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The Bug At Volkswagen: Lessons in Co-Determination, Ownership, and Board Structure

by Charles M. Elson, University of Delaware, Craig K. Ferrere, Harvard Law School, and Nicholas J. Goossen, University of Delaware

Corporate governance scholarship has long considered the problems that arise in public companies with dispersed ownership. In the absence of large, concentrated shareholdings, no party is positioned to effectively monitor management. When strong oversight is lacking, managerial misfeasance and even malfeasance are more likely to result.

The automaker Volkswagen does not suffer from a dispersed ownership structure. In fact, it has several strong and highly active owners. The Porsche and Piech families have been involved with the company for many years and own 31.5% of Volkswagen’s equity. The German state where the company is headquartered, Lower Saxony, holds 12.4%, and an outside investor, Qatar Holding, owns 15.4%. Following the conventional corporate governance paradigm, we would not expect the company to now be embroiled in a major scandal. With such powerful economic incentives in not one but three actors, management should be subject to the kind of exacting oversight that could readily ferret out misconduct.

Yet problems arising from the separation of ownership and control are not the only issues that can lead to corporate wrongdoing—and Volkswagen is a striking case-in-point. It has recently been revealed that, despite the influence and financial stakes of its three largest investors, the company has long been involved in a massive emissions regulation evasion scheme. From 2007 to 2015, the Environmental Protection Agency has disclosed that the company cheated on federal emissions tests through the installation of a so-called “defeat device” on at least eleven million of its vehicles.

The defeat device operated by rendering inoperative the emissions control system in certain Volkswagen car models. This software would track federal testing procedures and activate when the car was being inspected, suppressing emissions at that time so that they would appear to meet the EPA requirements. With the device in place, the company could fool regulators and hide emissions of as much as 40 times the allowable amount of nitrogen oxide.

The board claims to have been unaware of this scheme. But at this point, it may be important to note that German companies have an unusual “two-tier” board structure in which a “management board” is accountable to a “supervisory board.” A member of the “supervisory” board representing the State of Lower Saxony asserted that the board was informed about the regulatory violations only shortly before they were disclosed to the public. Even Martin Winterkorn, the company’s CEO, expressed surprise at news of the wrongdoing. He insisted that the violations were the result of “the grave errors of a very few” employees. The evasion of emissions regulations through a highly developed and widespread managerial effort suggests a serious failure in the board’s monitoring and oversight function.

But, again, given the company’s concentrated ownership structure, the problem cannot be attributed to the separation of ownership from control. In the discussion of the Volkswagen emissions scandal that follows, we explore the causes of the scandal, highlighting issues that arise outside of the conventional dispersed ownership paradigm. We believe that the failure of oversight at VW can be explained in large part by problems arising from the composition and functioning of the company’s two-tier board (including the principle of “co-determination”), and the identity and seriously conflicted incentives of its largest shareholders.

The Emissions Scandal and Its Causes

The current conflagration enveloping Volkswagen has many causes and provides many important lessons for corporate directors. At the heart of the scandal is, of course, bad management—and, more pointedly, unethical behavior on a corporate-wide scale. That such a pervasive and highly developed scheme to evade emissions standards could occur over such an extended period of time and throughout so many levels of the organization attests to a management culture gone awry. As a general rule, corporate cultures that embrace transparency and integrity thrive—and those that do not end

2. Id.
4. Id.
up failing sooner or later. Why then did such a problematic culture exist at Volkswagen? We suggest that the culprit may be the composition of the board itself in combination with the unique governance structure, known as “co-determination,” that defines many German companies, including VW. The proper function of the board of directors is to actively monitor management and thereby ensure corporate efficiency and competitiveness. If management knows that the board is scrutinizing its actions critically, it tends to behave better. But this does not appear to have been the case at VW.

There are three major problems from a corporate governance standpoint with the Volkswagen Board. First is the higher dividend than common shareholders. The preferred dividend has to be paid in full and is therefore the same for preferred shareholders as for common shareholders. Preferred shareholders receive a dividend for preferred shares only, whereas common shareholders receive a dividend for their common shares. Thus, preferred shareholders in a company cannot usually give up their voting rights. However, the voting right comes alive if no dividend is paid. For this privilege, preferred shareholders are usually given the first right to vote before common shareholders receive dividends. For example, one widely cited study of global corporate stock ownership reported that, in the year 2000, only 7.6% of NYSE-listed companies had at least a 25% control block, and only 1.7% of such companies had a 50% control block.7 In the rest of the world, by contrast, most public companies are much more likely to be controlled by families, groups, or individual blockholders. For example, the same study cited above reported that, in the year 2000, 82.5% of German-listed companies had a greater than 25% control block and almost two-thirds (64.2%) had a 50% control block.8 And even though the percentage of listed German companies without a 25% blockholder has more than doubled in the past 15 years, over two-thirds of such companies continue to follow this alternative model of public company ownership structure.9

In such controlled companies, the dominant shareholder’s voting control is frequently established or enhanced through a number of mechanisms. First, control often results from the use of dual or multi-class shares that confer voting rights that are disproportionate to the dominant shareholder’s percentage economic stake in the firm. Second, control is sometimes obtained through the use of pyramidal ownership structures. In 2000, as reported in the same study cited earlier, 17.6% of listed German companies had dual-class stock and some 15% of companies with a family control block of 20% made use of a pyramidal ownership structure.10 The agency problem in controlled companies is only worsened by mechanisms like shares with enhanced voting rights and pyramid company ownership structures, which both further insulate controllers from the economic consequences of company transactions.

Volkswagen has a controlling shareholder that uses both pyramidal and dual-class structures to enhance control. Through Porsche Automobil Holding SE, an investment holding company, members of the Porsche and Piëch families control of 50.7% of the voting rights.12 This control is further leveraged through the use of a pyramid structure11 that gives the Porsche and Piëch families control of 50.7% of the voting rights.12 This control is further leveraged through the use of a pyramid structure. Half of the shares of Porsche Automobil Holding are ordinary voting shares, and the other half are non-voting shares.13 The Porsche and Piëch families own the ordinary shares, but not the non-voting shares.14 Through these structural devices, the families control five board seats (half of the investor representatives on the supervisory board), while limiting their own economic exposures.

8. Id.
9. See Julian Franks and co-authors, in this issue.
10. See Gilson at 1646-47.
11. Under German company law (Aktiengesetz) common and preferred shareholders have similar rights except for the following differences: Preferred shareholders receive a higher dividend than common shareholders. The preferred dividend has to be paid in full before common shareholders receive dividends. For this privilege, preferred shareholders usually give up their voting rights. However, the voting right comes alive if no dividend is paid for two years. Moreover if a dividend is not paid for one or two years, the preferred dividend has to be fully paid for the past years before the common shareholders receive a dividend.
12. See footnote 1 above.
14. Id.
The nature of the agency problem that affects controlled companies differs from the agency problem that tends to reduce the value of, and is the main corporate governance challenge facing widely held companies in the United States. For the outside investors in U.S. public companies, the bluntness of the market for control as a disciplinary mechanism and the difficulties inherent in aggregated shareholders’ use of formal power through proxy voting create an inability to effectively monitor the officials and directors of such companies. In this sense, the directors and officers of U.S. companies have de facto control, and the agency concern in such cases is thus about management opportunism.15

In controlled companies, by contrast, the controlling shareholder has an economic incentive to monitor management because it stands to capture a significant proportion of any increase in share value that results from such monitoring. For this reason, a controlling shareholder has at least the potential to be a more effective monitor of corporate management than is possible with the mechanisms available in the widely held model.

So, in a controlled company, then, management opportunism is, again, at least in theory, much less likely to be a significant problem. But there is another kind of agency problem that can arise in such companies—namely, opportunism by the controlling shareholder at the expense of the minority shareholders.16 The incentive for such opportunistic behavior arises from the fact that not all of the costs borne by the company are “internalized” by the controller because the controller does not own 100% of the equity. This creates the potential for non-proportional diversions of pecuniary benefits from the company to the controller through self-dealing transactions.17 In addition to such pecuniary “private” benefits that come at the expense of other minority shareholders, there may also be non-pecuniary—or what might be referred to as “psychic”—private benefits associated with the position of control over a business enterprise.18 As one example, the prestige and status associated with being at the helm of a large enterprise may weigh more heavily with some controlling shareholders than the increase in their wealth resulting from a higher share value. To the extent this is so, some controllers are likely to pursue goals other than the maximization of profitability and firm value.19

The problems at Volkswagen, however, do not appear to stem from the diversion of value through self-dealing transactions designed to enrich the controlling shareholders. The real issue that led to the scandal appears to have originated in the ways that nonpecuniary private benefits influenced the management and strategy of the company. One member of the controlling families, Ferdinand Piëch, was able to take leadership of the company and direct it in pursuit of his own ambitions for industrial domination. It was in the course of that pursuit that the emissions scandal occurred.

Agency problems of this non-pecuniary type can be especially pernicious. To be sure, the top managers of widely held public companies may have a similar predilection for activities such as empire building, but there is at least some constraint on inefficient behavior from markets and the shareholder franchise. In the case of controllers, though, that constraint is entirely lacking. Controllers are immune from proxy contests and can “just say no” to any takeover offer. They are, in large part, free to set the company’s strategy largely as they wish, subject only to a different, much less demanding set of constraints, that we discuss later. Finally, the courts, as the final backstop, are almost completely ineffective as a restraint on this type of behavior because the concept of self-dealing is not elastic enough to encompass actions such as deciding to expand into new markets, and the deferential business judgment rule would shield this form of conduct from judicial scrutiny.

Ferdinand Piëch, the grandson of Ferdinand Porsche, the founder of the Porsche company, owns 10% of Porsche Automobil Holding, the family investment fund.19 From 1993 until 2002, he was the CEO of Volkswagen.20 After he retired from that position, he became chairman of the supervisory board. He was chairman when the emissions scandal occurred, stepping down only earlier this year after a failed attempt to oust the then-CEO.21

At some point, Piëch’s interest in VW appears to have become largely non-pecuniary, his goal no longer (if it ever was) to create more wealth for this family (or his shareholders). A number of commentators have claimed that, for him, “what is important is power, not money”22—and that his real underlying objective was to create the world’s largest automobile manufacturer.23 He was very nearly successful in that respect. For instance, in 1993, the year he took over as CEO, the company sold just 62,061 cars in the United States. At the end of his tenure, in 2002, United States

16. Id. at 1281-82.
17. See Gilson, “Controlling Shareholders,” at 1663.
18. Id. at 1663-64.
19. Id. at 1665 (“the existence of private benefits of control means that for the controlling shareholder the separation theorem does not apply; that is, the controlling shareholder’s utility is affected by company decisions in ways other than through the decisions’ impact on the company’s stock price”).
21. Id.
sales had reached 355,648 cars. In this quest to expand his company’s size and market share, Piëch assembled a 12 brand automotive empire—one that included the likes of Audi and Bugatti as well as VW—that aimed to displace Toyota as the world’s largest.

A number of observers have also suggested that such drive and ambition may well have been tinged with a degree of “megalomania.” As Piëch built his empire, seemingly without much regard for profitability and shareholder value, the means by which the company achieved its growth may have been irrelevant (see the box inset on the attempt by Porsche to take over VW in 2009). As the controlling shareholder, with the cooperation of the labor unions and the government—which both sought greater employment—Piëch had for years the effective power to direct all corporate activities toward this goal. The emissions actions at VW, unfortunately, are consistent with this paradigm of growth at all costs, including as it turns out, outright misfeasance. And in the face of such pressure for growth, the culture of VW’s board failed to provide the appropriate counter-weight to the dominance of its chairman.

The Issues Arising from Having the Government as Shareholder

The second major structural problem with the VW board—one that might be viewed as leading to the controversy—was the identity and influence of one major shareholder. When a dominant shareholder happens to be a government, the goals of that shareholder are unlikely to match those of the remaining public equity investors. To the shareholders, the concept of long-term returns on capital is paramount, but governments are typically motivated by political considerations, particularly the employment of their citizens. The government of Lower Saxony has had significant influence over the affairs of VW and its board since the company’s creation. Volkswagen was originally a state-owned enterprise until, in 1960, the “Volkswagen Law” was enacted by the German government that enabled the company to be privatized while allowing Lower Saxony to retain a 20% voting interest in the company (despite the fact that their actual equity position was only 12.4%) in order to maintain government interest in the company. The government—through both the employment of its citizens. The government of Lower Saxony has had significant influence over the affairs of VW and its board since the company’s creation. Volkswagen was originally a state-owned enterprise until, in 1960, the “Volkswagen Law” was enacted by the German government that enabled the company to be privatized while allowing Lower Saxony to retain a 20% voting interest in the company (despite the fact that their actual equity position was only 12.4%) in order to maintain government influence. The VW Law also required the vote of 80% of the shareholders to approve any corporate action by the company and mandated the appointment of two governmental board members. In this way, Lower Saxony, despite the divestment, retained ultimate control over the enterprise.

Governments as shareholders almost invariably prove to be problematic. The interest of Lower Saxony in VW, while theoretically economic and so consistent with the interests of other shareholders, was actually political in nature. The principal interest of political leadership is the retention of power through reelection, and governments tend to be reelected when there is popular content created by high employment. A higher rate of employment for the citizenry acts to solidify a leadership’s political base, rendering the ultimate corporate profitability of the enterprise to shareholders a secondary objective. Therefore, the main motive of the governmental shareholder is to maximize employment, if necessary at the expense of shareholders. And so in cases where the board is composed in part of political representatives, even very limited government ownership creates a skewed board decision-making process. Furthermore, the incentives of governmental directors to expand the employee base at the expense of the proper corporate objective—that is, long-run profitability and value maximization—also has the potential to divert the focus of other directors from value maximization out of the fear that the government will campaign for their replacement should they fail to comply with its goals. With government representatives on the board, the other board members are likely to feel pressure to accommodate them by making decisions under the constraint of the government’s incentives, particularly the preservation of jobs. In such a case, the government effectively acts as a controlling shareholder and, when combined with the family-controlled votes, the potential for conflicts with outside investors is compounded. Either of these blockholders can veto any major decisions. With dual-class stock, the Porsche and Piëch representatives can act in their self-interest as long as the government’s interests are also reflected in their actions. This extraordinary mix of incentives seems quite capable of giving rise to and then tolerating a culture in which there was an incentive to cut corners and falsify emission rates, in order to satisfy both the government’s expectations for jobs and Piëch’s goal of market dominance.

Perhaps not surprisingly, in the face of the emissions scandal, Lower Saxony has shown no sign of abandoning its 20% holding. In a recent press release, Stephen Weil, one of the government’s representatives on the board, announced the State’s continuing support of the company. In an odd coincidence, Weil was elected to office with the support of the German Green Party, which certainly did not promote excessive automotive emissions. Although there is no evidence
that German politicians had any involvement in the emissions scandal at this time, critics claimed that “Berlin fought hard to shield its carmakers from closer scrutiny and, in a high profile clash with its European partners two years ago, from emissions targets.”34 Even in the wake of the emissions scandal, German Prime Minister Merkel defended the stance as necessary to protect employment in the sector—a clear indication of the government’s employment-based goal in its investment in VW, the region’s single largest employer.35

Of course, the government’s desire to employ its citizens is by no means an illegitimate goal. However, when the government is a major shareholder with its representatives on the board, it creates a misalignment of incentives that may not prove to be beneficial to either the overall profitability of the corporation or the consuming public. Indeed, in this case, it can be argued that the government, in its single-minded pursuit of higher employment, did not make compliance oversight a primary goal and left the company vulnerable to the lapse whose consequences it now confronts.

Issues Arising from The Law of “Codetermination”

Under the German Codetermination Act (Mitbestimmungsgesetz), all companies with 2000 or more employees must have both shareholder and employee representatives on its supervisory board.36 The Volkswagen supervisory board has long met this requirement. Its board has 20 members, with ten elected by the shareholders and the remaining ten selected directly by the workforce.37 This board is mainly responsible for selecting and monitoring the separate “management board” that in turn runs the company.38

The inclusion of labor representatives on the board presents serious difficulties for the employee-monitoring function of management. The board and management are responsible for supervising employees. Ordinarily, it is management’s duty to set compensation levels, prevent and penalize shirking and misfeasance, and efficiently coordinate labor. But with labor representatives on the board, the party that is susceptible to shirking is also the party responsible for the preventive monitoring.39 As a result, oversight is likely to be less efficient.40 Although the primary aim of monitoring is meant to identify and constrain shirking, it also has the effect of providing oversight designed to ferret out illegal acts. By so doing, effective oversight reduces the likelihood of both misfeasance and malfeasance. But the conflict of interests and incentives inherent in the German model may have undermined the oversight function, and reduced attention to appropriate legal compliance.

The bigger issue is how board practice in Germany has evolved to limit the negative effects of labor representation on investor interests. There is an obvious board-level divergence of interest between the shareholder representatives and the labor representatives. Shareholders gain when wages are not allowed to exceed competitive levels, while working conditions conducive to efficient production are maintained. Of course, the shareholder directors and the labor directors are at cross-purposes because of the potential for much of the shareholder gains from holding the line on wages to come at the expense of employees. As a result, the board process in German companies like Volkswagen has often deteriorated into factionalism.41 In such cases, the most reliable way of serving the interests of the shareholder faction may often prove to be by weakening the board42 and shifting the deliberative process into informal channels.43 But one obvious problem with this response is that it further erodes the ability of the supervisory board to effectively monitor legal compliance.

In sum, the dual nature of board decision-making under co-determination is highly problematic to shareholder interests. By giving employees access to more company information and voting rights within the board decision-making process, labor is better motivated and positioned to demand a greater share of profits through higher compensation and other concessions.44 But at the same time, shareholder directors may be understandably reluctant to bring new and potentially profitable projects to the full board since, by revealing them to the labor directors, the values of the projects themselves are likely to be reduced by being subjected to demands to share the potential gains.45 Most changes in company policy will affect the wages, livelihood, and working conditions of labor participants; and, as a result of the dual nature of decision-making authority in co-determined firms, all such strategic decisions are subject to the threat of labor hold-up strategies.

35. Id.
36. Mitbestimmungsgesetz, 1976 BGB1 I S.
38. Id.
39. Stephen M. Bainbridge, “Privately Ordered Participatory Management: An Organizational Failures Analysis,” 23 Delaware Journal of Corporate Law 979, 1065 (1998) (hereinafter Bainbridge, “Participatory Management”) (“Does it not seem odd, then, that those who are to be monitored should be allowed to choose the monitors?”).
40. Id. at 1066 (“If employees are entitled to voting representation on the board of directors, monitoring by the board and its subordinate managers will be less effective, which will cause agency costs to rise.”).
41. Id., at 1064 (“it is standard practice for employee and shareholder representatives to have separate pre-meeting caucuses”) (citing Klaus J. Hopt, “Labor Representatives on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe,” 14 International Review of Law and Economics, 203, 204 (1994).
42. Id. at 1064 (“many German firms have used various corporate governance devices to limit the power and function of the supervisory board on which labor representatives sit”); Mark J. Roe, “German Codetermination and German Securities Markets,” Columbia Business Law Review 167, 168 (hereinafter Roe, “German Codetermination”) (“In reaction to German codetermination, players inside the firm, namely managers and shareholders, seem to have reacted by weakening the firm’s supervisory board or, more properly, keeping it weak, despite global business changes that led to its strengthening elsewhere.”)
43. Id. at 174 (describing informal channels of information flow to shareholders).
44. See id. at 173 (“Internal rent-seeking between capital and labor could be in play”).
Despite their equal representation on supervisory boards, shareholder directors in co-determined firms hold some advantage over labor directors through their ability to select the chairperson of the supervisory board. If a two-thirds majority of the board, which cannot be obtained without some shareholder support, does not elect the chairperson, then the shareholder representatives alone get to select the chair. This is critically important because the chairperson is given two votes as the deciding tie-breaker on board matters. 

Thanks to this structural advantage, shareholder representatives in German companies have tended to be successful in seizing control of board function and steering the board deliberative process through more advantageous channels. 

Shareholders representatives in co-determined firms often manage much of the board work informally or directly with management in ad hoc committees. But as already noted, such a practice has the drawback that the board’s access to essential information about these projects and its ability to make reasoned decisions about them are often severely limited. Practices such as giving supervisory directors board materials only slightly before the meeting and sometimes requiring that they be returned just after, reducing the number of meetings of the board and its formal committees, or increasing the board’s size to impractical and unwieldy numbers that encourage free-riding and impede efficient meeting management are common in German co-determined companies. 

As a result of this response, the supervisory board is significantly weakened and its ability to function as a monitoring body is limited.

In effect, then, the German co-determined firm appears to run the risk of becoming something of a headless state, its supervisory board neutered in an effort to avoid inefficiencies in the manner in which it structures the decision-making process. What is left is just a balancing of powers, with policy largely determined in the confluence of each interest. Of course, the massive regulatory scandal that occurred at Volkswagen was in no party’s interest. But it occurred under the chairperson of the supervisory board. As we already noted, Ferdinand Piëch, the grandson of Volkswagen’s founder, was the long-time leader of the company. Under his leadership, the company appears to have followed, without question, his “desire to make VW the best and biggest carmaker in the world.”

Nevertheless, a power struggle earlier this year illustrated in dramatic fashion that control cannot be exercised unilaterally at Volkswagen. Piëch, disappointed with the company’s performance under Winterkorn, the CEO that he had hand-selected several years earlier, announced that he was dissatisfied and attempted to oust him. But, it was immediately apparent that, acting alone, he did not have the votes to remove Winterkorn. Even within the controlling families, the members do not vote as a single block nor do they always agree. Some family members, such as his cousin Wolfgang Porsche, did not support the change. Additionally, Stephen Weil, the premier of Lower Saxony, pledged his support, and the State’s 20% vote, for Winterkorn. Additionally, the leader of the works council pledged its support for Winterkorn. Therefore, Piëch’s attempt to replace the CEO backfired and Winterkorn survived. And Piëch was forced to resign from the supervisory board.

The co-determination structure compels this form of power-sharing. Before he was ousted, Piëch’s interest in growing Volkswagen into the world’s “biggest carmaker” appeared to be largely if not completely consistent with the interests of the board representatives of labor and government. Most important, the policy favoring growth without regard for profitability promised to expand Volkswagen’s employee base. And thus this failed attempt to unseat Winterkorn was at bottom reflective only of a new alignment of the employees and works council with management. Before the scandal and after the departure of Piëch, Winterkorn had the workers’ support: “Together with him we have written an unprecedented success story,” works council chair Osterlich said. This support was absolutely necessary for a CEO like Winterkorn to keep his job. The demonstration of the power of the works council and Lower Saxony, through their ability to influence the Volkswagen leadership, has made clear the reality that Winterkorn and the supervisory board are dependent on the continued appeasement of both groups to implement their objectives.

45. See id.  
47. Id.  
48. See footnote 39 above.  
49. See Roe, “German Codetermination.”  
50. See footnote 1 above.  
52. Id.  
53. Id.  
54. Id.  
55. Id.  
56. Id.  
Piëch, who led the company during the period that it was misleading regulators, was long an ideal company leader from labor’s perspective. His primary focus was not on making money. Rather, he set out to create an empire through aggressive brand acquisitions. Piëch believed that “It is not possible to bring a company to the summit while maintaining harmony,” so he had to make a choice between labor and shareholders. He chose labor.58

The unlikely alliance between an industrial tycoon and labor was possible only within the unique structure of Volkswagen and the German law of co-determination. The ability of shareholders to control the direction of the company—for example, through the market for corporate control—was severely curtailed by the voting structures on the board. Piëch’s own economic incentives were sharply diminished by the separation of control rights from cash-flow rights. He owned Volkswagen through both a pyramid structure and dual-class shareholdings. His holdings were derived first through the family’s holdings in Porsche, which it controlled through a 10% economic interest. For him, the private benefits of empire-building clearly outweighed the sacrifice of potential wealth, most of which would have been shared with outsiders. This powerlessness of shareholders to influence the direction of the company, along with Piëch’s interest in building the world’s largest automaker, coincided with labor’s interests and gave opportunity and reason for the alliance.

But, as discussed earlier, the true puzzle of the emissions scandal is that highly interested parties permitted a compliance failure that not only benefited none of them, but ended up imposing very large costs on all of them, including labor and local government. Regulatory non-compliance did not in the end further the objectives of any party. However, because the co-determination structure forced an alliance between the shareholder-controller, management, and labor—one that was reinforced by the participation of local government—there was no one to monitor any of those parties. Compliance systems require a relationship that includes healthy distrust and skepticism between the board and management, and management and labor—a relationship that is less likely to develop when the parties’ primary objectives are all so closely aligned.

**Conclusion**

The problems at Volkswagen resulted from the conflict of objectives that is inherent in the structure of the VW board. Policy was determined by the individual interests of each party that was represented on the board. Thus large-scale consideration of the company’s ethical posture seems to have been secondary. This resulting blindness to the potential for corporate malfeasance on what turned out to be a global scale is viewed in these pages as the result of the confluence of three problems that can be traced to the composition of VW’s board. The presence of a dual-class controlling shareholder, the government as a major equity-holder and putative board member, and, finally, the German corporate model of co-determination all contributed to this massive board failure in oversight.

The implications of this failure of corporate governance practice are straightforward. First, the use of dual-class stock (which is now prohibited in Germany) only magnifies the problem inherent in the presence of a controlling shareholder. Second, the presence of the government as a major investor in a public corporation complicates and damages the ultimate corporate mission of shareholder return. Third, the German corporate organizational governance structure of co-determination creates an environment in which a corporation must juggle the conflicting interests of the shareholder and the labor representatives, thereby limiting the prospects for long-term corporate success. The scandal gives investors and directors much to reflect on. Ultimately, it is a testament to the importance of board composition, theory, and structure in helping to build and maintain a corporate culture that promotes integrity and, in the final analysis, the long-run success of the company.

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The combined Porsche-Piech family accumulated its large block of Volkswagen voting shares through an extraordinary series of events during 2005-2009.

Connections between the extended family and Volkswagen went as far back as the 1930s, when Ferdinand Porsche designed the iconic Volkswagen “Beetle.” Several family members were actively involved in the Porsche firm, particularly Ferdinand Piech, a grandson of Ferdinand Porsche. Piech was head of engineering at Porsche but stepped down in 1972 after disputes with other family members.

He then joined Volkswagen, becoming head the Audi subsidiary and then, from 1994 to 2002, CEO of the entire Volkswagen Group. He subsequently joined the supervisory board (Aufsichtsrat) of Porsche and was one of the family members who still controlled a majority of voting shares. He stepped down as supervisory board chairman in April 2015 after a failed attempt to oust CEO Martin Winterkorn.

Between 1993 and 2008, Wendelin Wiedeking was CEO of Porsche (head of the Vorstand, or operating management board) and led a dramatic increase in Porsche’s sales and profits through extensive manufacturing process improvements and some new product lines, particularly the Cayenne SUV.

By contrast, VW’s financial performance was quite mediocre. Although it sold 50 times as many cars as Porsche, it was much less efficient and profitable, and its shares sold at a much lower multiple of revenue. Its market capitalization was only $17 billion in 2005.

The 1960 “Volkswagen Law” had always seemed to make a takeover of VW out of the question but, starting in the early 2000s, other EU countries argued that the VW Law violated EU corporate governance rules. The possibility that the VW Law might be repealed made a takeover of VW thinkable.

**VW Share Price in Euros**

![VW Share Price Chart](chart.png)

Porsche began acquiring shares in Volkswagen in 2005 under the direction of Wiedeking. On September 25, 2005, Porsche announced that it had a 20% stake but was doing so only to ensure the continued independence of VW.¹ In August of 2006, Porsche announced its position had increased to 25% but, again, continued to deny it wanted to acquire VW.

By March of 2007, its share ownership had increased to 31%.² Wiedeking argued that the shares were a good value and that VW could improve operationally.

VW’s share price in 2007 (see chart) was twice that of 2005 but Porsche continued buying shares and call options at ever higher prices with much borrowed money. Porsche paid even higher prices in 2008 despite the beginning of a worldwide banking crisis.

In October 27 of 2008, Porsche announced it owned 42.6% of VW shares and held call options on another 31.5%.³ The combined holdings of Porsche and the state of Lower Saxony amounted to 94% of VW shares.

Because several investors and hedge funds had shorted VW shares, a “short squeeze” developed. VW shares closed at Euro 514 on October 29, more than ten times the price of early 2005. On that day, Volkswagen was the most highly valued company in the world.

But Porsche’s position had been acquired with largely short-term borrowings. $13 billion would be due on March 24, 2009, but rolling over more than a bit of that would not be feasible under the circumstances.⁴ VW shares began dropping after the end of November 2008.

Despite its operational mediocrity, Volkswagen’s financial situation was far superior to Porsche’s. It was unlevered and held $12 billion in cash.⁵ As a member of both companies’ advisory boards, Ferdinand Piech had a clear view of both of their finances.

Because no banking institution or outside investors emerged to rescue Porsche financially, the only solution became, ironically, a VW acquisition of Porsche.

Piech became the head of the supervisory board for the now combined companies which included the following marques: Porsche, Volkswagen, Audi, SEAT, Skoda, and Bentley.

After the VW-Porsche merger, and an equity investment by the government of Qatar, the Porsche family holding company (now “Porsche SE”) still retained 50.7% of VW’s voting shares even though their economic interest was only 15.75%.⁶ Porsche SE was, however, also liable for much of the debt accumulated in trying to take over VW.

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3. Germany does not have a securities law equivalent the US SEC 13D.
5. Presumably, Wiedeking had intended to use VW’s cash hoard to pay off Porsche’s debt after acquiring VW and believed that the Volkswagen law would be repealed. The German Government opposed repeal, however, and the 80% voting requirement continues to prevent an outside takeover of Volkswagen.
6. The Porsche and Piech families owned 50% of Porsche Holdings SE which held 50.7% of VW group’s voting shares, but which represented only a 31.5% economic interest. See Financial Times, October 19, 2015 at https://next.ft.com/content/fd07f2d0-7645-11e5-933d-ef6cd3c11c89#axzz3t17h6rNx