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THE IMPACT OF EU OVERSIGHT ON CORPORATE GOVERNANCE IN THE GERMAN AUTO INDUSTRY

Jason Gorn

Introduction

As the European Union (E.U.) marks its 50th anniversary, its efforts to create a single European free market continue to face a number of obstacles. A key business policy concern among E.U. member states and corporations is the E.U. policy directive that aims to facilitate corporate takeovers in the interest of European corporate efficiency in the global market place. As the European Union struggles to establish economic regulatory command through measures such as its directive on takeover bids, member nations and corporations come under pressure to adhere to E.U. prescribed European practices rather than following only their own perceived national and corporate self-interest. Germany, in particular, provides a special challenge to E.U. oversight as the result of an ongoing debate on international corporate governance policies. A number of German laws and business practices conflict with E.U. policies. German corporations rely on concentrated corporate ownership and control to protect corporate stability. Alterations to German policies and corporate governance structures that protect German corporate ownership are a threat to Germany's control over its industries, opening the door to hostile takeovers of German corporations. Such policy alterations, advocated by the E.U., test the resiliency of the E.U. and Germany's commitment to the E.U.

Germany's strongest and most protected industry, the automobile industry, provides the best example of the challenges that face the German corporate system under E.U. governance. The current debate over Porsche's bid to control Volkswagen has opened a "Pandora's box of governance issues."[1] German state and corporate policies have long been geared toward protecting the German automobile industry from perceived disruptive forces, particularly corporate takeovers that might result in foreign ownership or major consolidations of German corporations with a loss of German jobs. This analysis explores the issues facing the German auto industry, and the matter of corporate takeovers in particular, while assessing the impact of E.U. oversight on the German auto industry and the

German corporatist state. This assessment reveals inherent resistance by Germany and other E.U. member states toward E.U. policies that facilitate corporate takeovers and describes a number of corporate governance policies and government laws that continue to thwart takeovers in the German auto industry. This resistance has, for the time being, effectively derailed the current E.U. directive aimed at facilitating corporate takeovers.

The Importance of the German Auto Industry

The German automotive industry is the key industry in the German economy. "It is of eminent significance for growth and prosperity of Germany as a business location. It is indispensable…for guaranteeing a high level of income and for safeguarding a high employment volume." (Becker, 217) More than a third of all vehicle production in the E.U. is in Germany. The German auto companies worldwide production amounts to 23% of total world passenger car production and the German car brands possess a 47% market share in Western Europe. About 20% of the annual German gross domestic product in the last decade was earned by the auto industry. The auto industry produced a German foreign trade surplus in cars of 79 billion euros in 2004, which amounts to 80% of the entire German trade surplus. The industry directly employs approximately 770,000 Germans, with an estimated 1.5 million more employed in the multitude of industries and services upstream and downstream from automotive production (e.g. mechanical engineering, chemicals, etc.), not counting those in car sales and trades such as repair and service, etc, which add another 3 million jobs. It is estimated that one in seven German jobs depend on the auto industry. The German auto industry, understandably, has been referred to as the "engine of the German Economy." (Becker, 218-19)

The Importance of Corporate—State relations in the German Auto Industry

Germany is a federal state made up of different states or "lands." Many aspects of social and economic life are decentralized in Germany and are the responsibility of these state governments. The major German automotive corporations are Volkswagen, BMW, DaimlerChrysler, Porsche, Opel, and Ford Werke. Each manufacturer has its headquarters in a different state, with the exception of Porsche and DaimlerChrysler, which share Stuttgart in the state of Baden-Württemberg as the site of their headquarters. The automotive companies that make up the German automotive industry have strong regional ties to the German states in which they were established and in which they maintain their headquarters. Each of the German car companies, therefore, must deal with its own regional government, as well as the national German government. Because of these strong regional ties, each company can rely on its own state government to help represent its interests at the national level as well. (Dankbaar, 2) The economies of these states are centered on their main industry, with each of these automakers typically being the major employer, directly and indirectly, in their respective regions. This is particularly true for Volkswagen, which transformed Wolfsburg in the state of Lower Saxony into one of the largest auto production sites in the world. Volkswagen is the only major employer in the region (Dankbaar, 1), which makes the workforce in the state of Lower Saxony highly dependent on the company.

As in other German industries, the close association of each German automobile manufacturer with its home state sometimes includes state ownership in the company, although most often this is not the case. Substantial state ownership occurs in about 10% of German companies throughout all sectors, as compared to 25% of French firms and 1% of

U.K. firms, as of 1993. (Whittington and Mayer, 104) State ownership of firms in Germany, when it occurs, is also more plural. "Reflecting Germany's federal nature, state shareholdings are found at various levels—federal, regional, … and even municipal….Among the regional states, the most notable participation is probably Lower Saxony's in VW…at about 20%" (Whittington and Mayer, 104-5) Even when there is no direct state ownership in a particular company, the German government and the regional state governments in which manufacturers are based take a corporatist, protective attitude toward the politically powerful and important German automobile companies.

The history of each of the major German automobile manufacturers, their relationship to their regional states, as well as their place within the German auto industry as a whole, provide case examples of the blending of corporate-state interests and of the challenges facing the German auto industry and German economy as a whole. This analysis will focus on Volkswagen, Porsche and DaimlerChrysler in particular.

Volkswagen

The German government founded Volkswagen (VW) as a state owned company in 1937. Volkswagen (meaning "people's car") was founded with a social agenda. The original purpose of the company was to increase employment by employing the vast number of workers needed to produce an affordable car on a grand scale. Ferdinand Porsche designed the original Volkswagen car, the famous Beetle, at Adolf Hitler's request. The Beetle was designed to become the German Model T. At that time, an average American worker could afford a car, thanks to the economies of scale introduced by Ford and General Motors. In contrast, the average German worker in 1937 could not afford a car. VW has continued to follow the business model of a volume, mass-market producer, but has evolved from a single product company (the Beetle) to a volume manufacturer that offers a broad range of products covering wide sections of the market. In the 1980s and 1990s, VW shifted further in the direction of increasing the scope (product range) of its production through the acquisition of the Spanish company, SEAT, and the Czech company, Skoda. VW has further expanded into the premium car market, primarily through its Audi subsidiary, but also with the acquisition of ultra luxury nameplates such as Bentley and Bugatti. (Dankbaar, 1) VW is, therefore, increasingly trying to satisfy all things automotive to all segments of the market.

Volkswagen was privatized in the early 1960s. The descendents of Ferdinand Porsche, including his grandson Ferdinand Piëch, own shares in Volkswagen, as well having control of Porsche through its supervisory board. (Brecht and Mayer, 30; Dankbaar, 2) VW and Porsche have had many links throughout the history of the two companies. Ferdinand Piëch was the chief executive of VW from 1993 until 2002. When VW was privatized in the 1960s, the German government passed a law aimed at recognizing and perpetuating the social importance of Volkswagen to its native state of Lower Saxony by establishing an institutional corporate safety valve to prevent a foreign or hostile takeover that might otherwise result in the loss of thousands of jobs in Wolfsburg. This law allowed Lower Saxony to own a controlling 20% stake in the company and prevented other shareholders from acquiring more than this 20% stake of voting shares. This 1960 law (known as the "Volkswagen law") preserved a state interest in VW that effectively prevented a hostile takeover, until Ferdinand Piëch launched a bid by Porsche to take a controlling interest in VW in September 2005. This takeover bid created a protracted power struggle with Porsche acting in apparent defiance of the VW law. The Porsche takeover of VW has just recently come to fruition, as

of March 2007, and hinged on the likelihood that the E.U. court would strike down the German Volkswagen law. The Porsche bid for VW highlighted the anti-takeover VW law. This law had already become a focus of conflict between Germany and the E.U., since the law is in apparent conflict with the E.U. directive on corporate takeovers.[3] This and other conflicts between German automobile industry interests and the E.U. will be discussed in greater detail below, after considering the situation of other German automobile manufacturers as well, beginning with Porsche.

Porsche

Porsche is a niche automobile manufacturer and is much smaller than the other German car companies. However, Porsche is highly profitable. In fact, Porsche produces the highest profit margins on its sales in the entire global auto industry, even though all its cars are produced in Germany, with high German manufacturing costs. (Becker, 10) Ferdinand Porsche founded the company in the 1930s and all the voting shares in the company are still controlled by approximately 50 of his heirs (from the Porsche and Piëch families). These family members retain total control of the company through a signed voting pact and corporate governance rules that allow them control despite the fact that their 100% ownership of Porsche's voting shares represents only about 10% of the company's capital. It is estimated that the Porsche heirs together own an additional 10% of non-voting stock as well. (Brecht and Mayer, 30) This family control of Porsche precludes the possibility of hostile takeovers, with the Porsche and Piëch families firmly in control of the company's supervisory board and its destiny. Porsche's business plan, at least until recently, has been to remain a niche player in the auto market; but it is not a small company. Porsche has approximately 8,000 employees and had total earnings in the year 2005-2006 of 2.11 billion Euros, despite sales of just 96,794 cars, which nevertheless represented a sales volume record.[4]

Although Porsche is based in Stuttgart, in the state of Baden-Württemburg, Porsche has longstanding close ties to VW, which has particularly helped Porsche over the years. Porsche used VW parts in its first cars. Most recently, Porsche was able to develop its luxury SUV, the Cayenne, with only a modest investment because of a partnership that it formed with VW to share the platform used for the VW Touareg. This agreement helped Porsche expand beyond its limited sports car line and reap high profits from a vehicle that it could not have profitably developed on its own.[5] Porsche, therefore, has much to gain by increasing its access to VW model platforms and electronics, which are costly to develop. The operant Porsche business plan of remaining a boutique auto maker and out-sourcing much of its product development and production has been exposed as unsustainable by Porsche management's desire to forge closer ties with VW. Analysts have said that Porsche's VW takeover bid stemmed from the fear of a possible link-up between VW and DaimlerChrysler that would have jeopardized Porsche's historic partnership with VW.[6]

BMW

BMW (Bavarian Motor Works) is another regional automotive powerhouse. BMW was founded in 1916 in Munich, Bavaria. The corporate practices at BMW emulate the traditional, somewhat isolationist values of Bavaria, as demonstrated by BMW's rather closed corporate culture. (Dankbaar, 1) The Quandt family controls BMW, as well as several other major companies. BMW's business model has traditionally focused on the premium or high-

end market as a specialist producer rather than a volume producer. More recently, however, BMW has hedged its bets with a limited expansion into the mass-market segment with the Mini Cooper car and the lower end BMW 1 series. BMW has also pursued an extension of its high-end market into the ultra luxury field with the acquisition of the Rolls-Royce brand.

Opel and Ford Werke

Opel and Ford Werke are American owned subsidiaries of General Motors and Ford, respectively. These German subsidiaries of the two big American auto companies nevertheless hold a significant place in the German auto industry. Opel is headquartered in Frankfurt in the region of Hessen. Ford's European headquarters and production facilities are in Köln in Northrhine-Westfalia. Opel is an old German company dating from the 1860s that was bought by General Motors in 1929. Europeans consider Opel a German car and the region and its workers generally look upon Opel as a German company. Nevertheless, Opel is controlled from the American headquarters of General Motors. Ford founded Ford Werke in 1925 and it is perhaps even more tightly associated with its American founder. However, Ford Werke still represents a major employer in Köln. (Dankbaar, 2) These companies are mass-market producers that have been criticized as too focused on the American emphasis on productivity and cost cutting rather than the typical German automobile manufacturer's focus on engineering, product innovation and quality. The reputation of the German auto industry for engineering has often allowed German manufacturers to obtain a premium for their cars that has historically helped them to overcome the disadvantage of high cost production in Germany. The different business cultures at Opel and Ford, as compared with the other German manufacturers, is reflected in less innovative product lines and a lower consumer image that has required Opel and Ford Werke to compete more on price against the other European mass market manufacturers, and has resulted in lower profit margins or losses. A comparison between the net returns on 2004 sales between Opel, which had a net loss on sales of minus 4%, and the world auto industry leading net sales returns of Porsche at plus 17%, illustrates the potential difference in added value afforded by image, although these two manufacturers occupy very different market niches. (Becker, 4 and 10)

DaimlerChrysler and Expanding Scope and Competition in the Auto Industry

DaimlerChrysler was created in 1998 as the result of a merger between the German company Daimler-Benz, which produces the Mercedes-Benz luxury brand, and the U.S. mass-market manufacturer, Chrysler, with the German managers in control of the new company. The German corporate culture of DaimlerChrysler reflects the relative social and political conservatism of its home state of Baden-Württemburg, where its headquarter city of Stuttgart is located. (Dankbaar, 1) The merger with Chrysler reflected an extension of Daimler-Benz down market that had already been started with the development of its Smart Car subsidiary in the late 1990s and the expansion of the Mercedes-Benz line to include the relatively inexpensive Mercedes A-class.

This product expansion reflects the competitive picture in the German auto industry in which the high-end manufacturers, such as Mercedes-Benz and BMW, try to poach sales and generate growth in the middle and lower segments of the market at the expense of the historic mass-market producers. At the same time, as we have noted, VW and other mass

producers try to move into the high end of the market for growth and higher profit margins. DaimlerChrysler has also followed BMW's and VW's expansions into the ultra-luxury market. BMW and VW acquired the Rolls Royce and Bentley brands, respectively. DaimlerChrysler responded by developing its own new Maybach ultra-luxury brand. This situation of ever expanding model ranges is occurring world wide in an auto industry replete with over capacity and stagnant real growth.

The efforts of relative niche players like Merecedes-Benz and BMW to extend their market into the lower range, and the efforts of the mass-producers, such as VW, to expand into the upper market segment, have not addressed the industry's problem of over capacity. Instead, each manufacturer that has followed this route faces the increased cost of maintaining greater model diversity with lower than planned profit margins resulting from a glut of new models across all market segments that has led to increased price competition in each price range. Becker has referred to this situation as an "oligopolistic destructive competition. As the market as a whole is no longer growing, every producer is trying to generate growth at the cost of the other competitors....the result in the end is that none can be the lucky winner; to a greater or lesser degree they are all losers with stagnant market volumes and shrinking profit margins." (Becker, 11) Maynard and Bunkley quoted a veteran auto industry analyst, John A. Casesa, in the *New York Times* as saying that, "This industry is ripe for further consolidation because the most profitable markets have matured; they're not growing anymore. These are classic conditions for consolidation."[7]

The Risks of Merging with a Non-German Partner

Although consolidation can clearly be a method to reduce overcapacity in the auto industry, this was not Daimler-Benz's intent when they merged with Chrysler in 1998. Instead, they sought market expansion and a possible increase in efficiency through economies of scale. However, Daimler inherited an aging and relatively weak product line in the acquired Chrysler brands and was faced with the investment and engineering challenge of coming up with competitive models for the four Chrysler brands, one of which they eliminated (Plymouth). The Daimler-Benz strategy of acquiring an expanded world market share through its merger with Chrysler is now seen as an apparent failure. Furthermore, the merger that resulted in DaimlerChrysler led to a relatively wide distribution of corporate ownership, as compared to the narrow distribution of ownership and control typical of German companies, particularly in the German auto industry (excluding the American controlled companies of Opel and Ford). The Daimler-Benz/Chrysler merger resulted in Americans holding 10% of the shares in the resulting DaimlerChrysler Corporation. (Dankbaar, 1) This brings into play an American shareholder expectation of maximizing share value.

Shareholders vs. Stakeholders

American shareholder interest in maximizing share price over the short term is at odds with the traditional German mentality of shareholders as company stakeholders. German company shareholders and voting blocks are not widely distributed among financial and other private institutions, mutual funds, pension funds, insurance companies, and individuals, as compared to the broad distribution of company stocks held by these factions in America (or in the U.K.). (Becht and Mayer, 29) Instead, German board and shareholder voting blocks are more tightly held and include trade unions and banks with a

stake in the company, in addition to the holdings of founding families, other German companies, and, in some cases, the state. These German shareholders have a long-term stake in the companies that they hold and are typically categorized as risk adverse, interested in the long-term stability of the corporation, and are concerned with the social implications of risky organizational change. (Luo, 38)

The Risks of Shareholders: The DaimlerChrysler Example

The German auto companies have only mediocre market capitalization levels, especially in comparison with Toyota, the world's most valuable carmaker with a market capitalization of 239 billion dollars.[8] This reflects the fact that, overall, Germany lacks a shareholder culture, with a market capitalization of only 30% of its GDP, compared to 122% in the U.S. and 152% in the U.K. Typically, individuals and institutional investors own few shares of German public corporations. (Luo, 42) If the present major stakeholders in the German auto companies lose control over their tightly held shares and limited voting blocks, "Acquisitions by outsiders could put Germany's automobile industry in the same position as Britain's, where every notable name has been sold to foreign owners."[9]

The vulnerability of DaimlerChrysler to such a takeover is perceived as having increased as the result of its swallowing of Chrysler and the resulting depreciation and dilution of its stock. This came to a head in February 2007 when the Chrysler division of DaimlerChysler reported that it had lost 1.48 billion dollars. Dieter Zetsche, DaimlerChrysler's chief executive, announced that "all options are on the table" in regard to a sale of the Chrysler division.[10] Zetsche has cited his desire to maintain control of the German parent company, Daimler, as his reason for proposing to divest Daimler of the Chrysler division by seeking suitors for Chrysler.[11] Since this announcement, DaimlerChrysler has had negotiations with a number of potential suitors for Chrysler, including private equity firms who "would most likely impose plant closings and layoffs to turn around Chrysler for a quick resale."[12] This potential "doomsday" scenario for Chrysler, in which it is bought by a private equity firm and cannibalized to turn a quick profit, represents a prescient warning for German Daimler itself. Adam Jonas, an analyst of the European auto industry for Morgan Stanley in London, was quoted in the *New York Times* as saying, "Should the sale [of Chrysler] fail to take place, DaimlerChrysler shares will probably fall once more, leaving the company even more vulnerable. If Zetsche doesn't get this right…the door will be open to interlopers."[13]

Back to the Future for Daimler?

After the potential sale of Chrysler, DaimlerChrysler shareholders have advocated a return to the "old days," with the resurrection of the Daimler-Benz name and a renewed emphasis on the Mercedes luxury brand.[14] Presumably, this restructuring would allow a return to the previous concentration of shareholders who hold a stake in the company and a typical German corporate concentration of voting blocks that could fend off hostile takeovers in the future. This potential effort by DaimlerChrysler to divest itself of its American corporate division is an effort to reassert its German roots and return to the typical protectionist German corporate influences of the past.

Daimler-Benz: the Role of Banks in German Corporations

Prior to its merger with Chrysler, Daimler-Benz represented a classic example of German corporate structure. Corporate government at the former Daimler-Benz, like most German corporations, was "characterized by a lesser reliance on capital markets and outside investors and a stronger reliance on large inside investors and financial institutions to achieve efficiency..." (Luo, 42) Instead of market and outside investors, Germans firms receive strong investment from banks that are influential in the design and functioning of the companies themselves. This is a result of the fact that the banks themselves sit on the boards and commissions of the companies. Ernst-Jürgen Horn, in his evaluation of industrial policy in *Managing Industrial Change in Western Europe*, reports that the "banking system is said to have an extraordinarily intimate relationship with the big industrial groups.... Excessive economic power.... allows the banks to act as brokers, investment analysts, dealers and much else besides." (55) Horn then goes on to list three major factors in bank control: "(i) Participation of banks in non bank corporations. (ii) The Depotstinmrecht, that is the proxy votes by banks on behalf of shares deposited with them by clients. (iii) The representation of banks on the supervisory boards of non bank operations." (55). Horn sites statistics that show how imbedded banks are in firms. For example, in the annual meeting of sixteen corporations, the bank-owned shares came to over 25 percent of shares represented in corporations. Banks also control proxy votes and represented through proxies over 25 percent of the votes in 41 corporations, and over 50 percent in thirty. This means that through proxies alone, not including bank owned shares, banks could vote on 10 percent of the shares in fifty cases, going as high as 25 percent in twenty-nine cases. (56)

In "Anatomy of a Governance Transformation: The Case of Daimler-Benz," Denis Logue and James K. Seward reported that in the late 1980's banks were the top 5 shareholders in the Daimler-Benz company, controlling 78.39 percent of the voting stock. (90) The structure of Daimler-Benz was a prime example of the typical German corporation. Deutsche Bank in particular has had deep and historic ties to Daimler-Benz, with links to both of its parent companies, Daimler and Benz. Deutsche Bank was heavily involved in the merger of these two firms in 1926 and supplied the chairmanship of the newly merged company over its first decade. (Whittington and Myer, 97) Deutsche Bank's investment in Daimler-Benz in 1993 consisted of roughly 28 percent of the company's stock. As Logue and Seward explain, Deutsche Bank exerted incredible power in managing the company. This has to do with the typical German corporate structure of the company. "Large German companies have two governing boards: the supervisory board and the management board. The supervisory board is composed of directors and representatives of various labor groups; including 'white collar' employees...The supervisory board of Daimler-Benz has twenty members. The chairman of Daimler-Benz's supervisory board, Hilmar Kopper, also happens to be the chairman of Deutsche Bank's management board." (Logue and Seward, 90) The supervisory board's task is to appoint the management board and to approve major corporate decisions. Much of this is left up to banks.

As Logue and Seward also point out, "This bank dominance effectively means that under the traditional system of corporate governance in Germany, external capital markets exert little discipline." (91) The proponents of this German system of stakeholder corporate governance, as opposed to shareholder corporate culture, argue that large shareholders like the banks share strategic motivations with the operational managers to advance the company's business rather than a motivation to merely maximize the value of a company's

shares. According to Sigurt Vitols, "Large German banks have tended to view their shareholdings as a mechanism for protecting their loans and strengthening their business relationships with companies rather than as a direct source of income." (Vitols, 342) Horn concludes," It is hard to assess how far the close relationship between the banks and the big corporations contributes to overall industrial performance. It has been argued that the banks are well equipped to provide strategic advice and that, wanting good returns, they are vitally concerned with the efficiency of their clients." (56).

The Pressures of Globalization on German Corporate Structure

The argument against the German stakeholding system fits into the general views on globalization, which are increasingly being promoted by the European Union. The E.U. seeks to promote actions that are in the interest of international competitiveness (as opposed to the potentially more myopic interests of corporate stakeholders) and in the interest of developing a single capital market. The E.U. policies, therefore, tend to encourage corporate restructuring in "stakeholder countries" such as Germany. These policies are designed to facilitate takeover bids when such bids are in the interests of a company's general shareholders, as opposed to the interests of only its stakeholders. This E.U. policy of breaking down the protectionist barriers to takeovers has been contentious, as can be seen in the close votes in the European Parliament on provisions in the E.U. law (directive) concerning takeovers. For example, in July 2001, 273 representatives voted for and 273 voted against a proposed directive text, which defeated that effort.[15] To a large degree, the E.U. efforts have been "incremental—rather than fundamental" in advancing changes in ownership, employee representation, and management institutions. (Vitols, 339) Proponents of these changes argue that, "since international capital markets are increasingly dominated by diversified portfolio investors (such as mutual funds and pension funds) seeking higher returns, companies must adopt the shareholder model or be starved of the external capital needed to invest and survive." (Vitols, 338) According to this argument, obtaining access to capital markets will ultimately drive corporations away from the non-market driven features of the stakeholder model in order to achieve greater competitiveness.

The DaimlerChrysler merger took Daimler-Benz at least incrementally in the direction of market forces and incrementally away from its stakeholder foundations. DaimlerChrysler was incorporated under German law as a German stock corporation (AG) and retains a two-tiered German system of corporate governance with a supervisory board of major shareholder and employee representatives and a separate management board, all in keeping with the German stakeholder system. However, shares of DaimlerChrysler are widely held and company shares are traded on both the NYSE and the Frankfurt Stock Exchange, and at other locations around the world, with the necessary transparency in financial reporting. Americans are estimated to hold 10% or more of the stock. (Dankbaar,1) Although Deutsche Bank remains the largest single shareholder, the bank's holding were diluted from 28% to 12% by the merger. (Whittington and Mayer, 97) When the going recently got rough, with Chrysler division losing 1.48 billion dollars and the world automotive industry ripe for further consolidation, even this incremental move by Daimler toward market/shareholder forces, and the resulting dilution of the stakeholder system at Daimler, has been enough for DaimlerChrysler CEO Dieter Zetsche to adapt a cut and run policy toward Chrysler. By divesting the Chrysler division and the American shareholder pressures that came along with the Chrysler acquisition, Zetsche hopes to avoid putting the

core German company in play for a takeover, with a little help from stakeholder promoting German laws and German corporate governance institutions.

Takeover from the Inside: Porsche and VW

DaimlerChrysler's takeover fears did not arise in a vacuum. DaimlerChrysler has been the observer of Porsche's partially hostile takeover of the much larger VW Corporation over the last 18 months. This takeover raises still other concerns relating to corporate globalization-type reforms and E.U. policy, as well as potential conflict of interest concerns relating to cross investment in German companies, even by competitors in the same industry. It also points to a flaw in the German system of concentrated corporate ownership and control, which may allow an inside player to wrestle control of a company if German restraints against takeovers are relaxed. The Porsche takeover of VW shows that, at least in the short term, German firms may have to be more concerned about takeovers from within their boarders than from outside. The stereotypical xenophobic nature of the German psyche may care less about this threat, but such inside takeovers are not necessarily in the general shareholders interest, or even in the interest of a particular corporation such as VW.

Although Porsche has historic engineering and product ties to VW, these ties have seemingly benefited the smaller Porsche Company to a greater degree. It is unlikely that Porsche would have been able to manufacture automobiles without access to VW parts from its very beginning. As auto makers look to expand the scope of their lines into new models in order to compete, the small European niche players other than Porsche have all been absorbed by larger firms. The writing is on the wall, even though Porsche remains highly profitable in the present. As we have seen, Porsche's present profitability was aided by the highly advantageous deal that Porsche was able to make with VW to give it access to the Touareg SUV platform for its Cayenne version luxury SUV. This platform was developed at a total estimated cost of 1.2 to 1.8 billion dollars. Porsche invested only 420 million dollars, which is "very, very little for a new car," according to Ferdinand Dudenhöffer, director of the German Center for Automotive Research at the University of Gelsenkirchen. "There is no question, VW had all the risks and Porsche earned the greatest profits," according to Dudenhöffer.[16] VW also does most of the manufacturing of the Cayenne for Porsche at its factory in Bratislava, were the cost of manufacturing is lower than at existing Porsche plants in Germany. If Porsche's interests are allowed to dictate future developments, VW's own brands may suffer in Porsche's interest, as the wide range of brands and models that VW owns may potentially, if not already, compete with Porsche, particularly Audi. This conflict has, in fact, already been demonstrated in the Cayenne/Touareg deal. This deal went through well before the present Porsche takeover effort, but it still likely reflects the strong position of Piëch and other Porsche representatives on the VW advisory board, even before the takeover. Audi insiders complain that the VW/Porsche cooperation on the Cayenne delayed the introduction of the Audi Q7 luxury SUV by 3 years. This car has only just recently come to market, well after the Cayenne, likely costing Audi market share and profit. Other VW brands besides Audi may also stand in the way of Porsche's current or potential market niche, particularly Bugatti and Lamborgini. Will the fate of these brands be determined by VW's best interest or in the best interest of Porsche?[17]

Cross Ownership of Corporate Shares: Conflicts of Interest

These market concerns are not simply details of the German auto market; they arise

from a potential conflict of interest inherent in the German corporate governance structure that allows cross ownership in a competitor's company. This conflict of interest is potentially magnified by the concentrated ownership of controlling shares in German companies and it is spotlighted by Porsche's bid for VW. In the case of VW, the VW law served to counter the possibility that the owner of another company in the same industry could amass a controlling stake that would allow him to influence management to act against the interests of the company, and therefore against the interest of Lower Saxony. This law guaranteed Lower Saxony the single largest voting block of shares, which no other single owner could exceed. Even so, Ferdinand Piëch, who with his family controls 100% of the voting shares of Porsche, was likely able to influence VW in the interests of Porsche even before he attempted his takeover of VW. Piëch's pre-existing power on the VW supervisory board certainly helped him to launch and pull off Porsche's takeover of VW from the inside.

In the future, globalization and an accompanying shareholder culture may apply pressure for reforms to the German corporate culture that allows for concentrated cross ownership of stock in a competitor, such as the shares and influence exercised by Porsche in VW. Such influence is potentially counter to the interests of a free market and to the interests of company's general shareholders if the competitor gains undue influence in the company, as may have happened in the case of Porsche and its influence on VW. Even before the Porsche/VW takeover bid there had already been some pressure to change the German corporate practice of allowing a retired former CEO to assume the company's board chairmanship, where he may appoint his successor and maintain undue influence. (Luo, 43) This practice was still in place at VW and it is one of the German corporate practices that Piëch exploited in his takeover of VW. Piëch holds the strong position of Chairman of VW's supervisory board because he was the recently retired CEO of VW. Piëch's power was also magnified because he already controlled a large number of voting shares through the holdings of Porsche and his family in VW. Porsche AG already held two seats on the VW supervisory board, in addition to Piëch's own seat, even before the takeover attempt was launched. At the start of the Porsche and Piëch takeover bid, "Investors, analysts, and members of the VW supervisory board [cried] foul over Piëch's conflict of interest, since he juggles ownership in Porsche with his role as VW chairman."[18]

The Palace Coup: Heads Roll

Christian Wulff, the premier of Lower Saxony who sits on the VW board representing the state of Lower Saxony, initially attempted to block Piëch's takeover by proposing that both Piëch and the other Porsche managers who sit on the VW board be removed. He supported this proposal by citing the German corporate governance code that recommends (but does not demand) that a chairman step down if he holds a position with a competitor.[19] This did not happen. The CEO of VW, Bernd Pischetsrieder, sided with Wulff. Piëch and his collaborators on the VW board removed Pischetsrieder in November 2006.[20] Piëch stayed on, increasing Porsche's shares in VW and demanding an additional Porsche seat on the supervisory board. When Pischetsrieder was forced out as CEO, Volkswagen's No. 2 executive, Wolfgang Bernhard, also resigned. Bernhard had been brought to VW from Chrysler to pursue a stringent cost-cutting program at VW to help better position VW as a competitive mass-market producer. With the removal of these two executives and the appointment of Martin Winterkorn, a Piëch protégé, Piëch consolidated his hold on VW and reasserted VW's old priorities from his tenure as CEO at VW. Since these management

changes, VW has shifted its emphasis from cost-cutting back to high-quality engineering and design, in line with the market strategy advocated by Mr. Piëch, who trained as an automotive engineer.[21] Only the VW law could conceivably stand in the way of Piëch's and Porsche's takeover of VW, a takeover which reassembles the parts of Piëch's grandfather's automotive legacy into one empire.

The E.U.'s Uphill Battle to Facilitate takeovers

Piëch's takeover bid was always dependent on the E.U. striking down the German VW law. Piëch had reason to believe that the E.U. would comply with his wishes. The E.U. Parliament has long recognized that a directive on a common framework for cross-boarder takeover bids is essential. Under increasing conditions of globalization, such transactions "can contribute to the development and reorganization of European firms, a key condition for withstanding international competition and developing a single capital market. That said, [takeovers] are still subject to very divergent national rules [that] give rise to numerous problems…" (COM (2002) 534 final, page 3)

The contentiousness of this takeover issue can be seen in the E.U. legislative history involving the framing of a directive on takeover bids. The E.U. first began work on a directive to approximate E.U member state's laws that govern takeover bids in 1985. By 1990, the E.U. Commission had devised the text of a directive aimed at "harmonizing" the field of takeover bids in Europe. This proposal encountered strong opposition from certain member states and required revision. (COM (2002) 534 final, page, 2) By 1997, however, the Commission adapted an amended proposal and by 2000 the Council unanimously adopted this position. Controversies on certain issues persisted and amendments were proposed. The tie vote in the European Parliament on a compromise text, mentioned above, led to the defeat of the text in July 2001. This defeat centered on three controversial political considerations that reflect Europe's ambivalence on takeovers. The first political consideration was a rejection of the stipulation that the board of a company facing a takeover must obtain approval from shareholders before it can take defensive measures against a bid. The second political consideration was the perception that the E.U. takeover directive provided insufficient protection to the employees of companies facing a takeover. The third political concern was that the proposal still failed to achieve a level playing field with the United States. (COM (2002) 534 final, page 2) Despite the existence of an E.U. law to facilitate takeovers, political divisions such as these have continued to hamstring the E.U.'s efforts.

In 2002, the European Commission proposed new rules to address outstanding concerns on the takeover directive. This new revision contained articles that had specific implications against the survival of the German VW law, or similar measures. Specifically, Article 11 of these provisions stipulates that restrictions on the transfer of securities, such as the imposition of a ceiling on shareholding or restrictions on voting rights, "are rendered unenforceable against the offeror or cease to have effect once a bid has been made public (Article 11)." (COM (2002) 534 final, page 4) These provisions, and other provisions designed to prevent both pre-bid and post-bid defenses to takeovers, were adapted in the Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids. However, last minute negotiations at the time, resulting from strong resistance on the part of several countries, including Germany, heavily watered down this E.U. takeover directive. These negotiations resulted in an amendment that allows countries to

opt-out of certain key provisions of the directive. This amendment also exempts companies from the rules if the bidder is not subject to the same obligations.[22] A recent review by the Commission of the European Communities on the implementation of the Directive on Takeover bids, released on February 21, 2007, found that a majority of states exploited these loopholes in a protectionist fashion, which may have resulted in new obstacles to takeovers. (SEC(2007)268, page 10) This report notes that Germany is one of many countries that allow its companies to opt out of the two key provisions in the takeover directive, including the important Article 11 (breakthrough rule) as well as Article 9 (the board neutrality rule). (SEC(2007)268, page 12) For the time being, the German VW law remains on the books.

The E.U. Moves to Strike Down the VW Law

Although many countries, including Germany, exploited the loophole of optional exemptions to block the E.U. directive on takeovers, the E.U. nevertheless proceeded to take legal action against countries that refused to apply the fundamental rules. The German Volkswagen law soon came under scrutiny by the European Commission, which complained to Germany about the law in 2004.[23] The E.U. subsequently took Germany to court over this law in 2005. Porsche and Piëch's takeover bid for VW has, therefore, assumed that this law would be struck down. A Porsche spokesman recently confirmed this assumption when he claimed "that the European Court of Justice would confirm the invalidity of the VW law and so cause the German government to change or abolish this law."[24] Porsche's assumption appears to have been correct. On February 13, 2007, an advocate general on the European Court of Justice, Damaso Ruiz-Jarabo, reached a preliminary ruling stating that the VW law unreasonably prevented any intervention in the management of VW and was "not based on overriding reasons relating to public interest."[25] Although the advocate's opinions are not binding on E.U. judges, the court follows these opinions approximately 80% of the time.[26] Should the court fail to strike down the VW law, or should Germany try to circumvent the authority of the court (perhaps through appeals invoking the opt-out provisions of the directive), Porsche will "find itself holding a costly stake in the company without being able to exercise more than 20% of the voting shares."[27]

The Porsche Takeover of VW: A Fate Complis

Since this announcement by the European Court advocate general, Porsche expanded its holdings in VW to 31% of the voting rights. This acquisition exceeded the stipulated greater than 30% holding required to trigger a mandatory bid for the entire company. This stipulated mandatory bid for the entire company is the result of Article 5 of the E.U. takeover directive that sought to protect minority shareholders and guarantee them an equitable price. However, this provision does not stipulate that the buyout offer be at a buyout induced premium share price, or even at current market value, only that the offer be made at the stock's average value over a period of at least 6 months, to be determined by German law. (2004/25/EC: Article 5, section 4) Since Germany opted out of the directive rule that would have obliged the VW board to hold a general meeting of shareholders to vote to approve or block the bid, the general (non-voting) shareholders in VW have no power over the bid price offer other than that stipulated by the German implementation of Article 5 of the E.U. takeover directive. This meant that Porsche was able to make a below market offer to buy the remaining shares in the company. Porsche and Piëch's inside influence allowed Porsche to gain control of VW at a relative bargain price without paying

shareholders the typical premium that a takeover entails. Major VW shareholders are reportedly distressed at this result.[28] Since Porsche now already controls the company with 31% of the voting shares, it does not need the remaining company shares, most of which exert no influence on how the company is run. Porsche's below market bid for these shares is only a formality. Porsche is not likely to have to buy any shares at the offered price, which is well below the current market-trading price. This is fine with Porsche, which does not plan to further increase its shares, according to a Porsche spokesman.[29] Porsche and Piëch, therefore, gained control of VW "on the cheap," and the E.U. takeover directive stipulation (Article 5) designed to protect the share price for minority shareholders was ineffective in this case.

Politically, Porsche has had to convince the Germans that it is a stable partner acting in the interests of VW and of Germany, emphasizing that Porsche is not an outside (foreign) interloper. Porsche and Piëch's public relations program in this vein seeks to paint Porsche as the savior of VW, with Porsche acting to protect VW from the consequences of the E.U. court's impending decision to strike-down the VW law. Porsche's campaign insinuates that if Porsche does not gain control of VW, the elimination of the VW law will result Volkswagen being acquired by an outside buyer who would insist on American style restructuring with the loss of thousands of jobs. Adam Jonas, the auto industry analyst at Morgan Stanley in London, interprets Porsche executives as saying, "Trust us, we're not trying to flip this thing for value. This is a hundred year investment. Leave it with us, and we'll watch out for it."[30]

CONCLUSION

The German fear of takeovers in its auto industry is understandable given the vital importance of the auto industry to the German economy. The example of the British auto industry, in which every significant British-owned manufacturer succumbed to foreign takeover, is certainly prescient to the German auto industry and Governmant. The English car brands were often bought strictly for their marketing cache, to be resurrected in another country without any British ties or contribution to the British economy, as exemplified by a Chinese manufacturer who now manufactures a Chinese sports car under the MG nameplate. Germany is not alone in its resistance to lift barriers to takeovers. The E.U.'s own recent commission report (SE(2007)268) concluded that a large number of countries have failed to act to lift barriers against corporate takeovers through laws that would change protectionist corporate governance policies, as stipulated by the E.U. directive on corporate takeovers. Instead, there has been a strong trend for corporations and countries to use loopholes in the E.U. takeover directive to find acceptable ways to block takeovers instead of facilitating them. This threatens to convert the existing E.U. directive into a directive on allowed protectionist practices.

Striking down the VW law only removes one solitary law among the numerous institutionalized German corporate protections. Ironically, the German VW law had already outlived its usefulness. The law stood in the way of market forces that pushed two German companies to effectively consolidate into one holding. This consolidation of VW and Porsche serves the needs of Porsche, one of the most profitable German auto manufacturers, and may perpetuate German ownership of VW in the long haul. However, the E.U. system of creating a single free market by directive, including facilitation of corporate takeovers, has been exposed as weak. Although German stakeholder corporate governance and German corporatist state policies and regulations are at odds with the market integration efforts by

the E.U., German corporatist policies will not go away as long as they are useful and are perceived as strengthening German commerce. If market forces subsequently prove that these policies are detrimental to German corporate and state interests, as globalists predict, then the Germans will change these policies. If market forces do not prove German stakeholder protectionist policies to be detrimental, particularly given their longstanding proven stability benefits, then these policies will persist.

The E.U. must let the market dictate, as E.U. directives will not dictate the market. The European Commission, in its report on the implementation of the Directive on Takeover Bids (SE(2007)268) has concluded as much when it announced that the E.U. will take no immediate efforts to rewrite the directive to achieve better implementation of its objectives. Instead, the Commission plans to take "into account the potential negative effects of the new takeover rules on the European market….and try to analyze the reasons why Member States are so reluctant to endorse the fundamental rules of the Directive." (SE(2007)268) In other words, the Commission will continue to observe German (and other European) corporate systems, including the German auto industry, but it will 'leave well enough alone,' at least for now.

End Notes

1. "One Hand on Two Steering Wheels"
2. "Top EU Court Finds against VW Law"
3. "Top EU Court Finds against VW Law"
4. Annual Report 2005/2006-Dr.Ing.h.c.F.Porsche AG
5. "One Hand on Two Steering Wheels"
6. "One Hand on Two Steering Wheels"
7. Maynard and Bunkley
8. Maynard and Bunkley
9. Maynard and Bunkley
10. Isidore
11. Maynard and Bunkley
12. Landler, "Intertwined Chrysler"
13. Maynard and Bunkley
14. Maynard and Bunkley
15. COM (2002) 534 final, Proposal for a Directive…
16. "One Hand on Two Steering Wheels"
17. "One Hand on Two Steering Wheels"
18. "One Hand on Two Steering Wheels"
19. "One Hand on Two Steering Wheels"
20. Milne and Buck
21. Landler, "Porsche Raises"
22. 2004/25/EC: Article 12: "Optional arrangements"
23. "Top E.U. court finds against VW law"
24. McHugh
25. McHugh, ABC News
26. McHugh
27. Landler, "To strengthen control"
28. Milne and Buck

29. "Porsche moves to keep Volkswagen"
30. Maynard and Bunkley

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