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Brigid Gavin*

Shareholders' Rights in the European Union

In the European Union there has been increased mobility of capital and transnational ownership with the completion of the internal market. However, the harmonisation of standards, which would give shareholders equivalent rights throughout the Community, has not kept pace. This article examines the reasons for this and discusses new issues that the global integration of capital markets has brought to the forefront of the debate on shareholder protection.

Shareholders' rights and their legal protection result from the separation of ownership from control in the modern corporation. External owners of funds (shareholders) supply finance to companies. Managers control the use of those funds in the enterprise. How can the shareholders, who have imperfect methods of assessing what managers are doing with their money, be sure of getting a return on their investment? Managers can pursue their own private interests rather than the interests of the external investors. The essence of the problem pertaining to the governance of corporations is asymmetric information between the two parties. This implies the need for legal protection of shareholders.¹

The policy debate on corporate governance has attracted increasing attention in a number of European countries in recent years. In Britain the Cadbury Committee was set up to investigate concerns about the adequacy of financial control in companies and discontent with directors' pay.² In Germany the government has set up a work group to examine the influence of large powerful banks in the governance of non-financial firms.³ In France Senator Marini has called for a substantial reform of French company law to improve the rights of shareholders.⁴ The driving force behind the policy debate is the increasing financial power and activism of institutional investors, notably pension funds.⁵ The economic rationale for shareholder activism is to align the interests of owners and managers and so to enhance both shareholder value and corporate competitiveness.

In the policy debate the emphasis has been on shareholders' rights at the national level. However, given the increasing mobility of capital across borders which has resulted from the completion of the internal market, the issue of shareholders' rights at the European level is assuming a position of increasing

importance.⁶ The mobility of companies across borders within the internal market is ensured by the Treaty of Rome which provides for the free right of establishment (Article 52). But if there is to be free movement of enterprise, the treaty stipulates that there must be legal protection for shareholders and these safeguards should be equivalent throughout the Community (Article 54(3)(g)). Thus the European institutions were mandated to develop harmonised European regulation for the legal protection of shareholders.

The Principal – Agent Problem

The essential problem of corporate governance is the "principal – agent problem" which is caused by asymmetric information between the principal (owners, i.e. shareholders) and the agent (managers).⁷ In general terms a contract is concluded between the firm as a legal entity and the shareholders, which

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¹ For an overview of corporate governance theory see A. Schleifer and R. Vischny: A Survey of Corporate Governance, Harvard University, mimeo, 1996.

² The Cadbury Committee published its Report in 1992 entitled The Financial Aspects of Corporate Governance, and the Committee adopted a "Code of Best Practice on the Financial Aspects of Corporate Governance".

³ To study this problem the work group entitled Kontrolle und Transparenz im Unternehmensbereich/Banken, was set up in 1995. Handelsblatt, 2 November, 1995, p. 39.

⁴ The report entitled La Modernisation du Droit des Sociétés, was published in La Documentation Française, 1996.

⁵ American corporate pension funds are required by national legislation to exercise their voting rights as shareholders in companies both at home and abroad. See S. Davis: Shareholder Rights Abroad: A Handbook for the Global Investor, Investor Responsibility Research Center, Washington, D.C. 1989.

⁶ For a comprehensive study see K. Lannoo, Corporate Governance in Europe: Report of CEPS Working Party, Centre for European Policy Studies, Brussels 1995.

gives the shareholders certain rights vis-à-vis the assets of the firm. But it is impossible to write "complete" contracts, i.e. contracts with the firm that guarantee the agent will always act in the best interests of the principal.⁸ Where the future is unknown the manager and the financier have to allocate residual control rights. The manager will have to make decisions in circumstances not fully foreseen by the contract. As a result of this the manager ends up with significant discretionary power over the utilisation of shareholders' funds. This can result in "opportunistic" behaviour on the part of managers who pursue their private goals rather than profit maximising activities for their shareholders.

The most common solution to the agency problem is the granting of legal protection to shareholders. These rights are exercised by voting to elect the board of directors of the company whose function it is to represent shareholders' interests. However, the effectiveness of the board of directors in defending shareholders' rights has been questioned.⁹ Therefore it would appear that legal protection alone is often insufficient to ensure that shareholders get an adequate return on their investment. Consequently, alternative mechanisms of governance have evolved.

Economic Mechanisms of Corporate Control

There are two main mechanisms which are designed to solve the problem of monitoring and control over managerial discretionary power. The first major mechanism is that of "concentrated ownership" which occurs most notably through the existence of large shareholders.¹⁰ In this case one or more investors in the firm have substantial minority stakes, such as 10 or 20 per cent ownership. In the extreme case, one large shareholder has outright control by having 51 per cent ownership. Where equity in the firm is concentrated in the hands of a few large shareholders, who have a collectively large cash flow stake, each investor will have sufficient incentive to invest in information acquisition, thus overcoming the problems of collective choice which occur in widely held company ownership. With this mechanism, the exercise of control over management will be direct and effective.

Where ownership of equity is dispersed among numerous small shareholders, the hostile takeover has emerged as a mechanism which simultaneously exercises control over management and also serves to concentrate ownership.¹¹ Acting through the capital markets, a bidder makes a public offer to the dispersed shareholders of the target firm and if they

accept this offer acquires control over it. The credible threat of a takeover, which frequently leads to management being replaced, will discipline managers to act in shareholders' interest. In this model, takeovers are considered to be the most important corporate governance mechanism for countervailing managerial discretionary power.¹²

Which system is optimal? Given the present state of economic theory it is not possible to say that either one system of corporate governance is the optimal one. Both systems have their respective costs and benefits but both work efficiently. Since economic theory does not explain why the two different systems exist attention has been given recently to the role of national regulation in shaping corporate control mechanisms.¹³

Next we will examine the national regulation of two countries in the EU – Germany and the United Kingdom. These two countries are representative of the two theoretical models outlined in the above theory. The empirical evidence shows that concentrated ownership through large shareholders is the norm in Germany and those shareholders are able to exercise control directly. In the United Kingdom, the general rule is that of dispersed ownership by diversified shareholders who are not able to exercise control directly but there is an active takeover market.¹⁴

When shareholders buy securities in a company they get certain rights vis-à-vis the managers. These

⁷ Cf. M. Jensen and W. Meckling: Theory of the Firm: Managerial Behaviour, Agency Costs and Capital Structure, in: *Journal of Financial Economics*, Vol. 11, 1976, pp. 5-50.

⁸ Cf. S. Grossmann and O. Hart: Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, in: *Journal of Political Economy*, Vol. 94, 1986, pp. 691-719. Another important work in this field is O. Hart and J. Moore: Property Rights and the Nature of the Firm, in: *Journal of Political Economy*, Vol. 98, 1990, pp. 1119-1158.

⁹ For evidence of this see J. Warner, R. Watts, K. Wruck: Stock Prices and Top Management Changes, in: *Journal of Financial Economics*, Vol. 20, 1988, pp. 461-492.

¹⁰ Cf. J. E. Stiglitz: Credit Markets and the Control of Capital, in: *Journal of Money, Credit and Banking*, Vol. 17, 1985, pp. 133-152.

¹¹ Cf. J. Franks and C. Mayer: Capital Markets and Corporate Control: A Study of France, Germany and the U.K., in: *Economic Policy*, Vol. 11, 1990, pp. 191-231.

¹² Cf. F. Easterbrook and D. Fischel: *The Economic Structure of Corporate Law*, Harvard University Press, Cambridge MA 1991.

¹³ For analysis of the US situation see M. Roe: *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton University Press, New Jersey 1994. For a comparative international analysis, see S. Prowse: *Corporate Governance in an International Perspective: A Survey of Corporate Control Mechanisms among Large Firms in the United States, the United Kingdom, Japan, and Germany*, Bank for International Settlements, Economic Papers, No. 41, Basel 1994.

rights are determined by the voting procedures for shareholders in the annual general assembly (AGM) of the company. In principle, the rights of shareholders under national law in Britain and Germany are quite similar. The following are the major issues on which shareholders are required to vote before managers can implement decisions in both countries:¹⁵

- elect the board of directors or members of supervisory board;
- approve the financial accounts of the firm;
- appoint the auditors;
- approve the dividend;
- authorise new shares;
- approve stock options;
- approve takeover defence;
- approve merger or acquisition;
- limit voting rights.

However, in practice, firms are owned, organised and financed in very different ways in the two countries. The differences between the regulatory regimes of Britain and Germany will be illustrated with respect to four areas of regulation which affect corporate governance.

The Board of Directors

The board of directors of a company is responsible for monitoring the managers on behalf of the shareholders. In Britain, there is a one-tier board structure where the shareholders have the power to elect the board of directors in the AGM. But because of the organisational problems associated with widely dispersed shareholders, the board is, in effect, chosen by the chief executive officer (CEO). Consequently, the board typically consists of a significant number of incumbent managers. This is considered to be an institutional weakness.

Under German company law, there is a two-tier board structure composed of the board of managing directors (Vorstand) and the supervisory board (Aufsichtsrat). The supervisory board is the controlling body. It appoints the managing directors and oversees their activities. In companies with over 1,000 employees, the supervisory board must consist of 50 per cent representatives of shareholders and 50 per cent representatives of employees. Thus, shareholder representation on the supervisory body is ensured by law and they can exercise control directly through it. But the most important difference is the practice of co-determination (Mitbestimmung), in Germany, which makes labour an effective "stakeholder" in the enterprise.

Relations between Financial Institutions

The role of financial institutions in corporate governance is very different in Britain and Germany. In Britain banks are not large shareholders as equity purchasing is subject to strict prudential rules under the supervision of the central bank. Non-bank credit institutions, such as insurance companies and pension funds, are large share owners but they do not have concentrated share holdings in any one single firm. They diversify their investments over many firms.¹⁶ This principle stems from the fiduciary requirement of liquidity as these shares are held primarily for purposes of trading. Consequently, they cannot exercise control directly.

Germany has a system of universal banking which allows banks to provide the full range of financial services, including the provision of risk capital to industry in the form of equity purchase. Thus, German banks own shares for their own account and they are used for purposes of control over managers. Although the empirical evidence shows that banks have less ownership than industry itself, this understates their control. The proxy voting power exercised by banks on behalf of small shareholders serves to concentrate their governance even more than ownership.¹⁷

The Regulation of Securities Markets

The existence of large powerful banks has coincided with small under-developed capital markets. This situation in Germany has been determined by the regulatory environment which was biased against non-bank finance until the 1990s. By comparison, the regulation in Britain favoured the growth of securities markets.

One of the most important elements of the regulation of securities markets is the financial

¹⁴ Cf. J. Franks and C. Mayer: Ownership and Control, in: H. Siebert (ed.): Trends in Business Organisation: Do Participation and Cooperation increase Competitiveness, JCB Mohr (Siebeck), Tübingen 1995.

¹⁵ These issues are those which are common in Germany and the UK. There are also some differences, such as in the UK shareholders vote on such issues as approving the auditors' fees, approving the board fees, which are not put to shareholder voting in Germany. On the other hand in Germany shareholders vote to approve the executive bonus plan and profit allocation, which are not voted on by shareholders in the UK. But these differences are of not of major importance.

¹⁶ The institutional investors are the largest owners of shares in publicly quoted companies in Britain. They possess on average 59 per cent of shares, households are the second largest group with 19 per cent and industry 4 per cent (K. Lannoo, op. cit., p. 12).

¹⁷ Cf. A. M. Santomero and H. Langhor: The Extent of Equity Investment by European Banks, in: Journal of Money, Credit and Banking, Vol. 17, 1985, pp. 243-252.

disclosure requirements for listing on national stock exchanges. They are determined by national accounting rules which determine the amount of information which firms must give to external investors. German rules give managers a much larger discretionary margin in reporting profits compared to British standards. The German practice has served to discourage external investors.

Takeovers

In contrast to Britain, there has, historically, been a very low level of takeover activity in Germany. This has led to the criticism that there are structural barriers to takeovers. The factors most frequently cited are the proxy voting power of banks, and the concentration of ownership in the corporate sector itself. The latter leads to the phenomenon of "pyramiding" which, in effect, leads to a violation of one-share-one-vote. However, there is non-consensus in the literature on the different approaches to takeovers in the German and Anglo-Saxon systems.¹⁸

From this brief comparison of national regulation we can conclude the following. Although shareholders' rights in the two countries are, in principle, quite similar, they may vary considerably in practice because of the different institutional arrangements for the board structure, the existence of concentrated shareholders who are "insiders" and dispersed shareholders who are "outsiders", national stock exchange rules for disclosure of financial information and different approaches to takeovers.

Given these divergences in different national systems of regulation the European Community sought to harmonise regulation for the internal market.

Harmonisation Activity

In order to achieve the treaty goal of providing equivalent shareholder protection throughout the EU, a number of directives in the area of company law have been prepared by the Commission.¹⁹ In order to assess the achievements and limitations we will give a general overview of what has been achieved to date and where the major problem areas are.

Disclosure: European rules have been established for the disclosure of information by companies on all matters relating to their formation and organisation.

Capitalisation: European rules have been established on all matters concerning the capitalisation of companies such as the increase and decrease of capital, transfer of shares, share subscriptions etc.

Mergers: European rules have been established on

mergers (of the share exchange type) and similar rules apply in the case of a demerger.

Financial accounts: European rules have been developed for the financial accounts of firms. The accounts must provide comprehensive information which is required by externals for assessing the company's financial situation.

Auditors: There are European rules to ensure that the auditors are independent and properly carry out their task.

Thus, for shareholders wishing to invest in a company anywhere in the EU, the rules are the same as regards publicity, capitalisation, preparation of financial accounts, rules concerning the introduction of shares to the stock exchange etc., no matter in which country the company is registered.

This reduces transaction costs for shareholders in their efforts to make informed decisions about the companies in which to invest their capital, and shareholders' rights are protected in all these matters.

Major Problem Areas

In the following areas there is still fundamental disagreement:

Company board structure: The Commission has long proposed that for all public companies a two-tier board structure should be established. The relevant distinction would be between those directors who are responsible for supervision on the one hand and day-to-day management on the other. However, the most fundamental disagreement has been on the provisions relating to representation of workers. The proposal requires that a company with 1,000 or more employees (including employees of subsidiaries) must set up a system of employee representation to provide regular information and consultation with employees. Britain argued that this issue was related to the free movement of workers within the Community rather than the right of establishment. Consequently, the issue remains stalled.

Public takeovers: The Commission proposed a directive in 1989 for the regulation of public takeovers in the internal market. The main provisions of the directive were a ban on partial takeover bids (an investor acquiring one third of a company's voting rights would be obliged to bid for the whole

¹⁸ For a discussion of this issue see J. Franks and C. Mayer: *Ownership and Control*, op. cit., followed by M. Hellwig: *Comment on Ownership and Control*, pp. 196-200.

¹⁹ For an overview of European corporate law see A. Dorresteyn, A. Kuiper, G. Morse: *European Corporate Law*, Kluwer, Deventer, Boston 1994.

company's shares), greater transparency through disclosure of information with respect to the public bidders' intentions, and devices to limit the defences of target companies. The directive was not adopted largely due to the opposition of the United Kingdom which was unwilling to give up its system of voluntary self-regulation (the UK Takeover Code) in favour of the statutory approach embodied in the EU directive.²⁰ The continued deadlock in the Council led to the Commission's redesigning the regulation in line with the subsidiarity principle.

□ *European company statute*: The adoption of a regulation for a European company statute (SE) would mean that a company which is incorporated in one member state would be allowed to set up subsidiaries and branches throughout the EU, while being subject to the laws of its home state. Although multinational firms are in favour of a European corporation which would operate EU-wide as a single legal entity, the issue remains blocked, again largely due to the provisions contained in the regulation on worker representation. Germany has repeatedly stated that it would not accept a European company statute which contained less stringent rules for worker participation than does its own national company law.

From this overview we see that no progress has been made on a number of key issues relating to shareholder protection in the European internal market. Because there has been no agreement on the board structure of public companies there are no EU-wide rules for shareholder voting procedures. This means that the principle of one-share-one-vote and majority voting in the general assembly are not implemented throughout the internal market and there are numerous devices in the national regulations to get around them.

The most divisive issue in the harmonisation of European corporate law has been the conflict between the German legal tradition of state-mandated worker representation in companies and the British legal tradition of voluntarism. This has been the most frequent source of disagreement on most outstanding issues. This issue may now have been

settled by the adoption of a specific directive on European works councils under the Social Chapter of the Maastricht Treaty.²¹

Since the 1990s the issue of financial accounting standards has taken on increased importance with the integration of global capital markets. And this has called for a new approach towards regulation in the EU.

Towards International Accounting Standards

Accounting standards are crucially important for shareholder protection for two reasons: first to allow shareholders to make informed decisions about companies in which they wish to buy securities; second, they are essential for the enforcement of laws protecting shareholders' rights. In the case of a legal dispute between shareholders and the firm some measure of the firm's income and assets must be verifiable in court. Hence legal protection of shareholders must be backed up by a system of financial disclosure.

Despite the directives adopted, the rules on financial accounting have not been fully harmonised in the EU. What has been achieved is equivalence and comparability of financial information published by companies. Comparability of financial information is assured by supplementary information which is provided in the national formats. Thus substantial differences have not been eliminated. This problem was solved by the application of the principle of mutual recognition for purposes of listing on European stock exchanges. But given the globalisation of stock markets, more and more European firms are turning to international capital markets, and especially US capital markets, to achieve the most efficient means of finance.²²

Consequently, the present trend among large European companies is a movement towards the use of international accounting standards which have been drawn up by the International Accounting Standards Committee (IASC). This Committee is a private organisation which represents the accounting profession from seventy-eight countries. It has already developed a number of international accounting standards. It has been requested by the International Organisation of Securities Commissions (IOSCO) to come up with international standards which would be accepted by all countries for purposes of stock exchange listing.

This has called for a new policy initiative in the EU. The new strategy of the Commission, which was

²⁰ T. Jenkinson, C. Mayer: *The Assessment: Corporate Governance and Corporate Control*, in: *Oxford Review of Economic Policy*, Vol. 8, 1992, No. 3, pp. 1-10.

²¹ The Directive was adopted by the Council of Ministers in September 1994 with Britain opting out.

²² For a discussion of the conflict between the EU and the United States on the recognition of accounting standards, see M. A. Schneider: *Foreign Listings and the Preeminence of U.S. Securities Exchanges: Should the SEC Recognize Foreign Accounting Standards?*, in: *Minnesota Journal of Global Trade*, Vol. 3, 1994, No. 2, pp. 301-337.

published in 1995, takes a clear option in favour of IAS and it is working actively to bring about conformity between European and international accounting standards.²³ This, together with the clear line taken by the European Round Table of industrialists points to the conclusion that IAS will become the global accounting standards accepted by the IOSCO in the near future.²⁴

The new approach has been termed "regulatory contracting out". Governments contract out to private professional bodies the responsibility for setting standards. The voluntary coordination of international accounting standards is a more efficient and flexible means to achieve international harmonisation as governments do not have the necessary information to make standards for dynamic markets.

However, there is no international body which has a mandate for the enforcement of accounting standards. The IASC has made considerable progress in harmonising international accounting standards but they have no mandate to enforce those standards. Therefore for purposes of credibility there is need for governments to enforce the standards. Thus the enforcement of financial accounting standards will remain an essential part of the European internal market law.

A similar approach for setting European shareholder voting standards was recently made by Davis and Lannoo.²⁵ An EU-wide private organisation comprising the most important economic actors, notably pension funds, could be set up along the lines of the IASC. The work of the committee would be to achieve consensus on European voting mechanisms. Once these mechanisms have been agreed upon in the relevant professional body they would be proffered to the European Commission for the legislative channel. In this way they would become law in the internal market.

Conclusions

This paper has addressed the question of the legal protection of shareholders in the EU. We have shown that shareholders' rights are still determined by national law and that structural barriers fragment the internal market on core issues. We examined two countries which are representative of the two basic models of corporate governance in the EU – Germany and the United Kingdom – and found that, in principle, shareholders' rights are very similar in the two countries. However, in practice, the national regulations governing the organisation, ownership and financing of firms are so different in the two

countries that the exercise of these rights may vary considerably in practice.

The harmonisation programme of the EC has failed to achieve substantive rules for shareholder protection at the European level. It has been blocked for years on a number of key issues. Until the early 1990s the main stumbling block was the issue of worker representation on company boards which reflects the fundamental clash of philosophy between the German model of "stakeholder capitalism" as opposed to the British model of "shareholder capitalism".

As a consequence of the globalisation of financial markets, the issue of financial accounting standards has emerged as the most urgent issue with respect to shareholder protection in the 1990s. The new regulatory element here is that the activity of standard setting has effectively been taken over by a private economic agency, the IASC, which represents the accounting profession. And companies are moving away from the statutory regulations of governments and voluntarily accepting the standards made by the private body. The new approach has been termed "regulatory contracting out".

In the European context the Commission has taken a position in favour of the new approach and is actively cooperating with this body in order to maximise conformity between European and international standards. Ultimately, the Commission has the responsibility for the implementation of financial accounting standards as they are an integral part of internal market law.

The new regulatory approach of private agency standard setting and governmental agency implementation could now be used in the context of shareholder voting rights in the internal market. An EU-wide body comprising the major private actors who wish to vote their foreign and domestic stock could form a professional group comparable to the IASC. They could work out consensus on shareholder voting rights and these rights would then become law in the internal market.

²³ In November 1995, the European Commission published its paper entitled Accounting Harmonisation: A New Strategy vis-à-vis International Harmonisation, Brussels, Com (95) final.

²⁴ The European Round Table groups together 45 European industrial leaders and it set up a Task Force in 1995 to ensure European influence on the work of the IAS.

²⁵ Cf. S. Davis, K. Lannoo: Shareholder Voting in the EU: Results of a Survey, Paper presented at Corporate Governance Workshop, Centre for European Policy Studies, Brussels, 22 November, 1996.