

Shareholder Protection in the United States, Germany and Croatia – A comparative analysis

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Abstract

The purpose of this paper is to provide a comparative analysis between the United States, Germany and Croatia. I analyzed the legal framework within each country regarding existing corporate governance laws, which regulate shareholders protection. In this paper, I examined the historical development of this field of law in each of these countries.

The most important features of shareholder protection in the United States, Germany and Croatia are compared and the most prominent cases are explained.

The fundamental difference between the American and European model is that the United States has the shareholder-oriented model of corporate governance, while Germany and Croatia have the stakeholder-oriented model.

An interesting discovery in this paper is the resemblance of the legal provisions in Germany and Croatia. While the laws are the same on paper, the enforcement in Croatia is lacking, mainly due to asymmetry of information, where the shareholder are unaware of their legal rights.

In light of this research, two conflicting perspectives exist regarding shareholder protection. The first perspective is that too much shareholder activism occurs and that it slows down company operations. The second perspective is that more shareholder protection and activism is needed to limit the power of the managers.

Based on this comparative analysis, I conclude that the solution should be found between these two perspectives. Currently, shareholder protection does not give the expected results for the simple reason that the small shareholders do not want to participate in the every-day business of a company, while the institutional shareholders have the ability to protect their own interest without additional shareholder protection laws.

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1. INTRODUCTION

The need to provide the shareholders with protection in their relations with the company and its managers exists since the first corporations have been formed. That necessity is different from country to country and it depends on many factors.

Shareholder's activism has taken diverse forms, for instance, because of the cultural background of the country such as Germany, where the higher responsibility towards other interested parties exists (stakeholder oriented). The situation in the United States is quite the opposite and the focus is on the owner of the shares (shareholder oriented).

The way the companies developed also plays a significant role; the main characteristic of US companies is highly diversified ownership with many, at the beginning, individual and later also institutional investors. On the contrary, even today when talking about some of the biggest German companies, their most interesting feature is that they are family owned and one or few people have the majority influence. That being said, the situation on the open market is quite different and the possibility of the hostile takeover is much higher in the US while in Germany and Croatia the ownership structure itself provides a certain protection and insulation from the attempts of hostile takeovers.

Another difference lays in the internal organization of the companies. The US system knows only the one tier system whereas German and some other European systems, including Croatian, strongly rely on the two tier organization which in their eyes provides better protection and the oversight for the shareholders.

Lastly, some events such as the financial crisis and market collapse, the scandals connected with the managing directors or simply bad experiences, might provide motivation to develop greater shareholder protection.

Some of the scholars tried to categorize shareholder's rights and put them in some basic groups. The division I find the closest to being correct has separated shareholder's rights in four different groups. Namely, the control rights (exercised through vote), the economic rights (right to dividend and the right to sell your shares), the information rights (through annual reports) and lastly, the litigation rights (the right to sue).¹ All of the legal scholars agree that the protection and participation should be granted only to the long-term shareholders whose interests lay in increasing the value of the company and not just in short term speculations.

After the Enron scandal in the US and the global financial crisis, during which many shocking details regarding the functioning of big corporations came out to the public, strong pressure was put on the governments. Pressure was placed by the interested parties, particularly the potential investors, but also by the general public to initiate the creation of a better system of corporate governance which would open stronger participation possibilities for the shareholders and in that way prevent the problems in the future.

After introducing new modern laws, in US, Germany, but also Croatia, which provided for better protection and participation of the interested parties, the expectations were high.

Even though the changes are quite recent or are still undergoing, two different opinions can be heard from the scholars; first, some would say that the effect of these new regulations is close to being zero and that the shareholders' activity remains really low. Others on the contrary started criticizing the excessive activity of the shareholders which started creating problems in

¹ Velasco, J. „Fundamental Rights of the Shareholder“ Notre Dame Law School Legal Studies Research Paper No. 05-16; UC Davis Law Review, Vol. 40, No. 2, pp. 407-467, 2006. Available at SSRN: <http://ssrn.com/abstract=761904>

the everyday running of the company.² I believe that the truth is somewhere in the middle; smaller individual shareholders still have problems with being heard, while the bigger, institutional shareholders use their newly acquired rights in the broadest way possible.

In this paper I analyze the basic differences between US and German corporate governance, their main features and the influence of the global movements on the Croatian legal system, which just recently joined the European Union and its unified market. I also analyze the effects and the results of the US and the German system and make recommendations for the possible future changes in Croatian legal system.

² Foley Stephen, „Delaware's Top Judge Warns Over Activism“ Financial Times on March 25th, p. 13 available at:http://digital.olivesoftware.com/Default/Skins/FinancialTimesUS/Client.asp?skin=FinancialTimesUS&simigvis=My4yOTUuMTQ5MTU3MDU2NTg0OTUuMTM5NTgyMjMxMDMyNy4tNTMyNDg5MjY_*&AW=1396201043507&AppName=2

2. HISTORICAL BACKGROUND AND DEVELOPMENT OF THE SHAREHOLDERS ACTIVISM

Key statement describing corporate governance in general is the „separation of ownership and control“.³ The consequence of that situation is mirrored in a problem between the roles of the shareholders (“the owners”) and the board. In a classical corporation, *the owners* have a right to appoint the Board of Directors that represents and manages the company in their name. This relationship is called the Principal-Agent relationship⁴, in which the principal (“the owner”) tries to control and oversee the performance of the directors who are supposed to maximize his investment. The conflict between the two parties is as old as the relationship between the two, naturally, and it arises when the performance of the Board of Directors is unsatisfactory in the eyes of the shareholders.

2.1 History of shareholder activism in the United States

The United States corporate governance system is an example of a shareholder-oriented model, with a diffuse shareholder body. The United States currently has the most developed and best functioning corporate governance system. The beginning of shareholders’ activism can be traced back to the first half of the 20th century. In the period from ‘30s to ‘50s shareholders’ interest in participation in companies’ work grew and shareholders were more keen to participate in annual general meetings. The main premise of this system is the interest of the shareholders. The protection of shareholders and future investors was increased in 1934

³Berle A.A. & Means G.C., *The Modern Corporation and Private Property*, (rev.ed.) Transaction Publishers, New Brunswick-London, 1968.

⁴Jensen, Michael C., and William H. Meckling. 1976. "The Theory of the Firm: Managerial Behavior, Agency Cost, and Ownership Structure." *Journal of Financial Economics* 3, no. 4 (October): 305-60

after the introduction of the “Securities Exchange Act”⁵, which regulated the market of secondary securities (bonds, stocks, debentures). Even more importantly, this law established the Securities and Exchange Commission (hereinafter SEC), “the policeman of Wall Street”⁶, the federal agency in charge of supervising and enforcing U.S. securities and other related laws. Even from that time, we can follow court decisions regarding principal-agent conflict or shareholders’ protection of their rights. One interesting case is *Dodge v. Ford Motor Company*⁷ from 1919, in which the court defined the fiduciary duties that the management has towards the shareholders, primarily, duty of care and duty of loyalty. This case describes and defines the relationship between the two parties in the best and clearest way. During the entire history of American corporate governance, the conflict between the principal and the agent remains the focus of most court cases.

The main characteristics of the following decades, especially the ‘60s and ‘70s were strong managers and weak owners.⁸ Companies in United States during this period grew quickly and steadily, the ownership was dispersed and big companies had diversified their operations in many fields outside their core business. Few outsiders were members of the boards, and the majority of the board was usually comprised of company officers or other insiders over which the CEO had great influence. During this time, shareholders did not have a lot of influence on the board election since they had no direct voting rights and proxy voting was complicated and expensive.⁹ This period is also unique due to the lack of hostile takeovers. As stated above, the U.S. system of corporate governance was shareholder oriented, which means that the relations with other possible stakeholders, such as employees

⁵ Securities Exchange Act Pub.L. 73–291, 48 Stat. 881, enacted June 6, 1934, codified at 15 U.S.C. § 78a et seq

⁶ Coffee C.J.Jr & Sale A.H., *Securities Regulation*, Foundation Press 2009 at 1-2, p.3

⁷ *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich., 1919) : the Michigan Supreme Court held that Henry Ford owed a duty to the shareholders of his company to run his business in order to make profit for them, and not for the benefit of the community as a whole or the employees.

⁸ Jackson G., *Understanding Corporate Governance in the United States*, Arbeitspapier 223, October 2010, p.11, available at http://www.boeckler.de/pdf/p_arbp_223.pdf

⁹ Gordon J.N., *Of Shareholder Value and Stock Market Prices*, Stanford Law Review, 59, 2007, p.1496-1497

or creditors, were regulated through contracts. Managerial paychecks depended on the size of the company and the revenue at the end of the year.¹⁰ This time period was when the greatest development and growth of the U.S. economy occurred.

Positive movement in the promotion of transparency was also made by the New York Stock Exchange in 1976, when it became mandatory for all the companies listed to introduce an auditing committee.

In the coming years and especially in the 1980s, the economic growth slowed down and also the competition on market became tougher, specifically coming from Japan and Germany. Hostile takeovers were frequent and had the opposite impact in comparison to mergers in previous years. Big conglomerate companies were bought, broken into pieces and sold to different buyers in their fields. Due to a possible hostile takeover, a new insurance instrument appeared for the managers, dubbed “the golden parachute,”¹¹ which protected them from a possible loss of the position in the company. However, it was also used to incentivize their actions during the takeover by the acquirer company.

The law regulating corporations is in the most cases state law, not federal law. The state with the most developed corporate law regulations and court practice is Delaware; most of the U.S. states took over the Model Business Corporation Act (MBCA)¹² and incorporated it into their legislation. Cases such as “Van Gorkom”¹³ and “Unocal”¹⁴ in the late ‘80s represent landmark cases in defining rules of corporate governance in the US. In the “Van Gorkom” case, the Delaware Supreme Court discusses the director’s duty of care (“business judgement

¹⁰ Jensen, M. C. & Murphy, K. J.: Remuneration: Where we’ve been, how we got to here, what are the problems, and how to fix them, ECGI - Finance Working Paper, 44/2004(July), 2004, available at SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305.

¹¹ Black's Law Dictionary Free Online Legal Dictionary 2nd Edition : „Golden Parachute: To compensate for loss of office after a takeover or merger, a huge bonus and/or lucrative contract or a stockholding of a new setup is offered to a director or a key employee“

¹² Model Business Corporation Act (MBCA), first published in 1950 is a model law prepared by the Committee on Corporate Laws of the American Bar Association and is currently followed by 24 states

¹³ Smith v. Van Gorkom 488 A.2d 858 (Del. 1985)

¹⁴ Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)

rule”) and sets up a standard for the duty of disclosure. In the “Unocal” case, the same Court issued a landmark decision on corporate defensive tactics against takeover bids. In this case, the court sided with the directors and basically approved their defensive actions.

Since companies needed money, new institutional investors appeared, such as pension, equity or hedge funds, which would provide money under their own terms. Some of them, like pension funds, relied on their informal engagement, and the others, like hedge funds were quite direct when taking over the control of the company. One of the criticisms from this time was that the pension funds were too inert and disinterested in participation in the functioning of the companies in which they had shares and that they reacted only in the case of crisis. Still, in those years shareholders’ influence grew again and they decided to use their “voice” in the company. Even though the investors wanted to stay out of the spotlight, they were active behind the scenes by using their voting right on certain issues or directly talking to the directors.¹⁵ Since the institutional investors had shares in large companies and were responsible for their clients’ money, they did not have the possibility to use the “Wall Street rule”¹⁶ whenever they were not satisfied with the performance of the directors or business results. Due to these problems, the institutional investors started developing the corporate governance agenda. Following the same reasons, company boards started to change their structure and more independent directors were appointed. Although the CEO’s influence still remained strong, change was happening. The link between company performance and executive pay got more attention with the shift of interest back to shareholders value¹⁷, but the shareholders still did not have a “say-on-pay”, and that led to the huge explosion of managerial paychecks in the ‘80s and the ‘90s. Because of the permanent fear of hostile

¹⁵ Cheffins Brian R., The History of Corporate Governance, Working Paper N°.184/2012, ECGI Working Paper Series in Law, January 2012, p.17, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1975404

¹⁶ „It is better switch than to fight.“ „Selling a stock rather than trying to change the company's policies.“

¹⁷ Jackson G., Understanding Corporate Governance in the United States, Arbeitspapier 223, October 2010, p.15 available at http://www.boeckler.de/pdf/p_arbp_223.pdf

takeovers, managers started to create different defenses from hostile takeover, the so-called “poison pills”¹⁸, which served them as a tool to deter the possible acquirer from taking over the company. Shareholders’ participation in this whole period was manifested through the right of vote and exit. Shareholders had the right to vote at the annual general meeting on the matters that were covered with the “catch them all” clause or were enumerated in the Articles.

By the beginning of the 2000s, the corporate governance system was well developed and was embraced by businesses and their managers. By that time, most of the key pillars in the U.S. model of corporate governance were in place.¹⁹ Most of the company’s boards were closed, independent, able to make high-risk decisions (they are paid through long-term incentives tied to share price performance) and were generally under loose control of the outside gatekeepers, such as auditors and accountants. Annual and auditor’s reports were superficial and drafted poorly. This environment led to one of the biggest corporate scandals in the U.S. history, “The Enron case” (2001), and the year after “The Worldcom case”(2002) in which the CEOs, together with other senior officers and auditors, committed frauds and caused multi-billion damages to its shareholders because of market speculations and share price manipulations. One of the ways they accomplished this was through falsification of balance sheets and issuance of highly complex financial statements in which they managed to disguise billions of dollars in debt due to their failed projects and investments.

One of the reactions to these scandals was the enactment of the “Public Company Accounting Reform and Investor Protection Act“, commonly know as the Sarbanes-Oxley Act²⁰ (hereinafter “SOX”) that introduced the major change of auditing process (more independence for the auditors) as well as the rules of mandatory corporate disclosure. This

¹⁸ Black's Law Dictionary Free Online Legal Dictionary 2nd Edition: „poison pills: A takeover prevention strategy that makes stocks look bad to the buyer.“

¹⁹ Supra note 15, p.22

²⁰ Sarbanes-Oxley Act, Pub.L. 107–204, 116 Stat. 745, enacted July 30, 2002

Act also introduced higher personal criminal liability for the CEO and the CFO of the company for issuing false financial statements. The SOX provides better protection for the “whistleblowers”. There is an absence of any increase of shareholders’ rights or the responsibilities through this act, but it can be said that it provides greater safety for the future and current shareholders because it lowers the general investment risk. The Sarbanes-Oxley Act will be analyzed in details in the second chapter, together with the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (2010)²¹ and the proposal of the “Shareholder Bill of Rights Act” (2009)²², that were in reaction to the 2008 market crisis.

2.2 History of shareholder activism in Germany

There are some serious differences between the U.S. corporate governance system and the German one. One characteristic for many European companies even today, especially in Germany, is that they have one majority/controlling shareholder, and the main focal relationship is the one between the majority and the minority shareholders and not so much on the principal-agent relationship. In order to provide better protection for the minority shareholders, the Germans introduced the two-tier system, with the management board (*Vorstand*) and the supervisory board (*Aufsichtsrat*), that was to serve as a buffer and insurance for the smaller shareholders.²³ Another different feature of the German system is the “co-determination”²⁴; participation of the workers on the board of the company that plays a significant role in the whole German business world, and explains clearly why this system is

²¹ The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173)

²² Shareholder Bill of Rights Act of 2009, S. 1074 (111th): Bill referred to the Committee, status: died

²³ Gorezi A., S.J.D. Dissertation : Shareholder Rights, Executive Compensation and Stakeholder Protection: A Comparative Overview of United States and chosen European Jurisdictions, Central European University, September 2011, p.37

²⁴ Regulated throughout the years with four different acts: “Coal and Steel Co-determination Act“ (1951), „Works Councils Act“ (1952 and 1972), „Co-Determination Act“ (1976) and the „Third participation Act“ (2004)

considered to be stakeholder-oriented. The most important act regulating co-determination is the “Co-Determination Act” (1976), and it will be reviewed later in this paper. The last aspect of this system that is specific is the general role of banks and their influence on companies.

Many German companies in the '20s and the '30s were (and still are) family owned, but during that time, the dispersion of ownership started to occur. The risk of hostile takeover grew and the majority shareholders tried to protect themselves by introducing multiple voting shares or voting caps for other shareholders, disregarding their ownership share in the company.²⁵

During the '40s, duty towards all stakeholders was introduced (including the Reich).²⁶ During this time, the banks were a really important piece of the puzzle. Shareholders had to register their holdings with the bank and provide them with proxies if they were not to vote directly.²⁷ By the end of the 20th century, the voting caps and multiple share votes were prohibited, following another mode of maintaining control had to be invented: the pyramid system.²⁸ After the reunification of the country, the role of banks came into focus again²⁹ and new laws were passed in order to redefine the position of the banks.³⁰ “The Act on Control and Transparency of Enterprises” (hereinafter KonTrag)³¹ and “the Act on Transparency and Disclosure”³² were some of these new regulations. Throughout this whole period, German companies are characteristic for their block-holders and, in general, low risk of takeovers. For this reason, the German legislator has not dealt in details with the possible defenses from

²⁵ Marck R., & Steir L., „The Global History of Corporate Governance – An Introduction“, National Bureau of Economic Research, Working Paper No. 11062, Jan.2005, available at www.nber.org/papers/w11062.pdf at p.9

²⁶ Supra note 20, p.38

²⁷ Id.

²⁸ Hansmann H., & Kraakman R.H., „The End of History of the Corporate Law“, Yale School Working paper No.235, January 2000, available at SSRN www.ssrn.com/abstract=204528 p.23-42

²⁹ Supra note 19, p.9-10

³⁰ Supra note 18, p.39

³¹ Act on Control and Transparency of Enterprises (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*), 27.07.1998, published in the Federal law Gazette (*Bundesgesetzblatt, hereinafter BGBl*), I. S.786.

³² Act on Transparency and Disclosure (*Transparenz und Publizitätsgesetz*), 19.06.2002., BGBl, I.S.2681.

hostile takeover. The main premise was the neutrality of the board³³, however with the introduction of the Antitakeover Act in 2002 (that was a response to the 13th Company Law Directive³⁴, proposed by the EU), the legislator left an option for the introduction of super majority vote and authorization for the board to undertake some defensive steps. These problems will be referred upon in details in the next chapter. The shareholder activism, their rights and relationships with other entities within the corporation is in general regulated through “The German Stock Corporation Act”³⁵ (Aktengesetz, hereinafter AktG).

German court practice was not so fruitful nor developed regarding these issues in comparison to the U.S. one. Although, there have been recent changes in that field and several high profile cases regarding shareholder protection, hostile takeover and management’s fiduciary duty have come before the German courts. The most prominent cases are “The Mannesmann case” (2002) and the very recent “Volkswagen case” (2008). Their impact on the corporate governance in Germany will be analyzed later in the sub-chapter 3.2.2.2.

2.3 The History of shareholder activism in Croatia

Corporate governance is a totally new concept in Croatia as in most of the Central and Eastern European (CEE) countries, and the development in this field has been very recent. Before the 1990s, Croatia was a part of the socialist block of countries in Yugoslavia, with a planned, thus non-capitalistic economy. While the state owned all of the companies in the communist

³³ Höpner M., & Jackson G. : „Revisiting the Mannesmann Takeover: How Markets for Corporate Control Emerge“, *European Management Review* (2006) 3, p.142-155, available at <http://www.mpifg.de/people/mh/paper/HoepnerJackson%202006%20EMR%20-%20Revisiting%20Mannesmann.pdf>

³⁴EU Directive 2004/25/EC, adopted 21.04.2004 : provided for no defensive actions by the board during the takeover

³⁵ German Stock Corporation Act (*Aktiengesetz, AktG*), 6th September 1965, BGBl. I p. 1089, FNA 4121-1, Last amended by article six of the German Restructuring Act (*Restrukturierungsgesetz*) dated 9 December 2010 , BGBl. I p. 1900. Available in English at: <http://www.nortonrosefulbright.com/files/german-stock-corporation-act-2010-english-translation-pdf-59656.pdf>

states under the influence of the USSR, Yugoslavia chose a different approach of social-ownership³⁶ and workers' self-management. This system accepted some of the principles of the market economy and was more efficient in comparison to other communist models. Even though it was "better" in comparison to the total state planned economy, this model was not self-sustainable for many reasons and collapsed in the end.

At the beginning of the 1990s, with the transition to democracy, the economy also started its transformation into a market economy. Between 1990 and 1995, during the "*Homeland War*" in Croatia, fast-track privatization and transformation of companies occurred, followed by many cases of corruption and criminal activities. The change was faster than the creation and application of laws designed to regulate it.³⁷ The laws enacted existed on paper, but there were not many efficient ways of enforcing them at the time. As a result, large shareholders appeared, and in most of the cases they had total control over the company and managed it at the same time. Because of this high level of ownership concentration, protection of the minority shareholders will be discussed in depth later on. The fact is that the corporate governance rules and shareholder protection were not a priority for the legislature, since the whole system was changing and some of the basic laws such as company law were brand new.

Croatia, with its neighboring countries,³⁸ historically belongs to the German and Austrian-Hungarian circle, and due to that fact, the role-model for most of the new legislation was German law.

In the past 10 years, major progress was made in Croatian legislation regarding corporate governance; Croatian Corporate Governance Code³⁹ was introduced and enforced by the

³⁶ „društveno vlasništvo“

³⁷ Pistor Katharina, „Patterns of legal Change: Shareholder and Creditor Rights in Transition Economies“ 1. Eur. Bus. Org. Law review, 1. 2004, available at: SSRN, www.ssrn.com/abstract=214654

³⁸ According to Pistor, countries belonging to German and Austrian-Hungarian legal heritage are: Slovenia, Hungary, Czech Republic, Poland, Slovakia and Croatia

Croatian Companies Act (hereinafter ZTD)⁴⁰, which itself underwent improvements. The reasons for this development lie partly in the simple need of the market for better regulation, but also in the Croatian accession process to the EU, which spurred the necessary change. Today we can say that Croatia has a modern system of corporate governance, similar to that of other EU member states, especially Germany and Austria. However, it remains an open question whether these regulations came to life in the Croatian corporate world in its full potential.

2.4 Conclusion

This brief historical overview was provided to give an insight on the idea of corporate governance, and more specifically, shareholder activism in these three very different jurisdictions. It was to help better understand the current efforts made by the legislatures in this regard. The increasing role of the shareholder activism in the U.S., from the beginning of the century all the way until the present is obvious. It is a result of the need of the market itself for better regulation. Germany has a different direction of development, due to the fact that the ownership composition in the companies was different. The need for minority shareholder protection arose together with the duty to protect the other stakeholders. Another crucial aspect for Germany was the defining the role of banks in the whole system.

Croatia encountered special problems after gaining its independence. The task was to create a totally new system that relies on totally different foundations. During this period, the problems were dealt with as they occurred. Another facet of the problem was the influence of the socialism and the lack of any corporate governance. Having in mind this historical

³⁹ Zagreb Stock Exchange and Croatian Financial Services Supervisory Agency Code of Corporate Governance, 2007., available at : http://www.ecgi.org/codes/code.php?code_id=275

⁴⁰ Croatian Companies Act (Zakon o Trgovačkim Društvima, ZTD), Narodne Novine 111/93, last amended NN 68/2013

perspective, it is easier to understand the current efforts that are supposed to protect the shareholders.

3. SHAREHOLDER PROTECTION IN U.S., GERMANY AND CROATIA

3.1 Legal Framework

3.1.1 United States

The U.S. legal framework regulating corporate governance consists of a number of laws that date from different time periods.

The first federal law regulating this matter was the “Securities Exchange Act” (1934), which, among other things, made the communication between the shareholders legally dangerous and in that way suppressed shareholder activism. The rules regarding proxies, which called for filing different statements with the SEC, were time-consuming and expensive and they deterred the shareholders from engaging. These rules were found too strict and were amended through SEC procedural rules in the 1990s.

After the Enron and WorldCom scandals, the federal government passed the “Sarbanes-Oxley Act,” which broadly amended the 1934 Act and made a step forward towards improving financial reporting of corporations and their transparency, introduced tighter oversight of accountants and regulated some areas of corporate governance that had previously been regulated through state laws.⁴¹ The Act regulated outside auditing professionals, forced companies to submit additional reports, enhanced the criminal liability of the CEOs and CFOs for the company’s reports, and provided better protection for the “whistleblowers” etc. All of these provisions could be read as a direct response to abuses occurring in the Enron and WorldCom cases.

⁴¹ Supra note 3 on p.24

After the financial crisis and the huge impact it generated in the market, in 2010 a new law was enacted. The Dodd-Frank Act introduced changes into the whole financial services industry in the U.S. Regarding shareholder protection, this Act provided stronger rules on disclosure, and introduced, in Subtitle E, “say-on-pay” provisions for the shareholders, which gave them the right to vote and give their approval of executive compensation and also gave them the right to express their opinion on “golden parachute” provisions. Shareholders also received the right to nominate candidates for the membership on the board of directors.

Following the government regulations, other actors, such as company senior officers, auditors and accountants, have developed different types of soft law that helped improve corporate governance in the U.S.

The New York Stock Exchange (NYSE) and the NASDAQ have made their own Corporate Governance proposals in 2002, in which they opted for higher level of shareholder participation, especially regarding approving equity plans, and also for more independent directors and their larger role.⁴² Generally Accepted Accounting Principles (GAAP)⁴³ and the Principles of Corporate Governance⁴⁴ represent the latest efforts of professional interest in the relationships between entities, ethical conduct and transparent “doing business” with paying due attention to the protection of shareholders rights.

⁴² Holmstrom B. & Kaplan N. S., „The State of US Corporate Governance: What's Right and What's Wrong?“, National Bureau of Economic Research, Working Paper 9613, April 2003, available at: www.nber.org/papers/w9613 at p.23

⁴³ Federal Accounting Standards Advisory Board (FASAB) : 2013 FASAB Handbook of Federal Accounting Standards and Other Pronouncements, available at: <http://www.fasab.gov/accounting-standards/authoritative-source-of-gaap/accounting-standards/fasab-handbook/>

⁴⁴ Business Roundtable (BRT), an association of CEOs of leading US companies, 2012, available at: http://www.businessroundtable.org/sites/default/files/BRT_Principles_of_Corporate_Governance_-_2012_Formatted_Final.pdf

3.1.2 Germany

Basic law in Germany regulating the shareholder rights and their activism is the Stock Corporation Act from 1965. This law provides for the two-tier system that originated in 1870s⁴⁵ and is mandatory for the German stock corporations.

The Act on Control and Transparency of Enterprises from 1998 and the Act on Transparency and Disclosure from 2002 have made improvements regarding auditing companies' duties, general work of the supervisory boards and more transparency (strengthening the shareholders' position)⁴⁶. These laws also made the role of banks in Germany clearer and have put additional requirements on the banks in order to achieve better transparency and disclosure. Before these rules, banks were acting as proxies of the shareholders and were quite powerful and active in the company's everyday business. New rules have made it obligatory for the banks to send notices to the shareholders and give them the option to choose on who will vote in their name, the bank or some shareholder association. The banks also have the duty to advise the shareholders and give proposals in the interest of their customer and not of their own ones.⁴⁷

As previously mentioned, the German Antitakeover Act from 2002 was a reaction to the attempts made by the EU through its 13th Company Law Directive in which it was provided that no antitakeover measures should be conducted by the boards of the target company. The new Act in Germany did not go as far as the U.S. provisions went, which allowed for different defenses (poison pills), but the German Act has provided that in the situations of hostile takeover, the board can receive authorization from the shareholders to take defensive measures.

⁴⁵ Baums T. & Birkenkämper A., „Corporate Governance in Germany – System and Current Developments“ European Corporate Governance Institute (ECGI), Oct.1998, available at: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=158038

⁴⁶ Id. on p.15

⁴⁷ Id. on p.17

It has been mentioned earlier that Germany has a specific law regarding workers participation in the supervisory board of the company. This phenomenon is called Co-Determination and is regulated through the “Co-determination Act” from 1976.⁴⁸ In the companies with over 2000 employees, half of the members of the supervisory board are appointed by the shareholders and the other half by the employees of the company and possibly trade unions. The chairman of the board is elected by the shareholders and in rare situations of stalemate; he/she has the decisive vote. Because of this latter solution, this system is sometimes referred to as “quasi-parity co-determination”⁴⁹ for the reason that in the end, the shareholders have the final say. Even though this situation may seem strange and unusual for outsiders, it is generally accepted in Germany and moreover, it functions well.

German Corporate Governance Code (hereinafter GCGC) was drafted by the Government Commission appointed by German Federal Minister of Justice. It was published for the first time in 2002.⁵⁰ The GCGC represents a code of standards, in which the aim is to promote trust and transparency, and it contributes to self-regulation. The recommendations in the GCGC may be of two different kinds, the first one is expressed with the word “*shall*” and it is in connection with the “*comply-or-explain*” principle. This means that the companies can stray from the recommendations, but if they do, they are obligated to disclose it in their annual report and explain the reasons for different practice. The other recommendations are expressed with the word “*should*” and in a situation of deviation, no explanation is needed. The CGCG gives recommendations on shareholders’ participation, transparency (publishing regular reports) and on executive compensations.

⁴⁸ German Co-determination Act (*Mitbestimmungsgesetz*), May 4th 1976, BGBl . I S. 1153, last amended by Article 2, Section 113 on December 22nd 2011 (BGBl. I S. 3044)

⁴⁹ Supra note 42, on p.10

⁵⁰ German Corporate Governance Code, July 29th 2002, BGBl I No.50, last amended on May 13th 2013, new Art.161 has been added to the Stock Corporation Act that enforces GCGC

3.1.3 Croatia

The Croatian legislature follows German and Austrian examples and has applied their regulatory solutions in domestic laws ever since Croatia became independent. During the accession period to the EU, Croatia adopted the entire “*acquis*” of the Community.

Croatian Companies Act adopted most of the solutions provided in the German Stock Corporation Act. It regulates the shareholders’ activity and prescribes what their rights are.

Through the Takeover Act,⁵¹ the whole 13th Company Law Directive has been implemented in Croatia. The Act provides for takeover steps, disclosure and transparency imperative and also opts for no defensive actions by the boards. This Act also contains the “squeeze out” provisions regarding the minority shareholders. The acquirer that owns at least ninety-five percent of the company shares has the right to buy out the remaining five percent from the minority shareholders for just compensation.

Croatian Code of Corporate Governance was published in 2007 and it is also enforced through the Croatian Companies Act (Art.272). The main goal of this Code is to make the internal corporate governance system transparent, especially in terms of the decision-making process; another function is related to financial reporting.⁵² The content of the Code is broader and more detailed, particularly regarding the shareholder protection and exercising shareholders’ rights, executive compensation, rules on disclosure and transparency etc. Although the legal framework is of good quality, problems occur in practice. Most of privately held public companies have not published their annual reports in accordance with

⁵¹ Croatian Takeover Act (Zakon o preuzimanju dioničkih društava), Narodne novine br. 109/07, 90/13 – Odluka USRH (Croatian Constitutional Court decision) broj: U-I-4469/2008 i dr., 99/13 – Odluka USRH broj: U-I-2470/2010 i dr., 148/13

⁵² Mintas Hodak Lj., Jurković Majić O., Majić H., „A Research on the Code of Corporate Governance in Croatian Business Practice“, Social Responsibility, Professional Ethics, and Management Proceedings of the 11th International Conference Ankara, Turkey, 24–27 November 2010, p.4

the Code, only the companies with a relevant number of employees and with a dominant position on the market comply with the provisions.⁵³

3.2 Shareholder's Activism and Protection of Shareholder's Rights

As it has previously been stated, the need for the shareholder activism and protection of its rights originates in the impossibility of the Board of Directors to manage the agency problem.⁵⁴ The activity of the shareholders can be manifested in two basic ways: through simply selling the shares (*exit*) or by vocalizing his disagreement with the management (*voice*)⁵⁵. The right to information can also be added to the category of shareholders basic rights, but this prerogative will not be analyzed in this paper.

Naturally, when talking about shareholders it should always be borne in mind that there are two different types of shareholders, as mentioned above, the individual and the institutional shareholders. And of course, their interests might be, and in most cases are, different.

When comparing the U.S. and German shareholder protection provisions, many similarities, but also many differences appear. It can be observed that the shareholders in U.S. have easier way of performing their activities than those in Germany, simply because of the difference in internal organization of the company, namely the two-tier system. Another type of limitation that is represented in Germany and slowly is penetrating the U.S., is the respect of the rights and interests of other stakeholders, mainly the employees.

In Croatia, having the system quite similar to the German one, could be expected to find same problems as in Germany, but that is not the case. Croatian problems with the shareholders'

⁵³ Id. on p.7

⁵⁴ Meckling W.H. & Jensen M.C., „Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure“, 3 Journal of Financial Economics 4, July 1976, at 308.

⁵⁵ Jackson G., Understanding Corporate Governance in the United States, Arbeitspapier 223, October 2010, p.24

participation mainly lay in their passive attitude and in general lack of knowledge and awareness of their rights.

Even though the shareholders enjoy high level of rights and have tools to participate, somehow their activity remains low (in Europe).

In general, shareholders have strong rights “on paper”, but when it comes to utilizing them, they, more than often, run into different obstacles that are in most of the cases too complicated to overcome. Recent developments gave more power to the shareholders and they got the say on many situations that can occur in the company.

The shareholders materialize their right to participate in decision making and running the company through their right to vote at the general meeting. The right to nominate and elect directors, mandatory approval of fundamental corporate matters (situations in case of takeovers or dissolution of the company) and the say on executive compensation (“Say-on-pay”) and are some of the most important recent developments that will be dealt with in this chapter. Issues that will also be described and touched upon are the actions against the managers before courts and possibilities of protection of minority shareholders.

3.2.1 The Right to Nominate and Elect Directors

3.2.1.1 United States

Director’s elections represent the core of the corporate governance.⁵⁶ In the US there has been a strong idea of strengthening the shareholders’ role in these procedures, both on state and federal level. Under the previous legal framework, the capability of the shareholders to

⁵⁶ Ventrizzo M., Boconi University, „Empowering Shareholders in Director's Elections: A Revolution in the Making“, ECGI, Working Paper No.147/2010, March 2010, at p.2, available at: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1558467

nominate candidates for the board was quite narrow. It was quite simple for the current directors to influence the election of their candidates, another typical situation was that the number of nominees was equal to the number of available seats on the board. The state of Delaware reformed its corporate law and included the possibility to allow access to the corporate proxy statement for the shareholders. Naturally, some limitations were included, such as the duration of ownership and the minimum threshold of ownership. These changes also provided for the possible reimbursement by the company to the shareholders for soliciting proxies. It is important to emphasize that all of these reforms were on a opt-in basis, meaning that these new possibilities could but also could not be awarded to the shareholders through the bylaws of the company. In the end, this whole reform could have been meaningless because it is still possible not to include any of the new provisions in the company bylaws.⁵⁷ Another problem represents the voting itself and the application of the plurality voting system which makes it really hard for the minority directors to be elected. This problem could be solved with applying the cumulative voting system (pool of votes).

The things became clearer after the introduction of the Dodd–Frank Wall Street Reform and Consumer Protection Act in 2010. This federal law introduced many changes in the whole financial sector. It created the right for the shareholders to nominate and elect board members. In section 971, it is prescribed that the shareholders have the right include their nominee through the use of company's proxy statements. Through SEC rules from the same year⁵⁸, it has been decided that this option will be available for the shareholders that own at least 3 percent of the company's shares for a minimum of three years continuously (long-term shareholders).

⁵⁷ Id. p.7-13

⁵⁸ SEC open meeting on 25th of August 2010, available at <https://www.sec.gov/news/press/2010/2010-155.htm>

BRT Corporate Governance Rules from 2012 mention election of directors in a way that it should be done through majority vote and that the candidates should submit their resignation letters with the board before the voting, for a case of not receiving a majority vote.⁵⁹

3.2.1.2 Germany

Situation regarding nomination and election of the managing directors in Germany is quite different than in the US. Since the most of the companies in Germany have the two tier board structure, the appointment of the Management Board goes through a different procedure.

The Management Board is appointed by the Supervisory Board for a term of 5 years, with the right to be re-elected.⁶⁰ Members of the Management Board can be revoked for a cause by the Supervisory Board.⁶¹ Supervisory Board members are appointed at the General Meeting of the shareholders with the simple majority of the present votes and by the employees, if the rules of Co-determination should apply.⁶² The members of the Supervisory Board are also appointed for the term of maximally five years, with the possibility of re-election. It is also possible for the class of shareholders or for a single shareholder to appoint up to one third of the shareholders' representatives, if it is allowed through the Articles of the company.⁶³ The composition of members of the Supervisory Board is equal, half of the board is appointed by the shareholders and the other half by the employees, the chairman of the board is the representative of the shareholders. In situations of stalemate, the chairman has the decisive vote. Shareholders holding at least 5% of the shares have the right to make a proposal of a certain decision to be discussed at the General Meeting, including a nomination of the

⁵⁹ Business Roundtable (BRT), an association of CEOs of leading US companies, 2012, available at: http://www.businessroundtable.org/sites/default/files/BRT_Principles_of_Corporate_Governance_-_2012_Formatted_Final.pdf, on p. 13

⁶⁰ Stock Corporation Act (*Aktiengesetz, AktG*), 6th September 1965, BGBl. I p. 1089, FNA 4121-1, §84 AktG

⁶¹ § 84(1)

⁶² § 101 AktG, see also German Co-determination Act (*Mitbestimmungsgesetz*), May 4th 1976, BGBl. I S. 1153

⁶³ § 101 (2)AktG

candidate for the Supervisory Board. In specific cases when the Supervisory Board is incomplete and there is a problem with appointing members, the appointment can also be made by the court upon a motion made.⁶⁴

Members of the Supervisory Board may be dismissed by the shareholders, without a cause (with the supermajority of 75% of the votes) and before the end of their term. The supermajority threshold may be reduced through the Articles of the company, but it still has to be higher than 50% of the votes.⁶⁵ This procedure can be initiated by the shareholders holding at least 10% of the shares or they represent at least one million euro of the share capital⁶⁶, this is also a tool for minority shareholders. In systems like the German one, there is a possibility that the one controlling shareholder has the power to control both boards, situation of potential “back scratching” occurs.

The voting can be done directly (postal vote or vote by way of electronic communication are also a possibility) at the General Meeting or through proxies (banks).

Banks have a specific role in German companies. New changes have been made recently in order to limit their influence. Banks are now required to transfer all the communication they as proxies might have with the company, to the shareholder.⁶⁷ Furthermore, they should ask the shareholders for instructions on how to vote on a specific matter, if the instruction is not given timely, they are allowed to vote in their own interest. Another novelty is a duty of the banks to give useful information and advice to the shareholders, disregarding their own interest.⁶⁸

⁶⁴ § 104 AktG

⁶⁵ § 103 (1)AktG

⁶⁶ § 103 (3)AktG

⁶⁷ § 128 AktG

⁶⁸ § 135 AktG

The two tier model, in general, should provide a better protection for the shareholders. The reason for this lays in the fact that they are represented by professionals who are supposed be independent, loyal and should know their job. This model, in my opinion, also provides better independence of members of one board from another, simply for a reason that they are not working side by side on a daily basis, which is a case in companies with one tier board structure.

3.2.1.3 Croatia

It has already been said that the Croatian Companies Act almost represents the replica of the German Stock Corporation Act. Croatian law recently allowed founders of the companies to choose between one and two tier model. Vast majority of stock corporations has the two tier model and for that reason it will be in the center of attention in this part.

Even though Croatia does not have laws regarding co-determination per-se, employee representation in the boards exists and is widely accepted. These matters in Croatia are regulated through labor law or collective agreements.

Procedure of electing members of the Management Board is the same as in Germany, they are elected by the Supervisory Board for a five year term and they can be revoked for a cause.⁶⁹

The member can in extreme cases be appointed by the court. Every change that is made regarding any of the two boards needs to be reported to the court registry. This takes time and costs a certain sum of money.

Supervisory Board is appointed by the General Meeting of the shareholders, they are appointed for a four year term. Member of a Supervisory Board can be revoked at any time by

⁶⁹ Art.244 ZTD

the one who elected him.⁷⁰ The decision need to be approved with the 75% majority vote. As in Germany, the board member can be revoked on the request of shareholders holding at least 10% shares, if they are holding at least 10% of the company equity or own at least 8.000.000 HRK in company equity.⁷¹

Voting at the General Meeting is conducted through direct vote or through proxies, it is also allowed to exercise the voting rights via postal vote or in a electronic way.⁷² The decisions are made with the simple majority vote. The role of banks and authorized brokers is also regulated in a same way as in Germany.

It is evident that the Croatian legislator used German law as a model to regulate company law in Croatia. Even though the rules are the same, some specific problems occur. It is characteristic for Croatia that many of the stock corporations are owned by a single shareholder or by one family. In situations like this, it is useless to talk about independency of the managers. It is also clear that the shareholders activity, regarding nominating and electing managers, remains low. Most of the small shareholders do not have any motivation in participation in the company's life, beyond receiving dividend and annual report.

3.2.2 Shareholders' Vote on Fundamental Corporate Matters – Takeovers

Shareholders have a say regarding many situations that may arise in company's life and that are so important that they as owners, should have a right to express their opinion. The decisions regarding merger, defensive tactics, takeovers etc, are laid before the shareholders for their say. The matters on which the shareholders have a say may be enumerated in the Articles of the company or they can be covered with an open-end clause. Although in theory

⁷⁰ Art.259. ZTD

⁷¹ Art.260 ZTD

⁷² Art.274 ZTD, usage of electronic vote is allowed only if it is conducted in real time

it sounds quite straightforward, there are many drawbacks when we are considering the shareholders' participation on these matters. The General Meeting of the shareholders has a say on fundamental matters, not on day to day business decisions and strategies. Even though shareholders say is accepted as one of the basic rights, there are certain limitations to it.⁷³ Firstly, the managers are those who are deciding what matters will be presented to the shareholders so this leaves a great possibility of manipulation. Secondly, when making decisions regarding fundamental matters, in most of the times, supermajority vote (75% of the shares or even more) is required. This creates different problems in different jurisdictions. Namely, in the US, where the companies have a large number of small shareholders, it is a quite a problem to achieve this level of majority vote. On the other hand, in Germany and other European jurisdictions, including Croatia, a different problem emerges. Most of the companies have one or few controlling shareholders that, in most of the cases, own over 75% of the shares. In this situation, they are qualified to make fundamental decisions even when the minority shareholders may be against it.

3.2.2.1 Shareholder vote in the United States

The shareholders in the U.S. have other rights next to the ones regarding election of the directors and bylaw amendments. They also have a say on mergers and amendments of the Articles/Charter. Shareholders in the U.S. do have the initiative to make decisions and change company's bylaws, even without the approval of the board. But this possibility is pretty much limited with the legal framework that prescribes bylaws to be in accordance with the corporate law and the Articles/Charter of the company.⁷⁴ Another thing is that the directors

⁷³ Gorezi A., S.J.D. Dissertation : Shareholder Rights, Executive Compensation and Stakeholder Protection: A Comparative Overview of United States and chosen European Jurisdictions, Central European University, September 2011, p.58

⁷⁴ Id. p.58-59

have the same right and sometimes they might use it to limit the shareholders rights. The U.S. laws allow inclusion of the so called “poison pills” in the bylaws of the company, which allow the management to take defensive actions in situations of the “hostile” takeover. Another thing that could be analyzed is the real meaning of the hostile takeover, even though it is not a topic of this paper. The attempts of takeover are seen as hostile only in the eyes of the current management board, since their position with the new owner might not be safe. Situation is not that dramatic for the shareholders, since they are free to sell or not to sell their shares on the market, of course, for the price that is acceptable for them.

As already said, the managers have a strong influence on which matters will be put before the shareholders for the decision. One of the management’s strategies of avoiding the shareholders was simply transformation of the situation about which the shareholders should vote, to the one they should not. In the cases of takeovers, courts have taken different approaches in handling the problems that arose.

U.S. court practice has been quite rich in this field and has taken different positions towards this problem with time. The common tactic used by the boards was to disguise the takeover actions with a simple sale of assets. In cases before the Delaware and Pennsylvania courts, such as *Paramount Communications Inc. v. Time Inc*⁷⁵ and *Farris v. Glen Alden Corp*⁷⁶ in which the boards tried to avoid the shareholders say on the transactions, the court applied the *de facto* doctrine and regarded the transaction through its structure and meaning, and not the name of it. Even after these cases, courts were in general, deciding in favor of the directors and gave them sort of an approval to avoid shareholders’ opinions.

⁷⁵ *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140,(Del.1989)

⁷⁶ *Ferris v. Glen Alden Corp.*, 143 A.2d 25, (Pa 1958)

The most prominent and land marking case regarding the takeovers, has already been mentioned, the *Unocal Corp. v. Mesa Petroleum Co.*⁷⁷, decided by the Delaware Chancery Court. In this case the court allowed the directors to take defensive measures without the approval of the shareholders. They were protected with the *business judgment rule*. In this situation, the directors claimed that they were working in the interest of the shareholders, i.e. they were simply fulfilling their fiduciary duty towards the shareholders of the company. At first sight this decision might seem just and in the interest of the shareholders, but it has actually opened a clear path to limiting shareholders rights, such as a free sale of their shares when they wish to do so. It can be said that the courts are favoring the directors over shareholders in situations like this.

BRT mentions the need for respecting the interests of the long-term shareholders but with a clear distance from them, since the managers are representing the company and all of its shareholders.⁷⁸

3.2.2.2 Shareholder vote in Germany

Some of the most important decisions that need to be approved or made by the General Meeting of the shareholders are enumerated in the sec.119 of the AktG, amending the Articles, dissolution of the company and mergers being the most important ones. Fundamental decisions require a supermajority vote of the shareholders (in most cases 75% of shares or a 2/3 majority), but even the shareholders holding at least 5% of the shares can convene the General Meeting and demand discussion on a certain topic. The general principle regarding voting in Germany is “one share-one voice”.

⁷⁷ *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)

⁷⁸ *Supra* note 57, p.23-24

It has been mentioned previously in this paper that the shareholder composition in German companies was quite different in comparison to the ones in United States. Due to the fact that German companies often have a dominant shareholder or a small number of minority shareholders, the possibility of the hostile takeover is highly unlikely (but not impossible).⁷⁹ In most of the cases, the takeover would be negotiated privately with the owners, in a friendly environment.

Until the year 2002 and the introduction of the new German Antitakeover Act, boards of the company had no authorization to influence or act in a case of takeover. After the EU decided to take the position of neutrality of the boards in situations of takeovers (the 13th Directive), Germany opposed the proposal. This Act gave the possibility to the shareholders' meeting to authorize the boards of the company (both management and supervisory) to take actions in order to defend the company from the takeover, for a limited period of time. This means that the law allowed the shareholders to transfer their rights in the hands of the boards, in order to protect their interest in a better way. It should be emphasized that these defensive measures are quite limited, and are not at all similar to the poison pills allowed in the U.S.

For the reason of specific ownership structure, those rare cases of hostile takeovers that occur in Germany are very interesting.

The takeover of the German giant, *Mannesmann AG* by the Vodafone plc in 2000, was one of those cases. This case represents a successful hostile takeover and one of the main reasons for its success was the ownership structure in which the top ten shareholders controlled only 25.7% of the shares.⁸⁰ This takeover manifested that defense mechanisms in Germany were

⁷⁹ Baums, Theodor & Scott, Kenneth E. : „*Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*“, ECGI, Law Working Paper No. 17/2003, November 2003, available at <http://ssrn.com/abstract=473185>, p.21

⁸⁰ Höpner, M. & Jackson, G. : „Revisiting the Mannesmann Takeover: How Markets for Corporate Control Emerge“, *European Management Review* (2006) 3, p.147, available at

not functioning properly, first of all, workers through co-determination or the banks as block shareholders that could always have a say. The managers did not have many tools to use in this situation. Another issue arose from this case, regarding the fiduciary duties of the managers, but it will be more analyzed in the next sub-chapter.

Maybe even more interesting case occurred recently. The takeover battle between two German giants.

The Volkswagen & Porsche saga started in the year 2005 and ended in the year 2009. It is one of the most interesting cases in German corporate governance history. The fact that the whole situation was dealt by two families as majority shareholders of these companies makes it even more intriguing. Everything started with the strategic decision of the Porsche board to acquire shares in VW in order to get access to their “know-how” but also to improve its financial stability.⁸¹ The Porsche wanted to acquire the controlling package in the VW through buying shares and options (in order to avoid disclosure regulation). In the end the Porsche did not succeed in gaining the controlling package and also had a significant debt to the financial institutions that followed its attempt of takeover. Many of the institutional short term investors, primarily hedge funds, lost major amount of money in these transactions. The situation was solved through the merger of the Porsche and VW, under VW terms, since the Porsche had a problem it a huge debt. Many interesting details of this case also involve the German state and also the state of lower Saxony that held a block of shares, the specific German laws regulating the status and the importance of the VW Company.⁸² The prominent figures of both companies, Piëch (VW) and Wiederking (Porsche) had a great role in the whole case. The hedge funds involved in the case sued the Porsche holding with Piëch as a

<http://www.mpifg.de/people/mh/paper/HoepnerJackson%202006%20EMR%20-%20Revisiting%20Mannesmann.pdf>

⁸¹ Nolte, Heike & Wright Butcher, Alva: „Volkswagen and Porsche: One Family, Two Car Companies, & a Battle for Corporate Control“ (January 31, 2012). Available at SSRN: http://ssrn.com/abstract_1996386

⁸² Volkswagen Act from 1960, this act limited the voting power of any shareholder to 20% and also introduced the 80% threshold for approval of changes in corporate control

head person for damages they suffered during the takeover, because of the misleading statements they gave during the process. On the March 17th 2014, the Stuttgart regional court dismissed all charges against the Porsche holding and its key officers.⁸³

It can be concluded that the shareholders (and the stakeholders) in Germany, have a say regarding the fundamental decisions in the company, but the range of their participation depends on the ownership structure and their personal interests. Some minority shareholders simple might want to acquire a better price for their share and they do not want to participate in any way in the life of the company.

3.2.2.3 Shareholder vote in Croatia

Provisions of the Croatian Companies Act prescribe the necessary vote and approval of the shareholders for the most important issues. The majority vote principle, as well as the “one share-one vote” principle, is accepted in Croatian system. Most of the decisions at the general meeting are brought with the simple majority vote, but some, such as decision regarding merger, dissolution, amending the Articles or the takeover; need to be reached with the 75% majority vote. It can be regulated through the Articles of the company that the requested majority of the votes need to be even higher. As it has been already mentioned, great number of stock companies in Croatia has a one majority shareholder or a small group of controlling shareholders.

Since Croatia is relatively young state with still developing and growing economic system, it has still not been recorded a case of a hostile takeover on a larger scale. Most of the takeovers happen in a “friendly” environment or through direct negotiations with the controlling shareholders.

⁸³ Die Deutsche Welle, March 17th 2014 , <http://www.dw.de/porsche-off-the-hook-in-hedge-funds-suit-over-volkswagen/a-17501640>

Croatia fully adopted the EU Directives regarding company law according to which, defensive measures by the company's managers are not allowed. During the accession period Croatia had to transplant great majority of EU legislative acts into its own legal system. Since the amount of materials was vast, in some cases there was no constructive debate over certain legislations that might affect the national economy or have a bad impact on some of the big corporations in the country. Germany knew how to protect its national interests; Croatia on the other hand, did not have that wisdom or even the opportunity to do so.

Interesting case linked to the attempt of the hostile takeover happened in the period between 2004 and 2008. The largest Croatian food company "*Podravka d.d.*" was in the centre of attention when its eight managers, including one high government official, were arrested in 2010 and charged for insider trading and damaging the company for the amount exceeding 50 million Euros. Their defense was in great deal based on claims that they were protecting the company from the hostile takeover by a Norwegian food company that previously had business relations with Podravka. The Norwegian firm discretely hired an Austrian consulting firm to acquire in their name 20% of Podravka's shares from the market. Company officials are charged for issuing unauthorized loans to smaller companies that were buying the shares of Podravka from the market, Croatian prosecution authorities believe that they were doing it for their own benefit. This case, after a long investigation, finally came to court in 2013 it is left to be seen what will be the verdict. Even though the public still does not know all the facts of the case, it is indicative that their defense relies solely on claiming that they were conducting defensive measures against the hostile takeover.

Another example of hostile takeover is the battle between *Barr Pharmaceuticals Inc* and *Actavis plc* over the Croatian pharmaceutical company "*Pliva d.d.*" in 2006. At that time more than 50% of the company's shares were in the hands of the institutional investors, with them their share in the company also had Croatian pension funds, Croatian state and European

Bank for Reconstruction and Development. The companies were giving public offers and counter offers through the period of six months, during which the offered price almost doubled. Barr won the battle and acquired almost 94% of all shares of the company. During this time, company's management stayed inactive and waited to see what will happen. The whole process was supervised by the Croatian Financial Services Supervisory Agency (HANFA). This case will be mentioned in the next sub-chapter, regarding the possible breach of the fiduciary duties by the Pliva's management.

From everything stated in this part of the paper it can be concluded, that even though the Croatian financial market is not so big, interesting things that deserve the attention of the state and the legal professionals can happen. By Croatian joining the EU and becoming a part of a European single market, these situations might become more frequent.

3.2.3 Say on Pay

The issue of the managerial compensation was always the one with a lot of controversies around it. This problem is also still very recent and in the phase of development. Shareholder's say on this matter is different from country to country, especially when we look (again) at the composition of the ownership. In the countries where the ownership is more dispersed it is harder to get a say on this matter than in the countries where there is a one controlling shareholder that has direct insight in every aspect of the corporation. "The higher level of ownership concentration, the lower level of executive pay."⁸⁴

After the crisis in 2008, there has been even higher pressure on the legislators to regulate, for most of the common people, incredible and excessive compensations for some of the officers

⁸⁴ Gorezi A., S.J.D. Disertation : Shareholder Rights, Executive Compensation and Stakeholder Protection: A Comparative Overview of United States and chosen European Jurisdictions, Central European University, September 2011, p.148

of the large companies. The investors ask for the more detailed information and better disclosure rules, while the opponents say that all the efforts are misplaced and unnecessary.⁸⁵ Reasons and motives differ from country to country depending on the social background and activity of the investors, such as more ownership dispersion in companies, need for social equality, especially in the state owned companies, tax reasons etc.⁸⁶

There is a vast difference in the perception of the excessiveness of the executive's compensation, since it is a fact that the executive compensations in the United States are much higher than those of the executives in European countries. This topic is approached from a different side in Europe than in the U.S. but the ultimate result is the same; more say for the shareholders and better transparency. When it comes to Croatia, the legal development is following the one happening in Europe, namely EU and Germany, but there is still low impact of these rules in the real life.

The referendum that was held in November 2013 in Switzerland on limiting the executive pay⁸⁷ may show the direction which other European countries will take if the inequality becomes even more evident.

3.2.3.1 Say on pay in the United States

The issue of the executive compensation has a longer history in the U.S. than in any other country in the world, but it has not been in the focus until recently. Two historical events that happened in America at the beginning of the 2000's changed the way the people think, especially the investors. Another specific feature of the U.S. up until recently was the

⁸⁵ Thomas, Randall S. & Van der Elst, Christoph : „*The International Scope of Say on Pay*“, ECGI, Law Working Paper N° 227/2013, September 2013, available at SSRN : http://ssrn.com/abstract_id=2307510

⁸⁶ Id. p.3

⁸⁷ Referendum was held on November 24th 2013, 65,3% of the voters were against limiting the executive compensation

performance-pay. The Board of Directors decides on this issue, currently that authority has been transferred to the compensation committees that consist of independent directors of the company.

After the Enron case in 2001, the intention to criminalize the excessive payments appeared, the Sarbanes-Oxley Act (hereinafter SOX) in 2002 introduced some new rules regarding the executive compensation, but they were mostly tied to misconduct of the CEOs and CFOs regarding the financial statements, in which case they had to return their bonuses and compensations or the rules regulated personal loans to the executive officers.⁸⁸

After the 2007 crisis in America and the financial collapse, many companies had to be saved with the government money, which caused strong reactions from the general public. The Emergency Economic Stabilization Act⁸⁹ of 2008 (hereinafter EESA) made the bailout of many companies possible. This law limited compensation for the executives of the companies that are receiving federal help.

The Dodd-Frank Act in 2010 introduced the mandatory say on pay principle and also the say on golden parachutes for the executives in any merger or acquisition. Sec.951 of this act gives the right to the shareholders to approve or disapprove the executive compensation through a non-binding vote. The limited reach of these provisions reflect in the fact that the shareholders can only express their approval or disapproval of the whole compensation package of the CEO and senior officers, which means that they cannot give their opinion on a specific part of the compensation package, like the bonuses or performance incentives.⁹⁰

These new regulations in the U.S. gave more power to the shareholders and increased their participation in the corporate governance. Even though the say on pay of the shareholders is

⁸⁸ Sec. 304, 402 of Sarbanes-Oxley Act

⁸⁹ Emergency Economic Stabilization Act, Division A of Pub.L. 110–343, 122 Stat. 3765, enacted October 3, 2008, available at <https://www.govtrack.us/congress/bills/110/hr1424/text>

⁹⁰ Supra note 83 on p.9

non-binding it can achieve its function in improving the transparency in large corporations. Shareholders are interested in the company's end result and the profit it makes and as long as they are receiving their piece they will most probably approve the generous compensation for the officers.

3.2.3.2 Say on pay in Germany

The two-tier system in Germany has its specifics regarding the executive pay too. Supervisory board of the company, that elects the management board, also has the power to set the compensation for the managers. Keeping in mind that the members of that board are also the employees and representatives of the banks, we can already conclude that there is more control and oversight of these matters than in other countries. Furthermore, the general feeling for equality has a strong impact on German position towards this matter. The compensation for the members of the Supervisory board is determined in the Articles of the company or by the general meeting of the shareholders. Their compensation is in most cases symbolic since one person can sit in more supervisory boards and their role does not require every day engagement.

The protection of the shareholders from dilution of their ownership was limiting the stock options for the executives all the way until 1998 and the Control and Transparency Act (“KonTraG”)⁹¹ which allowed the use of stock options as incentives for the executives. Also, the size of the company in many cases affected the compensation package more than the actual performance.⁹²

The changes made to the Stock Corporation Act (AktG) in 2009 had a strong impact on the executive compensation. Section 87 of AktG, sets the standards that supervisory board needs

⁹¹ Id. on p. 41

⁹² Supra note 82 on p. 149

to follow when deciding on the executive compensation. The supervisory board sets the remuneration package for every member of the management board separately. This remuneration system's goal is the sustainable development of the company.⁹³ The variable part of the compensation is based on a calculation for several years and the law also leaves the option for the supervisory board to limit the compensation in specific situation.

The difference in comparison to U.S., where the “say on pay” is mandatory, is that the general meeting in Germany has an optional say on pay. It should be mentioned that since 2010, all German companies listed on DAX have their management board compensation packages approved by the general meeting at least once a year.⁹⁴

There have been new proposals made by the German Corporate Governance Commission regarding the executive compensation. They propose setting the cap for the remuneration packages for each individual member of the management board and also introduction of mandatory say on pay for the listed companies.⁹⁵

The famous case regarding the golden parachute and executive compensation is the Mannesmann case that was already described previously. The issue before the German court was the question whether the compensation that the Mannesmann's CEO received after the takeover by the Vodafone, was appropriate. The amount he received was over 17 million Euros and the criminal charge was launched against him and the members of the supervisory

⁹³ § 87 (1) AktG

⁹⁴ Supra note 83 on p.44

⁹⁵ Government Commission, *Explanatory Comments on the Changes Proposed by the Code Commission from the Plenary Meetings held on 9 and 31 January 2013* at 6 (Feb. 2013), available at http://www.corporategovernancecode.de/eng/download/konsultationsverfahren_2013_02_05/Explanatory_comments_on_the_changes_proposed_by_the_Code_Commission_from_the_plenary_meetings.pdf

board that approved the payment. All the protagonists of this case settled outside the court so we cannot know what would be the decision of the German court.

3.2.3.3 Say on Pay in Croatia

The question of executive's compensation was until recently quite unknown. There are many reasons for that. The first reason is the historical one, during the socialism the director's salary was determined by the political decision and the directors of state owned companies were in most of the cases totally disinterested and with almost no motivation. Secondly, during the transition in Croatia and the process privatization, the legislator had bigger worries than the executive compensation, namely, drafting of the company act and setting up of the market economy as such. Croatian law does not regulate say on pay and this matter is solely in the hands of the supervisory board. The compensation of the supervisory board is determined in the Articles or by the general meeting of the shareholders.

After the privatization process most of the new companies had one majority shareholder who was in most cases also managing the company. So the most common conflict was between the minority and the majority shareholders.

Current legal solutions follow the example of other European countries. The main problem is the enforcement of the accepted rules on paper. Recent changes in the Croatian companies act allowed for the compensation to be determined in fixed amount, variable part and in the options of the company.

Croatian corporate governance code from 2007 provides rules regarding the managerial remuneration and the supervisory board role in it. This document gives a direction in which

the corporate governance in Croatia should go. The appointment of the compensation board within the supervisory board, full disclosure of the remuneration packet of every individual member of the management and even a method of determining the appropriate amount of compensation are to be found in this code.

But the reality is somewhat different, recent researches on corporate governance in Croatia show that only a small minority of companies in Croatia actually applies this code. It is stated that companies issue and publish annual reports, but their content is either poor or too complicated for the ordinary person to understand.⁹⁶

There is a quite a number of the stock corporations that are owned by the state or in which the state has the controlling block of shares. In the year 2013, Croatian Government issued a decision that regulates the compensation of executives in state owned companies.⁹⁷

With this decision Croatian Government has set the cap for the fix part of the compensation (maximal amount set at 3,2 average monthly net salaries in Republic of Croatia), bonuses and other stimulations are allowed only for the executives of the companies that have ended 2013 with net profit, after the approval of the supervisory board.

Although this decision has received positive reactions from the public, I am of opinion that it actually has the opposite effect. The professional managers in these companies are not motivated with this compensation package and probably feel underpaid and in most cases they

⁹⁶ Mintas Hodak Lj., Jurković Majić O., Majić H., „A Research on the Code of Corporate Governance in Croatian Business Practice“, Social Responsibility, Professional Ethics, and Management Proceedings of the 11th International Conference Ankara, Turkey, 24–27 November 2010

⁹⁷ Vlada Republike Hrvatske: Odluka o utvrđivanju plaća i drugih primanja predsjednika i članova uprava trgovačkih društava, NN br. 83/2009 do 22/2013

will probably quit the job. After the professionals leave, sadly but true, incompetent political directors take their positions.

3.2.4 Shareholder Actions against the Managers

In every jurisdiction liability of the directors for the damages exists. Every company law emphasizes the duties and responsibilities of the directors towards the company and its shareholders. The most common way of protection of company's interests is via the derivative suit.

United States have a rich history of court cases and the same thing cannot be said for the European countries. There are many reasons for a low number of law suits against managers; some of them are related to possible high costs, not having enough substantial information or simply fear of negative publicity that might drop the price of the shares.⁹⁸ Also, high level of protection for liability for managers and problems regarding organizing a great number of shareholders, are the reasons that the shareholders do not decide easily to sue.

3.2.4.1 Actions in the United States

The managers in the U.S. are strongly protected with the “business judgment rule” provision, which leaves a small possibility for the shareholders to sue them for their personal liability and breach of fiduciary duties.

The shareholders are not allowed to sue first; the initiative is in the hands of the board of directors (BoD). In most of the cases the board is not inclined to sue and this process at the

⁹⁸ Gelter, Martin : „Why do Shareholder Derivative Suits Remain Rare in Continental Europe?“, Working paper No. 190/2012, Fordham University School of Law; European Corporate Governance Institute (ECGI), February 7, 2012, available at <http://ssrn.com/abstract=2000814>

beginning takes a lot of valuable time from the shareholders. Special features of the U.S. legal system such as the rule that each party bears its own cost may also be quite discouraging.⁹⁹

Both MBCA and the Delaware Corporate law stipulate in its provisions that the shareholders need to file a derivative suit in the name of the company, since the directors owe the fiduciary duty to the company itself, and not the shareholders.¹⁰⁰ This means that in the end, even if they win the case the damages will be paid to the company.

It is in the best interest of the shareholders to start actions against the directors in their own name and for protection their own interests. This type of protection can be acquired through direct action (collective action) allowed under the securities law from 1933/34. This action is problematic because of the possible great number of small shareholders that need to act together, if only a small number decides to start the action, the rest can simply free-ride on their efforts and in the case of success, they all share the awarded compensation.

Shareholder derivative suits are generally rare in the U.S. because of the initial costs, high lawyer fees and difficult ways of achieving valuable information. In the end, the prosecution of corrupted directors that are in breach of their fiduciary duties is left to the criminal prosecutors, which is a step back for corporate governance.¹⁰¹

⁹⁹ Id. p.861

¹⁰⁰ Baums,Theodor & Scott, Kenneth E. : „*Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany*“, ECGI, Law Working Paper No. 17/2003, November 2003

¹⁰¹ Id. p.12

3.2.4.2 Actions in Germany

The situations in which the shareholders can seek for the court protection of their rights and interest are stipulated in the German AktG. To be able to file a suit, certain conditions need to be fulfilled, primary regarding the share that is owned by the shareholders that wish to sue.

Same as in the US, difference between the liability to the corporation and liability to the shareholders exists.¹⁰² For the breach of its fiduciary duty, the managers is primarily responsible to the company itself, this way of reasoning derives from the fact that the directors are in the contractual relationship with the corporation and not its shareholders per se. Furthermore, the German perspective is also that the directors owe the duty of care and loyalty not only to the shareholders, which is the situation in the US, but also to the other interested parties (stakeholders) such as the employees, creditors and even the local community where the company does its business.

If there is an action against the member of the management board for the breach of duty, the company is in principle represented by its supervisory board.¹⁰³ This provision implies a few problems. The fact that the managers breached their duties may bring the question of responsibility of those who elected him. Through suing the managers the supervisory board would in a way recognize its own mistake. For these reasons members of the supervisory boards are not too keen to initiate actions against managers, they simply use their right to revoke them if there is a reason, or even more often, those managers just do not get re-elected for another term.

¹⁰² Supra note 98, on p.13

¹⁰³ §112 AktG

The courts provide protection for the managers in way of applying strict standards when it comes to liability for the breach of fiduciary duty. Managers in Germany owe the company “diligence of the prudent businessman”, which means that the shareholders wishing to file an action against the manager need to fulfill three conditions. First, the breach of duty needs to be proven. Secondly, the intention or the gross negligence is required in order for the court to accept the law suit. And lastly, the company needs to suffer material damage in order for the manager to be held liable.¹⁰⁴ All these requirements make the derivative suit against the managers highly unlikely.

German law allows the shareholders to issue a binding decision for the supervisory boards, which makes it mandatory for them to bring the action against the managers. The threshold was previously set at 10% of the shares or € 1,000,000 in company’s equity in order to be able to initiate the action and even appoint a special representative of the corporation. This rule has been amended in 2005 and the threshold has been lowered to 1% of the shares or € 100,000.¹⁰⁵

These provisions still do not eliminate the basic problem concerning the costs of actions (advance court fees in Germany), bearing risks of failure (loser pays) or the fact that there is no special remuneration for the shareholder that initiated the suit, which implies that other shareholders that are free riders on the suit receive the same benefit. All of these things make the derivative suit in Germany rare phenomena.

¹⁰⁴ Baums T. & Birkenkämper A., „Corporate Governance in Germany – System and Current Developments“ European Corporate Governance Institute (ECGI), Oct.1998, available at: SSRN

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=158038

¹⁰⁵ §148 AktG

The shareholders in Germany have a possibility to file a rescission action against the decisions that were reached in an illegal way, such as the secret general meeting.

3.2.4.3 Actions in Croatia

In Croatia, as in Germany, the shareholders do not have an option of filing a direct action against the managers. The action always needs to be in the name of the company and for the damages that the company suffered, in other words, the derivative suit.

Following the German example, Croatian legislator included this shareholder right in the company law. The supervisory board represents the company vis-à-vis the management, but in the case of their failure to act, the shareholders have the authority to start the action by themselves and to appoint the special representative.

The only difference from the German provisions is that the threshold for the shareholders is set a bit higher. The threshold is set at 10% of the shares or HRK 8.000.000 in company equity. Lower threshold (5% and HRK 4.000.000) is set for a case if the action has not been filed within the prescribed time frame.¹⁰⁶

The right of the shareholders to attack the decisions of the company reached in an unlawful way through the rescission action is also protected by law.¹⁰⁷

¹⁰⁶ Art.273.a , ZTD

¹⁰⁷ Art.363 ZTD

3.2.4.4 Conclusion

After analyzing these three jurisdictions it can be noted that the American system provides a better start point for the shareholders that believe that their or the rights of the company have been violated. German approach gives even a smaller possibility to the shareholders to act against the managers. The fact that raising a suit against the managers is quite lastly and costly can lead to finding other ways of influencing the managers and protecting your own interests. In my opinion, the shareholders and stakeholders in Germany have several tools and paths of influencing the company's life, specifically through the participation in the work of the supervisory board, and the derivative suit represents the ultimate resort for them. Croatia has the problem of having good laws and following good examples from Europe, but at the same time, not having almost any enforcement of these rules. There are many reasons for that, but I believe that the most important one is, as mentioned numerous times, the low awareness of the shareholders of their rights.

4. CONCLUSION

After taking a deep look into all three systems, their historical background and the economic environment it can be said that the American system provides the most solutions for possible problems. This is also due to the fact that the US market is more active and dynamic than the European one. Moreover, the American experience in the crisis was much more painful than in the rest of the world and many of the legal solutions that are available now were a direct reaction to the anomalies that appeared in their economy.

The shift towards broadening of the protection on the other interested parties, namely the employees and the creditors can also be noticed. But even with this good regulatory foundation, it can be seen that the activism of the individual shareholders still remains low, namely because they do not have interest in participating and they only care about the end result of the company and the dividend they receive.

Institutional investors are using all the tools that were given to them in order to gain more control and information, it can be noticed that not much changed for them since they have had a say just because they were holding bigger block of the company's shares.

German system in general has a more traditional approach, many things were regulated by law and shareholders rights are clearly stated in the provisions, although the new amendments to the Stock Corporation Act and the new Antitakeover Act show some new tendencies.

Germany came out of the financial crisis even stronger and much of credit for that goes to their corporate governance system. Participation of the workers and the role of banks provided a better model of checks and balances and kept the most of the German companies

outside of the problems simply because more actors with different interests did not allow managers to lose themselves.

In Germany we can also notice low activity of the shareholders, but that is partially connected to the ownership structure in most of the companies where the majority shareholder has a direct influence on both boards. The tendency of appointing minority directors has been strengthening and it can also, in the future, affect the shareholders low activism, simply because of the fact that they also participate in the control over the company.

Croatia followed the German example basically to the letter, the internal structure of the company, legal provisions regarding the shareholders participation, even the soft law; the Croatian Corporate Governance Code follows the German pattern.

Croatia also accepted and implemented the whole community law of the EU. One of the problems I noticed is that most of these laws were simply transposed into Croatian legal system, sometimes even without the constructive debate or the opinion of the experts.

Croatian laws provide good protection of shareholders rights and the tendency is generally positive, but the problem is in low awareness, both the companies and the shareholders.

I am of opinion that more activities should be aimed towards education of all actors on the market.

In conclusion, the debate between the supporters of the stronger shareholder activism and the opposition could be described as exaggerated. The individual minority shareholders do not

wish to participate too much and the big institutional shareholders can, in the end, take care of themselves.

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