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Guest Post: Activist Shareholder: The New Kid on the German D&O-Block

By Kevin LaCroix on September 18, 2014
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Although I try to include on this blog topics involving issues from outside the United States, because of my background and experience, U.S-related topics tend to predominate. That is why I am always grateful to have the opportunity to publish a guest post from a non-U.S. reader. I have published below an article discussing D&O insurance issues in Germany from Dr. Burkhard Fassbach who is a partner in the Dusseldorf-based D&O advisory firm, Hendricks & Co. Burkhard is licensed to practice law in Germany and is standing legal counsel to the German operation of the London-based Hou den Broking Group.

I would like to thank Burkhard for his willingness to publish his guest post on my site. I welcome guest post submissions from responsible authors on topics of interest to readers of this blog. If you would like to publish a gues post, please contact me directly. Here is Burkhard's guest post:

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Preface

In the wake of the financial crisis, leading corporate governance experts in the U.S. have urged the separation of the personal union of chairman and CEO, i.e. the CEO-duality. The advocates make reference to the perks that the German two-tier board system entails. Through proxy fights taking place in shareholders' meetings, institutional investors and activist shareholders in the U.S. increasingly succeed in their endeavor to split the functions of chairman and CEO. The shareholders' meeting in Germany is in charge of the decision whether to grant D&O insuranc protection to the supervisory board members or not. Conflicts of interest almost invariably gain center stage in th context. The common goal of both debates is the split.

I. The German Stock Corporation Act's authority regime regarding the granting of D&O insurance coverage

Quoting to German literature and treatises on stock corporation law, Professor Christian Armbrüster of Berlin University has pointed to its authority rules according to which the decision whether to grant D&O insurance protection to the executive board members rests on the supervisory board. The granting of D&O insurance protection to the members of the supervisory board lies within the competence of the shareholders' meeting. The executive board effectuates the conclusion of the insurance contract. See Armbrüster, VersR 2014, 1 seq.

It has been in the journal 'The Supervisory Board' (2nd issue, 2013) that the author has red-flagged the necessity of separate D&O protection for supervisory board members with a distinct insurance carrier in the German two-tier board system. In adherence to the above-mentioned authority rules, foreign institutional investors will also have a say in the decision. Hence, in Germany the shareholders are in the driver's seat for this question.

In an article dating from May 10, 2013, published in the German daily newspaper F.A.Z. headed "majority of DAX (German Share Index) companies in foreign ownership", Gerald Braunberger, making reference to a pertinent academic study, demonstrated that the majorities of shares of the 30 companies listed in the DAX are owned by foreign investors. On average, foreign portfolios comprise 55 percent of these shares. For the most part, the foreign purchasers are wholesale investors such as pension and investment funds, banks, and insurers. The author points to the foreign shareholders' exerting influence on German companies, such as in the case of the chairman of the supervisory board of Lufthansa. Just as palpable was the influence of foreign investors on the fate of Deutsche Bank, the author claims. It was foreign investors who appreciably contributed to the decision to refrain from Jose Ackermann's inaugural to the office of the chairman of the supervisory board of Deutsche Bank after his removal from the office of chairman of its executive board. See Gerald Braunberger, Majority of DAX Companies in Foreig Ownership, F.A.Z., May 10, 2013, at http://www.faz.net/aktuell/wirtschaft/unternehmen/studie-dax-konzerne-mehrheitlich-in-auschlaendischem-besitz-12178297.html.

II. Activist shareholder

The term 'activist shareholder' is defined as a shareholder who uses her stock ownership in order to exert pressure on management in public. The activists' goals encompass both financial and ideational interests. In the former alternative, they seek to enhance the shareholder value by means of changing corporate policy and financial machin

ery, implementation of measures of cost cutting, etc.; in the latter alternative, they pursue goals such as disinvesting in certain countries or implementing a corporate policy that is more ecofriendly. Such activism manifests in various facets: proxy fights, public campaigns, resolutions of shareholders' meetings, negotiation and litigation with management. See at http://en.wikipedia.org/wiki/Activist_shareholder. This article will discuss recent endeavors to implement quasi-dualistic board structures in the U.S. The impetus in the U.S. to separate the function of CEO and chairman is rather unillumined in the German law society.

III. Severance of the CEO-duality in the U.S.

A scenario that was subject to comprehensive news coverage emerged in May 2013 at the shareholders' meeting o JPMorgan Chase & Co. in Tampa, Florida, where shareholders proposed the independence of the chairman drawing on the following rationale: 'Is a company a sandbox for the CEO, or is the CEO an employee? If he's an employee, he needs a boss, and that boss is the board. The chairman runs the board. How can the CEO be his own boss?' See supporting statement of shareholder proposal 6 in the bank's definitive proxy statement in 2013, here. James L. Dimon, CEO and chairman of JPMorgan, opposed the shareholders' demand for independence.

The occurrences were kicked off on the backdrop of a trader of the bank causing a gigantic loss. As a result, the leadership function of the CEO was cast doubt upon. The shareholders were eager to improve corporate governance structures of the bank by having an independent chairman acting as a counterweight to the chief executive. Voting culminated and became a referendum on James L. Dimon himself. It has been through intense lobbying that he was able to prevail. Eventually, 32.2 percent of the shares supported a separation of the two leadership positions in the bank. See Jessica Silver-Greenberg and Susanne Craig 'Strong Lobbying Helps Dimon Thwart a Shareholder Challenge', New York Times, May 21, 2013.

In just about every shareholder meeting of listed corporations in the U.S., shareholder activists speak out in favor of splitting the chairman from the CEO. Leading American economic journalists support this clear tendency. In the March 30, 2009 issue of the Wall Street Journal, Johann S. Lubin, under the headline 'Chairman-CEO Split Gains Allies – Corporate Leaders Push for Firms to Improve Oversight by Separating Roles', drew attention to an academic study conducted by the Millstein Center for Corporate Governance and Performance at Yale University School of Management. The study (Policy Briefing No. 4: Chairing the Board – The Case for Independent Leadership in Corporate North America) is available on the internet. See at http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/2009%2003%2030%20Chairing%20The%20Board%20final.pdf. Endeav-

ors to this effect are also continuously covered in the blog of the Harvard Law School Program on Corporate Governance. See at http://blogs.law.harvard.edu/corpgov/. Experts have proclaimed the independence of the chairman and issued an appeal to the NYSE and NASDAQ to make the independence of the chairman a mandatory listing standard.

In the March 12, 2013 issue of Fortune Magazine, Elizabeth G. Olson put the postulation in a nutshell:

'Governance groups say that the corporate coziness – the CEO acts as his own boss because he reports to himself in his chairman role – allows unchecked risk taking that may produce spectacular short-term results but winds up harming the company.' See Elizabeth G. Olson, 'Why the CEO-chair split matters', Fortune Magazine, March 12, 2013.

Meanwhile, activists in the U.S. have been producing overwhelming success. According to a paper written by Charles Tribbett printed in the journal 'THE CORPORATE BOARD', 44 percent of the S&P 500 corporations had implemented a split of the jobs of chairman and CEO in 2012. As regards the segment of NASDAQ 100, 62 percent of the corporations had a split in 2012. See Charles Tribbett, 'Splitting the CEO and Chairman Roles – Yes or No?' THE CORPORATE BOARD, November / December 2012.

IV. The German D&O two-tier trigger policy gaining interest in the U.S.

The necessity of separate D&O insurance protection for the members of the supervisory board is predicated on conflicts of interest. In essence, the rationale is conterminous with the one that U.S. American shareholder activists rely upon in furtherance of the separation of CEO and chairman. So do they invoke conflicts of interest in order to substantiate their position. Except for in a limited number of monistic European Public Companies, management is institutionally separated from monitoring in the German board system. And yet, which strikes the observer as odd, members of both organs, i.e. the executive and the supervisory board, are collectively insured in Germany under the same policy with the very same insurer. This is the result of an unreflecting reception of U.S. American coverage concepts in Germany. D&O experts in the U.S. convey their interest in the latest discussion surrounding the two-tier trigger policy in Germany. See guest post in D&O Diary at http://www.dandodiary.com/2013/05/articles/international-d-o/guest-post-the-german-two-tier-corporate-board-structure-and-its-impact-on-do-insurance-cover/. The upshot of the essential reasoning underlying such a concept of a two-tier trigge

D&O insurance structure is this:

Pursuant to the German Stock Corporation Act § 111(1), the supervisory board shall supervise the management of the company. As the monitoring of management rests with the supervisory board, any mistake (breach of duty) made by management can theoretically be converted into a mistake by the supervisory board. See Bachmann, NJW-Beil. 2014, 43 (44); see also BGHZ 117, 127 seq., BGH, ZIP 2007, 224 seq. Practice in damage case is permeated by the defendant members' of the executive board serving third-party notices on the members of the supervisory board that acted on the basis of the ARAG-doctrine. In such a scenario, the insurer must refrain from simultaneously representing the opposing interests of the defendant executive board members and the notified supervisory board members. The insurer is ensnared in an inherent conflict of interest. See Schäfer/Rückert, German language interview on the Director's Channel, at www.directorschannel.tv/do_-_versicherung_interessenkonflikt. If the insurer exerts his sole authority to conduct litigation, then, in accordance with the legal precedents set forth by the Federal Supreme Court, it shall protect the interests of the insured person in the same way a lawyer retained by that person would. See BGHZ 119, 276 (281); BGH r+s 2011, 499 (599). That is to say the insurer must not defend claims both on behalf of the executive and the supervisory faction.

V. Conclusion

According to the German authority regime in the Stock Corporation Act, the decision whether to afford separate D&O insurance protection to the supervisory board members (two-tier trigger policy) is one to be made by the shareholders' meeting in Germany. Thus, foreign investors in Germany – in particular from the U.S. – also have a say in this vital decision. Through their endeavors to sever the CEO-duality, activist shareholders in the U.S. are familiar with the rationale prompting the separate D&O insurance protection of supervisory board members in Germany. Conflicts of interest almost invariably become virulent in this context. The common goal of both debates, i.e. in the U.S. and Germany, is the split.