to a breach of directors' duties?**	**- Does the law provide strong, average or weak incentives for such a decision to be taken? - Is it consistent with the corporate objective? /Does it confirm differences regarding agency problems? - Is it encouraged or criticised in the literature?**
Case study 1 – decision to focus on the share price			
Delaware	short-term decision	Likely to be a lawful activity but might contribute to a breach.	Strong incentives, especially if beneficial for shareholders. Criticised in the literature.
UK	an example of short-termism	Lawful activity in general, can contribute to a breach.	Strong incentives for such decision, appears to be consistent with the shareholder value maximisation (as long-term considerations and ESV are encouraged but not obligatory). Criticised in the literature.
Germany	strong example of short-termism	It does not constitute illegal activity itself. However, it contributes strongly to	German law provides weaker incentives for decisions to focus on the share price; not consistent with the corporate

		a breach of directors' duties and more so, than in the shareholder orientated jurisdictions.	objective and it is criticised in the literature.
Case study 2 - decision to aggressively reduce the carbon emissions from a company's plant			
Delaware	long-term decision	Likely to be a lawful activity.	Weaker incentives – can only be taken if beneficial for shareholders. Consideration of long-term factors generally encouraged in the literature but the other factors can only be looked at if it is in the shareholders' interests.
UK	long-term decision	Likely to be a lawful activity.	Weaker incentives – can only be taken if beneficial for shareholders; it appears to be consistent with the ESV. Long-term investments generally praised in the literature but lack of evidence on this specific example.
Germany	strong example of long-termism	Likely to be a lawful activity.	There are greater incentives for this decision to be taken in Germany than in other jurisdictions. Consistent with the corporate objective. Sustainable development generally advocated in the literature, but lack of evidence on this specific example.
Case study 3 – excessive marketing			
Delaware	example of short-termism	Likely to be a lawful activity, however it might contribute to a breach of duty.	There are greater incentives for this decision, especially if beneficial for the shareholders.
UK	example of short-termism	Likely to be a lawful activity, however it could contribute to a breach.	There are incentives for this decision, however fewer than in Delaware; likely to be beneficial for shareholders and not consistent with the ESV. Criticised in the literature.
Germany	strong example of short-termism	It does not constitute an unlawful activity in itself, but could contribute to a breach.	There are fewer incentives provided by the law for this decision to be taken in Germany, or encouraged in the literature as weighing

			different interests is crucial. It does not seem to be consistent with the corporate objective.
Case study 4 – a lack of focus on environmental and health and safety issues			
Delaware	example of short-termism	It does not constitute an unlawful activity in itself, but could contribute to a breach.	There are greater incentives for this decision to be taken, consistent with corporate objective if it contributes to shareholder wealth maximisation. Criticised in the literature.
UK	example of short-termism	Unlikely to be a sole cause for the breach of directors' duties but it could contribute to it.	The UK law supplies reasonably strong incentives for such decision (but weaker than in Delaware); decision consistent with the letter but not with the spirit of the corporate objective. Heavily criticised in the literature.
Germany	stronger example of short-termism	It does not constitute illegal activity itself. However, it contributes stronger to the breach of directors' duties than in the shareholder orientated jurisdictions.	Inconsistent with the corporate objective – hence fewer incentives; less likely to be encouraged in the literature.
Case study 5 – promotion of cultural, social and civic aims			
Delaware	example of long-termism	Likely to be a lawful activity.	Weak incentives, but decision possible if profitable for shareholders (in one way or another). In general, supported in the literature.
UK	example of long-termism	Likely to be a lawful activity.	Incentives are weaker than in Germany but stronger than in Delaware, decision possible if profitable for shareholders; other factors considered subsequently. Supported in the literature.
Germany	strong example of long-termism	Highly unlikely to contribute to a breach.	The law furnishes strong incentives for such decisions; consistent with corporate objective (however, social aims cannot be only justification for the decision, it must be beneficial for the enterprise) and supported in the literature.

Case study 6 – a focus on dividend growth			
Delaware	example of short-termism	Unlikely to be a sole cause for the breach of directors' duties but it could contribute to it.	Agency problems between the board and shareholders as a class; directors solely responsible for dividend distribution. Strong incentives to focus on dividend growth despite weak shareholders. Abuses that lead to short-term decisions are likely. Criticised in the literature.
UK	example of short-termism	Unlikely to be a sole cause for the breach of directors' duties but it could contribute to it.	Shared division of power between the board and shareholders regarding distribution of dividends. Strong incentives to focus on dividend growth, despite dispersed ownership, shareholders are likely to put stronger pressure on the board than in Delaware. Decision criticised in the literature.
Germany	N/A	N/A	Shareholders mainly responsible for dividend distribution and only a limited role for management; confirms agency conflicts between majority and minority shareholders. Due to shareholders' leading role not relevant in terms of the parameters of managerial long-termism in Germany. At the same time shows, that one source of short-termism appears to be excluded or at least limited.
Case study 7 – investment in research			
Delaware	example of long-termism	Unlikely to constitute a breach.	The strongest position of the board among all jurisdictions and arguably the strongest short-term pressures – fewer incentives for the decision to be taken. Nevertheless, supported in the literature.
UK	example of long-termism	Unlikely to constitute a breach.	Encouraged in the literature. The board has a key role in deciding about investment in research and it is more interested in short-term investments. Shareholders

			are dispersed but stronger than in Delaware. Such decision is possible, fewer incentives than under German, but more than under Delaware law.
Germany	strong example of long-termism	Unlikely to constitute a breach.	The law supplies strong incentives for this decision. Long-term investments likely to be encouraged in the literature, lack of evidence on this specific example though. Due to strong influence of the majority shareholder on the board, the former attitude towards investment in research is crucial.

This table contains four columns: firstly, information on country/jurisdiction, secondly, an indication as to whether this is an example of short-termism or long-termism. Subsequently, whether a given decision is a lawful activity and/or has a chance to contribute to the breach is analysed. The last column addresses whether there are weak or strong incentives furnished by the law for such a decision to be taken, whether it is encouraged or criticised in the literature and finally if it is consistent with the corporate objective (cases 1-5) or confirms differences regarding agency problems (cases 6 and 7). The table also specifies each case study that has been analysed. It is not surprising that the second column is crucial in the discussion on the content and scope of long-termism. The third and fourth columns are also important as they indicate differences and similarities between jurisdictions and they present the notion of long-termism in a broader context. Moreover, currently the academic literature is the main source of evaluation whether the decision is an example of long- or short-termism; hence, it is vital to underline if it is criticised or encouraged by commentators. The conclusions on the content and breadth of long-termism will now be considered.

3.3 Conclusions

The dearth of sources in the area of decision-making in all three jurisdictions indicates that it is difficult for directors or management boards to judge whether a specific decision is long-term or short-term. It is a feature of all jurisdictions that legislation draws the legal command as a standard and the courts are left to intervene at a later date to define long-termism in greater detail. Certainly, there is no need for a static definition of long-termism and there are also positive consequences associated with the fact that the notion is not precise, as it can be used flexibly in different contexts and situations. However, there should be more guidelines

regarding its breadth. The principal conclusion that emerges in this thesis refers to long-termism being a flexible standard; hence, it must be evaluated in a specific case scenario. Creation of a list of factors or criteria that constitute a long-term managerial decision-making in every given situation is not possible. Case by case analysis enables us to put this subjective notion in context. It is argued strongly in this thesis that it is the best way to establish the parameters of long-termism. Nevertheless, the case-based approach is not flawless, as without background knowledge it is difficult to estimate why decisions are taken.

Of the seven case studies, three represent examples of long-termism and there are four examples of short-termism. The case studies have shown that jurisdictions are almost unanimous in the classification of examples, with the exception of the case regarding the decision to focus on dividend growth, which is not relevant in terms of managerial time-horizons in Germany. However, the clarity of the examples and the probability that the decision will be taken differ. The case studies underline that long-termism is widely advertised and promoted in the academic literature and in general, it has positive associations. In principle, in all three jurisdictions the academic literature promotes long-term, sustainable development, notwithstanding that in practice, short-term decisions are likely to be taken. This is clearly illustrated in the case studies, which focus on the share price, dividend growth and the decision that fails to consider environmental and health and safety issues. Consideration of the long-term consequences involves an analysis of the positive and negative consequences of the decision – deliberation of the whole impact of a particular decision on the company.

To start with, the first case study shows unequivocally that short-termism is identified with a focus on the share price, if the maximisation of the prices is perceived as a goal on its own. This is a particularly apparent example of short-termism in Germany where focus on short-term benefits is least connected with the corporate objective and hence, this jurisdiction provides the weakest incentives for such a decision. Surprisingly, the position in the UK and Delaware does not differ much from the one in Germany, in the sense, that decisions that focus on the share price will also be perceived as short-term in these legal systems the (although arguably an example of short-termism in Germany is stronger). With regard to the differences between the UK and Delaware, in both jurisdictions the interests of shareholders are paramount, although the ESV in the UK encourages more all-inclusive decision-making. Clearly, a focus on the share price is not a parameter of long-termism neither in the UK nor in Delaware. Finally, it must be highlighted that both the UK and

Delaware offer strong incentives for directors to focus on the share price, because of their corporate objectives.

In contrast, the second scenario exhibits a degree of long-termism. While share price maximisation is frequently scrutinised in the literature, a decision to (aggressively) reduce the carbon emission from the company's plant is not that common and also its impact on the company is more problematic to evaluate. Nevertheless, it constitutes an example of long-termism (and possibly a stronger example in Germany) if its merits go beyond myopic shareholders' gains. Furthermore, it is noteworthy that in Germany there are stronger incentives for such a decision than in two other legal systems. This decision epitomises long-term investment and sustainable development. A troubling question remains in relation to the justification for this decision. In the UK and Delaware, such a decision will be taken if it is viable for shareholders, whilst German law requires more balancing of different interests.

The table also demonstrates that excessive promotion of marketing is not within the parameters of long-termism. An over-concentration on one factor is perceived as a risky, short-term decision, even though it can turn out be a lucrative decision in some instances. It is useful to bear in mind that this is a less clear example of short-termism, as it is harder to exclusively associate it with short-term profit earning (and hence calculating decision-making) than it was in the first case study. This time this decision is seen as a stronger example of short-termism in Germany. The excessive marketing will be particularly at variance with balancing different interests whilst risky decisions are more likely to be taken in Delaware and the UK; and consideration of wider factors is less vital in shareholder orientated jurisdictions, especially in Delaware. It was also pointed out that in general the UK and Delaware laws supply stronger incentives for it than German law. However, comparing only the UK and Delaware, the conclusion arises that such decision will better incentivised in Delaware.

The fourth case study suggests that a lack of focus on environmental and health and safety issues is likely to be a vivid example of short-termism, especially in Germany – which is expected to be more sceptical towards such decisions. The table shows that this decision is likely to be taken in two other jurisdictions. The incentives for it are greater in Delaware – provided that it maximises shareholder wealth. In the UK it is also likely to be taken (as the BP case shows), although it is not consistent with the spirit of the ESV. There is a double-edged significance to these findings. On the one hand, the BP oil spill case emphasises that there is a link between consideration of these factors, long-term gains and sustainable development. On the other hand, neglecting environmental and health and safety considerations can be rooted in profit maximisation.

The final case presented in the context of the discussion on corporate objective discussed promotion of cultural, social and civic aims. This decision is an example of long-termism in all three jurisdictions. A decision such as this will normally not bring immediate or sometimes any financial profits for the company and long-termism in this scenario is portrayed as a long-term investment and promotion of the company. Hence, this decision might be regarded as controversial and not taken that often. The common feature in these three jurisdictions regarding the corporate objective is that in general social aims cannot constitute the only justification during the decision-making process. A decision must be also economically viable in the sense that it contributes to the company's development. It is naïve to request that directors ignore financial profits and the financial wellbeing of the company. A difference between the three systems relates to the significance of these social aims. In Germany, they are of relatively higher importance, followed by the UK and in Delaware of lowest.

In case study number six, a focus on dividend growth is identified with short-termism in the UK and Delaware if earnings growth is the sole or main justification for this decision. Tensions between the board and shareholders regarding the dividend policy are to be expected in both jurisdictions with dispersed share ownership structure and the personal goals of both groups are likely to jeopardise balanced distribution of dividends. It was also underlined that shareholders in the UK are expected to put stronger pressure on the board than shareholders in Delaware. In Germany, shareholders are mainly responsible for dividend distribution, therefore this decision cannot be analysed in the context of the management board's decision-making and the content of long-termism. Thereby dividend distribution cannot be identified as a source of short-termism in Germany.

Finally, the last case study shows that investment in research is an element of long-term thinking in all jurisdictions and arguably a particularly strong example in Germany. Again, investment in research is perceived as a long-term investment that contributes towards sustainable performance and building wealth in a durable manner. It was argued that in general it is more likely that in Germany the board will decide to invest in research due to the important role of long-term orientated majority shareholders in the decision-making process. This can be contrasted with the boards of directors responsible for investment in research in the UK and Delaware who would be expected to be more interested in short-term investments and short-term profits. Delaware law is perceived to have the fewest incentives to invest in research.

On balance, decisions to focus on share price and on dividend growth constitute the clearest examples of short-termism and the decision to invest in research is the most vivid

example of long-termism. A focus on short-term profits is the main feature of short-termism according to the case studies (case studies 1, 4, 6). Further, the case study on excessive marketing underlines that short-termism is perceived as an over-concentration on one factor. The decisions to reduce carbon emissions, to promote social goals and to invest in research epitomise long-termism; thus, future investments are key features of long-termism. The other examples of long-term investments are 'spending on employee training or the propensity to retain staff during economic downturns.'[849] It is almost impossible to state unambiguously which long-term investment will be beneficial for the particular company. As the case study on investment in research shows, such a decision can be also risky.

A decision, which is not a form of long-term decision-making, is likely to be an example of short-termism. For instance, the case study on environmental and health and safety issues indicates that a lack of focus on these factors is likely to amount to a short-term decision. At the same time, it demonstrates that there is a link between consideration of broader factors and long-termism. Examples of short-termism are more frequent than examples of long-termism, if correctly identified; they can be useful in determining the content of long-termism, by indicating what type of behaviour should be avoided.

It is still unclear whether short-term decisions are actually detrimental to long-term value creation[850] and the meaning of short-termism is far from clear; nevertheless, it is commonly understood as 'show[ing] a preference for strategies that add less value but have an earlier payoff relative to strategies that would add more value in the long run.'[851] Jackson and Petraki argue that short-termism goes beyond myopia and involves *demonstrably suboptimal* decision-making or behaviour.[852] Strand agrees with that saying that short-termism goes beyond myopia and concerns 'unquestionably suboptimal actions.' Myopia is not a proper proxy for short-termism, as it is difficult to separate myopia caused by the 'magnitude of incentives' from myopia caused by a 'short-time horizon.'[853]

The gap-filling exercise confirms that instances of short-termism are not easy to define and that short-termism often involves decision-making of a quality that is less than the highest standard – which is difficult to demonstrate empirically. Focussing on short-term factors is unlikely to constitute the sole basis for a breach of directors' duties, if disinterested directors act in good faith in the best interests of the company. The case studies show that it

[849] Jackson and Petraki, 'Understanding Short-Termism' 19, fn 4.
[850] ibid 17.
[851] ibid 9-10.
[852] See: ibid 11. [emphasis in original]
[853] Strand, 'Re-thinking Short-termism' 19.

can at the most contribute to a breach. This makes it more difficult to determine the standard of a decision taken.

The general pattern is that decisions that are considered as long-term decisions/investments are better balanced and have a more inclusive and holistic character. In the jurisdictions under scrutiny, long-termism is associated with the following words: reasonableness, well-thought through decision, balanced development, and decisions going beyond immediate profits and short-term shareholders' interests. Long-termism is associated with forward thinking; consideration of what is profitable not only here and now but also in the future. The following description of long-termism expresses this point well:

> [T]he idea that business should not get too caught up in the here and now, and instead think profound thoughts about the far-off future. Long-termism means striving perhaps a bit less hard to meet next month's sales target and redeploying that energy towards bigger, more ambitious goals. Long-termism also involves thinking about the sustainability of your business in every sense (…).[854]

It is worth recalling that long-termism is not the same as a successful decision. At the same time, unsuccessful decisions can be a result of short-termism, long-termism but also other external factors. This chapter now presents some general comments on the notion of long-termism in a comparative perspective.

3.4 Some general thoughts and moving towards Chapter VI

Apart from enriching the discussion on the content of long-termism during directors' decision-making, the analysis produced by the case studies also illustrates how complex the concept of long-termism is and why the perception of it varies between jurisdictions. The framework above can be illustrated in the following terms:

Jurisdiction	Delaware	the UK	Germany
Corporate objective	shareholder value maximisation	shareholder value maximisation and ESV	leaning towards stakeholderism
Directors'/management board's decision-making powers	wide powers	wide powers	wide powers
Agency	directors v.	directors v.	majority v.

[854] MT (Management Today), 'Learning Curve: Long-termism' (1 November 2011) <http://www.managementtoday.co.uk/features/1100038/MT-Learning-Curve-Long-termism/> accessed 17 February 2015.

conflicts	shareholders as a class	shareholders as a class	minority shareholders
	Very strong position of directors in this dispersed ownership jurisdiction; diffused shareholders	Strong position of directors in this dispersed ownership jurisdiction; diffused shareholders, but more empowered than in Delaware	Strong position of majority shareholder that is likely to influence the board
Conclusions	Directors have more power to pursue their own interests	Directors have more power to pursue their own interests	Less power for the board to pursue their own interests
	Tensions between the board and shareholders on the one hand and the shareholder value maximisation principle on the other means that short-term decisions are more likely	Tensions between the board and shareholders on the one hand and the shareholder value maximisation principle on the other means that short-term decisions are more likely	Influence of the majority shareholder on the decision-making and the fact that decision should involve some consideration of the interests of various stakeholders means that long-term decisions are more likely

The dichotomy between the UK and Delaware, on the one hand and Germany on the other is vivid. Similar results for the UK and Delaware were expected owing to their complementary corporate objectives and share ownership structures. However, the case studies also show that the results are not the same in these jurisdictions, because of the relatively stronger position of the board in Delaware and the application of the ESV principle in the UK. The encouragement afforded by the ESV principle to address a wider range of factors in the UK places it somewhere between Delaware and Germany in a notional spectrum. In general, long-termism in the UK and Delaware is associated more strongly with shareholder interests and in Germany with balancing the interests of various stakeholders. Hence, it is evident that long-termism is perceived differently in these jurisdictions.

On balance, it cannot be unequivocally stated that the stakeholder orientated countries are the ultimate exemplars of long-term decision making. However, short-term decisions are more likely to be taken in the UK and Delaware due to the shareholder value maximisation rule and the agency conflicts between the board and shareholders that are likely to create more short-term pressures. In the same vein Jackson and Pertraki argue that

in the Anglo-Saxon jurisdictions the agency conflicts and shareholder value maximisation feed short-termism.[855] Further, a study carried out in the 1990s on the role of corporate performance measures and incentive schemes in Germany and in the UK revealed that 'a smaller German equity market and a closer relationship between banks and their corporate clients' supports a longer-term approach in German companies.[856] What is more, an emphasis on secure employment and seniority pay in Germany after the Second World War 'explains an in-built tendency towards long-termism which contributed to higher levels of investment than in the English-speaking countries.economies.'[857]

Overall, there seems to be a compelling reason to argue that Germany offers greater long-term protection, as the legal system values the continuing development of the company and a lasting increase in value. Not only the corporate objective but also less visible, considerable agency conflicts during decision-making and share ownership structure with a strong position of arguably more long-term orientated majority shareholder, demonstrate that examples of long-termism (and also short-termism) are stronger in Germany.

Referring back to the corporate objective in Germany, consideration of the interests of various stakeholders appears more long-term orientated, as different points of view are taken into consideration. The decision is then analysed from different perspectives and the decision is more comprehensive. As a consequence, the perspective in a stakeholder jurisdiction is longer, fuller and more far-reaching, even if particular employees, creditors or shareholders might have only temporary relationships with the company, or occasionally put short-term pressure on the management board. The practice of considering the interests of various stakeholders' groups make managerial decision-making more accurate and all-embracing.

On balance, the critique of the stakeholder theory that this theory is too broad to be of much use, because it is not possible to define whose interests should actually be taken into consideration,[858] must be rebutted at this point. Consideration (or balancing) of the interests of various stakeholders is more strongly underlined in Germany, in comparison to the UK and Delaware. However, as the ultimate task of the management board in Germany is ensuring the company's profitability (expressed as 'appropriate profit realisation' rather than

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[855] Jackson and Petraki, 'Understanding Short-Termism' 49.
[856] Jeffrey Coates et al., *Challenging Short-termism*: *The Role of Corporate Performance Measurement Systems in the UK and Germany* (Chartered Institute of Management Accountants 1996) 1.
[857] Plender, 'Giving People a Stake' 211. The author underlines that this in-built tendency to long-termism is even more visible in Japan.
[858] See discussion in Chapter IV s 4.1.3 above.

'profit maximisation'), it is somewhat stretching matters to argue that the corporate objective in Germany is too vague.

Nevertheless, clearly the long-term approach will also have negative implications. Long-term orientation in the blockholder jurisdictions, like Germany, means that this system will suffer from an excessive growth focus, as it is not aiming at shareholder value maximisation. At the same time, market systems like the UK and Delaware are prone to short-termism as they do not concentrate on long-term project, but they are able to deliver shareholder value.[859] Bratton and McCahery argue that each system's investment minus is also its plus and vice versa, which confirms the hypothesis of equal fitness.[860]

To sum up, the aim of Chapters IV and V was to clarify the content and scope of long-termism, using the shareholder v. stakeholder debate and share ownership structure of the company as instrumental devices. Discussions on corporate objectives and share ownership structure not only assist in establishing the parameters of long-termism, but also indicate that consideration of long-term factors depends on how well the interests of shareholders are aligned with the interests of directors and whether these groups are actually long-term orientated. Thus, in order to facilitate long-term decision-making effectively, working incentives must be put in place. Without incentives, the debate on long-termism is incomplete, and as such, Chapter VI discusses some of the mechanisms and factors that could foster long-term decision-making.

[859] Bratton and McCahery, 'Comparative Corporate Governance and Barriers to Global Cross Reference' 29.
[860] ibid 28-29.

Chapter VI. A way forward – how can long-term decision-making be incentivised?

1. Introduction

This thesis argues that focusing the attention of directors on lengthening the time horizon during the decision-making process is an indication of good corporate governance. Chapter III has shown that each of the jurisdictions under scrutiny facilitate long-term decision-making. At the same time, it was higlighted that the jurisdictions should take firmer steps to give guidance as to the interpretation of this notion in order to change it from a theoretical idea to a meaningful concept. Chapters IV and V focused on practical case studies taken from the secondary academic literature in order to provide the notion of long-termism with content and scope. The case studies presented in Chapters IV and V in the context of the shareholder v. stakeholder debate and share ownership structure of the company emphasise that managers not only need to understand the notion of long-term decision-making but that they must also be motivated to make long-term decisions. In the most general terms, consideration of long-term factors depends not only on managers' attitudes (i.e. their professional orientation towards decision-making) but also on incentives (long-term and short-term) both from the market and from within the company (i.e. incentive system for executives, corporate governance structure, shareholders' influence on the board's decision-making, the role of lawyers and auditors etc.).[861] Hence, incentivising managerial long-term decision-making is the subject of this chapter. Chapter VI argues that the key advantage of incentives is that they make directors personally interested in achieving the long-term goals. Incentives are a more pro-active and importantly effective way of encouraging long-termism, in comparison to relying only on the law of directors' duties to police board behaviour on an *ex post facto* adjudication basis.

The current chapter presents only a handful of mechanisms and factors within the company that incentive the board's long-term decision-making. For reasons of space constraints, it is not possible to present an exhaustive list of incentives. Hence, the four most topical were chosen – three relate to directors and the last considers the role of shareholders

[861] Note however, that in the literature there are different taxonomies of the sources of short-termism. Salter argues that short-termism in management culture has three sources: firm-related, market-related and individual-specific sources – Malcolm Salter, 'How Short-Termism Invites Corruption' 10; Strand argues that in the US the traditional view is that short-termism arises from investors and that in Europe is generally considered to arise from the internal distortions of the corporation – Strand, 'Re-thinking short-termism' 18-19.

in the board's decision-making. These are in turn: executive remuneration, quarterly reporting, the board's tenure and finally shareholders' influence on the board's decision-making. These issues have generated a vast amount of discussion in the literature and this chapter clearly contributes to these debates. Further, this chapter presents similarities and differences between the jurisdictions under review regarding the future of long-term decision-making, i.e. divergences in the incentives and their effectiveness on a jurisdiction by jurisdiction basis. However, the chapter's paramount aim is enhancing long-term decision-making by showing how the chosen incentives currently contribute towards future-orientated decision-makingand also how they ought to be reformed and improved.

This chapter is structured as follows. Whilst scrutinising each incentive, it is outlined, first of all, why the incentive was chosen, and to what extent it ensures that directors take decisions which are in the long-term interest of the company. Subsequently, the position in each jurisdiction is discussed separately and conclusions are offered regarding each incentive. Finally, this chapter is rounded off with more general comparative conclusions on the incentives presented.

2. Directors' remuneration

2.1 Introduction

Short-termism is associated with, among other things, the way directors are motivated to perform, which above all is linked to executive remuneration.[862] The remuneration of executive directors (and members of the management board in Germany) is a source of continuing controversy. Apart from the fixed salary that is paid to them (naturally the non-executive directors and the members of the supervisory board also receive a salary), the executive directors also receive various benefits, incentives and bonuses under the service contract they enter into as managers of the company which forms the main source of their income.[863] A key complaint is that executive remuneration is insufficiently focused on the long-term goals and plans, leading to reckless, short-term decision-making by executives, as it pays off for them to secure immediate benefits from short-term focused actions.[864]

The fact that the remuneration packages often involve significant stock options is very frequently cited as one of the motives that contribute to short-termism,[865] as directors might be encouraged to focus too much on short-term share price increases in order to make

[862] See for instance: Wen, 'The Magnitude of Shareholder Value, 332 and the literature cited there.
[863] Davies, Worthington and Micheler, *Gower and Davies' Principles* 400.
[864] David Walker, 'The Challenge of Improving the Long-term Focus of Executive Pay' (2010) 51 BCLRev 435, 435-436; Helms, Fox and Kenagy, 'Corporate Short-termism' 51-52.
[865] Keay, 'Getting to Grips with the Shareholder Value Theory' 373.

a personal profit. The Kay Review portrays stock options as a disproportionate incentive, because managers share gains, but not losses, with shareholders.[866] The further weakness that has been uncovered is that the majority of 'variable compensation packages are set for a short-term period, mainly yearly' and often use 'irrelevant financial ratios as opposed to non-financial ratios and competitive benchmarks.'[867] Further, in the US the recent 'economic crisis revealed instances where corporate executives received very high compensation despite the very poor performance of their firms.'[868] A study conducted in the last decade in the US also shows that among more than 400 executives who were interviewed 'to determine the factors that drive reported earnings and disclosure decisions,' 78% of the sample admitted 'to sacrificing long-term value to smooth [over their] earnings,' i.e. using accounting techniques to level out net income fluctuations from one period to the next.[869] In Germany, the remuneration of the management board in the thirty largest listed companies (the DAX 30) increased by 445% between 1987 and 2005.[870] In the UK, the study of pay data reveals that the median earnings of a FTSE 350 director (largest 350 companies listed on the London Stock Exchange) between 2000 and 2013 'increased more than twice as fast as median pre-tax profits at FTSE 350 companies and four times as fast as their median market value.'[871]

It is not surprising that executive remuneration is subject to ongoing reform, which intensified markedly after the financial crisis. This subject generated a vast debate in the accounting, management and law & economics literature. Various reforms have been suggested and carried out all over the world. As the analysis below indicates, in the jurisdictions under review the reforms are principally aimed at increasing the transparency of remuneration components and 'say on pay' – i.e. shareholders' involvement in shaping the remuneration of executives. It is argued, for instance, that 'directors' remuneration plays a key role in aligning the interests of directors and shareholders and ensuring that the directors

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[866] Kay Review, para. 11.8.
[867] Martin Hilb, 'Redesigning Corporate Governance: Lessons Learnt from the Global Financial Crisis' (2011) 15 JMG 533, 533.
[868] Senate Committee Report No. 111–176 (2010) , 133 <https://www.congress.gov/congressional-report/111th-congress/senate-report/176/1> accessed 12 March 2015.
[869] Graham, Harvey, Rajgopal, 'The economic implications of corporate financial reporting' 4, 44ff.
[870] Rainald Thannisch, 'Reorienting management remuneration towards sustainability: lessons from Germany'in Sigurt Vitols, Norbert Kluge (eds.), *The Sustainable Company: a new approach to corporate governance* (ETUI aisbl, Brussels 2011) 128.
[871] The High Pay Centre, *Executive remuneration in the FTSE 350 – a focus on performance-related pay* (summary 2014) <http://highpaycentre.org/blog/new-high-pay-centre-report-performance-related-pay-is-nothing-of-the-sort> accessed 13 March 2015.

act in the best interest of the company.'[872] In order to avoid short-term decisions and short-term pressures on the board, tying the remuneration of the company's executives to long-term results is widely suggested[873] as a way of promoting long-term performance figures.[874]

In dispersed share ownership jurisdictions – like the UK or Delaware – law and economics scholars view executive remuneration as either a partial solution to the agency problem – being the tension between shareholders as a class and as managers – or as part of this agency problem.[875] The proponents of the former theory argue that the aim of the remuneration package should be to align the interests of managers with those of shareholders and the size of such pay checks is deemed to be evidence that the principal-agent problem is being addressed.[876] The supporters of the latter theory note though that managers have strong incentives to use their powers to influence executive remuneration.[877] This dispute is open-ended. Irrespective of the theory applied, it is argued in this thesis that aligning executive remuneration with long-term performance will be beneficial for the company, as it leads towards the reduction of short-term activities and re-focuses on the sustainable development of the company. On the other hand, in the concentrated ownership jurisdictions like Germany the agency conflicts generally arise between majority and minority shareholders. Hence, executive remuneration cannot be viewed in the context of the agency problem. However, as the research above shows Germany also suffers from the rapid increase of executive remuneration and the question arises here as to 'how to ensure that executive incentives are tied to the longer term interest of the company as a whole, rather than to the interests of the dominant shareholder.'[878] This section analyses first of all whether remuneration in the jurisdictions under review aims to incentivise long-termism and scrutinises the recent changes in the regulation of remuneration. In particular, whether remuneration is connected to corporate performance and whether long-term variables are promoted is evaluated. The role of 'say on pay' in incentivising long-termism is also briefly discussed. However, the

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[872] See i.e.: New Shareholder Rights Directive 4.
[873] Lucian Bebchuk, Jesse Fried, 'Paying for Long-Term Performance' 1915; Helms, Fox and Kenagy, 'Corporate Short-termism' 51-52; Kay Review 59 (Good Practice no 10)*;* The High Pay Centre*, Executive remuneration in the FTSE 350 – a focus on performance-related pay* (A Report for the High Pay Centre from Incomes Data Services October 2014) 8 <http://highpaycentre.org/blog/new-high-pay-centre-report-performance-related-pay-is-nothing-of-the-sort> accessed 13 March 2015; CED, *Built to Last: Focusing Corporations on Long-Term Performance* 12.
[874] Hu, 'Risk, Time and Fiduciary Principles' 336.
[875] Steven Bainbridge, *Corporate Governance after the Financial Crisis* (OUP 2012) chapter 4; Lucian Bebchuk, Jesse Fried, 'Executive Compensation as an Agency Problem' (2003) 17(3) JEconPerspect 71.
[876] Bainbridge, *Corporate Governance after the Financial Crisis* 114.
[877] ibid 115; Bebchuk, Fried, 'Executive Compensation as an Agency Problem.'
[878] OECD, *Board Practices: Incentives and Governing Risks*, Corporate Governance (OECD Publishing, 2011) 8 <http://dx.doi.org/10.1787/9789264113534-en> accessed 2 March 2015.

provisions on remuneration will not be presented in detail but only in the above mentioned context. Secondly, some suggestions are offered on how to further incentivise long-termism in the jurisdictions under review. Finally, comparative conclusions are presented. This thesis will now review the first incentive in Germany, UK and Delaware.

2.2 Germany

Remuneration packages

According to the AktG, remuneration of a management board member includes all monetary components, that is: '[fixed] salary, profit participation, reimbursement of expenses, insurance premiums, commissions, incentive-based compensation promises such as subscription rights and additional benefits of any kind.'[879] The remuneration packages in Germany generally consist of: fixed compensation, i.e. not performance related (e.g. base salary and company cars), short-term compensation (annual cash bonuses) and long-term compensation (the value of shares, options and compensation based on long-term incentive plans).[880] The study carried out in 2011 on the 108 biggest German corporations, illustrates changes in executive compensation components between 2005 and 2009. [881] The remuneration packages for CEOs and other executies were analysed separately here. Regarding CEOs,' the data shows that in 2005, 45% of the remuneration was fixed; the average share of short-term incentives was 42% and long-term 14%. [882] With regard to other executives, that was 39%, 45% and 16% respectively.[883] In 2009, the following changes in remuneration structure were observed. In the case of CEOs, the fixed remunearion increased to 49%, short-term incentives declined to 36% and finally long-term incentives increased to 15%.[884] A similar development was observed in 2009 for non-CEOs: 48% of remuneration was fixed, short-term incentives declined to 36% and long-term compensation components increased to 17%.[885]

Current regulation of executive remuneration

Among the three jurisdictions under review, the remuneration of the management board in listed companies in Germany appears to be the most aligned with the continuing

[879] § 87 (1) 1 AktG.
[880] Moritz Heimes and Steffen Seemann, 'Compensation and Incentives in German Corporations' (University of Konstanz, Working Paper Series 2011-20) 8, 28ff <http://www.wiwi.uni-konstanz.de/workingpaperseries> (accessed 9 September 2015).
[881] Heimes and Seemann, 'Compensation and Incentives in German Corporations.'
[882] ibid 28.
[883] ibid.
[884] ibid 30.
[885] ibid.

development of the company. As was discussed in Chapter III,[886] director remuneration in a German listed company must seek to promote the company's 'sustainable development' (*nachhaltige Unternehmensentwicklung*) [887] and the calculation basis of variable remuneration components in a listed company should therefore be several years long.[888] Moreover, the *Kodex* provides that the management board should act with 'the objective of sustainable creation of value'[889] and that the compensation of both the management and supervisory board members must 'be oriented toward sustainable growth of the enterprise.'[890] As explained in Chapter III, the key problem with these recently introduced provisions is that it is far from clear how 'sustainable development' or 'sustainable creation of value' should be interpreted.

How should the law on executive remuneration be changed?

The starting point for this discussion is that the requirement for a connection between director remuneration and a company's sustainable development should apply to all companies, rather than be limited to listed companies. Moreover, guidance on how to understand sustainable development would be beneficial to clarify directors' duties and enhance understanding of these provisions. A few interpretations are currently suggested,[891] which constitutes a potential source of confusion for the board. Furthermore, the author of this thesis shares the view that there is arguably too much focus in the German literature on sustainability in the context of the capacity of resources[892] and corporate social responsibility in general.[893] Naturally, consideration of CSR-related factors will be beneficial for the company. However, as Fleischer correctly argues the aim of this provision is rather to reduce the 'time preference conflict' (*Zeitpräferenzkonflikt)*.[894] This conflict was described by Kräkel as a conflict between management and shareholders, where the former traditionally prefer – for various reasons – short-term investments whereas the latter prioritises long-term investments.[895] Hence, it is pertinent to note that the main emphasis in this provision should

[886] In Chapter III s 3.1.3 and s 5.3 above the positive law regarding the remuneration in Germany was discussed. In addition, Chapter IV s 2.4 analysed how the academic literature interprets the phrase 'sustainable development.' In turn, this chapter critically evaluates how the existing law on remuneration ought to be reformed in order to further incentivise long-termism.
[887] § 87 (1) 2 AktG.
[888] § 87 (1) 3 AktG.
[889] § 4.1.1. Kodex.
[890] § 4.2.3 and 5.4.6 Kodex.
[891] See: Chapter IV s 2.4 above.
[892] Fleischer, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' 802-803.
[893] Gregor Thüsing and Gerrit Forst, 'Nachhaltigkeit als Zielvorgabe für die Vorstandsvergütung' GWR 2010, 515, 515; and the literature cited there. (my translation)
[894] Fleischer, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' 802-803.
[895] Kräkel, *Organisation und Management* 280-281 see also Chapter V s 2.2.2 above.

be on moving away from short-term, exaggerated profits[896] and it should rather be defined as creating long-term value.[897] Even the replacement of the phrase 'sustainable development' with 'sustainable creation of value' used in the *Kodex* would be more appropriate, as it goes beyond mere CSR.

An additional criticism of these provisions is that the board cannot be forced to aim for sustainable development under the current regulation. Mandatory provisions in this respect would be counter-productive and the adherents of the present position might argue that it is in the board's best interests to promote the sustainable development of the company. However, in order to improve the focus on the continuing development of the company, there should be at least some enforcement mechanisms in place that would oblige the board to show that they have undertaken all necessary steps to achieve the sustainable development of the company.

Apart from the general aim of the regulation of remuneration, the actual structure of regulation is crucial in incentivising long-term development in Germany. According to § 87 (1) 3 AktG the calculation basis for the variable pay components should be several years – which in the literature is interpreted as between two and five years. To start with, there is no agreement as to whether the term 'sustainability' is identical with 'several years.' Wagner notes that some commentators argue that the latter defines and describes the former, but he does not share this view.[898] It is also pointed out that the wording suggests that several years should be understood as at least two years,[899] or that the four-year period appears to be the most suitable.[900] Finally, there are also views that the term several years should be understood as 3-5 years and that the upper limitof five years is based on the maximum tenure of the member of the management board, according to the § 84 (1) 1 AktG.[901]

The provision analysed in the section immediately above clearly precludes short-term incentives – variable remuneration packages in Germany can no longer be set for a short-term period. However, it remains questionable whether these are really long-term incentives or simply medium-term incentives as argued by Roth.[902] The author rightly points out that

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[896] See similarly: Thüsing, 'Das Gesetz zur Angemessenheit der Vorstandsvergütung' 519-520.

[897] Gunther Friendl, Verena Springer, 'Current topic: Sustainable Compensation Systems for Executives' (2011) 2 <http://www.finexpert.info/fileadmin/user_upload/downloads/pdf/Current_Topic/current_topic_sustainable_compensation_2011-06-03.pdf> accessed 10 March 2015.

[898] Wagner, 'Nachhaltige Unternehmensentwicklung'779.

[899] Bauer, Arnold, 'Festsetzung und Herabserzung der Verstandsvergütung' 722; Hüffer, *Aktiengesetz*, § 87 mn 4d; Spindler, *Münchner Kommentar Aktiengesetz* § 87 mn 88.

[900] By reference to § 193 (2) 4 AktG on conditional capital increase. See: Spindler, *Münchner Kommentar Aktiengesetz* § 87 mn 88.

[901] Berger, *Vorstandsvergütung* 118-119 and the literature cited there (my translation).

[902] Roth, 'Corporate boards in Germany' 330-331.

pension payments which might be a proper long-term incentive are not of substantial importance.[903] Accordingly, incentives set up for up to five years will not be always perceived as long-term in focus. Nevertheless, basing compensation on the performance of several years rather than on shorter periods is definitely a move in the right direction and a few benefits of the new regulation on variable remuneration can be identified. First, the management board has more options when calculating profit figures. Secondly, there is reduced scope for annual profits to be increased by activities that reduce future profits and finally 'management has high risk-taking incentives when bonuses are based on short-term performance.'[904] Friendl and Springer note also that the new regulation is successful:

> In 2009, 92% of variable cash compensation of the DAX [30 companies] was short-term oriented. Only five companies paid their executives a bonus on a multi-year assessment (...). In 2010, the compensation structure has entirely changed due to the new rules. Now 50% of the DAX companies calculate bonuses or at least part of their bonuses on a three-year assessment. Few companies even use longer periods.[905]

In order to minimise the negative effects of offering shares and options to executives – i.e. too much focus on short-term results, in 2009 the AktG was changed and a blocking period of at least four years (it was previously two years) for the exercise of stock options regarding newly authorised capital was introduced.[906] The German solution indicates how stock options, which are traditionally associated with short-termism can be reformed to prioritise longer-term orientated corporate performance. This provision of the AktG is not applicable to existing stock options. According to Friendl and Springer most stock index DAX 30 companies use share-based compensation and after the changes in the legislation more than half of the companies with stock-based compensation require at least a four-year blockholding period.[907]

'Say on pay'

Furthermore, in 2009 a non-binding vote of the shareholders' meetings of listed companies regarding the approval of remuneration schemes was introduced.[908] Since the vote is non-binding, it implies neither rights nor duties for the shareholders' meeting and the obligations of the supervisory board to determine remuneration of the management board pursuant to §

[903] ibid.
[904] Friendl, Springer, 'Current topic: Sustainable Compensation Systems for Executives' 3.
[905] ibid 4.
[906] § 193 (2) 4 AktG.
[907] Friendl, Springer, 'Current topic: Sustainable Compensation Systems for Executives' 3.
[908] § 120 (4) AktG.

87 remain unaffected. However, a proposal has been made for a New Shareholder Directive to introduce a mandatory 'say on pay' in the whole of the European Union.[909] The proposal notes that board remuneration can only be paid in accordance with a remuneration policy that has been approved by the shareholders.[910] The remuneration policy must be 'clear, understandable, in line with the business strategy, objectives, values and long-term interests of the company and (…) incorporate[s] measures to avoid conflicts of interest.'[911] Moreover, it should be explained 'how it contributes to the long-term interests and sustainability of the company.'[912] The new proposal also requires the company to establish a maximum level of total remuneration paid, and explain how the pay and employment conditions of employees of the company were taken into account when setting the policy or directors' remuneration.[913] The remuneration policy must be publicly disclosed.[914] The companies will be also obliged to draft a comprehensive report, which should include, among other things, 'an explanation of how the total remuneration is linked to the long-term performance of the company and furnish information on how the performance criteria were applied.'[915]

The proposed reform has had a mixed reception in the Member States. First of all, 'say on pay' already exists – for instance in Germany and UK – and the question arises whether the European regulation is really required.[916] The main debate around 'say on pay' is whether it will actually decrease pay levels. The New Shareholder Directive looks very promising, especially as it underlines the alignment of remuneration with the long-term and sustainable development of the company. Improving the accountability of managers towards shareholders, may also be a great tool to strenghten the influence of the short-term shareholders on the board.[917]

Conclusions

German company law clearly attempts to align the remuneration of the management board of a listed company with its continuing development. It remains to be seen whether the recent changes to the AktG and Kodex will be effective. It is argued that guidance on how to understand 'sustainable development' is required. Preferably, this term should be changed and enforcement mechanisms duly introduced that encourage the board to aim towards the

[909] Art 9a and 9b New Shareholder Rights Directive.
[910] Art 9 a (1) ibid.
[911] Art 9 a (2) ibid.
[912] Art 9 a (3) ibid.
[913] Art 9 a (3) ibid.
[914] Art 9 a (4) ibid.
[915] Art 9 b ibid.
[916] Strand, 'Re-thinking Short-termism' 33-34.
[917] See similarly: ibid 37.

sustainable development of the company. At the moment it is not clear whether the recent changes will actually support the sustainable creation of value.[918] In particular, the impact of 'say on pay' – already introduced in Germany and also proposed in the New Shareholder Directive – on incentivising long-termism is debatable. However, the report by Friendl and Springer suggests that at least some of the recent changes incentivise a degree of departure from some short-term practices in Germany.[919] Moreover, the current changes are definitely a move in the right direction; they set Germany on track towards more long-term focused decision-making in the boardroom. It is not argued that the German model should be blindly copied in Delaware or UK but these changes should be duly studied there.

2.3 The UK

Remuneration packages

Recent research has revelead that fixed elements made up just over a fifth of the total earnings of FTSE 100 directors in the UK in 2012-13, and the rest consists of various incentives of a short-term, medium-term and long-term nature. A change in the balance between fixed and variable pay elements over the last thirty years is easy to observe.[920] At first, managerial bonuses were focused on share options.[921] After the criticism of share options as being ineffective in aligning the executive's incentives with shareholder returns, '[o]ver time the role of performance-related-pay in executive remuneration has increased, for example, through long-term incentive plans (LTIPs).'[922] In fact, it has been pointed out that in the UK pay packages typically consist of LTIPs and annual bonuses and '[p]erformance-related executive pay has now become a firmly established practice at nearly every major UK-listed company.'[923]

As such, share options and LTIPs are the main long-term incentive awards. Of the two, LTIPs dominate FTSE 350 incentive practice, although a minority continue to favour share options. The crucial difference between LTIPs and share options is that LTIP participants are not required to buy shares before they can realise a gain:

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[918] Friendl, Springer, 'Current topic: Sustainable Compensation Systems for Executives' 7.
[919] ibid.
[920] High Pay Centre, *Executive remuneration in the FTSE 350: A Report* 40.
[921] Kay Review para. 11.8.
[922] BIS, *Metrics and Modes Used to Assess Company and Investment Performance* (BIS Research Paper No. 190 2014) 11 <https://www.gov.uk/government/publications/metrics-and-models-used-to-assess-company-and-investment-performance> accessed 3 November 2015.
[923] High Pay Centre, *No Routine Riches: Reforms to Performance-Related Pay* (May 2015) 8 <http://highpaycentre.org/pubs/no-routine-riches-reforms-to-performance-related-pay> accessed 11 August 2015.

> Participants in an LTIP are granted an initial block of 'free' shares at the beginning of a performance cycle, usually three years, and the value of any final award is dependent on pre-specified performance targets. In contrast, share option participants are given the option to buy company shares in the future at a price fixed at the date of grant. [924]

Furthermore, the Kay Review suggests that professional remuneration consultants, who specialise in the design of incentive schemes, have acquired greater influence over remuneration practices. The difficulty lies in the fact that the interests of remuneration consultants are more closely aligned with the interests of the members of the boards who select them, rather than the interests of shareholders. [925]

Performance-related pay is criticised in the UK: 'as performance-related-pay has increased, rather than assist in the alignment of incentives between executives and shareholders, the research suggests that executives have an incentive to maximise short-term share price performance at the cost of long-term value creation.' [926] It has also been established that LTIPs with a span of three years may actively encourage short-term decision-making: the tenure of a corporate chief executive is usually between 3–5 years. Many, probably, most, important strategic decisions about the future development of a large complex business will exceed the chief executive's tenure Hence, on the one hand, it encourages to make decisions, the immediate effects of which are positive even if the long run impact is not. On the other, it does not really pay off, from the managers' perspective to make strategic decisions.[927]

The Kay Review also points out that in practice incentives related to short-term share price could be more effective in encouraging long-term decision making, as 'share prices are generally more forward looking than historic accounting data.' [928] Having said that, the Report notes that 'such incentives will create many distortions of their own, particularly those related to the management of expectations.' [929] Moreover, in a recent report by the High Pay Centre, the percentage change in the median remuneration of FTSE 350 directors and selected corporate indicators between 2000 and 2013 was studied. [930] Although one long-term incentive bonus, i.e. LTIPs, increased by 268.3%, share option schemes (the other long-term incentives) dropped by 29.5% in that period. In total, the increase in short-term incentives was even greater, as for instance annual bonuses increased by 313.9%. These

[924] High Pay Centre, *Executive remuneration in the FTSE 350: A Report* 17.
[925] Kay Review para. 11.9.
[926] BIS, *Metrics and Modes Used to Assess Company and Investment Performance* 11.
[927] Kay Review para. 11.10.
[928] ibid, para. 11.11.
[929] ibid.
[930] High Pay Centre, *Executive remuneration in the FTSE 350: A Report* 7.

findings suggest that directors were not in fact paid for their performance and were not only rewarded when there was clear evidence of corporate improvement or returns to shareholders.[931] Indeed, the research by the High Pay Centre suggests 'there is either no relationship or at best a weak link between directors' pay and performance.'[932] The report of the High Pay Centre from May 2015 repeats the criticism of the current performance-related pay system in the UK and, among other things, points out that '[t]he designated performance measures do not always align with the long-term interests of the company and can create perverse incentives.'[933]

The reform of executive remuneration

In order to tackle all these problems related to remuneration, the Kay Review recommended the following reform:

> Companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business. [934]

The aim of the changes suggested by the Kay Review was to align any bonuses paid to the executives to the performance of the company in the long-term and it was also stressed that '[r]ewards should reflect long-term value creation rather than the amount or volume of transactions.' [935] The UK Government rejected the proposals; arguing that the changes suggested by the Kay Review:

> [S]hould be achieved by promoting the development of good practice by companies, rather than by mandating a particular structure of company directors' remuneration packages. Companies and their shareholders should be given the flexibility to negotiate remuneration structures that work for the specific circumstances of the company.[936]

Therefore, even if the Government is in favour of long-term performance related incentives, it is unlikely that the UK will impose the long-term performance incentives in the form of

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[931] ibid.
[932] ibid 49.
[933] High Pay Centre, *No Routine Riches* 8.
[934] Recommendation 15, Kay Review para. 11.12.
[935] Kay Review 79,
[936] BIS, *Building a Culture of Long-term Equity Investment, Implementation of the Kay Review Progress Report* (2014) 42 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367070/bis-14-1157-implementation-of-the-kay-review-progress-report.pdf> accessed 3 November 2015.

mandatory regulation or include non-mandatory provisions to relate incentives to long-term performance in the Companies Act 2006 (as has happened in Germany) or the UK Code.

Instead, the reform of the remuneration system in the UK has taken the following path. In 2013, the directors' remuneration report of quoted companies was amended[937] and the UK Code was also changed in 2014 regarding the remuneration policies of executives.[938] It is claimed that the aim of these recent amendments – which are analysed below – was to change the prevailing corporate culture and that they are focused on 'boosting transparency' and accountability to shareholders.[939] Unfortunately, it was neither explained what should be the direction of this new corporate culture, nor how the development of good practice should happen.

According to the new rules, the directors' remuneration report consists of the annual report on remuneration and the directors' remuneration policy.[940] The annual report on remuneration sets out how the remuneration policy was implemented in the previous financial year and contains details of not only the single total figure of remuneration for each director but also a reference to all of the actual payments made to directors.[941] As previously mentioned this part of the report must be produced annually and is subject to an advisory, i.e. non-binding vote by shareholders.[942] The new part of the report, i.e. the directors' remuneration policy, describes the components that must be included in the directors' remuneration report.[943] Importantly, the policy must indicate how the components support the short and long-term objectives of the company, the maximum that may be paid in respect of that component, a description of the framework used to assess performance (which includes among other things details of any performance period).[944] The remuneration policy is subject to a binding vote by shareholders at least every three years.[945] Hence, by virtue of the new remuneration policy, a mandatory 'say on pay' rule has been adopted in the UK. It should be also stressed that the remuneration report overlaps with the Listing Rules of the Financial Conduct Authority, as according to the latter there is a requirement imposed on the

[937] In the UK, the board of directors of a quoted company has a duty to prepare and approve an annual remuneration report for each financial year. See: ss 420-422A, s 439-439A CA 2006 (after the changes made by ss 79-82 of the Enterprise, Regulatory Reform Act 2013 c 24) and the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (SI 2013/1981)) (henceforth: 'Large and Medium-sized Companies and Groups Regulations 2013').
[938] Principle D.1 UK Code.
[939] BIS, *Building a Culture of Long-term Equity Investment* 42.
[940] See especially Part 3 and Part 4 Large and Medium-sized Companies and Groups Regulations 2013.
[941] Schedule 8, Part 3 ibid.
[942] s 439 CA 2006.
[943] Schedule 8, Part 4 Large and Medium-sized Companies and Groups Regulations 2013.
[944] ibid Schedule 8, Part 4, s 26.
[945] s 439A CA 2006.

company to obtain shareholder approval for any long-term incentive scheme in which a director is eligible to participate.[946] A recent Deloitte report found that in 2014, 79% of companies in the FTSE 100 received more than 90% of votes in favour of their annual remuneration report, with 83% having over 90% in favour of the policy report.[947] The figures from 2013 show that the support for the remuneration report was slightly higher and it amounted to 80%.[948] This high support of the executive's remuneration questions whether 'say on pay' will be an effective tool in regulating remuneration. It is also questionable whether any reduction of remuneration will always incentivise long-term performance, as shareholders might use remuneration to put pressure on the board to support their (sometimes short-term) aims.

Furthermore, in the 2012 UK Code it has been recommended that remuneration should be related to executive performance: '[a] significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.[949] The 2014 UK Code goes even further in promoting long-termism and underlines the link between remuneration and the long-term success of the company: '[e]xecutive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied.'[950]

Thus, in theory at least, a shift towards remuneration focused on the long-term success of the company can be observed. However, on examining the practice, the message is rather mixed, at least according to a Deloitte report and a High Pay Centre report. The Deloitte report on FTSE 100 directors indicates, on the one hand, that companies are currently trying to better connect the interests of directors and shareholders by stronger emphasis of the long-term aims, increasing the shareholding requirements and simplifying the remuneration structures.[951] Moreover, further advantages are listed, e.g. more than a

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[946] Listing Rule 9.4.
<https://fshandbook.info/FS/html/handbook/LR/9/4> accessed 29 June 2015.
[947] Deloitte, *Your Guide – Directors' remuneration in FTSE 100 companies* (2014)
<http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/tax/deloitte-uk-ftse-100-overview.pdf> accessed 20 March 2015.
[948] Deloitte Press Release: *FTSE 100 companies respond to new disclosure regulations and voting regime* (4 September 2014)
<http://www.deloitte.com/view/en_GB/uk/news/news-releases/61d4c8e00da38410VgnVCM3000003456f70aRCRD.htm> accessed 20 March 2015.
[949] Principle D.1 UK Corporate Governance Code September 2012, Financial Reporting Council
<http://www.slc.co.uk/media/5268/uk-corporate-governance-code-september-2012.pdf> accessed1 October 2015.
[950] Principle D.1 UK Code.
[951] Deloitte Press Release: *FTSE 100 companies respond to new disclosure regulations and voting regime.*

third of FTSE 100 companies have implemented new LTIPs 'in the past 12 months, which is more than at any time in the last ten years.'[952] More than 75% of FTSE 100 companies have amended remuneration arrangements: 'in over a quarter of performance share plans, the participants will not receive any shares for five years,' 'a quarter of companies have increased the shareholding required by directors' and 'a third of companies did not increase salaries for chief executive directors.' [953] On the other hand, it was noted that many companies still decide 'to base their performance-related-pay on earnings-per-share performance (and other stock market related measures), rather than on strategic performance goals' which can result in focusing solely 'on the short-term share price rather than long-term value creation.' [954]

A High Pay Centre report from May 2015 is even more critical and suggests the abolition of performance-related pay, since it concentrates too much on short-term share price gains. [955] This report recommends the abolition of the LTIP (as they are 'one of the main vehicles for unearned executive payments'),[956] abolition of share-based awards with payments only of cash awards,[957] and the targeting of a broader range of company-specific targets, with a particular emphasis on productivity. [958]

Conclusions

Overall, it is difficult to state whether the new remuneration report and the changes in the UK Code will encourage, as the Government anticipates, 'companies and their shareholders to agree simpler pay structures which are more clearly linked to long-term performance.'[959] The Code certainly makes an explicit correlation between remuneration and the long-term success of the company. However, it must be stressed that the Code operates on a 'comply or explain' basis and the incentives designed to promote the long-term success of the company (whatever this means) can be easily avoided. Moreover, the Code is applicable only to public listed companies and therefore the application of this provision is rather limited. Regarding the new remuneration report it is likely that it will improve transparency regarding executive remuneration and should help to avoid unreasonable increases in executive pay (due to the requirement of public disclosure of the report). Nonetheless, its influence on incentivising long-term decision-making is less clear. Admittedly, the whole report refers on numerous

[952] ibid.
[953] ibid.
[954] BIS, *Building a Culture of Long-term Equity Investment* 46.
[955] High Pay Centre, *No Routine Riches* 35.
[956] ibid.
[957] ibid 36.
[958] ibid.
[959] ibid 42.

occasions to the performance measures used in assessing remuneration,[960] but the performance periods may vary as it is not stipulated that they must be long-term orientated.[961]

At a more general level, it remains to be seen whether these recent changes will change corporate culture and will contribute to incentivising sustainable long-term business performance. It will definitely not be a rapid process, if at all successful. The flexibility retained by companies, with regard to the shaping of executive remuneration, is on the one hand to be welcomed, as it allows the adaptation of incentives to the company's situation. On the other hand, as was stated above, it also provides some leeway to bypass the requirement of linking remuneration to long-term performance. Further, the above research shows that LTIPs are extremely controversial and there is no agreement as to whether they have a positive impact on the company. Finally, the current regulation of remuneration in the UK is very complex and difficult to penetrate, which makes it less accessible. Transparent, clear and coherent regulation of executive remuneration where the variables would be better linked to long-term performance would be beneficial.

2.4 Delaware

Current regulation of executive remuneration, including remuneration packages

In general, executive remuneration (in the US referred to as executive compensation) is divided into three groups. Firstly, 'salary and benefits that do not depend on the firm's performance,' secondly, bonuses and other incentive-based 'compensation that (…) [are] based on the firm's performance according to specified accounting metrics,' and finally, stock options and other incentives that are 'based on the performance of the firm's stock price.'[962]

It is the final category in the preceding sentence that has been the focus of the current reforms on remuneration. Performance-linked incentives (stock options and the like) are believed to contribute towards the alignment of manager and shareholder interests, and for the company it is also the most reasonable way of compensating managers, as they are only paid for their performance.[963] The first category, salary and other fixed parts of the remuneration, does not serve that aim, because managers compensated on a fixed basis would rather prefer to reduce risk, as 'they will value preservation of assets over the creation

[960] See i.e.: ss 21, 26, 27, 44 Large and Medium-sized Companies and Groups Regulations 2013.
[961] ibid Schedule 8, Part 4, s. 26 (d).
[962] Bainbridge, *Corporate Governance after the Financial Crisis* 113.
[963] ibid 113-114.

of new wealth.'[964] Moreover, accounting metrics do not seem to be an appropriate tool for incentivisation of senior managers as they can be manipulated by the choice of accounting techniques.[965] To illustrate briefly changes in the US executive compensation packages, the analysis of the CEOs' executive compensation packages of the S&P 500 companies[966] shows that in 2008 salary constituted 17% of total compensation, bonuses amounted to 21%, options[967] 25%, stock[968] 32% and other components 5%.[969] In comparison, in 2012 salary declined to 12%, bonuses increased to 23.3%, options declined to 17.9%, stock increased to 40.5% and other components declined to 4.3%.[970]

Linking executive compensation with long-term performance

Among other reform proposals, long-term performance related incentives are advocated in the literature. Indeed, this is the most prominent concept in the context of this thesis. Bebchuk & Fried are the most outspoken proponents of this concept and they have presented it in various papers, focusing on one particular form of performance related incentives, i.e. equity based compensation.[971] They argue that such incentives should be linked with long-term performance,[972] i.e. maximising the long-term value of the company rather than the short-term price.[973] Their research concentrates on the compensation of top executives only.[974] Eight principles for tying equity compensation to long-term performance were suggested by these authors.[975] For instance: executives should be 'blocked' from unloading restricted stock and options for a specific time after they vest but the unwinding should not be tied to retirement. All equity-based incentives should also be subject to the aggregate limitations suggested by the authors and the timing of the equity awards should not be discretionary. These structures and arrangements were suggested to avoid speculations with respect to equity-based awards. Finally, a prohibition on hedging[976] and derivative

[964] ibid 113.
[965] ibid.
[966] A stock market index of the 500 large companies in the US made by Standard & Poor's.
[967] The grant-date values of option grants (calculated using the Black-Scholes).
[968] The fair market value of restricted stock.
[969] Carola Frydman, Dirk Jenter, 'CEO Compensation' (NBER Working Paper No 16585, 2010) 44 <http://www.nber.org/papers/w16585 > accessed 10 September 2015.
[970] Martin Conyon, 'Ececutive Compensation and Board Governance in US Firms' (2014) 124 EconJ F60, F72.
[971] The most common examples of equity-based compensation are stock options.
[972] See i.e.: Lucian Bebchuk, Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2004) Chapters 14 and 16.
[973] Bebchuk, Fried, 'Paying for Long-Term Performance' 1922; Lucian Bebchuk, Jesse Fried, 'How to Tie Equity Compensation to Long-Term Results' (2010) 22 (1) JACF 99, 99.
[974] Bebchuk, Fried, 'Paying for Long-Term Performance' 1921.
[975] They are all to be found in the appendix – Bebchuk, Fried, 'Paying for Long-Term Performance' 1958-1959.
[976] Investing in two securities with negative correlations.

transactions[977] that could reduce or limit the beneficial incentive effects of long-term equity based plans has been suggested.[978]

One of the difficulties with these proposals is that it is far from certain whether long-term performance related incentives have any practical relevance or are likely to become more widespread, as the executives are not obliged by the law to follow them. The 2014 Investor Responsibility Research Center Institute ('IRRCi') Research Report shows, that issues other than longer-term performance; i.e. 'the role, the size of the company and existing pay policies' influence executive remuneration.[979] Research on S&P 1500 companies[980] indicates that fewer than a quarter of these companies apply performance measures and/or economic profit in long-term incentive plan design and three years or less is the longest accountable rolling performance period for 90% of executives.[981] According to the report:

> This short-term outlook risks losing sight of the factors that will determine future value, such as investment into research and development, innovation and human capital, which can take more than three years to fully impact sales, economic profit growth and return on invested capital.[982]

Executive compensation in the US is not only subject to regulation at the state level but also in terms of federal securities laws. In general, companies have a lot of freedom in shaping executive remuneration. In the *Disney* case,[983] the Delaware Court of Chancery refused to overturn an extremely high severance package, focusing in the judgment on directors' duties and the process of establishing the compensation rather than its amount. Thus, it is unlikely that any advice regarding the structure and shape of executive compensation or encouragement towards performance related incentives will be found in the case law. Not going into much detail, the current legislative reform at the federal level focuses mainly on the improvement of disclosure and transparency rules regarding executive compensation

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[977] A security whose price is dependent upon or derived from one or more underlying assets. It could be used as an instrument to hedge risk, but also for speculative purposes.
[978] Bebchuk, Fried, 'Paying for Long-Term Performance' 1956-1959.
[979] IRRCi Research Report, '*The Alignment Gap Between Creating Value, Performance Measurement, and Long-Term Incentive Design'* (2014) 64 <http://irrcinstitute.org/wp-content/uploads/2015/09/alignment-gap-study1.pdf> accessed 3 November 2015.
[980] A stock market index of the 1500 top companies in the US made by Standard & Poor's. It covers 90% of market capitalisation in the US.
[981] IRRCi Research Report, *The Alignment Gap* 64.
[982] ibid 64.
[983] *Re Walt Disney Company Derivative Litigation* 907 A.2d 693 (DelCh 2005). This judgment was affirmed by the Delaware Supreme Court – *Re Walt Disney Company Derivative Litigation* 906 A.2d 27 (Del 2006).

rather than incentivising long-term performance. The 2010 Dodd-Frank Act imposes requirements regarding executive compensation;[984] however, not all of the provisions have been implemented so far.[985] Section 951, already in force, introduced for instance an advisory 'say on pay' shareholder vote on executive compensation that should happen at least every three years. In general, the effectiveness of 'say on pay' is also disputed in the US. Bainbridge, for instance, argues that as the requirement of shareholder approval is non-binding and the managers will be protected by the business judgment rule, this concept is likely to be of minimal effect.[986] Thus, its contribution towards limiting the level of remuneration is far from certain let alone sufficient to incentivise long-termism. Secondly, s. 952 on the independence of the compensation committee and compensation consultant, was also implemented and this is likely to improve transparency of executive compensation but it is not directly connected with incentivising long-term performance.

Moreover, s. 953 requires disclosure about certain compensation matters, including information that shows the relationship between executive compensation actually paid and financial performance. In addition, s. 953 requires the companies to disclose firstly, the median of the annual total compensation of all its employees except the CEO, secondly the annual total compensation of its CEO and finally the ratio of the two amounts. This 'pay for performance' provision would contribute to aligning executive compensation with the performance of the executives to a significant extent and arguably incentivise long-term performance. Section 953 was the subject of lengthy debates and on 29 April 2015 the Securities Exchange Commission ('SEC') released the proposed rules on pay v. performance for public comments for 60 days.[987] Finally, on 5 August 2015, the SEC voted 3-2 to adopt the pay ratio disclosure rules.[988]

Further, s. 954, prohibits the listing of securities of issuers that have not developed and implemented compensation 'claw-back policies.' On 1 July 2015 the SEC proposed rules and on 5 August 2015 final rules regarding 'claw-back' policies were issued. They

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[984] See s 951-957 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (Pub L 111–203, 124 Stat 1376–2223).
[985] <https://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml> accessed 12 August 2015.
[986] Bainbridge, *Corporate Governance after the Financial Crisis* 135.
[987] <https://www.sec.gov/rules/proposed/2015/34-74835.pdf> accessed 12 August 2015.
[988] Michael Segal, 'SEC Adopts Pay Ratio Disclosure Rules' (Harvard Law School Forum on Corporate Governance & Financial Regulation 6 August 2015) <http://corpgov.law.harvard.edu/2015/08/06/sec-adopts-pay-ratio-disclosure-rules/#more-71343> accessed 12 August 2015; for the dissenting note on this provision see: Michael Piwowar, 'Dissenting Statement on Pay Ratio Disclosure' (Harvard Law School Forum on Corporate Governance & Financial Regulation 5 August 2015) <http://corpgov.law.harvard.edu/2015/08/05/dissenting-statement-on-pay-ratio-disclosure/#more-71325> accessed 12 August 2015.

should be complied with for the first fiscal year beginning on or after 1 January 2017.[989] The aim of s. 954 is to extend the 'claw-back' regime to all executive officers, as currently under the Sarbanes-Oxley Act only the senior executives (the chief executive officer and chief financial officer) are required to return any bonus or other incentive-based or equity-based compensation due to material non-compliance with any federal securities law financial reporting requirement.[990] The provision that is not yet in force is s. 955, which requires companies to disclose whether they permit employees and directors to hedge their companies' securities; however, the Commission proposed implementation of this provision in February 2015.[991] Overall, the full implementation of all provisions of the Dodd-Frank Act is awaited. It is hoped that they will improve transparency regarding executive compensation and that this in turn will contribute towards enhancing accountability to shareholders.[992]

Conclusions

Executive compensation in the United States has underwent some recent reforms, but they are arguably insufficient to incentivise long-term performance. The Dodd-Frank Act has been implemented only partially and as a consequence the transparency of executive compensation has not been enhanced. Managers are also not incentivised to improve their performance as disclosure of the relationship between performance and compensation is not required. This sends a mixed message to the markets and will definitely not contribute towards incentivising long-term performance and leaves a lot of freedom for companies in shaping the compensation. It looks like the idea of tying remuneration with performance has been dropped. It is not argued in this thesis that executive remuneration should be regulated in detail at the federal or state level; rather it is pointed out that in the light of the notorious problems surrounding executive compensation, a consistent and coherent approach from the legislators would be beneficial.

2.5 Summary on executive remuneration

First of all, changes in executive remuneration are on the agenda in the UK, US and Germany. Moreover, it is evident that tying remuneration with long-term performance is

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[989] <https://www.sec.gov/rules/proposed/2015/33-9861.pdf> accessed 12 August 2015; Joseph Bachelder, 'The SEC Proposed Clawback Rule' (Harvard Law School Forum on Corporate Governance & Financial Regulation 28 October 2015) <http://corpgov.law.harvard.edu/2015/10/28/the-sec-proposed-clawback-rule/#more-71803> accessed 30 October 2015.

[990] s 304 Sarbanes-Oxley Act.

[991] <https://www.sec.gov/rules/proposed/2015/33-9723.pdf> accessed 24 March 2015.

[992] Louis Aguilar, 'Aligning the Interests of Company Executives and Directors with Shareholders' (Harvard Law School Forum on Corporate Governance & Financial Regulation February 2015) <http://blogs.law.harvard.edu/corpgov/2015/02/16/aligning-the-interests-of-company-executives-and-directors-with-shareholders/#more-68331> accessed 2 March 2015.

advocated in all jurisdictions under review, despite the differences in corporate objectives or share ownership structure. Thüsing and Forst pointed out in 2010 (even before the introduction of some the recent reforms) that discussion on remuneration in the US, Germany and the UK is very similar. Although Germany discussed remuneration in the context of sustainability, the literature in the US couched its debate in terms of the long-term success of the company, and executive remuneration was in general widely discussed in the UK; the function of each of these debates was the same.[993] According to this thesis, remuneration tied up with the long-term, sustainable development of the company ought to be advocated. As early as 1990 Jensen and Murphy argued that what is important is 'not how much you pay, but how.'[994] Performance orientated remuneration, despite the debates surrounding it, is likely to be more effective than encouraging directors through directors' duties to consider the long-term consequences of their decisions, owing to directors' broad discretionary powers.

Currently, Germany seems to be the most advanced jurisdiction in aligning remuneration with the long-term sustainable development of the company, although these provisions are not mandatory and some weaknesses of the German system have been underlined. On the one hand, this tendency might appear surprising, considering the fact that executive remuneration cannot be viewed here in the context of the vertical agency problem. This confirms the theory put forward in Chapters IV and V above, that Germany is the most long-term orientated among the scrutinised jurisdictions. The recent reforms in the UK (the effects of which are yet to be seen), also show that remuneration is slowly becoming connected to long-term performance. The question that arises is whether the changes in the UK (especially in the UK Code) were inspired or at least influenced by the German solution. It is difficult to answer this question but some similarities are apparent. It is especially evident through the change in wording from: '[a] significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance[995] in the 2012 UK Code, into the requirement under the current UK Code to link the executive remuneration with the 'long-term success of the company.'[996] The latter provision clearly emulates § 87 (1) 2 AktG and 4.2.3 Kodex which recommend linking executive remuneration with the sustainable (i.e. future-centred) growth of the enterprise.

Further, regarding the USA, it is surprising that the legislative intervention aimed at increasing the transparency of remuneration components is the least consistent and effective

[993] Thüsing and Forst, 'Nachhaltigkeit als Zielvorgabe für die Vorstandsvergütung' 515-516.
[994] Micheal Jensen, Kevin Murphy, 'CEO Pay–It's Not How Much You Pay, But How' (1990) 68 HarvBusRev 138.
[995] Principle D.1 UK Code 2012.
[996] Principle D.1 UK Code.

in a country where problems with executive compensation are particularly widespread. Clearly, the US is far behind the other jurisdictions. At a more general level, the improvement of remuneration's transparency is the focus of not only reforms in the US, but also in the UK (i.e. the Large and Medium-sized Companies Regulations 2013[997]). In the US, the discussion of linking remuneration with the long-term success of the company has occurred mainly in the literature. However, this is not enough to incentivise long-term performance and results; a clearer link between remuneration and performance is needed.

Moreover, 'say on pay' is a feature of each of the jurisdictions under review and its main aim is the improvement of accountability of managers to shareholders. The author of this thesis is sceptical if this instrument will solve the remuneration problem and it is especially uncertain (at least at the moment) that it will incentivise long-termism. The evidence available so far shows that shareholders rarely reduce directors' remuneration. Moreover, there is a danger that short-term orientated shareholders who are happy with directors' performance will not want to cut their remuneration, which in turn encourages more short-termism. It is argued that the reform of remuneration should concentrate on changing its structure rather than reducing its amount.

Finally, this section illustrates that changes regarding remuneration are taking place at different levels in the jurisdictions studied. In this section, it was underlined that in Germany the AktG and Kodex were reformed. In the UK, the UK Code was reformed and some statutory changes regarding disclosure requirements were introduced. However, it was argued that in the UK, the incentivisation of sustainable long-term business performance will happen mostly through the creation of a change in corporate culture. It is also difficult to assess the ongoing reform in the US. Since not all relevant provisions of the the Dodd-Frank Act have come into force yet.

3. Quarterly reporting

3.1 Introduction

The previous section discussed the role of executive remuneration in incentivising long-termism and it was argued that each jurisdiction had reformed this field, but from slightly different angles and slightly different approaches. This section will consider the role of quarterly reporting in directors' decision-making. As illustrated below, it is commonly argued that focusing on quarterly profits is one of the key examples of short-term behaviour because if the performance of directors is assessed on a quarterly basis, it is highly likely that

[997] SI 2013/1981.

at least some of them will focus on short-term results. A connection between managers' focus on short-term (quarterly) earnings estimates and a focus by investors on stock prices is evident.[998] Moreover, it is unrealistic to expect boards and management to adopt policies that look to generate long-term economic wealth for shareholders when shareholders are focused primarily on quarterly results and short-term stock price maximisation. On the other hand, Strand argues that the research does not establish a casual connection between the abolition of quarterly reporting and 'an appreciable increase in long-term investment' and that the elimination of quarterly reports results in 'poor prior performance, missing analysts' forecasts, lower anticipated profitability, less informed investors, and more uncertain operating environments.'[999]

This section provides a snapshot of the role of quarterly reporting and the attitude towards it in the jurisdictions under review. Following this, comparative remarks are offered on the role of longer-term reporting in incentivising directors' long-termism and the section concludes by arguing that mandatory quarterly reporting should be abandoned. The topic of quarterly reporting in the context of the law of the UK, Germany and Delaware will now be addressed.

3.2 The UK

Until recently issuers of shares allowed to trade on a regulated market where the UK acts as home Member State were obliged to produce quarterly reports which were called interim management statements ('IMS').[1000] Quarterly reporting was heavily criticised in a 2011 report titled 'A Long-term Focus for Corporate Britain:'

> Quarterly reporting (by both companies and fund managers) was viewed by some respondents as providing little indication of long-term performance. A number of respondents highlighted that a focus by investors upon quarterly reporting encourages short-term behaviour amongst both fund managers and company boards, imposing pressure to perform over the short-term. One respondent viewed the recent focus upon quarterly reporting as a factor leading to increased uncertainty and volatility.[1001]

The Kay Review suggested removing mandatory quarterly reporting,[1002] in order to improve the quality of reporting and '[r]educe the pressures for short-term decision making that arise

[998] Jackson, Petraki, 'Understanding Short-Termism' 22.
[999] Strand, 'Re-thinking Short-termism' 16-17 and the literature cited there.
[1000] Disclosure Rules and Transparency Rules ('DTR') 4.3, Financial Conduct Authority.
[1001] BIS, *Summary of Responses* para. 53.
[1002] Recommendation 11, *Kay Review* 13.

from excessively frequent reporting of financial and investment performance.'[1003] Following the recommendation of the Kay Review and the 2013 EU Transparency Directive, which prescribed abolition of the requirement to publish interim management statements, as they 'encourage short-term performance and discourage long-term investment,' [1004] the UK Government removed the mandatory quarterly reporting requirements.[1005] The necessary changes were introduced by the Financial Services and Markets Act 2000 (Transparency) Regulations 2014.[1006] The DTR 4.3 remained in force until November 2014,[1007] and was removed a year before the deadline established by the 2013 EU Transparency Directive for the implementation of the changes.[1008] However, issuers are still allowed to publish voluntary interim management statements.[1009] According to the UK Government:

> Rigid quarterly reporting requirements can promote an excessively short-term focus by companies, investors and market intermediaries and impose unnecessary regulatory burdens on companies, without providing useful or meaningful information for investors.[1010]

On the whole, the removal of the mandatory quarterly reporting has been welcomed. Such frequent reporting without a doubt is too cumbersome for some companies and diverts the board's attention from longer-term aims and building corporate value. Therefore, companies now have a choice regarding their reporting frequency.[1011]

3.3 Germany

In Germany the Security Trading Act[1012] applies to listed companies 'trading in securities, money-market instruments and derivatives on and off stock exchanges'[1013] and provides that

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[1003] ibid 10.
[1004] Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC of the European Parliament and of the Council, Directive 2003/71/EC of the European Parliament and of the Council and Commission Directive 2007/14/EC (henceforth: 'Directive 2013/50/EU') 1 point 4.
[1005] BIS, *Building a Culture of Long-term Equity Investment* 7.
[1006] Financial Services and Markets Act 2000 (Transparency) Regulations 2014 (SI 2014/1261).
[1007] See: <http://fshandbook.info/FS/html/handbook/DTR/4/3> accessed 1 April 2015.
[1008] See: <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013L0050> accessed 1 April 2015.
[1009] See: <http://www.fca.org.uk/news/firms/ps14-15-transparency-directives-requirement-interim-management-statements> accessed 1 April 2015.
[1010] BIS, *Building a Culture of Long-term Equity Investment* 19.
[1011] See similarly: Allister Heath, 'Short-termism is bad – but so is excessive long-termism' (24 July 2012) <http://www.cityam.com/latest-news/allister-heath/short-termism-bad-so-excessive-long-termism> accessed 1 April 2015.
[1012] *Wertpapierhandelsgesetz* (henceforth: 'WpHG'), 9 September 1998 (BGBl I, 2708).
[1013] § 1(1) WpHG (translation after <http://www.iuscomp.org/gla/statutes/WpHG.htm#1> accessed 1 April 2015.

apart from the annual financial reports (*Jahresfinanzbericht*),[1014] the companies are currently required to provide a half-year financial report (*Halbjahresfinanzbericht*).[1015] Until recently, the companies were also required to issue interim reports (*Zwischenbericht* or *Zwischenmitteilung*).[1016] Interim reports have been required in Germany since the 1960s.[1017] The law regulated interim reports in the following manner: 'a company that issues shares is required to produce an interim report in the period between ten weeks after the beginning and six weeks before the end of the first and second half of the financial year,'[1018] unless the conditions specified in the Security Trading Act are fulfilled and the company is required to produce quarterly reports.[1019]

In general, the reporting requirements are extensive and numerous in Germany and arguably they encourage short-term decision-making. As noted above, the EU Transparency Directive 2013/50/EU requires all Member States to abolish the obligation to publish interim management statements by 27 November 2015. Hence, such requirement to publish interim reporting has been abolished in Germany as of 1 October 2015[1020] and some changes regarding the annual and half year reports were also introduced.[1021] Therefore, it is hoped that the changes prescribed by the Directive, especially the abolishment of interim reporting, will enhance longer-term decision-making.

3.4 Delaware

In the US, quarterly reporting has not been abolished and there are no signs that this will happen in the near future. At present, according to s. 13 of the Securities Exchange Act 1934, a publicly traded corporation is obliged to issue quarterly reports. Quarterly reports in the US are known as a Form 10-Q (whilst an annual report is known as Form 10-K).[1022] It seems that transparency is valued higher in this country than the prospects of longer-term investments, which could take place after prohibiting short-term reporting.

[1014] See: § 37v WpHG (my translation).
[1015] § 37w ibid.
[1016] § 37x ibid.
[1017] For the history of the interim reports consult (only in German): Nadja Kiehne, *Zur Entscheidungsnützlichkeit von Zwischenberichten: Eine kritische Würdigung vor dem Hintergrund der IFRS-Rechnungslegung und der aktuellen Corporate Governance* (Springer Fachmedien Wiesbaden 2012).
[1018] § 37x (1), (2) WpHG (my translation).
[1019] § 37x (3) ibid.
[1020] Art. 1, para. 27 *Gesetz zur Umsetzung der Transparenzrichtlinie-Änderungsrichtlinie*, 1 October 2015 (the Act on the implementation of the Directive 2013/50/EU)
[1021] Art. 1, paras 25, 26 the Act on the implementation of the Directive 2013/50/EU.
[1022] See: the SEC, *Division of Corporate Finance: Financial Reporting Manual* (12 Jan 2015) para. 1320.2 <http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf> accessed 2 April 2015

However, it is not the quarterly reporting itself, but quarterly earnings guidance that is a main source of controversy in the USA. Quarterly earnings guidance is usually included in a quarterly report and this is a way of informing shareholders about the forecasted performance of the corporation. The practice of issuing quarterly earnings guidance 'began in the early 1990s in response to demands from institutional investors and research analysts for increased discipline and corporate transparency.' [1023] Lipton et al. highlight that shareholders are simply given an opportunity to put short-termist pressures on the board and demand 'unsustainable ever-increasing (quarterly) earnings growth.'[1024] Moreover, focusing on quarterly results might be tempting as 'more immediate time horizons are more predictable and therefore perceived as less risky' from a managers' perspective. [1025] Introducing laws to end the practice of quarterly earnings guidance, with a refocusing on annual earnings guidance has been on the agenda since the mid-2000s. [1026] The National Investors Relations Institute for instance notes that in 2007, of the companies providing earnings guidance, more companies reported providing annual estimates (58%) than quarterly estimates (27%).[1027] Reforming quarterly earnings guidance is listed as one of the useful remedies for excessive short-termism. [1028] Importantly, managing for short-term earnings was criticised as decreasing shareholder value. Rappaport argues for instance that maximising long-term cash flow is the most effective means of creating value for continuing shareholders[1029] and that '[s]acrificing the company's long-term prospects to meet quarterly earnings expectations in an attempt to temporarily boost the stock price represents the antithesis of sound shareholder-value management.'[1030] Further, some commentators even link the collapse of Enron to an undue focus on quarterly earnings statements.[1031]

Eliminating quarterly earnings guidance has the potential to affect decision-making by decreasing the pressure to concentrate on short-term earnings. At the same time, it has also been observed that refocusing on annual earnings guidance is likely to be a long process.[1032] The CFA Institute even defines short-termism as focusing excessively 'on short-term,

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[1023] Lipton, Rosenblum and Cain, 'Some thoughts for Boards of Directors' 2.
[1024] Martin Lipton, Theodore Mirvis & Jay Lorsch, 'The Proposed Shareholder Bill of Rights Act of 2009' (Harvard Law School Forum on Corporate Governance & Financial Regulation 12 May 2009) <http://blogs.law.harvard.edu/corpgov/2009/05/12/the-proposed-%e2%80%9cshareholder-bill-of-rights-act-of-2009%e2%80%9d> accessed 30 March 2015.
[1025] Helms, Fox and Kenagy, 'Corporate Short-termism' 47.
[1026] ibid 50.
[1027] NIRI Issues Results of 2007 Earnings Guidance Practices Survey (News release 17 July 17 2007) <http://www.niri.org/other-content/pressreleases/070717earningsguidance.pdf> accessed 3 April 2015.
[1028] Lydenberg, 'Long-term Investing' 47.
[1029] Rappaport, 'The Economics of Short-Term Performance Obsession' 69.
[1030] ibid 72.
[1031] Duruigbo, 'Tackling Shareholder Short-Termism' 531.
[1032] Helms, Fox and Kenagy, 'Corporate Short-termism' 51.

quarterly earnings and a lack of attention to the strategy, fundamentals and conventional approaches to long-term value creation.'[1033] In their report, they recommend ending the practice of providing quarterly earnings guidance:

> The widely held consensus of the Panel is that publicly traded companies should end the practice of providing quarterly earnings guidance. The Panel believes that such guidance inadequately accounts for the complex dynamics of companies and their long-term value drivers.
>
> By proactively moving to change a culture that has become overly obsessed with meeting a quarterly earnings number, companies would also motivate analysts to effectively differentiate themselves and their analyses, thereby encouraging a long-term outlook by both the institutional and individual investment communities.[1034]

In this thesis, it is argued that the quarterly earnings guidance culture inevitably leads towards a shorter-term investment horizon. Not everyone agrees that terminating the practice of publishing quarterly earnings guidance will encourage a more long-term approach to investments. The research conducted by Houston et al. suggests that managers tend to cite the reduction of short-term decisions as a reason for stopping quarterly earnings guidance. However, it is argued that the main motive is actually poor operating performance.[1035] In addition, some research suggests the cessation of the publication of quarterly guidance does not increase the 'total long-term investments in capital expenditure and R&D,' although it has been noted that there is 'some tentative evidence of an R&D increase for a subsample of firms.'[1036] Similarly, the findings of the research conducted by Chen et al. demonstrates that managers decide to stop giving quarterly earnings guidance when they do not have positive news to share. Moreover, they point out that despite the criticism of this institution, relatively few firms decided to discontinue earnings guidance and that this has occurred only when the decision was beneficial to them.[1037]

To sum up, it is argued that voluntary quarterly reporting would be much more appropriate meaning that companies would be allowed to produce regular reports and at the same time, they would be given an opportunity to tailor the reporting towards their individual needs. For example, some firms might choose longer-term horizons, which leads towards the making of decisions with a more long-term perspective. Finally, voluntary

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[1033] CFA Institute, *Breaking the Short-Term Cycle* 4.
[1034] ibid 7.
[1035] Joel Houston, Baruch Lev, Jennifer Tucker, 'To Guide or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance' (2010) 27 (1) CAR 143, 144, 179.
[1036] ibid 179.
[1037] Shuping Chen, Dawn Matsumoto and Shiva Rajgopal, 'Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance' (2011) 51 JAccEcon 134, 149.

quarterly reporting contributes towards the curtailment of the significance of quarterly earnings statements.

3.5 Summary on quarterly reporting

In general, quarterly reporting and quarterly earnings guidance are very controversial concepts and generate lively debate. Mandatory quarterly reporting is prohibited in the UK and since recently also in Germany. In the US, there is an on-going discussion about the role and function of quarterly earnings guidance but quarterly reporting is not challenged. Whilst the research presented above indicates that there is no clear connection between on the one hand, the abolition of quarterly reporting or the cessation of the practice of quarterly earnings guidance and, on the other hand, the generation of an appreciable increase in long-term investment strategies, it is striking that if a company wishes to create and achieve longer-term goals, focusing less on quarterly reporting[1038] will be only beneficial.

4. Board tenure

4.1 Introduction

The extent to which executive remuneration and quarterly reporting ensures that directors take decisions which are in the long-term interest of the company has been analysed so far in this chapter. In this section, another incentive that is said to encourage long-term behaviour by managers is subjected to scrutiny. The length of directors' tenure in the context of directors' decision-making and consideration of the long-term interests of the company is crucial, although clearly under-researched in comparison to the other incentives presented earlier in this chapter. Directors with shorter tenures who wish to secure an extension to their service contract are more likely to invest in short-term projects in order to ensure that the effects of their management approach are discernible during their time in office.[1039] Jackson and Petraki argue that short board tenure may not only be associated with high job turnover, but that it may also enhance uncertainty and focus managers on short-term goals, even if contracts are renewed regularly.[1040] Hence, from this perspective, directors with longer tenures are less prone to short-term pressures and more likely to invest in some long-term projects. This section summarises briefly the length of the manager's tenure in the jurisdictions under review and argues that service for a period in excess of one year is

[1038] See similarly: Helms, Fox and Kenagy, 'Corporate Short-termism' 45.
[1039] Jackson, Petraki, *Understanding Short-Termism: the Role of Corporate Governance* 25.
[1040] ibid.

necessary to incentivise longer-term decision-making. The position in the UK, Delaware and Germany are now analysed in turn.

4.2 The UK

The Companies Act 2006 does not discuss the length of a director's tenure on the board. The company in its articles of association can decide this matter individually. As discussed in Chapter II, the Model Articles for Public Companies provide only that '[a]t the first annual general meeting all directors must retire from office.[1041] Moreover, a public company may incorporate retirement by rotation, which stipulates that one-third of directors must retire on an annual basis. They are entitled to seek subsequently re-election as a director:

> At every subsequent annual general meeting any directors—
> (a) who have been appointed by the directors since the last annual general meeting, or
> (b) who were not appointed or reappointed at one of the preceding two annual general meetings, must retire from office and may offer themselves for reappointment by the members. [1042]

The lack of mandatory provisions suggests that companies have considerable freedom to shape the length of the appointment of a director. However, all directors of companies listed on the London Stock Exchange who must comply with the UK Code 'should be submitted for re-election at regular intervals, subject to the achievement of continued satisfactory performance.'[1043] The UK Code also requires annual election by shareholders of all directors of FTSE 350 companies and states that '[a]ll other directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter at intervals of no more than three years.'[1044] It is quite clear that the UK Code favours very frequent elections, especially for FTSE 350 companies. Such an approach definitely has its strengths; it enhances the board's accountability towards the company's shareholders. On the other hand, short appointments might contribute to short-term thinking on the part of the board. As was underlined in Chapter V above, managing for the long-term might be 'antithetical to the interests of the manager' who only has 'a temporary interest in the company,'[1045] who, for instance, is in office only for a year. Keay rightly points out that

[1041] Art 21 (1) Model Articles.
[1042] Art 21 (2) ibid.
[1043] B.7 Main Principle UK Code.
[1044] B.7.1 ibid.
[1045] Keay, 'The Global Financial Crisis' 24.

'if executive directors look to the long term they may feel that they are not likely to gain any praise or benefits from enriching the company.'[1046]

Therefore, it is argued that directors should be elected for periods longer than one year (at least two years in a row would be optional) to encourage a more long-term approach towards their decision-making. Overall, if the company is not satisfied with the director's performance, he can be removed (as only an ordinary resolution is needed) by shareholders before his period of office expires.[1047]

4.3 Delaware

According to the DGCL directors must be elected annually[1048] and '[e]ach director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal.'[1049] The board of directors may, but does not have to, be divided into one, two or three classes (so called 'staggered boards'); § 141 (d) DGCL provides that

> [T]he term of office of those of the first class to expire at the first annual meeting held after such classification becomes effective; of the second class 1 year thereafter; of the third class 2 years thereafter; and at each annual election held after such classification becomes effective, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire.

Consequently, a member of a staggered board cannot serve longer than three years and a member of a non-staggered board no longer than a year. However, directors might be re-elected, as the law does not provide any board term limits in this respect. The number of terms that a director may serve is vigorously debated in the US. Katz and McIntosh argue that in the USA 'regulators have wisely refrained from adopting guidelines regarding director tenure.'[1050]

Historically long tenure is perceived as 'an asset to board effectiveness and a feature that goes hand-in-hand with solid corporate performance and good management,'[1051] as building up knowledge about a company's affairs undeniably takes time. On the other hand, longer tenure might be seen as an obstacle to board diversity (Katz and McIntosh are

[1046] Keay, 'Getting to Grips with the Shareholder Value Theory' 373.
[1047] s 168 (1) CA 2006.
[1048] § 211 (b) DGCL.
[1049] § 141 (b) DGCL.
[1050] David Katz, Laura McIntosh 'Renewed Focus on Corporate Tenure' (The Harvard Law School Forum on Corporate Governance and Financial Regulation 22 May 2014) <http://blogs.law.harvard.edu/corpgov/2014/05/22/renewed-focus-on-corporate-director-tenure/> accessed 4 April 2015.
[1051] ibid.

sceptical whether this is really accurate)[1052] or to board independence. Roe suggests that not only CEOs – who are still the most important decision makers in the company, but also senior managers are likely to favour projects that produce results during their tenures rather than in the longer-term.[1053] It is pertinent to note that this reasoning applies to all managers; hence, longer tenure enhances the chances of making longer-term decisions. Further, as the average tenure of S&P 1500 directors was 10.8 years in 2013 (an increase from 10.3 years in 2012),[1054] their terms in office are long anyway.

It is argued in this thesis that longer terms in office – rather than annual re-election – should be advocated in Delaware and in general in the USA. The extension of the particular tenure will not make a huge difference, as in practice directors tend to stay in office for longer than a year. The longer terms in office are likely to have positive long-term consequences (i.e. if not chosen every year, directors will be subjected to fewer pressures to present short-term results) and in general would contribute towards longer-term decision-making in the companies. There is a support for this opinion in the literature as well. For instance, Lipton et al. argue that '[q]uinquennial rather than annual or triennial elections of corporate board members should be revisited.'[1055]

4.4 Germany

In Germany, the length of a director's tenure is also likely to influence the decision-making process, although the agency conflicts, which occur in Germany are not between the board and shareholders as a whole but mostly between minority and majority shareholders.[1056] Nevertheless, the management board is still responsible for the management of the company in Germany and longer periods of appointment are likely to incentivise them towards the taking of a longer-term approach. The supervisory board appoints the members of the management board 'for a period not exceeding five years.' The legislation is clear that 'appointment may be renewed or the term of office extended, provided that the term of each such renewal or extension does not exceed five years.[1057] The appointments for periods longer than a year are clearly allowed; thus, the supervisory board is strongly encouraged to propose such longer tenures.

[1052] ibid.
[1053] Roe, 'Corporate Short-Termism – In the Boardroom and in the Courtroom' 980, 996.
[1054] Katz, 'Renewed Focus on Corporate Tenure.'
[1055] Lipton, Mirvis and Lorsch, 'The Proposed Shareholder Bill of Rights Act of 2009.'
[1056] Chapter V s 1 above.
[1057] § 84 (1) 1, 2 AktG.

4.5 Summary on board's tenure

The aim of this section was to show that lengthening the period of appointment of directors is a relatively easy tool (compared to, for example, the reform of executive remuneration) that would strongly incentivise directors towards long-term performance. It is difficult to argue against Jackson and Petraki's position that:

> Longer contract duration may be one device in establishing a long-term bond between the company and the individual by providing job security and appreciation. More generally, it is also crucial to provide career pathways within the company structure so as to fulfil the professional ambition of managers throughout different stages of their career.[1058]

In general, managers should stay in office for at least two years; rather than be re-elected on an annual basis. A period of service of one year is insufficient, because then directors are more concerned with renewing their contracts than with the long-term development of the company. At the same time, a longer term in office does not preclude the early termination of a director's service contract if he does not fulfil his duties properly. Currently, only German law allows for a director's term in office to be longer than a year; as in Delaware directors in a non-staggered boards must be elected annually and in the UK the Code requires the directors of the FTSE 350 companies to be re-elected annually.

5. The role of shareholders

5.1 Introduction

Three factors presented so far have explored how managers can be incentivised to take decisions, which are in the long-term interests of their appointee companies. Managers have the legal authority to bind the company in contract and as such, the time horizons involved in the decisions they take on its behalf are paramount. However, the position of shareholders and their objectives are also vital in this process, as they might pressurise the board and demand short-term or long-term results. A number of commentators agree that shareholders influence management's decision-making.[1059] Apart from this general consensus, there is no

[1058] Jackson, Petraki, 'Understanding Short-Termism' 53.

[1059] See i.e.: ibid 26ff; Paul Rose and Bernard Sharfman, 'Shareholder Activism as a Corrective Mechanism in Corporate Governance' (Ohio State Public Law Working Paper No. 225 2013) 31ff, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2324151> accessed 9 July 2014; Stephen Bainbridge, 'Preserving Director Primacy by Managing Shareholder Interventions' (UCLA School of Law Law-Econ Research Paper No. 13-09 2013) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2298415> accessed 16 April 2015; Bebchuk, 'The Myth that Insulating Boards Serves Long-Term Value'; Paul Davies, 'Shareholders in the United

agreement in the literature and not enough empirical evidence to state unequivocally whether any particular shareholder preference (i.e. long-term or short-term shareholders) or any form of shareholder engagement in the running of the company (also called shareholder activism or shareholder empowerment) contributes towards the long-term development of a company.

The aim of this section is to highlight the influence of shareholders on the decision-making processes of the board and to this end, a few important debates are briefly scrutinised (as they are far too complex to be presented in detail). This section is structured as follows. Firstly, the role of the shareholders in promoting long-term decision-making under UK and Delaware (or actually broader under US) law will be presented jointly, as they face similar challenges due to the dispersed nature of share ownership in these jurisdictions.[1060] Secondly, the role of shareholders under German law is presented. Finally, some comparative reflections are offered.

5.2 The UK and Delaware

The study on the role of shareholders in influencing board decision-making in the UK and USA requires the analysis of the discussion on long-term v. short-term shareholders, the importance of institutional investors in these two jurisdictions and the role of shareholder activism. These notions will be presented in turn here.

5.2.1 Long-term and short-term shareholders

In general, shareholders' preferences are divided into the long-term or short-term. Shareholders that are focused on short-term profits are frequently called traders or short-term shareholders, as opposed to long-term shareholders who invest in the company for longer periods.[1061] However, it is not clear when a shareholder can be treated as a long-term shareholder. For instance, the Rock Centre Research notes that long is at least 2.8 years. [1062]

Kingdom' (European Corporate Governance Institute (ECGI) - Law Working Paper No. 280/2015) <http://ssrn.com/abstract=2557680> accessed 16 April 2015.

[1060] See: Chapter V s 1 above. Nonetheless, it should be pointed out that the position in these common law jurisdictions is not identical i.e. there are differences in proxy rules as explained by: Bonnie Buchanan, Tina Yang, 'A Comparative Analysis of Shareholder Activism in the US and UK: Evidence from Shareholder Proposals' (2008) <http://www.researchgate.net/publication/228452719_A_comparative_analysis_of_shareholder_activism_in_the_US_and_UK_Evidence_from_shareholder_proposals> accessed 16 April 2015. Furthermore, traditionally shareholders in the UK are perceived to be more powerful than in the US: see the discussion in Chapter V and especially: ss 2.1.2 and 2.1.3 above; and also Alan Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' (2013) 36 Seattle U L Rev 639, part III and 689-690.

[1061] Jackson, Petraki, 'Understanding Short-Termism' 29-30.

[1062] Anne Beyer, David Larcker and Brian Tayan, 'Does the Composition of a Company's Shareholder Base Really Matter?' (Rock Centre for Corporate Governance, Stanford Closer Look Series – CGRP 42, 2014) 2

The Kay Review observed that the existence of short-term shareholders in the market in itself does not constitute evidence of damaging short-term behaviour, as it is outcomes and not processes that are important.[1063] There seems to be no compelling reason to disagree with this statement that neither short-term nor long-term shareholders are positive or negative; the crucial issue is whether and how they influence decision-making in the corporation.

The common belief is that long-term shareholders are more likely to support and encourage long-term decision-making, thus, they should be favoured by the company.[1064] In principle, it is difficult to disagree with Strine who points out that it is not reasonable to expect a company to be focused on long-term performance if the investors who determine the fate of their managers are not themselves long-term orientated.[1065] In this vein, short-term shareholders are frequently accused of influencing directors to focus their decision-making process on decisions that guarantee short-term gains, because the main purpose of the investment for the traders is to make profit (and trading is characterised by a preference for exit in case of company's decline);[1066] whereas 'the shareholders many of whose holding remain largely stable over time are interested in a company's sustained prosperity.'[1067] Long-term shareholders are sometimes referred to as owners as they have some strategic motivations in exercising control over company decision-making ('such as in the context of restructuring, family control, inter-firm business networks') – they prefer to exercise their voice rather than leave the company.[1068] Therefore, de facto they are interested in longer-term gains and the long-term development of the company.

Nevertheless, not everybody agrees that long-term shareholders are a guarantor of long-term value maximisation. Fried, for instance, suggests that in a non-transacting firm – i.e. a firm, which does not repurchase its own shares – it is more profitable over time if managers decide to serve long-term, rather than short-term, shareholders.[1069] However, at the same time he stresses that this norm favouring long-term shareholders over the short-term is far from

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<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2474792> accessed 16 April 2015.

[1063] Kay Review para. 1.5

[1064] Tamara Belifanti, 'Shareholder Cultivation and New Governance' (2014) 38 DelJCorL 790; Jesse Fried, 'The Uneasy Case for Favoring Long-Term Shareholders' (2015) 124 YaleLJ1554, 1567- 1575 and the literature cited there.

[1065] Strine, 'One Fundamental Corporate Governance Question We Face' 1-2.

[1066] Jackson, Petraki, 'Understanding Short-Termism' 29-30.

[1067] Final Report of the Committee on Corporate Governance: The Hampel Report (January 1998) para. 1.18 <http://www.ecgi.org/codes/documents/hampel23.pdf> accessed 5 February 2014.

[1068] Jackson, Petraki, 'Understanding Short-Termism' 29-30.

[1069] Jesse Fried, 'The Uneasy Case for Favoring Long-Term Shareholders' 1561.

certain at least in a typical US company – which is a transacting firm i.e. buys and sells a large volume of its own shares.[1070] Fried points out that:

> On average, U.S. firms trade 30% of their own shares over a five-year period. In transacting firms, managers can benefit long-term shareholders merely by transferring wealth from other shareholders through bargain repurchases and inflated-price issuances. (…) In a transacting firm, long-term shareholders, like short-term shareholders, can benefit from managers' deliberately destroying value. In particular, long-term shareholders can benefit when managers underinvest in firm projects to buy back stock at a low price, overinvest in projects to sell stock at a high price, manipulate the stock price downward around the time of repurchases, and manipulate the stock price upward around the time of equity issuances. There is evidence suggesting that managers seeking to increase long-term shareholder value engage in these very activities, which may well destroy more value than short-termism.[1071]

Common sense suggests that long-term shareholders are more likely to encourage long-term decision-making by the board since long-term shareholders should be more interested in the long-term prosperity of the company. However, the author of this thesis agrees with Fried that more research that is empirical is needed to find out whether long-term or short-term shareholders have interests that are actually better aligned with the creation of economic value over a longer period. [1072] Moreover, research conducted at Stanford University suggests that companies prefer shareholders with long-term investment horizons. Nevertheless, the authors of this research also point out that there is little evidence to suggest that 'the composition of a company's shareholder base directly impacts upon corporate decision making, operating performance, or value creation.'[1073]

5.2.2 The role of institutional investors

The discussion of long-term v. short-term shareholders leads us on to consider various types of shareholders i.e. individual and institutional investors. In the UK and US, institutional investors currently own a large portion of equity on the regulated stock markets. Therefore, the analysis of the role of this shareholder group has generated a vast amount of scholarship. To illustrate the role of institutional investors, in the UK, individual investors owned 54% of shares in 1963 but this amount dropped to under 21% by 1989.[1074] By 2014, UK individuals

[1070] ibid 1557, 1560.
[1071] ibid 1626. [footnotes omitted]
[1072] ibid 1626.
[1073] Beyer, Larcker, and Tayan, 'Does the Composition of a Company's Shareholder Base Really Matter?' 2. Apart from mentioning shareholders' investment time horizon the authors also analyse shareholder activism (which will be mentioned below) and point out that companies prefer non-activist shareholders.
[1074] Christine Mallin, *Corporate Governance* 105.

owned only about 12% of all public equity.[1075] In the US, institutional investors owned 67% of public equities in 2010.[1076] There are different types of institutional investors such as investment funds, insurance companies, pension funds, sovereign wealth funds, private equity funds, hedge funds and exchange traded funds.[1077]

Institutional investors play a vital role in dispersed ownership jurisdictions. Owing to the fact that they tend to be more long-term focused, ultimately they have the power to counter-balance traditionally short-term perceived dispersed shareholders. Mallin, for instance, notes that many institutional investors will express their dissatisfaction about the company directly to management (the voice option), because they cannot sell their shares (exercise the exit option), as this is not viable given the size of their shareholding 'or a policy of holding a balanced portfolio.'[1078] On the other hand, the time preference of the other investors is not settled and some are clearly associated with a focus on short-term earnings.[1079] Most notably, hedge funds[1080] have been accused of favouring action that is beneficial in the short-term rather than long-term run.[1081] The role of hedge funds and whether they are entirely short-term orientated is currently vigorously debated in the literature.[1082]

5.2.3 Shareholder activism

After analysing the role of long-term and short-term shareholders, with particular consideration of institutional shareholders, this section will examine whether active or

[1075] Office of National Statistics, 'Ownership of Quoted Shares for UK domiciled companies, 2014' 1 <http://www.ons.gov.uk/ons/dcp171778_415334.pdf> accessed 10 September 2015. This figure does not include individual overseas investors.
[1076] Marshall Blume, Donald Keim, 'Institutional Investors and Stock Market Liquidity: Trends and Relationships,' (The Wharton School, University of Pennsylvania, Working Paper, 2012) 4 <http://finance.wharton.upenn.edu/~keim/research/ChangingInstitutionPreferences_21Aug2012.pdf> accessed 16 April 2015.
[1077] Serdar Celik and Mats Isaksson, 'Institutional Investors as Owners: Who are they and what do they do?' (OECD Corporate Governance Working papers, No 11 OECD Publishing 2011) 9, figure 1 <www.oecd.org/daf/corporateaffairs/wp> accessed 15 April 2015. The taxonomy of institutional investors and their evaluation lies beyond the scope of this research.
[1078] Mallin, *Corporate Governance* 106.
[1079] Jackson, Petraki, 'Understanding Short-Termism' 26-27.
[1080] A type of an investment vehicle the main purpose of which is to secure against market risk. Its name refers to the hedging techniques they are using.
[1081] Sofie Cools, 'The Dividing Line Between Shareholder Democracy and Board Autonomy: Inherent Conflicts of Interest as Normative Criterion' 2014 (2) ECFR 258, 286.
[1082] See i.e.: the discussion between Bebchuk et al. and Lipton at Harvard Law School Forum on Corporate Governance & Financial Regulation <http://corpgov.law.harvard.edu/tag/bebchuk-brav-jiang-study/> accessed 9 April 2015; Brian Cheffins, John Armour, 'The Past, Present and Future of Shareholder Activism by Hedge Funds' (2011) 37 JCorpL 51; John Coffee Jr, Dalius Palia, 'The Impact of Hedge Fund Activism: Evidence and Implications (ECGI - Law Working Paper No. 266/2014 September 15 2014) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2496518> accessed 15 April 2015.

passive shareholders have an impact on board decision-making. After the recent financial crisis it has been widely debated whether shareholder engagement in corporate governance would have helped to avoid this crisis.[1083] In general, shareholder activism covers a broad spectrum of activities and is practised in multiple forms depending on the aim and resources of the activist[1084] including: the right to vote, calling shareholder meetings, drafting proposals for the agenda of such meetings, electing, re-electing, and sometimes replacing the directors, ratifying board decisions, engaging in informal dialogue with the management, etc. Shareholder activism is a vast topic and it will not be analysed here in detail. It is not the aim of this thesis to discuss how to enforce shareholder engagement[1085] or discuss different forms of this engagement at length. It is only its impact on long-term or short-term decision-making that is scrutinised in this section.

There is no agreement regarding the desirability or effectiveness of shareholder activism. The opponents of this concept note that shareholder activism usurps the role of the board and that the possibility of short-term pressures from shareholders is a significant factor in favour of board insulation from shareholders. In their view, board's insulation is one way of promoting long-termism.[1086] Bratton and Wachter argue that shareholder empowerment enables and encourages the board to maximise the market value of the stock[1087] and maximising the stock price might lead to sacrificing long term-shareholder value.[1088] Applying the shareholder wealth maximisation norm, Bainbridge argues that 'directors are obliged to make decisions based solely on the basis of long-term shareholder gain.'[1089] Moreover, shareholder activism has been criticised on the basis that shareholders in general may lack appropriate incentives to engage in activism due to 'rational apathy' – the costs of engagement are higher than the expected benefits – and they would prefer to sell their shares if they are unhappy with the way the company is being run.[1090]

[1083] Brian Cheffins, 'The Stewardship Code's Achilles' Heel' 1005ff.
[1084] Strand, 'Re-thinking short-termism' 4 fn 7.
[1085] Although some forms of shareholder activism were discussed above in the context of executive remuneration.
[1086] See i.e.: Bainbridge, 'Response, Director Primacy and Shareholder Disempowerment;' Bainbridge, 'Preserving Director Primacy by Managing Shareholder Interventions'; William Bratton and Michael Wachter, 'The Case Against Shareholder Empowerment' (2010) 158 UPaLRev 653; Lipton and Rosenblum, 'A New System of Corporate Governance.'
[1087] Bratton and Wachter, 'The Case Against Shareholder Empowerment' 653.
[1088] ibid 703.
[1089] Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' 573.
[1090] Mathias Siems, *Convergence in Shareholder Law* (CUP 2007) 89.

Supporters of shareholder activism, on the other hand – amongst which Bebchuk is the most prominent[1091] – argue that shareholder activism increases the long-term value of the company by monitoring closely the managers and preventing abuses of their powers. Bebchuk challenges the view that existing or higher board insulation is value-enhancing overall in the long term and underlines that shareholder empowerment has significant long-term benefits.[1092] He also points out that although board insulation may produce some beneficial long-term effects, at the same time it will generate significant long-term costs and it is not certain that it will contribute towards building long-term value.[1093] Similarly, Cools points out that problems of passivity, short-term thinking and private interests cannot be settled by the reduction of shareholder power.[1094] Dent is also a supporter of shareholder empowerment. He notes that the objections to shareholder power are myths – they are greatly exaggerated and have no empirical basis.[1095]

In the USA, various mechanisms have been suggested to facilitate shareholder activism and long-term shareholders. In particular, the 'shareholder cultivation' theory suggested by Belifanti deserves attention.[1096] The shareholder cultivation approach primarily involves an interplay between a firm and its shareholders[1097] and is focused on achieving long-term value. Its aim is to 'identify, attract, and cultivate a core of committed shareholder stewards who understand the firm's purpose' and values.[1098] Based on Delaware law, the author offers a very comprehensive and detailed analysis of the currently available and future tools for recruiting engaged shareholders.[1099] Among the strategies proposed are the issue of shares that have superior voting and economic rights, the implementation of dividend policies that favour long-term shareholders, the establishment of a shareholder loyalty rewards point program, a transaction tax as an incentive for stewardship, the integrated reporting of financial, environmental, and social performance, and the suspension of shareholder voting rights in some cases.[1100]

Shareholder activism is currently promoted by the Government in the UK and the clearest evidence thereof is the Stewardship Code which was introduced in 2010. Its main

[1091] See i.e.: Bebchuk, 'The Case for Increasing Shareholder Power'; Lucian Bebchuk, 'The Myth of the Shareholder Franchise' (2007) 93 VaLRev 675; Bebchuk, 'The Myth that Insulating Boards Serves Long-Term Value.'
[1092] Bebchuk, 'The Myth that Insulating Boards Serves Long-Term Value' 1686.
[1093] ibid 1637.
[1094] Cools, 'The Dividing Line Between Shareholder Democracy and Board Autonomy' 288-289.
[1095] George Dent Jr, 'The essential unity of shareholders and the myth of investor short-termism' (2010) 35 DelJ CorL 97, 97.
[1096] Belifanti, 'Shareholder Cultivation and New Governance.'
[1097] ibid 807.
[1098] ibid 792.
[1099] ibid Part IV.
[1100] ibid, 796-797, Part IVF.

aim is to encourage institutional shareholders' activism.[1101] The Stewardship Code sets out good practice recommendations on engagement with investee companies and operates on a 'comply or explain' basis. The aim of stewardship is 'to promote the long term success of companies in such a way that the ultimate providers of capital also prosper.'[1102] The origins of the Stewardship Code are to be found in the Walker Review[1103] and in the Kay Review.[1104] The Kay Review notes that shareholders should try to promote the importance of long-term decision making with the company's directors. Directors' decision-making is inevitably connected with the profit earned by the shareholders: '[i]n the long run, the profits earned by high performing companies are the only source of returns for savers who invest in equities.'[1105] The extract above confirms that the Stewardship Code was introduced to address shareholder short-termism. However, it is far from clear whether it will be an effective tool as it has faced some serious critiques. For instance, Dignam notes that encouraging stewardship in the UK is problematic as it creates an imbalance of power between shareholders and the board, to the detriment of board independence.[1106] Meanwhile, Cheffins points out that the Stewardship Code is unlikely to enhance shareholder empowerment on a large scale due to changes in share ownership structure – the Code 'focuses primarily on UK-based asset managers and "mainstream" domestic institutional investors who own less than one third of the shares in the UK quoted companies.'[1107] The other forms of incentives for shareholders such as: advantages conferred in favour of long-term investors over traders, capital gains tax (as most of the shareholders do not pay that tax), and differential voting rights for long-term shareholders, were clearly rejected by the Kay Review because 'the introduction of such provisions by legislation or regulation would involve practical difficulties and would be unlikely to achieve the intended effect.'[1108] Therefore, it seems that the recent proposal by Moore and Walker-Arnott[1109] to introduce a 'two-tiered' approach to public company investor relations, where long-term and committed

[1101] The most recent version of the Code is from 2012; The UK Stewardship Code (The Financial Reporting Council, September 2012) <http://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx> accessed 15 April 2015.
[1102] The UK Stewardship Code 1.
[1103] The Walker Review of Corporate Governance of UK Banking Industry (2009) <http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm> accessed 23 April 2015.
[1104] Kay Review 46, Recommendation 1.
[1105] ibid, para. 1.5
[1106] Dignam, 'The Future of Shareholder Democracy in the Shadow of the Financial Crisis' 641.
[1107] Brian Cheffins, 'The Stewardship Code's Achilles' Heel' 1006, 1013, 1024-1025.
[1108] Kay Review para. 8.32.
[1109] Marc Moore, Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 (3) JLawSoc 416.

investors would create an 'inner circle' whilst other investors would be treated as outsiders i.e. 'lower-tier' investors, has little chance of being anything else than an important academic paper.

On the whole, the debate on the role of shareholder activism in increasing the long-term value of the company is inconclusive both in the UK and US. Additionally, recent empirical data – carried out by Ernst & Young on more than 3000 companies listed in the US from a broad spectrum of institutional investors – suggests that 72% of respondents believe that 'whether activism is beneficial over the long term depends on the particular circumstances involved.' [1110] Only 11% stated that a rise in activist investing is having an appreciable positive effect on their long-term portfolio value. 17% do not agree with that statement and argue that 'notwithstanding some exceptions, activists are focused on financial engineering for short-term gain and are not interested in the long-term value of the company.' Some of them also argue that activism created a harmful dynamic in how companies think, at the same time promoting short-termism and creating distraction.[1111]

5.3 Germany

The previous section briefly scrutinised the impact of shareholders on board decision-making in the UK and US and now German law is analysed. The role of long-term v. short-term shareholders and shareholder activism (including the function of institutional shareholders) will be presented in the same way as the section dealing with the UK and the US. Germany is a jurisdiction with concentrated rather than dispersed share ownership, with large majority shareholders who are able to control and monitor the board and major agency conflicts between majority and minority shareholders. [1112] The case studies presented in Chapter IV and particularly in Chapter V underlined the important role of shareholders in German corporate governance. The point was also made that they are more powerful than shareholders in the UK or Delaware.[1113] Moreover, two case studies presented in Chapter V have shown that majority shareholders in Germany are, in general, long-term focused and definitely more long-term focused than shareholders in dispersed jurisdictions.[1114] On the whole, shareholders without a doubt play an important role in Germany and majority shareholders influence board decision-making. In light of this concentrated share ownership

[1110] Ernst & Young LLP, 'Shareholder activism: an Engagement Opportunity' (The Harvard Law School Forum on Corporate Governance and Financial Regulation 10 April 2015) <http://corpgov.law.harvard.edu/2015/04/10/shareholder-activism-an-engagement-opportunity/#3> accessed 10 April 2015.
[1111] ibid.
[1112] Chapter V s 1 above.
[1113] Chapter V and especially: ss 2.1.2 and 2.1.3 above.
[1114] Chapter V s 2 above.

structure and the fact that majority shareholders are believed to be in general more long-term orientated, the discussion on the role and status of shareholders takes a different angle than applied in the case of the UK and US.

5.3.1 Shareholder activism and institutional investors

Shareholder activism in Germany is under-researched[1115] and underdeveloped in comparison to Anglo-American jurisdictions. However, Juschus argues that '[s]hareholder engagement does matter and is becoming more and more relevant for corporate Germany and investors themselves.'[1116] Moreover, Sturm underlines that shareholder activism is likely to rise considering the growing importance of institution al investors in Germany.[1117] To illustrate this point, the increase in the number of institutional investors in Germany – in 1995 the financial assets of institutional investors amounted to 56.4% of German GDP, in 2000 it was 99.3% and 117.3% of GDP in 2007 (by way of comparison in the USA the institutional investors owned 140.8%, 185.1% and 211.2% of the American GDP accordingly).[1118]

Schaefer and Hertich have carried out empirical research in this field (analysing shareholder activism in DAX 30 companies in 2008-2010) and concluded that it 'remains a relatively ineffective instrument for shareholder engagement, in contrast to research findings for the US and UK financial market.'[1119] The authors argue that 'taking into consideration the increasing internationalisation of German corporate ownership' (i.e. in the last 10 years foreign investors 'have almost tripled their equity stakes in listed German companies') and 'the introduction of corporate governance standards and legal regimes similar to those in place in the Anglo-Saxon world, shareholder activism is expected to play a more relevant role in the German business world in the future.'[1120] In this vein, Besse and Heuser note that '[o]ver the past few years there has been a noticeable increase in the frequency of activist investors building up considerable stakes in German listed companies in the context of public takeovers.'[1121] Juschus offers a thorough analysis of shareholder activism[1122] and

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[1115] Henry Schaefer and Christian Hertrich, 'Shareholder Activism in Germany: An Empirical Study' (2013) 12(2) IUP JCorGov 28, 28; Sebastian Sturm, *The Influence of Institutional Investors on Corporate Management and Corporate Governance in Germany: A Multi perspective Analysis* (Diploma Thesis GRIN Verlag 2008) 1.

[1116] Alexander Juschus, *Shareholder Engagement in a New Environment and its Positive Impact on Corporate Governance in Germany* (unpublished PhD thesis University of Durham 2007) 18.

[1117] Sturm, *The Influence of Institutional Investors on Corporate Management and Corporate Governance in Germany* 1, 6, 34ff.

[1118] Eric Gonnard, Eun Jung Kim and Isabelle Ynesta, 'Recent Trends in Institutional Investors Statistics' (OECD Financial Market Trends 2008) 4.

[1119] Schaefer and Hertrich, 'Shareholder Activism in Germany' 28.

[1120] ibid.

[1121] Dirk Besse, Moritz Heuser, 'Shareholder Activism in Germany' (Harvard Law School Forum on Corporate Governance & Financial Regulation 7 June 2014)

argues that in general it has a positive impact on corporate governance in Germany.[1123] The author also suggests how shareholder engagement could be improved,[1124] as at the moment shareholder rights are only exercised to a limited extent in this legal system. [1125] Moreover, it seems that in the future European law will oblige both Germany and the UK to encourage shareholder activism and long-term shareholders.

The New Shareholder Rights Directive was discussed earlier in the section on executive remuneration. It is worth reminding at this point that it aims to encourage long-term shareholders in various ways. First of all, through an improvement in the engagement of institutional investors and asset managers. Secondly, it suggests approval mechanisms on related party transactions. Further, it increases transparency regarding institutional investors and introduces mandatory & binding say on pay provisions. Finally, it aims to enhance the transparency of proxy advisors.

5.4 Summary on the role of shareholders

In all three jurisdictions, the role of the shareholders in board decision-making cannot be underestimated. Without a doubt, directors are influenced by the shareholders' attitudes. However, it is difficult to state unequivocally to what extent exactly. Further studies – and particularly empirical research – in this field are required to assess especially the role of long-term shareholders and shareholder activism in enhancing long-term development of the company. The author of this thesis shares the widely held view that in the UK and US long-term shareholders are more likely to favour long-term decision-making. At the same time, it is strongly pointed out that as this debate is inconclusive, empirical evidence is needed to support that view. In this section, the role of institutional investors in the UK and US was also stressed. Finally, the debate on whether shareholder activism or disempowerment contributes towards long-term shareholder value was outlined.

Similarly, in Germany shareholders influence board's decision-making and in Chapters IV and V it was argued that they are actually more powerful than shareholders in the UK and Delaware. However, the discussion on shareholder activism, long-term v. short-term shareholders and institutional investors is less developed. This may change in the near future when the New Shareholder Rights Directive – encouraging shareholder engagement and long-term shareholders – will be adopted.

<http://corpgov.law.harvard.edu/2014/06/07/shareholder-activism-in-germany/> accessed 24 April 2015.

[1122] Juschus, *Shareholder Engagement.*

[1123] ibid chapter 2.

[1124] ibid chapter 10.

[1125] ibid 6.

6. Comparative conclusions on incentivising long-termism

The aim of this chapter was to present some important factors and mechanisms that will serve to incentivise long-termism during the decision-making processes of directors and to outline similarities and differences between the jurisdictions under review. In particular, the degree to which these factors are likely to be effective in the UK, Delaware and Germany was examined. It was outlined that these incentives are vital and widely discussed in all jurisdictions under scrutiny, despite the differences between them. This chapter highlights several important points.

First of all, it illustrates important similarities and differences between the jurisdictions. It shows a clear division between the UK and Delaware on the on hand and German law on the other. As was argued in Chapters IV and V, these differences are caused by distinctive corporate objectives and the share ownership structures of the companies. For instance, the role of shareholder activism and institutional investors has been hotly debated for a long time in the UK and US and only recently introduced in Germany. Moreover, shareholders are more powerful in Germany than in the two common law jurisdictions under review. On the other hand, there are also some similarities between the jurisdictions. Remuneration that is linked to long-term performance is currently being advocated in all of them and they each have difficulties related to quarterly reporting. Moreover, in all jurisdictions there is in general flexibility regarding the length of appointment of directors to the board. Moreover, European law (and especially the New Shareholder Rights Directive) is a source of convergence between UK and German law regarding quarterly reporting and shareholder activism. In particular, mandatory quarterly reporting is prohibited in the UK, and Germany has follow that path recently whilst there are no signs that it will be changed in in the USA in the near future.

Secondly, the claim is put forward in this chapter that the four incentives introduced are the most effective was of enhancing long-term decision-making, especially when directors can personally benefit from the achievement of the long-term goals. These incentives are examples of more practical reforms that can be introduced or continued with to encourage directors to take long-term decisions. In this chapter four key incentives (both already working and not yet in force) were presented; however, undeniably more is needed to enhance long-termism.

Turning finally to the practical question, as to which of the incentives presented would be the most effective in encouraging long-term decision-making, the following points must be made. Although each of them has a potential to foster long-term decision-making, their features and advantages differ. Tying executive remuneration to the long-term

development of the company is widely promoted. This is probably the most efficient way of making the board personally interested in ensuring the future development of the company, as long-term decision-making is likely to give them more personal profits. This chapter has made few suggesetings regarding improving long-term decision-making through executive remuneration. With regard to Germany,[1126] it was argued that guidance on how to understand 'sustainable development' is required. Preferably, this term should be changed and enforcement mechanisms duly introduced that encourage the board to aim towards the sustainable development of the company. In the UK, [1127] transparent, clear and coherent regulation of executive remuneration was proposed, as the current regulation is very complex and difficult to penetrate. In the US, [1128] the full implemanteation of the Dodd-Frank Act is awaited.

Prohibition of the mandatory quarterly reporting has a similar function to long-term orientated executive remuneration – it discourages short-term decision making. Arguably it is less effective, as it is not directly linked to directors' personal gains. The lengthening of the board's tenure is the other indirect way of fostering long-term decision-making. At present, it is clearly the least popular factor in incentivising long-termism among the systems under scrutiny, since the jurisdictions have not recognised its potential as yet. Finally, shareholders can also play an important role in fostering long-term decision-making and this is a current discourse in the UK, Delaware and in Germany. Thus, can they be forced to have long-term goals? The answer to that question is negative. However, shareholders can be educated (through eg. academic publications or press releases) about their role in board decision-making and especially about the dangers related to irresponsible short-term decision-making.

[1126] See: Chapter VI para 2.2.
[1127] See: Chapter VI para 2.3.
[1128] See: Chapter VI para 2.4.

Chapter VII. Comparative conclusions

1. Approach of this thesis

This thesis applies a comparative methodology[1129] – in the sense that functionally equivalent institutions are compared, paying at the same time attention to both similarities and differences between the jurisdictions – in order to address the central questions of this thesis; i.e. the relevance and parameters of long-termism in the UK, Delaware and Germany. As part of that process, the legal content, nature and scope of long-term managerial decision-making was evaluated and concrete practical examples were advanced in the discussion.

It must be underlined at this point that after conducting this research some preconceptions about the legal systems under scrutiny must be abandoned. To start with, although long-termism plays a very important role in the academic debates in the UK and US, it does not necessarily translate into pronounced legal provisions specifically incentivising long-term decision-making. Going back to the justification for this research – it was sparked by section 172 CA 2006 and the amount of debate it raised with regard to the notion of long-termism, it is striking that this is a concept which is afforded particularly attention in the US. Nevertheless, it was also startling to note that long-term decision-making does not yet seem to be rooted firmly in the scholarship, which discusses Delaware law. In the UK, the contrast between the discussions in the literature on long-term decision-making and the actual instruments that encourage it is probably less clear. This can be attributed to the embedding of long-termism into the legal landscape through the enactment of section 172 CA 2006 in 2007 and the UK Code. Nevertheless, the underlying features of this system; i.e. the ascendancy of shareholder value theory and a predominantly dispersed share ownership structure, suggest that long-term decision-making is not that straightforward. As such, the studies on German law provided the most surprising results. The first challenge of this thesis was to identify whether the concept of long-term decision-making is actually present in this jurisdiction, as the term 'long-term' is neither used in the legislation nor visibly present in the academic literature. Only subsequently was it established that the discussion on time horizons of decision-making has different dynamics in Germany. The concept of 'sustainability' rather than 'long-termism' is used in the AktG and Kodex and it was established that future orientated decision-making is more widespread in Germany than in the two other legal systems. Two other factors that contribute towards the more long-term

[1129] See: Chapter I para 2.2.

approach of the German corporare system are: a more concentrated share ownership structure of the corporations and its general tendency towards stakeholder value theory.

Seen from that perspective, this thesis provides answers to the research questions that were posed in Chapter I:[1130] firstly, are the approaches adopted in the chosen jurisdictions regarding the content and scope of long-termism radically different or very similar? Secondly, do the legal sources and legal forms differ in these jurisdictions? Thirdly, can it be said that the approach taken in any particular jurisdiction is 'better' for the protection of a company's interests?

Finally, and most importantly, this thesis offers the following four main original contributions:[1131]

1. It identifies jurisdiction-specific and concrete factual examples of the content and scope of the long-term standard for managerial decision-making.[1132] Seven examples were constructed with the following important factors in mind, namely the differing legal families, overarching corporate objectives, share ownership structures, corporate governance and corporate cultural conditions in each of the three jurisdictions.

   The gap-filling exercise is the principal original contribution of this thesis. It offers a pioneering analysis of the parameters of long-term and short-term decision-making. The novelty of the case studies consists in the bringing together of a number of potential examples of long-termism (and short-termism) and exploring at length the insights they offer in the comparative context, as every case study is duly analysed against UK, Delaware and German law respectively. What is more, the seven practical examples offer reasoned conclusions about their status in each legal system and finally they act as guiding factors for directors in approaching these seven kinds of decisions.

   To give a short summary of the case studies, the first case scenario is particularly useful as it shows that in all legal systems short-termism is identified with a focus on the share price, where the maximisation of such prices is perceived as the sole objective. The strength of incentives for such a decision however, differs among jurisdictions. The second case study, i.e. a decision to reduce the carbon emission from the company's plant, is portrayed as an example of long-termism (and possibly as a very strong example in Germany). However, legal systems under review justify this decision differently. Further, the third case study notably shows that the excessive promotion of marketing is not within the parameters of long-termism. An over-concentration on one factor is

[1130] See: Chapter I para 2.1.
[1131] See also: Chapter I para 2.4.
[1132] See: Chapters IV and V.

perceived as a risky and short-term decision, although it is a slightly less clear example of short-termism.

Importantly, the fourth case study suggests that there is a link between consideration of environmental and health and safety issues, long-term gains and sustainable development. Furthermore, this scenario argues that neglecting environmental and health and safety considerations can be rooted in profit maximisation. The fifth case scenario discussing promotion of cultural, social and civic aims is vital, as it suggests that this decision is an example of long-termism in all three jurisdictions (these factors are of relatively higher importance in Germany, followed by the UK and Delaware). The importance of the sixth case study on dividend growth consists in indicating that this is a short-term decision in the UK and Delaware if earnings growth is the sole or main justification for this decision. A decision to focus on dividend growth is not relevant in Germany in the context of the board's decision-making or parameters of the long-termism. Finally, the seventh case scenario shows that investment in research is an element of long-term thinking in all jurisdictions and arguably a particularly strong example in Germany.

2. It suggests a comprehensive comparative analysis of the relevance of long-term considerations during the decision-making processes. This thesis offers a holistic approach to long-termism; i.e. not only were the applicable legislation, case & soft law and secondary academic and other sources analysed, but also practical case studies were introduced to provide a thorough examination of long-term considerations. What is more, presenting the underlying features of the legal systems (civil v. common law division, board structure, corporate objective and share ownership structure of the company), enabled the notion of long-termism to be assessed within the broader legal, commercial and cultural context. Finally, Chapter VI provides a different angle to the discussion on long-term considerations. It shows a strong connection between the system of incentives and long-term decision-making. The broad structure of the thesis provides a real understanding of how to interpret and measure long-termism.

3. It isolates specific examples of the incentives already available in the jurisdictions under review and the possible incentives that could encourage long-term managerial decision-making.[1133] In the same way as the examples of long-termism, the incentives are also tailored to the differing legal families, overarching corporate objectives, share ownership

[1133] See: Chapter VI.

structures, corporate governance and corporate cultural conditions prevalent in the UK, Delaware and Germany.

4. An evaluation is made of the extent to which there is formal or functional convergence in the nature, content and scope of the long-term standard for managerial decision-making in each of the three jurisdictions under review.[1134] Thus, a contribution can be made to the topical 'convergence v. divergence' debate in the comparative company law literature.

The rest of this concluding Chapter is structured as follows. To start with, the next section on convergence v. divergence sketches out the author's concluding observations with regard to the fourth original contributions articulated in the preceding paragraph. As part of that process, the evidence of formal & functional convergence and divergence is presented separately. Further, whether any legal system under review offers any competitive advantage regarding long-term considerations is evaluated. This is followed by comments on the relationship between similarities and differences among the jurisdictions regarding long-term decision-making and the bigger differences between the legal systems. Finally, the future of long-term decision-making is addressed. This section attempts to suggest some potential developments in this area.

2. Long-term decision-making in the UK, Delaware and Germany – a case of convergence or divergence?

2.1 Introduction

This section takes stock of the results of the comparative research and comments on the debate of convergence v. divergence in the context of long-term decision-making. The picture is mixed and it cannot be unequivocally stated whether convergence or divergence is to be observed. On the contrary, there are some instances of functional and formal convergence as well as divergence. These are presented in turn – answering at the same time the research questions outlined above.

2.2 Functional convergence

Functional convergence – i.e. the existence of legal frameworks that serve similar functions, but may be expressed in different legal forms – is a paramount feature in the context of long-term decision-making and shall be discussed at the beginning.[1135] First and foremost, the interesting point in comparing these three jurisdictions is the functional equivalence of the

[1134] For the convergence v. divergence debate see: Chapter I para. 2.4.
[1135] See: Chapter I para. 2.4.

different legal constructs deployed in these three systems. A study of the relevant statutory provisions, commentaries thereto, court cases and soft law, reveals that the notion of considering the long-term consequences during decision-making is present in all legal systems under review. However, the UK, Delaware and Germany adopt different terms to express the idea. In the UK, the expressions employed are the 'likely consequences of any decision in the long-term' and the 'long-term success of the company.' Meanwhile, in Delaware, we find phrases used such as 'long run profitability and shareholder gain,' 'long-term sustainable growth in shareholder value' and 'long-term shareholder value.' Finally in Germany, one encounters terms such as the 'company's sustainable development,' 'ensuring continued existence of a company and profitability of the company,' 'sustainable creation of value' and 'sustainable growth.'

However, each of these terms concern future-orientated, reasonable, well-thought through and well-balanced decision-making that goes beyond routine day-to-day management of the company and considers issues other than immediate profit. Thus, all these terms entail elements of long-term decision-making. According to the case studies presented in Chapters IV and V, long-termism is above all about careful investments and forward thinking. The decision to invest in research was pointed out as the most obvious example. Moreover, the decisions to reduce carbon emissions (i.e. a decision to invest in the development of the company) and to promote social goals were characterised as instances of long-term decision-making in the UK, Delaware and Germany. On the other hand, a focus on short-term profits was accentuated as the main feature of short-termism according to the case studies. At the same time, the case study on excessive marketing highlights dangers related to an over-concentration on one factor.

One final observation on functional convergence flows from the discussion on executive remuneration.[1136] To start with, it is evident that tying remuneration to long-term performance is on the agenda in both the UK, Delaware and Germany, despite the formal differences in the approaches taken. Secondly, discussions on executive remuneration in the US, UK and Germany, in general appear to be very similar, despite differences in the terminology used.

2.3 Formal convergence

Formal convergence occurs when an increased similarity in the formal legislative structures can be observed across a range of jurisdictions.[1137] As illustrated in this research, the reviewed legal systems are far from identical, yet they share a number of similar features.

[1136] See: Chapter VI para 2.
[1137] See: Chapter I para. 2.4.

Formal convergence can be observed only with regard to the more general concepts. The first example relates to the overall approach in each legal system to future-oriented decision-making. The jurisdictions increasingly encourage the boards to promote long-termism via the positive law and a system of incentives.[1138] The gap-filling exercise also confirms that long-term decision-making is widely promoted in the academic literature.[1139] One is bound to say that, at least, in theory, long-termism is clearly favoured over the short-term approach.

Secondly, at the very basic level, what the UK, Delaware and Germany have in common is that in general, managers enjoy broad discretionary powers during decision-making; hence, they are free to have regard to long-term factors. This thesis also points out that this discretion is limited by various factors, for instance, the division of power within the company, the corporate objective and the share ownership structure of the companies. Thus, in all jurisdictions under scrutiny the preceding factors operate as restrictions on the breadth of capacity for decision-making by the board.

Moreover, the gap-filling exercise confirms that the concept of long-termism is marginalised to some extent by such breadth in the capacity of directors, as a lack of focus on long-term factors is unlikely to constitute a sole basis for the breach of directors' duties, if disinterested directors are acting in good faith in the best interests of the company. The case studies show that focusing on short-term factors can only contribute to the breach at the very most.

The next observation relates to the fact that all jurisdictions share an important premise: long-termism is expressed as a flexible standard, which does not have a clear content and neither the legislation, court cases nor corporate governance codes supply clear guidance as to its exact parameters.[1140] The notable exceptions, adding at least some ambit to the concept of long-term decision-making are the A.1 Supporting Principles of the UK Code (where the role of strategic aims, the company's values and entrepreneurial leadership in risk assessment is highlighted), rule § 2.01 of the ALI Principles (discussing the role of non-financial factors in achieving long-term shareholder value) and the 2004 judgment of the Düsseldorf District Court (a landmark decision on shaping the management's remuneration with particular consideration of the company's long-term growth and development). It is also clear from the analysis of the UK, Delaware and German law that long-termism is a flexible concept; it must be evaluated in a specific case scenario. Finally, the notion of long-term decision-making is most visible across jurisdictions in the context of the relevant soft law.

[1138] See: Chapter III para 6 and Chapter VI.
[1139] See especially: Chapter V para 3.2
[1140] See: Chapter III para 2.2.

Corporate governance codes in all systems encourage the boards to prioritise long-term factors.

2.4 Divergence

It was articulated in the sections above that the concept of long-term decision-making is present in all legal systems under scrutiny, although expressed in a different manner. The different notions used, clearly show that the legal form in which long-termism is expressed differs in the UK, Delaware and Germany. Hence, it must be underlined at this point that it is difficult to unequivocally assess whether these comparable approaches result in analogous practical consequences. The case studies outlined in Chapters IV and V aim to resolve this deadlock regarding the parameters of long-termism. Nevertheless, the law must be more active in changing long-termism into an actively working notion and providing it with content.[1141]

The comparison of the UK, German and Delaware law with regard to the legal sources used to express long-termism presents a mixed picture. With regard to similarities, all three legal systems clearly underline the importance of long-term decision-making in their corporate governance codes. Moreover, in the same vein their case law abstains from engaging in a discussion about the parameters of long-termism. Without a doubt, legal scholarship in the UK, Delaware and in Germany plays an important role in analysing the concepts of long-termism and short-termism. However, it cannot be stated that it constitutes a source of law in any of these jurisdictions. Here, the similarities end – the idea of future orientated decision-making is to be found in the UK and German legislation, but not in Delaware. In the latter jurisdiction, long-termism is filtered mainly through the general principle of the corporate objective (i.e. long-term shareholder value) – derived from the DGCL & case law; and subsequently extensively discussed in the literature and outlined in the soft law. Whereas in the UK, the main source of long-termism is the CA 2006 and the UK Corporate Governance Code. Importantly, only in the UK does this concept derive directly from the law of directors' duties. Finally, regarding the sources of long-termism, Germany is placed somewhere between the UK and Delaware. On the one hand, the imperative of securing the company's sustainable development and the necessity of considering the continued existence of the company and its profitability are included in the AktG. On the other hand, long-term decision-making is a consequence of the underlying features of the German legal system; i.e. stakeholder theory and concentrated share ownership structure.

[1141] See section 3 below for some suggestions regarding the future development of long-termism.

The jurisdictions differ as to the relevance of long-term decision-making.[1142] Due to its modest presence in the law, Delaware lags behind the UK and Germany in this regard. In the UK, long-termism is clearly encouraged, but because having regard to long-term factors is not mandatory, its actual role in practice is not clear. Similar to the position in the UK, having regard to the sustainable development of the corporation in Germany is not mandatory. However, it is promoted in this jurisdiction in various ways where it is stressed the most prominently among the systems.

A further difference between the systems was accentuated through the case studies.[1143] With the exception of the case concerning the decision to focus on dividend growth (which is not relevant in Germany in the context of long-termism), all other decisions were classified in the same way – as examples of either long-termism or short-termism in the UK, Delaware and Germany. Namely, decisions to focus on the share price and on excessive marketing as well as a decision that lacks focus on environmental and health and safety issues were ascribed as short-term decisions, whereas the promotion of cultural, social and civic aims, investment in research and decisions to reduce the carbon emissions from a company's plant were treated as examples of long-termism.

Nevertheless, these laws differ with regard to the clarity of examples of long or short-termism and the probability they will be taken by directors as a result of the strength of the relevant incentives supplied by the law. The table summarising the gap-filling exercise set out in Chapter V[1144] illustrates these differences in the following way. To start with, the first five case studies were discussed in the context of the company's corporate objective. A decision to focus on the share price constitutes a stronger example of short-termism in Germany than in the UK and Delaware, as the German corporate objective provides a weaker incentive for such a decision to be taken. Moreover, the position in the UK and Delaware is not identical. In both jurisdictions, the interests of shareholders are paramount, although the ESV in the UK encourages more all-inclusive decision-making. The second scenario – a decision to reduce the carbon emissions from a company's plant – is an example of long-termism. There are greater incentives for this decision to be taken in Germany where the balancing of different interests is afforded more weight than in other jurisdictions. In the UK and Delaware, such decision can only be taken if it is beneficial for shareholders. The third case study suggests that excessive marketing is an example of a risky, short-term decision-making in all jurisdictions, due to an over-concentration on one factor. There are fewer incentives provided by the law for this decision to be taken in Germany, or encouraged

[1142] See: Chapter III para 6.
[1143] It is clearly illustrated in Chapter V para 3.2.
[1144] Chapter V para 3.2.

in the literature as weighing different interests is crucial. The UK and Delaware laws supply stronger incentives in comparison and in particular, excessive marketing is more incentivised in Delaware.

Further, a lack of focus on environmental and health and safety issues constitutes an example of short-termism in all three legal systems. The gap-filling exercise suggests that it is a stronger example in Germany – which is expected to be more sceptical towards such decisions. Two other jurisdictions offer greater incentives for neglecting environmental and health and safety issues. The incentives for it are greater in Delaware – provided that it maximises shareholder wealth. In the UK, it is also likely to be taken, although it is not consistent with the spirit of the ESV. The next case study – a decision to promote cultural, social and civic aims – is an example of long-term decision-making in all three jurisdictions. As social aims cannot be the only justification for a decision to be taken, it must be also economically viable for the company. A difference between the three legal systems relates to the significance of these social aims. In Germany, they are of relatively higher importance, followed by the UK and with Delaware being the lowest.

Turning to the case studies analysed in the context of the company's share ownership structure, a focus on dividend growth is identified with short-termism in the UK and Delaware if earnings growth is the sole or main justification for this decision. However, shareholders in the UK are likely to put stronger pressure on the board against such action than in Delaware. In Germany, shareholders are mainly responsible for dividend distribution and management has only a limited role. Hence, this decision cannot be analysed in the context of the management board's decision-making in this jurisdiction. Moreover, the decision to invest in research is an example of long-termism in all legal systems. German law supplies arguably the strongest incentives for this decision among the legal systems under review, followed by the UK. Delaware law is perceived to have the fewest incentives to invest in research.

The incentives presented in Chapter VI also provide examples of divergences between the UK, Delaware and Germany. First of all, due to European Union law, mandatory quarterly reporting are already prohibited both in the UK and in Germany. Meanwhile in the US quarterly reporting is not challenged. Secondly, only in Germany can a director's single term in office be longer than a year, as in the two other systems there are rules that require the annual election of directors. Finally, Chapter VI illustrated differences in the role of shareholders in the UK, Delaware and Germany, especially a strong division between the UK and Delaware, on the one hand and Germany on the other hand was emphasised.

Another difference between the systems relates to the relationship between the corporate objectives and long-termism.[1145] The similar division as above is evident here. In the UK and Delaware long-termism is identified the strongest with the interests of shareholders – due to the shareholder value primacy norm. In contrast, as the German law endorses stakeholder value theory, long-termism is also connected with the interests of various stakeholders rather than the shareholders only. This divergence was particularly evident in the gap-filling exercise. The cases studies also show that a decision is more likely to be taken, if it is consistent with the corporate objective.

The final divergence between the UK, Delaware and Germany concerns the influence of differences in share ownership structures of the companies on the content of the long-term standard, in the sense that the gap-filling exercise indicates that there is a link between the share ownership structure, agency problems in the jurisdictions under review and the parameters of long-termism.[1146] It ought to be stressed that the mainstream theory of the predominance of concentrated share ownership in Germany and dispersed share ownership structure in Delaware and UK were accepted for the purposes of this thesis. This research contributes to the convergence v. divergence debate in a modest way to the extent that it argues that decision-making is likely to be more short-term orientated in dispersed ownership jurisdictions (UK or Delaware) and centred more on the long-term in concentrated ownership jurisdictions (Germany).

2.5 Is the approach taken in any particular jurisdiction 'better' for the protection of a company's interests? Conclusions regarding similarities and differences between the jurisdictions.

The dearth of sources with regard to the parameters of long-termism in the UK, Delaware and Germany and the relevance of long-term decision-making in these systems suggests that none of the legal systems under scrutiny succeeds best in promoting or achieving long-term decision-making. Long-termism is perceived differently in these jurisdictions – it is associated more strongly with shareholder interests in the UK and Delaware and with balancing the interests of various stakeholders in Germany. Moreover, every system is different and works in different circumstances, therefore it is impossible to state which one is actually better. This thesis argues that, although Germany is not the ultimate exemplar of long-term decision-making among the jurisdictions under review, it offers greater long-term protection, as this jurisdiction strongly values the continuing development of the company – which was illustrated in the analysis of the positive law (including incentives) and the case

[1145] As illustrated in Chapter IV.
[1146] See: Chapter V.

studies. Nevertheless, the relevance of long-term decision-making should be highlighted more strongly in Germany and practical examples of long-termism are awaited: it is hoped that the case studies presented in this thesis will assist in achieving that objective. More importantly, it is pertinent to note that German solutions might not work in the UK or Delaware due to differences between them. Therefore, it is not necessarily a reasonable prescription that the UK and Delaware ought to converge towards the German system.

Furthermore, this thesis also illustrates that the UK and Delaware, despite many important similarities (e.g. long-term shareholder value, the relationship between long-termism and share ownership structure of the company), differ in the degree to which they give detailed expression to long-termism (e.g. lack of provisions similar to s. 172 CA 2006 in Delaware). Delaware characterises minimalist intervention by the legislator with regard to the time horizon of a board's decision-making and the UK represents a middle position between Delaware and Germany in that respect. Nevertheless, it is not currently possible to state unequivocally whether the UK or Delaware position is better.

The foregoing analysis illustrates that currently there is no clear answer with regard to convergence or divergence as to long-term decision-making in the UK, Delaware and Germany. None of the national corporate governance systems under review offers any clear competitive advantages and the near future does not suggest any changes. Thus, the question addressed in the first Chapter of whether judge-made law in the common law systems is more efficient than civil law, code-based systems, must be answered negatively. In the context of long-term decision-making, case law has not yet proven to play an important role in the UK, Delaware or Germany. Moreover, both the UK and Germany – common law and civil law jurisdictions – include the notion of future orientated decision-making in their legislation.

This leads us to question the theoretical explanations for the similarities and differences between the jurisdictions. Certainly, this is caused by multiple reasons; however, only a few can be outlined. First of all, this study shows that all legal systems suffer from similar problems – in this case, profit maximisation that threatens the balanced development of the company. One of the ways of tackling this problem is the development of future orientated decision-making in the UK, Delaware and Germany. Secondly, the differences between the systems are often an effect of deeper historical, political and cultural factors. However, some reasons for the discrepancies between the jurisdictions with regard to long-termism are easily explicable. For example, the differences in the corporate objectives and share ownership structures will clearly have an impact on long-termism. Some other trends are also important. For instance, changes to the rules on quarterly reporting in the UK and

Germany are an effect of European Union law. The changes to the executive remuneration in all systems are an effect of the financial global crisis, which implies the globalisation of laws. Moreover, the jurisdictions borrow concepts from each other, eg the business judgment rule and the corporate governance codes.

3. The future of long-term decision-making in the UK, Delaware and Germany

This thesis shows that future-orientated decision-making is a topical issue in all three jurisdictions. Although no legal transplant is suggested nor is it claimed than any of the systems offers any clear comparative advantage, the natural question that arises is what can the legal systems learn from each other from this comparison? Hogg and Lubbe aptly note in this context that:

> This is a somewhat dangerous question for comparative lawyers to ask. They can fall into the trap of assuming that useful lessons can automatically be learned from other systems, without appreciating important differences. Another trap exists in the temptation to suggest that certain doctrines or solutions from one system can simply be transplanted into another without consideration of the attendant problems and consequences.[1147]

Nonetheless, as the systems face similar sets of problems; comparative material is crucial in understanding the debate on long-term decision-making. It is argued that comparison between systems should encourage further debate and reform with regard to the notion of long-termism. It is contended that this comparative research furnishes compelling justification for the following future developments. Firstly, all systems have been slow to develop a logical and coherent concept of long-term decision-making and as a result in practice directors in all these legal systems must wrestle on a daily basis with the issue of whether particular decisions are short-term or long-term. Obviously, the intention of the author of this thesis is not to suggest a comprehensive definition of long-term decision-making, but this thesis makes a case for a more consistent approach towards long-termism in the UK, Delaware and Germany. The current state of affairs is insufficient. There should be stronger encouragement from legislators and the judiciary for companies to concentrate on long-term factors. Convincing directors that it is actually worthwile to consider long-term factors could be the starting point. Directors should realise that a proper consideration of

[1147] Martin Hogg, Gerhard Lubbe, 'Formation of Contract' in: Reinhard Zimmermann, Kenneth Reid and Daniel Visser (eds) *Mixed Legal Systems in Comparative Perspective: Property and Obligations in Scotland and South Africa* (OUP 2004) 65.

long-term conseqences of decisions might effectively minimalise the risks of breach of duties and of litigation.[1148]

In each jurisdiction, different terms used to express long-term decision-making must be replaced with one clear concept. With regard to the UK, s. 172 CA 2006 should be reassessed and a more progressive way of encouraging long-termism should be suggested. Underlining the benefits of adopting a proper long-term inclusive approach, rather than just a box ticking exercise[1149] – as a way of reducing the risk of breaching section 172 – could be a good starting point for the improvement of this provision. Even creation of the written statement on the analysis of long-term interests might be considered. Meanwhile, German law should emphasise that sustainable development or sustainable creation of value is not only about CSR-related factors, but predominantly about creating long-term value for the company. As it was suggested in Chapter VI,[1150] in the context of executive remuneration, the replacement of the phrase 'sustainable development' with 'sustainable creation of value' used in the *Kodex* would be more appropriate, as it goes beyond mere CSR. In Delaware, the legislator must answer the question whether the current system sufficiently encourages long-term decision-making, even if they are against expressly articulating long-term considerations in the DGCL. The analysis of the soft law instruments in the US[1151] shows that long-term shareholder value is clearly encouraged as a key corporate objective. Hence, it is suggested that these existing best practice guidelines and handbooks could serve as a tool for improving the long-term decision-making in Delaware. Especially, it was underlined in this thesis that § 2.01 (and the comments that follow) of the ALI Principles[1152] provides the board with some meaningful guidance regarding the content and scope of long-termism.

Furthermore, a broader debate about the parameters of long-termism in the UK, Delaware and Germany must take place. This is the clearest weakness that hinders long-term decision-making. All three legal systems need to provide the board with more descriptive guidance of what is understood by future orientated decision-making; for instance, the annual collection of examples of successful decisions (from a company perspective, with a short justification) or best practice statements from different fields and industries would be helpful. This 'bank of good decision-making' (i.e. successful decisions, put in the context and including the analysis of decision-making process)[1153] could be managed by bodies

[1148] Referring back to the points and comments made in the context of the UK law: see Chapter IV para 2.2.
[1149] As suggested by Loughrey, Keay and Cerioni, see: Chapter IV para 2.2.
[1150] Chapter VI para 2.2, section: 'How should the law on executive remuneration be changed?'
[1151] Chapter III para 5.4.
[1152] Chapter III para 5.4 and 5.5.
[1153] As mentioned in Chapter III para 3.1.1.2.

responsible for issueing the corporate gavernance codes and best practice guidelines. Furthermore, any comments from the judiciary, even obiter dictum, would be extremely beneficial for the purposes of enhancing a long-term approach. Without supplementary case law or any form of guidance as to the ambit of long-termism, this concept will remain enigmatic.

After demonstrating the need to strengthen and improve the concept of long-termism in the positive law as part of directors' duties, this thesis propounds the view that fostering long-term decision-making by incentivising it, is clearly a more effective approach to adopt than simply relying on the law of directors' duties to police board behaviour on an *ex post facto* adjudication basis. Whilst legislation is a reactive way of encouraging long-termism, incentives are pro-active and a more practical way of fostering long-term decision-making. For instance, by tying executive remuneration to long-term performance or long-term development of the corporation, directors would be personally interested in furthering this aim. Chapter VI highlights that currently the legal systems are paying closer attention to the incentive structure for the managers. However, further incentives should be introduced. To sum up, the importance of this thesis is located in its capacity to fill a gap in the comparative company law literature regarding the content and scope of managerial long-term decision-making. In particular, it is suggested that the articulation of country-specific parameters of long-termism proposed by this thesis undoubtedly contributes towards the emergence of a better understanding of this concept.

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