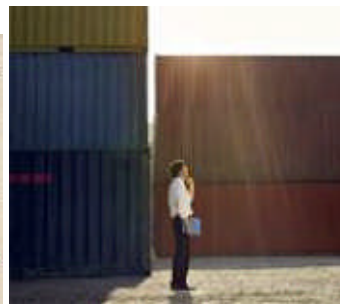
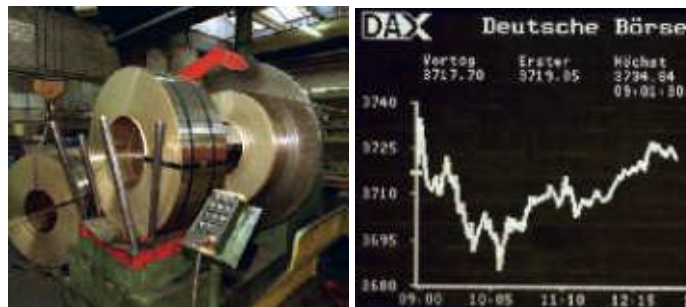


## The Courage of Taking Responsibility

The responsibility of property ownership as a foundation of our economic order



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## The Courage of Taking Responsibility

### Preface

The duration and multifaceted nature of the current financial, economic and debt crisis show that the causes of the crisis are complex. They include individual acts of human error or wrongdoing on the part of decision-makers in business and politics as well as collective errors of judgment in academia and serious aberrations of the economic and financial system. It was neither exclusively the greed of investment bankers and private investors or market failure or the government's inability to adequately regulate the industry that caused the crisis. All these factors and others combined and mutually reinforced each other. The end result has been a tangled web of factors that has blurred the public perception of the key underlying causes.

In this position paper, the BKU highlights one aspect that we consider to be crucial: the connection between property ownership and responsibility. Because we are convinced that the decoupling of ownership and responsibility, a trend for which there is ample evidence, is the key cause for the fundamental and almost unmanageable nature of the crisis. There will always be greed and human error. The moral sense of individuals of what is right or wrong always needs to be sharpened. What is crucial, however, is that there are structural reasons for the outbreak of the economic and financial crisis. Corrective action must be taken both in terms of incentive systems governing individual behaviour and in terms of corporate governance and supervision.

Incentive structures that reward the wrong behaviour of market actors, thereby endangering property ownership, are worrying. This applies both to aspects of the economic order as well as to the principles of good corporate governance. In this paper, the focus lies on the big public limited companies with a wide spread of share ownership.

This paper sets forth positions, defines issues and makes proposals on the "responsibility of property ownership", whose pros and cons will be assessed in a dialogue process both inside and outside the BKU, and to which much more detail will be added later.

## **I. The responsibility of owning property: Defining the problem and approaching a solution**

### **1. Strengthening responsibility and liability is indispensable**

Since the days of the East India Company, public limited companies have been established, initially thanks to state privileges granted on a case-by-case basis, later on the basis of general legislation designed to enable the financing of large-scale high-risk investment projects by collecting many individual capital contributions. The privilege of having one's individual liability limited to the purchased share led to a manageable level of risk for the individual investor, who cannot exert direct influence on the operational management of the company. In the 19<sup>th</sup> century, the legal form of the public limited company became increasingly important for financing the expansion of railroad networks, the development of mining and metallurgy as well as the growth of the banking and insurance business. The history of the industrialisation of the Western world is closely intertwined with the triumph of the public limited company, without which the raising of required levels of equity would hardly have been possible. The increasing use of the legal form of a public limited company ensured that the division between legal ownership of the company and actual decision-making power in the company, which is a hallmark of this type of company, would become a regular feature of the business world.

The globalisation and internationalisation of capital markets have even deepened this division. The average holding period of shares has kept getting shorter, so that the shareholder has increasingly turned into a "sharecropper". If, today, shares are traded in a matter of milliseconds, the question arises who can possibly be the individual who has assumed an obligation, as shareholder, by acquiring property, as stipulated in our Basic Law.

We are dealing here with a troubling trend towards an undermining of the personal responsibility that comes with owning property, in other words, a trend towards a collectivisation of liability. If, in case of a bankruptcy, neither the company executives nor the members of the supervisory board are required to help pay for settling the damage, it is not just the question of fairness that is raised. Also, the issue comes up whether the incentives for company decision-makers to exercise caution and act prudently need not be re-adjusted. In view of global challenges, the legal form of public limited companies will continue to be practical or even necessary in all cases where large-scale investment projects need to be organised and financed. But in these cases, too, a proper sense of proportion needs to be respected and the right kind of balance must be struck in order to strengthen the culture of responsibility. This would, at the same time, be the best and constantly renewed justification for the privilege of limited liability that government has granted public limited companies.

This is why this paper specifically focuses on public limited companies, especially those whose shares are widely spread, rather than on small and medium-sized private limited liability companies. In their case, the direct personal liability of the managing director and

the guarantees banks require executive partners to provide ensure that the responsible decision-makers are liable to an extent that, even if it is not the same, at least comes close to that of an owner-manager. In any case, for the reasons mentioned, the liability of an executive partner of a private limited liability company is much more far-reaching than that of a member of the board of a public limited company. If the culture of responsibility is to be strengthened, it is the public limited company that must be recognized as a problem and not the small and medium-sized limited company.

## **2. The Christian view of the human person and the principles of Christian social teaching provide guidance for understanding the role of property ownership**

The basic principles of Christian social teaching are clearly expressed in the Christian view of property. The right to private property flows from the personal freedom of the individual. According to the social teaching of the Church, however, owning property is not only an individual right, but it also has a social character. This view is rooted in the belief in the Bible's Creation story, according to which God "has given the earth for the use and enjoyment of the whole human race" (Rerum Novarum 7). To put it differently: the Creation is a gift of God to all human beings, all those who are alive today and all future generations!

This "universal destination of earthly goods" does not conflict with the right to property, but it does establish a reference to the common good, apart from property's private use. In secular legal terminology, this theological concept has become known as the social obligation of property.

This point exemplifies the sustainable triangular relationship between economy, ecology and the social dimension: without the private benefits of owning property there is no economic incentive for hard work, innovation and investment and no careful management of resources. Without the social obligation inherent in property, however, there is a growing gap between the rich and the poor and little interest in protecting resources for future generations.

If the personal freedom of the individual is the ultimate foundation of the right to property, property also enables individuals to be free. The church father Thomas Aquinas (Summa theologica II-II, q. 66, a. 2) already stated that property was a necessary part of human life. He mentions three reasons: "1. Because every man is more careful to procure what is for himself alone than that which is common to many or to all [...] 2. Because human affairs are conducted in more orderly fashion if each man is charged with taking care of some particular thing himself [...] 3. Because a more peaceful state is ensured to man if each one is contented with his own."

Catholic social teaching derives society's "institution of property" from the common good. Even non-owners benefit if a society recognizes and protects property rights.

### **3. Property, freedom and responsibility are mutually dependent**

Our ideas of the rule of law, representative democracy, human rights and a market economy all go back to the basic principle that property must be protected from arbitrary rule and third-party threat. Because experience shows that property rights are indispensable for a dynamic economic order: property creates freedom by demarcating people's separate spheres of action. Property rights define boundaries for the state which is obliged to protect them, not interfere with them arbitrarily. Property ownership encourages carefulness, long-term thinking and sustainability. Property rights can create the right conditions for competition and creativity.

Adam Smith, the Scottish moral philosopher and economist, did not only regard property as a prerequisite for the "wealth of nations", but also for virtuous behaviour: "A person who can acquire no property can have no other interest but to eat as much and to labour as little as possible" (Adam Smith: *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book II, p. 315). The right to and the building up of property, therefore, promote behaviours such as thriftiness and abstention from instant gratification, foresight and caution when taking action and circumspection and carefulness when managing one's own affairs. A broad dispersal of ownership facilitates the development of these behaviours. In other words: property ownership promotes responsibility.

Walter Eucken, the founder of the Freiburg School of "Ordoliberalism", counted the right to private property among one of his "constitutive principles of the competitive order", emphasizing that only property ownership safeguards economic independence and freedom of action. Each company needs equity, i.e. property, that is made available by owners to be used by the company for its purposes. If, by doing so, property is productive and contributes to the meeting of customer demand as well as job creation, this way of committing property to a company is an excellent example of the social obligation of property.

### **4. Liability is the legal requirement of the competitive system**

"Whoever reaps the benefits must also bear the liability." With this phrase, Walter Eucken starts his discussion of the problem of liability in his "Principles of Economic Policy" (Tübingen, 1952, p. 279 et seq.<sup>1</sup>). He goes on to argue that liability is designed to "enable or facilitate the selection of companies and business leaders. Moreover, it is supposed to ensure that capital is deployed prudently. The more liable the responsible person is for his investment, the more caution will be exercised in making the investment. In this way, liability acts as a precaution against the squandering of capital and forces everyone to carefully sound out the market. In addition, liability is important for the competitive system because it discourages the takeover of other companies motivated by a thirst for power. Cost accounting becomes the key factor. (...) Liability that is as universally applicable as possible acts against concentration." (loc.cit., p. 280). Limiting liability means shifting at least

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<sup>1</sup> Page numbers cited refer to the original German text of Eucken's book, because there is no official published English translation.

part of the risk to others. This is a problem both in terms of social ethics and in terms of regulatory policies. The principle to be applied is that everyone must be personally accountable for their actions.

A total rejection of any kind of limited liability, however, would probably lead to much higher risk-aversion among people, because they couldn't, or wouldn't want to, bear certain risks. Taking out insurance against specific risks is therefore a solution that is in keeping with market principles and offers benefits for the overall economy, because it enables economic activities that would otherwise be shunned. A certain retention should still be imposed on the insured, because the insurability of all risks may encourage less cautious behaviour.

### **5. Limitations of liability must be linked to specific conditions**

One question keeps recurring: who will pay for damage that goes beyond the paid-in capital? The current banking crisis illustrates what happens when financial institutions are threatened by insolvency. It is not only shareholders who will have to absorb the financial loss but also creditors and - to an unprecedented degree - taxpayers, if government has to step in the breach and organise a bail-out in order to stave off so-called systemic consequences.

This is why any limitation of liability must be linked to conditions:

- special obligations for responsible managers of limited liability companies to exercise due care;
- minimum equity requirements (e.g. no reductions in the minimum equity requirements for a company that have been in force until now);
- specific transparency obligations, mainly for capital market-oriented companies;
- adequate obligations to promote the common good.

### **6. Owner-managers and company executives: different dimensions of assuming responsibility for a business**

Responsibility is more than just doing your duty. It is an illusion to believe that the negative consequences of limiting liability to the personal culture of responsibility of business owners and executives could be contained simply by committing them to manage the company in a way that is in compliance with the law and existing rules and to produce specific business results. Such rules are important and must be underpinned by sanctions. However, apart from fulfilling one's duty and meeting targets there still remains a part of leadership responsibility that must grow out of the personality of the business owner, executive, shareholder or supervisory board member him- or herself. Precautions must be taken against the risk that attempts are made to compensate for the negative consequences of limitations of liability by implementing constantly new regulations. This cannot prevent undesired behaviour in the end and leads to more and more confusing sets of rules.

Fully liable owner-managers and company executives as board members of public limited companies represent different forms of entrepreneurial responsibility. In many industries, the contributions large public limited companies make to growth and prosperity are undisputed. In these companies, the entrepreneurial function is generally exercised by highly professional board members, who work for the company as senior executives, on the basis of a board director's contract.

Even so, in our economic system, the fully liable owner-manager is still considered to be the ideal model of an entrepreneur. They should not be idealised, however. Some owner-managers tend to be rather bossy, are often reluctant to accept external advice or miss the right moment for handing over the company to the next generation. But these business owners or their families are directly confronted with the consequences of such behaviour. By being strictly subject to the principle of liability and by being closely and directly tied to the property they manage they act under institutional conditions that produce an indissoluble connection between entrepreneurial decisions on the one hand and personal responsibility and liability under civil law on the other. Owners should be free to do with their property what they want, but they need to be aware that they must answer for the consequences of their actions and that they will be liable for any damage they may cause others in the process.

The role of owner-managers in small and medium-sized companies often promotes the development of specific lifestyles and attitudes: the interest in a long-term and careful management of the property, the close relationship between company and family, the strong roots in the familiar local community and the high willingness to become engaged in politics, society and culture. In a society in which ownership is widely dispersed and small and medium-sized businesses flourish certain values such as freedom, personal responsibility, social commitment, personality and subsidiarity can develop particularly strongly. Therefore, a vibrant society of property owners with a broad middle class comes very close to the model favoured by Catholic social teaching. It can be an effective protection against the collectivisation of the human person and the nationalisation of property and offers many opportunities for leading a life of self-determination and self-reliance.

### **7. Company executives in limited-liability companies must be sufficiently liable**

In capital market-oriented companies, property ownership and management are usually not in the same hands. Depending on the distribution and spread of a company's shares, an atomisation of property may occur. Many co-owners of the company, being only small shareholders, may not have any influence and may not even want to exert any. While for many shareholders a share is a title of ownership, they still mainly regard them as an investment instrument, especially because of their uncomplicated tradeability and low transaction cost. Small shareholders are often not really interested in their legal position as owners and are happy not to have to look after their shares other than paying attention to



dividends and share prices. Such an attitude does not make much sense from the perspective of regulatory economic policy. Owning property in a company entails obligations and requires the owner to take care of their property. Whoever does not want to do so, would be better advised to buy corporate bonds rather than shares. If regulatory policy does not require a shareholder to show much interest in his position as owner, the question arises who exercises the function of the owner in public limited companies whose shares are widely spread. This function is expressed in the right to attend annual general meetings and play a part in the appointment and monitoring of the management board and supervisory board. If the shareholder does not exercise this right effectively, supervisory board and management board are risking to become a self-contained system with little transparency in which a culture of accountability is not likely to grow.

### **8. Long-term instead of short-term orientation**

Also, under the influence of US-American, capital market-driven business practices, companies and company shares have been degraded to mere trading commodities in the past few years. It is not just that the holding period of shares of large public limited companies has gone down considerably in the last few decades. Also, the percentage of shares held in capital funds has strongly grown. Another typical feature is that the term of office of board directors has become consistently shorter. This shows that institutional investors, as short-term owners, do not have a long-lasting interest in the companies they have invested in and its employees. The same applies to company executives who only work for the company for a short period of time or whose remuneration is geared towards delivering short-term results but not to a sustainable development of the business.

Even disclosure requirements in quarterly reports do not produce more long-term thinking in companies. In our view, a company is a social organism in which people work productively together, find meaning in what they do and work towards generating sustainable profits. In order to achieve this, corporate governance must be based on long-term thinking. This also includes equity investments in such a company.

### **9. The problem of size and complexity**

The bigger capital market-driven companies become and the more they are integrated, the more their internal and external responsibility must be defined and monitored by an efficient institutionalised system. It is the responsibility of companies themselves, and it is in their own interest, to develop adequate institutions and processes that safeguard responsible entrepreneurial decisions by owners, supervisory board members, executives and employees even in complex structures. Setting standards by adopting voluntary Corporate Governance Codes can be helpful in this context – especially if the members of commissions drafting these codes abide by them themselves. Awareness of the need for positive ethical behaviour of decision-makers needs to be raised again and again. On top of that, however, government must review minimum requirements for corporate governance and the rights and duties of corporate decision-makers in the light of the experience gained

in the crisis years of the recent past and re-adjust them as part of a further development of company law.

These regulations, however, can only define a framework for corporate governance and must be designed in such a way that companies have an incentive, beyond meeting legal requirements, for sustainably enhancing their culture of leadership and responsibility in competition with others.

### **10. The danger of shifting responsibility to others**

The problem of limiting liability is even exacerbated by the multi-step delegation of responsibility which is produced by the effects of the capital market: a private investor, wanting to spread his financial risk, buys shares of an investment fund of a private equity firm. This firm invests in companies and attends their annual general meetings – or doesn't. In order to avoid conflicts of interest, the private equity firm does not send any representative to serve on the supervisory board, but delegates its responsibility to the supervisory board members elected by the annual general meeting. These members then delegate their responsibility, in a third step, to the management board. What is the result of this multi-step delegation of responsibility, combined with limitations of liability, in the case of insolvency? Owners and creditors have to absorb the financial loss, but the responsible members of the management board or supervisory board escape any personal liability, unless they can be shown to have acted negligently (non-compliance with the "Business Judgment Rule", § 93 par.1, sub-par. 2, German Stock Corporation Act). The violation of the personality principle by the combination of multiple delegation of responsibility and limited liability has produced – as became obvious during the crisis – an unacceptable degree of organised irresponsibility.

## **II. What needs to be done to foster a culture of responsibility**

### **1. Strengthening the sense of responsibility of owners in partnerships and public limited companies**

Depending on how the principle of liability is implemented, entrepreneurs live in two different worlds. If we look back on legal regulations adopted in many countries in the past few decades, we can see that the liability of partnerships and public limited companies has developed in opposite directions. Legislators have often failed to see the trend towards avoiding liability, or they have even deliberately looked the other way or even promoted it. In view of the negative consequences, the ever-growing rift between the two worlds of liability should now be closed again, by

- correcting or at least mitigating the legal discrimination against fully liable owner-managers and by
- adding effective elements of supervision, transparency and liability to privileges granted listed public companies after proper justification.

All proposals on how to reform company law have to be judged by the criterion whether they help to strengthen the liability of and within companies. Therefore, the following proposals and ideas do not provide a final answer, but are only designed, by highlighting some possible approaches, to indicate the direction in which a reform of company law should go, one that is geared towards responsible practices.

## **2. Promoting the role of owner-managers**

The fully liable owner-manager has been besieged on many fronts. It is therefore one of the priority tasks of regulatory policy to strengthen the idea of property ownership and the culture of responsibility associated with it and to reduce the competitive disadvantages that owner-managers face.

### **a) Tax law**

Small and medium-sized companies are made to suffer disproportionately by a complicated tax system and the cost of bureaucracy, which is passed on to companies. De facto, there is no consistent neutrality in our tax law between partnerships and public limited companies as far as company finance and legal form are concerned. Tax law unfairly discriminates against the build-up of equity in partnerships. This must be removed. What is needed for this purpose is the recognition of notional interest from equity as operating expenditure, thus making it tax-deductible. Owner-managed companies could also be supported by a more practical design of tax privileges for retained profits in income tax law.

If tax law needs to differentiate between partnerships and public limited companies at all, it would make sense – unlike current practice – to impose a higher tax rate on public limited companies than on partnerships, because they benefit from the privilege of limited liability and generate higher profits to the extent that earnings will not be reduced by assuming liability obligations. Through preferential tax treatment, the preparedness to assume full liability, as against limited-liability companies, could at least be encouraged. Recognising interest from equity as operating expenditure could compensate for the assumption of liability in partnerships.

### **b) Labour and social law**

Many provisions of labour and social law are geared towards the reality of large limited-liability companies and often impose considerable burdens on small and medium-sized companies most of which are managed by fully liable owner-managers. This creates unnecessary incentives for fully liable entrepreneurs to seek the safe haven of limited liability. This applies especially to labour law regulations such as continued payment of wages and to the fact that our entire social security system is wage-based. Just as tax law, labour and social law offer good opportunities for creating incentives for moving away from limitations of liability.

**c) External consulting**

External consulting, done on a voluntary basis, provided by an independent and competent group of consultants, can improve the corporate culture even of non-listed family businesses. It is crucial that these groups of consultants include individuals who are truly independent of the family and the company that hired them and who are able to express and take criticism. Also, if these individuals are to be effective "sparring partners", they must be highly qualified professionals.

**d) Liability and transparency**

In the law on private limited companies, there is a competition going on for the broadest possible limitations of liability combined with the lowest possible capitalisation, as the introduction of the "Unternehmergeinschaft" demonstrates. This trend must be corrected so that companies have a sound financial basis right from the start.

Accounting standards, such as those that apply to large public limited companies and that may be tightened following current EU negotiations, do not make any sense for fully liable owner-managers. Especially the transparency obligations that are imposed, while indispensable for large public limited companies, seriously jeopardise the competitive position of small and medium-sized companies. Therefore, accounting standards for SMBs should not follow an "IFRS light" model, but should be in keeping with the precautionary principle of German GAAP (HGB).

**e) Corporate finance**

The unfair discrimination against owner-managed companies must be corrected, not just as far as taxation and labour and social standards are concerned, but also in terms of corporate finance. The access of SMBs to loans must not be put at risk by steps to regulate financial markets, such as the "Basel III" rules, for example. This risk exists if savings banks and cooperative banks, which played no part in triggering the crisis, are required to deposit amounts of equity that are unjustifiable in view of their lower-risk lending business. What must be prevented at all costs is to weaken the culture of long-term financing, so typical of German SMBs, by imposing exaggerated supervisory requirements.

**3. Strengthening responsibility and accountability in listed public limited companies****a) Principles of responsible corporate governance**

Any kind of limitation of liability dulls the perception of the costs and risks involved in making decisions. Wherever the law allows limitations of liability, this privilege must come with special obligations to exercise due care in taking business decisions. How these obligations are to be met in actual practice, cannot be finally determined by legislation, but is mainly a matter of entrepreneurial responsibility. What is needed, however, is a regulatory framework, for which we offer some relevant questions and ideas below, which will be discussed in our dialogue process.

**b) Strengthening the responsibility of shareholders in annual general meetings**

Accountability in listed public limited companies needs to be made more transparent and the rights and powers of owners in annual general meetings need to be enlarged. AGMs need to have efficient powers of supervision of management and supervisory boards. In this context, it seems to make sense to introduce separate Corporate Governance audits.

Owning property should be a good reason for having a say in decisions involving that property. That is why shareholders should feel obliged to get involved in the decision-making process at AGMs of listed companies. Whoever does not exercise their rights of participation, should not complain afterwards if, for example, all sense of proportion has been lost in fixing compensation for the members of management and supervisory boards. It should be possible to transfer voting rights to authorised proxies or to shareholder associations. Electronic participation options prior to and during an AGM should be designed in a user-friendly, practical way. Also, in the run-up to an AGM, recommendations for resolutions should be prepared in such a way that the ordinary shareholder can easily grasp the different voting alternatives. We would like to know: How can the participation of shareholders in AGMs (including by electronic means), which is desirable for ethical and regulatory reasons, be noticeably boosted? Should custodian banks be required to inform their investors how they can fulfil their duty of participation, or have it done on their behalf? Should institutional investors be required to explain, in public, why they do not exercise their participation rights at AGMs? Should institutional investors be required to disclose their voting behaviour to their investors?

Unlike the owners of cooperative shares (or miners' union shares that played an important role in mining in the past), shareholders are not liable for potential financial loss of the company beyond the capital they paid in. For many listed companies, it is a serious problem that their investors have no interest in the long-term development of the company or in the dividends they are entitled to, but are set on re-selling the shares quickly at higher rates. A share, however, should be a long-term investment and not degenerate into a mere gambling chip. An option that could be explored is offering incentives for owners to hold their shares for longer periods of time and put more trust in dividends than in the re-sale value of their shares. Possibly, stock corporation law should empower AGMs to create a link between the dividend payout rate per share and holding periods.

AGMs should have the competence to set a cap on all compensation for management board members based on a proposal of the full supervisory board. Compensation granted to the management board must be adequate in proportion to employee compensation as well as dividend payouts to shareholders and with regard to the interests of stakeholders and the general public. AGMs will be required to adopt a resolution on the various applicable ratios on the basis of a vote taken by the full supervisory board and to publish these resolutions. Proportionality is guaranteed if the pay gap between employees and board members is in a balance that strengthens social cohesion within the company rather than undermining it. AGMs should also have the power to decide whether outgoing management board or

supervisory board members, in case of an early termination of contract, should be eligible for compensation that exceeds the amounts payable for the remaining term of the contract.

**c) Supervisory boards as custodians of shareholders' property**

Supervisory boards are under a special obligation to promote a corporate culture of responsibility and accountability. Not in all companies do they do live up to this expectation, though – be it because of poor qualification, busy schedules or conflicts of interest. Being a member of a supervisory board is a responsible and time-consuming job. The question needs to be asked whether chairing the supervisory board of a German DAX-listed company can remain a part-time activity and whether more professionalisation is needed. What is obvious is that individuals who, in their regular job, are executives on a management board, will have a hard time taking on additional supervisory board functions, if they take this role seriously. This is especially true for the position of chairman of such a body, given its special responsibilities.

The idea of restricting multiple mandates should be considered: should members of a supervisory board representing shareholders or employees be allowed to simultaneously serve on a maximum of three supervisory boards only? Should individuals who have a regular full-time job or who, as employee representatives, are employed by the company or a trade union, be allowed to serve on one supervisory board only? (Groups of affiliated companies would be exempt from these regulations. Of course, a board member or a managing director of a parent company will still be allowed to serve on the supervisory bodies of subsidiaries as part of their full-time job.)

**d) Self-commitment must come with sanctions and personal liability obligations**

Recently, the "Code of Responsible Conduct for Business" was signed by a large number of CEOs of the 30 DAX-listed companies and of important SMBs. In order to monitor these self-commitments and develop them into standards for business conduct, third parties need to evaluate them and, if necessary, impose sanctions. Arbitration settlements that are provided by associations or chambers are opportunities for curbing misconduct. Agreements on honourable business conduct that are concluded voluntarily by interested parties have proven to be effective, even internationally. These kinds of regulations (collective action) should be adopted at all levels: local, regional, national and even global, and on the level of individual industries. Experience shows that social exclusion is the strongest and most sustained form of sanction whenever collective self-commitments are to be enforced. A good idea could be the establishment of a nationwide "Honorary Council of German Business" along the lines of the German Press Council. But apart from this, the personal liability of decision-makers is the key aspect. This is why liability rules for executives should be tightened, for example, by requiring that the non-insurable part of earnings makes up a third of all income received in the past three years.

### e) **Disentangling the complex system of limitations of liability**

The convoluted system of inter-related layers of limitations of liability and the concentration and accumulation of power within corporate structures pose serious risks for the entrepreneurial culture of responsibility. Therefore, it should be considered whether the demand already made by Eucken can be implemented that, in the case of a company takeover, a new owner who has controlling influence has to assume full liability, irrespective of the legal form of this entity. Additionally, or alternatively, one could also think, in these cases, of imposing special requirements on the buying company for achieving a qualified approval in the supervisory board or the management board. Especially in the context of financial market regulation, liability principles must be reinforced – specifically with regard to more stringent equity requirements for investment banks, higher retention for those issuing loan securitizations, getting rating agencies and auditing companies to shift their focus back to their original functions (rating agencies should offer no consultancy services for the design of financial products and give up their quasi-sovereign lending as part of government banking supervision).

### **4. Liability is an imperative**

The liability principle is fundamentally important for the proper functioning of a market economy that is based on private property rights. For this reason, it is alarming that many developments in economic policy over the past few decades have produced a de facto decoupling of property ownership and liability or an erosion of liability obligations, respectively. This seems to have been a cause for the sharply declining acceptance of the social market economy, as surveys have demonstrated. This trend is highly dangerous for a system of free enterprise and must be urgently and resolutely resisted.

This position paper sets forth a number of specific proposals and raises questions that are supposed to be answered in a dialogue process. Apart from discussing their implementability and adequacy, they should be assessed and interpreted in light of the intention behind them, which is to strengthen the importance of personal liability and a corresponding sense of responsibility and, thereby, to rebuild the foundations of a free economic system.

## **III. The Courage of taking responsibility – Executive summary**

### **1. Key propositions: Strengthening responsibility and liability**

- The importance of property ownership as a fundamental institution of economic and social coexistence originates from Catholic social teaching, which also provides the basis for defining the concept more precisely. In Catholic social teaching, the idea of personal property rights is derived from the common good: an inseparable part of the freedom of owning property is the willingness to accept liability for the consequences of entrepreneurial decisions. Wherever the

principle of liability applies, an entrepreneurial culture of responsibility that comes close to the ideal of the honourable Christian merchant has a better chance to thrive.

- Trust in the social market economy has dwindled. This trust can only be regained by strengthening the culture of responsibility of all stakeholders in the business community. The key tool for strengthening the culture of responsibility is a revival of the liability principle and the model of good governance associated with it.
- In large public limited companies with a wide spread of share ownership the responsibility of owners needs to be enhanced. Opportunities for shareholders to get involved in business decisions, and their obligation to participate in them, must be improved, just as the tools for monitoring the activities of management and supervisory boards.
- Limitations of liability distort competition. That is why the competitive position of fully liable companies vis-à-vis limited-liability companies must be strengthened and the trend towards limitations of liability, which is encouraged by political intervention, must be stopped.

Limitations of liability are privileges that need to be justified. They must lead to the application of special standards for business decisions in terms of transparency, due care and risk prevention.

## 2. Demands of the BKU

### a) Basic demands

- Introduction of a simple and fair tax system without "loopholes", that is manageable for small companies without too much bureaucratic hassle
- Implementation of the neutrality principle in terms of legal form and corporate finance between partnerships and public limited companies (issue of profit retention)
- Special obligations to exercise due care when accepting the privilege of limited liability
- Establishment of a nationwide "Honorary Council of German Business" (comparable to the German Press Council) that can issue public and non-public reprimands in case of violations of the principles of the "honorable merchant" and that accepts relevant complaints

### b) Strengthening the fully liable owner-manager

- Tax privileges for fully liable entrepreneurs as against public limited companies as a compensation for their privilege of limited liability
- No application of the accounting standards developed for capital market-oriented companies to small and medium-sized owner-managed companies
- Financial market regulations under Basel III must not jeopardise the access to credit and the culture of long-term financing of SMBs



- Stronger use of external consulting on a voluntary basis even for non-listed family-owned and foundation-owned companies

**c) Strengthening the responsibility of owners in public limited companies**

- Do liability rules for company executives have to be tightened, e.g. by requiring that the non-insurable part of earnings amounts to a third of all income received in the past three years?
- Should the convoluted structuring of limitations of liability be prevented by the principle that an owner, irrespective of its legal form, is required to assume full liability when taking over another company?
- How can the moral obligation of shareholders to participate (also electronically) in annual general meetings be brought more strongly to the public's attention?
- How can public limited companies be induced to make it easier for its shareholders to participate in AGMs by, among other things, drafting recommended resolutions in a more easily understandable way?
- Should an option be introduced to pay out staggered dividends according to how long shares are held?
- Should it become mandatory for institutional investors to disclose their voting behaviour in AGMs to their customers?
- Should the supervisory board chairmanship of large listed companies (M-/Tech-/Dax etc.) be a full-time mandate?
- Must the number of supervisory board mandates at large listed companies (M-/Tech-/Dax) that are held by a natural person be limited to a maximum of three?
- Should individuals having a regular full-time job be only allowed to exercise one supervisory board mandate in a listed company (Tech-/M-/Dax etc.)? Exemptions would have to be considered, if
  - the supervisory board mandate is part of a full-time job in a group of companies,
  - the supervisory board mandate is held as part of a reportable material interest.
 (In this case, full-time supervisory board chairmen could only exercise one additional supervisory board mandate, but not chair a second supervisory board.)
- Should compensation payments made to outgoing members of the management board and the supervisory board have to be approved by the annual general meeting, if these payments, based on a vote of the full supervisory board, are above the compensation still due according to the employment contract?
- Should the AGM, based on a vote of the full supervisory board, have the competence for setting a ceiling for the total compensation of management board and supervisory board members?



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