

Digitization and AI in the Board Room - Germany -

Digitization and Artificial Intelligence in Corporate and Capital Markets Law

German and East Asian Perspectives

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Digitization and AI in the Board Room

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The German Corporate Governance System

- Two-tier system as the general rule
 - Mandatory for stock corporations incorporated according to the German Stock Corporation Act, management board and supervisory board
 - Supervisory board may not manage the company, disputes whether this restricts the supervisory board also in its monitoring capacity
 - Monitoring duty of the supervisory board and supervisory directors
- One-tier system is an option for European Companies (Societas Europaea), the European Regulation on SE provides a more flexible framework
- Board of directors monitored by a supervisory board in a partnership limited by shares (KGaA, nucleus of the German stock corporation) with a monistic (one-tier) SE as a general partner

Digitization and management

- Digitization is a topic primarily to be addressed by the management and therefore in Germany by the management board
- AI is developing and will change the way we live and work
- Relevance of digitization, digitalization and AI not only for day-to-day business but for the business model of the company
- Duty to obey the law: complexity of legal norms such as data protection, anti-discrimination and so on
- Chief Digital Officer (CDO) or similar positions (Chief Information Officer, CIO/ Chief Technology Officer, CTO/ Chief Data Officer) are common in listed German companies

Duty to digitize and use AI?

- The general duty of care of managing directors is linked to securing the company being profitable in the long-term. Developing the business model has to take account of digitization, digitalization and AI
- German business judgment rule provides safe harbor for informed business decisions, however, not every information (data/AI) has to be taken into account, there is discretion (the manager may assume to have acted on an informed basis)
- The more common the use of data and AI is in a certain business environment, the more challenging the task for directors or officers will be to justify that they took decisions without using extensive data or AI

Digital board rooms

- Organizational tool (digital)
- Materials in digital form: according to an older study, a significant proportion of companies provides the supervisory board access to the management information system
- Two-factor identification and other security features
- For printed materials: duty to return; in a digital board room: restrictions for printing, and copying, access only during the tenure of board members
- Tools for digital meetings and digital voting as incorporated features

Digital board meetings

- German Stock Corporation Act: Section 110 (3) 1 the supervisory board must come together for two meetings per calendar half year
- The governmental reasoning for the Transparency and Publicity Act last amending section 110 (3) notes: in well founded reasons video and telephone conference instead of in person meeting is permitted
- Digital board meeting
 - Video conference (as communication style is similar to in person meeting)
 - Not: telephone conference, e-mails and chats
- Possibility to hold all meetings digital? Or:
- Minimum number of in person meetings?
 - Minimum number of meetings for listed companies per year: academia is split, good reasons for a minimum of two in person meetings

Section 30 Works Constitution Act: Meetings of the works council

(1) The works council normally meets during working hours. (...) Meetings of the works council are not public. They take place as face-to-face meetings.

(2) In derogation from paragraph 1 sentence 5 participation in a works council meeting may take the form of a video or telephone conference provided

- 1. the prerequisites for such a form of participation have been laid down in the standing orders while ensuring that face-to-face meetings have priority.
- 2. not *at least* a quarter of the members of the works council submit their objection to the chairperson within a period to be determined by the chairperson and
- 3. it is ensured that third persons cannot take note of the content of the meeting

Recording of the meeting is not allowed.

(3) If the works council meeting is held with the additional possibility of participating by video and telephone conference, participation on site is also deemed necessary.

German Corporate Governance Code 2022

D. Supervisory board procedures

II. Cooperation within the Supervisory Board and with the Management Board, 4. Meetings and adoption of resolutions, Recommendations

D.6 The Supervisory Board shall also meet on a regular basis without the Management Board.

D.7 It shall be noted in the report of the Supervisory Board how many meetings of the Supervisory Board, and of the committees **were held in person or as video or telephone conferences and how many meetings of the Supervisory Board and the committees** the individual members attended in each case. ~~Participation by telephone or video conference also counts as attendance, but this should not be the rule.~~

XXXX Amended in 2022

XXXX Deleted in 2022

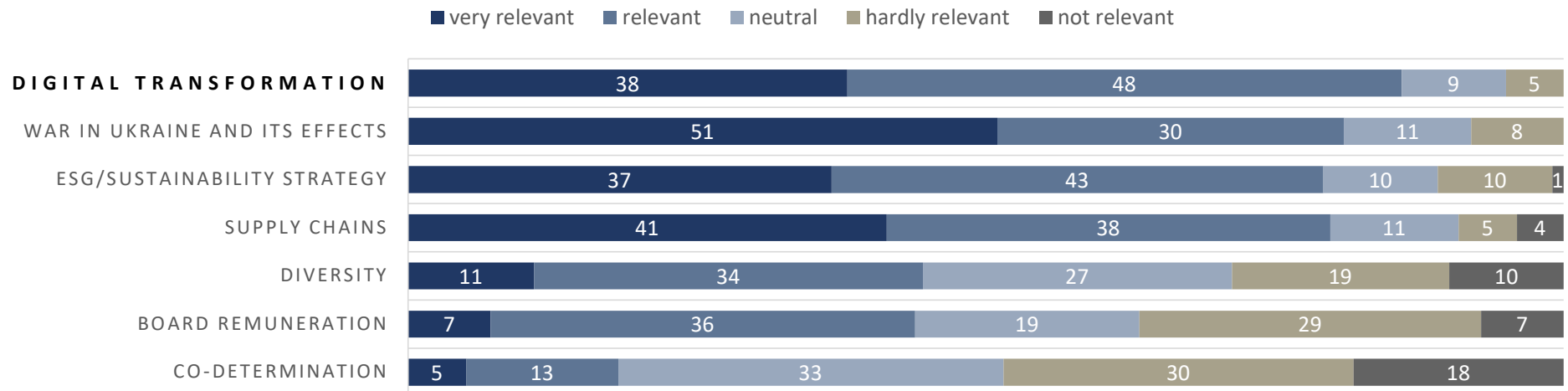
Digital resolutions

- In person meetings as the traditional concept in German company law, not only for stock corporations
- German Stock Corporation Act: Section 108 (4) allows resolutions without meetings of the supervisory board, German literature is divided: some treat videoconferences as meetings, others not
 - 108 (4): The supervisory board and its committees may adopt resolutions in writing, by telephone or by other comparable forms, subject to more detailed provision in the by-laws or in the rules of procedure of the supervisory board, only if no member objects to proceeding in this manner.
 - The governmental reasoning introducing section 108 (4) notes: if companies are international video conferences are necessary for resolutions
 - Academia is divided, traditional majority view declined to accept video as a meeting
- Modernization of Partnership Law Act (2021: also virtual meetings), Act on Virtual General Meetings of 2022 (decision of the general meeting)

Digitalization as a topic in board meetings

- According to a recent survey of the leading German law firm Hengeler Müller, Digitalization is topic number one in German boards

What subjects have been on the board agenda in particular in 2022?



Digitalization as a topic in board meetings

- According to a recent survey of the leading German law firm Hengeler Müller, Digitalization is topic number one in German boards
- Digitization affects the board in its monitoring capacity
- Cyber security
- The business model of the company
- Use of digital tools, also of AI by the management board
- Forcing the management board to use AI via rules of procedures (for the management board?) adopted by the supervisory board

Digital experts / competences in the board

- Some call for digital experts in supervisory boards, similar to financial experts (Section 100 (5) German Stock Corporation Act: at least two financial experts in German stock corporations)
- Questionable whether boosting the number of experts in the board is good Corporate Governance
- German corporate Governance Code: skills matrix
- Digitalization is a relevant skill for board members, named in 80% of DAX 40 companies with regards to shareholder representatives
- More members with relevant skills needed?

Use of artificial intelligence by board members and the board

- AI for internal investigations
 - The supervisory board may conduct internal investigations if managing directors are subject
 - Supervisory board will use AI to process huge data volumes
- AI for specific decisions
- Use of AI as subject for a board resolution
 - General rule that not every director has own control-rights
 - „Private“ use of AI to prepare board meetings
- AI as assisting tool for Director nomination

Director nomination

- Fleischer, Der Aufsichtsrat 2018, 121 referencing a NBER Working Paper, Erel/Stern/Tan/Weisbach, Selecting Directors Using Machine Learning
- Supervisory board is responsible for the appointment of managing directors and proposes candidates to the general meeting for the appointment of supervisory directors
- Nomination committee, according to the German Corporate Governance Code only responsible for the nomination of candidates for the supervisory board
 - Co-determination: proposal of shareholder representatives
 - Separate committee for (preparation) appointment of managing directors
- Use of artificial intelligence by director search firms

European Artificial Intelligence Act:

Proposal of the EU-Commission (2021), general approach by the Council in December 2022, to be discussed in the parliament, Trilogue...

- No specific reference to company law
- Humans must have ultimate responsibility
- Ultimate responsibility as general rule, applicable also to company law
- Managing the company has to be in line with the law, therefore in line with AI Act if company is using artificial intelligence
- Supervisory board has to monitor whether all legal rules concerning digitization (data protection, consumer rights, national security, non-discrimination, artificial intelligence) are obeyed (system, not individual checks)

Director liability

- Section 93 German Stock Corporation Act concerning the liability of the management is also relevant for the liability of supervisory directors, Section 116 German Stock Corporation Act
- German business judgment rule, Section 93 (1) 2
 - No dereliction of duties will be given in those instances in which the member of the management board, in taking an entrepreneurial decision, was within their rights to reasonably assume that they were acting on the basis of adequate information and in the best interests of the company
- Ultimate responsibility of the board members for using digital means and artificial intelligence

Duty to use AI?

- Duty to monitor the company with respect to existing as a profitable business and existence of the company in the long run
- For the management, the literature assumes a duty to make use of AI at least according to market standards
- Supervisory board has to monitor whether management makes sufficient use of AI
- Use of AI for internal investigations as general standard, also for internal investigations conducted by the supervisory board

AI as a board member

- Outsourcing the board to artificial intelligence??
 - Bainbridge on outsourcing the board to board services: instead of nominating individual directors, the general meeting chooses a board service for the entire board
 - Such a board service might also be an AI
 - Currently not possible but social norms may change and AI may be accepted
- In a German stock corporation managing and supervisory directors have to be natural persons, even juridical persons are not accepted
- Wyoming statute on autonomous corporations with an algorithm having capacity of a director

AI as directors in foreign (US and EU-) companies

- Wyoming autonomous LLC (Fleischer ZIP 2021, 2205)
- German-US treaty as basis for accepting companies founded in the US (private international law: incorporation theory)
- US companies accepted with algorithms as directors? As long as having only natural persons as directors is not a building principle of German company law (ordre public, possible as long as the majority of directors are natural persons?)
- Companies in the European Union with AI as directors would be accepted
- De lege ferenda in Germany also for German companies? Wyoming autonomous LLC as an equivalent of the German GmbH & Co (partnership without natural person as liable partner)? US LLC may choose to be taxed like partnerships (taxing only members/partners), but: how to tax an AI?

Autonomous / self-driving corporations

- Armour/Eidenmüller, Harvard Business Law Review 2020, 87
- Self-driving subsidiaries
 - Self driving subsidiaries as a first step?
- Corporate objectives for self-driving corporations
 - If AI performs better than humans, why stick to humans?
- Alternative control and liability regimes
 - Not agency problems but: who sets the goal?
- Regulatory competition
 - Who will take a lead?

Conclusion

- Both managing and supervisory directors (as well as directors of a European Company) have to be natural persons, but artificial intelligence might help the supervisory board to fulfil its tasks
- Video-conferences are to be classified as board meetings but a minimum number of in-person-meetings are crucial for the functioning of the supervisory board
- Directors may owe a duty to digitize and use AI, boards need such competences but not special digital experts
- The EU-AI Act will codify the principle that humans have ultimate responsibility, in line with current German company law
- Self driving corporations might emerge in the future

Selected Publications

- AdAR/Hengeler Müller, Supervisory Board Survey 2022
- Armour/Eidenmüller, Self-Driving Corporations, Harvard Business Law Review, 2020, 87
- Fleischer, Algorithms in the supervisory board [Algorithmen im Aufsichtsrat], Der Aufsichtsrat 2018, 121
- Fleischer, Ein erstes Rechtskleid für die Decentralized Autonomous Organization: Die Wyoming DAO LLC – Vorbild auch für Deutschland?, ZIP 2021, 2205:
- KPMG, DAX Digital Monitor 2022
- TUM/Noerr, Digitalization & Compliance, Compliance Study 2022 (in German)
- Spindler, Digitalization and Corporate Law – A View from Germany, ECFR 2019, 106
- Spindler/Seidel, in: Chibanguza/Kuß/Steege, Artificial Intelligence [Künstliche Intelligenz], 2022