Errors, Omissions and Emissions at Volkswagen

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The current conflagration enveloping Volkswagen (VW), involving a massive emissions regulation evasion scheme, has many causes and provides important lessons on compliance for US directors and compliance professionals. At the heart of the scandal is, of course, bad management. That such a pervasive and highly developed scheme to evade emissions standards could occur over such an extended period of time and through so many levels of the organization attests to a management culture gone awry.

Generally, corporate cultures that embrace transparency and integrity thrive. Those that are lacking do not. Why, then, did such a problematic culture exist at VW? The culprit may be twofold.

First, we have concerns with the board itself and its unique governance structure, known as "co-determination," that defines many German companies. The proper function of the board of directors is to actively monitor management and thereby ensure maximum corporate performance. If management knows that the board is scrutinizing its actions critically, it will tend to behave better. But this does not appear to have been the case at VW.

Second, the compensation structure for the company’s executives, mandated by German law, creates a perverse incentive to maintain employment at all costs to the ignorance of, and detriment to, a proper compliance culture.

To begin with, the ownership structure and consequent board structure of the company was problematic from a governance standpoint. Members of the Piëch and Porsche families own and control over half of the company’s voting shares through the controversial dual-class structure. Combined with the government of Lower Saxony, which owns another 20 percent, these two groups effectively controlled the entire operation.

Controlling shareholders always complicate the governance paradigm. The issue is a misalignment with the goals of the other non-controlling shareholders. Two problems are presented here: First, controlling shareholders cannot monitor themselves so as to prevent self-dealing or poor management, and minority shareholders have too little say. In this case, the company was dominated by Ferdinand Piëch, the grandson of Ferdinand Porsche, who chaired the company’s board for years. That he man-
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Second, governmental shareholders are always troublesome. The complications of stakeholder theory in Germany are not limited to German companies. The solution to the problems created by co-determination, in an employment-connected compensation scheme and governmental shareholders, would involve a broad and complex legal and societal reset. But each of these approaches creates great enterprise risks and needs to be reconsidered.

For the near term, though, the lesson of VW is pretty clear. For shareholders: Invest in such ventures at your own risk. Ultimately, it may prove financially unhealthy.

But what lessons may directors and compliance officers take from the Volkswagen debacle? There are essentially four points worth considering. First, the problematic board function concerns that co-determination provoked in VW are not limited to German companies. In the United States, stakeholder theory, from which co-determination emanates, can lead to the very issues that VW faces today. Even though the stakeholder approach, which involves shifting board fiduciary obligations from shareholders to other corporate constituents, including employees, remains popular in some financial circles, it leads to the same misalignment of incentives that created the issues plaguing Volkswagen.

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Third, the problems created by the dual-class controlling shareholders that defined Volkswagen are also present in many corporations. Where economic investment is separated from voting interests, numerous issues arise involving potential malfeasance and misfeasance by the controlling holder.

Fourth, while Dodd-Frank does not mandate the same compensation straight-jacket as its German counterpart, the actions of the German government and subsequent VW controversy is a warning of the dangers of an employment-based compensation scheme.

The scandal gives investors, compliance professionals and directors alike much to reflect upon. But ultimately, it is a testament to the importance of appropriate board composition, theory, structure and appropriate compensation incentives in assuring a corporate culture that promotes integrity and ultimate company success.

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