

Current Issues in European Corporate Governance

Background Note prepared for the Euro 50 Group Meeting on Corporate
Governance

European Investment Bank

Luxembourg, 10 July 2003

Marco Becht

ECARES, Université Libre de Bruxelles & ECGI

1	Overview.....	2
2	Two Models.....	3
2.1	Four Flavours.....	4
2.2	Geography.....	4
3	Which Model is Superior?.....	5
4	Improving the Models.....	5
4.1	Widely held Model.....	5
4.2	Blockholder Model.....	6
5	European Union Policy.....	6
5.1	European Commission Action Plan.....	6
5.2	European Commission's Takeover Directive.....	7
5.3	Liability and Litigation.....	7
5.4	Monitoring the Monitor.....	7
5.5	Regulatory Competition versus Harmonisation.....	7
5.6	Lamfalussy.....	8
5.7	Transatlantic Issues.....	8
6	Additional Resources.....	9

1 Overview

After the recent scandals in the United States, corporate governance was added to the agenda of Heads of State and might be there to stay, at least for a while. This development marks the peak of a recent scandal driven policy programme that goes back to the early 1990s at the national level and hit the international scene with the 1998 Russia/Asia/Brazil crisis

In October 1990 the collapse of Polly Peck International in the United Kingdom sent shock-waves through the City of London, the accounting profession and the corridors of the Bank of England. Industrialist and Bank of England Director Adrian Cadbury was put in charge of a committee that produced a report and recommendations that have been a model for over 100 corporate governance codes in more than 37 countries today. In 1998 the Russia/Asian/Brasil crisis was linked to corporate governance deficiencies in these markets and finance ministers explicitly linked emerging market corporate governance to contagion and the financial stability of OECD countries. As a result corporate governance, accounting and disclosure were added to the work programmes of the International Monetary Fund, the World Bank and the OECD.

Financial economists have been interested in corporate governance for much longer and for more fundamental developments that have fundamentally changed the face and nature of international capital markets and financial systems over the last twenty years:

- Privatisations;
- The growth of pension and other fund investment;
- Mergers waves and takeovers;
- Deregulation;
- European and international capital market integration.

Perceptions of comparative corporate governance practices have changed over time and some issues remain controversial:

- Life-time employment and the bank industry nexus in Japan were characterised as key drivers of Japan's economic success in the early 1990s. Today, corporate governance is cited as one of the major obstacles to structural reform in Japan and one of the roots of its debt problems.
- Universal banks in Germany have been hailed as engines of economic growth, sources of effective oversight and criticised as too powerful. Like in Japan, the "Deutschland AG" system – an alliance between banks, insurance companies, the corporate sector and politics – is said to prevent necessary structural change. The transformation of Germany's large banks from universal into investment banks and the apparent demise of the "Deutschland AG" model is hailed by some and mourned by others.
- Employee involvement on German boards is widely rejected in other EU countries, although many have some form of employee involvement in corporate governance. The German system of codetermination itself is criticised because it is said to stifle the functioning of the supervisory board and it discriminates against employees of German corporations working outside of Germany.
- The Dutch system of self-appointing boards, powerful takeover defences, corporations with a global reach coupled with large capital markets is criticised as violating most principals of

“good corporate governance” and, at the same time, is hailed as an example of a European alternative that can be very successful.

- Close links between the state and powerful corporate interests are often cited as yet another obstacle to corporate restructuring and change in Europe. Volkswagen AG, that is controlled by the state of *Niedersachsen* and protected by a special law, has been singled out by the European Commission as an obstacle to a single market in corporate control. The Wallenbergs are criticised for investing too much in sunset industries and preventing necessary change in Sweden.
- Leveraged buyouts in the United States have been characterised as a major source of corporate restructuring and competitive edge, but also linked to the growth of high-yield bond markets and the collapse of the Savings and Loans. So far, LBOs have not played a major role in Europe.
- Hostile takeovers and the market of corporate control are perceived as another important driver of corporate change in the United States and the United Kingdom. In the UK, the most active hostile takeover market in Europe, hostile takeovers are controversial. The nature of the market for corporate control in the United States, with substantial anti-takeover protections coupled with powerful board incentives in the form of severance pay and options is highly controversial in the United States itself and in Europe.
- In Europe the role of families and other large blockholders controlling listed corporations is equally controversial. They can be a source of effective monitoring or yet another obstacle to corporate change and a source of inefficiency.

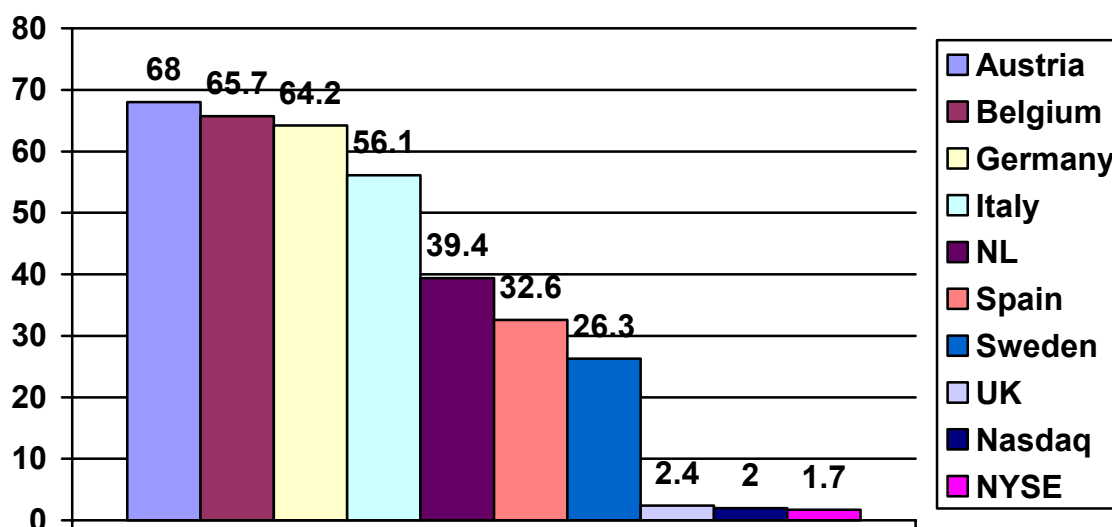
The remainder of this note is structured as follows: Section 2 provides a stylised map of corporate control arrangements in Europe. Section 3 sets out the theoretical merits of each model. Section 4 discusses the potential of various policies that have been proposed in the context of each model. Section 5 provides a brief outline of the policies that are currently debated in Europe and the United States. Section 6 gives hyperlinks to a survey of the scientific evidence on corporate governance and to key policy documents that have been put out by the European Commission and by various institutions in the United States.

2 Two Models

The economics and finance literature distinguishes two basic models of corporate control and governance: the **blockholder model (B)** and the **widely held corporation model (W)**. In the blockholder model an individual, a group of individuals or an organisation command many (most) of the votes at the corporation’s shareholder meetings. The blockholder has the power to appoint and/or remove the board of directors and the blockholder appointed board appoints and/or removes the CEO.¹ In contrast, the widely held corporation has a broad equity base with many small shareholders who, individually, command a small number of votes. The incumbent board nominates the new board, that is confirmed by the passive mass of small shareholders in a vote. Formally the board appoints the CEO. In practice, the CEO appoints the board, putting incumbent managers in control of the widely held corporation.

¹ In some countries the ability of blockholders to appoint, remove or influence boards is limited by company law (Germany, Holland) or listing rules (in the United Kingdom). In Belgium a blockholder commanding 50% of the votes (plus one vote) can remove the board at any time (“*ad nutum*”), bringing the Belgian system very close to the stylised description of the blockholder model.

Figure 1. Percentage of Listed Companies under Majority Control



Source : Barca and Becht (2001)

2.1 Four Flavours

In practice, each of the main models comes with two flavours. In the blockholder model blocks of votes can be acquired with a proportional amount of capital (“one-share-one-vote”; Model **B1**) or with a less than proportional amount, through legal devices that give blockholders more than one vote for each Euro invested (“one-share-more-votes”; Model **B2**). Prominent examples are equity capitalisations with non-voting shares, shares with multiple voting rights or issuance of certificates without votes. The most complex of these devices are “Chinese boxes”, “pyramids” or “control cascades” that combine companies to control chains. At each level of the chain the controlling blockholder brings in outside capital while keeping control, thereby reducing the cost of control.

For widely held companies we distinguish between those open to hostile takeovers (Model **W1**) and those that are not (Model **W2**). In companies that are open to hostile bids, an outsider can purchase shares to form a controlling block, moving the company from the widely held to the blockholder model. The incumbent board (and/or CEO) is forced to hand control to the blockholder. In well defended companies, share blocks cannot be assembled without board and/or CEO approval. Takeover defences in widely held companies include devices like voting right restrictions, share transfer restrictions, staggered boards, “blank cheque” preferred stock and “poison pills”.

2.2 Geography

The use of the different models varies across the European Union and the United States. Most corporations in continental Europe are dominated or controlled by a blockholder with “one-share-one-vote”. Exceptions to this rule are the Nordic countries (shares with multiple voting rights) and the Netherlands (certificates, priority shares), where deviations from “one-share-one-vote” play an important role.² A majority of widely held corporations is found in the United States, the United Kingdom and Japan. However, the United Kingdom is the only country where most corporations

² To a minor extent the model is also used in France (double voting rights after voting shares are held for a certain number of years) and Germany (non-voting stock is commonly issued by mid and small-cap family controlled firms).

are open to hostile takeovers. In the United States most incumbent boards can rely on a range of devices that give them “the power to just say no” to hostile bidders; in Japan, a network of cross-holdings shields corporations from unfriendly challenges to insider control.³ Widely held corporations in continental Europe are also well shielded from hostile takeovers.

3 Which Model is Superior?

The blockholder model and the widely held model are the poles of a classic economic tradeoff. There are costs and benefits associated with each model of corporate control. Theory does not tell us that one model is superior.

The widely held model provides diversification opportunities, spreading corporate risk over a large investor base. It is also associated with higher secondary market liquidity and, as a result, a lower cost of equity. The potential costs of the widely held model are considerable. Boards are “unaccountable” and/or captured by CEO who pursue “visionary” projects, like massive acquisition programmes financed through equity issues to their broad shareholder base. At the same time there is a lack of monitoring at the shareholder and the board level.

The most obvious way of solving the problems of the widely held model is a move to the blockholder model. Large shareholders, at least in theory, have the power to monitor management, either directly or through boards they appoint. However, there are also potential costs. Boards are now captured by blockholders, who might pursue their own aims, not those of all shareholders. For example, blockholder controlled boards (and CEOs) might engage in transactions with companies the blockholder owns at non-market prices, at the expense of minority shareholders. By definition, blockholder controlled companies (at least those of the “one-share-one-vote” variety) have a narrower equity base and lower secondary market liquidity. To increase secondary market liquidity, blocks must be sold, moving the company into the widely held regime and closing the circle of the tradeoff.

4 Improving the Models

Numerous policy measures have been suggested to reduce the potential cost associated with the widely held and the blockholder model, preferably while leaving their advantages intact.

4.1 Widely held Model

In the widely held model, dispersed shareholder do not have enough “voice” in important decisions. A straightforward policy is to raise the effectiveness of “voice” mechanisms and to reduce their cost, for example by allowing corporate voting by mail and/or electronic voting. Proxy solicitation concentrates voting power temporarily, for example through proxy fights.⁴ This policy option is currently explored by the SEC in a public consultation (see section 6).

Board capture by the CEO is another potential problem of the widely held corporation that was highlighted by the recent scandals in the United States. The standard remedy is an increase in the autonomy of the board from the CEO, for example through the appointment of non-executive and, preferably, independent directors. Particularly sensitive issues like remuneration, audit and

³ Individually the holdings are small, knotted they provide a formidable defense.

⁴ A recent example is the proxy fight over the HP and Compaq merger in the United States.

nomination for election to the board a delegated to committees staffed with a majority of independent directors. In unitary board systems that combined the role of Chairman and CEO in one person (by law in France and practice in the United States), the two roles are increasingly separated.⁵

On issues where board autonomy is deemed to fail in any case, the autonomy of the board from shareholders can be reduced. For example the corporate charter or the law might prescribe that sensitive decisions are put to a shareholder vote. Shareholders might also nominate directors for election to the board.

A preferred route in the United States has been to increase directors' liability. For example, the Sarbanes-Oxley legislation introduced in 2002 has further increased the liability of CEOs and CFOs. The open ended contract between shareholders, boards and the CEO is not only enforced via corporate elections, but also through the courts. In Europe shareholder suits are (still) less common than in the United States (see below).

In theory, facilitating hostile takeovers is yet another way of reducing the potential cost associated with the widely held model. Hostile takeovers discipline management ex-post by removing them from the helm of the company and ex-ante by threatening the removal of poor management. Introducing a "market for corporate control" in continental Europe via a Takeover Directive has been a policy priority for the European Commission (see below).

4.2 Blockholder Model

The main problem of the blockholder model is the fear that power is exerted at the expense of the minority shareholders. A direct approach to the problem is the reduction of power the blockholder has over the board. The OECD Principles of corporate governance (1999), for example, recommend the appointment of directors who independent of the CEO and of blockholders. The trouble is that directors are hardly "independent" if they can be removed by a blockholder at will. This problem could be solved if some directors are appointed by the minority, for example through "cumulative voting".

An alternative route imposes outright limits on the voting power of blockholders. For example, to protect minority shareholders early corporate charters imposed voting right ceilings or "one-member-one-vote" rules. The restriction can also operate at board level, by preventing blockholders from removing directors without minority's approval. The trouble is that these measures also protect boards (and management) from hostile bids, weakening this potential mechanism in widely held corporations.⁶

5 European Union Policy

5.1 European Commission Action Plan

On 21 May 2003 the European Commission presented an Action plan on corporate governance. This followed the Sarbanes-Oxley Act and a series of policy documents issued by various bodies in the United States (the Conference Board's Peterson Report, new listing rules from the NYSE, an SEC consultation on shareholder voting; see additional references). The Action plan closely follows

⁵ Board composition and director independence are at the centre of various recent policy initiatives (NYSE, Conference Board, European Commission; see section 6).

⁶ See Becht, Bolton and Roëll (2003) for further details.

the recommendations of its “High Level Group of Company Law Experts” chaired by Jaap Winter. The key features of the action plan are:

- Requirement to publish an annual corporate governance statement;
- Improving the ability of shareholders to vote, in particular across countries;
- Creation of nomination, remuneration and audit committees;
- Setting minimum standards for director independence;
- Confirming directors’ collective responsibility for financial statements;
- Studying the move to a “shareholder democracy” by imposing “one-share-one-vote” (abolishing system B2)
- Increasing structural flexibility by giving all companies a choice between different board structures (as is already the case in Italy and France);
- Stiffening sanctions for directors (special investigation by courts/regulator at instigation of minority shareholders, “wrongful trading rule”, EU wide director disqualifications);
- Studying the potential for abuses in/by pyramidal groups and their delisting.

5.2 European Commission’s Takeover Directive

An older, pending policy initiative from the European Commission is its proposed Takeover Directive. The Directive is discussed in detail in Colin Mayer’s briefing note.

5.3 Liability and Litigation

If effective, securities litigation could be a useful corporate governance tool in blockholder and widely-held systems. Securities litigation is an important phenomenon in the United States, where approximately 250 suits are filed a year. Most suits settle out of court, for an average of \$13 million a case. Exposure to litigation is also rising in Europe. In 2001 there were press reports of 69 suits brought against directors and officers in the European Union, compared to hardly any reports of such incidents in 1995 or before. A substantial number of these suits were brought against European companies having issued securities in the United States.

In parallel, the U.S. market for Director and Officer liability insurance is estimated at \$3 billion and the leading U.S. litigators take 25-30% of the settlements they obtain from corporations and the insurance companies.

Is securities litigation a viable tool for improving corporate governance? Should Europe welcome and reinforce the arrival of this U.S. practice?

5.4 Monitoring the Monitor

Paul Myners, the former Chairman of Gartmore Investment Management, has recently drawn the attention of the U.K. policy debate to the governance of pension and other investment funds. The Commission’s action plan recommends more institutional shareholder voting, but is silent on regulating and providing incentives to an increasingly central agent.

Do the conflicts of interest that exist between funds owned by banks required special attention? Does Europe need the equivalent of the U.S. Investment Companies Act of 1940?

5.5 Regulatory Competition versus Harmonisation

National and EU legislation and jurisprudence has favoured increased competition between corporate governance models. One example is the recent jurisprudence of the Court of Justice that

grants companies the freedom to choose their governance model by moving their place of incorporation (the *Centros* and *Überseering* decisions; see section 6). Another is the mutual recognition of models, and the increasing tendency of national corporate law to allow freedom of choice between different models of organization of governance bodies: for instance, the recent reform of Italian and French corporate law allows a choice between the traditional Italian/French model, an English-style model, and a German-style model of corporate governance. A third, and possibly even more pervasive legal change in the same direction is the establishment of the *Societas Europaea* (SE) adopted in October 2001 by the EU and soon to become operational (Nordea, the Nordic banking group, has just announced that it will reincorporate as an SE in 2004). The legal form of SE allows companies to transfer their seat, across borders, and do business as a “European company”. The governance of a SE can be designed according to a menu of different choices.

This competition may have benefits. Companies may have greater flexibility in choosing their corporate governance model, which is good if their choice produces no negative externalities. In particular, new firms seeking to raise capital can choose models offering high shareholder protection, and thereby get a lower cost of capital or more abundant funding.

But there are costs as well, insofar as this increased freedom of choice allows also established companies to switch corporate governance model. The danger is that they may switch in favour of a model that reinforces the power of blockholders or their managerial entrenchment. This race to the bottom is less far fetched than one might think, if one just recalls the tendency of US corporations to reincorporate in Delaware to take advantage of the more manager-friendly laws and courts of that State. Therefore, there is indeed a potential negative externality from the greater freedom of choice arising from competition between models.

What is the right strategy for the European Union in this area, mutual recognition (freedom of contracting and regulatory competition) or harmonisation? Where does the Union need minimum standards? How does one draw the line between minimum standards and harmonisation?

5.6 *Lamfalussy*

To date, the European Commission’s corporate governance initiatives have been implemented as company law directives. It is widely recognized that this process has been lengthy, unpractical and afflicted by all the other shortcomings and difficulties identified by the Committee of “Wise Men” in the area of securities regulation (the Lamfalussy Committee). The Lamfalussy Committee has made suggestions for reforming the European policy making process in the area of securities regulation.

Could and should the European Union’s put its corporate governance initiatives under the Lamfalussy process? If yes, what types of initiatives are required/suitable?

5.7 *Transatlantic Issues*

There is a clear clash of cultures between the United States and Europe in the corporate governance area. The U.S. authorities, in particular the SEC, believe that they have the duty to protect U.S. investors from abuse by foreign issuers and that this should take the form of subjecting non-US companies issuing securities in the United States to U.S. rules, laws, judges, rulings, settlements and fines.

The European approach to transatlantic corporate governance has been based on single market idea of mutual recognition. So far the competent U.S. authorities have not recognized the relevant European standards as “equivalent” have started to impose their new rules, in particular those enshrined in the Sarbanes-Oxley Act.

How should Europe react? Should it engage in a “standards war”, seeking to impose its own standards on U.S. issuers and auditors? Should Europe bring its own standards in line with U.S. standards and hope for mutual recognition? Should Europe push for international standards, like it did in accounting? Can European companies afford to ignore the US Capital markets and limit themselves to issuing securities “at home”?

6 Additional Resources

Becht M., F. Bolton and A. Roëll (2003), “Corporate Governance and Control”, ECGI Working Paper in Finance No. 2 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=343461), forthcoming in the *Handbook of the Economics of Finance*, North Holland

European Commission (2003), Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward*, COM (2003) 284(01) (http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0284en01.pdf)

Final Report from the Committee of Wise Men chaired by Alexandre Lamfalussy on the Regulation of European Securities Markets (2001) (http://europa.eu.int/comm/internal_market/en/finances/general/lamfalussy.htm)

European Court of Justice, Case No C-212/97, Centros Limited -v- Erhvervs-og Selskabsstrelsen (19th March 1999) (available from <http://www.curia.eu.int/jurisp/cgi-bin/form.pl?lang=en>)

European Court of Justice, Case No Rs. C-212/97, Überseering BV –v- Nordic Construction Company Baumanagement GmbH (NCC) (5 November 2002) (available from <http://www.curia.eu.int/jurisp/cgi-bin/form.pl?lang=en>)

Sarbanes-Oxley Act of 2002, One-Hundred Seventh Congress of the United States, 2nd Session (<http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>)

Report of the NYSE Corporate Accountability and Listing Standards Committee (2002). (http://www.nyse.com/pdfs/corp_govreport.pdf)

Conference Board (2003), Report of “Commission on Public Trust and Private Enterprise” (Peterson Report) (<http://www.conference-board.org/knowledge/governCommission.cfm>)

U.S. Securities and Exchange Commission, Solicitation of Public Views Regarding Possible Changes to the Proxy Rules (<http://www.sec.gov/news/press/2003-59.htm>)

Collection of Corporate Governance Codes (full-text) (<http://www.ecgi.org/codes>)