



Department of Law

Corporate Governance and Collective Bargaining

**A comparative study of the evolution of
Corporate Governance and Collective Bargaining in
France, Germany, UK and Portugal**

Volume I

Bruno Mestre

Thesis submitted for assessment with a view to obtaining the degree of
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Abstract: *the object of this thesis concerns the institutional complementarities between the national systems of corporate governance and employee representation (including collective bargaining) in an evolutionary comparative and European perspective. This thesis defends that there appears to be currently a phenomenon of hybridisation of the patterns of corporate governance in Europe that is introducing market elements in relational/governmental systems and relational elements in market systems. The systems of employee representation appear to be also converging towards a phenomenon of controlled decentralisation that consists in the diversification of the powers of the actors at the level of the company and in the development of new types of agreements. The underlying intention appears to be the recognition of employees as stakeholders of the company. This thesis concludes that the new types of collective agreements may not be effective as a means of counterbalancing the pressure of shareholders and employees are left in a delicate position.*

Introduction and Methodology

1. The link between Corporate Governance and Collective Bargaining as the object of the research

Corporate Law (and Corporate Governance) and Labour Law were, until recently, seen as radically separate fields of study. Corporate Law and Corporate Governance were seen as a field of Law that dealt with the relationships between the owners of the company and their managers; it was a heavily proprietary view of the company that insulated it from the environment in which it was active and the several relationships that established with everyone that entered into contact with it. Labour Law, on the other hand, had a heavily ideological and adversarial configuration; it was seen as a field of law that protected the worker from the exploiting employer and intended to promote social peace by eliminating the discrepancy of bargaining power between the employer and the worker and thus creating some form of social justice. With the exception of the particularity of the German Enterprise Law (*Unternehmensrecht*) that analysed the influence of workers in the co-determined boards of medium and large German companies, Corporate Law and Corporate Governance and Labour Law were seen as distinct fields of study that could not have any kind of interconnections.¹

This perspective of these fields of Law was increasingly challenged since the 1970s when some Law and Economics scholarship commenced to investigate further the nature of the company. This literature drew upon the seminal work of Ronald Coase concerning the nature of the firm and brought attention to the fact that the firm could not be isolated from the societal environment in which it was active and that it established a number of relationships with several constituencies - within and outside the limits of the firm - without whom it was unable to function.² The details of this investigation

¹ See the classical textbooks of Cozian, M., A. Viandier, et al. (2002). *Droit des Sociétés*. Paris, Litec, Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz. Schaub, G. (1996). *Arbeitsrechtshandbuch - systematische darstellung und nachschlagewerk für die praxis*, C.H Beck. Däubler, W. (2006). *Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb*, Rowohlt Taschenbuch Verlag

² Coase, R. (1937). "The Nature of the Firm." *Economica* 4(16): 384-405.

and the main arguments for each theory will be laid out in the following section: the most important thing to retain by the time being is that nearly all the legal scholarship agreed that the nature of the firm could not be reduced to the relationship between the owners and the managers of the company but that it also had to embody a wider degree of constituencies – named as stakeholders, i.e: someone that has an interest in the firm and is not a shareholder – that equally made an investment in the firm and without whom the firm could not function. This placed a considerable degree of pressure upon the persons responsible for the management of the company – the managers – who had to take into account a wider degree of constituencies in the performance of their job.³

The debate on the nature of the company ran almost parallel to another debate concerning the governance of the company. Governance is to be understood here in an extremely wide perspective that intends to stress the existence of conflicts of interest - coined as agency costs - between the different actors dealing with the company and propose solutions to the resolution of those conflicts.⁴ The debate concerning the governance of companies arose from the seminal work of Berle and Means⁵ that intended to call attention to the potentially detrimental effects that an unrestricted managerial autonomy could have upon the investments of the shareholders and the society as a whole. An intensive investigation that embodied law, finance and business management decided to investigate the potential impact of these negative externalities of unrestricted managers in society and devise means to reduce or eliminate them.⁶

Despite this investigation, one critical actor curiously remained ignored within the debate concerning the best way to govern the company: labour.

³ An extremely interesting explanation of this debate may be found in Blair, M. M. (1999). "Team Production Theory of Corporate Law." *Virginia Law Review* 85: 247 ff.

⁴ Mann, A. (2003). Corporate Governance systeme - funktion und entwicklung am beispiel von Deutschland und Großbritannien, Duncker & Humblot.

⁵ Berle, A. and G. Means (1932). The modern corporation and private property. New York, Harcourt Brace.

⁶ See the seminal works of Monks, R. A. G. and N. Minow (1995). Corporate Governance, Blackwell Business, Van der Berghe, L., C. Van der Elst, et al., Eds. (2002). Corporate Governance in a Globalising World: convergence or divergence? A European perspective, Kluwer.

Although every study of Corporate Governance pointed the workforce as a critical stakeholder in the theory of the firm, few attempted to investigate the interactions between the internal governance of the firm and the types of labour relations established with the firm. This difficulty is perfectly understandable: the patterns of the regulation of labour across countries are extremely complex to study because they did not arise merely by means of market forces but by a combination of market, culture and social policy of the State. Some courageous attempts were made nevertheless: the groundbreaking studies of Blair, Gospel and Pendleton, Höpner and Jürgens, Sadowski, Schuppelt and Weiss, just to name a few, attempted to outline the interactions between corporate governance and labour relations and establish some conclusions on how to integrate labour in Corporate Governance.⁷ These seminal studies launched the founding stones for a debate on the role of employees in Corporate Governance and influenced to a great extent this study.

The purpose of this study is to analyse the interactions between Corporate Governance and Employee Representation. This study will build upon the concept of institutional complementarities to explain the evolution of employee representative structures in parallel to corporate governance. Considering that the governance of companies and the structures for employee representation have suffered considerable modifications over the last 20 years, this thesis will attempt to outline in what terms the traditional structures of corporate governance and employee representation were complementary to each other and how the modifications that in the meanwhile occurred in the traditional patterns of corporate governance have produced some considerable modifications to the patterns of employee representation. The countries covered in the analysis will be Germany, France, the UK and Portugal. The reasons for the choice of the countries are easy to explain: each one of the first three countries stands as the paramount model for a peculiar pattern of corporate governance and employee representation; the inclusion of the fourth country is based upon the nationality of the researcher, the absence of Portugal

⁷ Blair, M. M. and M. J. Roe, Eds. (1999). Employees and Corporate Governance, The Brookings Institution, Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford, Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." Socio-Economic Review 3(2), Jürgens, U., D. Sadowski, et al., Eds. (2007). Perspektiven der Corporate Governance, Nomos-Nomos.

from comparative law studies and the possible academic interest of the modifications in corporate governance and employee representation patterns in a medium-sized country strongly dependent of exports for its economy.

The conclusion that is going to be defended in the end of this thesis may be summoned in the following words: corporate governance and labour representation patterns are complementary. The development of the distinct models of corporate governance and labour representation are not due to insufficiencies in the protection of the rights of shareholders but to a bundle of circumstances that comprise the macro-economic context, the culture of the country and the preferred model of growth. The last few years have witnessed an evolution in the traditional patterns of corporate governance that brought Continental patterns closer to the anglo-saxon model and anglo-saxon patterns closer to the Continental model. Despite this evolution and evident reciprocal influence, the birth of a unique model of corporate governance is not to be expected; each country will develop a hybrid model in which the best characteristics of its system are maintained and the optimal characteristics of the other system are introduced. The developments in the governance of companies have, nonetheless, introduced considerable modifications to the organisation of companies and the workforce. Labour representation and collective bargaining patterns had to evolve in accordance with the new institutional architecture of companies and the new organisation of companies. The final result may equally be the hybridisation of labour representation and collective bargaining patterns; although the main characteristics of each system are maintained, there appears to be a convergence towards the realignment of interests between the management and the employees. This is expected to create a new type of complementarity between corporate governance, labour representation and collective bargaining in terms that the negative externalities may be reduced and the maximum total output of the firm will be increased.

2. Methodological remarks

It is useful to make some methodological remarks before engaging any further into the thesis. The purpose of this section is to provide the reader with a precise glimpse of the research question that occupies this thesis, the framework of analysis that is going to be used and the justification for the use of the concepts and methodology. This should not be seen as an abstract of the thesis but simply as an elucidation concerning the treatment of the subject.

The object of this thesis consists in a comparative study of the evolution of the structures of Corporate Governance, Labour Representation and Collective Bargaining in four countries - Germany, France, UK and Portugal. Corporate Governance - a concept that will be defined in greater detail below - will be fundamentally framed as the set of processes and rules that affect the means by which a company is directed; the purpose of these processes and rules will be to regulate the conflicts of interest that occur within the most relevant constituencies that compose companies for the purposes of this study: shareholders, managers and employees.⁸ The choice of each one of these countries for the analysis is due to the fact that - with the exception of Portugal - each one of them stands as the paradigmatic model for a particular modality of regulation of Corporate Governance and Employee Representation. Germany stands as the example of stakeholder capitalism and employee participation; German companies bet on strategies of incremental growth underpinned in stable governance structures that privilege patient capital and a close involvement of the employees in the affairs of the company by means of the mechanism of co-determination (*Mitbestimmung*). France stands as the model for State intervention in the economy by means of direct ownership of shares or the statutory regulation of the industry; the position of employees is closer to involvement than participation; although employees are gifted with extensive rights to information and consultation and collective agreements enjoy *erga omnes* effects, their position within companies is considerably weaker than their German counterparts and their possibility to influence the

⁸ Mann, A. (2003). Corporate Governance systeme - funktion und entwicklung am Beispiel von Deutschland und Großbritannien, Duncker & Humblot.

managerial decision-making is limited. The UK stands in sharp contrast to these former models. The ownership structures of companies is heavily dispersed, the levels of market capitalisation are remarkably high in European terms and managers privilege strategies of financial result and radical innovation (as opposed to incremental growth). The mechanisms of collective bargaining are heavily decentralised and the scope for employee involvement is remarkably low; the system of monism and voluntarism, the distinctive features of British industrial relations, grant trade unions with a monopoly for employee representation and the absence of any binding framework for industrial relations creates a flexible but conflictual system of social dialogue. Portugal is a medium sized country with an extremely open economy heavily dependent of exports and open to foreign direct investment. The major characteristics of the Portuguese system are essentially identical to the French system (concentrated ownership, State intervention, weak employee involvement). The inclusion of Portugal in this study is due to the nationality of the researcher, the absence of Portugal from comparative law studies and to the relative interest in the analysis of the developments in Corporate Governance and Collective Bargaining in a medium sized strongly export dependent country.⁹

Each one of these countries has exhibited in the last 20 years a slow but steady evolution of its patterns of Corporate Governance and Employee Representation. The evolution of Corporate Governance in Continental Europe towards more Anglo-Saxon standards and the evolution of Anglo-Saxon Corporate Governance towards more Continental standards has raised a considerable debate on the debate best system of governance and

⁹ For the analysis of each one of these systems see Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press. and Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford. For Portugal see Silva, A. S., António Vitorino, et al. (2006). Livro Branco sobre Corporate Governance em Portugal, Instituto Português de Corporate Governance, Social, M. d. T. e. d. S. (2008). Livro Branco sobre as Relações Laborais.

convergence/divergence of patterns of Corporate Governance.¹⁰ Simultaneously, all of these countries appear to be currently undergoing a process of decentralisation their structures of collective bargaining: this movement of decentralisation exhibited two great tendencies: the increased degree of responsibility that the actors at the level of the company have assumed in relation to the traditional employee representatives - trade unions - and the development of new types of collective agreements that had a substantially distinct content in relation to the normal type of collective agreements.¹¹ The question that occupies this thesis consists in knowing whether and to which extent these two movements could be linked.

The analysis of the potential links between these two movements (convergence in the patterns of corporate governance and collective bargaining) will be made by means of some founding concepts: these concepts will be the contractarian conception of the company, the theory of institutional complementarities and comparative law. The contractarian conception of the company consists in a theory that - drawing upon Ronald Coase's seminal work "*The nature of the firm*" attempted to reconceptualise the company as a nexus of implicit and explicit relational contracts among all the persons that are somehow related to the company - shareholders, managers and stakeholders. Considering that the relationships between each one of these persons and the firm not only suffered from informational asymmetries but was equally capable of having external effects on third parties, the purpose of the regulation would

¹⁰ Peltier, F. (1997). "La convergence du droit français avec les principes de la Corporate Governance américaine." *Revue du Droit Bancaire et de la Bourse* 60: 53 ss, Bratton, W. W. and J. A. McCahery (2002). Comparative Corporate Governance and Barriers to Global Cross Reference. *Corporate Governance Regimes - convergence and diversity* J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford, Hansmann, H. and R. Kraakman (2002). Towards a single model of corporate law. *Corporate Governance regimes: convergence and diversity*. J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford, Hopt, K. J. (2002). Common principles of Corporate Governance in Europe. *Corporate Governance Regimes - convergence and diversity*. J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford, Van der Berghe, L., C. Van der Elst, et al., Eds. (2002). *Corporate Governance in a Globalising World: convergence or divergence? A European perspective*, Kluwer, Wymeersch, E. (2002). Convergence or divergence in Corporate Governance patterns in Western Europe. *Corporate Governance Regimes - convergence and diversity*. J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford, Gordon, J. N. and M. J. Roe, Eds. (2004). *Convergence and Persistence in Corporate Governance*, Cambridge, Goergen, M., M. Martynova, et al. (2005). Corporate Governance Convergence: evidence from takeover regulation, European Corporate Governance Institute.

¹¹ Sciarra, S. (2004). The Evolving Structure of Collective Bargaining in Europe 1990-2004. Florence, University of Florence, European Commission.

be to reduce the costs associated with these information asymmetries and externalities (named as agency costs).¹² The theory of institutional complementarities consists in an application to this conception of the firm of a theory developed by Aoki. This author considers that each society is made by institutions; the purpose of the institutions is to reduce the agency costs associated with the functioning of a given element; two or more institutions will be considered as complementary when the combination of the two reduces the agency costs associated with its functioning to such an extent that one may say that the whole generated by the combination of the two is greater than the sum of the parts. In this sense, particular patterns of corporate governance and employee representation will be considered as complementary when the joint output of both is greater than each one of them in isolation or when each one of them is combined with another non-complementary element.¹³ Finally, each one of the countries will not be analysed isolated but within a comparative framework. The use of comparative law is not alien to scholars of corporate governance and labour law because each one of these fields of law has traditionally been by definition studied comparatively. Although the analysis of each one of these countries will often impose a detailed review of the legislation and case-law associated to it, the analysis will always be made to the furthest possible extent within a comparative framework in an attempt to outline and contextualise the function and the intentions underlying the statutory regulation and the decisions of the courts.¹⁴

The reasons underpinning the use of these concepts are manifold: the contractarian conception of the company is currently the most widely used conceptualisation and endowment of the company; this does not mean that there are not other conceptions, as this thesis will attempt to demonstrate further, but simply that this is the one that currently appears to capture to the

¹² Coase, R. (1937). "The Nature of the Firm." *Economica* 4(16): 384-405, Eisenberg, M. A. (1999). "The Conception that the Corporation is a Nexus of Contracts and the Dual Nature of the Firm." *Journal of Corporate Law* 24: 819-816, Hansmann, H. and R. Kraakman (2000). "The essential role of organizational law." *Yale Law Journal* 110(3): 387 ff.

¹³ Aoki, M. (2001). *Towards a comparative institutional analysis*, Stanford University Press, Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." *Socio-Economic Review* 3(2).

¹⁴ Blainpain, R. (2004). Comparativism in Labour Law and Industrial Relations. *Comparative Labour Law and Industrial Relations in Industrialised Market Economies*. R. Blainpain, Kluwer.

best extent the reality of the company. The contractarian conception of the company equally assists in understanding the theory of institutional complementarities. The agency costs approach to the regulation of collective bargaining appears currently to be the most plausible explanation of the development of certain patterns of collective bargaining in the presence of certain patterns of corporate governance. This does not mean that there are not other explanations - such as the historical approach or the varieties of capitalism approach - but this appears to provide the most satisfactory and complete explanation of the subject.¹⁵ Finally the use of comparative law is almost mandatory in a study that intends to comprise more than one country; the understanding of the particular dynamics of corporate governance and collective bargaining within one country and the modifications currently occurring sometimes may only be understood in a comparison with distinct forms of doing things and outlining their differences and commonalities.

This allows us to understand the methodology and the approach to be used throughout this thesis. The purpose of this thesis is to analyse in a comparative perspective the evolution of corporate governance and collective bargaining in four countries. The analysis will be made under a contractarian conception of the company; the purpose of this work is to attempt to understand the common evolutions under an agency costs approach and observe if the emerging patterns of corporate governance and employee representation may be said to be complementary to each other. Although the agency costs approach will be predominant throughout the thesis, it will not be in any form exclusive; other explanations to the development of these elements will be considered and contextualised in its due place.

¹⁵ Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press, Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford.

Part one - Theories of the company, Corporate Governance and Employee Representation

Chapter 1

1.1 The contractarian conception of the company in contrast with other theories

Since this thesis deals with companies, one must begin by defining what a company for the purposes of this subject is. This small dissertation of the concept of company should not be understood merely as an intellectual exercise but as an enunciation of the multi-dimensional character of the company. This section will attempt to demonstrate in the following lines that the understanding adopted of the concept of company will influence to a decisive extent the solutions to be extracted from the conflicts of interest emerging between its shareholders, managers and stakeholders.

The nature of the company is a subject that has been intensively debated over the last 200 years. The results of the discussion may be simplified and reduced to three distinct theories: the ownership model, the social institution model and the nexus of contracts model. In essence, the ownership model considers the company to be the ownership of the shareholders; the followers of this theory consider that the contributions of the shareholders in capital companies entitle them to ownership-like rights over the company, that they delegate the task of managing those assets to the managers by means of an election and that are entitled to hold them accountable for its progress. The sole purpose of the company will be to pursue the interests of the shareholders in the same form as the purpose of the right of ownership over a thing is to pursue the interests of the owner and the purpose of the agent (manager) is to pursue the interests of the principal (shareholder).

The social institution model encompasses a number of different theories,¹⁶ which consider the company to be a societal construction, an organisation of social and political significance that has claims and duties towards society as a whole. The social institution model views the company as something more than the private association of its owners that is given several benefits by the community (such as legal personality and limited liability) on account of its dimension of public interest. The supporters of this model stress the benefits that society grants to corporations and their owners, on account of its role in generating wealth, and claim that the management of these companies is liable to their interests in consideration for the benefits of the corporate form. Monks and Minow stress that this position has influenced to a great extent some judicial decisions; they quote Justice Louis Brandeis who claimed in 1932 that the corporate structure should be seen as a privilege that should be upheld only in those cases in which it was consistent with public policy and welfare.¹⁷ Finally, the nexus of contracts model considers the company to be a contracting site, at which the parties to a business enterprise agree on the terms on which they are prepared to supply the inputs of the firm and the ways they are remunerated by doing so; it acts as a common party to a number of contracts and avoids the needs for cross-contracting between the members of the various groups. It praises the role of the market in creating the conditions for the best allocation of resources of all the parties interested in the success of the firm – shareholders, employees, suppliers and distributors – and charges the management with the task of managing all those relationships so that each party may receive the best return possible for its input.¹⁸

¹⁶ Namely the *benign managerial model*, the *stakeholder model* and the *political model*. The *benign managerial model* views the management of the company as trustees of the assets of the company for the various groups affected by their activities. The *stakeholder model* considers that the pursuit of the interests of the shareholders obliges management to balance the interests of all the constituencies of which the company depends (stakeholders). The *political model* sees the corporation as a form of human organisation to which democratic principles should apply in order to avoid that the interests of one party damages excessively the welfare of the other parties. See Parkinson, J. (2003). "Models of the company and the employment relationship." *British Journal of Industrial Relations* 41(3): 481-509.

¹⁷ Monks, R. A. G. and N. Minow (1995). *Corporate Governance*, Blackwell Business.

¹⁸ Jensen, M. and W. Meckling (1976). "The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure." *Journal of Financial Economy* 3, Parkinson, J. (2003). "Models of the company and the employment relationship." *British Journal of Industrial Relations* 41(3): 481-509.

Each one of these theories has its pros and cons. Beginning with the pros, the ownership model has the advantage of placing the focus on the rights that shareholders enjoy over their capital (namely voting rights, especially in regulations where multiple-voting shares, which deteriorate the relationship between ownership and control, are forbidden or severely limited) and reduces the company to the relationship between the “owners” of the company – the shareholders – and the managers, who act as “agents” of the owners. The ownership model has relations with the property law conception of “co-ownership” of goods and to the contract of agency: the rights over the good are exercised in a democratic basis and the elected management acts on behalf of the owners, taking care of their best interests. The social institution model has the advantage of recognising that the corporation is an entity legally separate from its owners with a wholly distinct social role. This is particularly true in the situations in which the amount of the capital of the company is so large and the participation of the shareholder so small that the position of the shareholder is closer to that of a lender of capital than to an owner. The management of the company will then act as a trustee of the assets of the shareholders, trying to fulfil simultaneously the societal interests to which the law set up the corporate form. The nexus of contracts model has the advantage of recognising that companies need to establish and promote contractual relations with a number of different constituencies without whom the company would be unable to function. This is even more so if we consider that corporate law is not only concerned with regulating the relationships between the shareholders and the shareholders and management but also with establishing priorities in relation to the claims of third parties by means of the rules of asset partitioning. This is particularly relevant in those situations in which there is a strict separation between ownership and control and in which the dispersion in the ownership of companies renders it difficult to enforce the ownership model’s claim of the accountability of make managers to the shareholders (see the seminal work of Berle and Means).¹⁹

As regards the cons, each one of these theories fails for over-emphasizing a specific aspect of the company and forgetting other equally

¹⁹ Berle, A. and G. Means (1932). The modern corporation and private property. New York, Harcourt Brace, Hansmann, H. and R. Kraakman (2000). "The essential role of organizational law." Yale Law Journal 110(3): 387 ff.

important determinants. The ownership model fails because it does not recognise the corporation as a legal person, which is incapable of being owned and has assets of its own that are distinct from the contributions of the shareholders. Its assumption is valid only to companies with closely held shares, i.e companies in which one person or a strict group of persons own the entire capital of the company in terms of being capable to exercise a decisive influence over their destiny. In these companies, the separation between ownership and control is a technicality and the relationship between shareholders and managers may be very close to a relationship of agency. The ownership model also fails in companies with dispersed ownership because the power of the individual shareholder in proportion to the total capital is so small and the costs of class-action are so great that the position of the shareholder is closer to the one of a lender of capital than to that of a shareholder in closely held companies. The social institution model also fails because it renders the objectives to be pursued by the management indeterminate and is incompatible with effective managerial accountability. If we consider that management boards have a duty to maximise the welfare of all the constituencies potentially affected by the company (such as shareholders, suppliers, creditors, distributors, employees, local communities, environmental, race and gender discrimination activists, etc, all considered to be in equal standing) we will quickly leave management boards without a criterion of how to run the company, since all of these interests are clashing in divergent degrees. This is even more so if we consider that all of these groups have different bargaining powers, and hence different strengths to make their voices heard, and that there are no governance mechanisms to determine and ensure the degree of compliance with the interests of the different constituencies. Imposing upon managers to take into account all of these interest groups will leave the management boards without direction and prey to the interests of the stronger groups. This theory developed the concept of "*social interest*" in order to assist the management board in the performance of its duties: the management would have to promote the aggregate welfare of society as a whole. This is however a very indeterminate concept. On the other hand, this theory proposes no internal governance devices to ensure the compliance with the objectives. Management boards would be left with full discretion to pursue whatever interests they think more adequate, since failure in one field could be

compensated by success on another. This might open way for an unrestricted managerial authority and allow managers to use the control granted to them in order to extract private rents from the firm at the expense of other constituencies. Finally, even the nexus of contracts theory fails in three distinct aspects: (1) by over-emphasizing the role of the market in promoting the best allocation of goods among all constituencies interested in the company and not recognising the role of regulation in the structure of companies, (2) for failing to recognise the specificity of the position of the shareholders in the firm and (3) for failing to recognise the organisational dimension of firms. As regards the first aspect – the absolute reliance on the freedom of contract to produce the best allocation of resources – it is more a position of principle than an absolute truth. The concept of a free market is an oxymoron and the guarantee of the bargaining position of the parties to produce the optimal allocation of resources depends to a great extent of the intervention of the State to correct the unequal position of the parties.²⁰ Even more, if this theory was to be taken seriously, there would be no need for regulation of company and contract law because the game of the parties would ultimately produce the best optimal company and commercial code, which is empirically not observable as the role of regulation in commercial life is increasing. Hansmann addressed this problem and concluded that while there is empirical evidence of an increase of contractualisation in small closely held companies (with no more than 30 shareholders) in larger companies there is absolutely no evidence of a decrease in regulation. Hansmann considered that regulation in tax, bankruptcy and accounting law sufficiently protected the interests of all interested constituencies in small companies – thus opening way for more contractual autonomy – but failed to do so in larger companies because the high number of shareholders and stakeholders evolved would make individual bargaining extremely difficult and the State took upon itself the task making the best choices and of designing default terms to be observed by the companies.²¹ As regards the second aspect – the position of shareholders within firms – it

²⁰ Hyman, R. (2007). Labour Markets and the Future of "Decommodification". Social Embedding and the Integration of Markets. O. Jacobi, M. Jepsen, B. Keller and M. Weiss, Hans Böckler Stiftung.

²¹ Hansmann, H. (2004). Corporation and Contract. Annual Meeting of the American Law and Economics Association Yale. The increasing contractualisation of the internal governance of small company forms will be analysed comparatively further in this thesis.

appears to be inaccurate to refuse to recognise them a certain ownership-like rights in relation to the firm since, no matter how dispersed the ownership is, there is in all listed companies at least one group of controlling shareholders who monitor the performance of the management and can make a decision on the destiny of the firm. On the other hand, even if the class-action costs are enormous, it is theoretically possible for small shareholders to collude and overthrow the management of the firm. Company laws also usually require the approval of a qualified majority of shareholders in significant corporate actions (such as mergers and modifications to the company charter) capable of affecting their interests to a great extent but it does not require the consent of other parties also capable of being significantly affected (such as creditors).²² These investors have ownership-like claims on the firm and exercise them to their best interest. Since the shareholders (controlling and small) are the only group who is contractually entitled to do this, it is fair to distinguish them from all other constituencies with whom the company may enter into contract. As concerns the third aspect – the disregard of the organisational dimension of firms – the nexus of contracts theory fails to address the internal structures of companies, in which the relationships between all parties are better described as a combination of authority and coordination than as an open-ended contract between all parties.²³

The concept of the company as a nexus of contracts will be adopted throughout this work. The subject imposes the conceptualisation of the company as a nexus of contracts because this conception allows for a more clear perception of the reality of the conflicts occurring within and without the boundaries of the firm. Despite the criticisms mentioned above that have been made to the theory,²⁴ for the purposes of this thesis the corporation may be more correctly defined as a single contracting party, regulated to some extent by law, that coordinates the activities of suppliers of inputs and of consumers of products and services. Each company must undertake a “*constitutional*”

²² Rock, E. B., H. Kanda, et al. (2004). Significant Corporate Actions. *The Anatomy of Corporate Law*. R. Kraakman and H. Hansmann, Oxford University Press.

²³ Simon, H. A. (1991). "Organisations and Markets." *Journal of Economic Perspectives* 5(2): 25-44.

²⁴ For more details please see Eisenberg, M. A. (1999). "The Conception that the Corporation is a Nexus of Contracts and the Dual Nature of the Firm." *Journal of Corporate Law* 24: 819-816.

decision on how to control the vital areas of its production process, named as “*control problems*”. These control problems are: (a) the financing of the company, (b) the labour process and (c) the relationship with suppliers and distributors. This does not mean that there are not other parties also of great relevance to the some companies (such as the environment) but the analysis will be limited to these parties because they are the fundamental actors without whom no company may function. The option for the concrete control problem is conditioned by a number of variables, such as the economic environment, the financing of the company, the products to be made, the regulatory environment, etc., and the solutions given to the structure of the company are transitory, volatile and strongly conditioned by the economic and regulatory environment. As Ruigrok and Van Tulder put it, when studying the restructuring of companies,

*“restructuring implies handling various social and economic relationships at the same time. A change in one relationship inevitably affects the other relationships as well. (...) Consequently, an analysis of restructuring requires an identification of the appropriate actors and their strategies”*²⁵

This thesis will attempt to demonstrate to which extent the management of companies has managed to solve the diverse control problems that the conceptualisation of the company as a nexus of contracts presupposes. The assumption underlying the thesis will claim that the options of the managers on how to contract all of these specific relations will depend on a number of factors, such as the predominant governance structure, the concrete economic situation of the time, the prevailing method of organisation of production and the patterns of employee representation and collective bargaining, which obliged companies to adopt a certain structure to abide with the laws of the market.

²⁵ Ruigrok, W. and R. v. Tulder (1995). The Logic of International Restructuring, Routledge.

1.2 Theoretical analyses of Corporate Governance

1.2.1 The object of Corporate Governance

The study of Corporate Governance departs from the fundamental assumption that all industrial societies must make a set of fundamental choices of how firms are governed, since both have enormous implications for economic wealth and the broader welfare of nations. “*To govern*” comes from the Latin “*governare*”, which means “*to hold in check, control*” or “*to influence something*”. Despite the commonality of the control problems in all industrial societies and the current discussion on the best governance system, there is no unitary definition of corporate governance. That is the reason why in virtually all studies about corporate governance it is customary to begin with a short definition of the subject. Considering that corporate governance is an extremely extensive and rapidly evolving area, covering a variety of subjects, it is difficult to maintain a common denominator of all the fields covered by corporate governance.

Departing from the conceptualisation of the company as a nexus of contracts, there are three very important sets of actors or interest groups that contract with the company and determine to a great extent the ways in which the company is managed. Those interest groups consist in shareholders, management and labour. Corporate governance will be considered as the field of studies that analyses the interaction between these distinct interest groups: it is concerned with who owns and controls the company (shareholders), how the firm is going to be managed (management) and the relationships to be established with a key set of actors without whom the company will be unable to work (labour). These interest groups may have both common and divergent interests; they make alliances and oppose each other at distinct times and in accordance with their variable interests. The justification to the relevance given to these three distinct groups consists in the recognition of the investments - in terms of money or human capital - that all of them make in the firm: shareholders invest their money in the firm; managers invest their efforts and reputation; employees invest their skills and efforts in one particular firm. The consideration of employees as stakeholders deserves a further consideration: employees are considered as stakeholders not only on account of their

investments in terms of skills and efforts in one particular firm but also on account of the social considerations that underpin the use of labour. Labour Law literature constantly emphasises that "*Labour is not a commodity*" and the recognition of the dignity of human effort and the social importance of labour can be made by means of their acknowledgement as stakeholders of the company. This does not mean of course that there are not other actors (named in the corporate governance literature as stakeholders) that also have an interest in the firm, such as local communities, suppliers and others as the literature on corporate social responsibility emphasises.²⁶ The subject imposes the focusing on the former three sets of actors because they are the ones most directly interested in the way that the firm is managed and are the ones that have the greatest power to influence directly the behaviour of the other actors within the firm. That is the reason why this analysis will focus on the interaction between these actors and only marginally consider the interests of the remaining stakeholders.

1.2.2 Interest groups - who is a relevant part in the company

The firm, perceived as a nexus of contracts, contracts with a number of different constituencies that have a direct interest in the way in which the firm is managed because they make a direct investment in the firm. These different constituencies might be named as interest groups: this is a concept that refers to all coalitions of actors that participate in the activities of a company with whom they are in an economical relationship.²⁷ The most important ones of these constituencies consist in shareholders, managers and labour. Shareholders are the decisive interest group because they make a direct financial investment in the firm and they are in a position of residual claimants; they only gather the profits of the activity of the firm after the claims of the remaining constituencies have been satisfied. This distinguishes them from

²⁶ Merely as an example, see the very interesting articles of Herrmann, K. K. (2004). "Corporate Social Responsibility and Sustainable Development: the European Union as a case-study." *Industrial Journal of Global Legal Studies* 11: 205-232. ; Ashford, R. (2002). "The Socio-Economic Foundation of Corporate Law and Corporate Social Responsibility." *Tulane Law Review* 76: 1187-1205.

²⁷ Mann, A. (2003). *Corporate Governance systeme - funktion und entwicklung am beispiel von Deutschland und Großbritannien*, Duncker & Humblot. See also Monks, R. A. G. (2002). "Creating value through corporate governance." *Corporate Governance* 10(3): 116-123.

simple providers of capital and entitles them in virtually all jurisdictions to property-like claims on the firm: they have a right to elect and dismiss the management of the firm and participate in a number of fundamental decisions, such as mergers and wound ups.²⁸ Managers are the second most important interest group because they are the ones who are effectively in charge of the company. They make the fundamental decisions of the company and decide in what terms it is going to be managed. Finally, the subject imposes the consideration of employees as a fundamental interest group in the company. There are a number of reasons for this: firstly, companies are unable to function without employees and therefore the relationships with the providers of skills and labour must be considered in the governance of the company. Secondly, employees enjoy across a number of jurisdictions distinct powers of influence (*Mitwirkungsrechte*) in the management of the firm. These powers might go from a simple right to be informed on certain issues - as transfers of undertakings - to co-determination in other issues depending of the jurisdiction. The most important thing to retain is that European jurisdictions have tended to recognise certain rights to the employees that might influence the management of the firm. The last chapter of the thesis will attempt to demonstrate that these powers of influence of the employees have tended to go in a convergent direction in all jurisdictions covered. This justifies by itself the relevance given to the employees amid all the interest groups.²⁹

This does not mean, of course, that there are not other parties extremely interested in the ways in which the firm is governed. The Corporate Governance literature has identified a number of constituencies - named as stakeholders - that also have a direct interest in the company, such as creditors, suppliers, distributors, clients, the State, social and environmental activists, etc.³⁰ Sometimes they have such extensive powers that they may influence to a decisive extent the ways in which firms are governed. For instance, where firms cannot rely on internally generated funds for financing,

²⁸ Hansmann, H. and R. Kraakman (2000). "The essential role of organizational law." *Yale Law Journal* 110(3): 387 ff.

²⁹ Blair, M. M. and M. J. Roe, Eds. (1999). *Employees and Corporate Governance*, The Brookings Institution.

³⁰ Leyens, P. C. (2007). "Corporate Governance: Grundsatzfragen und Forschungsperspektiven." *Juristen Zeitung* 26(22): 1061-1112.

they will have to have recourse to debt and share equity; both of these forms of financing may place considerable constraints on management because they might use the firm to pursue their own agendas and considerably modify the governance of the firm.³¹ The financial crisis of 2009 that spanned across all industrial nations revealed the potential of influence of banks and other financial institutions in the governance of companies. They will not be of direct interest to my study however, because they are an interest group with several specificities (they are subject to a very detailed regulation for example) that deserve an independent consideration. The most important interest groups for this thesis will be shareholders, management and labour because without them the company will be unable to function.

1.2.3 Agency problems - identifying the conflicts of interest between the main interest groups and the strategies to solve them

The rationale for corporate governance lies in a fundamental assumption: considering that the interest groups in the company are economically rational agents, each one of them is supposed to maximise the expected utilities from the flow of money coming from the company towards him. Shareholders will want higher dividends, management will want higher remuneration and reputation and employees will want higher wages and employment security. The claims of the distinct interest groups places barriers due to the competition for input factors on the markets around the company. In a perfect state of the world, each individual interest group would have the full information on the state of the market and would be able to make a perfectly rational decision on the claim to make. Modern economics emphasise however that the interest groups around the company suffer from a number of information asymmetries that keep them from making fully informed decisions.³² The economists name the problems generated by these information asymmetries as agency problems: in the more general sense of the term, an agency problem arises whenever the welfare of one party – the principal – depends on the actions

³¹ Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582.

³² Mann, A. (2003). Corporate Governance systeme - funktion und entwicklung am Beispiel von Deutschland und Großbritannien, Duncker & Humblot.

taken by another – the agent. The problem lies in motivating the agent to act in the interest of the principal rather than on the narrow self-interest of the agent. Since the agent is in a much better position to influence the destiny of the company than the principal, it has an incentive to act opportunistically in relation to the principal.

There are three types of agency problems relevant to this study: (1) those that arise between the shareholders and the managers (the shareholders will want to managers to act in their interest); (2) those that arise between the majority shareholders and minority shareholders (the majority shareholders – who have control of the firm – will want the managers to act in their interest); (3) those that arise between the firm and its employees (the basic problem is to ensure that the firm is not managed in order to exploit the employees and the investments they make on the firm).³³ The function of the law and of corporate governance is to compensate for these information asymmetries and mitigate the agency problems that occur within the firm.

There are several strategies available to the interest groups that compose the web of contracts around the company to overcome these agency problems. The governance strategies may be classified in two large groups, internal and external strategies. Internal governance strategies consist in those that act within the company, i.e. they consist in mechanisms internal to the company structure that intend to prevent expropriation of an interest group by means of an opportunistic behaviour of the other interest group. There are five types of internal governance strategies: agent constraints, affiliation rights, appointment rights, decision rights and agent incentives.³⁴ Agent constraints consist in a governance strategy that intends to prevent opportunistic behaviour by commanding them not to take actions that would harm the interest of their principals. They may consist either in rules or standards: the difference is that rules act *ex ante* (i.e: they forbid or command a specific behaviour) and standards act *ex post* (i.e they leave the evaluation of the legitimacy action to a third party). Affiliation rights consist in a governance strategy that dictate the terms by means of which the principals affiliate with their agents. They also

³³ See the seminal work of Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford.

³⁴ The classification comes from Ibid.

might act ex ante (by setting the terms of entry into the relationship) or ex post (by setting the terms of exit of the relationship). Appointment rights consist in a governance strategy that intends to prevent opportunistic behaviour by setting the terms by which principals may select and remove their agents. Decision rights consist in a governance strategy that constrains the margin of manoeuvre of agents by providing principals with the power to initiate and ratify the decisions of the principals. Finally, agent incentives attempt to reduce agency costs by altering the incentives of agents. They may consist either of reward strategies (in which the agent receives a premium for advancing the interests of the principals) or trusteeship strategies (in which bad behaviour is penalised). External governance strategies consist in those that act on the outside of the company, i.e they seek to constrain opportunistic behaviour by external mechanisms. The most important of these mechanisms consist in the capital markets. If shareholders are not satisfied with the behaviour of management, they will simply sell their shares and invest in another company. This modification of the ownership structure of the company (in terms of concentration and the identity of the owners) might be of considerable importance because it may subject managers to distinct pressures. This might be an important mechanism if we combine it with the prevalence of takeovers in some jurisdictions. Takeovers may act as powerful disciplinary devices; if managers do not wish to be displaced by a bidder, they must convince shareholders not to sell their shares. The only way to achieve this is to provide results to the shareholders in such an amount that will compensate the premium that the bidder wishes to offer for the shares. Even in jurisdictions in which takeovers are virtually absent - such as Continental Europe - capital markets consist in an important governance strategy if we take into consideration the importance of disclosure. Disclosure consists in a governance strategy that bets upon the reduction of information asymmetries by providing the principal with sufficient information concerning the activity of the agent in terms that the principal will be able to make a fully informed decision. For instance, if the principal (shareholder) is fully informed on the financial situation of the company and the remuneration practices of its managers, it will be able to evaluate better the decision on whether or not to invest in the company. This is likely to have an impact on share prices and condition the behaviour of the management board because the management

board will have to take into consideration in their actions that shareholders will be monitoring their strategies by means of the provision of information. This obliges the management board to act in the interest of shareholders and to state the reasons underpinning their actions because otherwise they may be dismissed or the shares may be sold to other shareholders.³⁵

The different agency problems and the different information asymmetries that occur within the firm might also lead to distinct coalitions of interest groups. This is a phenomenon in which two interest groups gather forces against the other. There are three distinct types of possible coalitions: class-conflicts, insider/outsider conflicts and accountability conflicts.³⁶ Class-conflicts refer to a situation in which management and shareholders unit their forces against employees in order to pay them lower wages or reduce the size of the labour force, so that they may free resources to divide between management and shareholders; insider/outsider conflicts refer to a situation in which management and employees unite against shareholders, in order to preserve their jobs; accountability conflicts refer to a situation in which employees and shareholders unite against management in order to control their activities and the impact that it may have in the company. These coalitions will be analysed with a greater detail in the final chapter of this thesis, in which the impact of the modifications of the governance of companies in the systems of collective bargaining will be analysed. It is sufficient to keep in mind that there are different interest groups in the company and that these interest groups may make coalitions in order to reduce the agency costs *vis-à-vis* the other interest groups: these coalitions may present several problems of their own because they may be used either as a means of reducing agency costs (as it occurs in accountability coalitions, in which employees and shareholders attempt to control the margin of manoeuvre of the management board) or as a means of expropriation of the weaker interest group (as it occurs in class-conflicts, when

³⁵ The economic function of disclosure was exemplary analysed by Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press.

³⁶ For a good introduction on the typology of these conflicts, see the very good texts of Beyer, J. (2003). Corporate Governance in Deutschland, Max Planck Institute für Gesellschaftsforschung. ; Cioffi, J. W. and M. Höpner (2005). "Left-Wing support for shareholder capitalism." Mitbestimmung(8): 57-61. ; Höpner, M. (2005). Corporate Governance in transition: ten empirical findings on shareholder value and industrial relations in Germany, Max Planck Institute für Gesellschaftsforschung.

management and shareholders unite against employees). This conflicts will be extremely important in understanding the legal methods used to reduce them: for instance, the recognition of fiduciary duties in accordance with the philosophy of enlightened shareholder value may be seen as a means of reducing the insider/outsider conflict because it is a means of obliging shareholders to recognise the importance of other interests in the management of the firm.

This chapter should end with an enunciation of the concept of corporate governance for the purposes of this work. Corporate governance will be seen as a system of rules and standards destined to reduce the agency costs that the different interest groups that contract with the company face vis-à-vis the other interest groups. The basic idea consists in the recognition that the legislation has made of the existing agency problems and the distinct strategies that it has used to mitigate them.

1.2.4 complementary approaches - other perspectives on Corporate Governance.

Corporate governance is an extensive field of study and there is a variety of definitions of governance. Despite the fact that this chapter will adopt a theoretical approach that will see governance as a means of reducing the agency costs facing number of corporate constituencies, it is useful to know and make use of other approaches to corporate governance in order to understand more fully the evolution registered in the jurisdictions under study. Gospel and Pendleton undertook an effort of synthesis of the several approaches that have been made to define Corporate Governance in a paper entitled "*Finance, Corporate Governance and the Management of Labour: a conceptual and comparative analysis*".³⁷ Considering that this paper deals very closely with the object of this thesis - the interactions between Corporate Governance, Labour Representation and Collective Bargaining - it is useful to recall their work and analyse the several approaches that have been made towards Corporate Governance. It is also very useful to have in mind these distinct approaches because Corporate Governance is a subject that must be

³⁷ See Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582.

seen within a wider context and the ideas underpinning these distinct approaches to Corporate Governance will be often used in the development of this thesis. They should be seen as complementary to the nexus of contracts model - and not as opposing to this conception.

a) historical approach - the historical perspective to corporate governance places the focus in the three stages of development of capitalism: personal capitalism, managerial capitalism and shareholder capitalism. Personal capitalism refers to the time in which financing was strongly related to the concrete person (individual or small partnership) and ownership and control were closely related. Managerial capitalism refers to the development of large corporations that needed great amounts of capital to function. This led to the development of three distinct forms of governance: in the UK and US, the resource to active capital markets led to the dispersion of ownership and the separation of ownership and control underlined by Berle and Means;³⁸ in continental Europe, the idea of coordinated capitalism prevalent after 1945 influenced the development of two distinct models of corporate governance: in France, the State took the task of financing large corporations by means of State ownership or the provision of finance by State companies; in Germany, this led to the consensus driven capitalism characterised by bank shareholdings, interlocking shareholdings and concentrated ownership. The final stage of capitalism – shareholder capitalism – begun in the 1980s and was due to the falling profitability of companies. Managers were increasingly placed under pressure to deliver results to the shareholders and shareholders became the dominant group in the constellation of interest groups within the company. This led to several modifications of ownership structures and the rights of shareholders within companies, obliging managers and employees to rethink their position within the company.

b) financial approach – the financial approach places the focus on the forms of financing of the company. This school of thought distinguishes between two diverse types of governance systems, market systems and relational systems. Market systems consist in governance systems in which the emphasis is placed on financing via equity shareholding and market-based

³⁸ Berle, A. and G. Means (1932). The modern corporation and private property. New York, Harcourt Brace.

debt. Equity markets are extensive in these systems and there is usually a high-turnover of shares and corporate bonds. Investors enjoy diversified portfolios and may easily sell their investments. Under these systems, there is an outsider form of governance based on relatively strong legal rights for investors and an active market for corporate control (particularly in the form of M&A and takeovers). Shareholdings are usually dispersed and few companies have dominant shareholders. Relational systems consist in governance systems in which the emphasis is placed on banks and other loans, since security markets are weak and investors are more likely to be long-term. There is also a predominance of concentrated shareholdings in each one of these systems, since each firm tends to have one dominant shareholder or a restrict group of dominant shareholders. This pattern of financing is said to influence to a great extent the behaviour of the distinct interest groups: usually, market systems are connected with exit strategies and relational systems are connected to voice strategies. This means that whenever an agency problem arises between the distinct constituents of the company (managers, shareholders and employees), in market systems the constituents tend to leave the company as a sign of protest, whereas in relational systems there is more emphasis on dialogue and mutual problem solving as a means of overcoming agency problems. This school of thought has been under great protest lately because it is criticised for not capturing the reality of South-European countries, in which the State plays a very influential role in the Governance of companies.³⁹

c) **legal systems approach** – the legal systems approach derives from a very influential paper published by Raphael LaPorta, which argues that the legal family has a decisive influence in the governance strategy adopted by companies. According to this author, the three distinct legal families existing in the Western world (namely, the Common Law, the French tradition and the Germanic tradition) afford distinct levels of protection to investors of public companies, in accordance with a typology designed to measure the level of investor protection. The argument of the authors claims that systems with the strongest levels of protection of shareholders exhibit more dispersed

³⁹ See the excellent book of Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press.

shareholdings and are economically more efficient. Therefore, in accordance with this school, the differences in governance structures are to be explained by the distinct levels of investor protection in each legal family. This school has been under heavy criticism on three grounds: firstly, the methodology is said not to reflect the reality of the legal system of each country; the western countries have borrowed from considerably from their neighbours some legal innovations and it does not consider the influence of EC Law; secondly, this classification is generally considered to be biased towards the common law; thirdly, this classification is equally criticised for disregarding the historical circumstances in which the public corporations of each country developed. Finally, we may also point out that this paper reduces the problems of agency to the relationships between managers and shareholders (including non-controlling shareholders) and disregards the wider degree of interest groups that interact with the company - in particular finance but also labour, which is completely ignored by the authors. It is notable that the authors disregard the impact of labour in the governance of companies, which may be very extensive as it occurs in Germany. Nevertheless, it has the merit of calling attention to the distinct levels of investor protection in each legal system and their possible impact on the governance of companies.⁴⁰

d) **varieties of capitalism approach** – the varieties of capitalism approach has called attention to the political economy of a given country in order to understand the differences in governance strategies. Finance and corporate governance arrangements are said to be interrelated in specific categories, influencing the relationships between owners and managers, the nature of the business strategies and the extension of cooperation between firms. This approach considers that there are two major governance systems, liberal market economies and coordinated market economies: liberal market economies are said to place more emphasis on short-termism and radical innovation; they favour quick results and shareholder orientation as a measure of firm performance; coordinated market economies are said to place more emphasis on long-termism and incremental innovation; they favour the building

⁴⁰ La Porta, R., F. Lopes-de-Silanes, et al. (1999). "Corporate ownership around the world." *The Journal of Finance* 54(2): 471-517. ; for an excellent critique of the former paper see: Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute.

of market shares and long-term strategies as a measure of firm performance. This approach is underpinned in the idea of complementarity: two institutions are said to be complementary when they reinforce each other in terms of increasing the aggregate output. The whole is to be greater than the sum of the parts when they are complementary. In these terms, concentrated shareholdings and employee involvement are said to be complementary to coordinated market economies, whereas dispersed shareholdings and liberal labour markets are said to be complementary to liberal market economies. The introduction of alien elements into the system is considered negative because it will not be complementary to the other elements of the system.⁴¹

1.2.5 the objective of the corporation – in whose interest should the company be managed?

this short overview of the theoretical discussion on corporate governance may not be finished without a short reference to the discussion on the objective of the corporation. The main questions here concern the shareholder value/stakeholder value debate. As a preliminary point, it must be said that none of these theories put in question the fundamental proposition that the company should be run in the interest of the shareholders. If it weren't so, company law would end because there would be no incentives to gamble the money in a venture as a corporation. The debate concerns the patterns according to which one may measure the interest of the shareholders. Shareholder theorists consider the company to be the property of the shareholders and that management should be accountable to them only. They view the company as a "money-making machine" that should be focused in generating the biggest profits possible to the shareholders, even if it means that it would come at the expense of the other constituencies that also bargain with the company: the stakeholders. For shareholder theorists, it is perfectly reasonable to dismiss 1000 persons to keep profitability levels or to refuse to engage in long-term

⁴¹ See the seminal work of Hall, P. and D. Sokice, Eds. (2001). *Varieties of capitalism: the institutional foundations of comparative advantage*. Oxford, Oxford University Press. ; see also Zumbansen, P. (2007). Varieties of Capitalism and the Learning Firm: Corporate Governance and Labour in the Context of Contemporary Developments in European and German Company Law. U. o. C. Centre for Business Research. ; Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." *Socio-Economic Review* 3(2). ; Höpner, M. (2005). Politisch-institutionelle Determinanten aktionärsorientierter Reformen, Max Planck Institute für Gesellschaftsforschung.

commitments with the stakeholders if it provides shareholders with a gain from their investments. They view the company purely in financial term. The stakeholder theorists are affiliated to the institutional/nexus of contracts theories of the firm and consider that, although the primary responsibility of the firm is in relation to shareholders, the survival of the firm depends on the promotion of the relationship with the stakeholders without whom the company may not survive. In the view of the stakeholder theorists, it is reasonable to refrain from making a profit in the short-term if it is necessary to ensure the survival of the company as a whole (which is not to be confused with the shareholders). The enlightened shareholder theorists are a reinvention of the stakeholder theorists that consider that the company is to be run in the interests of shareholders in the long-run. They consider that the management of the company is under a duty to promote the interests of the shareholders by means of the promotion of the relationships with the remaining stakeholders. The relationships with the remaining stakeholders are to be cultivated having in mind the long-term interests of the shareholders. The enlightened shareholder value theory is particularly important for labour representation and collective bargaining; if we consider that the management of the company in the long-term interests of the shareholders depends of the promotion of the relationships with the stakeholders and that employees are a particularly important stakeholder group because without them the company will be unable to function, then this opens a considerable margin of manoeuvre for the promotion of employee representation and collective bargaining because they are the channels by means of which employees may make their voice heard and have an actual impact in the management of the company or in the protection of their interests.

1.2.6. conclusion - Corporate Governance as a complex system that needs a variety of approaches.

The analysis of these distinct approaches to corporate governance appear to allow us to understand that they are mostly complementary rather than conflictual. The agency costs approach inherent within the contractual conception of the company appears to be the most wide ranging because it reduces corporate governance to its lowest common denominator. The

conceptualisation of corporate governance within the agency costs approach assists in understanding the remaining approaches; for instance, the evolution of capitalism emphasised by the historical approach might be conceptualised as a means of overcoming the agency costs that the development of capitalism entailed; the passage from the stage of personal capitalism to managerial capitalism (characterised by large companies with distinct ownership patterns) gave rise to a number of agency costs that did not exist in an economy characterised by small manager-owned companies; the financial approach might also be understood as the conceptualisation of the strategies for overcoming agency costs that the market/insider systems generate; the legal systems approach had the merit of bringing attention to the potential impact of the law - namely the protection of shareholders and the agency costs vis-à-vis managers that they necessarily entail - in the investment decisions; finally, the varieties of capitalism approach emphasises the role of the institutional complementarities in the reduction of agency costs within the firm and the distinct modes of functioning of firms. It equally shows us that there is not one but several distinct models of capitalism and that the optimal configuration of firms should vary in accordance with the distinct institutional endowments - i.e: the economic model adopted in the country - in which they are active. This allows us to conclude that these approaches are not exclusive but complementary and that they must be seen as a whole in order to understand the dynamics of Corporate Governance.

1.3. The scope of the comparative analysis

After having clarified which concept of corporate governance is going to be adapted in this thesis and the complementary approaches, it is now time to make a brief description of the dominant governance patterns in each one of the jurisdictions covered - Germany, France, the UK and Portugal. The reasons for the choice of each one of these jurisdictions lie in the recognition of their modelling role for each governance pattern. There are several distinct models of corporate governance, i.e. there are several patterns of interaction between each one of these distinct interest groups in corporate governance. These patterns of interaction consist in different forms of relationship between capital, management and labour; they were designed in specific circumstances

in time to provide an answer to some agency problems and give rise on their turn to other types of agency problems; each one of them has a comparative advantage that may be offset by the others; and each one of them is currently in a state of evolution that raises the question of knowing whether they are not going to become hybrid models in the future. This chapter will attempt to make a brief description of the existing models of corporate governance and the characteristics exhibited by each one of the jurisdictions to be studied.

1.3.1 patterns of corporate governance

The theoretical literature on corporate governance usually classifies the different corporate governance systems in models. These models consist in institutional arrangements between shareholders, management and labour that share some common characteristics. The following lines will proceed to describe the three distinct corporate governance models that the theoretical literature has distinguished: market/outsider systems, blockholder/insider systems and governmental systems.

a) market/outsider systems – market/outsider systems are prevalent in common law countries and are characterised by the following common traits: dispersed equity holdings, portfolio orientation among equity holders, a broad delegation to management of the discretion to run the business and liquid labour markets. Dispersed equity holdings point to the fact that companies seldom have a controlling shareholder or group of shareholders. It is relatively common to invest in the stock market and a large number of firms go public in order to gather the necessary capital to run their businesses. The necessary consequence of this large market capitalisation and dispersion is the portfolio orientation among shareholders. Shareholders seldom concentrate their investments in just one company; they prefer to diversify risk by spreading their investments in a number of distinct companies. A distinctive characteristic of these systems is the recognition of a broad discretion to the management board to run the business. This is a necessary consequence of the dispersed ownership structure and the disinterest that shareholders usually have for the management of the business. Since ownership and control are separated in these companies (meaning that no shareholder has sufficient voting power to

exert pressure upon the management of the company), the management is usually free to run the business as it best deems fit. Management discretion does not mean that boards are unaccountable to anyone however. Market systems are usually coupled with a number of external corporate governance devices that reduce the agency costs between management and shareholders. The final distinctive characteristic of market systems consists in its liquid labour markets. This expression intends to translate the reality that the working life in these countries is usually precarious, dependent on the results of the firm and with a low degree of social dialogue. Labour is seen as a commodity that may be dismissed when the firm is in a crisis.⁴²

The prevailing governance devices to reduce agency costs between shareholders and managers are affiliation rights and external devices. As regards the affiliation rights, if shareholders are unhappy with the way that the company is being managed – usually measures in terms of return of investment and share prices – they will simply sell their shares to other investors. They will not constrain management in any way or use other internal governance devices in order to make their voice heard. Whereas this might not constitute a problem when the sale of shares occurs in private dealings, it exposes management to takeovers. The market and the threat of takeover might act as an external disciplinary device on management, coercing them to act in the interests of shareholders. The only conclusion is that the freedom granted upon management is not so wide as it seems because they have to be very attentive to share prices in order to avoid takeovers. This explains why market/outsider systems are also connected to the idea of shareholder value as the objective of the corporation. There are no known mechanisms to reduce agency costs between employees in relation to managers and shareholders in these countries.⁴³

⁴² Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press, Gospel, H. and A. Pendleton (2005). Markets and Relationships: Finance, Governance and Labour in the United Kingdom. Corporate Governance and Labour Management: an international comparison H. Gospel and A. Pendleton, Oxford.

⁴³ Davies, P. and G. P. Stapledon (1993). Corporate Governance in the United Kingdom. Aspects of Corporate Governance. M. Isaksson and R. Skog, Juristförlaget, Colombera, M. (1996). "Le regole di corporate governance nel Regno Unito: il Cadbury Committee e il Greenbury Committee." Rivista delle società: 440-464.

Market systems have a number of advantages and disadvantages. As regards the advantages, market systems create incentives for investment by allowing shareholders to diversify their risk by creating investment portfolios. If we add to this feature the high liquidity prevalent in these markets, it becomes easy to understand why they have such active stock markets. Companies also benefit from market systems because it provides management with a great source of finance, encouraging business start-ups and management entrepreneurship in high-risk/high-dividend sectors (particularly new technologies). Finally, the high dispersion of capital reduces the room for majority/minority shareholder conflicts and facilitates the evaluation of management on objective criteria: since management cannot collude with the majority shareholders in order to expropriate minority shareholders and employees, it must provide objective criteria to the shareholders as a class in order for them to evaluate their performance and decide whether to maintain their investment or sell their shares.

As regards the disadvantages, market systems are criticised for being too focused on short-termism, being too unstable and lacking internal governance devices to ensure that management acts in the interest of shareholders. Market systems are usually focused on short-termism, meaning that management has to deliver quick-results to the shareholders if it wants to avoid the threat of takeover. This might not be the most rational attitude however, since certain markets depend on a longer-term view and firm-specific human capital investments in order to for the business to be profitable. This is particularly so in certain technological companies, in which investments only pay-off in a medium to long-term perspective. Therefore, short-termism is said to create agency problems between shareholders, managers and employees. Another criticism generally pointed out to market systems consists in its instability. The high prevalence of takeovers and shareholder litigation introduces elements of instability in the company, which might endanger its business strategy and render the company prey to a number of investors. Market systems are also criticised for lacking internal governance devices to ensure the reduction of agency costs. The introduction of outside monitors on the board of directors was seen as a positive measure to ensure the reduction of agency costs because the internal governance structure of the firm will have

an element independent of the management that is responsive to the shareholders.⁴⁴

b) relational/insider systems – in contrast to the market systems, relational/insider systems are characterised by concentrated ownership, intense dialogue between capital and management and a moderate level of employee intervention in the affairs of the company. Concentrated ownership refers to the existence of a majority or near majority of stock held by one investor or a concise group of large investors. These large investors are normally individuals, families or other firms, in particular banks. The concentration of ownership in the hands of a small number of individuals entitles them to exercise effective control over the company. They are the ones who have the greatest influence in the running of the affairs of the company. Like market systems, blockholder systems leave the orientation of the company to the hands of the management. However, in contrast to the market systems, there is an intense level of dialogue between management and the major shareholders of the company. Large block investments allow majority shareholders to have the greatest influence in the election of the management and to closely monitor them in their activity. They are entitled to privileged information rights and may easily use their voting power to coerce management into orienting the company in accordance with their interests. Relational/insider systems are also normally gifted with variable levels of employee intervention in the life of the company. Employees are normally regarded as key stakeholders and are provided with a number of intervention rights in the life of the company.⁴⁵

Relational systems have a number of advantages and disadvantages. As regards the advantages, the majority shareholder's preference for a voice strategy in reducing the agency costs of their relationship with management is seen as extremely advantageous. The firm-specificity of their investments creates incentives for them to monitor management closely and ensure that the

⁴⁴ Bratton, W. W. and J. A. McCahery (2002). Comparative Corporate Governance and Barriers to Global Cross Reference. Corporate Governance Regimes - convergence and diversity J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford. Isaksson, M. and R. Skog, Eds. (1994). Aspects of Corporate Governance Juristförlaget.

⁴⁵ Monks, R. A. G. and N. Minow (1995). Corporate Governance, Blackwell Business, Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage, Oxford, Oxford University Press.

firm is run to their best interest. But in contrast to the market systems, where the governance devices are essentially external, relational systems allow managers and shareholders to engage in a dialogue to clarify the strategy that the company is going to pursue. This is seen as positive because it allows management to perform long-term investments and firm-specific investments in human capital without having to fear the constraints of the stock-market and the threat of takeover. On the other hand, if management fails to pursue the adequate strategy, they may easily be dismissed without a modification in the ownership structure of the company, thus ensuring the stability of the business. As regards the disadvantages, relational systems are said to give rise to two types of agency problems: those that arise between majority and minority shareholders and majority shareholders and employees. Since majority shareholders have an effective control of the company, they might coerce management to engage in investments that benefit specifically the large investors, to the detriment of small investors; on the other hand, there is the problem of knowing whether the majority shareholders will expropriate employees. That is the reason why relational systems are characterised by two types of governance devices to reduce these agency costs: trusteeship strategies and appointment rights. The first type of strategies refers to the existence of a separate board to control the activity of the management and ensure an adequate representation of the interests of all shareholders; in Germany, this is made by the paradigmatic supervisory board (*Aufsichtsrat*); the second type of strategies refers to the existence of employee representative structures that are entitled to a number of powers in relation to management and ensure the representation of their interests in the decision-making structures of the companies. The paradigmatic example is the German co-determination (*Mitbestimmung*) regime, which obliges supervisory boards to have a number of representatives of employees but one may also mention the Dutch Law on the structure of companies (*Strukturwet*) or the French Law on mandatory bargaining with the employees in some respects (*obligation de négocier*). Both of these devices are designed to reduce the agency costs that majority shareholders face vis-à-vis minority shareholders and employees.⁴⁶

⁴⁶ Ibid, Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford.

c) governmental systems – the final governance pattern relevant to my thesis consists in a subtype of relational systems prevalent in central and southern Europe. In central and southern Europe in general and in France in particular, the dominant corporate governance pattern was dictated by the State, who assumed an interventionist role in the economy and effectively owned and controlled the most important corporations. The State control was achieved by three distinct means: one means was by direct State shareholdings in large corporations; they dominant shareholder in the key companies of those systems was the State, who used them to pursue their own political agendas. When the State did not have a majority shareholding in those companies, it attempted to hold control of them by other strategies such as golden shares (shares with special voting or nomination rights belonging to the State), political ties (the persons in charge of the company were politically affiliated to the dominant political forces), control of the sources of finance (such as control of banks and insurance companies) and cross-shareholdings. The main difficulty in capturing the governance dynamics of these types of systems consists in the fact that the traditional agency problems that I mentioned above do not work here. The State pursues its own political agenda, in a traditionally dirigist attitude to the economy, which may go for or against all or some of the relevant interest groups in the company. Therefore, the understanding of the Governance dynamics of the southern European companies does not depend solely on the analysis of the self-interested behaviour of the different interest groups in the company but also of the taking into consideration of the political dynamics that influenced the course of the countries in the last years.⁴⁷

1.3.2 the selection of the four countries

Each one of the governance patterns briefly described above are prevalent in three countries that function as the paradigm for them: the paradigm for market/outsider systems is the UK; the paradigm for relational/insider systems is Germany; and the paradigm for Governmental systems is France. The

⁴⁷ Hansmann, H. and R. Kraakman (2000). The end of history for corporate law. Program for studies in law, economics and public policy, Yale Law School, Goyer, M. and B. Hancké (2005). Labour in French Corporate Governance: the missing link. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford, Tiberghien, Y. (2007). Entrepreneurial States. Reforming Corporate Governance in France, Japan and Korea, Cornell University Press

following lines will attempt to describe shortly how each one of the governance patterns was implemented in each one of these countries. Portugal will equally be added to the analysis. The introduction of Portugal will serve to demonstrate further how a small economy has managed to readapt itself to the international trends in corporate governance.

a) Germany - in virtually all studies about corporate governance, Germany is presented as the model of a stakeholder oriented governance pattern. The fundamental characteristics of the German corporate governance system rest in three distinct but complementary characteristics: (a) a highly concentrated ownership structure with a dominant role of banks in the financing of the company and in the supervisory board; (b) a highly technically specialised management with a productivist orientation; (c) an extensive system of labour co-determination. Taken together, these features are said to favour a consensus orientated culture in the management of the company that favour incremental improvements in the production and a long-term investment culture, that shields German companies from the fear of the stock markets.⁴⁸

The ownership structure in German corporations exhibits a high degree of concentration. This means that the shareholdings of German companies are in the hands of clearly identifiable individuals or groups of individuals that have no collective action problems and may exercise control over the company. This high degree of concentration derives from: (1) the dependence of the company of the actions of a number of interest groups; (2) the strategic interests of other organisations and (3) the importance of banks in external finance and monitoring. German companies were in the hands of large investors and minority shareholders played only a limited role. In a study dated from 2001, only 9.5% of the shareholders of the largest 650 German companies held less than 5% of the shares of the company; the majority of the companies exhibited shareholders that held more than 75% of the shares (38,1%) or between 10-25% of the shares (17,8%). If we consider the total number of Aktiengesellschaften in Germany (the preferred legal form for large companies), 71,67% had one single owner that held more than 50% of the

⁴⁸ Jürgens, U., J. Rupp, et al. (2000). Corporate Governance and Shareholder Value in Deutschland, Wissenschaftszentrum Berlin für Sozialforschung.

shares; 38% held more than 65% of the shares of the company; and merely 9,5% held less than 5% of the shares of a company. If the analysis is extended to the GmbH (the preferred legal form for small and medium sized companies), the figures claim that 69,54% have one owner with more than 50% of the shares. The situation is similar if we consider the two admitted forms of limited partnership in Germany - the Kommanditegesellschaft and the GmbH & Co KG⁴⁹ in which the proportion of persons holding more than 50% of shares were 78,68% and 69,15% respectively.⁵⁰ A high proportion of firms remain unlisted private companies and the number and market capitalisation of listed corporations is low in international standards. This concentration of ownership is particularly important if we take into consideration that German company law allowed for important deviations from the one share/one vote principle in public companies. The Aktiengesetz allowed both for the existence of multiple voting rights and voting caps, which reduced the necessity for proportionality between ownership and control and allowed a small number of investors to have a decisive influence on the firm without having to invest the correspondent amount of capital.⁵¹ Another distinctive characteristic of German corporate governance consisted in the network of cross-shareholdings that large public corporations were embedded in which connected the destiny of a company to the strategic interests of the other organisations. This network was achieved by means of pyramidal conglomerate holding companies (*Konzern*) and dense industry-bank networks. The following scheme reveals the degree of interconnection between the 100 largest German public companies:⁵²

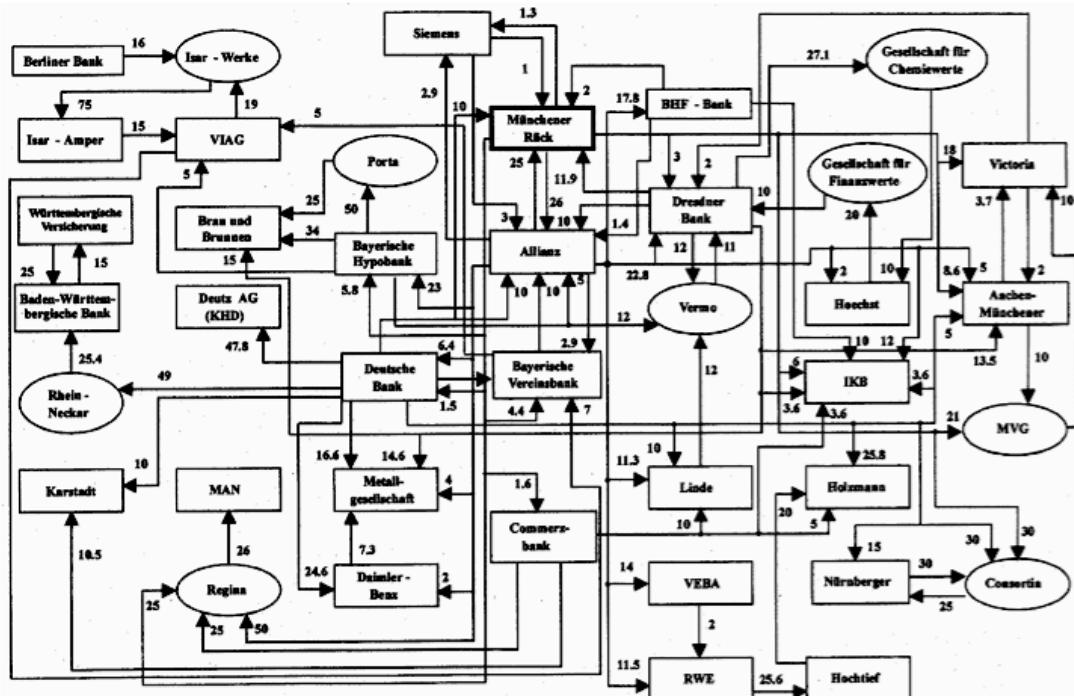
⁴⁹ The difference between the Kommanditegesellschaft and the GmbH & CO KG is simple. Whereas the former is a simple limited partnership with a natural person as the general partner, in the latter the general partner is a GmbH.

⁵⁰ Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203.

⁵¹ Commission, E. (2007). Report on the proportionality principle in the European Union, European Commission.

⁵² Adams, M. (1999). "Cross holdings in Germany." *Journal of Institutional and Theoretical Economics* 155(1): 80-109.

Figure 1: The German Network of Cross Holdings



These ownership stakes involve high levels of commitment to particular companies, unlike the most diversified and liquid trading of market systems. Institutional shareholders (corporations and banks) tend to pursue strategic organisational interests in promoting cooperation between firms and generating relationship specific rents. These dense intra-corporate networks suppress markets for corporate control and create incentives for voice rather than exit. There is also a very important element connected to this system of cross-shareholdings, which consists in interlocking directorates. Interlocking directorates consist in a form of cooperation between companies in which the representatives of one company sit at the board of the other, in order to ensure the flow of information between the companies and the coordination of their activities. Considering the degree of cross-shareholdings between the firms, it is not surprising that banks and other companies set up personal interlocks by seats on the supervisory board of the respective firms, thus exercising a decisive influence on the appointment, decisions and dismissal of the management board.⁵³ These personal interlocks are characterised by

⁵³ It is worth noting that the main organ of German public companies is not the general meeting of shareholders but the *supervisory board* (Aufsichtsrat), which is elected by the shareholders and employees and has the task of nominating and supervising the activities of the *management board* (Vorstand). For a comparative perspective see Barbiera, L. (2000). Il Corporate Governance in Europa - amministrazione e controlli nelle società per azioni in Italia, Francia, Germania e Regno Unito. Milano, Giuffrè.

extremely close relationships and interdependencies between board members of different companies in Germany. Jürgens/Rupp stress these characteristics as they call the attention to the fact that the persons who sit at the supervisory boards and have the task of controlling management are part of “*an encompassing network that functions as a means of social integration and cohesion among the business elites and to whom they owe the position they have*”.⁵⁴

A final word must be given to the fundamental importance of banks in German corporate governance. German banks play a central monitoring role. Banks are closely related to businesses through credit, large equity stakes, the exercise of proxy votes and supervisory board representation. Banks intervene in governance through credit because they are the main external sources of financing of corporations, amounting to circa 65% of the external sources of finance. The credit tends to be relational and is generally coupled with other governance devices that ensure the correct application of funds. Another main characteristic of German banks consists in large shareholdings. These shareholdings may be either direct (in the name of the bank) or indirect. The main forms of indirect shareholdings consists in the setting up of subsidiaries (*Vorschaltgesellschaft*) and investment funds. A *Vorschaltgesellschaft* consists in a firm set up by banks and other financial firms, which holds large stakes in public corporations. The function of the *Vorschaltgesellschaft* is to function as a white knight in hostile takeovers. Investment funds consist in financial instruments set up by banks and other financial companies destined to invest in firms by means of equity holdings. Although the law requires investment fund managers to vote the shares themselves and not give proxies to third parties, this provision does not exclude an informal agreement between the manager of the fund and the bank about how to vote. German banks also exercise decisive influence on public corporations by means of proxy votes. There is a tradition that shareholders deposit their shares with banks together with a proxy (written power of authority) that authorises the bank to vote in the name of the shareholder. The proxy cannot be given for more than 15 months and is revocable at any time. The bank is allowed to vote in accordance with what it

⁵⁴ Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203.

deems better in the absence of specific recommendations of the shareholders. The combination of large equity stakes (direct and indirect) and the exercise of proxy votes allow banks to have a decisive influence on the election to the supervisory board of German companies. According to some estimates, they may represent circa 82,67% of all votes present at the meetings.⁵⁵ This leads us to the a very important point as regards the participation of banks in German corporate governance: its presence at the supervisory board. Banks hold seats in nearly all major companies' supervisory boards. The reason for their taking up of such an active involvement in the affairs of the company is connected to their role as the main providers of credit: they have to supervise the activity of the company in order to ensure that their funds are being well-spent. This monitoring role of banks is regarded as a widely positive thing since not only this encourages relations credits and shelters companies from short-term pressures from the stock market but also it ensures an effective mechanism of representation of the interests of small shareholders by means of the system of proxy votes. This reduces the agency problems that may occur between small shareholders vis-à-vis large shareholders and ensures a more balanced governance. A last very important point concerning the role of banks is the fact that these banks are regionalised. Each Bundesland in Germany exhibits its own bank - named as savings bank (Sparrkasse) - which collected savings from the persons living in the region and invests in the company of the region. These banks are normally owned by the regional government and are destined to tie the interests of the industry to a particular region by means of a privileged relationship with the local bank.⁵⁶

Management consists in the second distinguishing feature of German corporate governance. German corporations are said to have a technically oriented management much biased towards incremental improvements in the

⁵⁵ Baums, T. (1999). "Il sistema di "corporate governance" in Germania ed i suoi recenti sviluppi" Rivista delle società: 1-19.

⁵⁶ Beyer, J. and M. Höpner "The disintegration of organised capitalism: German corporate governance in the 1990s." West European Politics 26(4): 179-198, Schmidt, H., J. Drukarczyk, et al. (1997). Corporate Governance in Germany. Baden-Baden, Nomos Verlagsgesellschaft, Backhaus, J. G. (1999). Company Board Representation. The Elgar Companion to Law and Economics. J. G. Backhaus, Cheltenham, Barbiera, L. (2000). Il Corporate Governance in Europa - amministrazione e controlli nelle società per azioni in Italia, Francia, Germania e Regno Unito. Milano, Giuffrè, Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203.

production. This orientation is derived from several institutional features making up the world of German management boards. Management careers tend to follow functional specialisations; educational backgrounds in science and engineering dominate the highest positions, managers remain closely tied to their occupation and lack a generalist orientation. The strong tendency for technical functions to be incorporated into the management board limits the relative importance of financial considerations. Managerial authority also tends to be rooted in technical competence rather than in supervisory or business related skills. Management is not so strongly set apart from other occupational grounds in either educational backgrounds or forms of compensation. This productivist ethos of the business organisation acts as an integrating mechanism, with a strong focus on incremental innovation, quality standards and the build up of long-term market shares. Another distinctive characteristic consists in the legal principle of collegiality in management decision-making; this principle works against the strong dominance of the President and balances financial considerations with other managerial functions, such as operations and personnel. Finally, moderately high rates of internal promotion and long management tenures help to stabilise the long-term relations that managers enjoy with their suppliers, customers, banks, works councils and other corporations. The limited role of the external labour market favour the orientation towards long term profit instead of short term success. Managerial compensation also traditionally avoids high-powered incentives, such as stock options.⁵⁷

This technical orientation of German management stands in sharp contrast to the financial and marketing orientation predominant in market outsider systems. This explains the predominance of engineers in German management boards and the high status that they enjoy there. This philosophy was exemplary synthesised in the words of P. Lawrence:

⁵⁷ Jackson, G., M. Höpner, et al. (2005). Corporate Governance and Employees in Germany: changing linkages, complementarities and tensions. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford.

“Technik exerts a pervasive influence on German firms and on German managerial thinking....the German company is Technik in an organisational form. The skilled worker, the foreman, the superintendent, the technical director are all participants in Technik. Of course, there are many things which they do not have in common, but Technik is something which transcends hierarchy. It may also transcend particular functions in the company.”

“This somewhat de-economised view which German managers have of the business enterprise is central. The idea that the firm is not a “money-making machine” but a place where products get designed, made and eventually sold, with profits ensuing, tends in Germany to restrict the allure of accountants and financial controllers and to dignify the makers and those associated to them.”⁵⁸

It becomes easy to understand why German management boards are considerably more concerned with cost-reductions and the improvement of the quality of the final product than the reaching of financial objectives and financial operations with other companies. The following table proves the discrepancy of management philosophy between German and Anglo Saxon boards. The figures do not need further explanations:⁵⁹

Percentage of management that accounts the following objectives among their three main purposes:	UK	Germany
Reaching of financial objectives:	72%	53%
Takeovers, mergers, joint ventures and spin-offs	46%	28%
Cost-reduction	15%	36%
Improvement of productivity	15%	36%

The final pillar of German corporate governance consists in its extensive system of employee codetermination (Mitbestimmung). Employee voice is strongly institutionalised in German companies by two means: firstly, by means of the institution of the works council (Betriebsrat), which may be set up in all

⁵⁸ Lawrence, P. (1980). *Managers and management in West-Germany*. London, Croomhelm.

⁵⁹ Jürgens, U., J. Rupp, et al. (2000). Corporate Governance and Shareholder Value in Deutschland, Wissenschaftszentrum Berlin für Sozialforschung.

companies having a minimum of five employees. Works councils enjoy extensive rights to information, consultation and co-determination (meaning that certain managerial decisions may only be implemented with the agreement of the works council). Secondly, in public companies of a certain dimension, employees may elect up to half of the representatives at the supervisory board.⁶⁰ This strong form of employee representation in the boards of companies is complemented by a number of external factors that ensure that the labour market is de-commodified. This de-commodification of labour consists in the high specialisation of workers in branch-specific skills (in contrast to firm-specific skills) that is achieved by a quasi-public system of employee training financed by branch-wide employer organisations. Strong occupational identities act against generalist careers and elaborate internal promotion. Internal hierarchies tend to be flat and the occupational qualifications of supervisors tend to overlap with those of subordinates. Wage differentials between firms and regions are low on account of strong industry-wide bargaining. Employees tend to be highly flexible in the workplace. This institutional endowment underpins the major characteristics of German employee participation in corporate governance: employees are not treated as commodities but as a strategic resource of companies; the views of the employees must be taken into account on the basis of the extensive system of employee co-determination. This reinforces the consensual nature of the decision-making structure of the board and the adequate representation of the interests of a key stakeholder – employees – in the company.⁶¹

It is easy to conclude now why Germany is considered to be the model of insider/relational governance patterns: the high degree of ownership concentration (coupled with significant deviations from the principle of one

⁶⁰ There are three levels of co-determination in large companies. In companies employing between 501 and 1999 employees, employees may elect up to 1/3 of the seats in the supervisory board (*Mitbestimmungsgesetz* 1952); in companies employing more than 2000 employees, employees may elect up to ½ of the seats, with the safeguard that the chairperson elected by the shareholders has a quality vote in technical ties (*Mitbestimmungsgesetz* 1972); in companies of the iron, steel and coal industry, employees have full co-determination (*Montan-mitbestimmungsgesetz*). See Schaub, G. (1996). *Arbeitsrechtshandbuch - systematische Darstellung und Nachschlagewerk für die Praxis*, C.H Beck. and Däubler, W. (2006). *Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb*, Rowohlt Taschenbuch Verlag

⁶¹ Jackson, G., M. Höpner, et al. (2005). Corporate Governance and Employees in Germany: changing linkages, complementarities and tensions. *Corporate Governance and Labour Management: an international comparison*. H. Gospel and A. Pendleton, Oxford.

share/one vote) ensures that companies are in the hands of a small number of investors; the central role of banks ensures the representation of minority shareholders and the exemption of management from the pressures of credit; the pattern of interlocking ownership reduces the scope for deadly competition between firms and creates a climate of cooperation and interdependency, that shields companies from hostile takeovers; the dependency of the management from the supervisory board and the managerial culture create incentives for long-term relations and incremental innovations, rather than merely the pursuit of market objectives; the legal institutions for employee representation ensure the de-commodification of labour and the taking into account of their interests in the decision-making structure of the company. This creates incentives for voice rather than exit and a consensus oriented culture between all interest groups in the company.

b) UK – similarly to Germany, the UK is also represented as a paradigmatic model but of market/outsider patterns of corporate governance. The fundamental characteristics of the Anglo-saxon system rest in three topics: (1) a dispersed ownership structure with a strong presence of institutional investors; (2) a finance-orientated management widely attentive to the signals of the stock market and (3) liquid labour markets in which the labour force is seen as a commodity.

The ownership structure of English public companies stands in sharp contrast to the one presented in the former chapter. As a preliminary point, one must say that equity markets play a fundamental role in the system. The market capitalisation of domestic firms listed in the London stock market is more than the double of the one found in the German exchange and greater than the one found in the Euronext. The market capitalisation of the largest 700 companies reaches the threshold of 80% and London is the most important stock exchange in Europe. Another considerable dimension consists in the fair dispersion of the ownership of firms especially among the largest firms with the widest market capitalisation. Only 16% of the largest 170 quoted firms have a shareholder with more than 25% of the equity, in contrast to 79% in France and 80% in Germany. However, despite the dispersion of ownership, institutional investors heavily dominate the equity market in the UK. For this purpose, institutional investors do not mean banks and financial companies (as in

Germany) but pension funds, insurance funds, unit trusts, investment trusts and other non-bank financial institutions. These institutional investors own circa 50% of the total equity traded in the UK. Overseas investors own an additional 32%. In contrast to the situation described in Germany, commercial banks do not have the tradition of investing in equities to a significant extent. Similarly, there is little cross-ownership of firms (less than 1%) and family ownership is of little or no significance being reduced to a small number of companies that remain for several reasons in a residual number of families. The nature of the ownership is also a significant element. Although institutional investors own circa 50% of all equity traded, there is considerable ownership dispersion on account of the investment strategy pursued by these investors. These institutional investors follow the strategy of dispersing their investments through a number of firms, avoiding putting all the eggs in one basket and expecting to collect gains either from the results of several companies or from the sale of shares to other investors; therefore, firm specific investments are residual. The primary reason for investment is a financial one and not to secure private benefits of control. This is an extremely important element if we combine it with the central role of pension funds (both domestic and overseas) in the system. Pension funds hold circa 1/3 of the equity market by value. In contrast to the strategy of other institutional investors – in particular insurance funds – who prefer fixed interest assets – in particular bonds and property – on account of its predictable and stable outflows, pension funds prefer quick returns from equity. This picture is completed by the attitude of specialist fund managers. These managers have weak incentives to participate in the governance of companies and exercise voice strategies because their remuneration is usually tied to the results that they may provide to the contributors to the fund and because they bear the costs of intervention but do not reap the benefits of voice: their contracts are usually for 3-5 years and their reputation and gains depend on the amount of money that they may generate to the members of the fund during that period.⁶²

⁶² Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582. ; Gospel, H. and A. Pendleton (2005). Markets and Relationships: Finance, Governance and Labour in the United Kingdom. *Corporate Governance and Labour Management: an international comparison* H. Gospel and A. Pendleton, Oxford.

The management of Anglo-saxon companies also differs to a great extent from the one found in German companies. The first striking element of differentiation concerns the education of managers; the predominant educational backgrounds of British managers consist in finance and marketing. This is in itself a significant element because it reveals that they are much more sensible to the need to deliver financial results than to create products. Also, in contrast to the situation found in Germany, where the path to the management ladder depends on a number of internal job promotions, in the UK there is a great external labour market for managers. Managers are normally recruited from outside the company and they are expected to bring proofs of value into the firm. The most important element consists in the management's dependency on delivering results to the shareholders. The reason underpinning this strong financial logic of management lies in the external and internal devices for the reduction of agency costs used in British companies. As regards the external governance devices, the most important external device consists in the market for corporate control. The legal and institutional environment in the UK is extremely favourable for the occurrence of hostile takeovers in a number of grounds: the City Code on Takeovers and Mergers places the decision on the success or failure of the bid solely on the hands of shareholders; the mechanism underpinning this shareholder primacy philosophy consists in the duty of neutrality incumbent upon management, which forbids the management of the target company of undertaking any action that might frustrate the bid or deny an opportunity to the shareholders without the approval of the shareholder in a general meeting and the provision of enough information and time to make a reasonable decision as to the merits of the bid. The presence of institutional shareholders also creates incentives for the existence of hostile takeovers. Institutional investors regard the companies in which they hold equity merely as financial investments and they do not wish to have any kind of relational links with the management of the company; this is even more evident with some institutional investors (mainly pension funds) that tend to value short-termism because they have to provide quick and sound results to their members. This ownership structure has the following consequences: institutional shareholders become not only are receptive to takeover offers that might provide them in the short-term with an advantage but they also want the management of the companies in which they invest in to be

conscious of those facts, so that they will take due regard to their interests. The impact of these circumstances for labour is very detrimental because labour is merely regarded as a commodity in British firms and mass redundancies in order to keep profitability levels and stock prices, in order to meet the financial demands of shareholders, are not uncommon.⁶³

As regards the internal governance devices, there are also mechanisms to reduce the agency costs that derive from the separation of ownership and control that act within the company. In general terms, British corporations use the following mechanisms: shareholder rights, board structure and composition and executive remuneration. As regards shareholder rights, British investors are very keen on maintaining the power that they enjoy in corporations and they have long held campaigns in order to eliminate non-voting shares and create pre-emptive rights for the existing shareholders in the issue of new shares. The idea is to create a system of proportionality between ownership and control of the company (one share/one vote) and be able to secure their control of the company by opposing the entry of any new unwanted shareholder in the company that might disturb their balance of interests. As regards the board structure and composition, the main pressure of investors is to introduce a system of checks and balances to constrain the concentration of power into the hands of the President of the board. The pressure goes in the sense of splitting the role of chairman and chief executive officer and introducing a number of independent directors in the board whose function will consist in the control of the activity of the management. Finally, the practices of executive remuneration provide the last element to the puzzle: the pressure of shareholders go in the sense of tying the remuneration of management to results, set up remuneration committees to decide the remuneration of the work of the management and to limit the compensation paid to managers on account of their dismissal. The idea is to tie the interests of managers to those of shareholders.

The consequence of these policies upon the behaviour of management can be easily observed. Since shareholders prefer to exercise strategies of exit rather than voice, they prefer quick financial results, management is recruited

⁶³ Davies, P. and G. P. Stapledon (1993). Corporate Governance in the United Kingdom. Aspects of Corporate Governance. M. Isaksson and R. Skog, Juristförlaget.

from outside the firm, there is a number of external and internal governance devices that compels management to be particularly attentive to the interests of shareholders and the management board is expected to provide financial results to the shareholders in terms of dividends and share price appreciation. This explains why management is greatly oriented towards the provision of financial results: surveys reveal that 70% of managers believe that the interests of shareholders should be given first priority (in contrast to 17% in Germany and 22% in France) and 89% believe that companies should be able to maintain dividends at the cost of employment reductions (in contrast to 40% in both Germany and France). This situation differs sharply from the one found in Germany because the firm is seen as a money-making machine and not as an institution per se.

A final word must be given to the situation of employees in British firms. Once again, the situation couldn't be more different from the one analysed in the former paragraph. Whereas German labour markets contain a number of institutions designed to de-commodify the performance of labour, in the UK labour is really seen as a commodity in British firms. This is underpinned in a number of different mechanisms: there is no mechanism for the participation of employees in the decision-making structure of the firm; the management board is elected solely by the shareholders and is accountable solely to the shareholders. Management may perfectly disregard the interests of labour in their business strategy because there is no internal governance mechanism that forces them take into account their interests.⁶⁴ As regards collective bargaining, there is no sector-level or national-level system of collective bargaining to reduce wage differentials and avoid wage competition between firms and regions; all collective bargaining takes place at the level of the shop by means of shop-stewards, who are often politically bond to the political interests of trade unions and have a temptation to free-ride on the sacrifices of

⁶⁴ The strength of this statement must be reconsidered at the light of two points. Firstly, this paragraph is merely describing the fundamental characteristics of the system and disregards the impact that European law has had on the structure of companies. This particular aspect will be left for the final chapter of my thesis. Secondly, this statement disregards the fiduciary duties that managers owed to employees already under section 309 of the Companies Act 1985 (which was reformulated in 2006). This aspect was disregarded because, although managers owed fiduciary duties to employees, there were no internal governance mechanisms designed to enforce it. The discussion further below, concerning the analysis of the evolution of the management of companies, will describe these aspects in greater detail.

others. There is equally no system of extension of collective agreements and the principle of voluntarism - a fundamental characteristic of the British system of industrial relations - implies that collective agreements are not binding neither for the employer nor for the trade unions. Finally the protection afforded to the interests of labour either by statute law or by the common law is very weak in comparison with continental European countries and employees may be dismissed with little or no cost.⁶⁵

The consequences of this philosophy are easy to guess: labour is seen as an element outside the company, a strategic resource to be used by the company and not truly a constituent element of the company. The company should be run primarily to the interests of the shareholders and the labour force should be used in the same way as other resources in the promotion of those interests.

It becomes easy to conclude now why the UK is considered to be the model of market/outsider systems of corporate governance. Its dispersed ownership structure, the nature of the investors (mainly institutional investors), the preference for exit instead of voice (because shareholdings in the company are seen essentially as a financial investment), the pressures from the stock market and internal governance devices and the weak room for the representation of the interests of stakeholders – mainly employees – in the decision making structure of the board, make the management of UK corporations extremely dependent of the humours of the shareholders. There is little or no room for the consideration of the interests of other constituencies apart from the shareholders. This makes the corporate governance regime extremely shareholder-oriented and the use of the firm merely as a financial device.⁶⁶

⁶⁵ Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher.

⁶⁶ Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." British Journal of Industrial Relations 41(3): 557-582, Rickford, J. (2004b). "The emerging european Takeover Law from a British perspective." European Business Law Review: 1379-1421, Deakin, S., Richard Hobbs, et al. (2005). Anglo-American Corporate Governance and the employment relationship: a case to answer?, ESRC Centre for Business Research, University of Cambridge, Poole, M., Roger Mansfield, et al. (2005). "British managers' attitudes and behaviour in industrial relations: a twenty year study." British Journal of Industrial Relations 43(1): 117-134.

c) France – the French system of corporate governance should be isolated from the traditional market vs relational regimes because it represents a governance style that is predominant in southern Europe. Although ownership is considerably concentrated in this governance regime, there are two distinguishing features that significantly modify the picture in relation to the German governance pattern and make it worthy of an isolated structure: firstly, the State has a fundamental dirigist role of the economy and influences to a great extent the prevalent governance patterns in large companies; secondly, although labour has significantly more mechanisms for internal representation in the governance of firms, it is still considerably weaker than their German counterparts. This alters to a considerable extent the equilibrium between the different interest groups within the company and creates a specific governance pattern. This section will attempt to analyse in the following lines the predominant characteristics of the French system. A division must be traced however between the major French companies that compose the so-called coeur financier (financial heart) of France and other large companies. The main governance characteristics of the companies composing the coeur financier consist in (1) governmentalism, (2) a publicly educated management, (3) concentrated ownership structure with heavy state influence and cross-ownership between large corporations and (4) weak labour influence. In companies outside the coeur financier of French companies, the major characteristics of those companies may be the following: (a) concentrated ownership structure in the hands of families and groups of individuals, (b) management strongly dependent of the owners of the company, frequently bond by family ties and (c) weak labour influence. It is worth reviewing each one of these characteristics in detail.⁶⁷

The analysis should initiate with the role of the State in French Corporate Governance. The understanding of the role of the State in French corporate governance should begin with a review of the French perspective on the firm. The traditional attitude of France towards corporations can be perfectly summarised in its institutional theory of the firm: the firm is seen as a creation of society that should promote the interests of society while promoting

⁶⁷ See the fundamental study of Goyer, M. and B. Hancké (2005). Labour in French Corporate Governance: the missing link. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford.

the interests of shareholders. The focus on shareholder value is seen as a profoundly negative thing, the purpose of the corporation and the task of managers should be to favour the prosperity and continuity of the firm and advance the interests of all interest groups in the company: in this sense, the philosophy of the firm takes into account the interests of a number of stakeholders.⁶⁸ The State is seen as an independent arbitrator between the different interest groups that compose the company; it is perceived as the best actor to ensure the alignment of the interests of all interest groups in accordance with the societal interest that the firm should serve. The State should command the economy in the name of a political ambition and of a strive for social progress; it acts in the name of the societal and economic actors. The reasons for the attribution of this role to the State lie in two distinct characteristics of the French society: the polarisation of interests and the chronic difficulty that these interest groups face to reach a consensus, since the notion of compromise in French culture often has a negative connotation, meaning “least optimal solution”. The State is seen as the perfect referee that ensures that all interest groups are represented and that no one dominates over the other.

The influence of the State in the governance of companies could be seen in four main areas: industrial politics, financial circuit, governance structure and publicly educated management. Industrial politics led the State to interfere directly with certain important corporate strategies; the administrative regulation of certain sectors conditioned the behaviour of the actors in those sectors and attempted to guarantee the public interest. The control over the financial circuit was a significant vehicle of influence; since companies needed money to function, the State influenced the governance of those companies by influencing the conditions of access to finance and establishing relational forms of financing that influenced the behaviour of the management. The State equally interfered directly in the governance structure of the most important companies; for instance, they held shareholdings in the most important

⁶⁸ The *institutional theory* is opposed to a *contractual theory* of the firm, which sees the firm merely as a civil law contract between *the shareholders* and should be used to promote the interests of *the shareholders only*. Please note that the French contractual theory of the firm is not equivalent to the perspective of the firm as a *nexus of contracts*, since the contracts covered in the latter theory are established with the shareholders and with third parties. See Cozian, M., A. Viandier, et al. (2002). Droit des Sociétés. Paris, Litec, Merle, P. (2008). Droit Commercial. Sociétés commerciales, Dalloz.

companies and special rights were attached to those shares, meaning that the nomination of the management board of those companies often depended of governmental decision; finally, a significant part of the managerial elite owed their education and professional experience to the public education. The best example of State influence in the economy may be seen in the concept of coordinated capitalism that was prevalent in France and continental Europe from the 1940s to the mid-1980s: the State nationalised the most important sectors of the economy; it imposed strong regulatory burdens on important companies that remained in private hands (such as financial companies, which had their loan contracts determined by law or subject to public approval); it competed on unequal grounds by providing better conditions to the industry (such as lower interest rates for loans); it influenced the composition of management boards in all important companies. Therefore, the State is an inevitable actor in French corporate governance because its action infiltrates to the core of the economy. The best description of it is colberist: protectionist and dirigistic on the one hand and investor and entrepreneur on the other.⁶⁹

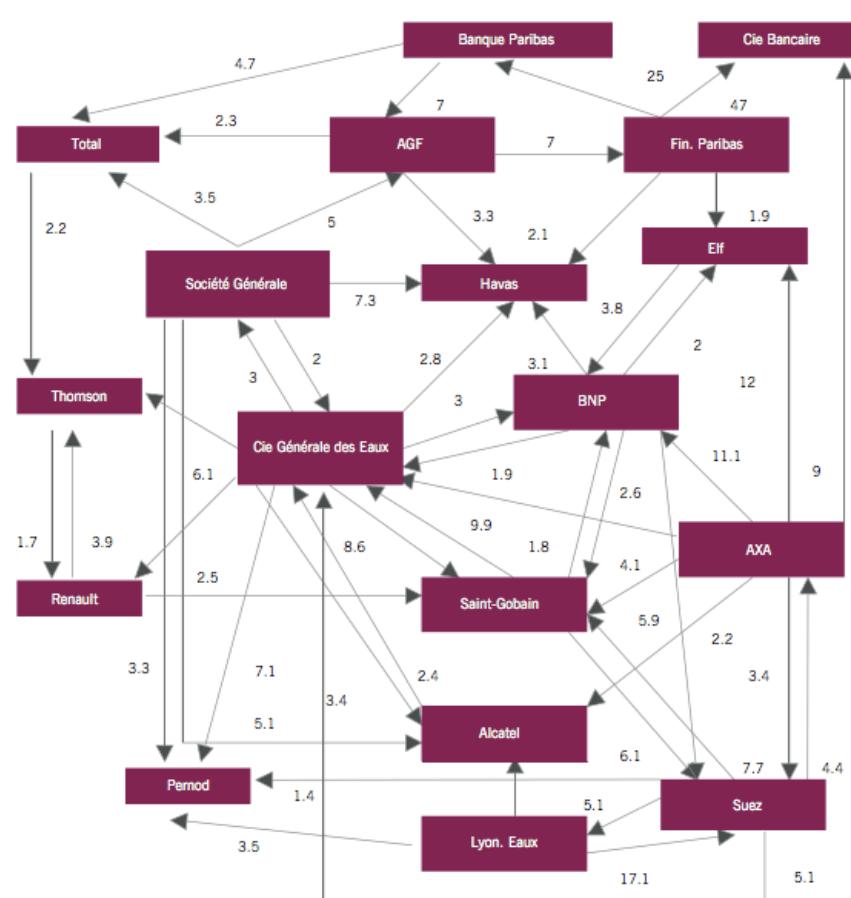
The ownership structure of French firms also influences to a great extent its governance pattern. The ownership structure of French firms in 1997 exhibited the following characteristics: if we take as a sample the CAC40 companies, the ownership structure of the is heavily concentrated in the hands of a dominant shareholder or group of shareholders; in this sense, 75% of the largest French companies exhibit a concentrated ownership structure, with the dominant shareholders being families (32,5%), the State (7,5%), cross-shareholdings with public companies (27,5%) and foreign investors (7,5%); a significant number of companies in this sample are widely owned (25%) but this seems to be a peculiarity of the CAC40. If we leave the CAC40 and look at the general listed companies, we will observe that the degree of concentration is very high as well with the average direct owner (usually individuals) holding 52% of the capital; it is also worth mentioning that in listed firms that do not norm part of the CAC40 there is usually a second-owner owning an average 10% of the share capital that is closely related to the first owner (meaning that

⁶⁹ Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Archichecture et Gouvernance des Organisations. For a comparative overview of the French case see Tiberghien, Y. (2007). Entrepreneurial States. Reforming Corporate Governance in France, Japan and Korea, Cornell University Press

a syndicate of owners controls an average 62% of the capital in non-CAC40 listed firms). The ownership structure is even more concentrated in non-listed companies: these companies normally exhibit an average shareholder holding 66% of the share capital; this shareholder is an individual in 51% of the cases, an institutional investor (financial or not) in 40% of the cases and other entities in only 9% of the cases.⁷⁰

The concentration of this ownership structure was further increased by means of a complex system of cross-shareholdings that ensured a coordination of the activities of all companies and virtually shielded them from the pressures of the stock market. The system of cross-shareholdings could be represented in this scheme:⁷¹

Figure 1 Cross-holdings in the French Corporate Governance Structure (% as of December, 1997)



⁷⁰ Data taken from: Goyer, M. and B. Hancké (2005). Labour in French Corporate Governance: the missing link. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford. ; Bloch, L. and E. Kremp (1999). Ownership and voting power in France. The Control of Corporate Europe. F. Barca and M. Becht, Oxford. ; Harbula, P. (2008). "The ownership structure, governance and performance of French companies." Journal of Applied Corporate Finance 19(1): 88-101.

⁷¹ Harbula, P. (2008). "The ownership structure, governance and performance of French companies." *Journal of Applied Corporate Finance* 19(1): 88-101.

The system of cross-shareholdings that was enforced in France was often coined as a model of financial heart (*coeur financier*). The model of the financial heart was founded in the years that followed WWII and rested upon a system of cross-shareholdings between the companies of a group or between different groups of companies and in a straight connection with the banking industry, itself based upon cross-shareholdings. This represents a specific model in the varieties of capitalism literature because the nature of finance is profoundly intermediary: the companies participating in the network of cross-shareholdings and their connection to the State created a hybrid system of governance in which the participating companies shielded themselves against the intrusion of any outsider that could disturb the balance of interests between the shareholders and the management and the State supervised the functioning of the system.

This model of the *coeur financier* was underpinned in three pillars: the different groups of companies participating in the network established a number of cross-shareholdings. The basic idea behind the cross-shareholdings between groups of companies consisted in shielding each one of the companies participating in the group from the appetites of potential bidders; the other companies would act as blocking shareholdings that would block any attempt of a hostile takeover. The different cross-shareholdings contained internal governance mechanisms to prevent opportunistic behaviours from the other members of the group. The essential governance mechanism consisted in interlocking-directorships; each company participating in the network would have a member in the board of the other company in order to ensure that the other company was complying with the common objectives underlying the establishment of the network. Banks equally played a significant role in the system guaranteeing the financing of the network by means of the establishment of a system of relational financing. This is a very important element if one considers two distinct aspects: firstly, the banks represented the main form of financing of the networks and participated actively in the governance of the networks by taking positions in the boards of companies and supervising the application of the money; secondly, the majority of the largest banks in France and the conditions under which they could provide credit were in the hands of the State; therefore, the State could supervise and intervene

actively in the governance of the network by means of the control of the financial system.⁷²

The third distinguishing characteristic of the French model consisted in the management. The management of French companies distinguished itself from the management of German and British companies on a number of grounds. One remarkable feature of French managers consisted in the fact that the majority of them owed their education and professional experience to the State; they were educated in the professional schools of administration in Paris and begun their careers in the hierarchies of State companies; they were also often politically compromised. The nomination of the managers depended to a great extent of the agreement of the remaining companies participating in the coeur financier: since the companies participating in the hard-core of the French economy were embedded in a system of cross-shareholdings and interlocking-directorships that coordinated the activities of each one and all, the ascension to the management boards of each one of those companies depended on the agreement of the remaining and the absence of opposition from the State, which fuelled the system by means of the control of the financial sector. These characteristics of French management boards ensured that the persons in charge of the governance of French companies would not disturb the functioning of the system and were compromised with the remaining elements participating in the system.⁷³

This distinctive characteristic of the management board was not applicable however only to the companies that were part of the coeur financier. In listed and non-listed companies that were outside that particular hard-core of the French economy, the State still had its influence albeit to a smaller degree. The higher educational system in France is fully public and therefore the persons holding management degrees still owed their education to the State. On the other hand, the concentrated ownership structure in French firms still ensured that there was an alignment of interests between the major shareholders and the management board because the managers depended on

⁷² Morin, F. and E. Rigamonti (2002). "Évolution et structure de l'actionnariat en France." *Revue Française de Gestion* 5(141): 155-181.

⁷³ Goyer, M. and B. Hancké (2005). Labour in French Corporate Governance: the missing link. *Corporate Governance and Labour Management: an international comparison*. H. Gospel and A. Pendleton, Oxford.

stable relations with the major shareholders to maintain their jobs. The influence of the State could be seen in the education of the managers and in their access to the financial circuit (that was controlled by the State) as well as the regulatory environment by industrial politics. Therefore the governance of non-listed companies or of listed companies that were not part of the coeur financier does not differ significantly from the Governance of the companies that are part of the hard-core of French corporate governance.⁷⁴

The final distinguishing feature of the French model consists in the weakness of labour. The French regulatory regime for the participation of labour in companies is underpinned in a dualistic approach, with employee representative structures acting both outside the company (by means of trade unions) and within the company (by means of works councils). However, the situation contrasts sharply with the German situation: firstly, trade unions are very weak and their most effective battling ground is politics; therefore, trade unions are politically compromised and are more concerned with influencing the political arena than acting on a bargaining ground; secondly, although works councils have extensive rights to information and consultation, they have no co-determination rights and have no seat in the boards of companies. If the management wishes to undertake a decision that is highly detrimental for labour, all it has to do is to communicate it to the workforce and eventually engage in a negotiation with the labour force; however, the final word as regards the decision lies in the hands of management only and the absence of an agreement is not impulsive of the enforcement of the decision. Therefore, although the situation for the workforce is not as dramatic as in the UK, there is little room for employee influence in the decision-making structure of the company.

One may conclude that the French system may be classified as a relational/insider system with concentrated ownership, stakeholder orientation, cross-shareholdings that shield companies from hostile takeovers and dialogue between management, shareholders and finance that resembles the German system to a large extent. There are however two distinguishing characteristics that justify its isolation as a specific model of governance and its distinction

⁷⁴ Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Architecture et Gouvernance des Organisations.

from the German system: firstly, the role of the State has no parallel in any other system; the State is seen as an independent referee that should intervene in the economic life and ensure that the actions of the economic agents are not made against the general interest; for that purpose it controls a number of corporations, holds shareholdings in others and controls the financial system that fuels the system of cross-shareholdings between companies, establishing relational forms of finance and supervising the application of the funds in the network; secondly, the role of labour is considerably much weaker than the one found in the German system. The system of labour participation is limited to information and consultation rights and labour has no influence on managerial decision making, besides some basic procedures of mandatory bargaining between management and labour. Both of these features alter the balance between the distinct interest groups that participate in the company and distinguish this relational system from the one found in Germany.

d) Portugal – the final country to be covered in my analysis is Portugal. Portugal is a small country in Western Europe whose governance characteristics resemble to a great extent those found in France: concentrated ownership, relational management, heavy presence of the State and weak labour participation. The inclusion of Portugal in the analysis was justified by the comparative interest of analysing the developments in Corporate Governance and Employee Participation in a medium-sized country with an extremely open economy that is heavily dependent of international trade and foreign direct investment for the functioning of its economy. Portugal had been experiencing lately some considerable evolutions in its traditional model of governance that are attempting to bring it closer to the Anglo-Saxon model. In order to understand the modifications, it is necessary to begin with a short description of the governance pattern in Portugal. This section will be organised in the following terms: (1) it will initiate with an analysis of the role of the State; (2) it will proceed to an analysis of the ownership structures, (3) it will complete the analysis with a description of the management boards and (4) finish with a description of the role of labour.

The role of the State in Portuguese Corporate Governance is very similar to the one found in France. The State is regarded as an independent

arbitrator, an actor that has a role to perform in the economy. The participation of the State in the economy was made by distinct means: in the period before the revolution of 1974, all industrial activity was subject to a regime of industrial licensing. This industrial licensing was a form of maintaining legal monopolies or cartels in the key sectors of the economy and conditioning the activities of the companies. Although the ownership of companies was in the hands of some private families and economic groups, the State had an indirect influence by means of political ties, the determination of the conditions of exercise of the activity in the industrial licensing and the regulation of the industrial policy. This picture did not change considerably after the revolution in 1974: the major companies were nationalised (in particular banks, utilities and all the key sectors of the economy) and the State became the major player. The bankruptcy of several companies triggered a successive wave liberalisations since the middle of the 1980s. Despite the extensive privatisation programs, the State has still reserved itself a very active and interventionist role in the economy by means of shareholdings in major companies and using its regulatory power to influence the behaviour of large companies and its impact in the economy. As an example, one of the largest commercial banks is State owned and this bank has several strategic shareholdings in all the major banks operating in Portugal. The State has shareholdings in nearly all the utilities sector (communications, water, energy) and similarly also has a number of political ties with the largest public companies: one of the greatest questions being currently debated is the legitimacy of the assumption of positions in the management of large companies by former politicians. This reveals that politics and the economy are strongly intermingled.⁷⁵

The ownership structure of Portuguese companies is also heavily concentrated. A survey of the 51 largest public companies traded in the Portuguese stock markets in 2005 revealed that the ownership structure of public companies is heavily concentrated, with nearly all companies reporting that their management board was subject to the pressure of one shareholder or a group of clearly identifiable shareholders. The major shareholders of Portuguese quotes companies are: (1) legal persons, holding nearly 42% of all traded stock, (2) individuals, (3) banks and other collective investment schemes

⁷⁵ Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond Princeton University Press. <http://www.finbolsa.com/histtour.asp>.

(10%), (4) the State, (5) creditors and suppliers and (6) management boards. The average ownership dispersion is merely 24%. The average size of the shareholding of the largest shareholder is 44%(!), with legal persons and individuals occupying the lion share of this percentage. Therefore, Portuguese companies are in the greater part in the hands of a small number of clearly identifiable domestic institutional investors and individuals; the remaining shareholders occupy the remaining part, leaving a residual amount of capital of quoted companies for dispersion. This situation is even more serious if we consider that the majority of Portuguese quoted companies are inserted in a web of cross-shareholdings with other companies. The institutional investors holding the lion's share of the capital of the company are themselves the object of shareholdings by the companies that they hold. This intermingling of the activities of all the companies by means of a network of cross-shareholdings ensures the coordination of the activities of all companies and leaves no room for any market for corporate control.

This situation is further reinforced if we consider the structure of the management boards. As a preliminary word, it must be stated that in virtually all quoted companies , there is evidence that 1/3 of the seats in their management board are occupied by someone who is either the largest shareholder or a close relative of the largest shareholder. There is also evidence that the managers of these companies admit that they are under the overwhelming pressure of the major shareholders of the company. This is a definitive proof that large public companies are effectively in the hands of large shareholders. It is also relatively common for management boards to contain members that occupied formerly public positions, normally at the managerial level. This means that large companies have a strong connection with politics and with the State. Finally, with the exception of the members who formerly occupied public positions, the market for management is almost residual: virtually all quoted companies reported to have the remaining members of their management boards recruited from their staff by means of internal promotions. Therefore, it seems safe to say that Portuguese management boards are essentially accountable to the majority shareholders and indirectly to the State.⁷⁶

⁷⁶ CMVM (2006). O Governo das Sociedades Cotadas em Portugal: situação em Dezembro de 2005, CMVM.

The weak position of labour further completes this picture. Portugal has a dualist system of collective bargaining, with the representation of employees ensured both by trade unions and by works councils. Despite this apparent wide-ranging system of employee representation, the powers of the workforce labour are very weak: in a situation similar to France, the powers of trade unions are extremely reduced and their struggle is essentially made in the political arena; as regards company-level bargaining, although the law provides for the setting up of works councils, their number is extremely residual and their power is reduced: they are limited to information and consultation rights and have no power to influence the decisions of the management board to any extent.⁷⁷

This short description of the Portuguese system of corporate governance conclude that the Portuguese situation mirrors in many ways the one found in France: the State has a very active role in the economy, the ownership is heavily concentrated, management boards are in the hands of majority shareholders and the State and labour has very weak rights of intervention in the life of the company. It is a governmental type relational system of corporate governance.

1.3.3 Conclusion - distinct patterns, distinct countries

This short description of the main models of Corporate Governance and each one of the countries under study reveals that there are diverse means of regulating the conflicts of interest within the company and, in this sense, governing the relationships between the distinct interest groups of the nexus of contracts that composes the company. The main models of corporate governance may be enunciated as market/outsider systems, relational/insider systems and governmental systems. Market/outsider systems give preference to dispersed shareholdings, large market capitalisation, focus in shareholder value and low levels of employee involvement. Their main purpose and objective is to provide returns to the investment of the shareholders, who are not interested in becoming more engaged in the company. That is the reason why the varieties of capitalism literature presents as their main advantages the

⁷⁷ Gomes, J. V. (2004). National Report Portugal. The evolving structure of collective bargaining in Europe 1990-2004. S. Sciarra. Florence, European Commission, University of Florence.

capacity to engage in radical innovation (as opposed to incremental growth) because the collection of money from the shareholders demands quick returns while criticising the low levels of employee involvement. These systems raise a number of agency costs however, most notably between the shareholders and the management; the dispersed nature of shareholdings and the collective action costs inherent to them isolates management from the pressure of shareholders. That is the reason why these systems bet extensively on external mechanisms of corporate governance (take-overs and disclosure) as a means of reducing the agency costs; disclosure exposes the internal situation of the company to the judgement of the investors, obliging the management boards to provide a premium to a managing of the company not attentive to their interests; the market for corporate control functions as a disciplinary device of bad managers.⁷⁸ The paradigmatic example of such a system in Europe is the UK: the UK exhibits all of these characteristics: dispersed shareholdings, focus on shareholder value - despite the fact that s.309 Companies Act 1985 considered that the fiduciary duties of managers were owed to the company, who should not be confused with the shareholders - a prevalence of external monitoring mechanisms and low levels of employee involvement.

Relational/insider systems are a distinct system of corporate governance that is underpinned on entirely distinct grounds: the shareholdings are concentrated in the hands of a few dominant shareholders, there is an intense dialogue between the management board and the major shareholders and there are moderately high levels of employee involvement (although this varies from jurisdiction to jurisdiction). The concentration of shareholdings and the intense dialogue with the management board have its advantages: there is a reduced scope for agency costs because there is a direct monitoring device and the management may be easily dismissed and the involvement of labour safeguards the interests of the stakeholders in the company. This creates an excellent institutional endowment for strategies of incremental growth because the capital is patient and can control the management effectively; on the other hand, the involvement of employees creates incentives for investment in firm specific skills. The only relevant agency costs are in relation to minority

⁷⁸ Slinger, G. and S. Deakin (1999). Company Law as an instrument of inclusion: re-regulating stakeholder relations in the context of takeovers, ESRC Centre for Business Research, University of Cambridge.

shareholders, who have no effective monitoring devices to prevent collusion between the management and major shareholders; that is the reason why, generally speaking, the levels of market capitalisation in these countries are low. This creates difficulties for companies to collect investment from small shareholders and explains the prevalence of banks and relational financing as the major sources of capital in these countries. The paradigmatic example of this type of governance system in Europe is Germany with its focus on stakeholder value, concentrated ownership structures, co-determination and extensive sector-level bargaining and dual-board systems that attempt to encourage a conciliation of interests between the shareholders and the main stakeholder of the company - the workforce. It is also worth mentioning that banks (particularly regional Sparrkassen) enjoy a considerable degree of influence in these countries.

Governmental systems may be considered as a subsystem of relational systems of governance. Although the ownership structures in these countries are heavily concentrated and there is an intense dialogue between the management and the major shareholders (thereby reducing agency costs) there are two distinctive characteristics that distinguish these systems from their pure relational counterparts: the levels of employee involvement are low and there is a third actor influencing to a considerable extent the governance of these companies - the State. As regards the first point, in contrast to pure relational systems, employee involvement is low in these countries and is limited to information and consultation procedures. A heavy personalistic and proprietarian conception of the company is prevalent and industrial relations are traditionally characterised by antagonism. As regards the second point, the State influences the governance of companies by several means: in the major companies by means of direct shareholdings in those companies; in other companies by means of the administrative regulation of the industrial sector and the control of the sources of finance. In any case, the presence of the State is overwhelming even if indirect. The function of the State is to function as an independent arbitrator. The strategies of growth in these countries are generally characterised by incremental innovation. France and Portugal exhibit the characteristics of these systems with concentrated ownership structures, management dependent of the major shareholders, confrontational industrial relations systems and low levels of employee involvement and heavy State

presence. Needless to say that the major agency costs in these countries exist in relation to minority shareholders because they have no means of influencing the decision-making procedures within the company and market capitalisation levels are low.

1.4 Explaining the diversity of the structures of Corporate Governance

The analysis of the main patterns of corporate governance and the characteristics of the countries that exhibit to the fullest extent those patterns should be followed by an examination of the reasons underpinning the development of those patterns. Before engaging into the analysis of the main theories explaining the development of distinct patterns of corporate governance it is worth warning that this discussion is coupled with a distinct discussion that - at least as an understatement - focuses on the potentially best model of corporate governance.⁷⁹ There is an intense discussion on the comparative merits and defaults of each distinct system of governance and the reasons underpinning the development of these characteristics. It is important to analyse the main points of this discussion in order to understand the reasons underpinning the development and internal balance of each system of governance and the reasons underpinning the transformations that each one of the systems is currently suffering. This section will attempt to synthesise the main points of that discussion.

Several explanations have been put forward for the understanding of the development of each distinct pattern of corporate governance. The main theories may be synthesised in two large approaches: one approach places the emphasis on the legal system enforced in that country; it departs from the assumption that legal rules (understood as statutory, court and legal practice) create agency costs between each one of the distinct interest groups that compose the company and therefore influence the strategic behaviour of each one of these interest groups, in particular the patterns of ownership and governance. The other approach places the emphasis on the institutional

⁷⁹ Hansmann, H. and R. Kraakman (2000). *The end of history for corporate law. Program for studies in law, economics and public policy*, Yale Law School, Hall, P. and D. Sokice, Eds. (2001). *Varieties of capitalism: the institutional foundations of comparative advantage*. Oxford, Oxford University Press.

endowment surrounding the company and considers that a plethora of elements encouraged the parties to adopt a distinct pattern of corporate governance on account of being the one that defended their interests to the fullest extent.⁸⁰ These theories consider that the main patterns of governance were developed to provide an answer to distinct needs in distinct times and that they must be contextualised within these needs in order to understand its development. The following lines will attempt to describe the major lines of these theories.

(a) rule-driven corporate governance - the basic assumption underpinning the theory of rule driven corporate governance considers that the legal rules enforced in a given country influence to a considerable extent to balance of interests of the companies subject to the laws of that country. The contractarian conception of the company that is being used throughout the thesis sees corporate governance as a system of principles and rules influencing the balance of interests between the conflicting interest groups within the company; this means that “rules matter” because the powers that one interest group may exercise vis-à-vis to the other interest group will condition the choices and the strategy of the latter group.⁸¹ The most relevant example are the take-over rules developed in the UK: these rules consist in a set of mechanisms destined to expose managers to the pressure of stock markets and use the market as a disciplinary device; if they don’t take proper attention to the interests of shareholders, they will face the pressure of a bidder that will offer a premium for the share and assume control of the company; this system encourages dispersed ownership and the philosophy of shareholder value; investors know that if their share prices fall, they may sell them to a bidder; therefore they prefer to invest in several companies and wait for the pressure of the stock market to function; on the other hand managers know that they will have to be particularly attentive to stock market prices if they want to avoid the threat of takeover; this influences the growth strategy of the company, which is more

⁸⁰ For a short overview of these theories, see Bebchuk, L. A. and M. J. Roe (2004). A theory of path-dependence in corporate ownership and governance. Convergence and persistence in Corporate Governance. J. N. Gordon and M. J. Roe, Cambridge University Press.

⁸¹ See the excellent work of Romano, R. (1996). "Corporate Law and Corporate Governance." Industrial and Corporate Change 5(3).

likely to be focused on a financial strategy of growth as opposed to a incremental strategy of growth.⁸² The most influential implementation of this principle was made in an extremely quoted paper by Raphael La Porta, Florencio Lopez de Silanes and Andrei Schleifer entitled “*Corporate Ownership around the World*”.⁸³ This study departed from the agency costs approach embodied in a contractarian conception of the company and considered that the quality of a corporate legal system should be judged in accordance with the protection that it afforded to its shareholders - the residual claimants of the firm, i.e: the interest group that collects the profits from the firm after the claims of all the other interest groups were satisfied and bear the risk of the success or failure of the enterprise.⁸⁴ The authors found, after an analysis of 27 legal systems, that countries with the strongest scores in the protection of the rights of minority shareholders (in accordance with their criteria) exhibited more dispersed ownership patterns and that countries with lower scores exhibited more concentrated ownership patterns. This led the authors to conclude that ownership concentration was a defence mechanism against managerial autonomy on account of the poor protection of the rights of shareholders and that the Anglo-saxon legal system was the most advanced system of corporate law because the dispersion in ownership meant that shareholders felt sufficiently protected in their claims to the point that they did not need to acquire a larger share of the company in order to reduce the agency costs vis-à-vis the management board.

This study was heavily criticised for its methodology, scores and conclusion. As regards the methodology, the study was heavily criticised for being considered as too biased towards the common law system (which would of course compromise the results) and for not considering other elements in the

⁸² Gilson, R. N. and B. Black (1995). *The Law and Finance of Corporate Acquisitions*, University Casebook series. Slinger, G. and S. Deakin (1999). Company Law as an instrument of inclusion: re-regulating stakeholder relations in the context of takeovers, ESRC Centre for Business Research, University of Cambridge. For a critical perspective on takeovers in the EU see Coates IV , J. (2003). Ownership. takeovers and EU Law: how contestable should EU Corporations be?, Harvard Law School.

⁸³ La Porta, R., F. Lopes-de-Silanes, et al. (1999). "Corporate ownership around the world." *The Journal of Finance* 54(2): 471-517.

⁸⁴ In order to understand the position of shareholders in companies and their role as residual claimants, see Easterbrook, F. and D. R. Fischel (1996). *The Economic Structure of Corporate Law*, Harvard University Press.

evolution of the system; for instance Portugal was classified as a French-style civil law system but the reality is that the greatest influence of its corporate law was the German system.⁸⁵ The criticisms extends to the fact that the authors did not take into account the reality of the corporate laws in practice; the authors simply read the “black-letter law” of corporate statutes and completely disregarded case law and the actual implementation of corporate law by means of lawyers. This is in itself a significant element: for instance, a statute may provide an extremely strong protection to shareholders but if there are no means to enforce it efficiently then the qualification in the index should be lower; on the other hand, corporate lawyers are known to set up specific mechanisms for the protection of shareholders by practice that does not have a direct correspondence in the law; these consist in socially typical but legally atypical phenomena. These elements influenced to a considerable extent the classification of each one of the indexes in the paper; several attempts have been made by national lawyers to reclassify the indexes used by LaPorta et allii in their own legal system and the results have been striking: French and German influenced legal systems are found to be much more protective of the rights of shareholders than the results achieved by the authors indicated and the recent reforms of Company Law undertaken in each one of these countries - to be analysed further on - did not have the expected impact over the levels of market capitalisation of companies. This means that there is strong evidence that the connection between shareholder protection and ownership structure may not be so linear as it was it was initially expected and that the levels of shareholder protection (particularly of minority shareholders in countries with concentrated ownership) are not substantially distinct from common law countries.⁸⁶ The most heavily criticised element of the study were its

⁸⁵ West, M. D. (2002). Legal determinants of World Cup sucess, Michigan Law and Economics Research Paper , Baums, T. and K. Scott (2003). Taking shareholder protection seriously? Corporate Governance in the United States and Germany, Stanford Law School, Rajan, R. G. and L. Zingales (2003). "The great reversals: the politics of financial development in the 20th century." *Journal of Financial Economics* 69: 5-50, Braendle, U. C. (2006). Shareholder protection in the USA and Germany: on the fallacy of LLSV. *German Working Papers on Law and Economics*, University of Machester.

⁸⁶ Armour, J., S. Deakin, et al. (2007). Shareholder protection and stock market development: an empirical test of the legal origins hypothesis, Centre for Business Research - University of Cambridge, Siems, M. M. and P. P. Lele (2007). "Shareholder protection - a leximetric approach." *Jornal of Corporate Law Studies* 7: 17-50, Elst, C. v. d. (2008). Shareholder mobility in five countries. *ECGI Working Papers in Law*, European Corporate Governance Institute.

conclusions however; there was an underlying assumption that “common law was better” and that the dispersed ownership structures with a focus on shareholder value should be regarded as the most advanced development of corporate law.⁸⁷ This is in itself a conclusion that the literature on the varieties of capitalism abhors: this approach to corporate governance emphasises the comparative advantages of each one of the distinct models of governance: the dispersed ownership model is appropriate to radical innovation and to collect capital independently of banks but is inadequate to pursue longer term strategies; concentrated ownership models are more appropriate to incremental innovation (because shareholders are patient) but lag behind in radical innovation. The comparative advantage of each one of this systems must be seen in relation to the product market in which it competes: market systems are better in high-tech sectors and relational systems are better in sectors such as pharmaceuticals or engineering that demand heavy investments in human capital.⁸⁸

Despite the methodological criticisms, the reality is that this paper had the merit of focusing the attention on the impact of the regulation of corporate law on the behaviour of the corporate actors. This means that legal rules are not neutral as to the actors within predominant corporate governance system of a country and that is capable of influencing it to a large extent. A strengthening of the rights of minority shareholders in countries with concentrated ownership is capable of influencing the strategy of the boards and the major blockholders because they are liable to have to face the pressure of a previously insignificant group, raising a new set of agency costs.

⁸⁷ Hansmann, H. and R. Kraakman (2000). The end of history for corporate law. Program for studies in law, economics and public policy, Yale Law School.

⁸⁸ Deakin, S., Richard Hobbs, et al. (2001). Partnership, ownership and control: the impact of corporate governance on employment relations, ESCR Centre for Business Research, University of Cambridge, Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press, Deakin, S., Hugh Whittaker (2007). "Re-embedding the corporation? Comparative perspectives on corporate governance, employment relations and corporate social responsibility" Corporate Governance 15(1), Zumbansen, P. (2007). Varieties of Capitalism and the Learning Firm: Corporate Governance and Labour in the Context of Contemporary Developments in European and German Company Law. U. o. C. Centre for Business Research.

(b) structure driven corporate governance - another explanation that has been put forward for the development of certain patterns of corporate governance consists in the so-called “*structure driven corporate governance*”.⁸⁹ This theory believes that countries developed distinct corporate governance patterns due to the distinct institutional endowments in which their companies developed. “*Institutional endowments*” is to be understood here as the whole set of factors influencing the activity of the company from the economical conditions, the regulation of the industrial sector, the prevalent type of organisation of work in those countries, the main interest groups influencing politics, tax policy, among other elements. These theories are strongly influenced by historical and financial approach to corporate governance, which emphasises the influence of the diverse stages in the development of capitalism and the role of the financial actors in the organisation of a particular pattern of corporate governance.

The institutional endowment relevant for the purposes of this thesis must be sought in the years that followed World War II. The reconstruction efforts that each country had to face demanded a particular macro-economic environment that would favour the setting up of the necessary firms. The first relevant element in this environment consists in the system of exchange rates set up by the Bretton Woods agreement. This agreement set up a system of fixed exchange rates destined to stabilize the currencies while at the same time providing each country with the necessary margin of manoeuvre to pursue its economic policies. This leads us to a second extremely important element that existed in Continental Europe but failed to implement in the UK: a system that came to be known as coordinated capitalism.⁹⁰ Considering that all the countries in Continental Europe needed to finance their reconstruction, there was a need for investment in the most important industries and ensure wage

⁸⁹ Hall, P. and D. Sokice, Eds. (2001). *Varieties of capitalism: the institutional foundations of comparative advantage*. Oxford, Oxford University Press, Ahlring, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." *Socio-Economic Review* 3(2), Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." *Oxford Journal of Legal Studies* 28(2): 201-245.

⁹⁰ Solomon, R. (1999). *The transformation of the world economy*, Macmillan, Eichengreen, B. (2007). *The European Economy since 1945 - coordinated capitalism and beyond* Princeton University Press.

retention in order to retain profits for reinvestment. The means to achieve this was by the setting up of a structure at the national level that joined at the same table the Government, trade unions and employers' associations that would bargain the necessary wages and working arrangements for the functioning and development of companies. Governments had to determine the necessary arrangements however for the functioning of this system: trade unions and employers' associations were organised along industry lines with mechanisms to prevent defection and free-riding on the sacrifices of others (for instance, Germany introduced the rule of "one trade union per sector" and France set up a "follow the leader approach" by creating criteria of union representativity). An extremely important element was the coordination of public policies in order to mobilise industries and capital. The purpose of those policies was to orient investments towards the most valuable sectors to the economy - preferably complementary industries. Germany achieved this by encouraging concentrated patterns of ownership and tying investments to particular locations. Banks (which were often regional Sparrkassen) and local governments invested heavily in key companies for the region in order to attach the company to that region and use it as a means of fostering the investment. France used the State as a means of coordinating the investments: banks were controlled by the State and gave preference to wealth-creating loans, interest rates were fixed administratively and the major companies were either State owned or the State had a relevant share in them. The setting up of the system of financial heart (*coeur financier*) ensured the coordination of the investments and shielded the companies from the pressures of the stock market. Portugal used a system of industrial licensing in order to guarantee legal monopolies to the key industries of the company and retain them in the hands of a few Government-friendly investors. A final element of great importance consisted in the technological factor: European companies imported Fordist methods of production from the US and could explore its potentialities without having to undergo the R&D expenses. This fostered the creation and expansion of Fordist production units across Europe in key sectors of the economy.⁹¹

⁹¹ Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond Princeton University Press, Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." Oxford Journal of Legal Studies 28(2): 201-245.

The only country in Western Europe that failed to adhere to this bargain was the UK. There are several reasons explaining the UK's resistance to coordinated capitalism. The pioneering efforts in industrialisation in the UK allowed it to restore its industrial capacity much quicker than in the remaining countries. Also, the heavily decentralised system of collective bargaining that - at that time - bet on the existence of closed shops as a means of ensuring employee adhesion and control over the shop floor resisted the concentration and coordination of trade unions at the industry and national levels. Finally, managers did not see a need to bet on major shareholders or banks in order to gather the necessary capital; they had managed to do it previously by means of the collection of investments from small shareholders in the movement of concentration and growth of companies that took place in the beginning of the XXth century that marked the passage from the personal to managerial capitalism and gave rise to the dispersed ownership patterns that characterised outsider systems of governance. These were the reasons why the UK opted out of a system of coordinated capitalism.⁹²

These structural elements may help us to understand the development of the particular patterns of Corporate Governance exhibited by each one of these countries. Germany needed large companies in key sectors of the economy in order to produce the structural goods that the economy needed the most. The means to set up these companies consisted in the following elements. Families or large shareholders provided part of the capital and tied their interests to the particular company; regional savings banks (*Sparkassen*) collected money from small investors and re-invested those amounts in large companies in order to attract them to a particular region and foster employment and economic growth in the region. Those banks were often held by the regional government and held shareholdings in the companies of the region in order to prevent their relocation. Industry level unions ensured the necessary wage moderation at the level of the industry and prevented free-riding of other companies and provided companies with the necessary means to reinvest. Co-determination in larger companies functioned as a monitoring mechanism in

⁹² Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond Princeton University Press, Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." Oxford Journal of Legal Studies 28(2): 201-245.

order to prevent shirking and ensure that the profits retained were reinvested in the company and not distributed as profits. These structural elements might explain the development of the particular German modality of Corporate Governance.⁹³ France followed a distinct path: in the French tradition of the colberistic state, the French government functioned both as an arbitrator and as an entrepreneur; it functioned as an arbitrator by conciliating by statutory regulation and tripartite bargaining the interests of the distinct pressure groups in France; it functioned as an entrepreneur by setting up companies or investing directly in the major French companies and encouraging the entanglement of the *coeur financier* in order to coordinate the actions of major French companies. As regards the role of labour, it created criteria of representativity for the major French trade unions, which ensured wage moderation at the industry level, and defended the interests of the workforce from the politisation of trade unions by a heavy statutory regulation of labour. This explains the ownership concentration, the role of the State and the weakness of labour in France.⁹⁴ Portugal followed a distinct path: the Government held the banking sector and the major utilities sectors directly; on the other hand, it ensured legal monopolies in key industrial sectors to some families that were in good relations to the regime. This encouraged the setting up of industrial conglomerates that supported the industrial development of Portugal. These elements explain why Portugal exhibited a corporate governance structure that is much similar to the French. Only the UK distinguished itself from this structure. The earlier industrialisation efforts helped the rebuilding of the national industries and the setting of large fordist production units. This earlier industrialisation was made - in the traditional British perspective of laissez-faire - independently from the State by means of the collection of investment from small investors. This explains the dispersed ownership structure of British companies. As regards trade unions, since the

⁹³ Schmidt, H., J. Drukarczyk, et al. (1997). Corporate Governance in Germany. Baden-Baden, Nomos Verlagsgesellschaft, Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203, Jackson, G., M. Höpner, et al. (2005). Corporate Governance and Employees in Germany: changing linkages, complementarities and tensions. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford.

⁹⁴ Goyer, M. and B. Hancké (2005). Labour in French Corporate Governance: the missing link. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford, Tiberghien, Y. (2007). Entrepreneurial States. Reforming Corporate Governance in France, Japan and Korea, Cornell University Press

UK had always exhibited an extremely decentralised system of collective bargaining, there was no means nor need for the coordination of the actions of trade unions at the industry or national level. This might explain the difference of the UK.⁹⁵

This short explanation reveals that the institutional endowment (in particular the macro-economic conditions) in which companies operate influences to a great extent the particular corporate governance regime that each country developed. These regimes should not be seen as superior but simply as an alternative means of providing an answer to the same demands. The macro-economic environment modified to a great extent since the Bretton Woods agreement and the impact of the modifications will be analysed in the next section. Therefore, that the particular macro-economic environment that prevailed throughout Europe from 1945-1974 - a time in which the main patterns of corporate governance of each country developed - influenced the development of those particular patterns of corporate governance in a decisive way.

(c) conclusion - the analysis of the main explanations underpinning the development of the main patterns of corporate governance under study may allow us to extract some preliminary conclusions. The rule-driven and structure-driven approach to the development of particular patterns of corporate governance should not be seen as mutually exclusive but as complementary explanations for the development of particular patterns of governance. The rule-driven approach places an emphasis on the influence of legal rules (understood as statutory, judge-made and legal practice) on the behaviour of the interest groups; it rightly points out that the powers that one interest group enjoys *vis-à-vis* the other interest group will necessarily condition their strategic behaviour. This is capable of influencing to a considerable extension the development of particular patterns of corporate governance. The study of La Porta et allii and the criticisms that have been made to it have partially confirmed this assumption; although the methodology and conclusions of

⁹⁵ Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond Princeton University Press.

LaPorta have been heavily criticised, the reality is that there appears to be a consensus around the potential influence of legal rules on the development of particular patterns of governance. This is very important for the analysis of the potential impact of the modifications that are currently occurring in the governance of European companies in the national patterns of corporate governance.

The structure-driven approach considers a wider set of elements in the analysis (besides the law) to understand the development of national systems of governance. The macro-economic environment is of particular importance here because the economic needs of the time and each country's strategy to achieve them are capable of influencing the development of the national patterns of governance. The origins of each national pattern of governance must be sought back to the times that followed World War II where there was a concern for reconstruction and industrial development. Germany bet in the role of regional banks, large shareholders and employee influence in order to foster the development of their companies; France and Portugal trusted in the intervention of the State by regulatory means, direct investment or State ownership; the UK followed a laissez-faire approach and developed its earlier industrialisation efforts, which were achieved by the collection of investment from small shareholders and decentralised levels of bargaining.

This leads us to conclude that the understanding of the development of particular patterns of corporate governance should not be seen isolated but framed within a wider set of elements that include legal rules and the institutional endowment in which companies developed their activities.

1.5 Patterns of Employee Representation - how do employees organise and engage in Collective Bargaining. Comparison of the distinct national models.

The thesis should proceed with an analysis of each one of the patterns of employee representation enforced in each one of the jurisdictions under study. The countries covered in my analysis will be Germany, France, Portugal and the UK. This section will wish to continue the analysis undertaken in the former chapter and attempt to demonstrate that, similarly to corporate governance, the models enforced in these countries equally stand for patterns of employee representation; This section will equally attempt serve as an introduction to the following sections that will attempt to demonstrate that there appear to be a certain degree of complementarity between the national models of corporate governance and employee representation and that the parallel evolutions registered in corporate governance will also have as a consequence a parallel evolution in the structures of employee representation. Before proceeding to the analysis, it is useful to clarify that the description of each national model that will be made bellow is necessarily synthetic and will be limited to describing the traditional characteristics of the system; this section will equally refrain from analysing the developments that have occurred in the last 20 years because that will be the subject of the next chapter (the evolution of the national models). The purpose of this section is to attempt to demonstrate that there are considerable differences between each one of the systems to the point that each one of them may be considered as an autonomous model of its own.

a) Germany – the German model of employee representation has been one of the most influential and thoroughly studied throughout the world. The reason for its reputation lies not in its complexity – it is in fact a model of an appalling simplicity and persistence – but rather in the particular equilibrium of interests that it attempted to achieve. The German model of employee representation can be classified as a purely dualist model: the German literature crisply distinguishes between the representation of employees outside the company (by means of trade unions (*Gewerkschaften*)) and inside the company by

means of the works council (*Betriebsrat*). Trade unions may designate one of its members to function as a shop-steward (*Gewerkschaftsvertrauensleute*) within the company although its tasks are severely limited to communicating to the employees and the employer the agenda (*Tarifpolitik*) of the trade union and the collective agreements celebrated and inform the trade union of the situation of the company in order for it to take it into account in the formulation of its *Tarifpolitik*.⁹⁶

The subject imposes that the analysis should begin with the representation of employees outside the company in German labour law. The key concept in German collective labour law is the constitutionally protected concept of coalition (*Koalitionen* - §9(3) GrundGesetz). Besides granting to each citizen the general freedom of association (§9(1)GG), the Grundgesetz provides in its §9(3) that each German citizen has the right to set up coalitions for the guarantee and promotion of the conditions of work and the economy in all occupations. It is this provision that fundaments the representation of employees and employers outside the level of the company by means of the trade unions and employers' associations. This is an extremely important provision in the German *Grundgesetz* whose impact should not be underestimated. This provision rather constitutionalises the perspective of the regulation of the economy and working life in Germany. In accordance with this provision, the employers and associations of employers and the associations of employees (trade unions and associations of trade unions) are granted the right to regulate (*Gestalt*) the conditions of work and the economy. The German legal thinking has tended to interpret this provision as a constitutional delegation of the State to the trade unions and employers/employers' associations of the duty to regulate the conditions of work and the economy.⁹⁷ The trade unions and employers' (organisations) act as if they were the State in the regulation of the conditions of work and the economy.⁹⁸ Therefore, in Germany, the freedom

⁹⁶ Däubler, W. (2006). Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb, Rowohlt Taschenbuch Verlag

⁹⁷ Fuchs, M. (2004b). National report Germany. The evolving structure of collective bargaining in Europe. U. o. F. European Commission. Florence, Däubler, W. (2006). Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb, Rowohlt Taschenbuch Verlag

⁹⁸ Wiedemann, H. (1999). Tarifvertragsgesetz, München, Fuchs, M. (2004b). National report Germany. The evolving structure of collective bargaining in Europe. E. Commission and U. o. Florence.

of association (*Koalitionsfreiheit*) goes well beyond the simple recognition of the right to colligate and defend the interests of its members: the constitutional paragraph has embedded within it a corporatist structure of the regulation of the economy and working life by means of the association and social dialogue between employers and employers associations and trade unions.⁹⁹

This corporatist structure that arises from the constitutional perspective of the freedom of association deserves further developments. The German Constitution opted for a regime of trade union monopoly (*Einheitsgewerkschaft*): this means that trade unions would have to organise along industrial lines and that only one trade union per sector would be allowed. The means to achieve this consisted in a ruling from the German Federal Labour Court (*Bundesarbeitsgericht*) that created the concept of social power (*sozialen Mächtigkeit*) for an employee association to be recognised as a trade union; this is an elusive concept that consists in a form of representativity: the association of employees must demonstrate (by means of several criteria) that it has the capacity to be a social opponent to the employer and effectively protect the interests of their members. Therefore only the most representative association of employees in the sector would be allowed the privilege to engage in collective bargaining. This led to a high degree of centralisation of collective bargaining in Germany mainly at the level of the sector. Trade unions and employers' associations at the level of the sector would autonomously regulate the conditions of work and the economy in the sector concerned. The preoccupation to avoid trade union fragmentation was so evident that even the law and the internal statutes of trade unions protected and enhanced the monopoly power of individual unions at the level of the sector. Trade unions enjoy the right to establish their professional and geographical area of competence (*Tarifzuständigkeit*) in their internal charters. Since the majority of unions are affiliated to a unitary umbrella organisation named as DGB – *Deutsche Gewerkschaftsbund* – there are no overlapping competences because the internal statutes of this umbrella association has an

⁹⁹ Däubler, W. (2006). Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb, Rowohlt Taschenbuch Verlag

internal procedure to avoid them. Each union is keen in guaranteeing its own monopoly power in a specific sector because that is where their strength lies.¹⁰⁰

The regulation of the economy and working life was made by means of collective agreements. These collective agreements fall essentially within three broad categories: pay agreements (*Tarifverträge*), general agreements on pay grades (*Rahmentarifverträge*) and framework agreements on employment conditions (*Manteltarifverträge*). Tarifverträge determine the wages for particular well-specified occupations; Rahmentarifverträge determine the wages for occupations determined in a more abstract manner, in wide-ranging professional categories, giving rise to a discussion on the precise category in which the activity of the worker falls. Manteltarifverträge consist in collective agreements regulating the conditions of employment that extend beyond remuneration. These regulations range in scope from norms on working time, pay supplements for overtime, night work and shiftwork and leave, to preconditions for dismissal and periods of notice. Most framework agreements on employment conditions run for a term of several years. Although Germany's statute on collective agreements allows for single employers to sign a collective agreement (§2(1) TVG), the practice reveals that this possibility was seldom used; the majority of collective agreements were signed between the trade unions and the employer's organisations that enjoyed a situation of monopoly at the level of the sector. In addition, although Germany follows the principle of double affiliation as regards collective agreements, meaning that the employee has to be affiliated to the trade union in order to be able to claim the provisions of the collective agreement, the practice reveals that collective agreements enjoy a wide degree of coverage either due to incorporation agreements (*Verweisungsklauseln*) voluntarily introduced in labour contracts to apply the provisions of the collective agreement.¹⁰¹

One may attempt to provide an economic justification for the German regulation of employee representation outside the company. The idea was to

¹⁰⁰ Streeck, W. and J. Visser (1998). An evolutionary dynamic of trade union systems, Max Planck Institute für Gesellschaftsforschung, Däubler, W. (2006). Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb, Rowohlt Taschenbuch Verlag

¹⁰¹ Thüsing, G. and T. Lambrich (2002). "Arbeitsvertragliche Bezugnahme auf Tarifnormen." Recht der Arbeit 55(4): 193-213, Ebeling, R. (2003). Die Bezugnahme auf Tarifverträge im Arbeitsvertrag. Law. Regensburg, Regensburg. **PhD:** 283.

establish a bilateral monopoly at the level of the sector so that neither the employees nor the employers would have excessive power in the determination of the conditions of work. Considering that both of them enjoyed monopoly power at their respective sides, the outcome of the bargaining will be determined by non-economic forces: these non-economic forces could well be the economical situation of the country, the company's need for competitiveness, the need to moderate wages in order to finance expansion or innovation, etc. Both sides would need to enter into a dialogue and reach a mutually optimal solution.¹⁰²

Germany equally has a significant system of employee representation within the company. This representation is regulated by two sources: a statute named as the Law on the Constitution of the Company (*Betriebsverfassungsgesetz*) and a number of statutes on Co-determination (*Mitbestimmungsgesetze*). The first provision regulates the powers of the employee representative bodies at the level of the company. These bodies may be the works council (*Betriebsrat*), the representation of young and trainees (*Jugend- und Auszubildendenvertretung*) and the economical committee (*Wirtschaftsausschuss*). The fundamental representative body within the company is the works council however. A works council (*Betriebsrat*) consists in a non-associative form of employee representation; it is to be elected amid the employees in all companies having at least 5 employees and represents all employees of the company independently of their actual exercise of the right to vote (meaning that an employee cannot claim that (s)he is not represented because it did not vote) (§1BVG). There are several forms of Betriebsräte depending on the structure of the company: if the company is a simple company with one undertaking, then one simple Betriebsrat will suffice; if the company has several undertakings, the works councils of each undertaking are allowed to set up a global works council (*Gesamtbetriebsrat*) whose competence will be limited to the common interests of the whole company (§47 BVG); if the company is organised as a Konzern, then the employees will be entitled to elect a *Konzernbetriebsrat* (§54 BVG).

¹⁰² For the dynamics of a bilateral monopoly see: Cooter, R. and T. Ulen (2008). Law and Economics, Pearson/Addison Wesley.

The BVG regulates the rights of influence (*Mitwirkungsrechte*) of the works council in the affairs of the company. Germany has equally taken an extremely courageous step in comparative law literature concerning the powers of this form of employee representation providing it with extensive rights to influence the affairs of the company.¹⁰³ The basic rationale behind the provision of influence rights to the employees lies in the conception that employees are equally part of the company and that every person affected by an event in the company should at least have the possibility to be informed of it and have a word on the matter. In this sense, it is perhaps the most perfect application of the conception of the company as a nexus of contracts outlined above in the beginning of this thesis. In order to accomplish its tasks, the works council has a duty to apprehend and influence the events happening within the company (*innerbetrieblichen Angelegenheiten*) that directly concern the employees. The BVG considers that this is best achieved by a joint-work and mutual confidence (*Vertrauensvolle Zusammenarbeit*) between the employer and the employee representatives (§2BVG). In order to achieve that, the works council is gifted with a number of rights that may be classified in the following pattern:¹⁰⁴

(a) **Rights of Influence** (*Mitwirkungsrechte*)

- (a.1) Information rights (*Unterrichtungsrechte*)
- (a.2) Listening and Consultation rights (*Anhörungs und Beraterungsrechte*)

(b) **Rights of Co-determination** (*Mitbestimmungsrechte*)

- (b.1) Opposition and Veto rights (*Zustimmungs- und Vetorechte*)
- (b.2) Co-determination rights (*Mitbestimmungsrechte*)

Information rights consist in the right of the works council to be acquainted with certain circumstances occurring in the company. They find their source in the general duty of the employer to work with a spirit of mutual trust with the works council (§80(2) BVG). Listening rights consist in the duty of the employer to hear the opinions of the works council over some subjects; they are better conceived as proposition rights, which consist in the right to address the

¹⁰³ Biagi, M. (2003). Forms of employee representational participation. Marco Biagi, selected writings. K. Law: 191-233.

¹⁰⁴ Schaub, G. (1996). Arbeitsrechtshandbuch - systematische Darstellung und Nachschlagewerk für die Praxis, C.H Beck. §225; Däubler, W. (2006). Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb, Rowohlt Taschenbuch Verlag

employer and make the necessary remarks to it (§§80(1), 92(2), 102(1) BVG). Consultation rights consist in a more advanced form of proposition rights that oblige the employer to discuss the subject with the works council. This does not oblige the employer to reach an agreement but merely to discuss the subject with the works council in good faith and in a spirit of cooperation; it is more correctly conceived as a right to engage in bargaining but always leaving the employers' prerogative untouched (§§74(1) and 111 BVG). Opposition rights consist in the right to oppose a certain decision of the employer; although this does not have in principle any consequences over the validity of the decision, it may have more attenuated consequences; for instance, the works council may oppose a decision of dismissal of an employee in a number of grounds; if the works council opposes the dismissal and the employee contests the dismissal in the courts, then the decision will be avoided by the courts; if not, the decision will remain valid despite the opposition of the works council (§102 BVG). Veto rights consist in the right to block a certain measure that the employer wants to implement; in contrast to the opposition right, the exercise of the veto right renders the decision void. Although the initiative to implement the measure departs from the employer, the works council may still veto it (§99 BVG). Finally, co-determination rights consist in the strongest form of influence over the decision of the employer; before implementing a decision, the employer is obliged to ask for the consent of the works council and engage in a bargaining with it. If no consent is reached both parties need to address a conciliatory board (Einigungsstelle) in order to reach an agreement. The difference between veto and co-determination rights lies in the autonomy to make the decision: whereas in the veto right the principle of negative consent applies (meaning that the employer is free to apply the measure except when the works council opposes it), in the co-determination rights the principle of positive consent applies (meaning that the employer is not free to implement the decision without the previous agreement of the works council). The works council has co-determination rights in the following subjects: social (§87 BVG), workplace conformation (§91 BVG), personnel (§§ 99, 102 BVG) and economical subjects

(when it concerns fundamental modifications to the structure of the company – §§111 BVG).¹⁰⁵

The statutes on Co-determination (*Mitbestimmungsgesetze*) are some of the most thoroughly studied statutes in the world and certainly some that raises the most discussion. The general statute on co-determination (*Mitbestimmungsgesetz* - MtBG) provides that in capital companies¹⁰⁶ that have more than 2000 employees, the employees will be entitled to the election of representatives with decision-making power to the supervisory board and management board. In public companies (*Aktiengesellschaften*) with more than 2000 employees, the workers and the shareholders will be entitled to an equal number of seats in the supervisory board (*Aufsichtsrat*) (§7MtBG). The supervisory board is to elect a president (*Vorsitzender*) by a 2/3 majority that has a quality vote in a situation of deadlock. In addition, the management organ (*Vertretungsorgan*) of the company (which needs to be elected by a 2/3 majority by the co-determined supervisory board) will need to include a labour director (*Arbeitsdirektor*) that will exercise the same competences as the employee representatives in the supervisory board. Companies with more than 500 but less than 2000 employees are also co-determined, albeit to a less extent. §129 BVG provides that §76 BVG 1952 is to be maintained. This provision commanded that in companies that reached the thresholds mentioned above, the supervisory boards of those companies needed to include 1/3 of employee representatives. The Law for co-determination in the coal and steel industry (*Montanmitbestimmungsgesetz*) finally completes the co-determination framework; this statute provides that the supervisory boards of companies operating in the coal and steel industry needed to have 11 members, of whom 4 were elected by the shareholders, 4 by the employees and 2 independent members.

A final word must be given to the coordination of the activities between these actors (trade unions, works councils, co-determined boards). The answer

¹⁰⁵ Ibid, Däubler, W. (2002). Betriebsverfassungsgesetz: kommentar für die praxis, Bund Verlag. Schaub, G. (1996). Arbeitsrechtshandbuch - systematische darstellung und nachschlagewerk fur die praxis, C.H Beck.

¹⁰⁶ The relevant companies for this purpose are the public corporation (*Aktiengesellschaft*), the partnership limited by shares (*Kommanditegesellschaft*), the close corporation (*GmbH*) and the cooperatives (*Genossenschaft*).

lies in §2 BVG: this provision commands that each one of these actors should develop its activity in mutual confidence and collaboration (*vertrauensvolle Zusammenarbeit*) with due respect to their respective competences. This means that when exercising their respective competences, each one of these actors should have in mind the concerns of the other bodies and reach a mutually optimal solution so that the well being of both the worker and the company be enhanced. This is a significant provision whose importance should not be underestimated: §9(3) of the German Constitution lays down a corporatist structure of the economy: this is another expression of that same corporatist structure; there are several sources of employee influence but each one of them must work not in their own self-interest but in the interest of the economy as a whole that comprises the interests of the employees as a class, the interests of the employees of concrete undertakings and the interests of capital and management in having a well-managed and profitable company.

To sum up, one may say that Germany contains a corporatist structure of the economy. It contains several sources of employee influence either at the level of the sector or at the level of the company that provide the best example of the idea of coordinated capitalism expressed above on occasion of the analysis of the structural elements influencing the development of the distinct patterns of corporate governance. Germany contains structures for the representation of employee voice as a class (at the level of the sector by establishing a system of trade union monopoly) and as stakeholders of the company (by means of the several channels of employee influence (Mitwirkungs)). The law commands the mutual collaboration of these diverse channels of employee influence for the benefit of the company and the economy as a whole. In this sense, it is the legal proof of the ideal of stakeholder capitalism that prevails in Germany.

b) France – the French model of employee representation has equally received a considerable degree of attention in the comparative law literature although the adequacy of its solutions seem to have received a wider degree of acceptance and consensus than those found in the German model. However, the relative consensus concerning the French model of employee representation stands in sharp contrast to the evolutions registered in that model. In sharp contradiction to the German model, which has enjoyed a considerable degree of stability, the French model has had a turbulent evolution shaped by the needs of the moment.

The French model of employee representation may be classified as a dualist model: employees may exercise voice either by means of trade unions (*syndicats*) or by means of works councils (*comités d'entreprise*). However, in sharp contrast to the German model, there is a considerable degree of overlapping between these two forms of employee representation: trade unions enjoy mandatory representation in the works council and the shop-stewards enjoy a considerable power in France. Besides these two bodies, the French law also provides for two “independent” employee representatives in the company: the staff-delegates (*délégués du personnel*) and the committee for health and safety at work (*Comité d'Hygiène, Sécurité et des Conditions de Travail* (CHSCT)).¹⁰⁷

In France, trade unions consist in the legal form for the defence and promotion of the common interests of a given professional group (L. 2131-1CTF). The source for the recognition of the freedom of coalition lies in the constitutionally recognised freedom of association (*liberté syndicale*) in France.¹⁰⁸ In contrast to other countries, where the freedom to set up trade unions is reserved only to subordinated employees, in France the freedom to set up trade union organisations is open to all professional groups and not just to subordinate workers; in similar terms, the French law equally recognises the

¹⁰⁷ Moreau, M.-A. (2004). National Report France. The Evolving Structure of Collective Bargaining in Europe. S. Sciarra. Florence, European Commission, University of Florence, Mouret, J. (2007). Collective Relations in France: a multi-layered system in mutation. Decentralizing Industrial Relations and the Role of Labour Unions and Employee Representatives. R. Blainpain, Kluwer: 41-65.

¹⁰⁸ Although the freedom of coalition unequivocally enjoys constitutional protection in France, that does not arise directly from the text of the Constitution of 1958 but from a ruling of the *Conseil Constitutionnel* from 1989 (89-257DC) that, building on earlier case law, provided it with constitutional value.

capacity of the employers to organise themselves in a union. The French understanding of trade unionism as a simple form of exercise of the constitutionally recognised freedom of association had important consequences: trade unions may be formed by a simple deliberation of their members and acquire legal personality by the deposit of their statutes in a registry. There is no room for judgements of opportunity and the only requirements imposed on trade unions is that they be independent from the State and the employer. Another important element consists in the fact that the extremely wide reading of the freedom of association is valid at all levels. Unlike in Germany, where there is one confederation of trade unions, trade unions may colligate and organise at the several levels in accordance with their will. In this sense, French trade unions may be considered as the purest expression of an associative form of employee representation.¹⁰⁹

Another significant characteristic of the regulatory framework of trade unions in France is the idea of representativity (*représentativité*). The recognition of the pure and simple freedom of association led to a trade union fragmentation in France, which manifested itself at all levels of bargaining: company, sector and national. This had the effect of putting side-to-side organisms that were equal in rights but not in aptitude to defend the interests of the workforce. This led to the development of the idea of grading the representativeness of the trade unions and thrusting the most important tasks to the most representative trade unions. Representativeness consists in the aptitude recognised to a coalition of representing the interests of the workforce (both unionised and non-unionised) and of promoting their interests. There is no division of rights however between the trade unions: there is one basic set of rights recognised to all trade unions and one specific set recognised to the most representative. It is more correct to say that the large powers recognised to trade unions are conditioned by their representativeness.¹¹⁰ This means that

¹⁰⁹ Dockés, E. (2008). Doit du Travail Dalloz, Pélissier, J., A. Supiot, et al. (2008). Droit du Travail, Dalloz.

¹¹⁰ For an historical perspective of the idea of *représentativité* see Julliot, S. (2005). Les turbulences au sein du double canal de représentation en France. Recomposition des systèmes de représentation des salariés en Europe. S. Laulom, Publications de l'Université de Saint-Étienne., pp.166-169 and Moreau, M.-A. (2004). National Report France. The Evolving Structure of Collective Bargaining in Europe. S. Sciarra. Florence, European Commission University of Florence.

France also followed a common trend in systems of employee representation of introducing criteria of representativity for the admission of employee representative structures as valid actors for collective bargaining. Nevertheless, there are significant differences in relation to Germany that distinguishes the French criterion of “*représentativité*” from the German “*Sozialen Mächtigkeit*”: whereas the latter led to a system of trade union monopoly at the level of the sector and at the national level (there is only one confederation of trade unions), the former did not pose an obstacle to trade union pluralism at the level of the sector and at national level. There is a considerable degree of fragmentation even among the trade unions recognised as representative.

It is worth viewing in some detail the legal regulation of the representativity of trade unions, which was the object of a major reform in 2008. The original regime, set up in 1982 by the Auroux laws, distinguished between presumed representativity and proven representativity. The cardinal point between the two forms of representativity was the national confederations of trade unions. There were a number of national confederations that had been previously recognised as representative by means of a statute of 1966; in the event that a trade union was affiliated to one of those organisations declared as representative in the 1966 statute, it would be presumed as representative. This presumption operated *de jure*. If the trade union was not affiliated to any of those organisations, it enjoyed a self-representation (representation propre); nevertheless, in the event that it was contested, it had the burden of proof of its representativity. This representativity could be proved by a number of criteria of both a quantitative and a qualitative nature, such as: (1) the number of members, (2) independence, (3) quotisations, (4) experience and age. Although the quantitative criteria prevailed, it did not suffice, as trade unions that could prove its independence and experience were generally deemed representative. This regime suffered a severe blow in 2008 in terms that, in practice, eliminated the presumed representativity and set up a more stringent general regime of proven representativity. In accordance with the new regulation, all trade unions will have to prove their representativity at the level they which to act (company, sector and national) in accordance with stringer new criteria. This is expected to reduce the number of trade unions active in each level and attenuate even further the *dispersion syndicale* in France although it is not expected to

introduce a system of trade union monopoly similar to the one found in Germany.¹¹¹

This regulatory framework led to the development of the “French model” of trade unionism that may be characterised in two terms: fragmentation and political orientation. The trade union fragmentation is a consequence of the extremely generous understanding of the constitutionally recognised freedom of association that allowed the “mushrooming” of employee representative structures; the criteria of representativity attenuated but didn’t eliminate this effect. There are a number of trade unions deemed as representative (even within the same sector) and confederations of trade unions. The political orientation of trade unions is a consequence of the French regulatory framework. The French labour market is heavily regulated and the margin of manoeuvre recognised to trade unions depends of the legal provisions: this means that it is the law itself that determines the powers of trade unions within a certain subject. Since trade unions were sometimes severely constrained in bargaining activities, they turned their action towards the political level. They attempted to influence the labour market by means of close connections with the political parties and by means of tripartite bargaining at the national level. This had several important consequences: the bargaining of the trade unions at the levels of the sector and the company was more heavily influenced by its political perspective than by the concrete interests of the employees at that sector/company. The combination of these two elements (fragmentation and political orientation) led to a certain degree of distrust of the trade unions by the employees themselves that further weakened unionism in France.¹¹²

Representative unions enjoy a number of prerogatives: the most important consists in the right to engage in collective bargaining. There are three levels of bargaining in French Law: company, sector and national. There are several marked differences in relation to the German model however. The foremost characteristic consists in the wide degree of statutory regulation of the labour market. France has always had a very large experience with codification and statutory regulation and the labour market was no exception: France has

¹¹¹ Dockés, E. (2008). Doit du Travail Dalloz.

¹¹² Moreau, M.-A. (2004). National Report France. The Evolving Structure of Collective Bargaining in Europe. S. Sciarra. Florence, European Commission, University of Florence.

always had extensive labour codes. The relationship between the law and collective bargaining was simple: the law laid down (very generous) minima that could only be improved upon by the social partners. The only exceptions were expressly provided for in the law when it unequivocally declared that it could be derogated in a less favourable way by the collective agreement. Another significant characteristic of the French model of collective agreements is the predominant role of the State: the State supervised collective bargaining at the sector level in order to be acquainted with the needs of the sector, advise the partners and organised tripartite bargaining at the national level in order to negotiate the labour regulation. Trade unions rapidly understood that their main level of influence would be the national level and therefore concentrated their efforts at that level. The French model equally exhibited another significant characteristic: the coverage of collective bargaining. Collective agreements celebrated by the representative trade unions had an *erga omnes* effect: this means that they would be applicable to all employees of the employer independently of affiliation. The law equally provided for administrative procedures of extension (that were often used) in order to ensure the coverage of the agreements also to employers not bound by the collective agreement. Collective agreements might be celebrated between individual employers or associations of employers and representative trade unions. They may be classified as collective agreements (*convention collective*) or collective accords (*accord collectif*): the former regulates the whole conditions of employment and social guarantees; the latter regulates one or more specific subjects within the whole range of subjects relative to collective bargaining (such as wages or working time). The relationship between the distinct levels of bargaining (*firm-sector-national*) was also regulated - before the revolution of 2004 - in accordance with the *principe de faveur*: lower levels of bargaining could not derogate the higher levels of bargaining. The combination of these three provisions (heavy regulation, State influence and short margin of manoeuvre) suffices to distinguish the French model of collective bargaining from the German model and consider it as an independent pattern.¹¹³

¹¹³ Moreau, M.-A. (2004). National Report France. The Evolving Structure of Collective Bargaining in Europe. S. Sciarra. Florence, European Commission, University of Florence, Mazeaud, A. (2006). Droit du Travail, Montchrestien, Ray, J.-E. (2006). Droit du Travail - droit vivant, Editions Liaisons, Pélissier, J., A. Supiot, et al. (2008). Droit du Travail, Dalloz.

The representation of employees inside the company also has a very peculiar regime. The representation of employees within French firms is made by means of a non-associative structure that combines elements of trade unions and employee representatives. There are two types of employee representatives at the level of the company, elected representatives and designated representatives: the elected representatives are the works council (*comité d'entreprise*), the staff-delegates (*délégués du personnel*) and the Committee for Health and Safety at Work (CHSCT). The designated representatives are the shop-stewards (*délégués syndicales*) and the trade union section (*section syndicale*).¹¹⁴

The *comité d'entreprise* consists in an organised structure trusted with the task of ensuring the collective representation of the interests of the employees at the level of the company. In a similar way to the German *Betriebsrat*, it may be established at the various levels of decision-making within the company (company, group, group of communitarian dimension). But unlike the German *Betriebsrat*, it has a tripartite structure: the *comité d'entreprise* is composed by (1) the employer, (2) elected representatives of the trade unions and (3) employee representatives. The employer (or one of its representatives) is the president of the comité and is charged with the task of conducting its operations. The trade unions have the right to designate some of its members to stand for elections at the representatives of the works council. The employees of the company elect the works council but, since it is a tripartite body, the trade unions have the right to designate a number of affiliated workers (in accordance with the size of the company) to stand as trade union representatives at that body. Since there is trade union pluralism in France, the idea is to select the most representative trade unions to defend the interests of the employees at the level of the company. Elected employees not affiliated to any trade union finally complete the works council. They are expected to represent the interests of the employees as stakeholders of the company (and not as a class as the trade union representation attempts to ensure). The works council has several types of competences: social and

¹¹⁴ Mouret, J. (2007). Collective Relations in France: a multi-layered system in mutation. Decentralizing Industrial Relations and the Role of Labour Unions and Employee Representatives. R. Blainpain, Kluwer: 41-65.

economical competences. It is worth seeing each one of these competences in detail.

As regards the social competences, the comité d'entreprise is charged with the competence to control and manage all the social and cultural activities established at the level of the company for the benefit of the employees, independently of their source of financing. This was defined as every non-legally mandatory activity performed essentially at the benefit of the personnel of the company, without any discrimination, to improve the collective conditions of the life of the personnel of the company.¹¹⁵

As regards the economical competences, its object is to ensure the collective representation of the employees and to allow for the consideration of their interests in the decision-making procedures of the company. The Auroux laws, which will be analysed in further detail below, provided in 1982 the main impulse for the economic competences of the works council.

Another significant difference between the French comité d'entreprise and the German Betriebsrat consists in the fact that the powers of the French comité are limited to information and consultation rights: the comité merely has the right to be informed and consulted about a number of subject matters; it is merely a forum for discussion and conciliation; the employer's prerogative and competence to implement a certain decision is in no way touched by the powers of the comité; although the employer has a duty to inform the works comité and discuss the subject-matter with it, its margin of autonomy in adopting the decision is in no way affected by it. If we may use the often quoted words of Pothier, the employer is bound to a duty of means but not to a duty of result.¹¹⁶

The staff-delegates (*délégués du personnel*) consist in the second form of elected employee representation in the company. It is perhaps the oldest form of representation because its origins date back to 1936. The function is of

¹¹⁵ Pélassier, J., A. Supiot, et al. (2008). *Droit du Travail*, Dalloz.

¹¹⁶ Lorenz, E. (1995). "Promoting workplace participation: lessons from Germany and France." *Industrielle Beziehungen* 2(1): 46-63, Gumbrel-McCormick, R. and R. Hyman (2006). "Embedded collectivism? Workplace representation in France and Germany." *Industrial Relations Journal* 37(5): 473-491, Mazeaud, A. (2006). *Droit du Travail*, Montchrestien, Ray, J.-E. (2006). *Droit du Travail - droit vivant*, Editions Liaisons, Mouret, J. (2007). Collective Relations in France: a multi-layered system in mutation. *Decentralizing Industrial Relations and the Role of Labour Unions and Employee Representatives*. R. Blainpain, Kluwer: 41-65, Pélassier, J., A. Supiot, et al. (2008). *Droit du Travail*, Dalloz.

the staff-delegate is to serve as an intermediary between the employer and the employees: they are trusted with the task of presenting the individual and collective complaints concerning wages and the application of labour regulations in the company. If the staff-delegate detects an irregularity in the working conditions in the company, he is expected to bring the event to the knowledge of the employer, so that he may undertake appropriate measures; in the event that he fails to undertake any measures, the staff-delegate has the power to address the labour inspectorate and complain to the industrial tribunal (*conseil de préud'hommes*).

The CHSCT consists in a specific body elected to protect the health and safety of the working conditions of the employees. They are expected to conduct inspections in the company in order to supervise the salubrity of the working conditions and communicate their opinion to the employer; the employer is also expected to consult the CHSCT when it plans to introduce measures likely to have an impact over the working environment. They are elected indirectly by the works council.

The shop-steward (*délégué syndical*) consists in a designated employee representative at the company. He is to be designated by representative unions at the level of the company or undertaking; they are not elected by the employees. The main tasks of the shop-steward consists in functioning as a link between the employer and the trade unions and between his union and the employees of the company. It is expected to represent the employees as a class (and not as stakeholders) inside the company. The labour reforms undertaken during the 1980s and 1990s provided the shop-steward with increased competences to the point that it became a key actor within the company, as it will be demonstrated further during the analysis of the evolution of employee representative structures.

The final actor consists the trade union section (*section syndicale*) within the company; this is an automatic actor because it is simply composed by all the employees affiliated to a particular trade union within the company. Since

2008, they are expected to elect a representative: the representative of the trade union section within the company.¹¹⁷

To sum up, one may say that, although the French structure of employee representation may be classified as a dualist structure, it presents a number of differences in relation to the pure dual model found in Germany that suffice to consider it as a model of its own. The main characteristics of the French model consist: (1) outside the company – trade union fragmentation and political orientation, heavy State influence and the *erga omnes* effect of collective agreements; (2) inside the company – proliferation of employee representative structures, representation of employee interests as a class and as stakeholders and limited participation rights. Outside the company, the main characteristics of French trade unionism help us to understand the particular model of employee influence in the regulation of the economy. Since the French labour market is heavily regulated by statute and the labour laws are bargained between the Government, the trade unions and the employers' associations, the trade unions essentially concentrated their efforts at the political level. Therefore, in a similar way to the French model of corporate governance, in France the State also enjoys a considerable degree of influence in the regulation of working life by means of an intermediation with the trade unions and the employers' associations. The fragmentation of trade unionism (that the more stringent criteria of representativity have been attenuating) ensures the representation of all the political interests of the employees and employers in the law-making procedure. At the level of the sector, trade unions could only improve upon the very generous minima laid down by the law (in the elaboration of which they participated). This means that their task is essentially limited to the determination of the wages and the conditions of work (professional careers, working time, etc) at the level of the sector. The *erga omnes* effects of collective agreements and the often-used administrative procedure for the extension of collective agreements helps to eliminate competition in terms of wages and other conditions of work at the level of the

¹¹⁷ For a short but elucidative analysis of the employee representation within the company in France see Mouret, J. (2007). Collective Relations in France: a multi-layered system in mutation. Decentralizing Industrial Relations and the Role of Labour Unions and Employee Representatives. R. Blainpain, Kluwer: 41-65. For a dynamic perspective and a contextual analysis see Moreau, M.-A. (2004). National Report France. The Evolving Structure of Collective Bargaining in Europe. S. Sciarra. Florence, European Commission, University of Florence.

sector because all the employees are bound by them independently of affiliation. Inside the company, France has a curious model that attempts to ensure the representation of the interests of employees as stakeholders of the company and as a class (*i.e.* the representation of the interests of the employees of the sector concerned). There is a plurality of representative bodies, both elected and designated. The main actor (elected) – the comité d'entreprise – may be classified as a pure unitary system of in-company employee representation because it combines at the same table the employer, (elected) trade union representatives and elected employee representatives.¹¹⁸ Although the committé is not gifted with co-determination rights (merely information and consultation), this particular combination of interests helps to ensure that there may be some effectiveness at company-level bargaining because the employees are represented both as stakeholders and as a class at the level of the company. The objective is to ensure that the employer effectively engages in a procedure for information and consultation and not merely pay lip-service to the employees. The remaining actors (the staff-delegates and the shop-stewards) have had an increasing role in French companies (particularly small-companies) as the description of the posterior evolution will demonstrate. This description of the French model of employee representation reveals that France has achieved a particular balance of interests in the regulation of its labour market: the State is seen as an independent arbitrator that conciliates the interests of the parties, the statutory regulation of the labour market (by means of bargained laws) attempts to achieve a balance between the protection of the employees and the needs for competitiveness, the fragmentation of trade unions helps to ensure the representation of the diverse ideological interests and the intervention of trade unions in in-company employee representative structures assists in making an effective pressure upon the employer.

¹¹⁸ Biagi, M. (2003). Forms of employee representational participation. Marco Biagi, selected writings. K. Law: 191-233.

c) Portugal – the Portuguese model of employee representation has not received a great deal of attention in the comparative law literature. This disregard is, in my view, unfair because the Portuguese structures for employee voice have developed a hybrid model that combines elements taken both from the German and the French model. In comparative law the Portuguese model may be classified as a pure dualist model: the representation of employees outside the firm is made by means of trade unions (sindicatos) and inside the firm by means of works councils (comissões de trabalhadores), trade union sections (secção sindical) and shop-stewards (delegados sindicais). The following lines will attempt to describe the main characteristics of the system and the particular balance of interests within it.¹¹⁹

The most important actor in Portuguese employee representative structures is the trade union (sindicato). Trade unions consist in associative forms of employee representation that are constitutionally protected by means of a specific provision – art.55 CRP - that considers trade unions as a specific form of the exercise of the general freedom of association. The protection of the freedom to set up trade unions is, in general, identical to the one found in France and in many other countries. It contains both an individual (positive and negative) and an institutional dimension and must abide by the general requirements of independence from the employer, the state, political parties and religious confessions, having been freely set up, etc. Although the Constitution recognises the right to form trade unions to all workers, the legal thinking and case law have tended to restrict that possibility to the trade unions formed only by subordinate employees, as defined in the Labour Code. Similarly, the Constitution is rather laconic as regards the freedom of association of employers; this was recognised in statute by considering employers' associations as legitimate bargaining partners in collective agreements, a provision whose constitutionality was never questioned. There is such a concern in ensuring the bargaining capacity of employers' associations that the law even recognised bargaining capacity to existing employers

¹¹⁹ Gomes, J. V. (2004). National Report Portugal. The evolving structure of collective bargaining in Europe 1990-2004. S. Sciarra. Florence, European Commission, University of Florence, Gonçalves da Silva, L. (2004). Princípios gerais da contratação colectiva no Código do Trabalho. Estudos de Direito do Trabalho, Almedina. I: 167 ff, Leite, J. (2004). Direito do Trabalho. Coimbra, Serviços de Acção Social da Universidade de Coimbra, Lobo Xavier, B. (2004). Curso de Direito do Trabalho, Verbo, Monteiro Fernandes, A. (2004). Direito do Trabalho, Almedina, Romano Martinez, P. (2008). Direito do Trabalho, Almedina.

associations that were not set up with the purpose of engaging in collective bargaining. There is the tradition in Portugal of setting up chambers of commerce and industry, which consist essentially in associations of entrepreneurs of a given industry or related industries set up with the purpose of defending their interests. These associations are quite established for a long time and form an integrating part of the Portuguese economic life; the objective of the legislation was to take advantage of these pre-existing structures and confer them bargaining capacity in order to encourage collective bargaining. They simply need to register their charters in the competent ministry and require their recognition as an employers' association, which must be automatic because it is not dependent of any criteria of opportunity; it simply needs to abide by the same requirements of trade unions (corporative structure, democratic organisation, etc) and it is automatically recognised (art.447 CTP). Trade unions have a number of duties in accordance with Portuguese law; art. 56 CRP considers that trade unions have the right to (a) participate in the elaboration of the labour legislation, (b) participate in the management of social security institutions and (c) exercise the right to collective bargaining, among others.¹²⁰

The Portuguese system of trade unionism may be classified as one of trade union pluralism and political orientation. Trade unions may be freely set up by a simple deliberation of the subordinate employees that wish to compose it and abide by the meagre requirements of internal organisation. There are no criteria of representativity, *Sozial mächtigkeit*, recognition or others; they simply have to register their internal statutes (which determine their professional competence, which may be cross-industry) at the competent ministry and they become trade unions.¹²¹ This extremely generous regime was finally completed by a recent reform of the Labour Code that recognised trade unions' freedom of

¹²⁰ Gomes, J. V. (2004). National Report Portugal. The evolving structure of collective bargaining in Europe 1990-2004. S. Sciarra. Florence, European Commission, University of Florence, Lobo Xavier, B. (2004). Curso de Direito do Trabalho, Verbo, Monteiro Fernandes, A. (2004). Direito do Trabalho, Almedina.

¹²¹ The Portuguese legal thinking has tended to distinguish between *vertical* and *horizontal* trade unions: the former associate all the employees of a certain industry, independently of their profession (e.g: chemical sector trade union, which aggregates both engineers, chemical workers, administrative workers, sales persons, etc) and the latter associates the same professionals working across industries (e.g: trade union of the administrative employees). See Lobo Xavier, B. (2004). Curso de Direito do Trabalho, Verbo. pp.143-145.

organisation at higher levels (art.440 CTP).¹²² This emphasis on the most extensive reading possible of the freedom of coalition has historical roots; during the dictatorship, trade unions were set up by the Government and controlled in their entirety by it; they determined its coverage (they were generally sector-level unions), designated their leaders and affiliation was mandatory; trade unions were a part of the corporatist structure of society set up by the Regime. The revolution brought about with it a desperate will to erase all historical memories of the old regime and the recognition of any limitation to the freedom of association was seen as a reminiscence of the old regime of trade union monopoly. This serves as an introduction to the second characteristic of Portuguese trade unionism: its extreme politicization: political parties took over the existing trade union structures shortly after the revolution and attempted to use trade unions as a means of making politics. The consequence was that, in absolute contradiction to the constitutional command, trade unions are not only related to political parties but also use the bargaining ground to make politics. This caused some public distrust of trade unions with adverse consequences over the movement. Recently, a group of trade unions that did not fit within this political sphere, formed a confederation named as Confederation of Independent Trade Unions (*Confederação dos Sindicatos Independentes*); they attempted to distance themselves from politics and perform independent bargaining; they have recently signed a very important collective agreement for the employees working in services available to the public (such as shopping-centres) and are increasingly gaining public recognition.¹²³

Trade unions have a number of tasks enumerated in art.56 CRP: the most important of them are the participation in the elaboration of the labour legislation and collective bargaining. As regards the participation in the labour legislation, there is a constitutional provision that commands that the trade

¹²² The former statute regulating trade unions (*Lei dos Sindicatos*) placed some demands of *representativity* over higher levels of organisation of trade unions (1/3 of the trade unions of the sector concerned). Some rulings considered this demand to be *inconstitucional* because it violated the interpretation of the freedom of coalition as a specific exercise of the general freedom of association (See ruling by the *Court of Appeals of Coimbra* of 26.06.1979).

¹²³ Menezes Leitão, M. J. (2001). "General features of collective bargaining in Portugal" *International Journal of Comparative Labour Law and Industrial Relations*: 441 ff, Gomes, J. V. (2004). National Report Portugal. *The evolving structure of collective bargaining in Europe 1990-2004*. S. Sciarra. Florence, European Commission, University of Florence.

unions participate in the elaboration of the labour legislation (art.56(1),a) CRP). The means to achieve this was by the setting up of a permanent council that bargains the labour legislation at a tripartite level between the trade unions, employers' associations and the government. Considering that the Portuguese labour market is heavily regulated by statutory law, the main area of intervention of trade unions is precisely in this council, which is where they concentrate their efforts. As regards collective bargaining, the Portuguese Constitution provides trade unions with a constitutional monopoly in terms of collective bargaining (art.56(2)CRP). Portuguese law recognises three levels of bargaining: national, industry and company. Collective agreements may be celebrated at each one of these levels and the rule is that the collective agreements of a more specific level (i.e: lower level) derogate the agreements of a higher level even if they provide for a less favourable treatment (art. 536CTP). Portuguese labour law is dominated by the principle of double-affiliation (such as Germany); this means that, in contrast to France, collective agreements do not enjoy an *erga omnes* effect. Despite its low unionisation numbers, Portugal enjoys a wide coverage of collective agreements, essentially by means of an administrative procedure for the extension of the agreements (*declaração de eficácia geral*) and by means of incorporation clauses (*cláusulas de remissão*) inserted in individual labour contracts in order to apply voluntarily the provisions of the collective agreement.¹²⁴ As regards the content of the collective agreements, they are generally poor. Since the statutory regulation of the labour market is so extensive and, previously to the approval of the Labour Code, collective agreements could only improve upon the (very generous) minima provided for in the law, collective agreements simply determined wages and professional careers; they also copied extensively the provisions of the law in order to serve as a means of disclosure of the statutory rights of the employees. The combination of these two elements may suffice to provide a picture of the powers of trade unions in Portugal.¹²⁵

¹²⁴ For a comparative study of these *incorporation agreements* covering German, Portuguese and British Law see Mestre, B. (2008). "Cláusulas de Remissão a CCT." *Questões Laborais* (30): 139-171.

¹²⁵ Menezes Leitão, M. J. (2001). "General features of collective bargaining in Portugal " *International Journal of Comparative Labour Law and Industrial Relations*: 441 ff.

Portuguese Labour Law equally has non-associative forms of employee representation. These occur within the company and consist in two cardinal actors: works councils (*comissões de trabalhadores*) and shop-stewards (*delegados sindicais*). Works councils enjoy honours of constitutional recognition; art.54CRP recognises as a fundamental right of workers the right to set up works councils in order to defend their interests and participate democratically in the management of the company. This provision was nothing but the recognition of a form of workforce representation that had previously some extra-statutory practical experience; works councils had been voluntarily set up during the 1970s (before and after the revolution) in order to engage employees in the life of the company and cope with the difficulties of the time. Although works councils are not gifted with co-determination rights they enjoy a number of rights, such as: (1) right to information, (2) right to supervise the management of the companies, (3) right to participate in the procedures for the restructuring of companies, among others. Their concrete powers in each subject-matter varies to a great extent; there is a graduation of their rights: (a) right to information, (b) right to consultation and (c) right to bargain; the first right merely provides the works council with the right to be acquainted with some aspects concerning the life of the company; the second right provides the works council with the right to be heard over some subjects (they may express their opinion but there is no mandatory bargaining); the final right creates a mandatory bargaining with the works council; although the employers' prerogative is in no way affected by it, it is obliged to engage in a procedure for negotiation with the works council.¹²⁶ Works councils are supposed to be set up at the level of the company (art.415 CTP); in the event that the company is divided in several undertakings, they may also establish sub-works councils (*sub-comissões de trabalhadores*); in the event that the company is organised as a group of companies or there are common interests to the workers of distinct companies working in the same geographical area, the workers may set up coordinating works councils (*comissões coordenadoras*) destined to coordinate the actions of the individual works councils. The understanding of

¹²⁶ This is where the influence of EU-Law was more evident, as I will demonstrate further. See, for the classification of the rights of the works council: Gomes, J. V. (2004). National Report Portugal. The evolving structure of collective bargaining in Europe 1990-2004. S. Sciarra. Florence, European Commission, University of Florence, Monteiro Fernandes, A. (2004). Direito do Trabalho, Almedina, Romano Martinez, P. (2008). Direito do Trabalho, Almedina.

the role of the works council – which is constitutionally recognised - must be seen within its due constitutional context: the original configuration of the works council in the post-revolutionary Constitution of 1976 foresaw a vindictive role of the works council; since the economic constitution was clearly marxist, the works council was seen as a form of workforce vindication in the workplace towards the building of a society without classes. The ideological neutralisation of the Constitution undergone in the constitutional revisions of 1982 and 1989 considerably modified the economic constitution; the main ideas were now full democracy, social market economy and privatisation. This had a profound impact over the role of the works council whose role turned from vindictive to participative; the works council was now expected to participate in the promotion of the common objectives of the company guided by an idea of social dialogue and compromise of a community of work inserted within a certain productive organisation. This is a radical shift in the role of the works council that explains its feeble powers of information, consultation and bargaining.

The shop steward (*delegado sindical*) is, curiously, the most important actor of Portuguese in-company employee representation. The meagre dissemination of works councils provided trade unions with a fantastic opportunity to interfere in the company life. Shop stewards consist in trade union representatives elected by all the employees affiliated to a particular trade union (named as trade union section); there may be as many shop stewards in a company as the trade unions represented in the company. In the event that one trade union section elects more than one shop steward, the shop-stewards affiliated to the same union may set up a trade union commission (*comissão sindical de empresa*); in the event that there is more than one shop steward in the company representing distinct trade unions they may set up a company inter-trade union commission (*comissão inter-sindical de empresa*), so as to coordinate their actions. The law does not provide for the tasks of the shop stewards because that is a matter left to the internal statutes of the trade union and collective bargaining. In general terms, one may say that they have two types of tasks: (1) bilateral information between the trade union and the company and (2) supervision of the compliance with the rules regulating labour relations, in particular collective agreements. The implementation of Directive 2002/14 also provided shop stewards with

important rights to information and consultation, as the last chapter of this thesis will attempt to demonstrate.

The original idea behind the recognition of the existence of works councils and shop stewards consisted in the setting up of a pure dual-channel of employee representation. The works council would represent employees as stakeholders of the company in their relationship with management and shop-stewards would represent employees as a class within the company, supervising the compliance with labour regulations and collective agreements. This 1970s were the time of major expression of this model; nowadays it is reduced to a reduced number of very large companies; although the basic model still exists as such, it has a very feeble expression currently.¹²⁷

To sum up, one may say that the Portuguese model of employee representation is a hybrid dual-channel model that combines elements from the German and the French models. From the German model, the Portuguese model extracts the dual-channel of representation in its purest form (the works council merely represents the employees and the powers of the shop stewards are extremely limited) and the principle of double-affiliation of the collective agreements; from the French model, the Portuguese model extracts the freedom of affiliation in its purest form (not even tempered by ideas of *repräsentativité* or *Sozialen Mächtigkeit*), the heavy statutory regulation of the labour market by means of laws bargained at a tripartite level with the trade unions and the employers' associations, the (traditional) relationship between law and collective bargaining (in which collective agreements could only improve upon the minima provided for in the law) and the weak powers of the worker representatives at the level of the company (they are limited to information, consultation and bargaining rights). This means that the powers of employee representatives (both associative and non-associative) are, in comparative terms, extremely weak; the trade unions concentrate their force at the political level because they are aware that their main strategy of influence of the labour market is by means of the conformation of labour laws at a

¹²⁷ Gonçalves da Silva, L. (2004). Princípios gerais da contratação colectiva no Código do Trabalho. *Estudos de Direito do Trabalho*, Almedina. I: 167 ff, Leite, J. (2004). *Direito do Trabalho*. Coimbra, Serviços de Ação Social da Universidade de Coimbra, Lobo Xavier, B. (2004). *Curso de Direito do Trabalho*, Verbo, Monteiro Fernandes, A. (2004). *Direito do Trabalho*, Almedina, Gomes, J. V. (2007). *Direito do Trabalho - relações individuais*. Porto, Coimbra, Romano Martinez, P. (2008). *Direito do Trabalho*, Almedina.

tripartite level. Nevertheless they equally enjoy considerable influence at the level of the sector, namely in the determination of the wages and the professional careers; the importance of the collective agreements (despite trade union fragmentation and dispersion) is such that the declaration of general efficacy and incorporation agreements are even seen as a normal component in collective bargaining and in labour contracts. This is constitutionally recognised in art.56 CRP, which provides trade unions with a bargaining monopoly although it refers to the law the competence of determining the conditions for the legitimacy and efficacy of the collective agreements (art.56(2)CRP). The weakest part consists in company-level representation; the powers of works councils are extremely limited, their numerical expression is meagre and the actions of shop stewards consist in the supervision of the compliance with the labour regulation. In this sense they mimic the (traditional) powers of the French structures of in-company employee representation but not their structure (works councils are only composed of employees and do not incorporate union representatives or the employer). The final result consists in a hybrid model that **structurally** resembles the German model (because it is underpinned in a dual channel of representation with trade unions and works councils; the similarities end here however because trade unions are not subject to criteria of *Sozialen Mächtigkeit* and works councils do not enjoy co-determination powers) but **functionally** resembles the French model (with heavy statutory regulation, main influence at the political level, sector bargaining limited to the determination of wages and professional careers (albeit important) and weak employee voice at the level of the company).¹²⁸

¹²⁸ For a sociological perspective of the Portuguese system of industrial relations see the excellent study of Menezes Leitão, M. J. (2001). "General features of collective bargaining in Portugal" *International Journal of Comparative Labour Law and Industrial Relations*: 441 ff.

d) UK – the final model relevant to this thesis consists in the British model of employee representation. This model is, in comparative terms, an extremely interesting model because the assumptions in which the comparative analysis has been built are somewhat inverted: the system is a monist system, collective agreements have no mandatory effect and the majority of collective bargaining is made at the level of the undertaking (and not sector nor company); also, as the last chapter will attempt to demonstrate, it was probably the system that demonstrated a more surprising evolution in comparative terms. The following lines will attempt to demonstrate the traditional characteristics of the system and the particular balance of interests within it.

The British system of employee representation may be summoned in two very influential concepts: monism and voluntarism. As regards monism, the UK is the paramount example of a monist/single channel system: the representation of employees is traditionally made exclusively by trade unions, which enjoy the monopoly of representing employees and engaging in collective bargaining. Although trade unions may be considered as associative forms of employee representation, the British conception of a trade union differs slightly from the ones that I have been describing lately. A trade union consists in an independent organisation (temporary or permanent) composed wholly or mainly by workers of one or more descriptions, whose main purposes include the regulation of the relations between the workers of those description (s) and employers or employers' associations. This definition must be completed by some further considerations: firstly, trade unionism is open to all kinds of workers (i.e: it is not limited to subordinate workers working under a contract of employment) with the exception of purely autonomous workers; secondly, although it must be an organisation, it needs not be permanent; a temporary coalition of workers set up for a specific purpose (e.g: bargaining certain conditions of health and safety at work when a disaster occurs) may be recognised as a trade union; organisations of trade unions and branches of trade unions may be themselves recognised as trade unions; thirdly, the trade union must be independent from the employer; independence means that the trade union is not under the domination or control or vulnerable to interference from the employer or groups of employers; a trade union may choose to be listed on a Certification officer that will issue a certificate of independence in the event that it recognises its independence; finally, the organisation of workers

must have a substantive element; it must be set up with the express purpose of regulating the relations between the workers of that particular description and the employer or employers' associations. As we can see, although British trade unions are broadly subject to the same requirements as associative forms of employee representation in the other jurisdictions under analysis, the fact that it covers all workers who are not purely autonomous and that it may be only temporary suffices to distinguish it as a specific model. Employers may also set up "trade unions", under the same requirements as employees; despite this, as it occurs in several countries, employers may also stand alone in collective bargaining.¹²⁹ The legal basis for each one of these forms of association is the internationally recognised freedom of coalition in various international law instruments that have binding force in the UK by means of the transposition of their provisions into national law.

The concept of voluntarism is the second influential concept in British industrial relations.¹³⁰ This extremely broad concept refers to three distinct realities. There is no legal framework for collective bargaining in the UK; this means that the collective regulation of the terms and conditions of employment took place mainly at a voluntary basis. In addition, there is no legal obligation for employers to bargain with trade unions; the employers may choose to bargain with a particular union by means of an act of recognition. To complete the picture, collective agreements have no mandatory effect in the UK; collective agreements remain mostly gentlemens' agreements – which are binding in honour only! These three dimensions of voluntarism deserve a further development.

Employers are under no duty to bargain with the trade unions; they may elect to do so by means of an act of recognition. Recognition may be defined as the acknowledgement by an employer or two or more associated employers of a trade union, to any extent, for the purposes of collective bargaining. This recognition consists, fundamentally, in an agreement between the employer and a trade union to discuss one or more issues. The recognition/agreement

¹²⁹ Collins, H., K. D. Ewing, et al. (2005). Labour Law: texts and materials, Oxford, Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher.

¹³⁰ See for further details - Davies, P. and M. Freedland (2004). National Report United Kingdom. The evolving structure of collective bargaining in Europe 2004. S. Sciarra, European Commission, University of Florence.

may be express or implied; in any case it is always purely voluntary.¹³¹ This agreement must be distinguished from the mere willingness to discuss a certain subject matter; the affiliation to an employers' organisation that has recognised the union does not imply that the union is also recognised by the employer (*Nugsat vs Albury Bros Ltd*); despite this, the EAT has inferred an implied recognition from the cumulative effect of (1) contacts between the employer and the union for the period of one year; (2) consulting the union's shop steward for the allocation of duties; (3) allowing him to collect union dues in the premises of the undertaking, (4) consulting him over security and discipline (*Joshua Wilson & Bros Ltd vs USDAW*).¹³² Where a union has been recognised outside the statutory procedure, there is no constraint upon the employer of varying the scope of the recognition or withdrawing it altogether. Even when the recognition is contained in an express agreement, it falls under the presumption of non-enforceability of collective agreements and its terms are not considered apt for incorporation in individual contracts of employment.¹³³ Finally, it must be said that there is no procedure to control the employers' choice of union. There is nothing preventing the employer from recognising a union that gathers only minimum support from among the workforce. The British Trade Union

¹³¹ The influence of EU Law led the UK to the enactment of a *statutory procedure for recognition*, by means of which an employer may be forced to recognise a trade union for a number of purposes. This is a considerable innovation in British law that is expected to bring about a considerable number of modifications to its structure of collective bargaining. I will analyse in detail below the *origins, details and impact* of this statutory procedure for recognition. For an excellent analysis see Barnard, C. (2007). *Worker Representation in the UK. Decentralizing Industrial Relations and the Role of Labour Unions and Employee Representatives*. R. Blainpain, Kluwer: 83-103.

¹³² Examples taken from Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher., pp.762-763.

¹³³ It was mentioned above that, traditionally, collective agreements do not enjoy a binding nature in British industrial relations. The trade unions have managed to contour this problem by means of *incorporation agreements*; these agreements consist in clauses inserted in individual contracts of employment destined to incorporate the terms of the collective agreement in the individual contract; the provisions then become *mandatory* by force of the individual contract of employment; they are the functional equivalent to the German *Verweisungsklauseln*. Despite this, the judiciary has distinguished between the terms apt for incorporation and those that are not; in Continental European terms, only the "*normative part*" of the collective agreement would be apt for incorporation. Since the recognition forms part of the "*contractual part*" of the collective agreement, it is not apt for incorporation and unionised employees may not demand recognition of their union based upon the incorporation agreement. See Mestre, B. (2008). "Cláusulas de Remissão a CCT." Questões Laborais(30): 139-171.; Anderman, S. (1993). Collective agreements and contracts of employment in the UK. The changing face of Labour Law and Industrial Relations - Liber amicorum for Clyde W. Summers. R. Blainpain and M. Weiss. Baden-Baden, Nomos Verlag.

Confederation designed a Code of Conduct according to which minority trade unions would refrain from attempting to conquer recognition in an undertaking where another union gather the support of the majority of the employees.

The concept and procedure of recognition is a distinguishing feature of British collective bargaining that is extremely difficult to classify in comparative law terms. The possibly best classification of it might be as a form of representativity: in a Darwinian world in which the employer is not statutorily bound to bargain with any trade union, only the strongest trade unions will be able to achieve recognition. They will be the only ones to be able to exercise effective power over the employer by means of the statutory immunity to the tort arising from industrial action.¹³⁴ The Code of Conduct of the TUC (that discourages minoritary unions from attempting to have recognition) further confirms this idea of attempting to avoid trade union fragmentation and reserving the most important tasks to the more able unions. The fact that the recognition is done in purely informal terms completes this idea: only the strongest (= most representative) unions will be able to claim the privilege of engaging in collective bargaining.

The British regulation of collective bargaining is also very specific and curious from a comparative point of view. The principle of voluntarism prevalent in British industrial relations also manifested itself at the level of the collective agreements: there is no legal regulation of the procedures or outcomes of neither collective bargaining nor any requirements that collective agreements cover certain specified matters, have certain duration, cover a legal form or include any specific terms. In addition, collective agreements are presumed not to be enforceable; they are merely gentleman's agreements that are binding in honour only. Although there was a short period, between 1971 and 1974, in which collective agreements were presumed enforceable by force of the Industrial Relations Act 1971, this Act was repealed by the Labour Government of 1974-1979 at the request of trade unions; also, although both statutory and common law allow trade unions and employers to provide the collective

¹³⁴ In contrast to many other countries, there is no statutory *right to strike* in the UK, not even as a constitutionally protected fundamental right. The improperly called *right to strike* may be more properly defined as an *immunity from strike* in a number of situations where the law recognises an *industrial dispute*. The law exempts trade unions from tortious liability for exercising industrial action in the context of an industrial dispute. See Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher., pp.975-1006.

agreement with binding force, the practice reveals that this possibility is seldom used.¹³⁵ The reason why trade unions refuse to allow any deviation from the principle of non-enforceability of collective agreements lies with the dynamic nature of British collective bargaining: they want to remain free to renegotiate the agreement as the need arises! Thanks to this specific procedure, in contrast to what occurs in Continental jurisdictions, there is no distinction between conflicts of interest (which concerns the renegotiation of terms) and conflicts of right (which concerns the interpretation of the terms); each one of these disputes is liable to resolution by means of the collective bargaining process. In addition, there are neither mechanisms for the extension of collective agreements nor solution to conflicts over the distinct levels of bargaining. This leads us to the final dominant characteristic of British collective bargaining: its extreme decentralisation. Although in the period between the two world wars there was an effective and prevalent system of multi-employer bargaining at sector and national levels (concerned essentially with the determination of wages and professional careers, like in Continental Europe), this regime began to loose expression after WW II in which the shop-floor bargaining became the prevalent level of bargaining. The reasons for the prevalence of shop-floor bargaining are difficult to explain but the generally accepted justifications are reduced to three points: (1) the prevalence of piece-work payment or bonus schemes in the organisation of work; (2) the decentralised structure of British companies and (3) the trade unions recognition of the importance and specificities of local labour markets. In short terms, trade unions would bargain at the level of the shop-floor the rates of pay that the local branches of companies could effectively afford; in addition, the alignment of interests between the workers and the company was made by means of piece-work schemes of remuneration, in which the company would

¹³⁵ The traditional British attitude to collective bargaining is one of *voluntarism*; between 1971 and 1974, the Conservative Government of the time attempted to *regulate* the activity of trade unions by means of the Industrial Relations Act 1971, which presumed that the collective agreements were enforceable. This Act met fierce opposition from shop stewards and the Labour movement, who always regarded state intervention in collective bargaining as undesirable. Trade unions also oppose inserting clauses of *enforceability* in collective agreements because they want to remain free to renegotiate the agreement in the event that the circumstances in which the agreement was celebrated modify substantially. Voluntarism in collective bargaining is, in this sense, a demand of trade unions for them to continue their activity. See *Ibid.* ; Collins, H., K. D. Ewing, et al. (2005). Labour Law: texts and materials, Oxford. Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher.

pay its employees in accordance with their effective contribution to the company in order to ensure the retention of profits for reinvestment.¹³⁶

The bargaining of collective agreements at the shop-floor level presupposes the existence of employee representation at that level. In this sense, Britain is also markedly distinct because its monist system causes that the representation of employees be made only by trade unions. The main actor at the company level is the shop steward. Shop stewards are trade union representatives at the workplace; a union in accordance with their internal charters appoints them but they must be legitimated by an election by the workers affiliated to a particular union in the workplace; in this sense they are both elected and designated employee representatives.

There are two types of shop stewards: trade union officials and union learning representatives. **Trade union officials** are the proper shop stewards; they have the task of (a) negotiating with the employer any matters falling within the statutory definition of collective bargaining in respect of a union that is recognised by the employer; (b) ensure, on behalf of the employees, the performance of the duties related to collective bargaining matters that the employer agreed to perform with the recognised union and (c) information and consultation procedures where specifically designated. **Union learning representatives** consist in a specific type of shop steward whose main function is to advise union members about their training, educational and development needs. Their advice is generally provided directly to members of their union at the place of work. Although trade unions have these tasks, they have comparatively few rights: the only statutory right that the members of recognised unions have is time-off (depending of employer authorisation); there is a Code of Conduct that goes further but it has no binding force.¹³⁷

Shop stewards are **not** non-associative employee representatives; in contrast to what we have been observing in the previous jurisdictions, shop stewards represent the interests of the members of the union in the relationship with the management. The British model of industrial relations traditionally does

¹³⁶ Davies, P. and M. Freedland (2004). National Report United Kingdom. The evolving structure of collective bargaining in Europe 2004. S. Sciarra, European Commission, University of Florence. ; Barnard, C., S. Deakin, et al. (2002). The Use and Necessity of Article 18.1(b)(i) of the working time directive in the United Kingdom - Final Report.

¹³⁷ Ibid.

not recognise non-associative employee representative structures; considering that it is a monistic system, the representation of employees is made solely by trade unions (which are by definition associative structures). In the past, trade unions could enforce a number of union security clauses to secure membership; the foremost example was the closed shop agreement, according to which the employer could employ only unionised members. A milder form of closed shop was the agency shop, which required non-affiliated employees to join the union or to pay a representation fee after their hiring. Although union security clauses are not per se illegal in the UK, they have lost all expression because the fierce anti-union policy of the Thatcher Government of the 1980s prevented unions from enforcing these clauses by rendering all industrial action illegal and protecting employees against discrimination from non-union membership. This led to their vanishing from the British industrial relations panorama.¹³⁸

To sum up, we may say that the British system of employee representation is a fascinating field of study for a Continental comparatist. Its underlying pillars – monism and voluntarism – have produced a system with several peculiarities that distinguishes to a radical extent the British model. The fact that all employee representation (both within the company and outside the company) is made by trade unions (who are associative forms of employee representation) has the consequence that it is very difficult to distinguish the participation of employees in the company as stakeholders and as a class. There is an overlap between both dimensions that must be solved internally by the internal charters and dynamics of the trade union. The fact that unions need to be recognised and that the recognition was a purely voluntary act also raises a number of difficulties for a comparatist to understand the system; the concept of recognition was classified as a form of representativity because only unions that could exercise an effective power could achieve recognition; in addition, since the TUC has internal procedures to avoid union fragmentation at the shop floor that would render recognition of individual unions more difficult, this may be a further contribution to its classification as a form of representativity, although the conceptual categories do not cover all the specificities. The regulation of collective bargaining is also surprising; the fierce opposition to the

¹³⁸ Deakin, S., William S. Morris (2005). Labour Law. Oxford, Hart Publisher., pp.790-806

enforceability of collective agreements by the trade unions to ensure the possibility of permanent renegotiation of terms is, to say the least, appalling at the eyes of a Continental lawyer. The fact that, in contrast to the remaining countries, the UK also introduced in a very early stage forms of decentralised bargaining that became the predominant forms of bargaining in the country distinguishes the model to a considerable extent. Finally, as regards in-company employee representation, in sharp contrast to the other jurisdictions under study, the UK has no non-associative forms of employee representation; shop stewards that represent only the members of the recognised union make all bargaining at the shop floor level. Since shop stewards are simultaneously union officials and employees of the company, they are expected to bargain both as stakeholders and as a class, which is a very challenging task for one person. The combination of these four features (single-channel representation – decentralised bargaining – non-enforceability of collective agreements – State abstention from industrial relations) produced a system with its own internal dynamics that may be considered an autonomous model. This model is currently undergoing a deep process of evolution however that will be analysed in the last part of this thesis.

e) comparative perspectives – although all four countries constitutionally recognise the right to set up employee representative structures, their practical configuration and tasks of the representatives vary to a great extent. The first great division occurs within the monist/single channel and dualist/dual channel systems; whereas the former only recognise associative forms of employee representation, the latter recognise both associative and non-associative forms. As regards the associative forms of employee representation, each one of the jurisdictions under study reveals a great degree of disparity in the practical configuration of the bodies; whereas some recognise the right to associate only to subordinate employees (Germany and Portugal) others accept that other non-professional workers also set up representative structures (France and the UK). Another great distinction consists in the recognition of the aptitude to engage in collective bargaining; whereas some are bound to criteria of representativity (Germany, France, UK) others have no mechanisms to prevent union fragmentation (Portugal); finally, their main bargaining strategies are also radically distinct: in Germany, the trade unions concentrate their actions at the

industry level – where they enjoy monopoly – to bargain the best solutions almost free from statutory regulation; in France and Portugal, the trade unions divide their action in the national level (by means of tripartite bargaining of the labour legislation, which has a preponderant role in the regulation of the labour market) and at the industry level in the determination of the wages and the professional careers; in the UK, the main bargaining ground of the trade unions was traditionally the shop floor level; sectoral bargaining lost almost all importance after WW II (except for some specific industries) and national bargaining has no place due to the virtual absence of statutory regulation of the labour market.

The regulation of the labour market is made essentially by means of collective agreements. Even here there is a great degree of disparity; the first great division concerns the enforceability of the collective agreements; whereas in continental Europe (Germany, France, Portugal) they have the strength of a “contractual law”, in the UK they are merely gentleman’s agreements. Another great division concerns its binding force; some jurisdictions apply the principle of double-affiliation (Germany, Portugal, UK), although attenuated by administrative and contractual mechanisms, and others attribute an *erga omnes* effect to collective agreements (France). The final disparity concerns the content of the agreements: as a principle, all agreements contain provisions concerning the determination of wages and professional careers; but, in countries with low degree of statutory regulation of the labour market (Germany, UK), they also include other provisions, such as the procedure to follow in situations of collective redundancies, information and consultation procedures, etc. There is a greater margin of collective autonomy in the regulation of the labour market. In countries with a large degree of statutory regulation of the labour market (France, Portugal), that intervention is made at the national tripartite level; the sectoral level is concerned essentially with avoiding wage competition and informing employees of their statutory rights. That is the reason why in these jurisdictions, it is normal that collective agreements simply reproduce the provisions of the law so as to inform employees of their rights.

With the exception of the UK – which follows a monist system – the remaining jurisdictions equally present forms of non-associative employee representation. This is made essentially by means of works council type bodies

that are elected by the employees in the company. However, even here, there is a wide degree of disparity. There are two main questions that need to be addressed: the relationship between associative and non-associative types of representation and the powers that these bodies enjoy. As regards the first question, all jurisdictions have managed to coordinate the activities of both bodies; the idea is to ensure that employees are represented both as a class and as stakeholders of the company. Some jurisdictions opt for a radical separation (Germany and Portugal) and others opt for a unitary body that is expected to function as a conciliatory board (France). Although the techniques are distinct, it seems that both countries have managed to achieve certain equilibrium between these two dimensions. The situation is more complex in the UK, where the shop steward (who is both an employee of the company and a member of the union) is expected to weight these two dimensions in its bargaining activity. As regards the second question, the rights that these bodies enjoy vary widely from very feeble rights to information and consultation (Portugal, France) to strong co-determination rights (Germany). This means that there is a graduation of the rights of influence that non-associative forms of employee representation enjoy in each jurisdiction.

To sum up, one may say that, although all the jurisdictions under study recognise the possibility of employees to organise and intervene in the life of the company and the regulation of the labour market, there are diverse forms of intervention with a variable extension. Each one of the jurisdictions under study also developed its own mode of intervention that influenced to a considerable extent other countries up to the point that it may be considered as an independent model.

1.6 Corporate Governance, Employee Representation and Collective Bargaining - institutional complementarities?

The majority of the studies on corporate governance focus on the relationships between the shareholders and managers of corporations and tend to use the agency costs approach as a means of improving the governance of companies. Much less attention is paid to the role of labour in governance structures. This absence appears to be caused by a combination of two distinct phenomena: the majority of the corporate governance literature arises from the anglo-saxon countries, where labour traditionally has a very weak role and its participatory mechanisms are not very different from those used by shareholders (such as stock options and pension funds, thus transforming employees in shareholders). The absence of effective mechanisms employee voice at the company level and the employee's use of company law instruments to align their interests with the company lead to a certain disregard of the impact of corporate governance structures upon labour management. In addition, in countries where labour has traditionally had a stronger participative role (Germany and France) the corporate governance literature has tended to ignore the impact of these mechanisms in governance structures on account of an academic feud: the participation of workers in decision-making structures is seen as the domain of Labour Law and not of corporate governance;¹³⁹ the predominance of privatistic views of company law in continental Europe (in which the company is seen predominantly as a private law contract between the shareholders) provides a further contribution to the ignorance of the interactions between corporate governance and labour. The combination of these factors might provide a reasonable explanation for the absence of labour in the traditional debates concerning corporate governance.

The picture has however changed lately with a number of studies that have attempted to analyse the interactions between corporate governance and collective bargaining in a number of countries. The focus of these studies

¹³⁹ The foremost example is Germany where employee participation mechanisms are not seen as part of Company Law (*Gesellschaftsrecht*) but of Enterprise Law (*Unternehmensrecht*). See Schaub, G. (1996). *Arbeitsrechtshandbuch - systematische darstellung und nachschlagewerk fur die praxis*, C.H Beck, Schmidt, K. (2002). *Gesellschaftsrecht*, Carl Heymanns , Däubler, W. (2006). *Das Arbeitsrecht - die gemeinsame Wahrung von Interessen um Betrieb*, Rowohlt Taschenbuch Verlag , Hueck, G. (2007). *Gesellschaftsrecht*, C.H Beck.

consists in the possible interferences between corporate governance and labour law and attempt to infer from this debate the exact role that labour should perform in the current governance debate. The main studies were undertaken by Gospel and Pendleton, Martin Höpner and Simon Deakin. Although these studies implement distinct methodologies in the analysis and focus different dimensions of the problem, one must describe the conclusions of each one of these scholars in order to attempt to get a glimpse of the mechanisms by means of which corporate governance and collective bargaining interact.

1.6.1 Multiple interactions between Corporate Governance and Employee Representation

This analysis should begin with the conclusions reached by Gospel and Pendleton.¹⁴⁰ These authors edited a book in which they requested to a number of prominent scholars across Europe, the US and Japan to describe their corporate governance and labour management systems in an evolutionary perspective. Drawing upon the data collected by each country report, these authors used an index methodology in which they attempted to correlate patterns of corporate governance and labour management in order to attempt to draw common patterns. The authors concluded that the relationship between one and the other is not so straightforward as one may guess. Corporate governance and labour management appear to mutually influence each other in a number of ways and the understanding of the reach of those mutual influences depends of the consideration of a number of variables. One extremely important variable consists in the *legal rights of influence* (*Mitwirkungsrechte*) that employees enjoy in the company. The most extreme case is Germany with its *Mitbestimmung* statute that directly empowers employees in the governance of the company. This is seen as the main cause of the strongly employee-friendly policies enforced in Germany and one of the main impediments (but not the only one) to the development of an anglo-saxon style of shareholder value in German corporations. The authors equally found a positive correlation between finance and labour management; the shareholding

¹⁴⁰ See the seminal work Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford.

structure of the company (both in terms of the dispersion of ownership and the identity of the shareholders) influences the *balance of interests* that managers must promote in their running of the business and the managers' attitude towards labour. The authors claim that the more financial a shareholder structure becomes, the less likely it is for managers to make long-term investments in the workforce. Time-horizons consists in another area in which governance is said to influence labour: the more "marketised" a governance system becomes, the more likely it is to adopt measures that encourage short-termism with adversarial consequences for the labour force. Finally, the authors equally founds that governance systems may also influence company-organisation: the term "company-organisation" encompasses a number of elements such as incentive structures and labour organisation. The marketisation of a governance system is said to encourage a given type of firm organisation in which the firm is decomposed in strategic business units that are managed in a purely financial manner; the decision-making structure is decentralised towards the level of the strategic business unit and the unit is expected to generate financial returns under penalty of being terminated. In contrast, insider systems do not traditionally use these types of organisations because the close-relationships between managers and shareholders impose that they have control of the entire production system; insider systems also tend to pursue strategies of market-share conquest in contrast to purely financial innovation. This has implications for labour because in market-systems labour tends to be particularly responsive to shareholder concerns at the level of the strategic business unit and in insider systems labour has to develop a relationship with the top-management in order to regulate the labour relationships. The authors also claim that there is a correlation between insider systems and the prevalence of multi-employer bargaining; since companies have control over the whole labour procedure and are interested in pursuing strategies of conquer of market share, they are interested in pacifying the labour market at the level of the industry in order to concentrate their attention in other aspects of the productive procedure.¹⁴¹

Having in mind these correlations, the authors considered that capital - management – labour interact within companies in a number of ways that they

¹⁴¹ Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford.

referred to as enterprise coalitions: this refers to the possible conflicts that may occur between the distinct groups. The authors identified three possible types of coalitions: class coalitions, insider/outsider coalitions and accountability coalitions. Class coalitions arise when management and capital have opposing interests to labour; this occurs when managers are under such an extreme pressure from capital to deliver value that they extract this value from labour by means of shorter wages and redundancies. Insider/outsider coalitions occur whenever when the interests of labour and management oppose those of capital. This might occur when management and employees are engaged in the pursuit of market share and shareholders demand financial results. Finally, accountability coalitions occur when the interests of labour and capital oppose those of the managers. This may happen when management is not transparent or is engaged in self-interested transactions to the detriment of the company. It is quite possible that employees and capital colligate to demand higher corporate transparency and reduce the agency costs of managers vis-à-vis capital and employees.¹⁴²

Finally, the authors conclude that the multiple interactions between corporate governance and labour management and the enterprise coalitions that have arisen as a consequence of those interactions have given birth to a number of institutional configurations: these institutional configurations consist in clusters of countries that represent some common patterns of organisation of corporate governance and labour management. There are three common patterns that correspond – boldly speaking – to the three distinct types of governance structures enunciated before. Market systems (UK) are characterised by weak employee voice, shareholder instruments for employee participation and decentralised collective bargaining. Insider systems present a wider degree of variation: there are the pure relational/insider systems (Germany, Austria, Denmark) that are characterised by strong-employee voice at the level of the sector and of the firm; and there are also governmental systems (France, Portugal) that are characterised by strong sector-level

¹⁴² Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582, Gospel, H. and A. Pendleton (2005). Markets and Relationships: Finance, Governance and Labour in the United Kingdom. *Corporate Governance and Labour Management: an international comparison*. H. Gospel and A. Pendleton, Oxford, Gospel, H. and A. Pendleton, Eds. (2005). *Corporate Governance and Labour Management - an international comparison*, Oxford.

bargaining but weak employee voice at the level of the firm. Therefore, in the view of the authors, the multiple means of interaction between corporate governance and labour management have given rise to three distinct types of patterns of relationship between corporate governance and labour management (that broadly correspond to the three distinct types of governance patterns) on account of the distinct enterprise coalitions that they create.¹⁴³

Simon Deakin has equally been attempting to analyse the multiple interactions between the patterns of Corporate Governance and Labour Representation and Collective Bargaining. The contribution of this author lies in analysing to a great extent - not only in theory but also in practice by means of several case studies - the potential links between Corporate Governance and Collective Bargaining. A research team commanded by Simon Deakin has been attempting to test in the field the traditional assumption that relational forms of governance promoted employee representation mechanisms and that outsider forms of governance prevented the emergence of these forms of representation due to the intense shareholder pressure; the pressure placed by shareholders would lead managers to restructure more quickly using redundancies in order to maintain employability levels.¹⁴⁴ The research team coordinated by this author conducted a series of extremely detailed studies that examined this hypothesis testing the prevailing governance type of some firms against the types of industrial relations implemented there. The conclusion of the author may be summed up in the following lines. The existence of a certain degree of shareholder pressure as the one that occurs in the UK is not necessarily a constraint nor an opportunity to the development of partnership practices. The key issues that seem to provide a decisive influence in the development of partnership practices seem to be the following: (a) the regulation of the product concerned, (b) the product markets and (c) the identity of the investors. As regards the regulation of the product concerned, partnership practices seem to

¹⁴³ For an excellent analysis of these types of coalitions, see Beyer, J. (2003). Corporate Governance in Deutschland, Max Planck Institute für Gesellschaftsforschung, Cioffi, J. W. and M. Höpner (2005). "Left-Wing support for shareholder capitalism." *Mitbestimmung*(8): 57-61, Höpner, M. (2005). Corporate Governance in transition: ten empirical findings on shareholder value and industrial relations in Germany, Max Planck Institute für Gesellschaftsforschung.

¹⁴⁴ For a good description of this view and the authors that promoted it, see Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford. Blair, M. M. and M. J. Roe, Eds. (1999). Employees and Corporate Governance, The Brookings Institution.

be easier to appear in sectors characterised by high quality standards that demand great investments in human capital and great employee involvement to improve the quality of the final product. As regards the product markets, the partnership practices seem to be easier to develop in products characterised by high standards of quality; when competition is solely based on price on relatively homogeneous product markets then partnership becomes more difficult to develop. The final relevant element concerns the identity of the investors: the existence of institutional investors (meaning investment funds) *per se* is no obstacle to the development of partnership practices; the great question depends on the capacity of the management board to develop a relational attitude with those investors and convince them of the benefits of enlightened shareholder value. Therefore, a more or less shareholder-oriented regime of corporate governance is no obstacle to the development of partnership practices since the deciding elements seem to be external elements to the company and the capacity of the management board to deal with them.¹⁴⁵

The studies of these authors may allow us to conclude that there may be a number of institutional complementarities between the patterns of Corporate Governance, Employee Representation and Collective Bargaining although these patterns should not focus merely on the statutory law but also take into account a wider degree of circumstances that considerably influence the means by which the company is managed and that give rise to distinct types of coalitions. Therefore, the patterns of Corporate Governance, Employee Representation and Collective Bargaining appear to be correlated to each other in a number of ways and under a variety of circumstances.

¹⁴⁵ See the following extremely interesting studies: Slinger, G. and S. Deakin (1999). Company Law as an instrument of inclusion: re-regulating stakeholder relations in the context of takeovers, ESRC Centre for Business Research, University of Cambridge, Deakin, S., Richard Hobbs, et al. (2001). Partnership, ownership and control: the impact of corporate governance on employment relations, ESCR Centre for Business Research, University of Cambridge, Barnard, C. and S. Deakin (2002). "Reinventing the European corporation? Corporate Governance, social policy and the single market" *Industrial Relations Journal* 33(5): 484-499, Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Deakin, S., Richard Hobbs, et al. (2005). Anglo-American Corporate Governance and the employment relationship: a case to answer?, ESRC Centre for Business Research, University of Cambridge, Deakin, S., Hugh Whittaker (2007). "Re-embedding the corporation? Comparative perspectives on corporate governance, employment relations and corporate social responsibility" *Corporate Governance* 15(1).

1.6.2. Institutional complementarities - why do certain institutions make sense in the presence of others?

Having in mind these distinct types of enterprise coalitions and the three patterns of relationship that they give rise to, one may inquire the reasons behind these patterns. The fundamental question consists in knowing why management and labour choose to adopt that specific configuration of their relations and not another. Some literature has attempted to provide an answer to this question based upon the concept of institutional complementarities.¹⁴⁶ An institution may be defined as a given set of rules that govern the interaction between the economic agents whose purpose and/or function is to minimise the transaction costs associated with market activity; they consist in shared beliefs that stabilise the interactions between agents; in this sense they function as a public good destined to coordinate the actions of the market agents. These institutions are not autonomously generated by the market or by an act of public power; they are rather the result of design and experimentalism in which the enforcer is part of the game. The multiple interactions between the agents in a given context will give rise to a number of rules, of formal (= legal) and informal character, that will become tacitly accepted and coordinate their actions; in this sense, they have a self-enforcing and self-sustaining character that may not be reduced to the legal sanctions for non compliance. Considering that the market agents in different countries are exposed to different influences, they will give rise to distinct institutional configurations. This means that the reciprocal interactions between the agents is not likely to give rise to one single best institutional configuration but rather to a diversity of equally optimal configurations. The basic idea to retain is that the multiple diverse reciprocal interactions between the market agents will give rise to distinct institutional configurations.¹⁴⁷

The concept of an institution (defined as self-enforcing rules of the game that are the result of a combination of multiple influences, law and

¹⁴⁶ Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." *Socio-Economic Review* 3(2).

¹⁴⁷ For the concept of *institution*, see Aoki, M. (2001). *Towards a comparative institutional analysis*, Stanford University Press.

experimentalism by the market agents) must be connected to the concept of complementarity. Complementarity comes from the Latin “*complementum*” – which means “*to complete*” – and refers to a situation in which two or more elements are combined to produce a particular outcome. The elements by themselves are void of meaning but when they are combined they produce a particular result that only arises from that specific combination. For instance, in the General Theory of Civil Law every student learns that rights and duties are complementary because the existence of a legal relationship depends on the presence of these two elements. In terms of the interaction between corporate governance and labour management, complementarity is a functional category that means that the performance of a given configuration increases when its elements assume specific properties. The acceptance of the idea of complementarity between two distinct sets of institutions (in this case, corporate governance and labour management) carries with it a number of important implications; firstly, one has to take the whole picture into account; the investigation of the merits of a particular institution is void of meaning if we disregard it from the constellation of which the institutions are part of. Secondly, there is a link between complementarity and institutional stability; a particular institutional configuration will be maintained as long as the constellation of which it is a part of remains constant. Finally, the actors of the game should seek equilibrium within the domestic system rather than copy (benchmark) foreign systems. The introduction of alien elements into a given system may not produce the desired result because they may not be complementary (*i.e.*: they may not *combine*) with the prevalent institutional configuration in a given country. One should seek for functional equivalents that complement domestic institutions.¹⁴⁸

The basic idea to retain from this idea of institutional complementarities is that the institutions of corporate governance and labour management do not arise out of nowhere and that there is no one single best model of corporate governance and labour management. The institutions of corporate governance and labour management arose in very specific circumstances in order for the market agents to extract the greatest value of their actions. The specific

¹⁴⁸ Höpner, M. (2005b). "What connects Industrial Relations and Corporate Governance? Explaining institutional complementarity." *Socio-Economic Review* 3(2).

configurations that each one of them assumed are destined to complement the other on order to combine and achieve the best possible outcome. The understanding of the interactions between the two depends of the understanding of the specific circumstances in which they were born.

1.6.3 Other literatures - alternative attempts to explain the mutual presence of sets of institutions

Although this idea of "*institutional complementarities*" is not expressly laid out in other literatures concerning the distinct corporate governance and labour management patterns, it is taken as implicit in the thought of the authors. It is useful to revise other perspectives on corporate governance and labour management at the light of this idea of institutional complementarities.

The historical approach and the financial approach to corporate governance place an emphasis on the organisation of the firm and the types of finance in order to explain the interaction between corporate governance and labour management. In accordance with these approaches, the managerial capitalism and the ownership concentration that characterised Continental Europe during a great part of the post-war period lead to the development of sector-level bargaining in order to control wages and allow firms to pursue strategies of expansion instead of innovation; this did not occur in the UK because the dispersed ownership structure and the market pressures discouraged affiliation to employers' organisations; since managers had to be attentive to the signals of the stock market, decentralised collective bargaining was seen as complementary to the market pressures because it allowed managers to introduce innovations more rapidly.¹⁴⁹

The variety of capitalism approach focuses its attention on the political economy of a given country. This approach distinguished between two types of political economies: liberal market economies (with a focus on market capitalisation, short termism, innovation and financial measures of firm performance) and coordinated market economies (with a focus on concentrated ownership structures, long-termism and incremental innovation). Decentralised systems of collective bargaining are said to be complementary to liberal market

¹⁴⁹ For a good description of this school and its main scholars see Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582.

economies and centralised collective bargaining and employee voice are said to be complementary to coordinated market economies for the same reasons as those enunciated above: longer time horizons, qualitative measures of firm performance and the absence of pressure of the stock market are said to influence the type of bargaining structures developed in each country.¹⁵⁰

The legal origin approach has equally reached similar results, although based upon distinct conceptions. This approach adopted an agency costs perspective to the understanding of corporate governance and collective bargaining and considered that they are the result of the agency costs derived from the statutory protection of investments. These authors claim that the concentrated ownership structures found in continental Europe were the result of a deficit in the protection of the interests of shareholders, that led shareholders to concentrate their investments to reduce the agency costs vis-à-vis managers.¹⁵¹ In addition, the political culture equally plays a role: the strong legal rights granted to employees in post-war continental Europe encourage the alignment of interests between employees and managers to the detriment of shareholders. Since common law countries did not share the same contingencies (they claim that common law offers stronger protection to shareholders and that there are weak employment rights), it did not develop the same governance structures. Therefore, in the view of these authors, collective bargaining and legal origin directly influence corporate governance leading to an institutional complementarity between shareholder protection, ownership structure and the structures of collective bargaining: the strong legal rights of employees and the weak protection of shareholders led to the concentration of ownership structures.¹⁵²

¹⁵⁰ Hall, P. and D. Sokice, Eds. (2001). Varieties of capitalism: the institutional foundations of comparative advantage. Oxford, Oxford University Press.

¹⁵¹ Hansmann, H. (1993). Probleme von kollektiventscheidungen und Theorie der Firma. Ökonomische Analyse des Unternehmensrechts. C. Ott and H.-B. Schäffer, Physika Verlag: 287-305, La Porta, R., F. Lopes-de-Silanes, et al. (1999). "Corporate ownership around the world." The Journal of Finance 54(2): 471-517, Bebchuk, L. A. and M. J. Roe (2004). A theory of path-dependence in corporate ownership and governance. Convergence and persistence in Corporate Governance. J. N. Gordon and M. J. Roe, Cambridge University Press.

¹⁵² La Porta, R., F. Lopes-de-Silanes, et al. (1999). "Corporate ownership around the world." The Journal of Finance 54(2): 471-517, Roe, M. J. (1999). Co-determination and the German Securities Market. Employees and Corporate Governance. M. M. Blair and M. J. Roe, Brookings Institution: 194-205, Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute.

1.6.4 conclusion

It seems that, at this point, one may attempt to draw some preliminary conclusions concerning the interaction between corporate governance and collective bargaining. One cannot say that there is a direct causal relationship between one and the other in terms that one configuration will necessarily lead to another; the cases of Germany and France are paramount in this aspect: both exhibit concentrated ownership structures but have radically distinct patterns of collective bargaining, particularly at the company-level (where the managerial prerogative is untouchable). The explanation of the diversity of patterns lies on a number of multiple interactions and configurations between one and the other, that depends on a disparity of elements such as the prevalent political economy of a country, the ownership structure, the legal rights of employees, the legal origin (in terms of the protection of shareholders) and the organisation of the firm, among other factors. These conditionings will lead each constituency of the nexus of contracts that is the company to adopt specific strategies to overcome the agency costs that they face vis-à-vis the other constituencies. This will lead to variable coalitions of interests (class - insider/outsider – accountability conflicts) that will shape the predominant corporate governance and collective bargaining patterns of a given country. Each constituent will develop a specific institutional configuration that is complementary to the other in order to reach the best possible outcome.

1.6.5 Interaction between the national models of corporate governance and employee representation

This section will attempt to demonstrate the possible interactions between the national models of corporate governance and of employee representation. Building upon the previous considerations of the possible institutional complementarities between corporate governance and employee representation, this section will attempt to demonstrate to which extent the traditional national models of corporate governance and employee representation may be considered as complementary in order to produce an optimal result and outcome. The following lines will attempt to demonstrate the possible multiple interactions between each one of the elements of the system and bring out the multiple equilibria existing within the system. The

methodology will consist in a matrix that will enunciate and compare each distinctive element, the multiple interactions and equilibria within it and the proposed institutional complementarities.

(a) Germany – the main characteristics of the German system are well known and they will be enunciated here briefly. Germany has an *strongly stakeholder oriented insider relational* system of corporate governance that is composed of five elements: (1) representation of employees in *works councils* that enjoy *co-determination* rights; (2) representation of employees in the *boards* of the medium and large companies (>500 employees); (3) extensive system of *sector-level collective bargaining*; (4) *bonding of investment* (*concentrated ownership structures* in which *banks* and *major shareholders* are active within the company in *long-term relations* with the *management board*); (5) Regional State (*Bundesländer*) interest in keeping companies in their location. The following matrix will demonstrate the interactions between these elements:

	Works councils	Co - d e t e r m . Superv. boards	Sector level bargaining.	B o n d i n g investm	R e g i o n a l States
Works councils	X	1	2	3	4
Co - d e t e r m . boards	X	X	5	6	7
Sector level Barg.	X	X	X	8	9
Bonding investm.	X	X	X	X	10
Regional States	X	X	X	X	X

(1) works councils and co-determined supervisory boards - there is a degree of complementarity between the works councils and the co-determined supervisory boards. In order to understand the complementarity it is useful to remember some preconditions. Germany has a mandatory dual-board structure of public companies (*Aktiengesellschaften*); the German dual-board has the particular characteristic of being a representative of the interests not only of the *shareholders* but equally of the stakeholders in the company. Here lies the explanation of the mandatory inclusion of employee representatives in the supervisory boards of medium and large companies in accordance with some pre-determined proportions. The supervisory board elects the management board and therefore the management board must have the agreement of the

employee representatives. The complementary relationship between the works council and the supervisory board is the following: *the works council serves as a recruiting ground for employee representatives at the supervisory boards; nevertheless one must notice that, in order to avoid conflicts of interest, the members that the works council recommended to the supervisory board must not be works council members because otherwise the works councils would be negotiating with itself.*¹⁵³ This particularity of interaction between the works council and the co-determined board deserves further explanation. The purpose of the *Aufsichtsrat* in the constitutional architecture of German corporations is to elect and supervise the *Vorstand* (management board). It functions as a forum of the shareholders and stakeholders of the company in order to ensure a conciliation of interests in the election and supervision of the management board. This explains the strongly stakeholder orientation of German management boards: their election and maintenance in job depends of the agreement of the shareholders and stakeholders of the company. The *Aufsichtsrat* refuses to recruit members directly from the works councils on account of the powers of influence (*Mitwirkungsrechte*) of the works council mentioned above; considering that the management board is going to bargain with the works council, if the management board is elected by persons dependent of the works council then the works council would be bargaining with itself. This would create agency costs in relation to shareholders who would face risks of expropriation on account of the excessive power of influence of the *Betriebsrat* in the life of the company. In addition, by recruiting employees not affiliated to the works council to the supervisory board, the supervisory board has a second channel of information about the state of affairs of the company (the rank and file) that helps to improve its supervision of the management board. This also acts in the interest of the shareholders who fear a threat to their investments on account of the possible excessive influence of the works council in the life of the company; the fact that the interests of the employees must be taken into account in the management of the company does not mean that the interests of the employees should predominate in the management of the company; this would have adverse economic effects as it would discourage investment. By having

¹⁵³ Backhaus, J. G. (1999). Company Board Representation. *The Elgar Companion to Law and Economics*. J. G. Backhaus, Cheltanham.

direct information on the situation of the employees in the life of the company, the *Aufsichtsrat* is able to monitor better the behaviour of the *Vorstand* and see if their investments are secured or if the *Vorstand* is simply holding on to its job by means of concessions to the works council. This particular balance of interests (works council – co-determined supervisory boards - management) helps to understand how the stakeholder orientation of German companies does not necessarily mean an employee-exploitation as shareholder-value theorists often caricaturise it. It consists in a constantly changing equilibrium that attempts to balance the interests of the shareholders, of the employees and the participation of the employees in the internal life of the company without giving predominance to the position of any of these interest groups in relation to the other. The cooperation between the works council and the supervisory board - in the terms mentioned above - is essential in this regard.

(2) works councils and sector level bargaining – there is equally a great degree of complementarity between German works councils and the extensive system of sector level collective bargaining. The complementarity is made in accordance with a strict division of tasks between the two bodies that help to conciliate the interests of the employees both as a class and as stakeholders of the company. It is useful to remember that Germany exhibits an extensive degree of sector level collective bargaining strengthened by trade union monopoly at the level of the sector. The basic task of trade unions is to defend employees as a class and avoid wage and working conditions competition in the sector concerned. The works council may not touch upon the decisions of the trade unions but may implement them in the company in the way that it best deems fit: for instance, the trade union defines the basic wage for a professional category for the sector; the works council bargains on how and when the wage is going to be paid. The interest of the works council is to convince the management of the company of the superiority of the proposed solution without undermining the solutions reached at the level of the sector. This helps to achieve a particular balance of the interests in which the employees are protected both as a class (by avoiding competition in working conditions at the level of the sector) and as stakeholders (by implementing those conditions having in mind the specific conditions of the company and in the interest of the company as such – *Unternehmen an sich* – in generating

profit while safeguarding the interests of the employees). The strict separation of tasks between the trade unions and the works councils is expected to reinforce their complementarity: if it were not so, the trade unions could start bargaining like works councils, having regard only to the interests of the major companies of the sector or the ones where they had most affiliates; works councils could free-ride on the sacrifices of others by undermining the bargaining reached at the level of the sector.

(3) works councils/supervisory boards and bonding of investment – these two elements of co-determination (*Betriebsrat* and co-determined *Aufsichtsrat*) should be analysed together in their complementarity to the distinctive German characteristic of “*bonding of investment*”. The bonding of investment consists in an umbrella concept destined to translate the distinctive relational character of German corporate governance. The first part of this thesis referred that the investors in German companies normally have a long-term perspective of their investment and they establish close ties with the *Vorstand* (by means of large shareholdings that ensure them the control and the particular relationship between the *Vorstand* and the *Aufsichtsrat*) in order to underpin that relationship. In parallel, the *Vorstand* prefers strategies of incremental growth in contrast to the anglo-saxon financial growth and radical innovation; the varieties of capitalism literature has emphasised these distinct models of governance of companies and concluded that none is superior *per se* and must be seen within its context. The workforce has a particular role in this German strategy of the bonding of investment: its roots date back to WW II when German companies needed capital to finance reconstruction but lacked access to capital markets. The solution lay in a specific investment in human capital by means of the retention of profits in order to finance the expansion of the company. But there was the problem of monitoring: the solution of employee ownership was not a viable solution because employees would not accept investments in worthless companies, their power would be diluted in capital increases if they were unable to invest more capital and the interest of the workers lay in job security and stable wages (and not hypothetical

dividends).¹⁵⁴ The solution lay in providing workers with co-determination powers in order to monitor the management of the company and the reinvestment of the profits that were not distributed as wages. The solution, applicable initially only to the coal and steel industries (*Montanindustrie*) was enlarged towards other companies in 1952 and 1976. The objective of the provision of co-determination powers to the employees was to replicate the success of the solution in the coal and steel industries and attempt to generalize this stakeholder view of corporate governance. The co-determination powers of workers (by means of the works council, the co-determined supervisory board and the relationship between these two analysed above) are complementary to the relational attitude that German investors have in companies because the incremental strategy of growth that distinguishes German companies needs heavy investments in human capital; these investments in human capital need the collaboration of the workforce (by means of the *Betriebsrat*) and the workforce needs to supervise the managerial observance of their interests (by means of the co-determined *Aufsichtsrat*). These three elements are complementary and it is not possible to achieve the same outcome without any of them: if employees had no means to monitor effectively the management board, the *Vorstand* would fall prey to the interests of the shareholders; if the shareholders did not have employee presence in the *Aufsichtsrat*, they would never accept reduced returns in exchange for incremental growth. These three elements are so inextricably bound together that the German Constitutional Court (*Bundesverfassungsgericht*) upheld on a memorable decision the constitutionality of the 1976 Act on Co-determination by emphasising the mutual dependence of these three elements.¹⁵⁵ This is the main rationale behind the particular German system of co-determination: *the relationship between the managers and the shareholders and the need to*

¹⁵⁴ Henry Hansmann – a remarkable American Corporate Lawyer and a recognised shareholder-value theorist – understood this very acutely and observed that this monitoring mechanism would always provide employees with 33% or 50% of decision-making power in companies independently of the size of the tradable stock of the company. It recognised co-determination as an extremely efficient mechanism of securing human-capital investments. See Hansmann, H. (1993). "Worker participation and corporate governance." University of Toronto Law Journal 43: 589-606, Hansmann, H. (1996). Comments. Employees and Corporate Governance. Columbia Law School.

¹⁵⁵ Bunderverfassungsgericht (1979). "Bundesverfassungsgerichtentscheidung 50, 290." Neue Juristische Wochenschrift: 699 ff.

invest in human capital to sustain incremental strategies of growth need governance mechanisms to overcome the substantial agency problems that employees (whose interests are distinct from the shareholders) face in this type of strategy; the most important governance mechanism consists in the provision of joint-decision making powers to the employees in the internal governance of the company so that the company-specific investment that they make be adequately safeguarded by the growth of the company, the security of their jobs and a sustainable increase of their wages. These three elements are inextricably bound together and they make sense only in the presence of the other elements of the configuration.

(4) works councils and regional states – Germany has a heavily decentralised tax system with substantial autonomy of the Bundesländer in collecting tax revenues. The Bundesländer therefore need the presence of large companies in their territories because the spill-over effect that those companies bring with them increase employment levels and provide them with tax revenues to pursue their public policies. Therefore it is normal that regional states get involved in the life of large companies that are located in their perimeter to the point that they become very relevant stakeholders in the life of the company. Works councils are complementary to this because their action influences the desire of the company to remain located in a certain circumscription. It is very common that the regional labour inspectorates get actively involved in the life of the works council (as supervisors, providing training, etc) in order to train them to act in the interest of the company and adequately promote the success of the company in that particular Bundesland.

(5) co-determined boards and sector-level bargaining – co-determined boards and sector-level bargaining are equally complementary. The presence of employees at the supervisory boards of companies – who enjoy extensive information rights on the concrete situation of companies in order to evaluate the performance of the management – provides trade unions with extensive information concerning the financial situation of companies and their concrete needs. This helps trade unions to conform their *Tarifpolitik* to the concrete situation of the companies of the sector, moderating wage demands in times of recession, providing for professional careers and training rights that work to the

mutual benefit of workers and companies and safeguarding the position of employees in the companies' pursuit of profit.

(6) co-determined boards and regional states – co-determined boards and the regional states are equally complementary. The previous version of the German Law on Public Companies (*Aktiengesetz*) allowed in its §12(2) an exception to the general prohibition of multiple voting rights (*Mehrstimmrechte*) when the existence of multiple voting rights in a company was necessary to guarantee “overwhelming concerns of the economy” (*überwiegender Gesamtwirtschaftiger Belange*). *Bundesländer* could use this provision in order to acquire strategic shareholdings in key companies to guarantee employment levels in the industries. This would ensure their presence in the *Aufsichtsrat* of the company. In addition, many companies set up together with the regional states development companies (*Entwicklungsgesellschaften*), which consist in companies with public and private capital. The presence of public authorities, major companies and workers in the supervisory boards of those companies helped to ensure an alignment of interests between the shareholders and all the stakeholders to the benefit of the local community as a whole.

(7) sector level bargaining and bonding of investment – the sectoral level bargaining and the bonding of investments are complementary because this obliges trade unions to have in mind a wider set of interests in their bargaining strategies and not merely the immediate interests of the employees. The *internal governance mechanisms* (*Mitwirkung*) to safeguard the human capital investments that the employees make in the company ensures that the shareholders of one company do not free ride on the concessions of the trade unions.

(8) sector level bargaining and regional states – regional states have an interest in creating a business friendly environment that would attract the investment into their premises; trade unions equally have an interest in having companies invest within their states because that is a possibility for them to increase their affiliation numbers and hence their bargaining power. Therefore contacts between both parties are common in order to create a business

friendly *Tarifpolitik* that would simultaneously defend the interests of the employees in their particular location.

(9) bonding of investment and regional states – there is a complementarity between the German characteristic of bonding of investment and regional states. Many *Bundesländer* operate regional savings banks (*Sparrkassen*) that collect savings from local residents. These savings banks are normally State companies and therefore are not subject to shareholder pressure. In order to commit companies to a particular location, these savings banks acquire strategic shareholdings in large companies and establish a relational strategy with the management board in order to provide the company with the necessary guarantees to expand and pursue strategies of incremental growth. The presence of employees in the boards of these companies (in which the *Sparrkassen* invested) helps to safeguard employee interests. Therefore there is complementarity between the distinctive German characteristic of bonding of investment and the activist attitude of regional states in attracting investment towards their locations.

Conclusion: the explanation laid above of the diverse interactions between the distinctive elements of the German corporate governance and employee representative structures helps us to understand the web of interactions between their composing elements and the *reasons* behind their particular configuration. The German employee representative structures are part of a larger mutually reinforcing set that must be seen within its own context. The main characteristics of the German corporate governance landscape may be reduced to three elements: relational investment – co-determination (works council + supervisory board) – sector level bargaining. There is an intricate relationship between these three elements in the sense that each one makes sense only in the presence of the other. The relational investment is complementary to co-determination because the need for investment in human-capital and the concessions of the workforce demand a monitoring mechanism of the interests of the employees; the contrary is equally true: co-determination makes sense only in the presence of relational investment because the pressure of the stock market or aggressive institutional investors are contrary to long-term perspectives on investment and human-capital is a non-existent

concept (labour is regarded as a commodity). Relational investment is equally complementary to sector level bargaining because the bargaining with the trade unions eliminate competition in labour and working conditions and provide the necessary social peace for companies to concentrate in investment strategies; if it were not so, there would be constant strikes and companies would compete in terms of working conditions undermining the co-determination because the workers would not make the necessary human capital investments. This would have adverse effects in German companies and undermine their incremental growth strategies. Finally, co-determination (works councils and co-determined boards) also relates to collective bargaining: the strict division of tasks between the trade unions, the co-determined supervisory boards and the works councils and the statutory obligation of collaboration (*Vertrauensvollezusammenarbeit*) between these three bodies (§2BVG) ensures the protection of the employees both as a class and as stakeholders and prevents temptations of free riding: the inclusion of non-works council members in supervisory boards provides trade unions with a channel of communication that helps to elaborate their *Tarifpolitik*; the separation of tasks between the trade unions and the works councils ensures that the activity of the works councils is limited to ensuring the engagement of the workers in the internal life of companies within the limits laid out in collective agreements and that trade unions do not act solely in the interest of the companies where they have more affiliates (§2(3)BVG); finally the independence of employee representatives in the supervisory board from works councils ensures that the management does not fail prey to the works council and limits its influence in the life of the company – which could lead to an expropriation of the shareholders – and preserves the institutional architecture of the German supervisory board as a forum of conciliation of interests.

The conclusion may be the following: the German system of employee representation (with extensive sector level bargaining and its particular system of co-determination) makes sense only in the presence of its particular corporate governance characteristics (relational investment with heavy bank influence); it is complementary to its culture of conciliation and long-term investments because it is the most efficient monitoring mechanism of the investment in human capital that its growth strategies demand. In this sense one element (co-determination and collective bargaining) reinforces the other

(*insider* system of corporate governance) because the particular growth strategies of companies demand employee involvement. If we want to use a transaction cost analysis (because this chapter has been explained at the light of the varieties of capitalism approach) it is the most efficient way of reducing the agency costs of shareholders vis-à-vis employees (who are stakeholders) and guarantee their investment in the company.¹⁵⁶

(b) France – the main features of French corporate governance have been outlined before and they will only be enunciated here briefly. France is the paramount *governamentalist* system of corporate governance in which the (Colberistic) State is both dirigistic and entrepreneur. The State exhibits a heavy influence on the governance of the major French companies by several means such as: (a) direct ownership, (b) indirect ownership (Golden Shares, cross-shareholdings, political ties), (c) control of finance (regulation of contracts, interest rates and ownership of banks), (d) publicly educated management and (e) a heavy regulatory interference in the market by means of industrial politics. It is worth mentioning that the State is regarded as an independent arbitrator between the conflicting interest groups in society. This is an element of extreme importance because this approach to corporate governance means that the traditional agency problems found in companies with concentrated ownership structures are not found here; the State pursues its own political agenda and acts in the name of the public interest, having regard to the interests of the several stakeholders of the company. The ownership structure also exhibits a heavy degree of concentration but in distinct terms than the ones found in Germany; besides the State, the major shareholders in French companies are families and other companies in an intricate network of cross-shareholdings. These cross-shareholdings and the heavily concentrated ownership of the companies that compose that web are intentional and compose the financial heart (*Coeur financier*) of the French economy: a coordination of the actions of the most important companies that

¹⁵⁶ This chapter and the following have been heavily influenced by an intriguing article by Dr. Jürgen G. Backhaus in which he analysed the law and economics behind German system of co-determination. His analysis is, to say the least, formidable and very clear for a non-native German. The methodology to be used in the analysis of the interactions between corporate governance and collective bargaining in the following countries were influenced by this study. See Backhaus, J. G. (1999). Company Board Representation. The Elgar Companion to Law and Economics. J. G. Backhaus, Cheltanham.

ensures their profitability and shields them against hostile takeovers that would unbalance the equilibrium. Banks also established a system of relational finance with major companies but not by means of shareholdings but by means of (statutorily regulated) contracts. As regards employee representative structures, the situation could not be more different from the one found in Germany: the French system of employee participation is more accurately described as closer to involvement than participation.¹⁵⁷ The labour market is heavily regulated by statute and the employee representatives do not have a great margin of manoeuvre; trade unions are fragmented and weak when compared to their German counterparts; their main battling ground is politics in the attempt to influence the labour legislation in tripartite bargaining conducted by the State; the bargaining at the level of the sector is limited to wages and professional careers because the Labour Code limits its margin of manoeuvre. Works councils exhibit a curious configuration: they are unitary bodies that conciliate representatives from the employees, the trade unions and the employer; they have no co-determination powers and their competences are limited to (extensive) information and consultation procedures.

In similar terms to the former paragraph, this section will use a matrix that will attempt to demonstrate the institutional complementarities that exist between these distinct elements of corporate governance and employee representation. It appears that, seen within their context, both elements mutually reinforce each other and give rise to a certain institutional configuration that is characteristic of countries that exhibit governmental corporate governance systems. The following matrix will attempt to explain the interconnections between the several elements of the puzzle.

¹⁵⁷ Expression taken from Laborde, J.-P. (2007). Closer to involvement than to participation: the role of employees in decision-making in large companies and enterprises in general according to French labour law. . Perspektiven der Corporate Governance. U. Jürgens, D. Sadowski, G. F. Schupert and M. Weiss, Nomos-Nomos.

	State	Owners.	Manag.	Finance	TU	WC	SLMR
State	X	1	2	3	4	5	6
Ownership	X	X	7	8	9	10	11
Managem.	X	X	X	12	13	14	15
Finance	X	X	X	X	16	17	18
TU	X	X	X	X	X	19	20
WC	X	X	X	X	X	X	21
SLMR	X	X	X	X	X	X	X

(1) State and ownership structure of French companies – in order to understand the matrix, it is useful to review the interactions between all the elements. The attitude of the French (Colberistic) State towards the economy is complementary to the ownership structure found in French companies. Although France exhibits a concentrated ownership structure similar to the one found in Germany, the traditional agency problems found in these structures are not present in French companies. The French State exercised considerable influence in the management of French companies by means of direct ownership and indirect ownership (Golden Shares, cross-shareholdings with State controlled companies, political ties to the major economical groups and control over the sources of finance). This is a considerable element whose importance should not be underestimated: the State is not a normal shareholder who acts in its own self-interest in collecting the residual profits; the State pursues its own political agenda in the governance of those companies in order to influence their management in the public interest. The State is seen as an independent arbitrator between the distinct interest groups that influence the economy to a considerable extent and influences the management of the companies that compose the *Coeur financier* of the French economy in the national interest. This creates a distinct set of agency problems that appear to explain the particular French configuration of labour representation (as the following paragraphs will attempt to demonstrate).

(2) State and French management – the influence of the State is also seen in the management boards of French companies. The majority of the management boards owe their education to the public system, the higher schools of education in Paris where the majority of the top-level public servants are educated. In addition, considering the concentrated ownership structure of

French companies (with heavy State influence) and the web of cross-shareholdings that maintains its integrity, the ascension to managerial positions depends on the agreement of the State and the remaining shareholders of the companies that compose the *Coeur financier*. This is equally another important question because that means that the management boards will be directly accountable to the interests of the major shareholders and the political agenda of the State.

(3) State and finance – the providers of finance prefer a relational attitude towards French companies by means of contract (and not shareholdings as it occurs in Germany). The State is partially responsible to this because its considerable influence over the sources of finance (by means of direct ownership of banks, strategic shareholdings and the statutory regulation of financial contracts) influences the functioning of the financial sector in the overall interests of the economy.

(4) State and Trade Unions – the State and the trade unions have also a complementary role. Since French trade unions are, for legal and historical reasons, extremely fragmented and politically engaged, the State understood that they did not possess the necessary *Sozialen Mächtigkeit* (social power) to adequately defend the interests of the employees. The State then took upon itself the task of defending employee interests in its various means of intervention in the economy. The main strategy to achieve this was by means of a collaboration with the trade unions: at the political level, trade unions exert a considerable influence over the statutory regulation of the labour market by means of tripartite bargaining between the trade unions, State and employers' associations; the impact of this bargaining should not be underestimated because France exhibits a considerable degree of regulation of the labour market by statute. At the industry level, the trade unions exercise a considerable degree of influence over the labour market by means of the determination of wages and professional careers with the employers' associations. Once again this is an extremely important feature: although France chronically exhibits low levels of unionisation (circa 9% of workers) and extreme trade union dispersion that weakens the labour movement, it enjoys an extremely high level of coverage of collective agreements (circa 90%). This

paradox is due to the recognition of *erga omnes* effects to collective agreements and by the extensive use of administrative procedures of extension of collective agreements to non-affiliated employers. This collaboration between the trade unions and the State has three advantages in relation to the German model: (1) it compensates the weaknesses of the labour movement by means of the intervention of the State; (2) it ensures a conciliation of interests in the statutory regulation of the labour market, attempting to combine competitiveness and social protection; (3) it tempers the sometime radical political motivations of some trade unions. Although the strategy is quite distinct from the one found in Germany, the State and the trade unions are complementary in French corporate governance because the State compensates for the weaknesses of the trade unions.

(5) State and works councils – there is equally a complementarity between the State and the particular configuration of the French works council. The French works council comprises representatives from trade unions, employees and the employer; in addition, although it has nothing similar to the co-determination rights that the German *Betriebsrat* enjoys, it is nonetheless gifted with considerable information and consultation rights. This provides the State (who exercises a considerable influence over the ownership and management boards of companies) with important information concerning the concrete situation of the company to help it exercise its influence in the companies that compose the financial heart of French economy also in the interest of the employees. Therefore it is the State who defends the interests of the employees in companies by collecting the necessary information in the consultation procedures with the works council and exercising its voting power in accordance.

(6) State and statutory labour market regulation (SLMR) – another significant characteristic of French corporate governance consists in the heavy statutory regulation of the labour market. The French State understood at an early stage that the polarisation of interests between and within trade unions and employers' associations and the French aversion to compromise (which is seen as a tie, a loss to both parties, the least optimal solution) were incapable of bringing the necessary peace to the labour market in order to underpin the

economy. The regulation has such an impact on the labour market that the French Labour Code is one of the most extensive in the world and the trade unions were traditionally bound by the *principe de faveur* meaning that they could only improve upon the (generous) conditions laid down in the law. The solution law in statute but this was not made unilaterally by the State. Labour laws are bargained in three partite negotiations between employers and trade unions with the supervision of the State. This ensures an adequate representation and conciliation of interests, provides the State with the last word regarding labour policy and ensures an effective implementation of the solutions.

(7) ownership structure and management – the particular ownership structure of French companies and the management boards are closely related. The State influence and system of cross-shareholdings ensures the stability of the financial heart of the French economy; the dependence of the agreement of the State and all the companies of the financial heart in order to reach managerial positions (due to a system of cross-shareholdings, which allows companies to exercise reciprocal influence) reduces the agency costs of managers vis-à-vis the shareholders of those companies because they will have to act in the interest of all the companies of the group. A system of interlocking directorships helps to underpin this system. This ensures a considerable coordination of activities between the companies and shields each one of them against takeovers from greedy bidders who would like to disturb the equilibrium.

(8) ownership and finance – the ownership structure and the financial system are related because the heavy State influence in both sectors and the relational strategy of investment of large shareholders allowed managers to pursue *relational financial strategies* in order to finance their growth.

(9) ownership and trade unions – there is a certain complementarity between the ownership structure of French companies (in which the State has a large influence) and the panorama of trade unionism because the influence of the State serves to compensate for the weaknesses of trade unions and reduce the

influence of large shareholders in the management boards of companies. This provides employees with an additional force in sector bargaining.

(10) ownership and works councils – there is equally a certain complementarity between the ownership structure and the powers and configuration of the works council because the information and consultation procedures provided the State with information about the situation of the company in order to exercise its voting rights in the interest of stakeholders (employees) and helped to gain the adhesion of the employees to the policies of the company. In addition, it provided trade unions with important information concerning the concrete situation of companies in order to prepare for sector bargaining.

(11) ownership and SLMR – there is equally a certain complementarity between the ownership structure and the SLMR, although it is more tenuous. I have outlined several times that the peculiar ownership structure of French companies allows shareholders to establish a relational engagement with the management boards and the influence of the State reduces agency costs vis-à-vis employees. Since trade unions are politically engaged, their main field of action is in the tripartite bargaining of the labour regulation. By determining the *rules of the game* in the statutory regulation of the labour market, the trade unions could avoid bringing politics into the sector bargaining and concentrate on bargaining wages and professional careers. The *erga omnes* effect of collective agreements and the administrative procedures for extension ensured the coverage of the agreements. This was extremely important in the times of *coordinated capitalism* because firms needed to retain profits to finance expansion. If politics were brought into the sector bargaining then there would never have been the necessary labour peace and companies would face severe liquidity problems.

(12) management and finance – management and finance are complementary in the French system of corporate governance because the heavy State influence in both sectors helped to underpin the *relational financing* necessary to sustain the growth of French companies.

(13) management and trade unions – there is a certain complementarity between management and trade unions because the political ties of the management boards (by means of education, need of the consent of other companies to reach the management boards and the influence of the State in ownership structures) made them more sensible to social issues in collective bargaining and contributed to overcoming the weaknesses of the trade union movement.

(14) management and works councils – there is equally a certain complementarity between the management and the works councils because the particular configuration of the works councils obliged the management board to conduct the internal affairs of the company having in mind both the interests of the employees as stakeholders and the interests of the employees of the industry. In addition, the dependency of the management board from the State influence reduced the possibility of influence of the other large shareholders in the governance of the company and the agency costs vis-à-vis employees.

(15) management and SLMR – there is equally a certain complementarity between the management board the SLMR. The heavy codification of the labour market (in which the trade unions and employers' associations had a great degree of influence) provided the management board with the rules of the game in labour management issues. This allowed them to concentrate in the bargaining of wages and conditions of work with the trade unions at the level of the sector in order to finance the sustainable growth and expansion of the company.

(16) trade unions and works councils – there is a certain complementarity between the trade unions and the works councils because the presence of trade unions in the composition of works councils provided them with more information concerning the internal life of the companies which could be useful in collective bargaining procedures; in addition, their presence in works councils protected the employees in the information and consultation

procedures, ensuring that the management would not merely pay lip-service to the works council.

(17) trade unions and SLMR – there is a certain complementarity between the peculiarities of French trade unions and the heavy statutory regulation of the French labour market because the trade union dispersion and their extreme politisation turned (bargained) statutory law into the main means of influence of trade unions in the labour market.

(18) works councils and SLMR – since the labour market is heavily regulated, works councils could concentrate on defending their interest in the internal life of the company – as genuine *stakeholders* – while the statutory law prevented them from engaging in competition in working conditions with other companies that would undermine sectoral bargaining.

Conclusion: French corporate governance and employee representative structures are complementary because there is one critical actor – the State – that influences to a considerable extent the management of the companies and attempts to overcome the weaknesses of the trade unions. The French trade unions are fragmented and politically engaged, which limits to a considerable extent their bargaining power and is liable to provoke social conflicts. In order to avoid that the employers would take advantage of this particular state of the world, the State had to take upon itself the task of limiting the influence of large shareholders in companies and defend the interests of labour internally. This was achieved by means of direct or indirect presence in the ownership of large companies, the influence upon the management boards and the several means of control over finance. This helped to balance the governance of French companies and introduce *stakeholder* considerations in their management. The particular configuration of the labour representative structures followed this paradigm: the State introduced an activist approach to the regulation of the labour market by imposing a heavy statutory regulation. Nevertheless this was not made unilaterally but within a tripartite bargaining. The trade unions quickly understood that their main level of influence would be the statutory regulation (also to give expression to their political views) the trade unions concentrated their efforts at that level in order to influence the regulation of the labour

market; the State was equally satisfied with this approach because it would always have the final word. The trade unions then concentrated their efforts also at the sector level; the influence of the State in large companies and the procedures for extension of collective agreements helped to mitigate the influence of large shareholders and ensured a wide coverage of collective bargaining. The possibility of competition in terms of labour costs was then eliminated. Finally at the company level, the particular configuration of the works council (a conciliatory board that represents employees both as *stakeholders* and as a *class*) provided companies, the State and trade unions with sufficient information on the internal life of companies and helped to organise the work more efficiently. In this sense, if we see the whole picture in context, the French configuration of employee representative structures is complementary to the particular configuration of French corporate governance because the agency costs that employees faced vis-à-vis shareholders were compensated by the State with a number of indirect mechanisms (ownership, influence upon management, control over finance and statutory labour market regulation).

(c) Portugal – the Portuguese system of corporate governance and employee representation may be classified as a governmentalist system of corporate governance. Although the influence of the State is not so direct as in France it is nonetheless extremely influential by indirect means. Its main characteristics have already been analysed and they will merely be recalled here: Portuguese companies exhibit a heavily concentrated ownership structure that pursues an insider relationship with the management board. Although the State is not a significant shareholder, the privatisation movement placed the major companies in the hands of a few investors that were politically engaged and had an interest in maintaining the companies in the country. In addition, the companies operate in heavily regulated markets and the State has a significant influence over finance. Companies are normally organised in industry-level employers' organisations. There is a heavy degree of statutory regulation of the labour market made by means of tripartite bargaining between the social partners and the State. The trade unions are extremely dispersed (there are no criteria of representativity), weak and politically engaged. The works councils have a feeble expression and enjoy no significant powers. There is a wide

degree of coverage of collective agreements nonetheless: collective agreements normally determine the wages and professional careers for the industry and are applied to all companies by means of an administrative procedure for extension, which is very often used. The following matrix will attempt to present the interactions between the distinct elements of this puzzle.

	Manag.	Ownp. Strt.	State	Sect. Barg.	SLMR
Manag.	X	1	2	3	4
Ownp. Strt.	X	X	5	6	7
State	X	X	X	8	9
Sect. Barg.	X	X	X	X	10
SLMR	X	X	X	X	X

(1) management and ownership structure – the management board is complementary to the ownership structure of Portuguese companies. The data collected by the Stock market supervision authority even claimed that the majority of the members of the management boards are either relatives of the major shareholders or closely related to them. There is a very close relationship between the management board and the major shareholders in terms that one may say that Portugal exhibits a truly relational system of corporate governance.¹⁵⁸

(2) management and State – the complementarity between the management and the State is not so clear but it exists. There was always a close connection between the management boards of major Portuguese companies and the State: during the dictatorship, economical initiative depended of ministerial licensing and the State guaranteed a legal monopoly or cartel to the major companies of the country. In addition, the wave of nationalisations that swept the country after the revolution placed these companies in management dictated directly by the State. The wave of privatisations that occurred in the 1980s did not erase completely the influence of the State upon management boards: although the State itself has small shareholdings, it maintains close relationships with the major shareholders of those companies, who are normally politically influential families. It is equally not uncommon to find former

¹⁵⁸ CMVM (2006). O Governo das Sociedades Cotadas em Portugal: situação em Dezembro de 2005, CMVM.

politicians at the boards of some major companies. This is an indirect means of influencing the governance of those companies; therefore, it may be said that there is an indirect relationship between the management boards of major companies and the State.

(3) management and sectoral bargaining – there is equally a complementarity between the management boards and the extensive system of collective bargaining. Portuguese trade unions are heirs of the corporations from the old regime and therefore their main action is and has always been concentrated at the level of the sector. The insider relationship between shareholders and management boards and the extensive system of sector-level collective bargaining (underpinned in an administrative procedure for extension that is almost automatically used in order to expand the effects of collective agreements) helps employers associations to bargain wages and conditions of work at the level of the sector having in mind the needs of social protection and the financial situation of companies. This situation mimics the one found in France and Germany to a great extent and therefore there is no need for further developments.

(4) management and statutory labour market regulation – considering the political engagement of Portuguese trade unions and the heavy regulatory tradition, it is normal that trade unions concentrate their efforts in bargaining at the tripartite level the labour legislation. This provides management with considerable freedom to manage their human resources underpinned in the – previously bargained – law and limit their sector bargaining to the determination of wages and professional careers.

(5) ownership structure and State – there is equally some complementarity between the ownership structure of Portuguese companies and the State. The State has an interest in maintaining an incremental growth strategy of Portuguese companies in order to maintain employment levels and social peace. This explains why the wave of privatisations in the 1980s placed some companies in the hands of a handful of very large investors, who had an interest in the success of the company to the indirect benefit of the national economy. The only exception lay in the utilities companies (water, gas,

electricity) that were purposely placed under extremely dispersed ownership structures so that the management board could pursue their growth strategies free from the pressures of isolated shareholders or the stock market.¹⁵⁹

(6) ownership structure and sectoral bargaining – the ownership structure appears also to be equally complementary to the large coverage of sector-level collective bargaining because the *relational compromises* with the management board and the strategies of *incremental growth* that they pursue help to organise companies in industry-level organisations that conduct yearly rounds of negotiations. This means that the management board is free to bargain the wages and the conditions of work always having in mind the interests of the companies and the needs of social protection.

(7) ownership structure and SLMR – the concentrated ownership structure of Portuguese companies may be also complementary to the statutory regulation of the labour market because the political engagement of trade unions prevent more extensive bargaining at the level of the industry; they prefer that the state dictates (in tripartite bargaining) the “*rules of the game*” of the labour market (which they influence in the tripartite bargaining) and reduce the sector bargaining to the discussion of wages and professional careers.

(8) State and sector bargaining – the State may be also complementary to sector bargaining because it provides it with an opportunity to influence the labour market to a further extent. The State opted for an extensive regulation of the labour market by statute and left to the employers’ organisations and trade unions the task of bargaining the wages and the conditions of work at the level of the sector. The administrative extension procedures of collective agreements – which are regarded as almost natural – help to ensure an extremely wide coverage of collective agreements and allow the State to influence the labour market at the level of the sector while providing the social partners with a margin of manoeuvre to reach the best possible solution. There is a coordination of actions: the State leaves to the social partners the task of deciding the best conditions of work for the sector concerned (under the

¹⁵⁹ Ibid.

observance of the statute) and then extends administratively those conditions to non-affiliated employees and employers by means of a ministerial decree.

(9) State and SLMR – there is also a certain complementarity between the State and the statutory regulation of the labour market. Since trade unions are politically engaged and extremely dispersed (because there are no criteria of representativity such as in France), there is the danger that weak unions would bring politics into negotiations and harm the interests of the employees. That is the reason why the State decided to regulate the labour market by statute and bargain the labour laws with the social partners at the tripartite level. This helps to ensure a conciliation of interests between the parties and reserve the last political word to the State.

(10) sector bargaining and SLMR - there may be also a complementarity between the sector bargaining and the SLMR. Since trade unions are have always dealt with a heavy degree of statutory regulation and have limited their actions from the beginnings to the determination of wages and conditions of work, they concentrate their efforts at the political level to influence the statutory law and do at the sector level what they do best: *bargain wages and professional careers*.

Conclusion: this description of the interactions Portuguese system of corporate governance and employee representation reveals that, although it has its own specificities, the Portuguese system may be considered as a Governmentalist system that mimics to a great extent the one found in France. Considering that the structures for employee representation in Portugal are very weak (works councils have almost no intervention rights and trade unions are fragmented and politically engaged) the State took upon itself a dirigist role of the economy and attempted to ensure a conciliation of interests. However, unlike in France, the historical contingencies of Portugal demanded a different approach. During the dictatorship, the control was made by means of licensing of the industrial activity and political ties between major companies and the Government. After the dictatorship, there were two distinct periods: one period of nationalisation and another of privatisation that placed major companies in the hands of major shareholders. The regulation of the industrial sector and the

interest of the shareholders in the stability of the companies helped to reach the public goals of large companies based on incremental growth and with high employment levels. The defense of the interests of the workforce was made by two means: firstly, by the heavy statutory regulation of the labour market; since labour laws were bargained at a tripartite level, this ensured the participation of the social partners in the determination of labour laws and allowed employees some voice. Secondly, by means of the administrative procedure for extension; despite low unionisation levels, there is still a considerable degree of collective bargaining at the level of the sector; this is explained by the concentrated ownership structures of large Portuguese companies (which underpins a relational attitude with management and organisation in employers' organisations) and by the experience of the trade unions in sector-level bargaining (dating from the times of the dictatorship). The collective agreements essentially determined wages and professional careers and enjoyed a wide degree of coverage on account of the administrative procedures for extension. This eliminated wage competition and ensured social peace in the labour market. The combination between these elements (industry regulation, concentrated ownership structures in the hands of investors connected to the country, relational attitude with the management, administrative procedures for extension and the tripartite statutory regulation of the labour market) ensured the protection of the employees in the labour market from the dispersion, weakness and political activism of the trade unions. Although the influence of the State is not so direct as in France it is nonetheless extremely important.

(d) UK – the final country to be analysed in this section will be the UK. The main characteristics of the British system of corporate governance and collective bargaining are widely known (mainly in Continental Europe) because the UK stands as the paramount example of the Anglo-saxon system of corporate governance. In contrast, its labour markets and employee representation structures also present several interrogations to a Continental European labour lawyer because its specificities differ to a great extent from the models found in Continental Europe. This section will present a matrix that will attempt to explain the several interactions between the British models of corporate governance and employee representation. It will defend that there

appears to be a certain degree of complementarity between one and the other in order to produce a mutually beneficial outcome.

The British system of corporate governance is part of the market/outsider systems of corporate governance that share, to a variable extent, the following characteristics: dispersed equity holdings, portfolio orientation among shareholders, large managerial autonomy to run the business and market for corporate control as an external monitoring device. The British ownership structure of its companies is characterised by (1) large market capitalisation, (2) dispersed ownership structure, (3) portfolio orientation among investors and (4) large presence of institutional investors (investment funds). The *management* of British companies normally has a background in finance or marketing, they are recruited externally and are under heavy pressure to deliver financial results to the shareholders on account of a number of governance devices, such as: (1) market for corporate control, (2) presence of institutional investors, (3) elimination of deviations from the principle one share/one vote and (4) configuration of the management board (separation of the role of CEO/Chairman and remuneration tied to results). Finally, in terms of company structures, British companies always exhibited a heavy degree of decentralisation: they were among the first to introduce the idea of strategic business unit as a means of firm organisation so that unprofitable units could quickly be closed as a means of maintaining revenues. This set of circumstances explains these three main paradigms of British corporate governance: (1) shareholders prefer strategies of exit to the detriment of voice; (2) management is extremely dependent upon delivering short-term financial results to the shareholders in order to increase their remuneration and keep their jobs; (3) company structures were adapted to these circumstances.

The British system of employee representation also exhibits some considerably unique characteristics. It is a system built upon monism, voluntarism and decentralised collective bargaining. As regards monism, the representation of employees is made solely by trade unions; there are no works council type bodies. As regards voluntarism, there is no duty to bargain and collective agreements have no mandatory effect; as regards decentralised collective bargaining, the majority of the collective agreements are signed at the level of the undertaking and have a flexible nature. Apart from a few

industries, there are almost no sector level collective agreements and the majority of employers are not affiliated to employers' organisations.

The following matrix will attempt to analyse the diverse interactions between each one of these elements:

	Manag.	Ownsp	Dec.Comp	Monism	Volunt	Dec.CB
Manag	X	1	2	3	4	5
Ownsp	X	X	6	7	8	9
Dec.Comp	X	X	X	10	11	12
Monism	X	X	X	X	13	14
Volunt.	X	X	X	X	X	15
Dec.CB	X	X	X	X	X	X

(1) management and ownership structure - the managerial culture predominant in anglo-saxon companies is complementary to the type of ownership structure the external corporate governance mechanisms, the absence of deviations from one share/one vote and the activism of the institutional investors places a great deal of pressure upon the management to deliver short-term financial results. The fact that they are recruited from the outside, they have their remuneration tied to results and their educational backgrounds are essentially in management and finance further contributes to this because it creates more incentives to have a purely financial approach to the management of companies.

(2) management and decentralised companies - the managerial culture is complementary to the decentralisation of anglo-saxon companies because the need to deliver results led to the organisation of companies around strategic business units; in contrast to Fordism, which organised companies in very large vertically integrated organisations that needed a large degree of social dialogue within them to function, the decentralisation of companies led to seeing these units in a purely financial perspective; they may be shut down at any time if there is need to cut costs to provide shareholders with dividends.

(3) management and monism – the British management is also complementary to the British system of employee representation. Since employers are not organised in sector-level organisations and British law

places no demands of representativity upon trade unions, there is a considerable degree of overlapping between the function of the trade unions as representatives of the employers as a class and as stakeholders of the company (as task that in Continental Europe competes to the works council). In Continental Europe, trade unions negotiate predominantly at the level of the sector and the bargaining at the level of the company is made with works council type bodies. The separation of tasks was important because the objective was to avoid competition in terms of labour at the industry level and to bargain working arrangements at the company level. As the previous paragraph attempted to demonstrate, the concentrated ownership structure predominant in Continental Europe (whether Bank or State) facilitated this organisation of employee representation because the relational attitude with the management boards allowed them to engage in a two-level bargaining with the employees. This institutional endowment did not occur in the UK; since management is constantly under the pressure of the stock market and distinct shareholders (who just want dividends) they could not organise at the sector level because they could not engage in close relationship with the shareholders in order to convince them of the advantages of a long term sustainable growth that is the precondition for industry level bargaining with the trade unions to avoid wage competition. That is the reason why the trade unions needed to bargain at the site level with each specific management team because each one of them is subject to specific pressures. The combination of these two elements prevented the development of works council type bodies because the subjection to the pressure of the management (statutory protection against dismissal is low in the UK) prevented free negotiations. The trade unions had to organise and bargain at the level of the company both as a works council (having in mind the specific situation of the company) and as a trade union (in order to prevent competition in working conditions and free riding on the sacrifices of others).

(4) management and voluntarism – the particular culture of the British management board and the voluntarism hat characterises British collective bargaining are equally complementary. The objective of voluntarism is to defend the interests of the employees in each specific company having into

account its specific ever-changing circumstances. It is worth noting that voluntarism is fiercely defended by the trade unions (and not by the employers) because it allows them to demand a renegotiation of the previously agreed terms and conditions of employment without the objection of the principle *pacta sunt servanda*. Since the management board is always subject to the caprices of the stock market and the institutional investors, the voluntarism is a means of readapting the collective agreements to those caprices. Since this situation did not occur in Continental Europe (where the relationship between the shareholders and the management is much more stable), the trade unions demanded in Continental Europe the strict observance of the contractual part of collective agreements because that is where the guarantee of their agreements lay.

(5) management and decentralised bargaining – the British management boards organised their companies since an early stage in strategic business units so that they could close the less profitable ones when necessary and maintain the revenues of the shareholders. Decentralised collective bargaining is complementary to this approach because this allowed trade unions to concentrate their action at the site level, defend the interests of those concrete employees and propose the necessary rearrangements. The resulting concession bargaining that characterised British industrial relations allowed managers to provide an answer to the interests of the shareholders while maintaining collective bargaining.

(6) ownership structure and decentralised companies – dispersed ownership and decentralised companies are complementary because the pressure that the stock market and the institutional shareholders place upon the management board oblige the latter to organise the company around strategic business units that are designed to answer shareholder pressures when necessary.

(7) ownership structure and monism – the dispersed ownership structure that characterised British companies is equally complementary to the monistic system of employee representation. The distinct pressures of the stock market and the institutional shareholders prevent the organisation of companies in

industry level organisations because these organisations presuppose a relational attitude with managers; this obliges trade unions to bargain with each specific company both as a trade union and as a class in order to counterbalance weak employee voice in the workplace.

(8) ownership structure and voluntarism – the dispersed ownership structure of British companies and voluntarism are complementary because that was the mean that the trade unions arranged to readapt their agreements to the ever-changing pressures from the stock market.

(9) ownership structure and decentralised collective bargaining – the relationship is very simple: the ownership structure placed great financial demands upon the management, which led the management board to organise the companies in strategic business units. The bargaining structures simply adapted to the organisation of companies and the types of pressures that the management boards were subject to.

(10) decentralised companies and monism – the relationship is also very evident. Management boards decided to organise the company in strategic business units and this led to the development of a monistic system of employee representation developed. Both are complementary because the weak protection of employees in those strategic business units and the arms length relationship between the shareholders and the management board obliged trade unions to act both as works councils and trade unions at the level of the undertaking.

(11) decentralised collective bargaining and voluntarism – the relationship is equally evident here. Decentralised collective bargaining developed because the pressure to which managers were subject to obliged them to reorganise their companies in decentralised forms. The combination of these three elements (shareholder pressure > decentralised companies > decentralised collective bargaining) obliged trade unions to adapt a voluntarist approach to shareholder pressures at the level of the site, in order to accommodate their ever changing circumstances and avoid the closure of the site and the consequential redundancies.

(12) decentralised companies and decentralised collective bargaining – the relationship is more than evident here. Since companies were organised in strategic business units and the interests of the employees were at the level of the site (because the ownership structure prevented a company-level bargaining), the collective bargaining structures had to readapt to this type of firm organisation in order to defend the interests of the employees where they needed more protection.

Conclusion: *monism, voluntarism and decentralisation of collective bargaining* may be complementary to the distinctive characteristics of the British model of corporate governance (dispersed ownership structure, financially educated management and decentralised company structures) for the following reasons: the pressure that the stock market places on the management board to deliver financial results and the decentralised company structures oblige trade unions to readapt quickly to ever-changing environments. The trade unions need to make bargaining at a company level basis because each company is subject to distinct pressures (which also prevents their organisation at the industry level) and the level of bargaining needs to be at the shop floor because if the units do not provide results they will be shut down. In addition, the collective agreements need to be highly flexible because the ever-changing demands of shareholders do not comply with rigid long-term agreements. There is a constant re-adaptation of the trade unions to the modifications occurred in companies.

2.6.6 Conclusion

This chapter has attempted to reveal the diversity of the configuration of employee representative structures and the possible interactions between employee representation and collective bargaining. The chapter initiated with a comparative overview of the systems of employee representation and collective bargaining within each jurisdiction under study. The diversity of employee representative structures and the types of agreements concluded is by itself appalling and every discussion about the merits and demerits of each national system is useless if attention is not taken to its institutional endowment. This is

where the thesis enunciated above gains more relevance: this chapter has introduced the concept of “*complementarity*” to explain the possible interconnections between each distinct system of corporate governance, employee representation and collective bargaining and the means by which it would be capable of producing an optimal outcome. This remaining of the chapter attempted to analyse the multiple interactions between each system of corporate governance, employee representation and collective bargaining. It defended that in Germany, co-determination was complementary to the particularities of the German system of corporate governance because the corporatist structure of the economy, the incremental growth strategies and the particular patterns of relational investment demanded a great contribution from the employees; co-determination was the best monitoring mechanism because it preserved their power independently of the size of the stock of the company and allowed them to conciliate their interests with those of the stockholders and have a word in the election of the management board. On the other hand, the particularities of the German system of collective agreements - industry-wide collective agreements destined to de-commodify labour and eliminate competition in terms of wages and employment conditions - were complementary to the strategies of incremental growth because companies could focus on the incremental improvements of their companies without fear of free-riders or unfair competition based upon labour standards. The same situation did not occur in France and in Portugal. Although both of these countries exhibit also a concentrated ownership structure, the identity of its investors and the dispersion and political engagement of the trade unions prevented the development of co-determination mechanisms. The answer lay in a particular actor – the State – that took upon itself the task of conciliating the interests of the actors concerned by exerting influence in the major companies (by shareholdings, regulation of the industrial sector, control of finance), extensively regulating the labour market by bargained statutes and extending the effects of the collective agreements reached. The State allowed some voice to the trade unions - in particular in the determination of the wages and working conditions at the level of the industry in order to prevent unfair competition - but always reserving to itself the last word. The situation in the UK was radically distinct and demanded distinct solutions. The governance structure of British corporations is the opposite of their continental counterparts and management

boards pursue other strategies of growth. That is the reason why the British trade unions decided to reorganise and adapt their struggle to the particular institutional endowment in which they bargained. Since the management depended of the fluctuations of the stock market and the pressure of institutional shareholders and organised their companies in decentralised units, British trade unions decided to have the monopoly of bargaining at the level of the undertaking and reach agreements that could be modified when the circumstances modified accordingly: this appears to be the origin of the particular principle of monism and voluntarism in the British system of industrial relations that is so appalling to Continental Labour Lawyers: trade unions could demand the renegotiation of the agreement when the pressures of the shareholders imposed a change in the managerial strategy without the employers being able to oppose them the principle of *pacta sunt servanda* in order to avoid engaging into negotiations. This provided a great degree of flexibility to the agreements and adaptability to the individual undertakings.

The multiple interactions between the distinct patterns of several actors that compose corporate governance and labour may explain the degree of complementarity between corporate governance, employee representation and collective bargaining structures. It appears that the structures of employee representation and the types of collective agreements reached were complementary to the model of corporate governance enforced in that country because each one of them appears to reinforce the other for the reasons laid out in the former sentences.

Chapter 2

Comparative developments in the national patterns of Corporate Governance: Causes, Comparative Analysis and Directions

2.1. Introduction - Convergence / Divergence / Hybridisation of national patterns

The former chapters analysed the main theories of corporate governance, the main patterns of corporate governance in each one of the jurisdictions under study, the main patterns of employee representation and attempted to use the theory of institutional complementarities to explain the development of these particular patterns of corporate governance and employee representation. It was argued that, under a contractarian conception of the company, these particular institutional configurations of corporate governance and employee representation were a means of reducing the agency costs that occurred between the interest groups that compose the company. The reasons for the development of the particular patterns of corporate governance were sought within the rule- and structure-driven approaches; these approaches, rather than mutually exclusive, are complementary in the sense that they attempt to call attention to the fact that legal rules are not indifferent for the behaviour of the interest groups within the company and that there are a number of elements - named as institutional endowments, covering the macro-economic context, the organisation of the company, the needs of the economy, tax and industrial policies, etc - influencing the development of particular patterns of corporate governance.¹⁶⁰

The models of corporate governance presented above correspond however more to a simplification than to the reality. A “*model*” is by definition a

¹⁶⁰ Aoki, M. (2001). Towards a comparative institutional analysis, Stanford University Press, Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." British Journal of Industrial Relations **41**(3): 557-582, Ahlering, B. and S. Deakin (2005). Labour regulation, corporate governance and legal origin: a case of institutional complementarity European Corporate Governance Institute, Gospel, H. and A. Pendleton, Eds. (2005). Corporate Governance and Labour Management - an international comparison, Oxford.

pattern, a representation, a simplification of the reality. The systems of corporate governance of each one of these countries has been undergoing considerable developments over the last 20 years up to a point that many question whether if they actually correspond to the concrete reality. These developments are manifold and they have given rise to a variety of interpretations: a torrent of thought believes that the differences between the systems will eventually erase and that the systems will converge to one best system of corporate governance; it consists in a Darwinian perspective that advocates the triumph of one single model of corporate governance (the Anglo-Saxon) in face of the competitive pressures of globalisation after the creation of the global market in 1989.¹⁶¹ Other approaches are more sceptical and, although they do not deny the current movement of transformation of the systems, they point out that the development of relational systems is not so radical as to create an Anglo-saxon style governance system and that market systems are equally converging and borrowing elements from insider systems. Two distinct opinions arose from this departing point: some claim that one single hybrid system of governance will be borne in the future and others claim that each country will borrow the best elements from the other system and develop its own system of governance.¹⁶² Finally, a third current of thought believes that the movement of convergence is more apparent than real and that the reality is that each country will maintain its own system and they will continue to diverge; these authors claims that there is a divergence within an apparent convergence trend.¹⁶³

The following chapter will attempt to analyse the developments in the structures of corporate governance of each one of the countries under study. The study will initiate with an enunciation of the major elements influencing the development of the structures of corporate governance; the chapter will make

¹⁶¹ Hansmann, H. and R. Kraakman (2000). The end of history for corporate law. Program for studies in law, economics and public policy, Yale Law School, Schilling, F. (2001). "Corporate Governance in Germany: the move to shareholder value." Corporate Governance 9(3): 148-151.

¹⁶² Jacoby, S. M. (2002). "Corporate Governance in Comparative Perspective. Prospects for Covergence." Comparative Labor Law and Policy Journal 22(1), Braendle, U. C. and J. Noll (2005). "On the convergence of national corporate governance systems." Journal of Interdisciplinay Economics 16.

¹⁶³ Van der Berghe, L., C. Van der Elst, et al., Eds. (2002). Corporate Governance in a Globalising World: convergence or divergence? A European perspective, Kluwer.

use of a structural analysis of the developments of corporate governance in order to attempt to frame the institutional endowments pressuring the traditional structures of corporate governance. The chapter will then proceed to analyse the developments in the following elements of corporate governance: (1) the traditional management structures of each one of these countries, (2) the ownership structures, (3) the rights of shareholders and (4) the impact of EU Law. A special section will be devoted to the developments in the structures of Small and Medium sized companies (SMC), which appear to have suffered some considerable developments at the light of the impact of the *Centros* case-law. The final part of the chapter will attempt to analyse each one of these developments against the background of the convergence / divergence / hybridisation debate.

2.2 Structural developments - changes in the macro-economic environment, technology and managerial philosophy.

The former chapter framed the development of the particular national patterns of corporate governance within the structural endowment of each country. The section argued that the system of coordinated capitalism developed after WWII in Continental Europe created the necessary conditions for the development of relational systems of corporate governance underpinned on (1) patient capital (banks, families or State), (2) industrial politics favouring incremental growth, (3) employee voice and extensive industry-level bargaining (although with variable intensity as the cases of France and Germany demonstrate) and (4) preference for Fordistic structures of production because they were the ones most adapted to provide countries with the goods that they needed the most. Only the UK failed to adhere to this neo-corporatist bargain because its previous experiences with industrialisation placed it in an advantageous position and the traditional British aversion to corporatism and intervention (*laissez-faire, laisse-passer*) obliged companies to seek other forms of organisation. This particular structure was particularly adapted to the economical circumstances of the time: the demand-side economic policies that were implemented at the time in Continental Europe lay upon a combination of wage retention and company expansion in order to produce cheap goods to fuel the economy. This formula suffered a blow in the beginning of the 1970s

with a number of causes that changed the structural elements in which firms operated.¹⁶⁴

The causes and impact of the crisis of the 1970s that modified to a great extent the previous economic model are manifold. One cause consisted in the tightening of the labour markets and the strikes that followed. The previous model had been underpinned in a massive migration from the fields towards the industrial units which lowered the price of labour and helped to ensure wage retention. The migration came to a halt in the 1960s and workers equally began to grow tired of wage retention. The bargaining power of the workforce increased and strikes followed leading to wage increases and a mounting inflation. Another significant element consisted in the end of the Bretton Woods agreement; the connection of the price of currency to gold came to an end in 1973 and the stability of currency that had underpinned the system equally came to an end; firms began to learn how to operate in conditions of monetary instability. The oil shock of 1974 also contributed to the situation because it brought with it a sudden increase in prices and the need to rethink the model of production. There was equally a break in the productivity because the existing technology began to mount out and did not suffice to deliver the quality needs of consumers. Finally, international competition from Japan and other Asian tigers placed European companies under a new pressure from competition. The combination of these elements led to a breakdown in growth with structural unemployment and a need to rethink the overall economy.¹⁶⁵

The combination of these elements led to a change of paradigm in the 1980s from a model of coordinated capitalism towards a model of financial capitalism. The main idea was that keynesian economics and coordinated capitalism was no longer capable of providing an answer to the challenges of the economy. Keynesian economics consists in an economic doctrine that advocates a mixed economy in which both the State and the private sector play an important role. This theory believes that the macro-economic trends influence considerably the micro-economic behaviour of individuals and that the

¹⁶⁴ Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond Princeton University Press. Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." Oxford Journal of Legal Studies 28(2): 201-245.

¹⁶⁵ Ibid. Armstrong, P., A. Glyn, et al. (1991). Capitalism since 1945, Blackwell.

aggregate demand for goods should be the driving factor of the economy, in particular in periods of downturn. The combination of State intervention (by means of interest rates and public investment) and private initiative should set the basis for full-employment to occur. This formula had provided very good results until the 1970s. The failure of this formula in the 1970s and the need for a new model was evident in British Prime Minister Callaghan's conclusions at the 1976 Labour Party conference:

"We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists and insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment at the next step".¹⁶⁶

The failure of Keynesian economics to provide an answer to the economic needs of the time led national governments to search out for other alternatives and try free market policies. The dominant trend in policy making became the reduction of the role of the State and of trade unions and to provide market participants with a maximum freedom to allocate the resources in the market. This had several implications in industrial policy: Government intervention by statutory and administrative regulation should be left to a minima and firms should be obliged to reorient their investments in accordance with the demands of the market in order to promote maximum allocative efficiency; industries should be deregulated in order to increase competition - both at the national and international levels - and increase their flexibility and capacity for adaptation; trade unions and the industry level organisation of work should be reduced to the fullest extent possible in order to promote allocative efficiency in labour markets (people should go to whatever job the economy demanded), the industry level determination of wages and working conditions should be reduced to the fullest extent in order to provide firms with maximum flexibility and increase their competitive advantages and national industries should be privatised. A final element consisted in the increasing financialisation of the economy. "*Financialisation*" refers to a phenomenon by means of which financial markets, financial institutions and financial elites gain greater influence over economic policy and outcomes, transforming the functioning of the

¹⁶⁶ Coates, D. (1980). Labour in Power. London, Longman.

economic system both at the macro- and micro-level and national and international levels.¹⁶⁷ This had a great impact over the behaviour of consumers and investors: as regards consumers, the levels of household debts grew exponentially; as regards investors, institutional investors - mainly hedge funds and pension funds but also other collective investment schemes - made an aggressive entry into capital markets and modified the governance patterns of companies because these funds are traditionally concerned with short-term profits and follow strategies of portfolio investment; they are merely concerned with the financial gains of companies and disregard completely incremental strategies of growth.¹⁶⁸

This situation continued throughout the 1990s and early 2000s. The end of the Communist block and the entry of the formerly communist countries in the model of capitalism was accompanied with a strong belief in the virtues of free market capitalism. Some even said that History was over and that the evolution of mankind had been evolving towards representative democracy and free market capitalism and the ultimate stages of human development because those were the political and economical regimes that provided humans with the greater margin of maneuver to develop themselves.¹⁶⁹ "Free market" is the keyword to understand the 1990s and early 2000s: international trade, international capital flows and international production grew to unprecedented levels; the entry of China and India into international markets boosted international investment and trade and strengthened the beliefs of free market capitalism (in particular India) on account of the extensive liberalisation and deregulatory programs implemented in those countries; the market capitalisation of firms grew to unprecedented levels and there was an explosion in stock markets - particularly those connected to the technological sector; a final element of great importance consisted in the introduction of new

¹⁶⁷ Power, D., G. Epstein, et al. (2003). Trends in the rentier income-share in OECD countries, 1960-2000, Department of Economics, University of Massachusetts.

¹⁶⁸ Stockhammer, E. (2007). "Charakteristika eines finanz-dominierten Akkumulationsregimes in Europa." *WSI-Mitteilungen* 60(12): 643-649. Armstrong, P., A. Glyn, et al. (1991). *Capitalism since 1945*, Blackwell, Eichengreen, B. (2007). *The European Economy since 1945 - coordinated capitalism and beyond* Princeton University Press, Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." *Oxford Journal of Legal Studies* 28(2): 201-245.

¹⁶⁹ Fukuyama, F. (1992). *The End of History and the Last Man*, Free Press.

technologies in the workplace - the so-called ICT revolution - that brought substantial modifications to the world of work.¹⁷⁰

The combination of these developments had a severe impact in the management of companies. The dominant managerial philosophy during the 1980s and 1990s became known as "*shareholder value*"; this managerial philosophy was created after an extremely influential book by Alfred Rappaport in 1982, which advocated that the only purpose of the company was to maximise the earning of its shareholders. The book advocated the use of governance mechanisms in order to maximise the value of the investment of the shareholders and increase the incentives to invest in the stock-market. The book advised the use of disciplinary devices for failure to provide earnings in the short-term such as the use of share-options, removal of barriers to takeovers and decentralisation of companies in strategic business units in order to facilitate restructuring.¹⁷¹ In addition, the stable macro-economic environment that characterised the Bretton-Woods system came to an end: firms had to compete in environments characterised by unstable currencies, international competition became more aggressive and obliged firms to bet on innovation as opposed to producing cheap massive goods, the liberalisation of capital markets and international capital flows opened doors to the entry of collective investment schemes in capital markets and tax reforms became increasingly regressive in order to encourage investment and entrepreneurship. This led to some extremely aggressive business practices: management became increasingly financialised and concerned only with providing financial results in the short-term at the expense of incremental growth, companies had to be managed in unstable environments (both economical and at the demands of shareholders), firms concentrated in its core-business and outsourced a great

¹⁷⁰ Oliner, S. D. and D. E. Sichel (2000). "The resurgence of growth in the late 1990s: is information technology the story?" *Journal of Economic Perspectives* 14: 3-22, Rao, J. M. and A. Krishna Dutt (2002). A decade of Reforms: the Indian Economy in the 1990s, Crafts, N. (2006). The world economy in the 1990s: a long-run perspective *The Global Economy in the 1990s: a long-run perspective*. P. W. Rhode and G. Toniolo, Cambridge, Eichengreen, B. (2006). Managing the world economy in the 1990s. *The Global Economy in the 1990s: a long-run perspective*. P. W. Rhode and G. Toniolo, Cambridge, Rhode, P. W. and G. Toniolo, Eds. (2006). *The Global Economy in the 1990s* Cambridge, White, E. (2006). Bubbles and busts: the 1990s and the 1920s. *The Global Economy in the 1990s. A Long Run Perspective*. P. W. Rhode and G. Toniolo, Cambridge.

¹⁷¹ Rappaport, A. (1986). *Shareholder value - the new standard for business performance*. New York, The Free Press.

part of its non-essential activities. This is, in essence, the philosophy of shareholder value that spread throughout much of the world - and in particular in the Anglo-Saxon countries - as the standard for business performance. This philosophy became exemplary synthesized in the words of Milton Friedman - the father of monetarism and the main responsible for the transition from keynesianism to this new philosophy that underpinned the 1980s and 1990s: "*the social responsibility of business is to increase its profits*".¹⁷²

This regime suffered a severe blow however from 2001 onwards. The cases of Enron and Parmalat (in 2003) raised severe doubts as to adequacy of this philosophy of shareholder value and the potential impact of companies' practices on society. The fact that it affected both companies in market and insider systems that had engaged into "*shareholder value practices*" (Parmalat was a company controlled by a dominant shareholder - the Tanzi family - by means of a pyramidal structure of ownership) meant that the problematic was not so much of a particular model of governance but of the dominant philosophy of business management. These scandals raised the need to improve the governance mechanisms of companies and raised an intense discussion concerning the best model of governance: how to encourage investment, growth and innovation while at the same time avoiding the negative consequences that each system entails.¹⁷³

These developments over the last 30 years have brought about considerable pressure upon companies to restructure their internal governance practices. The connection between the institutional endowments and the internal governance structures of companies has been laid out above on occasion of the description of the traditional structures of corporate governance in each country; the purpose of the following chapters is to analyse the impact of these developments (the modifications in national and international economy, the competitive pressures, the movement to shareholder-value

¹⁷² Friedman, M. (1970). The Social Responsibility of Business is to Increase its Profits The New York Times Magazine.

¹⁷³ Deakin, S. and S. Konzelmann (2006). Corporate Governance after Enron: an age of enlightenment? . After Enron. Improving Corporate Law and Modernising Securities Regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart Publishing, Norton, J., J. Rickford, et al., Eds. (2006). Corporate Governance Post-Enron. Comparative and International Perspectives, British Institute of International and Comparative Law.

during the 1980s and 1990s and the current attenuation of the internal governance failures that shareholder value entailed) in each national system.

2.3. The evolution of management structures

the analysis of the evolution in the governance structures of each one of the jurisdictions under study should initiate with an examination of the evolutions registered in management structures. One of the key characteristics of a company that distinguishes it from other forms of organisation of production consists in the existence of a delegated management (meaning that there is at least a formal separation between the providers of inputs into the company and those responsible for managing those inputs) with a board structure. One of the key problems of corporate governance consists in making managers effectively responsible for the interests of those that they must consider in the management of the company without constraining excessively the margin of maneuver and risk that any entrepreneurial activity necessarily entails. This is by definition the most paradigmatic example of an agency problem of managers vis-à-vis shareholders (including non-controlling) and stakeholders.¹⁷⁴

The institutional complementarities between each country's characteristic management structure and the institutional endowment surrounding it was outlined above; this section will be concerned with a description of the evolution registered in management structures and attempt to contextualise it within the modified institutional endowment that characterised the last 30 years. The evolution registered in some key areas of management boards consisted in (1) the constraint of managers' autonomy by the improvement of supervision mechanisms, (2) making the management boards more responsive to the interests of shareholders and (3) creating a longer-term investment culture with due regard to the long-term interests of the shareholders. The most remarkable evolutions were registered in the areas of (a) the division of tasks between the management and supervisory boards in the dual model and the reinforcement of supervisory mechanisms in the single-tier model; (b) the discovery and renovated scope for fiduciary duties; (c) the reinforcement of auditing

¹⁷⁴ Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press, Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford.

mechanisms, (d) modifications in remuneration patterns and (e) modifications in the social world of management. The following lines will attempt to describe how there appears to be a movement of convergence towards a hybrid system of governance, the reasons underpinning that evolutions and the means by which each country seems to have maintained its basic structure while borrowing the best element from the other structures.

2.3.1 basic management structures - national models compared

Before advancing further into the analysis of the modifications occurred in each country's management structures, it is important to make a brief descriptions of the board structures that have traditionally been developed in each jurisdiction to overcome the agency problems that occur within corporations. Germany, the UK, France and Portugal have developed difference governance arrangements for the constitution of the company that have been considerably modified recently, giving rise to a hybrid model of governance.

The German board is worldly famous for its dualist structure; this means that in every German public company, regardless of size or listing, there is a functional separation between the *Vorstand* (the management board) and the *Aufsichtsrat* (the supervisory board). Whereas the *Vorstand* is a typical management board charged with the task of running the affairs of the company, the position of the *Aufsichtsrat* is not so easy to explain; the most accurate description would be one of a mini-parliament representing the interests of all the interest groups of the company. The *Aufsichtsrat* is composed by a number of persons elected by the shareholders, a number of persons elected by the employees and the statutes of the company may provide for certain appointment rights (§101AktG).¹⁷⁵ This last point concerning appointment rights is extremely important as regards the role of banks in the German governance system because the shareholdings of banks are also connected with a number of special appointment rights that guarantee them representatives at the boards of those companies that control the management of the business and the application of their money. The *Aufsichtsrat*, legitimated by the election of all the interest groups, has the task of appointing, supervising and removing the

¹⁷⁵ The proportion of the number of shareholders to be appointed by the management and by the employees varies in accordance with the size of the corporation.

members of the Vorstand. It also has a number of indirect very important functions, which essentially consist in networking with the stakeholders of the company and balancing the interests within the corporation.¹⁷⁶

The British model follows a radically distinct philosophy. The British model consists in a single-tier board; this means that both management and control are entrusted to a single board of directors, which is vested with universal power. This radically simple model of internal governance of companies places such trust upon the management board to the point that managers were traditionally insulated from the interference of shareholders on account of a strict division of powers: the general meeting of the shareholders could only perform a pre-defined number of tasks (not including the supervision and interference with the managerial activity) and the task of managing the company was left in its entirety to the management board. It was this simple internal governance arrangements that gave rise to the agency problems outlined by Berle and Means arising from the separation of (dispersed) ownership and control.¹⁷⁷

The third relevant model consists in the French model. The French model is one that stands in between the German and the Anglo-saxon model. French shareholders have the possibility of choosing between two distinct models: the single-tier board and the dualist model. Despite this possibility of choice, figures reveal that the dualist model is very seldom used and that the vast majority of companies prefer the single-tier board.¹⁷⁸ The French single-tier board exhibits the following characteristics: the prominent characteristic consists in the concentration of the role of the chairman of the board and the

¹⁷⁶ Hopt, K. J. and P. C. Leyens (2004). *Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy.*, European Corporate Governance Institute.

¹⁷⁷ Ferran, E. (2005). *Company Law Reform in the UK: a progress report*, European Corporate Governance Institute. Berle, A. and G. Means (1932). *The modern corporation and private property*. New York, Harcourt Brace, Sealy, L. and S. Worthington (2008). *Cases and Materials in Company Law*, Oxford University Press.

¹⁷⁸ Cozian, M., A. Viandier, et al. (2002). *Droit des Sociétés*. Paris, Litec.

CEO are concentrated in the same person: le President Directeur Général.¹⁷⁹ This means that it is the same person that manages and supervises the board, concentrating the management of the company into the hands of one single person. The French tradition also does not open way for the inclusion of non-executive directors in the management boards of French companies, thus reducing the degree of supervision that the minority shareholders might effectively exercise (which is capable of generating agency costs of majority shareholders *vis-à-vis* minority shareholders) and concentrating more power into the hands of the management. A final distinguishing characteristic consists in the absence of any express provision of the fiduciary duties that managers hold in relation to the company and to the shareholders. This is in itself appalling considering the extensive regulatory tradition that characterises French law. One explanation for this deviation consists in the extensive degree of concentrated ownership intensified by the cross-shareholdings and the interlocking ownerships that characterise the French tradition: it might just happen that, since a small group of shareholders has the decisive word in the behaviour of the management board, they do not need supplementary provisions to exercise further supervision. This is however merely an hypothesis and is a debatable argument.¹⁸⁰

The Portuguese model is the fourth model relevant to this thesis. The Portuguese model of governance of companies may be an extremely interesting model for this discussion not only because it was subject a significant revolution in the reform of Company Law undertaken in 2006 – which is going to be analysed in detail further on – but also because its original conception was singular even in comparative terms. Traditionally, Portuguese public companies could choose between two mandatory models of constitution of public corporations: the single-tier model and the dualist model; however, in each one of these models there was a mandatory auditing organ that created a hybrid system of governance. The single-tier model was composed by two

¹⁷⁹ Please have in mind that this structure refers itself to the traditional version of the code that was enforced before the reform undertaken by the *Loi de Nouvelle Régulation Économique* (LNRE) that is going to be analysed in the following pages. For a short overview of French company law before the reform undertaken by the LNRE see Mestre, J. and M.-E. Pancrazi (2003). *Droit Commercial: droit interne et aspects de droit international*. Paris, LGDJ.

¹⁸⁰ This is essentially the argument of La Porta, R., F. Lopes-de-Silanes, et al. (1999). "Corporate ownership around the world." *The Journal of Finance* 54(2): 471-517.

organs: the management board (*conselho de administração*), elected by the general meeting of shareholders, and the auditing organ (*conselho fiscal*), which had the task of supervising the activities of the management board. The “dualist model” was in reality composed by three organs: the supervisory board (*conselho geral*, similar to the German *Aufsichtsrat*), the management board (*direcção*, nominated by the supervisory board) and a chartered auditor (*revisor oficial de contas*). The originality if the Portuguese model consists in the mandatory inclusion of a supervisory organ in each one of the models, making it a hybrid model that does not fit within neither the pure single-tier nor the pure dualist model.¹⁸¹

2.3.2 improving the supervision of the management board

One of the major areas of evolution in management boards consists in the improvement of its supervision mechanisms. These supervision mechanisms were not designed to constrain the managerial autonomy of the board or to allow shareholder influence in managerial matters; it simply consists in a set of mechanisms designed to make the functioning of the board more transparent and attempt to dissuade opportunistic behaviours of managers in order to attempt to create incentives to act in the interest of the company. The main modifications consisted in (a) the separation of the role of CEO and chairman, (b) the inclusion of non-executive directors and (c) the creation of stricter internal control mechanisms.

(a) separation of the role of CEO and chairman - one remarkable innovation occurred within all the jurisdictions under study concerning the improvement in the supervision of the management board consisted in the separation of the role between the CEO and the chairman. This is an important element whose importance should not be underestimated. Comparative Constitutional Law has called attention to the dangers of unfettered powers; each country has designed its system of checks and balances in order to avoid the excessive concentration of powers in the hands of one organ while avoiding to restrain its autonomy to perform its functions and above all avoiding that those checks and

¹⁸¹ For an interesting overview of this discussion, see Cunha, P. O. (2007). Direito das Sociedades Comerciais. Lisboa, Almedina.

balances would open way for interference of one organ in the competences of the other. This is an extremely delicate balance that is hard to achieve. The same reasoning applies to management boards; unfettered powers of decision in the hands of one organ are capable of creating agency costs vis-à-vis shareholders (in particular minority shareholders in concentrated ownership systems) and stakeholders. There is a need to improve the supervision of the management board in order to safeguard the interests of non-controlling constituencies.¹⁸² This need is so prevalent that it occurred in all regulations covered.

The foremost example is the **French** reform operated by the LNRE. This legislative act introduced a third optional model for French corporations (besides the British style single-tier and the German style dualist board) that has become the *de facto* default model for public corporations. The idea behind this reform consisted in providing a response to the common criticisms pointed out to the French model that consisted in handing over the *de facto* control of the company not to the management board but to the PDG, who tended to act as a *Roi-soleil* and exert a dominating influence over the remaining members of the board. The origins of the PDG must be traced back to 1943; the French Law of 4 March 1943 reacted against the separation of management and supervision of the board because, at that time, there was a feeling that it would lead to an unnecessary division of roles and introduce bureaucracy at the management board; the concentrated ownership structure that prevailed already that time in French corporations was felt as sufficient to ensure the necessary monitoring of the management board and there was no need for increased supervision. The reform of company law undertaken in 1966 further reinforced this role by simplifying the terminology and *de facto* trusting the management of the company to the PDG. The criticisms to the position of the PDG began in 1990 when certain managers were accused of colluding with the major shareholders in order to extract private benefits of control and creating agency costs vis-à-vis minority shareholders.¹⁸³

¹⁸² Hertig, G., R. Kraakman, et al. (2004). Issuers and Investor Protection. The Anatomy of Corporate Law. H. Hansmann and R. Kraakman, Oxford, Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford.

¹⁸³ Peyrevalade, J. (1999). "Le gouvernement d'entreprise ou les fondements incertains d'un nouveau pouvoir? ." Economica, Merle, P. (2008). Droit Commercial. Sociétés commerciales, Dalloz.

The groundbreaking default model introduced by the LNRE relies on the traditional one tier structure but breaks with the mandatory concentration of power in the hands of the PDG. The concept presented by the LNRE consists in a functional division between management and control, regardless of whether both tasks remain accumulated in the hands of the same person or are split between two persons. The President will have the tasks of deciding on the frequency of meetings, deciding on the agenda and presiding to the most important meetings. Its influence will be indirect since he will have a supervisory role. The *Directeur Général* will effectively be the CEO of the company since he will be responsible for setting up the business strategy and controlling its implementation on the day-to-day businesses (L.225-51-1 *Code du Commerce*). The *Principes de gouvernement d'entreprise* issued in November 2003 in fact recommend not only the functional but also the factual separation of the roles of CEO and chairman between two distinct persons in order to reinforce the idea of independence of the supervision of the board and the effectiveness of the supervision.¹⁸⁴

The separation of functions is even more remarkable if we take into consideration that it not only trusted them to different persons but it also considerably modified their powers: the board was given direct control over the management of the company but diminished its power in the direct management. The direct management of the company was trusted to the directeur-général. Therefore, if we were to summarise the division of tasks operated in France by the LNRE one could say that the board is now conceived as a collegial organ presided by the Président, in which the general business strategy is defined but not executed. The powers of the managing director are very large because the law gives him the most extended powers to manage the company and to act in its name in every circumstance. The control of his power is made by the Président, who must be a shareholder and must represent the

¹⁸⁴ Bouère, J.-P. (2001). "P-DG ou président et directeur général?" *Bull.jolly*: 695 ff, Vendeuil, S. d. (2001). "NRE et dissociation des fonctions du président du conseil et directeur général." *JCP E*: 1315.

interests of the shareholders in the supervision of the management of the company.¹⁸⁵

There are doubts concerning the actual impact of these transformations because the reality has shown that the separation of the role of CEO and chairman is essentially used in situations of transmission of power; when the CEO reaches the maximum age limit to exercise its functions, it is "elected" as President and trusts the role of CEO to a successor that will not normally be very willing to go against the will of the President - who in fact nominated him in the shadows. That was what occurred within the management boards of important quoted companies such as BNP-Paribas, Renault, Vinci, L'Oréal, Total, among others. The most effective means to improve the supervision would consist in a mandatory separation of the boards as it occurs in dual-board structures, also recognised in France but mostly exceptionally used. On the other hand, the "separation" was limited to listed companies because in non-listed companies there is an exceptional separation of the role of CEO and chairman. Despite these setbacks the reality is that the separation exists - at least in the law - and has been used in practice albeit with mixed results. Only the future will tell if this will be effective in bringing transformations to the French model of governance.¹⁸⁶

There is also a similar discussion in **Germany**, coined as the *CEO-Problematik*. The problem of the accumulation of the roles of control and supervision in the hands of the same person is not so serious on account of the mandatory existence of the Vorstand and the Aufsichtsrat and the statutory prohibition that the same person occupy a seat in both boards simultaneously (§105AktG). The main question concerns the transition from the Vorstand to the Aufsichtsrat immediately after the mandate of the CEO ended. This is a very important discussion because it is permitted by the AktG and is also very usual in practice. The problem lies in the fact that the president of the Aufsichtsrat will

¹⁸⁵ Freedman, D. (2001). "L'américanisation du droit français par la vie économique." *Archives de Philosophie du Droit* 45: 207-211, Magnier, V. (2001). "Réception du droit américain dans l'organisation des sociétés commerciales" *Archives de Philosophie du Droit* 45: 213-225, Hopt, K. J. and P. C. Leyens (2004). Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy., European Corporate Governance Institute. Menjucq, M. (2006). Corporate Governance Issues in France. *Corporate Governance Post-Enron. Comparative and International Perspectives*. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

¹⁸⁶ Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz.

in fact be supervising the board that he was managing previously and, since the Aufsichtsrat is competent for the nomination and dismissal of the Vorstand, it will tend not to allow any room for its successor to develop its own ideas and business strategies. The defenders of the permission of the transition from one role to the other point out that nobody will know the company so well as the former president of the Vorstand and that age and know-how are important assets to be valued in the performance of the function. The most generally accepted solution consists in the setting up of a mandatory cooling-off period, meaning that the person at stake would be obliged to a rest period, in which we would have no contact with the company and allow room to the new management to develop its own ideas. This is the best means to ensure an adequate supervision, balance of powers and checks and balances between the Vorstand and the Aufsichtsrat.¹⁸⁷

The UK also witnessed a reinforcement of the supervision of the board of directors. Traditionally, the British regime of Corporate Governance did not contain any internal governance mechanisms to diminish agency costs of managers *vis-à-vis* shareholders; the dispersed nature of the shareholdings and the traditional lack of interest of shareholders in pursuing strategies of voice as opposed to exit led shareholders to trust external mechanisms of governance more than internal ones. This situation changed considerable in 1992 with the publication of the Cadbury Committee of Corporate Governance. This Committee considered that the law should not interfere excessively in the internal governance mechanisms of non-listed companies; the draft of the best mechanisms to reduce agency costs should be a matter left to the shareholders and the management boards because British company lawyers had already designed a number of conventional mechanisms that imposed in practice and had a great capacity of adaptation in order to safeguard the interests of shareholders; company law (at that time the Companies Act 1985) should continue to be mainly enabling. The situation changed considerably in relation to listed companies; the willingness of the UK to attract foreign direct investment and the wish to develop American style capital markets created

¹⁸⁷ Schneider, U. H. (2006). Corporate Governance Issues in Germany - Between Golden October and Nasty November Corporate Governance Post-Enron. Comparative and International Perspectives. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

incentives to design mechanisms that would reduce the agency costs of managers vis-à-vis shareholders and therefore encourage investment without trusting all protection to the takeover activity. The result was the Cadbury Code of 1992. This Code - which was revised in 1995 (*Greenbury report*), 1998 (*Hampel report*) and 2003 (*Higgs and Smith reports*) - had no statutory backing and was an innovative form of regulation: companies were not obliged to adhere to its provisions but they had to explain why they chose not to do so and disclose the arrangements; this meant that the code became virtually mandatory in almost all listed companies.¹⁸⁸

One of the mechanisms designed to protect the interests of shareholders vis-à-vis managers in the Code consisted in the separation of the functions of CEO and chairman. The Combined Code of Corporate Governance of 2003 determined that:

“A.2. There should be a clear division of responsibilities at the head of the company between the running of the board and the running of the company's businesses. No one individual should have unfettered powers of decision”.

The Combined Code takes the view that the posts of CEO and chairman of the board should not be held by the same person and that there should be a clear and written division of responsibilities that will ensure a balance of power and authority within the board avoiding an excessive concentration of power like the one that occurs with the French PDG. In the event that the company decides that it is convenient that the same person holds both positions, it should be disclosed and objectively justified. The objective is to ensure transparency in the company. A special word should be given concerning the so-called *CEO-problematik* that occurs in Germany and France (the passage from CEO to the position of Chairman of the Board). Although the Higgs report recommended a blanket prohibition of such a transition, the Combined Code of 2003 took a more lenient approach and permits such a transition as long as it is communicated and approved by the members of the company. This ensures not only the transparency in the management of the company but also a great alignment of interests between the management board and the shareholders

¹⁸⁸ Gower, L. C. B. (1997). *Gower's Principles of Modern Company Law*, Sweet & Maxwell, Bourne, N. (2008). *Bourne on Company Law*, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). *Cases and Materials in Company Law*, Oxford University Press.

because managers will have to justify their choices at all times and occasionally get the approval of the shareholders.¹⁸⁹

This description of the evolution of British Corporate Governance helps us to understand the function that the Stock Exchange attempted to perform. The greatest concern was to reduce the agency costs of managers *vis-à-vis* shareholders and reduce the need for an excessive reliance on the market for corporate control as a controlling mechanism. This reduction of the managerial autonomy - by imposing a separation of the roles of CEO and chairman unless properly explained and subjecting the transition of CEO to chairman to the approval of the shareholders - also reduced agency costs, aligned the interests of managers with those of the shareholders and promoted a more active involvement of the shareholders in the company (because they would be acquainted and occasionally called to approve the option of the management board). This, combined with other causes to be analysed further on, might be capable of bringing some modifications to the “shareholder value” practices enunciated previously in this thesis.

As regards **Portugal**, the Portuguese law does not mandate expressly the separation of the functions of CEO and chairman. Art.395CSC simply states that the management board should elect one President that will combine the functions of CEO and Chairman (much like the French PDG). But the understanding of the reality of Portuguese company law needs to have in consideration that the single-tier model does not exist in Portugal in its purest form (because, as I mentioned above, every type of public company needs to have a mandatory supervisory organ (*conselho fiscal*) even if it merely has a management organ). The law attributes extensive powers to the *conselho fiscal* by commanding it to supervise not only the accounts of the company but equally the compliance with the law and the company charters as well as the behaviour of the management board. In this sense, Portuguese companies are under a much stricter supervision that balances considerably the powers of the President of the management board. The requirements are even stricter for listed companies: §II.2.3 determines that when the President of the board is equally the shareholder, the board is under a duty to reinforce the role of the

¹⁸⁹ Colombera, M. (1996). "Le regole di corporate governance nel Regno Unito: il Cadbury Committee e il Greenbury Committee." *Rivista delle società*: 440-464, Sealy, L. and S. Worthington (2008). *Cases and Materials in Company Law*, Oxford University Press.

non-executive directors in the supervision of the actions of the President. Therefore the management of Portuguese public companies - whether listed or not - are under strict supervision of the management board.¹⁹⁰

(b) non-executive directors – a second extremely important evolution registered in all jurisdictions under study consisted in the reinforcement of the role of non-executive directors. The following lines will attempt to demonstrate that, in virtually all jurisdictions, there appears to have been an evolution towards the recognition of the importance and role that non-executive directors might perform in the boards of companies. This is capable of bringing some serious modifications to the internal governance of companies because non-executive directors are capable of modifying the internal balance of powers within the management board. A non-executive director consists in a member of the management board that is not involved in the daily management of the firm. This means that their function does not consist in engaging actively in the running of the business of the firm but rather they perform a more supervisory role. Their function is not exactly the same but may be compared to the German Aufsichtsrat; the Aufsichtsrat has the task of electing and monitoring the management board and ensuring that they behaved in accordance with the interests of the shareholders. Non-executive directors do not elect the management board - which is directly elected by the shareholders - but they are trusted with the function of monitoring them in the same form as the Aufsichtsrat. Their legitimacy derives from an election by the shareholders (which is a separate election in some jurisdictions in order to ensure the transparency). In this sense, they consist in a mechanism for the reduction of agency costs based upon appointment rights (because they are legitimated by means of an election by the shareholders) and their role is to make a bridge between the management and the shareholders. There is a certain consensus of their role in reducing the agency costs of managers *vis-à-vis* shareholders on two reasons: they are legitimated by a direct election, which means that they are responsible directly towards the shareholders; on the other hand, the

¹⁹⁰ For the relative originality of Portuguese law in comparative terms see Câmara, P. (2008). O governo das sociedades e a reforma do Código das Sociedades Comerciais Código das Sociedades Comerciais e Governo das Sociedades. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.

management is equally directly elected by the shareholders, which means that they are directly accountable; finally, since the exclusive function of the non-executive directors consists in the monitoring of the management board, there is an increased control over the managerial autonomy legitimated by a direct election. The following lines will attempt to analyse the conditions and impact of the inclusion of non-executive directors in the boards of the companies of the jurisdictions under study.¹⁹¹

The foremost example of this evolution occurred in the UK. The UK traditionally boasted a single-board structure of corporate governance with a strict division of tasks between the general meeting and the management board. Considering the traditionally dispersed nature of shareholdings in the UK - whose origins were investigated above - the final result was that managers were largely unaccountable towards the shareholders because there were no effective control mechanisms. In this sense, the traditional governance structure of British companies was not very distinct from their Continental counterparts because the absence of shareholder pressure allowed them to pursue strategies of growth.¹⁹² The situation changed radically in the beginnings of the 1980s in which the movement of financialisation of the economy and the progressive entry of institutional shareholders in British capital markets brought considerable modifications to the internal governance structures of these companies making them more distinctively shareholder-responsive - a feature that became its predominant characteristic - as it was outlined in the beginning of this book. The UK suffered several modifications in terms of board structures and one of these modifications consisted in the widespread introduction of non-executive directors.

The origins of non-executive directors in British companies must be traced back to the Report of the Cadbury Committee, which recommended heavily its inclusion as a means of improving the governance of companies. Their inclusion was widely praised and several posterior reports - namely the Higgs report - continued to emphasize their importance in the boards of

¹⁹¹ Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press, Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford.

¹⁹² Dignam, A. and M. Galanis (2008). "Corporate Governance and the importance of Macroeconomic context." Oxford Journal of Legal Studies 28(2): 201-245.

companies.¹⁹³ Despite this there are still considerable doubts as concerns their role. Currently most UK companies - listed and non-listed - exhibit a single-tier board model in which executive directors manage and non-executive directors supervise. Despite the widespread use of non-executive directors on British companies, their role remains unclear and their effectiveness is currently the object of dispute and criticism. This question was addressed in a very important regulatory change in the UK, the Revised Code on Corporate Governance, which provided the first quasi-official description of their functions. Building in a widely divulged review undertaken by Derek Higgs, the Code emphasises that non-executive directors should not only monitor management but also contribute to the development of the strategy of the company. Two very important recommendations consist in the separation of the positions of board chairmain and CEO (both institutionally and factually), addressed in the former paragraph, and in the inclusion of at least 50% of the members of the board as non-executive directors. The combined effect of both elements consists in the functional distinction between management (executive directors) and control (non-executive directors) and in the reinforcement of the effectiveness of the board; since all directors – executive and non-executive – have the same powers, non-executive directors can also take initiative in managerial decisions and are not restricted to a post-decision approval, like the German Aufsichtsrat.

It is worth reading the Higgs report with more detail. The Higgs report starts by pointing out that there is no statutory definition of non-executive director. The business practice tends to regard non-executive directors as those members of the board that do not hold any executive or management position in the company in addition to their role in the board. They have to comply however with the same duties of directors that have been established in common law and case-law. Non-executive directors should not be seen as intruders in the board. Their role is complementary to the role of the executive directors. They have two main functions: firstly, they have to review the performance of the board and the executive, ensuring that they are complying with the statutes of the corporation and the law. While performing this function they have to ensure that the chairman of the board is aware of their views, which is the reason why the code recommends the separation of the role of

¹⁹³ Higgs, D. (2002). Review of the role and effectiveness of non-executive directors, Department of Trade and Industry.

CEO and chairman, in order to have a supreme independent instance in the company. Secondly, they have a more pro-active role, taking the lead to undertake the necessary actions to ensure the interests of the shareholders when conflicts of interest arise. This may be the case when the management sets up its own remuneration or when they engage in businesses that may benefit some or all of the members of the executive board. Therefore, their role is not exactly a mirror of the German Aufsichtsrat: they have both a supervisory and a pro-active role, since they have the duties to undertake the necessary actions in order to enhance the strategy of the company, contributing for example with expertise, advices and all necessary support to further the interest of the company.¹⁹⁴

It is equally important to have in mind that the role of the non-executive directors also suffered an evolution that reflects to some extent the evolution in British corporate governance. The inclusion of non-executive directors in the board in the beginning of the 1990s was clearly an instrument of shareholder value; since the main problem of British companies consisted in the agency costs of managers vis-à-vis shareholders, the inclusion of non-executive directors in the board (who were directly accountable to the shareholders because they depended on an election) was an instrument to curtail managerial autonomy and make them more shareholder responsive. The description of the functions in the Higgs report reveals a distinct path: although they are primarily responsible towards the shareholders, the reality is that they must ensure the compliance with the law, charters of the company and the interest of the company. Therefore their fiduciary duties are owed not to the shareholders but to the company. If we combine this role with the British evolution in terms of fiduciary duties - to be analysed further on - in which fiduciary duties were expressly codified in accordance with the philosophy of "enlightened shareholder value", it becomes evident that their role is to pursue the long term interests of the shareholders by means of the promotion of a good relationship with the stakeholders. The combined effect of these measures implies that their

¹⁹⁴ Higgs, D. (2002). Review of the role and effectiveness of non-executive directors, Department of Trade and Industry. Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press. Armour, J., S. Deakin, et al. (2003). "Shareholder primacy and the trajectory of UK Corporate Governance." British Journal of Industrial Relations 41(3): 531-555.

role has suffered an evolution from the simple guarantee of shareholder interests towards the supervision and promotion of the relationships with the stakeholders in the long-term interests of the shareholders. This is a more proactive role that approaches the British pattern of corporate governance from the Continental pattern by thrusting upon the non-executive directors the duty to supervise and promote the relationships with the stakeholders, therefore encouraging a more relational pattern of corporate governance.

France also seems to have discovered recently the advantages of the appointment of a non-executive director, although it seems not to have produced a great effect. The non-executive director is known in France as an independent director (*administrateur indépendant*) and their inclusion in the boards of companies has been strongly recommended. The inclusion of non-executive directors in the boards of companies has been extensively recommended in three very influential reports on corporate governance in French listed companies, the Viénot reports of 1995 and 1999 and the Bouton report of 2003. The Viénot reports of 1995 and 1999 are extremely demanding with non-executive directors, demanding not only that they be non-executive directors in the proper sense of the word, *i.e* not performing management duties in the company or group but also individuals devoid of particular bonds of interest (significant shareholder, employee, other) with the company. The preconditions for being an independent non-executive director were plainly spelled out in the Viénot report of 1999 in the following words: “*a director is independent of the corporation's management when he has no relationship of any kind whatsoever with the corporation or its group which might risk colouring its judgement*”. This is a quite demanding task for non-executive directors and there is a clear preoccupation in ensuring a great degree of transparency of French companies. Although the Viénot reports simply required that 1/3 of the board be composed of independent directors, the Bouton report went even further and recommended that the number of independent directors rose to ½

of the members of the board in companies with a dispersed ownership structure and deprived of any controlling shareholders.¹⁹⁵

Despite the recognition of the merits of independent non-executive directors, the recommendations of the Reports did not find their way into codification and their number remains insignificant in French companies. There might be two possible explanations for this occurrence. Since the ownership structure is heavily concentrated and the management boards are often bargained at the lobbies with the major shareholders of the company, it might simply occur that the major shareholders and the State do not wish to have any intruders in the management board so as to stand in the way of the pursuit of their interests. Secondly, the protection of the minority shareholders was addressed in a different way by means of the provision of information rights about the activities of the management board. If agency costs were to occur between majority and minority shareholders, the provision of information rights would simply help them to evaluate the value of their investments and decide whether to remain in the company or sell their shares; in these terms, the governance strategies employed vis-à-vis minority shareholders consisted in an affiliation rights strategy. Despite these setbacks, the pressure for the inclusion of non-executive directors in French companies remains and only the future will tell if they will succeed in transforming French corporate governance.¹⁹⁶

The discussion in **Germany** about non-executive directors follows closely the one made in France. German public companies have a mandatory dualist board with an institutional separation between management and supervision. The key question concerns the effectiveness of the supervision made by the supervisory board and that is the reason why the current German

¹⁹⁵ Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Architecture et Gouvernance des Organisations, Goyer, M. (2002). The transformation of Corporate Governance in France and Germany: the role of workplace institutions, Max Planck Institute für Gesellschaftsforschung, Menjucq, M. (2006). Corporate Governance Issues in France. Corporate Governance Post-Enron. Comparative and International Perspectives. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

¹⁹⁶ Delga, J. (2004). "L'administrateur indépendant en France: un mythe?" Semaine Juridique (5). Delga, J. (2002). "L'administrateur indépendant n'existe pas: dangers ; une référence inappropriate au système anglo-saxon " Reccueil Dalloz: 2858, Viandier, A. (2008). "L'administrateur indépendant des sociétés cotées." RJDA: 599.

discussion on corporate governance concerns the independence (*unabhängigkeit*) of the members of the supervisory board.

In principle, independence is seen as a precondition for the taking of a seat in the supervisory board because the existence of circumstances that may interfere with the judgement of the members of the board is seen as an impediment to the correct functioning of the supervisory board. The reality has proven otherwise: there is a tradition of migration of persons from the *Vorstand* to the *Aufsichtsrat*, which places a serious governance problem because on the one hand the supervisory board wants to take advantage of their knowledge of the company and on the other hand the person will be supervising its own work. There is also the problem of the assumption of mandates in other companies by members of the supervisory board, which raises concerns in situations in which the companies are direct competitors; although this might seem a paradox, multiplication of mandates might bring some significant economic advantages because the German system of cross-shareholdings and interlocking directorates may provide a very effective instrument of co-operation between companies. There is the concern of ensuring that the advantages of the interlocking directorates are not offset by conflicts of interest. Another important question concerns the presence of direct representatives of banks in the supervisory boards of companies. The problem is that these representatives are all except independent; this is a direct consequence of the consensus oriented culture and stakeholder orientation of German companies because the establishment of cooperative relations depend on the existence of supervisory mechanisms to prevent opportunistic behaviours. A final question concern the role of employee representatives, who tend not to be too independent.¹⁹⁷

The German Corporate Governance Code (*Kodex*) has taken a very careful approach to this issue in order to enhance the supervisory role of the *Aufsichtsrat* while safeguarding the traditional pillars of German Corporate Governance. It has decided to intervene only on a number of specific measures destined to combat some of the inefficiencies of the system. One approach

¹⁹⁷ Schmidt, H., J. Drukarczyk, et al. (1997). *Corporate Governance in Germany*. Baden-Baden, Nomos Verlagsgesellschaft, Baums, T. (1999). "Il sistema di "corporate governance" in Germania ed i suoi recenti sviluppi" *Rivista delle società*: 1-19, Nietsch, M. (2005). "Corporate Governance and Company Law Reform - a German perspective." *Corporate Governance* 13 (3): 368-376.

consisted in the introduction of sub-committees in the supervisory board; the supervisory boards of all German quoted companies are required to set up an audit committee, which will be competent for the handling of accounting, risk management and compliance, nomination of the auditor and determination of the fees. This audit committee (which is for all effects a non-executive committee within the supervisory board) is therefore subject to particularly high standards of independence in order to ensure the maximisation of its supervisory function. Former members of the management board are impeded to take positions in the audit committees of the Aufsichtsrat (5.3.2); this ensures that they will not be reviewing their own past work and that their successors will have the necessary margin of manoeuvre to undertake the necessary growth strategies - if necessary in deviation from the former management - independently from the constraints of the Aufsichtsrat. Another approach used by the Kodex consisted in the encouragement of the use of disclosure as a means of guaranteeing the independence of the members of the supervisory board. According to §5.5.2 of the Kodex, each member of the Aufsichtsrat must inform the Aufsichtsrat of any conflicts of interest that may arise of a consultant or directorship function with clients, suppliers, lenders or other business partners. This disclosure serves as a warning mechanism for the potential conflicts of interest and attempts to ensure that in all transactions in which there may be a conflict of interest, the decision will be taken as free and independently as possible.¹⁹⁸ The combined effect of these two measures might be a significant contribution to the independence and reinforcement of the role of the Aufsichtsrat within the German system of corporate governance.

Portugal has also followed the international trends towards the recognition of the importance of non-executive directors and has modified its statute for business corporations accordingly. One of the greatest novelties introduced in the reform of company law in 2006 was the introduction of a new model of governance that modified to a great extent the Portuguese company

¹⁹⁸ Schwark, E. (2002). Corporate Governance: Vorstand und Aufsichtsrat. Corporate Governance. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft: 77-118, Schneider, U. H. (2006). Corporate Governance Issues in Germany - Between Golden October and Nasty November Corporate Governance Post-Enron. Comparative and International Perspectives. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law. Armbrüster, C. (2006). Recent Developments in German Corporate Law. Centro di Ricerca per il Diritto de l'impresa, Libera Università Internazionali degli Studi Sociali.

landscape. According to art.278 nº.1, b) CSC, the shareholders of the corporation may choose to incorporate it in accordance with the following scheme: a management board that includes an auditing commission (comissão de auditoria) and a supervisory organ (Revisor Oficial de Contas (chartered accountant)). This audit committee consisted in a significant innovation in Portuguese company law and one in which the approximation towards the anglo-saxon model became more evident. The audit committee consists in a permanent specialised commission set up by the administrative organ between its members. Exclusively independent non-executive directors must compose it. The members of the audit committee may not exercise any executive functions in the company and are subject to the same standards of independence that apply to the members of the supervisory organ. One of the main questions as regards this model consists in the distinction of the functions of the audit committee and the supervisory organ. Although there is yet no case-law on the subject, the legal thinking and the statutes distinguish their functions in the following terms: whereas the audit committee is charged with ensuring that the management is complying with the statutes of the company and the law and must take all adequate actions whenever it finds any irregularity in the behaviour of the management, the supervisory organ must ensure the correctness of the accounts of the company and take all adequate actions (in terms of informing the shareholders and the audit committee) whenever it finds any accounting irregularities. Therefore, this is a particularly demanding model to the management of the company, since the actions of the management are scrutinised both by the audit committee (in terms of regularity of the behaviour of the management) and by the supervisory organ (in terms of the financial situation of the company). The audit committee does not have simply a supervisory function; in the same way as the Higgs report described the function of the non-executive directors, they must contribute to the overall strategy and success of the company, taking all necessary actions to engage with the management board in order to best promote the objectives of the company; their supervisory function, albeit it is their primary function, must be instrumental to the pursuit of the general objectives of the company. They are subject a particularly stringent standards of independence however. They are subject to the same standards of independence as those that apply to the members of the supervisory organ, which are quite high; the Portuguese

statute uses the legal technique of an exhaustive list of circumstances in which the director is presumed not to be independent; nevertheless, the list is redacted in such wide terms that one may well say that any person who is connected whatsoever with any interest group that might colour the judgement of the director in the exercise of its functions shall be deemed to be non-independent (art.414-A CSC).¹⁹⁹

The requirements for listed companies are even more stringent. Whereas the former model is strictly a voluntary model at the choice of the shareholders of the company, the Portuguese stock market authority demands mandatory non-executive directors from listed companies. §II.1.2.1 and 1.2.2 of the Code for Listed Companies requires that at least 25% of the members of the management board be non-executive directors. One should have in mind that the stock market authority distinguishes between non-executive and independent non-executive directors; the function of the former consists in collaborating with the management board in the pursuit of the strategy of the company ensuring that the decisions are taken in the interest of the company and the long-term interests of the shareholders; in this sense they are closer to the function of the British non-executive director because they have both a supervisory and an active function. The function of the independent director is strictly a supervisory function; in particular, they are trusted with the task of ensuring that the management of the company takes due account of the interests of the stakeholders of the company in the pursuit of the long term interests of the shareholders. Although non-executive directors may perform both functions if the size of the company advises to do so, in principle they must be distinct bodies.²⁰⁰

¹⁹⁹ See Cunha, P. O. (2007). Direito das Sociedades Comerciais. Lisboa, Almedina. Câmara, P. (2008). O governo das sociedades e a reforma do Código das Sociedades Comerciais Código das Sociedades Comerciais e Governo das Sociedades. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina, Oliveira Neves, R. d. (2008). O Administrador Independente. Código das Sociedades Comerciais e Governo das Sociedades. P. Câmara, R. d. Oliveira Neves, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina. ; Calvão da Silva, J. (2007). "Responsabilidade civil dos administradores não-executivos, da comissão de auditoria e do conselho geral e de supervisão." Revista da Ordem dos Advogados 67(1).

²⁰⁰ Oliveira Neves, R. d. (2008). O Administrador Independente. Código das Sociedades Comerciais e Governo das Sociedades. P. Câmara, R. d. Oliveira Neves, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.

(c) stricter internal controls – another significant evolution in the supervision of the activity of the management board consisted in the reinforcement of the internal controls that the other organs may exercise over the activity of the management. The analysis of the evolution in company law in each one of the countries under study reveals that all of them have reinforced their internal mechanisms for the improvement of the supervision of the activities of the management board in order to make them more responsive to the interests of the shareholders. The precise impact of each measure must be seen within the context of its system.

Germany introduced a number of modifications to its company law to improve internal control mechanisms. One measure focused on the frequency of the reports that the Vorstand has to make to the Aufsichtsrat in order for the latter to control the activities of the former. The intention was to increase their frequency. The Commission for the reform of German corporate governance did not thought it wise to simply increase the number of reports that the Vorstand had to make to the Aufsichtsrat because it depended on the concrete situation of the company and an exhaustive number of reports is no guarantee of the quality and reliability of the information contained in them. The Commission opted to create the duty to present follow-up reports in order to ensure that Vorstand is coping with its pre-determined plan or taking the necessary actions to guarantee the interests of the company. In the current version of §90(1)AktG, the Vorstand is statutorily obliged to present follow-up reports to the Aufsichtsrat whenever it believes that there is the possibility of deviation from the overall company strategy stated in the former reports. Although the Vorstand is statutorily obliged to present at least once a year its overall business strategy to the Aufsichtsrat, now it has an increased obligation of informing immediately the Aufsichtsrat of any circumstance that might stand in the way of the pursuit of the strategy laid out in the former report. Another significant improvement consisted in the increase of the number of actions that the Vorstand has to submit to the approval of the Aufsichtsrat. The former company law of Germany was strongly underpinned on a sharp division of tasks between the Vorstand and the Aufsichtsrat and on the principle of appearance: the company was simply bound by all the legal obligations entered into by the Vorstand. The reform of company law introduced by the KonTraG

modified §111(4)AktG in the sense of allowing the statutes of the company or the decision of a majority of the shareholders to submit certain legal obligations entered into by the Vorstand to the approval of the Aufsichtsrat. In the event that the Aufsichtsrat refuses its consent, the final word will belong to the general assembly of the shareholders, who must decide by a super-majority of 2/3; neither the statutes of the company nor a decision of the shareholders may modify this majority. In order to avoid that this obligation leads to an excessive interference in the activities and competence of the Vorstand, leading to a mixture of their roles, the Commission for the Reform of Corporate Governance in Germany drew up a Code of Best Practice, containing the measures that the Commission recommends to be subjected to the approval of the Aufsichtsrat. The Commission proposed that all businesses that modify the profitability perspectives of the company or its position of risk should be subject to the previous consent of the Aufsichtsrat. The catalogue of the concrete transactions – such as major disinvestments, the acquisition of shares in other companies, etc – should be left to the determination of the general meeting of the concrete company. One should have in mind that, in accordance with the strong regulation that Germany has of its Konzernrecht, this obligation of the Vorstand also covers those situations in which the major transactions are to occur in the dependent companies (§111(4)AktG). Another innovation consisted in the introduction of commitology in German listed companies. The Kodex also recommended the formation of committees within the Aufsichtsrat, in accordance with the specificities of the company and the size of its members, in order to specialise its functions and improve the control of the activities of the Vorstand (§5.3). The Aufsichtsrat shall take sufficient care to ensure that the committees are composed of persons with sufficient qualifications in order to improve the supervisory function of the Aufsichtsrat. In particular, all due diligences should be taken to form two specialised types of committees: an audit committee (*Prüfungsausschüssen*), which should handle issues of accounting, risk management and compliance, the necessary independence required of the auditor, the issuing of the audit mandate, the determination of the audit focal points and the fee agreement; it is necessary that the Chairman of the audit committee have sufficient knowledge of accounting principles, internal control mechanisms and should not be a former member of the management board of the company; and a *nomination committee*, composed

exclusively of representatives of the shareholders, which has the task of proposing to the general meeting suitable candidates to the supervisory board. Finally, the Kodex also recommends the introduction of a risk-management system in quoted companies. This risk-management system (*Risikofrüherkennungssystem*) was one of the most important innovations brought about by the KonTraG, inserted in §91(2)AktG. This provision commands the Vorstand to take all necessary measures in order to detect and prevent the occurrence of negative developments to the position of the company; in particular, it has to set up a system of supervision (*Überwachungssystem*). The efficacy of this system is to be controlled by the auditor, since the auditor is statutorily obliged to include its evaluation of the risk-management system within its report (§317(4)HGB). This provision was a significant innovation in German companies; one should have in mind that its primary concern was to defend the interests of the shareholders because it commands the Vorstand to be more attentive to the signs of the market and to take all necessary measures to keep the profitability levels of the shareholders.²⁰¹ The combination of these innovations (follow-up reports, approval of the Aufsichtsrat or general meeting, commitology and risk management systems) is expected to increase the communication channels between the Vorstand and the Aufsichtsrat (which comprises representatives of the shareholders, major stakeholders and employees) and reduce the agency costs of the management board vis-à-vis each one of these interest groups; in this sense it consists in a reinforcement of the traditional stakeholder orientation of German companies and a further binding of the interests of the Vorstand to the company as a whole (*Unternehmen an sich*, which is distinct from the shareholders).²⁰²

France also witnessed a similar evolution in the reinforcement of the internal controls of the management of French companies. One significant

²⁰¹ Schwark, E. (2002). Corporate Governance: Vorstand und Aufsichtsrat. Corporate Governance. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft: 77-118, Hopt, K. J. (2003). Unternehmensführung, Unternehmenskontrolle, Modernisierung des Aktienrechts - zum Bericht der Kommission Corporate Governance Corporate Governance. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft.

²⁰² Windbichler, C. (2002). Der Gemeinsinn der juristischen Person. Grossunternehmen zwischen Shareholder-value, Mitbestimmung und Gemeinwohl Gemeinwohl und Gemeinsinn im Recht. H. Münker and K. Fischer, Akademie Verlag: 165-179.

evolution consists in the introduction – at least in theory – of the trend of commitology in France. Both the Viennot (1999) and Bouton (2003) reports strongly recommend that all quoted companies have the following three committees: an audit committee, a compensation committee and a nomination committee. The task of the audit committee consists in a review the activities of the board and particularly the financial health of the company, selecting the external auditors and their fees. The members of the audit committee should be at least 1/3 independent directors and be financially literate, in order to understand perfectly the financial situation of the company. The compensation committee is charged with setting and reviewing the wages paid to the members of the management board. It should be composed of one corporate officer (*mandataire social*) and include a majority of independent directors. Nevertheless, one should mention that the last word as regards the determination of the compensation belongs to the management board; therefore, the powers of the compensation committee are merely advisory. Their function should not be underestimated however since they have to issue a report (that is to be disclosed) expressing their views on the remuneration policy pursued by the board, which may serve as a warning sign for excessive remunerations. Finally, the nominating committee is charged with the selection of the future independent directors. It must include among its members the chairman of the board and may cumulate its functions with the compensation committee (Viennot 1995). This recent trend towards the introduction of committology within management boards is particularly recommended for companies that opted to remain within the traditional framework of the PDG (*Président-Directeur Général*, which combines the functions of chairman and CEO) because the specialisation of the committees provides an adequate counterbalance to its power. Nevertheless, the recommendation did not pass into binding legislation and the majority of French listed companies resist the introduction of these committees; the most common one to be found is the audit committee and the remaining committees are residual in numbers.²⁰³

The Bouton report also recommended a stronger engagement of the management board as a whole in the control of the activities of the executive.

²⁰³ Menjucq, M. (2006). Corporate Governance Issues in France. *Corporate Governance Post-Enron. Comparative and International Perspectives*. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

That is the reason why the Bouton report recommended that any significant transaction that is not part of the announced strategy of the company should require prior approval by the board of directors; each company should elaborate an internal document stating which transactions in particular should be subject to the approval of the board and the rules and procedures governing that approval, which may be distinct from one department of the company to the other. This evolution is similar to the one described in Germany as concerned the number of subject-matters that would require prior approval of the Aufsichtsrat and the same justification applies: enhancing the control of the management board.²⁰⁴

France equally adopted the instrument of follow-up reports as a means of improving the internal governance of its companies. The French Stock-Market Authority (*Commission des Operations en Bourse* (COB)) has recommended the adoption for French listed companies of a system of periodic reports (*comptes trimestriels*) similar to the more anglo-saxon system of quarterly reports. This system of disclosure and publication of periodic reports is destined to reinforce the control over the activities of the management of the company and improve the confidence of the market over the company, in the sense that the management is acting in the interests of shareholders. It is worth saying that this system is particularly suited in France for the protection of minority shareholders; since ownership structures are heavily concentrated in France and the majority shareholders are capable of exercising a decisive influence both on the choice of the management board and on the strategies that they are about to pursue, this creates agency problems vis-à-vis minority shareholders, who may feel impotent to influence to a decisive extent the activities of the company. This system uses the market and the reputation of the company to influence the behaviour of minority shareholders; if managers and majority shareholders wish to maintain their influence in the company and keep the dispersion of the minority shareholdings, they will have to have in mind their interests and keep the results. Finally, the same COB also recommended in 2000 the introduction of a system of profit-warning: as soon as a listed company understands that its results will be below the threshold expected from the former period and from what the market would expect from

²⁰⁴ Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz.

it, it should intervene as quickly as possible in order to establish a satisfactory level of information as regards its elements. This system is similar to the *Risikofrüherkennungssystem* introduced by the KonTraG in Germany and is destined to ensure the alignment of the interests of managers with those of the shareholders, by ensuring that the market and the shareholders are well informed of the expected and actual level of profitability and that measures are being taken in order to reinforce the profitability levels of the company.²⁰⁵ One may attempt to state that these reforms in French company law appear to be strongly oriented towards the protection of minority shareholders; since ownership structures are heavily concentrated and there is considerable scope for the extraction of private benefits of control from majority shareholders and management boards, this discourages the investment in the capital markets; considering that the majority of these changes are directed towards listed companies and majority shareholders already have internal governance mechanisms to monitor the management board and the observance of their interests, one may conclude that the greatest beneficiaries of these modifications appear to be minority shareholders who invest in capital markets and may have other instruments to monitor the observance of their interests.

The evolution in the **UK** was similar to the one described in the former paragraphs. The UK also introduced a number of reforms to its company law in order to reinforce the internal controls over the activities of the management board and evolve towards a more relational (= voice) type of governance. As a preliminary word, one must say that the importance of the internal controls over the activities of the management board were clearly established as a principle in point C.2 of the Combined Code, where it is stated boldly that "*the board should maintain a sound system of internal control to safeguard shareholders investment and the company's assets*". This reveals by itself that one of the major concerns of the Code is to ensure that the interests of the shareholders are being adequately pursued and that the financial integrity of the company is not at stake by the activities of the management board. This system should include a group-wide supervision of financial, operational and compliance

²⁰⁵ Freedman, D. (2001). "L'américanisation du droit français par la vie économique." *Archives de Philosophie du Droit* 45: 207-211. ; Menjucq, M. (2006). Corporate Governance Issues in France. *Corporate Governance Post-Enron. Comparative and International Perspectives*. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

controls and risk management, whose results should be communicated to the shareholders; in this sense, it is another mechanism to reduce the agency costs of managers vis-à-vis shareholders that persist in countries with dispersed ownership structure. The Combined Code equally perceived the advantages of auditing and commanded the setting up of an audit committee in all quoted companies. This committee should be composed exclusively of independent directors with financial literacy. The task of the audit committee consists in the monitoring of the financial health of the company: in particular, it has to set the scope and review the results of the audit, its cost effectiveness and the independence and objectivity of the auditors.²⁰⁶

A significant innovation that deserves a paragraph of its own consists in the recommendation contained in the Code to set up dialogue with institutional shareholders. The management has an express duty to start dialogue with the institutional shareholders in order to determine the mutual objectives of the company. The chairman of the board has a particular responsibility in this matter because it has to maintain sufficient contact with the shareholders, in order to understand their issues and concerns, and communicate those views to the board. This is by itself a significant innovation in British Corporate Governance because, as it was described above, traditionally British Corporate Governance was based on a strategy of great managerial discretion and exit; if shareholders were not pleased with the activities of the management board, all they had to do was to sell their shares. This new system of dialogue with institutional shareholders - who are traditionally very activistic and demand results from the management board²⁰⁷ - ensures that the managers are more responsive to the interests of the shareholders and that major shareholders align their interests with those of the company in which they invest, approaching the British system to one of relational governance. Finally, a significant innovation consisted in the Operational and Financial Review (OFR) that companies with significant economic power will have to prepare. The OFR will contain sufficient information concerning not only the past performance but also the expected future performance and business strategy of the company,

²⁰⁶ Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

²⁰⁷ Tricker, B. (1998). "The role of the institutional investor in Corporate Governance." Corporate Governance 6(4): 213-216.

This serves to better assess and control the activities that managers are pursuing and whether they are being pursued in accordance with the interests of the shareholders.²⁰⁸ These measures are expected to create a more relational system of governance with a focus on long-term strategies of growth not constrained by the need to develop the stock markets; the answer lays in a requirement of the management board to engage into dialogue with the shareholders (in particular institutional shareholders) and to have more sustainable growth prospects in order to encourage the investment in the company. This is a significant deviation from the purely financial shareholder-value approach that characterised British corporate governance that may bring some consequences in the future.

Lastly, also **Portugal** reinforced its internal control mechanisms in the reform of company law operated in 2006. As regards listed companies, the recommendations of the Portuguese stock market supervision authority (CMVM - *Comissão de Mercado de Valores Mobiliários*) for the governance of quotes companies recommends the setting up in each quoted company of a risk-management system, in order to safeguard the financial stability of the company and detect all the risks connected to the activity of the company. This should be achieved by the setting up of internal control procedures of the activity of the management, destined to detect all the risks to which the company is exposed and is likely to suffer as a consequence of that management of the company. For non-listed companies, the reinforcement of internal controls was also achieved by the introduction of a third optional “anglo-saxon model” in Portuguese company law, which inserted within the widely used single-tier management board an auditing committee composed essentially of independent directors. Since this last element was analysed above, it will not be elaborated any further.

²⁰⁸ Ferran, E. (2005). Company Law Reform in the UK: a progress report, European Corporate Governance Institute. Hopt, K. J. and P. C. Leyens (2004). Board Models in Europe. Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy., European Corporate Governance Institute.

2.3.3 Fiduciary duties - legal clarification and transplants

Fiduciary duties were also a surprising area of evolution in which the corporate governance systems of all the jurisdictions under study seem to have evolved towards more unitary standards. Fiduciary duties may be classified as an agent constraints governance mechanism destined to reduce agency costs os managers vis-à-vis-shareholders that acts by means of the definition of standards that allow the judge to evaluate *ex post* the behaviour of the actor. The rationale for fiduciary duties consists in the uncertainty about the future; considering that the parties to the contract cannot agree on all possible circumstances about the future of their relations, there must be a standard according to which the behaviour of the agent will be judged *ex post*, so that it has incentives to behave *ex ante* in the interests of the principal. The objective of the system is to create the results that the parties would have reached in a perfect state of the world if they could bargain in each specific circumstance.²⁰⁹ The following lines will attempt to describe the evolution in the subject of fiduciary duties in the jurisdictions under study; each jurisdiction seem to have evolved towards an idea of enlightened shareholder value, meaning that the primary duties of directors are towards the shareholders but with a duty to weight the interests of the remaining stakeholders in the pursuit of the best interests of the shareholders. In other words, the basic idea behind the introduction of the governance mechanism of fiduciary duties and its structuring in accordance with the philosophy of enlightened shareholder value is to encourage the managers of the firm to promote goof relationships with the stakeholders of the company in the best interest of the shareholders.

It is useful to begin with the example provided by the **UK**, since it is the country in Europe with the most developed system of fiduciary duties. The general duties that directors owed to the company were traditionally found in case law rather than in a codified system. These duties were developed by courts of equity largely by analogy to the rules applying to trustees. This system led to an important difficulty: this evasive system of fiduciary duties kept directors from having a clear perception of their duties and opted to act in the benefit of shareholders exclusively because they were the ones who had the

²⁰⁹ Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press.

last word concerning their position in the company. The reform of Company Law that took place in the UK in 2006 was very important because it clarified the duties that directors faced. It is worth viewing each one of these modifications in detail.

The Company Code clarified that the duties that directors face are owed to the company and not to the shareholders (s.170(1)). This was a very important innovation that codified pre-existing case law and clearly laid out the duties of managers. Earlier attempts were made in the Companies Act 1985 by means of a few statutory provisions such as s.309 (duty to have regard to the interests of the employees). The problem was that these provisions were extremely vague and did not add anything to the existing body of case law. S. 170 Companies Act 2006 clarified that the purpose of the directors is not to enhance the well-being of the majority shareholders (who in fact control the nomination and removal of the directors) but of the company. This does not mean however that directors should not have regard to the interests of the shareholders or to weight them in the same position as the interests of the stakeholders. The Code specifically adhered to the idea of "*enlightened shareholder value*" as the objective of the directors. The code commands directors to act in good faith in the way that he believes that would be most likely to promote the success of the company for the benefit of its members as a whole; in doing this judgement of what is best for the company, the director is expected to evaluate: (1) the long term impact of the decision, (2) the interests of the employees, (3) the need to foster the business relationships with suppliers, customers and other stakeholders, (4) the impact of the operations on the environment, (5) the desirability of maintaining a reputation for high standards of business conduct and (6) the need to act fairly as between members of the company (s. 172). A simple reading of this provision reveals that this is a considerable deviation from the ideas of "*savage shareholder value*" mentioned a few pages before. The most important provisions are the first three commas; the express duty of managers to ponder in their business decisions the long-term impact of their decisions, the interests of the employees and the interests of the remaining stakeholders in the well-being of the company as a whole (and not the majority shareholders) represents a surprising evolution in British company law that has the intention of

approximating it closer to the standards used in continental Europe, where the company is seen more as a societal institution.²¹⁰

The Code equally discriminated to which duties directors were bound in their activity. In accordance with the Company Code, directors are bound to duties of: (a) exercise independent judgement, (b) exercise reasonable care, skill and diligence, (c) avoid conflicts of interest, (d) not to accept benefits from third parties and (e) declare interest in proposed transaction or arrangement. The statutory statement of these duties is equally important because they serve as a model for other nations and clarify more precisely the standards of behaviour according to which the pursuit of the idea of enlightened shareholder value should be guided.²¹¹

A final word must be given the express adoption in the Companies Act of the Business Judgement Rule in s.170. The business judgement rule consists in a means of avoiding liability for breach of duties that examines the procedure according to which the directors took the decision. The rule essentially claims that business activity does not go without risks; if the manager does a transaction that is detrimental to the interests of the company, one must examine whether he followed the necessary procedure in good faith to make a reasonably informed decision; as long as the director acted in a well informed manner, he cannot be held liable for the damage caused to the company. This is a rule that greatly contributes to the improvement of transparency within companies and further enhanced the application of fiduciary duties. The management board will be obliged to set up detailed decision-making procedures that will be able to provide shareholders with the necessary information concerning the preconditions under which they chose to adopt that decision and be able to prove that it was taken in accordance with the fiduciary duties that they are statutorily bound to the company. This is in itself an optimal solution because it does not only provide the management board with the necessary margin of manoeuvre to pursue its business strategy (that does not go without risks) as it enhances the fulfilment of the fiduciary duties as the

²¹⁰ Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish. Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

²¹¹ For a surprisingly very critical perspective of the introduction of the idea of enlightened shareholder value in British Company Law see: Charlton, L. W. o. (2002). "Employees, partnership and company law." Industrial Law Journal 31(2): 99-111, Barry, P. (2005). Company Law Reform White Paper, Department for Trade and Industry.

management board will be obliged to justify its decisions. This is an extremely effective means of binding the interests of managers to the company as a whole and reducing the agency costs vis-à-vis shareholders and stakeholders.²¹²

The advances in France were equally surprising especially because the introduction of fiduciary duties was not made by means of statute but by means of case law. French company law did not have an express statement of the duties of directors, despite the heavy codification of its company law. Two surprising decisions from the *Cour de Cassation* dated from 1996 and 1998 modified this course of events however, in the sense of the introduction of an anglo-saxon style fiduciary duty of directors. In a ruling dated from 27.02.1996, the *Cour de Cassation* judged that the directors of a company were bound to duty of loyalty in relation to the shareholders of the company; in 1998 the *Cour de Cassation* confirmed the former ruling and established that the directors also had a duty of loyalty in relation to the company. This duty of loyalty required the directors of the company not to act in their own self-interest in contradiction to the interest of the shareholders or the company they manage and compel to the revelation of all bonds or conflicts of interest that would oppose the managers to the persons in whose behalf they act. This was a remarkable evolution because it represented in a certain way a situation of a legal transplant operated by the judiciary.²¹³

French law traditionally opted by a strategy of rules and procedures as agent constraints within company law; i.e, the regulation explicitly prescribed which behaviours were prohibited or allowed to the directors of a company. This case law represented the introduction of a strategy of standards as a means of reducing agency costs, i.e. the indication of the duties that the directors were

²¹² Davies, P. (2002). Introduction to Company Law, Clarendon Law series, Ferran, E. (2005). Company Law Reform in the UK: a progress report, European Corporate Governance Institute, Fleischer, H. (2005). "Legal transplants in European Company Law - the case of Fiduciary Duties." European Company and Financial Law Review(3): 378-398, McCahery, J. A., E. P. M. Vermeulen, et al. (2006). The new company law: what matters in an innovative economy, European Corporate Governance Institute, Viswanathan, A. (2007). "The Companies Act 2006: towards shareholder engagement and streamlining the decision-making process " International Company and Commercial Law Review 18(6): 199-202.

²¹³ Daicle-Duclos, B. (1998). "Le devoir de loyauté du dirigeant" Semaine Juridique - édition entrepreise: 1486, La Nabasque, H. (1999). "Le développement du devoir de loyauté en droit des sociétés." Revue Trimestrielle de Droit Commercial: 273 ff, Merle, P. (2008). Droit Commercial. Sociétés commerciales, Dalloz.

bound to in the running of the business amounts to the introduction of ex post criteria on which to evaluate the behaviour of the management. This is expected to increase the litigation in relation to the behaviour of the management and to revolutionise the position of the judge in these cases, where it will be expected now to take a more active stance and make a positive evaluation of the behaviour of the management instead of imply applying the pre-described rules. The express recognition of a duty of loyalty of management in relation both to the shareholders and to the company is expected to serve as a last resource solution in those situations in which the management acts in a way clearly contrary to the interests of the company and its shareholders but in which there is no express provision to sanction him. This mechanism is expected to reinforce the rights of the shareholders and reduce the agency costs that managers face vis-à-vis shareholders, in particular non-controlling shareholders and reduce the scope for the extraction of private benefits of control. Unlike in the UK, there is no need to state the idea of enlightened shareholder value because that is the conception underlying the existing company law in France, where the company is seen as a societal institution. Finally, the introduction of a general clause of "*loyalty*" might also introduce indirectly the business judgement rule in France; before the rulings of the *Cour de Cassation*, the governance strategy used in France was one of rules and procedures; this idea of standards and the focus on the duty of loyalty (which is of itself a duty with a very broad meaning) will force judges not to review the merit of the decision but the circumstances in which it was undertaken in order to evaluate whether the director acted in an uninterested and correct manner. This is nothing but an indirect reception of the business judgement rule and the procedural mechanisms developed to implement them.²¹⁴

The lawmaker decided to attempt a codification of the fiduciary duties of directors in France albeit not to such a large extent as the one occurred in the UK. The LNRE determined more precisely the duties of the managers of the company when it redefined the powers of the management board. Art.L225-35

²¹⁴ Peltier, F. (1997). "La convergence du droit français avec les principes de la Corporate Governance américaine." Revue du Droit Bancaire et de la Bourse **60**: 53 ss. Freedman, D. (2001). "L'américanisation du droit français par la vie économique." Archives de Philosophie du Droit **45**: 207-211.

Code du Commerce currently states that directors are expected to (1) expressly veil for the enforcement of the orientations of the activity of the company determined by the company; (2) to deal directly with any question concerning the good management of the company; (3) to undertake all controls and verifications judged convenient. It is also worth noting that managers are expected to exercise these duties in good faith. These duties amount to concrete enunciations of a duty of loyalty in relation to the company and in relation to the shareholders of the company. These duties have already triggered some court decisions and the courts have been extremely demanding with the managers of listed companies as compared with the managers of non-listed companies.²¹⁵ The most paradigmatic example was the ruling *Cointrau* in which the *Cour de Cassation* recognised to each individual administrator an individual right to information concerning the decisions to be taken by the management board vis-à-vis the PDG; in the event that the PDG violates this duty to inform individually and to the fullest extent the individual managers, all acts and deliberations adopted at the meeting of the management board will be declared void. The LNRE adopted this case law by imposing upon the PDG or the chairman of the board the duty to inform to the fullest extent the managers in order for them to perform their missions (L.225-35(3) Code du Commerce). This is a sufficient indication of the current evolution in the subject of fiduciary duties in France.

Germany has also witnessed some significant advances in this area of fiduciary duties. The discussion around fiduciary duties in Germany is rather theoretical and its evolution and understanding has been visibly moulded in accordance with the reception of the legal thinking on this matter that originated in anglo-saxon countries. German company law did not have any express codification of fiduciary duties; it merely established that the managers of a company were bound by a duty of loyalty in two specific situations: in §88(1) AktG (which prohibits the management of the company from competing with the company) and §93(1) AKtG (which stipulates a statutory duty of confidentiality). This scarcity of sources led to the development of a very extensive case law and legal scholarship over the years that stated boldly two

²¹⁵ See Ibid. §388 and quoted case law. See also Administrateurs, I.-I. F. d. (2007). La gouvernance des sociétés cotées. Synthèse des recommandations sur le rôle et les modes d'action des conseils.

very important features: firstly, that the position of the manager in relation to the company is quite similar to one of a trustee (*Treuhänder*), although legally the relationship established between the company and the manager does not amount to a proper relationship of trustee as regulated in the BGB; secondly, that the manager is bound in relation to the company to a *duty of loyalty* that calls for a more demanding standard of conduct than the general obligation to act in good faith in contractual settings; this means that the manager of a company is in a particularly demanding position to have in mind the interests of its members.²¹⁶

This was particularly welcomed in the Kodex, which contains a very detailed part on the duties of directors named as “*conflicts of interest*” in §4.3. The Kodex states that members of the management board are bound to (1) a duty of non-competition, (2) not to accept or grant payments to third parties in connection with their work, (3) to pursue the interest of the company as a whole (which is distinct from its members), (4) to disclose conflicts of interest and require approval by the *Aufsichtsrat* in related party transactions and (5) require the approval of the supervisory board to engage in sideline activities. the provisions of the Kodex on this matter mirror those described both in France and in the UK, providing further evidence of a convergence of corporate governance standards in this matter. It is interesting to notice that the German pattern of corporate governance, in particular its co-determined supervisory board and ownership structures, already provides for a sufficient representation of stakeholder interests in internal governance arrangements and therefore the enunciation of fiduciary duties might appear as superfluous because there is a wide degree of consensus that the *Vorstand* is bound to the interests of the company and not of the shareholders. The enunciation of the duties of managers for listed companies seems to serve as a clarification or simple enunciation of something that was already implemented in practice. In this sense, it might have only a symbolic value. Despite this, the enunciation of the fiduciary duties of shareholders is particularly demanding with the duty of

²¹⁶ Schmidt, K. (2002). Gesellschaftsrecht, Carl Heymanns , Hueck, G. (2007). Gesellschaftsrecht, C.H Beck.

loyalty; there appears to be a concern to increase the transparency of the behaviour of the management board.²¹⁷

A very important innovation consists in the reception of the business judgement rule in the case law and in statute law as a limit to the liability of directors in cases of violations of their duties. The business judgement rule first appeared in Germany in the ruling *ARAG/Garmenbeck* of the BHG, where Germany's highest court recognised that the management of the company was entitled to a margin of manoeuvre in the decision making structure in the company. The BGH declared that the liability of the management would not be excluded when the management

"went beyond the borders within which a responsible action of the company orientated towards the well-being of the company and based on careful investigation must move or the behaviour of the Vorstand should be judged illegal".

The practical effect of this judgement consisted in the recognition that the judiciary may not control the content but the procedure by means of which the decision was taken and ensure that the management does not enter into precipitated or self-interested decisions. This is nothing but the judicial recognition of an anglo-saxon style business judgement rule. The statute law accompanied this case-law in accordance and the new redaction of §93(1) AktG reflects this philosophy. §93(1) AktG deals with the duty of care (*Sorgfaltspflicht*) and liability of the members of the Vorstand. It provides that the management is not to be judged liable for any unhappy transaction in the event that it took a reasonably informed decision destined to the prosperity of the company, taking all due diligences that are to be expected from the situation. This is nothing but the statutory recognition of an anglo-saxon style business judgement rule that is expected to approximate German governance standards from those applied in the UK.²¹⁸

²¹⁷ Fleischer, H. (2005). "Legal transplants in European Company Law - the case of Fiduciary Duties." *European Company and Financial Law Review*(3): 378-398, Armbrüster, C. (2006). Recent Developments in German Corporate Law. *Centro di Ricerca per il Diritto de l'impresa*, Libera Università Internationali degli Studi Sociali.

²¹⁸ Schwark, E. (2002). Corporate Governance: Vorstand und Aufsichtsrat. *Corporate Governance*. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft: 77-118, Armbrüster, C. (2006). Recent Developments in German Corporate Law. *Centro di Ricerca per il Diritto de l'impresa*, Libera Università Internationali degli Studi Sociali.

The advances in **Portugal** were equally significant. The reform of Company Law implemented in 2006 modified considerably art.64 CSC (entitled *fundamental duties of directors*) placing two fundamental types of duties upon directors: duties of care and duties of loyalty.²¹⁹ *Duties of care* mean that managers must reveal all availability, technical competence and knowledge of the company that are adequate to their functions and apply the diligence of a careful manager; *duties of loyalty* mean that the manager must act in the interest of the company, having in mind the long-term interests of the *shareholders* and taking due care of the interest of other *stakeholders*, such as employees, creditors and suppliers. A simple reading of the provision of the article evidences that the intention of the Portuguese legislator was precisely to introduce in Portugal the concept of enlightened shareholder value in a similar form as the one introduced in the UK by the Companies Act 2006.

The understanding of the precise reach of the duties of directors must be combined however with the new rules on the *liability of directors*, which introduced in Portugal the business judgement rule. The idea of the business judgement rule was not new in Portugal because the judiciary had been called before more than once to review the merit of the activities of the directors of companies; the courts refused to do so, controlling merely the procedure by means of which they took their decisions (and not their content) creating a jurisprudential line of business judgement rule.²²⁰ This jurisprudential creation found their way into legislation in art.72 CSC, which excludes the liability of the directors in the event that they (the directors) prove that they acted in informed terms, free from any personal interest and in accordance with criteria of business rationality. Several notes must be made about this apparently simple provision: firstly, it only covers the members of the management board; the members of the supervisory boards will not benefit from the business judgement rule because their function is quite diverse; secondly, the provision establishes a presumption of fault of the members of the management board. The shareholders merely have to prove that the behaviour of the management caused a damage to the company for them to be considered faulty; the

²¹⁹ The enumeration is not exhaustive since these are merely the fundamental duties. See Cunha, P. O. (2007). *Direito das Sociedades Comerciais*. Lisboa, Almedina.

²²⁰ See the interesting commented compilation of case law in Portuguese courts organised and commented by Nunes, P. C. (2005). *Corporate Governance*. Lisboa, Almedina.

directors then have at their disposal a board of salvation that consists in the business judgement rule: all they have to prove is that they acted in informed terms, free from any personal interest and in accordance with criteria of business rationality. This appears to be an original solution from the perspective of comparative law and one that protects the interests of shareholders and managers at the best. The shareholders are dispensed from proving that the transaction was taken in uninformed or self-interested terms, which might amount to a *probatio diabolica* since shareholders are normally not present at the meetings and face several information and collective action problems; all they need to show is that the transaction caused a damage to the company; secondly, the directors have a means of evading liability simply by claiming that the transaction was not intentionally detrimental and that it was taken in a regular basis; this is of benefit both to the management and to the shareholders because its indirect effect will be to invite management boards to do a more careful structuring of the deliberative process within companies. This will increase the transparency within the functioning of the boards of companies, which will be of benefit to the managers (who will avoid any suspicions), shareholders (who will be reinforced in their trust that the management is acting on their interest) and stakeholders (who will be given a means of having their interests protected, since management cannot be held liable for having regard to their interests even if it is at the cost of the short-term interests of the shareholders). The Portuguese solution appears to be an extremely balanced one that accompanies the international trends on the matter.²²¹

This comparative review of the evolution of the fiduciary duties of managers in each jurisdiction under study may allow us to conclude that there appears to exist a movement of convergence in the duties of managers. The most prominent examples were the UK and Portugal where the codification and enunciation of the fiduciary duties of shareholders was made in accordance with the perspective of enlightened shareholder value meaning that the pursuit of the interests of the shareholders must take due account of the interests of the remaining stakeholders. The cases of Germany and France were distinct; the internal governance mechanisms of the former and the societal

²²¹ Carneiro da Frada, M. (2007). "A Business Judgement Rule no quadro dos deveres gerais dos administradores." *Revista da Ordem dos Advogados* 67(1).

conception of the company that predominates in the latter served as an obstacle to the development of philosophies of shareholder value. Curiously, the enunciation of the duties of shareholders in both of them focused more on the development of the duty of loyalty and the introduction of the business judgement rule. The duties of loyalty appear to be an instrument for the protection of minority shareholders because their concrete focus is to limit the possibility of managerial self-dealing and binding their activities to the interest of the company as a whole; this reduces the scope for the extraction of private benefits of control from majority shareholders; the business judgement rule is an instrument for the provision of a greater degree of autonomy to managers in the pursuit of business strategies. It allows managers to evade liability as long as they prove that the decision was taken in fully informed terms and free from any conflicts of interest. This serves as an instrument for the protection of the shareholders as a whole (majority and minority).

2.3.4 Auditing - improving the transparency and effectiveness of external monitoring

The recent developments registered in the subject of auditing consisted in another significant evolution in the improvement of the supervision of the management board. The function of external auditors is twofold: firstly, they need to ensure that the financial statements of a company reflect the laws and accounting standards of the jurisdictions in which it is domiciled or its securities trade; secondly and in addition to the former task, shareholders and creditors increasingly rely on auditors to play a broader role in the monitoring of breaches of fiduciary duties by managers. In terms of governance strategies, they may be classified as an affiliation rights strategy because the entry or exit from the company or its contracting with it is underpinned in the accuracy of their reports, which are deemed to be of high value.²²² The recent developments that each one of the jurisdictions under study have demonstrated in the subject-matter of auditing also reveal a convergence of standards. There appears to be a movement of convergence in three domains: (1) in the sense of a closer cooperation between the supervisory organs of the company and

²²² Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford.

the auditor; (2) the increased demands for auditor independence and (3) in the question of auditor liability.

Germany has had some important evolutions in the question of auditing. Recent amendments to the German law have attempted to promote a more active collaboration between the Aufsichtsrat and the external auditor. Although the external auditor as a rule is elected by the general meeting and its primary function is to serve as a control device of the shareholders, since the mandatory dual-board structure in German company law commands the task of supervising the Vorstand to the Aufsichtsrat, the primary relationship of the auditor will naturally be with the Vorstand. The KonTraG 1998 increased this relationship by attributing to the Aufsichtsrat the right to conclude the auditing contract and confer the auditing mandate, which should cover all the matters relevant to the work of the supervisory board (§111(2)AktG). This is a significant innovation because the former law attributed the authority to conclude the contract to the Vorstand, which raised several problems of independence because the Vorstand would be attributing the contract to the persons that were supervising it. The most important contribution of this innovation consists in the possibility granted to the Aufsichtsrat of determining which subjects are necessary for the efficient control of the management board and therefore improve the information flow. There are signs that this innovation has been producing effective results in practice because the auditing report is handed over directly to the supervisory board and the auditor does not merely do a compliance examination of the finances of the company but engages in a much more pro-active and extensive report, examining the consistency of the risk-management systems (*Risikofrüherkennungssystem*), taking part on the meeting of the approval of the annual accounts and having the duty to denounce any irregularities that might question the substance of the report.

The issue of auditor independence was addressed in the Kodex. The Kodex now commands the auditor to issue a statement to the Aufsichtsrat disclosing any relationships (including but not limited to business, financial and personal relationships) that exist between the auditor and the company to be audited that might call its independence into question. This statement shall include the provision of non-audit services in the previous years or to be

expected in the following years.²²³ The idea of independence is central to the provision of auditing services in Germany and there are a number of rules destined to prevent the so-called opinion shopping, which consists in the use of competition in the market for auditing services for the purpose of obtaining favourable decisions. Firstly, the attribution of the competence to grant the auditing contract to the Aufsichtsrat and not to the Vorstand is in itself a guarantee of independence because the supervisory organ does not have any interest in inaccurate statements about the company; secondly, Germany has adopted legislation that makes it extremely difficult for a listed company to terminate the audit engagement once the auditor has been elected by the general shareholders meeting and audit agreement between the auditor and the company has been concluded: §318(3)HGB states that the auditor may only be dismissed in the two weeks following its nomination by an action brought in court by shareholders who, alone or jointly, own 20% of the capital of the company or €500.000 in the case of quoted companies; the auditor may only be dismissed if there is serious evidence of its lack of independence, in particular the causes indicated in §319HGB; finally, as regards the provision of non-audit services, the German BGH took a very reasonable decision in two famous rulings – *Allweiler* and *Hypovereinsbank* – that opened margin of manoeuvre in the provision of non-audit services provided that a number of perquisites destined to safeguard the independence of the audit service were satisfied (e.g: the auditor may not audit its own work; may not perform management functions or be an employee of the client; work as an advocate of the client; promote the stock of the client or have any other financial interests); this was a reasonable decision that went in accordance with the international standards in the matters of auditor independence in Sarbanes-Oxley or the Commission Recommendation of 16 May 2002.

The final question concerns auditor liability in Germany. Germany does not have an express rule concerning auditor liability and the courts have drawn upon the intricacies of its tort law to build a legal system of liability. The most accepted form of auditor liability is tortious liability for advices and

²²³ For a comparative perspective on this subject, see the very interesting study of Figueiredo, A. (2008). Auditor Independence and the Joint Provision of Audit and Non-Audit Services. *Código das Sociedades Comerciais e Governo das Sociedades*. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.

recommendations, where the person giving the advice (the auditor) is particularly qualified and is bound to know that other persons will place special trust in its advice (the report) and fundament their investment decisions upon that report. This serves as a deterrence device for the issuing of correct statements because auditors are aware that they will be held liable for incorrect statements. Recent German legislation has limited this possibility of liability however since legislators feared that excessive litigation could endanger the auditing market.²²⁴

The evolution in **France** has been similar to the one registered in Germany. France has considerably encouraged the cooperation between the audit committee (which must be composed by a certain proportion of independent non-executive directors) and the external auditor in order to reinforce trust in the accounts of the company. The Bouton report stresses that the dual auditorship (meaning that the accounts of the company are truly reviewed twice, one turn by the internal audit committee and another by the statutory auditor) consists in a true characteristic of the French system that ensures the transparency of the accounts of French companies and reinforces the investor confidence on the financial situation of the companies. This cooperation between the audit committee and the statutory auditor is further reinforced by a number of measures such as: the appointment of the external auditor by the management board should be supervised by the audit committee, who should be informed of the expertise of the statutory auditor and the fees paid and make a recommendation on whether the company makes the best offer.

France has equally undertaken a number of precautions to ensure that the statutory audit of French firms is truly made by independent auditors and that the reports that they issue may be trustworthy. The ethical code adopted by the firms authorised to conduct statutory auditorships commands the

²²⁴ Hommelhoff, P. (1998). "Die neue Position des Abschlussprüfers im Kraftfeld der Aktienrechtlichen Organisationsverfassung " *Betriebs-beräter*: 2567-2573; 2625-2632. Ebke, W. and A. Jurisch (2000). "Der unerwünschte Abschlussprüfer: Ersetzungsverfahren (§319(3) HGB) vs Anfechtungsklage (§243(1)AktG)." *Die Aktiengesellschaft* 45: 208 . Ebke, W. (2004). Corporate Governance and Auditor Independence. *Reforming Company and Takeover Law in Europe*. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch. Oxford, Oxford University Press. De Poorter, I. (2008). "Auditor's liability towards third parties within the EU: A comparative study between the United Kingdom, the Netherlands, Germany and Belgium." *Journal of International Commercial Law and Technology* 3(1): 68-75.

companies to be free from all ties that might colour the judgement of the auditor or in any way influence the relationship that they establish with the company that they are auditing. For French auditors, independence takes precedence over competence, quality of work, confidentiality, accepting of assignments and collaborating with other auditors. The Bouton report attempted to address the major threats to the independence of auditors: as regards the provision of other services to the client rather than auditing, the Bouton report took a rather firm stance and established the principle that the audit firm may not provide any other services for the company being audited. The only exception concerns ancillary work for the provision of audit services, which may be allowed subject to the condition that they are communicated and approved by the audit committee; in any case, no evaluation work should be allowed; as regards the terms of office, the law sets the maximum limit of 6 years for each term; despite the fact that it may be renewed the Bouton report recommends the rotation of audit firms, in order to reinforce the independence of the external auditor and avoid excessive relations with the management of the firm; as regards the participation in the affairs of the client and the undue dependence of one audit client, the Bouton report sees it as evidence of lack of independence and the statutory auditors in those situations should be removed from their functions; finally, France also has equally protective regulations concerning auditor liability. The external auditors of French firms may be held liable against the firm and against third parties for the statements they issued in their reports. The liability is based on tort and currently neither the law nor the case law allows statutory auditors to limit the amount of their liability; therefore, French auditors are in a particularly delicate situation and must exercise special precautions in their audit of the firms because they may be held liable against third parties in the event that someone bases their ruinous investment upon erroneous statements. All the third party needs to demonstrate is the damage, the auditors' fault or negligence and the causal link between the fault and negligence. In the event that the auditor commits an erroneous statement due to the fault of the management, it will not be held liable; however, in the event that the auditor is conscious of the fault of the management, it has a statutory duty to communicate it to the shareholders. All of this combined reveals that

France has an extremely advanced and sophisticated system of auditing of companies.²²⁵

The evolution in the UK is equally interesting, especially with the novelties brought about by the Companies Act and the Combined Code. The Combined Code commands companies to establish proper relationships with the company's external auditors in order to facilitate and reinforce their work (C.3). The approach followed by the combined code is pretty much similar to the one adopted in France. The board is commanded to establish an audit committee of independent non-executive directors; the audit committee must monitor the financial health of the company; in relation to the external auditor, it must make recommendations to the management board in relation to the (re)appointment and removal of the external auditor, its remuneration and terms of engagement and its necessary standards of independence, objectivity and independence of the audit process. In a similar way to the one described in France, British companies are equally subject to a dual audit. As relates to auditor independence, British companies are subject to standards that mirror those found in the other regulations under study. The external auditor must be free from any circumstances that might influence the functions it is asked to perform. The Combined Code has nevertheless an interesting perspective on the provision of non-audit services; whereas the regulations in Germany and France seem to have adopted a somewhat firmer stance concerning the provision of non-audit services, the Combined Code merely delegates to the audit committee the task of developing a policy that ensures that the necessary independence required of the auditor is not at stake. This is a somewhat more flexible approach than the one undertaken in the other countries but equally a riskier one, since the independent non-executive directors that composed the audit committee will be trusted with the task of implementing that policy. It all depends on the persons that concretely fill the position of the audit committee. Finally, the most interesting evolution in the UK consists in the possibility recognised in the Companies Act of limiting the liability of auditors. British case law was pioneer in the subject of auditor liability and is quite generous in the recognition of the liability of auditors for erroneous statements. The third party

²²⁵ Stevenson, J. E. (2002). "Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy ." *International Journal of Auditing* 6(155-182).

merely needs to demonstrate that the auditor owes him a duty of care, which arises when: (i) it was reasonably foreseeable that damage of the kind allegedly sustained would be suffered if the defendant failed to take reasonable care, (ii) there was sufficient proximity between the parties and (iii) it would be just, fair and reasonable to impose a duty of care on the defendant (*Caparo vs Dickman*). These perquisites were developed in a declaration issued by the House of Lords in which the upper chamber of the British Parliament developed the specific conditions for third parties to claim damages from the auditor: those perquisites are: (i) the work produced was required for a purpose made known to the auditor; and (ii) the auditor knew or should have known that its work product would be communicated to the non-client party for that purpose; and (iii) the auditor knew or should have known that its work would be likely to be acted upon by the non-client party for that purpose, without independent enquiry. These are quite demanding perquisites for liability but not altogether impossible. Interestingly, in order to avoid excessive litigation, the Companies Act allows auditors to limit the liability that they may owe to the company (and not to third parties) by agreement. Accordingly, although as a rule such limitations are forbidden, the company may limit the liability as far as it is reasonable considering the amount of the damages and the fault of the auditor by means of an agreement to be approved by the general meeting.²²⁶

Portugal has equally followed the international trends concerning auditing. The previous concerning Portuguese law have demonstrated that auditing is a mandatory part of the structure of Portuguese companies (whether single-tier (classical or anglo-saxon) or dualist board) and therefore Portuguese companies are subject to particularly high standards of auditing. The auditors are mandatorily chartered accountants in Portugal. The function of the auditors after the reform of company law elaborated in 2006 goes well beyond the simple task of reviewing the financial health of the company. In accordance with arts.420 and 420-ACSC, the auditor must: (1) examine the financial situation of the company; (2) examine the efficacy of the risk management system, the internal control system and the internal audit system; (3) notify the president of

²²⁶ Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, De Poorter, I. (2008). "Auditor's liability towards third parties within the EU: A comparative study between the United Kingdom, the Netherlands, Germany and Belgium." Journal of International Commercial Law and Technology 3(1): 68-75, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

the management board of any irregularities in the management of the company that might endanger its stability; in the event that the president does not answer to the auditor or the auditor finds the answer insufficient, the auditor has the duty to summon a meeting of the management board, take presence in that meeting and demand that actions be taken; if the meeting does not take place or the measures are considered insufficient, the auditor has the power and the duty to summon a general meeting of the shareholders and ask them to deliberate on those facts. If we consider that the members of the auditing are elected by the general meeting of the shareholders (art.415CSC), it becomes easy to understand how the system erected in Portugal mandates that the auditor controls and collaborates actively with the management board in the fulfillment of the objectives of the company while representing the interests of the shareholders at the same time.

In a similar way to what was described in the former jurisdictions, auditors are equally subject to particularly high standards of independence. The conditions for independence laid out in art.414-A CSC consist in a particularly extensive and wide ranging catalogue, essentially prohibiting that anyone who has a particular interest in the company assume any auditing functions in the company. Besides the normal perquisites for independence (such as not exercising any management functions in the company or in the group, relatives of anyone within the company) there are also other very demanding conditions, such as: (1) not receiving any particular advantages from the company; (2) not establishing any business relationships with the company or another company of the group; (3) not being bound to the interests of any competing company; (4) exercising more than 5 mandates in different companies. It is worth noting that the provision addresses specifically the provision of non-audit services to the company or another company of the same group, considering it to be incompatible with the standards of independence demanded from the auditor. In this sense, the Portuguese law goes further than the majority of legislations considering it to be incompatible *per se* the provision of audit and non-audit services.²²⁷

²²⁷ For a critical perspective on this solution, see Figueiredo, A. (2008). Auditor Independence and the Joint Provision of Audit and Non-Audit Services. *Código das Sociedades Comerciais e Governo das Sociedades*. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.

A final word must be given to the liability of auditors. The solution is provided for in art.82CSC. This provision considers that auditors are liable in two distinct situations: (1) they are liable in relation to the company and (2) they are liable in relation to the creditors of the company. As regards the first type of liability, art.82CSC considers that the auditors are jointly liable for the damages that their faulty behavior causes directly to the company and to the shareholders. This means that the shareholders are also protected directly by the rule and may claim compensation from the auditor by the damages caused directly to him. As regards the second type of liability, the auditors are liable in relation to the creditors of the company when they faultily disregard the provisions destined to protect their interests and the assets of the company become insufficient to satisfy their debts: that is the same this as to say that the auditor is liable in relation to the creditors when it refrains from acting and the company becomes insolvent. This is a strong incentive for auditors to exercise their functions diligently and improve the quality of the auditing services. As regards listed companies, there are two additional provisions concerning the liability of auditors in listed companies: art.10CVM considers that the auditors are liable for the damages caused by the inaccuracies of the report necessary for companies to issue stock or bonds; art.149CVM, which renders auditors liable for all the damages caused by the trust deposited in their prospect when the prospect faultily contains inaccuracies. The same thing applies as regards the liability of the auditors of non-listed companies.²²⁸

2.3.5 remuneration - strategies to tie remuneration to long term results

A final area in which the management boards of public companies exhibited a significant degree of convergent evolution consisted in the patterns of remuneration of the members of the management board. The importance of the patterns of remuneration should not be underestimated because they are related to the evolution of the business philosophy and to the ownership structures; the regulatory strategy that a legal system adopts for the setting of the remuneration of its management board quite often reflects the evolution of the traditional ownership structures and the economical objectives that

²²⁸ Concerning Portuguese law, see the fundamental text of Ferreira Gomes, J. Ibid.A responsabilidade civil dos auditores.

lawmakers wish to achieve with the company. Traditionally, there were two distinct types of patterns of remuneration; one based upon agent incentives and the other based upon regulatory intervention. The agent incentives system was based prevalent in systems with dispersed shareholding structures and attempted to reduce the agency costs that shareholders faced vis-à-vis managers by connecting a percentage of their remuneration to the residual claimants of the shareholders; the more money the company generated, the more money they would gain. This was a direct response to the collective action problems generated by the dispersed shareholding structure; the most effective way of convincing managers to pursue the agenda of the shareholders consisted in tying their own personal agendas to those of the shareholders. There lies the origin of the proliferation of share options and equity based pay. The regulatory system was developed in countries with concentrated ownership structures and intended to provide an answer to the agency costs that majority shareholders face vis-à-vis minority shareholders. Considering that the management is under the direct influence of the majority shareholders, there may be a problem that the majority shareholders take control of the management board and attempt to extract rents in excess of their voting power by means of excessive remunerations; since minority shareholders are powerless to use their voting power to form a blocking force, the traditional agent incentives system does not work properly. The answer lay in a regulatory system, in which the regulator attempted to curve the board's power to set their own remuneration and protect the interests of the minority shareholders. The answer essentially lay in a trusteeship strategy, in which an uninterested party (normally non-executive directors) would have to approve any of such transactions in order to safeguard the interests of the minority shareholders. A similar characteristic both to dispersed and concentrated systems consisted in the increased resource to disclosure to solve to governance problems caused by executive pay. Disclosure of executive pay allows the market to evaluate whether the payments being made to the board are excessive or not and create incentives for greater shareholder activism and divestment in the event that they are not in accordance with the market. Disclosure is a very effective governance mechanism that ensures better monitoring with minimum

regulation.²²⁹ The recent evolution in the jurisdictions under study reveals that there are signs of convergence in the systems: in countries with dispersed shareholdings there are increasing interventions in the form of regulatory strategies to reduce agency costs; and in countries with concentrated shareholdings there is a proliferation of agent incentives systems. The final result consists in a hybridisation of the remuneration patterns in all jurisdictions under study, although strong path dependencies limit the scope for evolution and preserve the fundamental characteristics of the system.²³⁰

The evolution in the UK represents an approximation to continental European standards. The UK is the traditional European country that represents the paradigm of the dispersed shareholding structures; therefore, it comes to no surprise that it is also the country that has the greatest number and resource to agent incentives systems as a means of reducing agency costs. The use of share options and other variable remuneration systems is so widespread in the UK that it forms part of the normal business culture.

There are currently signs that the picture is changing in the UK. The agent incentives systems are increasingly being changed to long-term incentive schemes. One of the greatest problems that agent incentives systems are said to create in dispersed ownership contexts consists in the encouragement of short-termism; managers have incentives to increase the profits of the firm in the short-term, in such a way as to increase their remuneration proportionately, endangering the long-term prospects and possible the survival of the firm. This is incompatible with the recent modifications operated in British company law, which – as the analysis of the fiduciary duties attempted to demonstrate – is increasingly being diverted towards longer-term perspectives at the light of the philosophy of enlightened shareholder value. The agent incentives systems

²²⁹ Disclosure equally has some inherent problems because it creates room for envious political activism on the part of some investors and misaligns the interests of shareholders and managers because the latter tend to manipulate the market price of shares downwards when they are granted and increase them progressively afterwards in order to profit from the variation. Nevertheless, current corporate governance scholarship values disclosure to a great extent. See Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press. Hertig, G., R. Kraakman, et al. (2004). Issuers and Investor Protection. The Anatomy of Corporate Law. H. Hansmann and R. Kraakman, Oxford.

²³⁰ Ferrarini, G., N. Moloney, et al. (2003). Executive Remuneration in the EU: Comparative Law and Practice, European Corporate Governance Institute, Hertig, G. and H. Kanda (2004). Related Party Transactions. The Anatomy of Corporate Law. H. Hansmann and R. Kraakman. Oxford, Oxford.

had to evolve in order to accompany the modifications in the legislation. The current objectives of the remuneration policy being increasingly practiced in the UK consists in maintaining a competitive pay package (in order to attract the best managers and tie their interests of the firm) and motivate directors to achieve long-term strategic objectives. Long-term motivation is promoted by the adoption of share-based compensation schemes such as performance share schemes, deferred equity transfers, conditional awards of shares and schemes designed to encourage the executive to invest in the shares of the company by means of transfers of shares/deferred rights to acquire the shares of the company that depend on the performance of the company over a longer period (usually circa 5 years). Typically, a long term incentive plan functions in the following way: an executive officer must draw a plan of up to five year; within each year he must fulfil a number of objectives that proves that the company is creating value for the shareholders during that period; in the event that the company fulfils its objectives within each year, the officer will be given a proportional increase in its remuneration. In plain terms: the strategy consists in waiving the carrot and giving it a bite each time it pushes the wagon to create incentives to reach the end of the track and eat the complete carrot. The importance of this long-term incentive plans should not be underestimated: considering that one of the critics traditionally appointed to British corporate governance consisted in its excessive focus on short-termism, the increased use of this type of plans creates incentives for a modification of the traditional British business philosophy to more continental standards.²³¹

British companies are also increasingly using trusteeship governance strategies in order to approximate them to their continental counterparts. The Combined Code is very clear on this matter when it states boldly that no director should be involved in the decision of their own remuneration (B.2). This obliges companies to have a remuneration committee, which should be composed in its entirety of independent non-executive directors (B.2.1); the remuneration committee is charged with deciding the remuneration of both the CEO and the chairman and should monitor the performance of the

²³¹ Buck, T., A. Bruce, et al. (2003). "Long-term incentive plans, executive pay and UK company performance." *Journal of Management Studies* 40(7): 1703-1721, Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582.

management; any long-term incentives plans should be subject to the approval of the shareholders (B.2.4).

A final instrument of governance consists in disclosure. The UK equally has very extensive disclosure rules concerning the remuneration of the management. The directors of quoted companies are required to prepare for each financial year a directors' remuneration report (s.420 Companies Act) that must be approved by the board of directors. The directors' remuneration report must contain information on the following facts: (1) remuneration committee, (2) remuneration policy and (3) detailed audited financial information. The combination of these features creates incentives for long-term investment and approximates the remuneration patterns and the governance strategies of British firms closer to their continental counterparts while maintaining the fundamental characteristics of the system.²³²

The evolution in **Germany** reveals to a great extent how a traditionally long-term stakeholder country has managed to introduce within its system some anglo-saxon remuneration structures in order to take advantage of some of the benefits of the system. To begin with, there is evidence that remuneration based partly on results is increasingly being used in Germany. Data reveals that within nearly all German quoted companies the remuneration of the management is being composed by a parcel that reaches 52,6% of variable remuneration based on stock-option plans. The influence of the UK remuneration system is so extensive that there are signs that the use of long-term incentive plans that attempt to use financial resources to align the interests of managers with those of the shareholders is increasingly being used in Germany.²³³ The Kodex states that the remuneration of the management board should be based on individual performance and include both a fixed and a variable portion: the variable portion should include annually payable components linked to the performance of the business and long term incentives containing risk elements (4.2.3). The reason for the introduction of variable remuneration systems in systems characterised with such a concentrated

²³² Buck, T., A. Bruce, et al. (2003). "Long-term incentive plans, executive pay and UK company performance." *Journal of Management Studies* 40(7): 1703-1721. Ferrarini, G., N. Moloney, et al. (2003). Executive Remuneration in the EU: Comparative Law and Practice, European Corporate Governance Institute.

²³³ Höpner, M. (2003b). Wer beherrscht die Unternehmen? Shareholder value, Managerherrschaft und Mitbestimmung in Deutschland Campus Verlag.

ownership structure such as Germany lays in the agency problems that majority shareholders face vis-à-vis minority shareholders. Although the concentration of voting power is of itself a sufficient control mechanism to ensure the alignment of the interests of management with those of the shareholders, there is the problem of a majority “assault” of the management board and that the majority shareholders essentially receive rents in excess of their voting power in the form of management remuneration. By connecting their remuneration to the success of the company, the minority shareholders will benefit from increased dividends and the guarantee that the company is not being managed in the interests of the majority shareholders exclusively.

Germany has equally understood the benefits of an independent remuneration system. Although, according to German company law, the competence to set the remuneration of the management board belongs to the Aufsichtsrat (§§87(1) and 112 AktG), the Kodex recommends the formation of a remuneration committee composed of independent non-executive directors within the Aufsichtsrat in order to determine the remuneration of the management board (4.2.2). This is an element of extreme importance because the guarantees of independence to which the members of the supervisory board committees are subject ensure a high degree of impartiality in the determination of the remuneration of the management board.²³⁴

Finally Germany has equally accepted the benefits of disclosure of the remuneration of the members of the management board although some consider it to be insufficient. The Kodex commands all listed companies to present the remuneration systems of the members of their management boards in the yearly Corporate Governance report in a “*generally understandable way*”; this should include the value and concrete forms of stock option plans or comparable schemes for components with a long-term incentive effect and risk character (4.2.5). Besides that, German companies are merely subject to the disclosure of the total remuneration systems in the end-of-year report (*Jahresabschlusses*) in accordance with §§285(9)a HGB and 160(1)5AktG. The disclosure of remuneration should be made on an individual basis, although this has seldom occurred because it has raised several criticisms from German

²³⁴ Höpner, M. (2005). Corporate Governance in transition: ten empirical findings on shareholder value and industrial relations in Germany, Max Planck Institute für Gesellschaftsforschung.

legal literature. In comparative terms, this is a relatively weak system of disclosure and several pressures are being made in order to approximate it to the anglo-saxon practice, although this has met with several resistance.²³⁵

The situation in **France** is somewhat different because France is proud of being on the avant-garde of remuneration systems. French companies seem to have been seduced by the appeals of the stock-options and the majority of French listed companies award stock options and variable remuneration systems to the members of their management board.²³⁶ The rationale for the inclusion of stock options in their remuneration packages is connected with the highly concentrated ownership structure of French companies; it is generally used as an instrument for the alignment of the interests of managers with the company and the protection of minority shareholders because their remuneration will depend of the success of the company as a whole; this was so important in French Corporate Governance that it was even mandatory for French managers to hold stock in the companies that they managed until August 2008, when a new French law eliminated that requirement. It is worth noting that the Bouton report 2003 makes an allusion to the purposes of the remuneration policy of the management board claiming that it should serve to promote a long-term partnership between the company, the shareholders and the stakeholders. This is nothing but the repetition of the long-term incentive plans that are increasingly being used in the UK and replicated in France and other places. The Bouton report makes a specific reference to the need to avoid that the remuneration packages of French managers create incentives for short-termism and endanger the communitarian perspective that French scholars have of the company.

²³⁵ Schward, E. (2002). Corporate Governance: Vorstand und Aufsichtsrat. Corporate Governance. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft: 77-118. Ferrarini, G., N. Moloney, et al. (2003). Executive Remuneration in the EU: Comparative Law and Practice, European Corporate Governance Institute. Schilling, F. (2001). "Corporate Governance in Germany: the move to shareholder value." Corporate Governance 9(3): 148-151, Jackson, G., M. Höpner, et al. (2005). Corporate Governance and Employees in Germany: changing linkages, complementarities and tensions. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford.

²³⁶ Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Architecture et Gouvernance des Organisations, Tiberghien, Y. (2007). Entrepreneurial States. Reforming Corporate Governance in France, Japan and Korea, Cornell University Press

France has also equally increasingly relied on independent directors and a remuneration committee in order to ensure the impartiality of the remuneration appointed to the management. The Bouton report 2003 recommends the setting up of a remuneration committee composed mainly by independent non-executive directors, which should be in charge of the determination of the remuneration policy to be pursued by management. This guarantee of independence is even stricter if we consider that the general meeting of shareholders must approve the remuneration of the management board as a whole proposed by the remuneration committee; and the concrete case of stock-options must be approved by a majority of 2/3 of the votes in the general meeting. The elaboration of the remuneration policy by an independent remuneration committee and the necessary approval by the general meeting ensure that the adequacy of the remuneration policy to the interests of shareholders is sufficiently scrutinised and approved. The main criticism to the system consists in the fact that the remuneration policy is made by the members of the board as a whole and is not individually disclosed. This means that the plan as approved by the general meeting is then distributed amid the members of the management board in accordance with their will. France has recently undertaken legislative measures to regulate this situation: a Government Decree of 7th October 2008 determined that listed companies (CAC 40) had to abide by the following rules: (1) Golden parachutes were limited to two years of wages and could not be granted in situations of voluntary departure or dismissal; (2) managers could not perform their duties under a contract of employment; (3) the amounts that managers could collect each year as supplementary pensions were limited; (4) the issue of stock-options was subordinated to the results of the shareholders as a whole (and not just the majority shareholders); (5) the granting of shares to the managers independently of their performance was prohibited. This solves the major problems that the remuneration committee could not address individually.

Finally, as regards disclosure, France law commands the annual report of the directors to indicate the total amount of compensation and benefits awarded to each corporate officer and the annual reports of listed companies should contain a chapter – elaborated with the assistance of the compensation committee – on the compensation of directors (art.L225-102-1; Viennot 1999; Bouton 2003). If we combine this with the powers of the general meeting in the

approval of the compensation of directors, it becomes easy to observe that France is at the forefront of the disclosure systems in the world, ensuring a high degree of transparency.²³⁷

The situation in **Portugal** has accompanied these international tendencies. The corporate governance reports issued by the CMVM confirms that the use of stock-options and performance based remuneration systems are increasingly being used in Portuguese listed companies. The variable part of the remuneration of directors is also taking an increasingly bigger proportion of their wages. In order to avoid short-termism, the use of long-term commitment plans is also not strange in the Portuguese remuneration policy of directors. Since the ownership structure of Portuguese corporations is heavily concentrated, the same rationale for the reason to use stock-options as the one in Germany and France applies.

Portugal has equally understood the advantages of committology in remuneration systems. Nearly all Portuguese quoted companies now have remuneration committees composed essentially of independent non-executive directors in order to determine the remuneration of the management board. In accordance with arts.399 and 429CSC, the remuneration of the management board must be approved by the general meeting of the shareholders in the single-tier model and by the supervisory board in the dualist model. This is a situation much similar to the one found in France that ensures a high degree of transparency in the determination and approval of the remuneration of the shareholders of the company.

Finally, as regards the disclosure rules, Portuguese listed companies subject to Portuguese company law (*i.e:* excluding companies subject to foreign law trading in Portugal) must publish a corporate governance report on their annual management report, which must include details on the remuneration of the members of the management board as a whole, distinguishing between executive and non-executive directors and between the fixed and variable parts of their remuneration (Regulation 7/01 CMVM).

²³⁷ Menjucq, M. (2006). Corporate Governance Issues in France. Corporate Governance Post-Enron. Comparative and International Perspectives. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law. Ferrarini, G. and N. Moloney (2004). Executive remuneration and Corporate Governance in the EU: convergence, divergence and reform perspectives. Reforming Company and Takeover Law in Europe. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch, Oxford.

Although this system is not as advanced as the British system, it consists in a debut for increased transparency of the remuneration practised within Portuguese management boards.

2.3.6 conclusion – hybridisation of the governance of corporate boards in accordance with the enlightened shareholder value philosophy

The comparative analysis of the evolution in management boards may allow us to extract some conclusions. These conclusions must be duly contextualised within the evolution in the economical conditions. The period that followed 1975 until 2001 was characterised by a phenomenon of financialisation of the economy in which the paradigm of shareholder value became dominant. The purpose of managers should be to enhance the prosperity of the shareholders to me measured in a purely financial basis. The cases of Enron and Parmalat led to an awareness of the dangers of a purely financial approach to the management of the company and to the potential agency costs that such an approach could raise. The answer to these problems lay in a combination of mechanisms that, without questioning the fundamental assumption that the company should be ultimately run to the benefit of the shareholders (who are after all the residual claimants in the company and the ones who can exercise control powers over it (with the exception of countries with co-determination statutes)) attempted to refrain the “*savage shareholder value*” approach to corporate management and governance and designed a new set of institutional mechanisms to align the interests of managers with the long term interests of the shareholders and stressed the relevant role that stakeholders could have in the governance of the company.

It seems that there is sufficient evidence to support the conclusion that the evolution registered in the management board in all the jurisdictions under study point towards the hybridisation of the corporate governance models in Europe. An extremely important characteristic consists in the improvement of the mechanisms of supervision of the management boards; boards are evolving towards more dualist models, creating supervisory organs or reinforcing the powers of the existing ones. This can be observed perfectly at the current trend for the separation of the role of CEO and chairman in all the jurisdictions under study and the current pressure for the inclusion of independent directors (in countries were the single tier-board is predominant as

it occurs in France, Portugal and the UK, albeit these countries exhibit distinct governance patterns). The importance of this evolution should not be underestimated because it appears to reveal the countries in which the boards traditionally had more uncontrolled powers of decision have recognised the advantages of including or reinforcing the internal controls of the activities of the management boards; this represents a strong guarantee for the existing shareholders of the company and obliges the management board to be more attentive to their interests in order to avoid a change in ownership or being dismissed by majority shareholders.

The evolution registered in the area of fiduciary duties is equally surprising not only because it is a phenomenon of a legal transplant but also because it reveals a path of convergence both to the Anglo-saxon model but maintaining the traditional societal conception of the firm. It is worth to begin by noting that the idea of fiduciary duties is a typical anglo-saxon conception as a response to the agency problems that dispersed ownership caused and that at least in two jurisdictions it has been a legal transplant operated by means of case law (France and Germany). The introduction of fiduciary duties does not mean an open adoption of the anglo-saxon style shareholder value however; the adoption of fiduciary duties was made at the light of the idea of enlightened shareholder value (particularly in the UK) and the configuration of those duties (distinguishing the duties of loyalty and the duties of care, particularly in relation to the stakeholders) and the rules of liability inherent to them (adoption of the business judgement rule) provides some evidence that the legislator did not want to hand over the management boards to the hands of the shareholders; the management board is now under an increased control (because it is subject to an express set of duties) but it may defend itself by the business judgement rule claiming that the interests of the shareholders demanded improved relations with the stakeholders. This is a rather balanced idea that joined both the societal conceptions of the firm (that have been imported by the UK) and the reinforcement of the rights of the shareholders; management will simple have to be accountable to them and explain in greater detail its business strategy.

This evolution is even more appalling if we combine it with the evolution in the areas of internal controls and remuneration policies. As regards the internal controls, the management board is under an increased scrutiny by the

shareholders, obliging it to be clearer about its operations; as regards the remuneration policies, the tying of their remuneration to the long term interests of the shareholders serves as the definite incentive for using a long term plan for the company.

The evolution in the area of auditing is equally surprising in its convergence: auditing is increasingly becoming mandatory, its independence is subject to stricter standards and its liability intends to deter any possibility of collusion between the auditors and those being audited. This reinforces the position of shareholders and creates a favourable climate for investment.

Finally, it is worth noting that the evolution registered was made without any significant modification of the existing company law; some surgical interventions merely adopted it towards more common standards. This is a strong evidence of a situation of path-dependency: company law structures are currently evolving but maintaining the existing regulations and *status quo*, in a pure situation of evolution in continuity. Instead of evolution one may coin the current transformations as a situation of adaptation.²³⁸

2.4 The evolution of ownership structures – who currently owns European companies?

A second extremely interesting point consists in the evolution that the ownership structures registered in all the jurisdictions under study. The ownership of companies is an element of extreme importance in an analysis of the development of the governance of companies because the knowledge of the types of shareholdings (concentrated/dispersed) and the identity of the shareholders (private, institutional, state) provides us with a picture of the objectives of the owners of the company and the types of pressures to which management will be subject. Dispersed shareholding structures usually mean that managers will be gifted with a wide margin of autonomy to run the business; the strategies to reduce the agency costs that that autonomy creates consists in the market for corporate control (external mechanisms) and in tying their remuneration to the interests of the shareholders (agent incentives internal mechanism). This means that managers will tend to be attentive to share prices

²³⁸ Bebchuk, L. A. and M. J. Roe (2004). A theory of path-dependence in corporate ownership and governance. Convergence and persistence in Corporate Governance. J. N. Gordon and M. J. Roe, Cambridge University Press.

and run the company for the short-run; concentrated ownership structures have the advantage of allowing the managers to pursue more long-term investment strategies by means of a dialogue with the shareholders; however, since the management board is in fact elected by the majority shareholders, this creates agency costs in relation to the minority shareholders that might discourage investment; this explains the recourse to trusteeship strategies (audit committees, mandatory auditing, independent non-executive directors) in countries with concentrated ownership structures, to protect the interests of minority shareholders vis-à-vis the majority shareholders. The following lines will attempt to describe the evolution registered in ownership systems in the jurisdictions under study. There appears to have been a number of parallel evolutions that consisted in: (1) the entrance of institutional shareholders on the market, (2) the dissolution of corporate networks and (3) privatisation. The modifications occurred in the ownership structures will modify the objectives of the shareholders of the company and consequently might bring about modifications to the governance of companies.

2.4.1 Arrival of institutional shareholders - investment funds hit European markets

Equity markets in Europe have been agitated over the last few years by the arrival of institutional investors. Institutional investors consist in collective investment schemes whereby a number of investors pool their assets in one fund that is to be managed by a professional manager and collect the resulting gains in proportion to their investment; they are equally known as private equity funds. The manager of the private equity fund normally uses the money to invest in existing companies, acquiring the control of it by means of several financial operations (such as LBOs, IPO, mergers, etc), influencing its management in the best interest of the members of the fund and distributing its share in the profits of the company to the investors. The nature of the investment might be classified either in venture capital, buy-out or special situations: the venture capital refers to investment in newly formed companies investing in niche markets; the buy-out refers to investment in mature companies, acquiring control of it by means of a purchase of shares; special situations refer to investment in distressed companies that still have a chance

of survival and are destined to sell them at a higher price. There are several types of private equity firms, which work in distinct ways (such as hedge funds, etc). A hedge fund is a special type of private equity fund that pursues a specific strategy of its own. Whereas private equity funds generally pursue a strategy of creating value - by becoming involved in the company and influencing its management - rather than creating it, hedge funds do the opposite: they take advantage of existing value. A typical example would be an hostile takeover bid: a private equity fund would acquire a majority stake in the company; a hedge fund would buy the shares of the company that is the object of the hostile takeover bid while at the same time attempting to sell the stock of the company making the bid; they pursue short-term investment strategies. Private equity funds are considered the most important financial innovation of the last few years due to their capacity to generate wealth, as the growing number of references made to it in the literature prove.²³⁹

Private equity funds are an industry that must be understood at the light of the increasing financialisation of the economy. Financialisation refers to a process whereby financial markets, financial institutions and financial elites gain greater influence over economic policies and outcomes. Financialisation transforms the functioning of the economic system both at the micro and macro levels and operates by three distinct conduits: (1) changes in the structure and operation of financial markets, (2) changes in the behaviour of non-financial corporations and (3) changes in economic policy. Its principal impacts are (1) elevate the significance of the financial sector in relation to the real sector and (2) transfer income from the real sector towards the financial sector. Private equity funds operate within this context and contribute to the effects attributed to the increasing financialisation of the economy.²⁴⁰

Virtually all the jurisdictions under study have registered a growth in the activity of private investment funds. The most remarkable example occurred in the **UK** and the understanding of its evolution depends on the consideration of

²³⁹ Tricker, B. (1998). "The role of the institutional investor in Corporate Governance." *Corporate Governance* 6(4): 213-216. Monks, R. A. G. and N. Minow (1995). *Corporate Governance*, Blackwell Business. Macey, J. R. (2008). *Corporate Governance - promises kept, promises broken*, Princeton University Press.

²⁴⁰ Kahan, M. and E. B. Rock (2006). Hedge funds in Corporate Governance and Corporate Control, European Corporate Governance Institute. ; Palley, T. I. (2007). Financialisation: what it is and why it matters Washington D.C, Economics for Democratic and Open Societies.

the following points. The ownership system in the UK has been experiencing over the last years a significant degree of concentration; whereas previously the median shareholder held generally less than 3% of the total equity of a firm, nowadays the median shareholding had risen to 9,9% of equity; the overall proportion of shares hold by institutional investors had also grown exponentially, from 29% in 1963 to 60,4% in 1992.²⁴¹ This amounts to a very important development because this threshold of equity easily allows for the coalition of a small syndicate of shareholders who will *de facto* hold control of the company. The majority of listed firms in the UK today report that they are potentially subject to the influence of a small group of shareholders that do not face collective action problems (unlike the remaining 70% of shattered shareholdings). This movement of concentration of ownership in the UK is the result of the activity of institutional investors. There are several reasons behind the increased participation of collective investment schemes in the stock market. One reason consists in the investment strategies of individuals; small shareholders have increasingly modified their investment strategy moving from direct shareholdings towards the participation in funds because the generally activist position of funds provides their members with bigger returns than those that they would get from their individual shareholdings. Another reason consists in the increasing strength of pension funds; employees and employers have increasingly turned to private mechanisms of social security in order to receive an extra-income when they retire; these occupational pension schemes are extremely active in the stock markets because, unlike the continental "pay-as-you-go" funding bases, they need to find an investment home for the steady stream of contributions by and in respect of those still at work. A third reason consists in the tax policy pursued in the UK that encouraged employers to set up pension funds external to the employing enterprise as trusts; this created incentives for pension funds to invest in equities because the stock market was the only market that could provide pension funds with the necessary levels of liquidity to finance their recipients. A final reason consists in the extremely

²⁴¹ Gospel, H. and A. Pendleton (2003). "Finance, Corporate Governance and the management of labour: a conceptual and comparative analysis." *British Journal of Industrial Relations* 41(3): 557-582, Clark, I., P. Almond, et al. (2005). "The Americanisation of the European Business System?" *Industrial Relations Journal* 36(6): 494-517, Cheffins, B. R. (2006). Dividends as a substitute for corporate law: the separation of ownership and control in the United Kingdom, European Corporate Governance Institute.

liberal approach adopted in the UK since the Thatcher ruling to stock markets that has encouraged the reception of investment from foreign collective investment schemes (in particular north-american) into their home companies. The result of these developments consisted in the recognition of the role of collective investment schemes as key actors in British stock markets; their role is so significant that the Combined Code even dedicated a specific chapter to them (s.2).²⁴²

Germany has equally demonstrated a surprising level of activity in the activity of institutional investors. The number of Germans investing in shares and collective investment schemes has more than quadrupled between 1991 and 2001 and the largest increase was in investment funds; between 1997 and 2001, the number of persons investing in funds rose from (million) 1.681 to 7.480 and the number of investors in funds exceeds the number of direct share owners. This development reveals that, in contrast to the pure stakeholder economy described earlier in this chapter, in which the major investors were banks and individuals, Germany is evolving more to an investment economy with very active and liquid stock markets; savings bank investment funds and credit cooperative associations are extremely popular businesses that have made an important contribution to this development. The largest investment company active in Europe nowadays is the DWS (*Deustche Wertpapiersparen*), managed by the Deutsche Bank. These investment funds have equally been extremely active in stock markets; the percentage of shares held by investment funds in the stock markets grew from a narrow 5,5% in 1991 to 13,6% in 1999; the majority of the shares hold by foreign investors (which now account to a total of 16% of the shares traded in German stocks) was held by foreign investment funds, in particular North-American pension funds. The effect of these trends are overwhelming because, although Germany has a comparatively low level of companies trading in the stock markets, they are very large companies with a considerable influence over the economic activity. In 2001, institutional investors held 56% of DaimlerChrysler,

²⁴² Gospel, H. and A. Pendleton (2005). Markets and Relationships: Finance, Governance and Labour in the United Kingdom. Corporate Governance and Labour Management: an international comparison. H. Gospel and A. Pendleton, Oxford. ; Davies, P. and G. P. Stapledon (1993). Corporate Governance in the United Kingdom. Aspects of Corporate Governance. M. Isaksson and R. Skog, Juristförlaget. ;

50% of Preussag, 84% of Thyssenkrupp, 80% of Lufthansa, 93% of Allianz and 81% of Deutsche Bank.

The legislative activity has accompanied the growth of activity of investment funds and law-makers have introduced several modifications to the regulatory framework governing the activity of these funds. The old *Kapitalanlagengesellschaftsgesetz* (Law governing the activity of investment companies), which was heavily criticised for being too restrictive as regards the activities of investment funds (notably for limiting the amount of equity shares that they could hold in their portfolio to 30% and further limiting it to 10% in each company), was substituted for the *Investmentmodernisierungsgesetz* (Investment modernisation law). The main innovations brought about by the *Investmentmodernisierungsgesetz* are destined to bring them closer to their anglo-saxon counterparts and encourage further the activities of investment funds in Germany. The main innovations consist in (1) the abolishment of fund categories (there were different legally defined fund types in Germany), (2) new standard simplified sales folder with an emphasis on disclosure to alert the investor in which fund he is investing, (3) a reduction of the initial capital to encourage the setting up of these funds and (4) an expansion of the activities of these funds. This considerably simplifies the German regulation of investment funds and makes them more competitive in relation to their anglo-saxon counterparts (who are generally unregulated limited liability partnerships with a company as a general partner).²⁴³

Banks have equally understood the evolution and they have begun to behave more like investment banks rather than the typical Hausbank. German banks understood crisply clear that the future for the financial business lay in an investment business and they have redefined their share ownership in several companies as an asset management and investment fund business accordingly. They have relaxed the system of cross-shareholdings and interlocking directorates that was fundamental for the former system of stakeholder value and have begun a reduction of their presence in the supervisory boards of publicly traded companies; they have also spun-off their shareholdings in different companies in order to form independent companies to manage those shareholdings; e.g: Deutsche Bank spun-off a subsidiary (DB-

²⁴³ Assman, H.-D. and R. A. Schütze (2007). *Handbuch des Kapitalanlagerechts*, C.H. Beck.

Investor) to manage the industrial assets owner by the bank; CEO Breuer stated that DB-Investor was set up with a profit perspective in order to attract investment. The importance of this modification should not be underestimated because it represents a paradigm shift from patient capital to shareholder value orientation in the banking sector, which has a great influence in Germany. This shift was reinforced by the increased presence of domestic and international institutional investors in the capital structure of banks.

Germany has equally discovered the benefits of private pension funds as a means to complement the insufficiencies of the public system. These private pension funds were recognised in the *DritteFinanzmarktförderungsgesetz* 1998 (Third Law for the promotion of stock markets) and in the *Altersvermögensergänzungsgesetz* 2001 (Law for complementary pension schemes) with the intention of promoting the investment in supplementary pension schemes. These pension schemes are, as their anglo-saxon counterparts, very active in stock markets and inclined towards ideas of shareholder value because they need to provide dividends to their investors in order to remain in business; they need to offer a substantial premium in order to encourage investment and not rely only on the publicly financed fund.

To sum up, one may say that Germany witnessed in the last 20 years a rise in the activity if institutional investors. These institutional investors are not only collective investment schemes but equally financial actors such as banks and insurance companies. These institutional investors have modified their strategies in accordance with ideas of shareholder value and are expected to bring about a seed of change in the German governance landscape dominated by the ideas of stakeholder value.²⁴⁴

France has followed these international trends in terms of the arrival of institutional investors. One of the major challenges that French firms had to

²⁴⁴ Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203. ; Jürgens, U., J. Rupp, et al. (2000). Corporate Governance and Shareholder Value in Deutschland, Wissenschaftszentrum Berlin für Sozialforschung. Goyer, M. (2007). Institutional Investors in French and German Corporate Governance: The Transformation of Corporate Governance and the Stability of Coordination

, Center for European Studies: Program for the Study of Germany and Europe Working Paper Series.

face in the 1990s was named internationalisation, which meant that French products had to be able to compete in international markets if they intended to remain competitive in an increasingly globalised world. The only way for French companies to gather the capital they needed to be able to restructure and compete in international markets was to invest in stock markets, opening their traditionally closed and concentrated ownership structures to outside investors. This opened way for the entry of foreign investors in French capital markets and for them to have an increasing weight in the governance of French firms. In only ten years, the percentage of stock held by institutional foreign investors in French companies increased from 10% to 36%. The impact of this evolution is even more dramatic if we regard it at the level of the individual firms: the following table provides us with a picture of the levels of foreign institutional ownership in some of the French largest companies; we can perceive that some of the largest French champions exhibit the following levels of foreign ownership: Michelin (47%); BNP-Paribas (67%); SocGen (50,8%). This is connected with a second distinguishing feature in France, which consisted in the remarkable levels of market capitalisation in terms of the growth of the stock market that it achieved during the 1990s. The figures reveal that the market capitalisation of French companies as a percentage of GDP grew from 8% in 1980 to 110% in 2004. Germany grew from 9% to 62% and the UK grew from 37% to 178%. Therefore, the French record is an impressive one and the figures reveal unequivocally the importance of the stock markets in French economy.²⁴⁵

The reasons for this spectacular growth in market capitalisation and foreign ownership must be sought within the several institutional features that made France a particularly attractive place for investment by foreign collective investment schemes. One dominant feature consists in the weakness of workplace representatives when compared with their German counterparts; management is extremely powerful and may implement the necessary modifications unilaterally. This creates an appetising environment for foreign

²⁴⁵ Bloch, L. and E. Kremp (1999). Ownership and voting power in France. *The Control of Corporate Europe*. F. Barca and M. Becht, Oxford, Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Architecture et Gouvernance des Organisations, Morin, F. and E. Rigamonti (2002). "Évolution et structure de l'actionnariat en France." *Revue Française de Gestion* 5(141): 155-181.

investors expecting quick returns. Another dominant feature consists in the traditional risk-aversion of French households and the preference to allocate savings in more safe investments, despite decreased returns. Banks and other financial institutions reproduce this institutional endowment since they are reputed to be the ones who invest the least in equities. The combination of these two features obliged French firms to turn to outside investors in order to receive the capital they needed to finance their investments. That explains the increasing prevalence of foreign institutional investors in French stock markets and the radical transformation they underwent in order to adapt their companies towards more anglo-saxon style practices, as the analysis in the evolution in management structures that I described in the former paragraph attempted to exemplify.²⁴⁶

To sum up, one may say that France equally accompanied these international trends in the evolution of the ownership structures – perhaps to a greater extent than Germany – and that (foreign) institutional investors are an inevitable party in French corporate governance that is expected to bring about significant modifications to the old state-led, stakeholder inclusive framework described in the beginning of this chapter.

Portugal has equally accompanied these trends in international corporate governance and institutional investors have made a significant entry in Portuguese stock markets. Although Portugal accompanied international trends at an early stage in investment funds by the creation of two distinct investment funds already in 1964, the nationalisation of the banking sector in 1975 paralysed the industry. The recovery took place in 1986 with the creation of the fund Invest and the industry of investment funds has grown ever since. The great step forward took place in the period between 1986 and 1996, in which Portugal welcomed 230 investment funds; in 2001 it registered 306 investment funds.

Another significant element consists in the fact that investment funds are not the only entities investing in the Portuguese stock markets because banks

²⁴⁶ Goyer, M. (2007). Institutional Investors in French and German Corporate Governance: The Transformation of Corporate Governance and the Stability of Coordination, Center for European Studies: Program for the Study of Germany and Europe Working Paper Series. ; Wirtz, P. (2001). The changing institutions of governance in Corporate France: what drives the process?, FARGO - Centre de Recherche en Finance, Archicecture et Gouvernance des Organisations.

and insurance companies are also extremely active. Nevertheless, they tend to give place to the investment funds, which are currently the main actors within Portuguese stock markets. The most remarkable evolution occurred in the years between 1990 and 2000; in that period, insurance companies saw their market share of investment companies decrease from 9,3% to a feeble 1,4% and investment funds accounted for the remaining 98% (34,2% for pension funds, 8,7% for real estate funds and 55,7% for equity funds). The importance for investment funds in Portugal may be understood if we take into account that nearly all the companies traded in the stock markets have investment funds amid their shareholders and that the average shareholding of each one of those companies amounts to 13%; therefore, investment funds have become key actors in the management of publicly traded companies over the last 20 years. Amid the different types of investment funds active in Portugal, the most significant ones are pension funds and equity funds. Considering that both pension funds and equity funds traditionally take a very activist stance in the governance of the companies in which they participate, it is expected that they have a significant role on the governance of public companies.

Finally, if we take into account the type of investors that contribute to investment funds, it becomes apparent that the majority of them are rich individuals or companies that invest large sums of money into those funds. Households and average private individuals are traditionally reluctant to invest in investment funds and prefer safer investments, such as real estate or savings. This is a significant phenomenon because since investment funds are financed essentially by rich individuals and companies that are not so risk-averse as households and small-investors, they will be willing to take a more activist attitude and intervene more actively in the governance of the companies in which they invest. However, this has occurred only to a very limited extent; since the number of investors in the Portuguese market is not sufficiently large to provide funds with the resources they need, they needed to turn to households and devise means to capture their investment. The only way to overcome the traditional suspicion of private individuals to investment funds consisted in the investment in safer assets, such as real estate and bonds. Although this has helped to overcome the suspicion, it curtailed the ability of

institutional investors to agitate the stock markets and their impact, although significant, has not been as remarkable as expected.²⁴⁷

A final word must be given to the impact of investment funds in the governance of publicly traded companies. There is evidence that they are bringing about a significant modification of the traditional patterns of governance in each one of the jurisdictions covered. Unlike the traditional profile of the typical institutional investor, who sees the company as a money-making machine and prefers a strategy of exit backed up by a portfolio orientation of its investment, investment funds have taken a very activist stance. Their activism may be exercised in relation to companies in general (general activism) or the specific companies in which they invest (specific activism). When investment funds develop general activism, they set up a policy to be pursued in every company in which they invest; when they set up a specific policy, it tends to be designed for the particular company by means of a dialogue with the management board. There is evidence that this general and particular activist stance of investment funds has brought about a convergence of the governance patterns of the companies in which they invest.

As regards the general activism pursued by institutional investors, they have long made pressures in the sense of making companies more shareholder friendly, namely campaigning (1) against non-voting shares, (2) in favour of pre-emptive rights for existing shareholders and (3) making the management board more transparent. There is evidence that they have been very successful in all of them; the first two elements will be analysed in the following chapter; the last element has been analysed in the former chapter, on occasion of the description of how management boards are increasingly more responsive to the interests of the shareholders by means of (1) separation of the role of chairman and CEO; (2) nomination of independent non-executive directors, (3) payment connected to performance measured as the benefits paid to the shareholders albeit not disregarding the interests of the other stakeholders.

As regards the specific activism, there is also evidence that institutional shareholders are increasingly engaged in the governance of the companies in

²⁴⁷ See the study of CMVM (2002). A indústria dos fundos de investimento em Portugal, CMVM.

which they invest. The increasing concentration of ownership in the hands of these shareholders tend to lock them in the companies in which they invest; the small number of large shareholders lowers the collective action costs and creates incentives for monitoring; the evolution in the area of fiduciary duties reveals that although managers are primarily responsible to the shareholders, they may evade liability if they prove that they are considering the interests of the stakeholders when managing the firm. The overall impact of this evolution consisted in creating incentives for relational shareholding: major investors are increasingly building sophisticated legal machineries for the exchange of information and the exercise of influence in the companies in which they invest. Close institution-company links revolve around cooperative stable relationships, with regular meetings and other channels for two-way flows of information and feedback mechanisms. These links are comparable in many ways to the ones established between banks and companies: close-working relationships based on honesty, integrity, stable stakeholding and regular contacts.

This attitude of institutional investors towards the companies in which they invest has brought about significant modifications to the traditional governance patterns: the most remarkable example occurred in the UK, where this idea of relational shareholding brings about a sharp contrast to the traditional outsider system of governance that they exhibited; but the particular activism of institutional investors has also brought about modifications to insider countries (Germany, France, Portugal) because their financial targets and the means of evaluating the performance of the management of the company has made the management boards of these countries more responsive to the interests of the shareholders and approximated their governance patterns to the anglo-saxon ones, although maintaining the traditional pattern in a

phenomenon of path-dependency; the final result will be one of hybridisation of governance.²⁴⁸

2.4.2 dissolution of corporate networks – anti-competitive defenses abolished

A second important development in the ownership structures of the countries under study consisted in the dissolution of the corporate networks. The jurisdictions under study that exhibited concentrated ownership structures often maintained their control by means of a complex network of cross-shareholdings, which protected those companies from takeovers from outside investors and facilitated the coordination of their activities by means of interlocking directorships. There is evidence that these countries are converging towards the anglo-saxon model because the web of cross-shareholdings that characterised their governance structure is progressively being dissolved and exposing their companies to competition and the pressure from shareholders. Unlike in the preceding chapters, this analysis will be limited to countries with concentrated ownership systems because those were the ones who exhibited this evolution that brought their companies closer to the anglo-saxon ones; British companies were seldom involved in corporate networks and they have not evolved towards it; however, the movement of dissolution was accompanied with a number of measures that, despite not standing in the way of convergence towards the anglo-saxon model, maintained some of the fundamental characteristics of the previous structures, providing further evidence of a pattern of hybridisation of governance. Another exception from this analysis is Portugal: although the ownership structure of Portuguese companies is heavily concentrated, the ultimate owners are a few families, banks and large investors that do not coordinate to a great extent their

248 Wymeersch, E. (2002). Convergence or divergence in Corporate Governance patterns in Western Europe. Corporate Governance Regimes - convergence and diversity. J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford, Bebchuk, L. A. and M. J. Roe (2004). A theory of path-dependence in corporate ownership and governance. Convergence and persistence in Corporate Governance. J. N. Gordon and M. J. Roe, Cambridge University Press, Gordon, J. N. and M. J. Roe, Eds. (2004). Convergence and Persistence in Corporate Governance, Cambridge, Braendle, U. C. and J. Noll (2005). "On the convergence of national corporate governance systems." Journal of Interdisciplinay Economics 16.

activities by means of cross-shareholdings. They prefer to set up *Konzern* and manage their activities within the several companies of the group independently of the other groups. The only exception is the banking sector where the Portuguese State bank (*Caixa Geral de Depósitos*) holds controlling shareholdings in other banks but does not take an activist stance. Therefore the analysis will be limited to the cases of Germany and France where the dissolution of corporate networks had a greater impact.

Germany demonstrated a remarkable evolution in this matter. The beginning of this chapter mentioned that interlocking shareholdings was one of the distinguishing characteristics of the consensus-oriented concentrated ownership system that characterised German governance. There are several signs that this traditional pattern of governance is changing considerably in Germany. The number of interlocking directorates in German companies has been declining gradually from 1984 onwards. Between 1984 and 1998, it declined from 12% to less than 7%. The trend is likely to continue as the CEOs of large banks such as the Deutsche Bank have revealed that in the future they will decline and reduce the number of seats in the supervisory boards that they are currently occupying. In addition, managers occupying the seats of the still existing boards are now financially oriented, such as Michael Diekman (*Allianz*), Joseph Ackermann (*Deutsche Bank*), Gerhard Cromme (*Thyssen-Krupp*) and Peter Löscher (*Siemens*); this indicates in itself an important modification of the economic and political function of the network.²⁴⁹

Capital ties between financial and industrial companies began to dissolve in the 1990s; between 1996 and 1998, the number of capital ties between the 100 largest German companies declined from 169 to 108; this sale of large blocks of ownership was encouraged by tax incentives undertaken by the Government; in 2001, the Government issued a tax reform that exempted the sale of share packages (which were previously heavily taxed) from any taxes at all. The basic idea behind the action of the Government was to encourage the sale of large blocks of shareholdings and progressively

²⁴⁹ Bernhardt, W. (2000). "Acquisitions, mergers and cancelations in Germany - in the white water of shareholder value." *Corporate Governance* 8(4): 327-334, Schneider, U. H. (2006). Corporate Governance Issues in Germany - Between Golden October and Nasty November *Corporate Governance Post-Enron. Comparative and International Perspectives*. J. Norton, J. Rickford and J. Kleineman, British Institute of International and Comparative Law.

dismantle the guild that German companies had set up and in which they were embedded at the industry levels.²⁵⁰

German banks also modified to a great extent their traditional role in the industry. German banks have evolved from *Hausbank* to investment bank and this had a severe impact on the ownership ties that they established with companies. Reputation building on international markets was seen as incompatible with the maintenance of strategic ties with companies; if banks wanted to attract foreign investors, they would need to convince those foreign investors that the companies which were active in German markets did not receive a specific cosy protection from those banks and that Germany would be a value terrain for investment, in particular by means of M&A. This led banks to redefine their relationships with companies towards a more arms-length relationship, preferring to establish relational credits rather than taking shareholdings and participating in the risk of the company. Credit banking and close relations to industrial companies may be combined; investment banking and organisational ties may not! The great modification arrived in 1997, when Deutsche bank supported the takeover attempt of Thyssen by Krupp, even though it had a representative at the supervisory board of Thyssen. The combined effect of this evolution reveals that the traditional pattern of networked companies is changing considerably in Germany, although the hardcore of those structures is still maintained and it was not completely erased.²⁵¹

France also made some significant progresses in this area. French companies have been progressively disentangling the web of cross-shareholdings from the beginnings of the 1990s onwards in order to transition from a financial network economy to a financial market economy and make French companies more appealing to foreign institutional investors. Figures reveal that, whereas cross-shareholdings accounted for more than 30% of the

²⁵⁰ Adams, M. (1999). "Cross holdings in Germany." *Journal of Institutional and Theoretical Economics* 155(1): 80-109, Schilling, F. (2001). "Corporate Governance in Germany: the move to shareholder value." *Corporate Governance* 9(3): 148-151, Höpner, M. (2005). Corporate Governance in transition: ten empirical findings on shareholder value and industrial relations in Germany, Max Planck Institute für Gesellschaftsforschung.

²⁵¹ Jürgens, U. and J. Rupp (2002) "The German system of Corporate Governance: characteristics and changes." DOI: FS II 02-203. ; Jürgens, U., J. Rupp, et al. (2000). Corporate Governance and Shareholder Value in Deutschland, Wissenschaftszentrum Berlin für Sozialforschung.

capital of companies in 1990, that proportion had declined to 20% in 1997.²⁵² This reveals that the ownership structure of French companies is becoming less concentrated and that the managers will necessarily have to be more attentive to the signs of the stock market. This effect is increased if we take into account the proportion of permanent shareholders in French companies; this group of permanent shareholders denominates the shareholders that are absolutely committed to a specific company and do not hold investments in other companies. According to the latest statistics, this group of stable shareholders has declined to an average 15% in French companies at the end of the 1990s. Overall, this group of committed shareholders has a reduced base in relation to the increasingly influent group of institutional investors. Although this ownership pattern continues to be highly concentrated if we compare it to anglo-american standards, the comparison with the dynamics of the system over a course of 10 years reveals a surprising evolution towards more anglo-saxon standards and a considerable modification of the standard model of governance. This evolution did not mean a complete erasing of the past however; the ownership structures of French companies continue to reveal a significant hard-core (*noyau-dur*) of interlocking directorships and committed shareholdings. This hard-core was composed essentially of families and state representatives that had a tradition in the company and refused to open hand of their control rights; however, their influence is merely residual and their permanence may be explained only by the wish to maintain their position in the company as a source of income. The evolution of the ownership structure in French companies as regards the dissolution of the corporate networks reveals that it is possible to evolve towards more financial standards maintaining certain key-characteristics of the system, in a true path-dependent evolution that gives to a hybrid system of governance.²⁵³

This comparative analysis of the evolution of the progressive dissolution of corporate networks in countries with concentrated ownership systems may allow us to conclude that the degree of ownership concentration is not so

²⁵² Bloch, L. and E. Kremp (1999). Ownership and voting power in France. The Control of Corporate Europe. F. Barca and M. Becht, Oxford.

²⁵³ Morin, F. (2000). "A transformation in the French model of shareholding and management." Economy and Society 29(1): 36-53. ; Morin, F. and E. Rigamonti (2002). "Évolution et structure de l'actionnariat en France." Revue Française de Gestion 5(141): 155-181.

intense as it used to be. This is several notable consequences: as a preliminary point, one must remark that the dissolution of the corporate networks exposes the companies to the chill winds of competition since they will no longer be able to rely on the coordination of activities and in the transfer of money from one company to the other in order to ensure the sustainability of the system; this must necessarily have severe consequences in terms of the governance of the company as they will be exposed to a much more competitive environment. The second remarkable consequence is the exposure of these companies to the pressure of the stock markets; since the movement of dissolution of corporate networks was equally accompanied with an increase in the market capitalisation of companies and the entry of institutional investors (collective investment schemes and hedge funds, among others) into the capital of those companies, this will bring about considerable modifications to the governance of companies; they will be increasingly under pressure to deliver more short-term results to the institutional shareholders and the threat of takeovers was no longer something from the Anglo-Saxon world but it became a reality. The final remarkable consequence may be the following: despite the entry of these investors into the capital of companies and the considerable changes that they are capable of bringing, the reality is that these countries still maintain a considerable dominant shareholder in the company; this means that although changes appear to be undeniable, they will not lead to a radical revolution of the system towards a fully anglo-saxon system; the most likely result will be one of hybridisation in a more market-oriented concentrated ownership system.

2.4.3 privatisation – State companies hit private competition

The privatisation of large companies was the last area in which the jurisdictions under study revealed a remarkable similar path of evolution. The first part of this thesis referred that privatisation was one of the greatest trends in the 1980s, when great state owned companies were sold to investors in public buy-outs. The privatisation process was connected with widespread dissatisfaction with the State as an owner of companies because the public budget pillow that supported those companies was criticised for not creating incentives to reach competitive standards in terms of efficiency, productivity, innovation and

orientation towards the consumer. A further critic often pointed out to public firms – particularly in France and Portugal – consisted in their manipulation for political purposes, in particular in the cases of monopolies. Privatisation was seen as the key to address these problems: privatisation exposed companies to competition and the pressure of investors, which is seen as creating the biggest incentives for a proper use of the funds available; privatisation was equally praised as an ideal measure to attract foreign investment and gift countries with the funds and know-how necessary to reach more competitive standards. This was a trend observed in all regulations under study that provides further evidence of the convergence of governance patterns in Europe.²⁵⁴

The most remarkable privatisation process took place in the **UK**. During the Thatcher ruling, there was an widespread perception that the poor-economic performance of the 1970s and the disappointing results reached by those companies during the same period (many were actually operating at a loss) was caused by the fact that those companies were not being run efficiently and that private investors could do a better job. The answer lay in offering those companies to investors. The first stages of the privatisation program took place in 1979 with the sale of 50% of British Aerospace. The results were surprising because the race for the acquisition of shares in the company revealed that the domestic market was not so small that it could not provide those shares to the public. Also, the surprising appetite by small investors for the shares of the company revealed that the State could alleviate its spending on the company and inject a considerable number of money into it without opening hand of its control. The success of the privatisation program of British Aerospace opened way for the privatisation of nearly all the remaining public companies.

Privatisation was equally accompanied with measures to maintain the independence of those companies. Since the majority of those companies were operating in a condition of monopoly (legal or natural) or providing essential services, there was the preoccupation that these privatisation programs could be hazardous to the economy and to society because the attitudes of private

²⁵⁴ Estrin, P. (1999). State ownership, corporate governance and privatisation. Corporate Governance, State Owned Enterprises and Privatisation. OCDE. Paris, OCDE.

parties when operating in conditions of monopoly or providing essential services are considerably different from the attitudes of the State. There were two means to preserve the services that those companies were offering and reach the objectives of the program. Firstly, privatisation was often coupled with dispersed ownership structures; special conditions for households and employee/management buyout programs were created in order to attempt to keep those companies from falling prey to the hands of majority shareholders; secondly, the privatisation program was also coupled with the implementation of regulatory agencies, in order to safeguard the interests of the consumers when the market conditions were unable to do so.

The combined effect of these developments implied a considerable modification to the governance of public companies: they became exposed to the chill-winds of competition and to the pressure of shareholders; they had to devise the same governance mechanisms as private companies to reduce the agency costs that their ownership structures created; finally, the interest of the consumers – which was seen as the key interest in all the process – was safeguarded by means of the manipulation of the ownership structures or the creation of regulatory agencies that conditioned the sector and reduced the margin of manoeuvre of the management of those companies.²⁵⁵

France also exhibited a significant experience with privatisation. The experience of privatisation in France was equally impressive because the size of the public sector in France and the influence of the State in the governance of large public companies is overwhelming. The deregulatory process in French corporate governance must be placed within its due context. The privatisation process was initiated in 1984 during the Mitterrand government. Mitterrand perceived that the public budget was not capable of supporting the competitiveness to which public companies were exposed to and initiated a movement of deregulation destined to lay the foundations for a rehabilitation of the capital markets. The objectives of the privatisation programs were clear: to provide French public companies with the necessary capital and know-how to

²⁵⁵ OECD (1999). *Corporate Governance, State Owned Enterprises and Privatisation*, OECD, Armour, J., S. Deakin, et al. (2003). "Shareholder primacy and the trajectory of UK Corporate Governance." *British Journal of Industrial Relations* 41(3): 531-555, Gospel, H. and A. Pendleton (2005). Markets and Relationships: Finance, Governance and Labour in the United Kingdom. *Corporate Governance and Labour Management: an international comparison* H. Gospel and A. Pendleton, Oxford.

finance their investments and improve their competitiveness in world markets.²⁵⁶

The problem lay in the fact that the French government did not want to open hands of their companies and intended to reserve to it the possibility of influencing, at least indirectly, the policies that those companies pursued in the French markets. The means by which the Government reserved the intervention in the life of companies consisted in the creation of hard-cores (*noyeaux-durs*) of committed shareholders that stabilised the life of the company during the waves of competition. These hard-cores are very much similar to the ones analysed previously in the dissolution of corporate networks. As opposed to the strategy pursued in the UK, France undertook a strategy of strategic configuration, in which the manager cherry-picks the hard-core of investors that will remain the ultimate owners of the company before opening their shareholdings to other investors. The process goes as follows: the Government selects a PDG that will be in charge of the privatisation process; the PDG personally establishes the contacts with those that will remain the ultimate owners of the company, the hard-core of stable shareholders; then the PDG initiates the privatisation process, selling the shares of the company in a sequential way: firstly, the stable shareholders get the key shareholdings; secondly, the institutional investors get the non-essential trenches that allow them to exert some influence; finally, the public at large may acquire participations in the company, causing public companies to have a certain percentage of dispersed ownership. When the sell-off is complete, the PDG summons a general meeting to elect the new board of directors. This was the means by which France managed to privatise its formerly State owned companies and attract foreign capital and, at the same time, preserve a strategic position within those companies that ensured that they would not jeopardise the social objectives they were set up to.²⁵⁷

Germany followed the same trends in privatisation. German state companies went through the same problems as their other European counterparts during the 1970s and 1980s; however, Germany's problems were

²⁵⁶ Eichengreen, B. (2007). The European Economy since 1945 - coordinated capitalism and beyond. Princeton University Press.

²⁵⁷ Morin, F. Ibid. The privatisation process and corporate governance: the French case.

aggravated following the reunification in 1989, since nearly all former east-german companies were economically inadequate to compete in the aggressive capitalist world. That is the reason why Germany decided to undergo a “follow the leader” approach and embark on a wide-ranging privatisation program during the 1990s. Privatisation was seen as the most adequate measure to inject capital in east-german companies and restructure some companies in the German industrial sector.

The German Government initiated privatisation movements during the 1990s of which the most remarkable example was the privatisation of Deutsche Telekom. The privatisation of Deutsche Telekom was so successful that it created a trend of investment amid German households; between 1990 and 2001, the percentage of the German population owning stock or investing in mutual funds rose from 8,9% to 20%. The traditional risk-aversion of German private individuals seemed to be shed away and Germany was becoming increasingly a nation of investors. Reunification contributed a great deal to this pressure of privatisation. In the follow up of the enormous losses faced by the German federal agency for the sale of east-german companies (*Treuhändanstalt*), privatisation was seen as the only way to restructure the archaic east-german industry.²⁵⁸

Another important issue consisted in the fact that Germany followed the same trends as the UK and France in ensuring that their companies did not succumb to the chill winds of competition. Privatisation was accompanied with measures to ensure that the interests of the consumers took precedence over the interests of the investors and that their national industries would not jeopardise the social aims they were set up to. In that aspect, Germany profited a great deal from the previous experience of the UK and managed to take advantage of its pioneering. Initial public offerings were made in such a way as to create incentives for the creation of a dispersed ownership structure, so that German firms did not fall prey to a handful of greedy investors; Germany also introduced a number of regulatory agencies and regulated the sectors in which they were active in order to control the activities of those companies. The

²⁵⁸ Schilling, F. (2001). "Corporate Governance in Germany: the move to shareholder value." *Corporate Governance* 9(3): 148-151, Höpner, M. (2005). Corporate Governance in transition: ten empirical findings on shareholder value and industrial relations in Germany, Max Planck Institute für Gesellschaftsforschung.

reasons for these precautions are easy to guess: since the majority of those companies were old state monopolies that were responsible for high levels of employment, there was the concern that those monopolies at the hands of private parties would create adverse effects; similarly, there was also the concern to avoid radical downsizings and mass-layoffs so as to avoid the weight on the unemployment insurance. Finally, privatisation also had an impact on the strategic change of banks towards investment banking. Banks received lucrative orders from investors to organise privatisation and they saw in that movement a golden opportunity to make money. Investors needed leverage to finance their share purchases; german households made their funds available for investment in shares. This contributed to the re-orientation of the shareholdings of German banks from Hausbank to portfolio investments and the consequential governance modifications that occurred in the companies in which they invested: more shareholder-friendly, financial investments. The spill-over effects of privatisation are large because the majority of privatised companies are pioneers in the adoption of shareholder value practices that are currently being emulated by other companies; their effects on banks and the consequential modifications that the banking sector introduced in the companies in which they invested reveals how widespread the effects of privatisation are.²⁵⁹

Portugal also introduced extensive privatisation programs in the 1990s. The privatisation programs in Portugal also mimic the experiences found in the other jurisdictions under study and provide further evidence of a trend of convergence in the governance patterns. The origins of the Portuguese privatisation program must be traced back to the revolution in 1974. The left-wing forces that dominated the revolution enforced an extensive nationalisation program that brought into state ownership 244 firms from key sectors of the economy.²⁶⁰ This fact corresponded to a considerable number of nationalisation

²⁵⁹ Beyer, J. and M. Höpner "The disintegration of organised capitalism: German corporate governance in the 1990s." *West European Politics* 26(4): 179-198. Berrar, C. (2001). Die Entwicklung der Corporate Governance in Deutschland im internationalen Vergleich. Baden-Baden, Nomos Verlagsgesellschaft, Höpner, M. (2003b). Wer beherrscht die Unternehmen? Shareholder Value, Managerherrschaft und Mitbestimmung in Deutschland. Campus Verlag.

²⁶⁰ In fact, the nationalisation program was so extensive that it even nationalised a barber-shop and two restaurants in Oporto.

operations given the participation in other firms by the ones that were directly nationalised. Furthermore, in 1977 a law (46/77) restricted the access of private entrepreneurs to certain sectors (insurance, banking, chemicals, shipbuilding, cements, brewing, and tobacco). This law was partially revoked in 1983 (decree law no 406/83) and as a result of its latest version (1997), few sectors still remain monopoly of the State, namely postal services, railways and ports. The privatisation process began in 1988 when a law was passed approving a partial (re)privatisation of state owned firms (up to 49% of their capital). Only after the Constitutional changes in 1989 was the privatisation process in all its extent made possible. The privatisation bill 11/90 made way for an ambitious privatisation program (more than 100 firms were privatised by the end of 1999). Still, the law restricted the operations to the sectors already open to private economic initiative.²⁶¹

The privatisation program was equally accompanied with the same measures as in other countries to ensure that these companies – which operated in key sectors of the economy – did not fall prey to the egoism of investors. As a preliminary point it must be said that the privatisation operations were made in such a way as to ensure an adequate dispersion of capital. One of the objectives of the privatisation was to allow for a wide participation of Portuguese citizens in the ownership of privatised firms through an adequate dispersion of capital, giving particular attention to the employees of the privatised firms and small subscribers. In order to attain this objective, part of the shares privatised were reserved for small subscribers and specifically for employees, who also benefited from lower prices than other small subscribers. Also, some of the privatised firms included, in their remuneration policy, the granting of shares to their employees. Moreover, they also had special terms of payment not available to other small subscribers namely delayed payment without interest, payment by instalment and cash discounts. In some cases, loans were granted in order to encourage employee share ownership. Finally, tax concessions were afforded to employee owners (higher amount of abatements to income tax). However, if these benefits were designed to enhance employee ownership, their conversion into immediate profits had to be

²⁶¹ Moura Ramos, L. and R. Martins (2002). Privatisation in Portugal: Employee Owners or Just Happy Employees? . G. d. E. M. e. Financeiros. Coimbra, Faculdade de Economia da Universidade de Coimbra.

limited. A period of time was defined (two years in the law no 84/88 of 1998, defined for each case after the privatisation bill of 1990) where employees were forced to keep their shares (the unavailability period). Also since 1990, within this period, employees could not delegate their voting rights. Another restriction was placed on the number of shares that each employee could buy, a limit defined for each different operation. Later on the decree law 243/91 gave employees the right to form investment funds with the shares bought. This permitted employees to overcome some of the constraints that small owners faced like limits to information access and real influence on the firm's General Assembly. Moreover this fund could also contain assets from other companies.²⁶²

The privatisation of some state owned companies did not mean that the State was entirely absent from those companies, as it maintains a strategic participation in the key sectors of the economy in order to be aware of what is going on and be able to influence the management of the company. In this sense, Portugal followed to a great extent the same strategy followed by France.

Finally, Portugal also followed the current trend of setting up of regulatory agencies in order to regulate the activities of private companies and ensure that they are run most effectively for the benefit of the consumers. There are currently a number of regulatory agencies in fields such as: energy, telecommunications, media and others. Considering that the presidents of the regulatory agencies are nominated by the State, this ensures the adequate independence and the protection of the public interest. These developments reveal that Portugal has accompanied the international trends in terms of privatisation.²⁶³

²⁶² Nunes, J. and L. Montanheiro (1997). "Privatisation in Portugal: an insight into the effects of a new political strategy." *Competitiveness Review* 7(2): 59-78.

²⁶³ Moura Ramos, L. and R. Martins (2002). Privatisation in Portugal: Employee Owners or Just Happy Employees? . G. d. E. M. e. Financeiros. Coimbra, Faculdade de Economia da Universidade de Coimbra.

2.4.4 conclusion - hybridisation of ownership structures: relational systems are more marketised and market systems are more relational

The analysis of the evolution of the ownership structures in public companies in all the jurisdictions under study allows us to extract a number of conclusions. As a preliminary point one must say that the evolution in ownership structures must be seen at the light of the change in economical conditions that initiated in 1974 - following the oil shock - and proceeded throughout much of the 1980s and 1990s. The increasing financialisation of the economy, the opening of the financial markets and the increased international competition had to modify the pre-existing institutional structure of ownership that each country had developed previously. This had a number of common impacts that must be seen within the context of each country.

One remarkable common consequence consists in the fact that all the countries under analysis seem to be currently evolving towards a greater degree of financialisation of their economies. The arrival of institutional investors is the most remarkable sign of financialisation of the economy and of the governance structure of companies. However, this does not mean that the governance systems of the jurisdictions under study will mimic in the future the one found in the US. The arrival of institutional investors in the UK has led to a concentration of ownership and an increasing call for a more insider/relational type of governance, that approximates the British model closer to the continental model. In Germany, France and Portugal, although institutional investors have brought about a considerable degree of agitation in the stock markets, their pressure is not so overwhelming as to eliminate the former patterns of governance. The most likely result appears to be a hybrid system of governance in which each country will retain its traditional pattern (path-dependencies) although incorporating patterns from the other systems and modifying to some extent its pre-existing structure towards a more market based governance in relational systems and a more relational based governance in market systems.

The disentangling of the dense network of cross-shareholdings and interlocking ownerships, that was seen as essential to preserve the autonomy of the companies and the long-term character of their operations, is currently being dismantled and companies are evolving towards the anglo-saxon model. They are increasingly competing and exposed to the pressures of capital

markets. Nevertheless, the dismantling was accompanied with measures to ensure the maintenance of a residual group of control, which means that the evolution towards the anglo-saxon model is not full. Another important element consists in the fact that the privatisation program has exposed formerly public companies to the pressure of competition and the investors. Nevertheless, in virtually all jurisdictions under study, this operation was made with a concern to ensure a wide degree of dispersion of the shareholdings and the setting up of regulatory mechanisms to guarantee the public interest (such as regulatory agencies or qualified shareholdings) that limits the degree of exposure of those companies to the pressures of the market.

The combined effect of these three developments consists in the hybridisation of the governance patterns: although the ownership structures of companies are effectively evolving towards a more anglo-saxon pattern of pressure of institutional shareholders and exposure to the stock market, the degree of evolution is limited by (deliberate) path-dependencies that preserve the hard-core of the pre-existing governance model; the final result appears to be one of hybridisation of the governance patterns in Europe: the continental patterns will slightly evolve towards more anglo-saxon patterns with companies increasingly exposed to stock-market pressures and institutional investors, albeit with a limited extent; the UK model is getting closer to the continental model by means of the emphasis on relational shareholdings.

2.5 The evolution in the rights of shareholder- power to the shareholders!

A third point in which all the jurisdictions under study revealed a surprising degree of convergence consisted in the reinforcement of the rights of shareholders of public companies. This is a point of extreme importance because since shareholders enjoy substantive control rights over the company and the activity of the managers on account of their position as residual claimants of the company, a reinforcement of their rights creates incentives for them to deepen further their engagement in the life of the company and enhance a stronger control over the activity of the managers. The mechanisms used to reinforce their position within the company varies within the several jurisdictions however because the governance structures are quite different

from country to country and “one size fits all” solutions do not adequately reflect the specificities of the national systems. Nevertheless, although the legal techniques used to reinforce the rights of the shareholders are divergent, there appears to be a common path of evolution in all the jurisdictions under study that may be synthesised in the following points: (1) the reinforcement of the rights to information, (2) the revival of the general meeting, (2) the increased reliance on shareholder litigation. It is worth seeing each one of these developments in detail before getting a clearer glimpse of the whole picture.

2.5.1 reinforcement of the rights to information - active shareholder engagement and accountability to the company

One of the common paths of evolution registered in almost all the jurisdictions under study consisted in the reinforcement of shareholders’ rights to information. The disclosure of information to the shareholders might be equated as an entry/exit governance strategy that attempts to reduce the agency costs that occur between the management and the shareholders by means of the reduction of the information gap that exists between the holders of capital and the decision-makers in order to allow the shareholders to make informed decisions concerning the exercise of their voting rights or the acquisition/maintenance of their shareholdings. It is generally acknowledged that information fulfils three distinct governance functions: (a) enforcement, (b) educative and (c) regulatory. The enforcement function of the right to information refers to the influence rights that shareholders enjoy in companies, such as the right to vote or the right to file a derivative suit. The exercise of voting rights (particularly in the situations of qualified majorities) or the exercise of the derivative suites would be rendered meaningless if the shareholders did not have the necessary elements to allow them to evaluate the behaviour of the management and undertake the necessary actions to make them more accountable to their interests. The educative function of the right to information refers to the encouragement of shareholder democracy in companies that is often praised but seldom enforced.²⁶⁴ The increased influence of shareholders in companies and the their involvement in the decision-making structure is seen

²⁶⁴ Bebchuck, L. (2005). "The case for increasing shareholder power." *Harvard Law Review* 118(3): 833-913.

as an element of good corporate governance that will tend to reduce even further the scope for self-interested decisions of the management board. The following lines will attempt to demonstrate that this seems to have been one of the guiding lines behind the reform of Company Law in the UK in the Companies Act 2006. The regulatory function of the right to information refers to the pressure placed upon firms for them to commit themselves to the observance of good governance strategies that go beyond the enforceable minimum requirements of corporate law. The strategy is essentially a reputational one; firms are expected to adhere to good corporate governance standards by providing information on their observance of what is seen as good law. Firms that refuse to provide that information or that simply do not adhere to those standards without providing for a reasonable explanation will be blacklisted and that is expected to have an impact over the decisions of investors.²⁶⁵ The combined effect of these functions is to force firms to adhere to governance strategies that are essentially to the benefit of shareholders because the ignorance of them will create incentives for shareholders to exercise their control rights in relation to the management of simply reduce the value of the shares in the market. It is now time to observe how each country implemented this right to information in closer detail.

France is a country that has introduced extensive rights to information in the reform of its company law undertaken in 2001 by the *Loi des Nouvelles Régulations Économiques* (LNRE) and in 2003 by the *Loi sur la Sécurité Financière* (LSF). These acts, already mentioned several times in this thesis, have introduced several modifications to the existing company law and the chapter relative to the information to be provided to the shareholders was one of the most important. The logic underlying the disclosure of information to the shareholders was one of protection of the minority shareholders. One of the key characteristics of the post-war French corporate governance consisted in the high degree of ownership concentration. This concentration created substantial agency costs of majority shareholders vis-à-vis minority shareholders that discouraged investments in capital markets. The traditional instruments used for the protection of minority shareholders – namely the

²⁶⁵ Hertig, G., R. Kraakman, et al. (2004). Issuers and Investor Protection. The Anatomy of Corporate Law. H. Hansmann and R. Kraakman, Oxford. Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press.

mandatory shareholdings by the members of the management board (L.225-25 Code Commercial) – were often rendered meaningless because the fear that the holders of decision power would tend to behave more like minority shareholders in order to increase the value of their shares led majority shareholders to oblige the members of the management board to subscribe insignificant numbers of shares (that often did not provide them even with one vote) and to compensate the observance of the majority shareholders' interests by other means.²⁶⁶ This situation raised intense agency costs in relation to the minority shareholders because the collective action costs kept them from forming minority blockages and the lack of information prevented them from exercising derivative actions. The result was a discouragement of the investment in capital markets that left firms with difficulties to raise capital.²⁶⁷

The LNRE and the LSF intended to attack these difficulties by means of the provision of information to shareholders. The LNRE intended to expand the information, with a number of new obligations, and the LSF intended to densify the information to be provided, in order to render the duties to inform more concrete and accessible. The main focus of attention consisted in the provision of information relating to the activities of the management board and the other shareholders. The provision of information relating to the activities of the management board was destined to lift the veil of secrecy that surrounded to working of the management board and make the decision-making procedure more accessible to the shareholders. This explains the adding of a new paragraph to art. L.225-37 of the Code du Commerce stating that the president of the board had a duty to disclose the conditions of preparation and organisation of the workings of the board and the internal control procedures implemented by the company, besides any limitations to the power of the president; the president of the supervisory board (*conseil de surveillance*) has an identical duty (L-225-68). This new report intends to provide shareholders

²⁶⁶ Ripert, G. and R. Roblot (1996). Traité de Droit Commercial, LGDJ, Merle, P. (2008). Droit Commercial. Sociétés commerciales, Dalloz.

²⁶⁷ Drummond, F. (2005). "L'information des actionnaires et des investisseurs." Revue de Jurisprudence Commerciale: 15 ff, Teller, M. (2007). "L'information des sociétés cotées et non cotées: une évolution certaine, de nouveaux risques probables." Revue Trimestrielle de Droit Commercial: 17 ff. Dom, J.-P. (2001). "La protection des minoritaires." Revue des Sociétés 119: 533-560.

with a precise knowledge of the functioning of the management and the supervisory boards and an access to the control methods that allows ensuring the reliability of the financial information and the forecasting of the company risks. It consists in the first text destined to provide information to the shareholders on the internal governance structure of the company. This report has the further effect of allowing the shareholder to penetrate the decision-making structure of the company and benefit from information that is not adequately expressed by numbers. This report is not to be confused with the management report mentioned above, that should provide information on the activities of the management board. This is an independent report that is destined to elucidate even further the shareholder of the decision-making structure within the board and that should be added as an annex to the management report. In the event that the company is part of a group of companies, the information to be provided is even more demanding: each company that is part of the group (provided that it is a société anonyme) should make an independent report and the company that is the head of the group should make a general report covering all the companies of the group.²⁶⁸

The content of this report deserves further considerations. This report should elucidate shareholders of (1) the preparation and organisation of the works of the board (management and supervisory), (2) the internal control procedures implemented in the company and (3) the limitations to the President's powers. The first distinguishing feature of this duty is that the company is reserved a wide degree of freedom in the determination of its internal organisation. The law does not mandate any substantive requirements relating to the organisation of the works of the board or of the internal control procedures. It merely requires the board to implement them and make them available to the public (=disclosure). This is an important element because the underlying reason behind the statute is that the market should reward good corporate governance and punish bad internal governance. The more transparent a company becomes, the more valuable it is expected to turn in the market. The content of the first obligation (the organisation of the workings of the board) is not expected to be extensive; it merely requires disclosure of the

²⁶⁸ Urbain-Parléani, I. (2003). "Les nouvelles obligations d'information des dirigeants envers les actionnaires." Ibid. 121: 779-793, Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz.

number of meetings, duration, subjects discussed and presences at the meetings. The content of the second obligation (internal control procedures) is expected to be more demanding. This innovation was transplanted from Sarbanes-Oxley and the anglo-saxon experience should be the guiding principle behind it. The company is now expected to implement internal procedures destined to detect frauds, undercapitalisation, weak performances and the disrespect of the internal bylaws of the company in terms of accounts, remuneration, strategy and investments. The objective of these controls is to provide the shareholders with an instrument destined to provide reasonable assurance as to the attainments of the following objectives: implementation of the strategies, reliability of the financial information and conformity to the statutes and bylaws. The procedures implemented to attain these objectives are organised around three poles: control environment, risk evaluation and information and communication. The overall effect of these demands is simple to observe: it is destined to provide the shareholder with sufficient and reliable information that the company has implemented internal control procedures destined to ensure that the acts of management are in conformity with the statutes and bylaws of the company and that the financial information effectively reflects the reality of the situation of the company.²⁶⁹ The objective of the third obligation (limitations to the powers of the President) is destined to disclose to the market the real power and influence of the President within the company. It is worth noting that previously French company law was strongly managerial, thrusting the direction of the company to the all-mighty PDG. This character has been suffering strong blows lately as there is the possibility to divide its role between the President and the Director and there is also the possibility to implement conventional limitations to its power. The public should

²⁶⁹ This second obligation deserves a further consideration. The provision is only applicable to *public companies* (*sociétés anonymes*). Nevertheless, one should take into account that the *sociétés anonymes* vary to a great extent between them: there are large listed companies, medium-sized unlisted companies and even small family-like companies. Art. L225-37 does not oblige the company to implement internal control procedures; it merely obliges the president to mention them in the report. This distinction has two objectives: it intends to safeguard the position of closely held companies, in which family ties and close monitoring substitute the need for an internal control procedure; and it intends to oblige listed companies to suffer the consequences of the market in the *absence* or in the *inadequacy* of an effective *internal control procedure*. Since we are dealing with disclosure, the last word belongs to the market and the board must convince the market of its management. Where there is no market for shares, this obligation is meaningless and substituted by other monitoring devices.

be properly informed of these limitations however in order to be acquainted with the deviations from the traditional role of French corporate governance.

In addition, shareholders are entitled to increased information about the members of the board. One of the first improvements introduced by the LNRE consists in disclosure of the mandates exercised by the members of the management board in other companies (L.225-102-1). This rule is not only destined to bind the board members to the observance of the rule that limits the number of mandates that they may accumulate; further on, it has a more far-reaching objective. Its main purpose consists in the disclosure of the relationships in which the members of the management board are involved and to allow the shareholders to evaluate the potential conflicts of interest that may arise.

This is even more so if we consider that the persons covered by the obligation are not only the members of the management board *per se* but equally the members of the supervisory board and of the *directoire*.²⁷⁰ This obligation of disclosure was also extended (albeit to a limited extent) to the salary of the managers. Although initially the LNRE intended to impose an anglo-saxon style of disclosure of the individual remuneration perceived by each member of the management board, the LSF gave a severe blow to this obligation and restricted it to a severe extent. In accordance with the current regime, only public traded companies are subject to this obligation of disclosure; but in exchange, these companies are subject to a severe scrutiny. In accordance with the renewed L.225-102-1 Code du Commerce, the shareholders should be informed in a report to be made by the management of all the remuneration and advantages perceived by each individual member of the management board of the company, even if the remuneration does not come from the company that they manage but particularly from the daughter/

²⁷⁰ Some authors have tended to contest the precise efficacy of this obligation of information because of the *problems of enforcement* that the practice raises. The *injunction procedure* (a compulsory procedure to obtain access to documents) envisaged by L.238-1 does not cover the disclosure of the mandates exercised in other companies and the *Code du Commerce* does not provide for any sanction for its inobservance, apart from the possibility of tortious liability. The only sanction may be the shareholder vote, although this raises considerable difficulties for the *minority shareholders*, who face significant *collective action problems* and may not form a sufficient majority to overturn the management board. See Dom, J.-P. (2001). "La protection des minoritaires." *Revue des Sociétés* 119: 533-560.

parent companies in the event that the company is part of a group of companies.

This information should cover both the fixed, variable and exceptional components of the remuneration and the criteria and circumstances in which they should be provided; it should equally cover the compromises assumed by the company to the benefit of its members of the management board. The report should include the stock options within the remuneration and advantages that each individual member receives. The legislator opted to provide a special attention to the stock options held by the members of the board and the employees. The key provisions here are L.225-102-1 and 225-184. The first provision commands the management board to inform the general meeting of the shares (*titres de capital*), bonds (*titres de créances*) or pre-emptive shares (*titres donnant accès au capital ou donnant droit à l'attribution de titres de créances*) hold by the members of the management board. In addition, the second provision commands the management board to inform each year the general meeting of the name, date and price of the stock options granted to each member of the management board of the company even if their refer to shares belonging to companies associated with the company that they manage.²⁷¹

The LNRE and the LSF also took into account the developments in the corporate governance literature that emphasise a sustainable economic performance in order to achieve the growth of the company. One of the ways to achieve this was to grant shareholders with information concerning several aspects of the company. One of the points affected consists in the management of the companies. The management board of publicly traded companies was trusted with the obligation to draw up a report in which it laid out in a detailed fashion the ways in which the company takes into account the social and environmental impacts of their activities (L.225-102-1(5)). Although this provision seems laconic for the time being it is nonetheless important in the sense that it attempts to further social conception of the company in French company law. But the legislator decided to go even further and draw up a procedure for shareholders to obtain more accurate information regarding the

²⁷¹ This refers to daughter companies and companies that are engaged in a *groupement d'intérêt économique* (L.225-180).

management of the company. Art. L.225-231 allows shareholders that hold or compose 5% of the company's capital to ask a number of questions to the President of the company concerning the management of the company and of the companies held by it. The president and the management board are under a strict duty to provide an answer to the questions of the shareholders in a way that interests the good governance of the company, i.e they are obliged to answer in such a way as to promote the good management of the company.²⁷²

The **UK** followed a path identical to that of France in the expansion of information rights. In contrast to France, one of the problems of the British governance system consisted in the lack of involvement of the shareholders as a whole in the company in which they invested; the British shareholder tends to regard its shareholding in a purely financial perspective and opted for strategies of exit instead of voice in the event that it was not satisfied with the governance of the company. This raised severe agency costs of managers vis-à-vis shareholders in the sense that the managers had to pay attention to the signals of the stock market and this curtailed the possibility of sustainable economic development of the company in the medium and long run. The Company Act 2006 attempted to modify this traditional culture and increase the engagement of the shareholders in the company in order to achieve a continental style long-term investment culture. One of the ways used to achieve this was through the enhancement of the rights to information. It is worth viewing in its due context the impact of the information rights in British corporate governance.

The reform to British company law was made under the premise that there was a lack of communication between directors and shareholders and that this had a negative impact over the management of the companies because neither party could understand well the needs and wants of the other. In addition, the British Government considered that the traditional investment attitude of British shareholders was no longer positive as it curtailed the possibility for incremental strategies of growth that could underpin the success of a number of industries. That was the reason why the reform to British

²⁷² Saintourens, B. (2002). "Les dispositions du décret du 3 mai 2002 relatives aux organes de directions de la société anonyme." *Revue des Sociétés* 120: 430-440. ; Saintourens, B. (2001). "Les organes de direction de la société anonyme après la loi relative aux nouvelles régulations économiques " *Revue des Sociétés* 119: 515-533. Dom, J.-P. (2001). "La protection des minoritaires." *Revue des Sociétés* 119: 533-560. Urbain-Parléani, I. (2003). "Les nouvelles obligations d'information des dirigeants envers les actionnaires." *Revue des Sociétés* 121: 779-793.

company law intended to create incentives for the engagement of the shareholders in the company. The engagement of the shareholders of the company was seen as complementary to the reform of the fiduciary duties of directors that, as we saw above, were underpinned in the idea of enlightened shareholder value, obliging managers to take into account the interests of the stakeholders in the promotion of the success of the company.²⁷³

Information was the strategy to achieve this engagement of the shareholders in the company. The Government considered that informed shareholders could be the best judges of the observance of the fiduciary duties by the managers and the best allocation of the resources that they made available to the company. For that purpose, the Government introduced a number of measures destined to enhance the timeliness and transparency of the decision-making procedures within the company and allow shareholders to have full access to the ways in which the company is being managed. There are two main areas of intervention within the information rights granted to shareholders: (a) accounts and directors' report and (b) general meeting. As regards the accounts and directors' reports, public companies will be obliged to draw up a detailed report of the individual accounts of the company in such a way as to provide a clear image of the financial situation of the company (s. 394). These individual accounts must be made each year for the company and should reflect in a progressive way the financial evolution of the company. In addition to the accounts report, directors must make each financial year a directors' report of the company, in which it should lay out in a clear way the identity of the directors of the company, the main activities undertaken by the company during the financial year (s.416(1)) and a business review, in which it should lay out the actions undertaken to fulfil its fiduciary duty to promote the success of the company (s.417). This business review is subject to a particularly stringent regulation as it should elucidate shareholders of the development and performance of the business of the company, the main trends likely to affect its future development, among other factors. In the event that the company is a quoted company, directors are required to draw up a third report:

²⁷³ Barry, P. (2005). Company Law Reform White Paper, Department for Trade and Industry, Ferran, E. (2005). Company Law Reform in the UK: a progress report, European Corporate Governance Institute, Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

a remuneration report (s.420). These three reports should be communicated to the shareholders individually, albeit it may be made by electronic form if the shareholders so agree such as to reduce costs. These disclosure requirements are more stringent for quoted companies. These companies are required to put on their website the these three reports (accounts, directors and remuneration) plus the preliminary announcements of their annual results and their full accounts and results. In addition, the use of electronic communications with shareholders should become the rule and paper the exception. The shareholders will be entitled, for instance, to a summary version of the full annual report and accounts.²⁷⁴

The understanding of the precise impact of these increased information rights must be linked to the substantial modifications introduced in the general meeting. The first significant innovation consists in the requirement for public companies to hold an annual general meeting (something not required of private companies) in order to make an assessment of the performance of the company (s.336(1)). The holding of the general meeting was linked to the reporting cycle in order to ensure that shareholders have a timely opportunity to hold directors to account. S.336(1) of the Companies' Act 2006 requires public companies to hold an annual general meeting within a period of 6 months of the end of the financial year. This annual general meeting is of extreme importance because it will oblige the management board to expose the accounts and reports of the company to the discretion of the shareholders and allow shareholders to hold management to account in this meeting. That is the reason why the obligation to hold an annual general meeting within a 6 months period was complemented with a number of provisions destined to enhance its effectiveness. The empowerment of the annual general meeting was achieved with a number of specific provisions that will be analysed in the following point. The most important point to retain was that the obligation to hold an annual general meeting linked to the reporting cycle was a means to achieve the engagement of the shareholders. Managers are under a pressure to inform shareholders of the concrete running of the business and of its effective financial situation and expose their reports to the judgement of the

²⁷⁴ Barry, P. (2005). Company Law Reform White Paper, Department for Trade and Industry, Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

shareholders in the annual general meeting. The combined effect of these measures was to use the information of the shareholders as a means to achieve their engagement in the life of the business and drift away from a strategy of exit towards a strategy of voice. This approximates the governance standards of the UK closer to the ones observed in continental Europe and serves as a further evidence of the convergence of governance patterns.²⁷⁵

Germany and **Portugal** will not be analysed in this point because their existing company statutes already provided shareholders with sufficient information rights and have not introduced any relevant measures concerning this subject.

2.5.2 revival of the general meeting - improving residual control rights

The rediscovery of the general meeting and the pressure towards a greater level of shareholder democracy was another area in which the regulations under study demonstrated a surprising degree of convergence. The general meeting is an organ of the utmost importance in company law because it is the place where the shareholders may exercise the influence rights that their position as residual claimants in the company grant them in order to control the activities of the management board and contribute to the reduction of the agency costs that occur between them. It is the natural development of the reinforcement of shareholders' rights to information because the increased information on the financial situation and activities of the board will create incentives for the shareholders to state their opinions and attempt to influence the management board in general meetings; it is therefore not surprising that the development of the information rights was accompanied with attempts to revive the general meeting of the shareholders. The countries under study revealed a surprising degree of convergence in the rediscovery of the general meeting as a means of empowering the shareholders: the following lines will attempt to contextualise the main modifications within the features of the national governance system.

²⁷⁵ Ferran, E. (2005). Company Law Reform in the UK: a progress report, European Corporate Governance Institute. Barry, P. (2005). Company Law Reform White Paper, Department for Trade and Industry. Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

Germany is perhaps the country that introduced the most extensive reform to its company law in order to revitalise the general meeting of its joint stock companies. The KonTraG introduced a number of modifications to the existing company law that drew German joint stock companies nearer to their anglo-saxon counterparts and empowered its shareholders to the greatest extent. The major reform consisted in the almost full introduction of a one share/one vote principle in German joint stock companies (AG), the reduction of the influence of banks and the reform to the general meeting. The combined effect of these provisions consisted in the empowerment of the shareholders and the general meeting in influencing the life of the company.

There is currently a discussion on the pros and cons of the one share/one vote principle. The principle defends that the voting power of the shareholders should be directly proportional to their stake in the company; the defenders of this principle refer that this encourages the investment in companies, reduces the agency costs of managers *vis-à-vis* shareholders, creates incentives for a more responsible investment (because if the shareholder ties a great share of its wealth to one company then it will be directly interested in the success of the company, with positive externalities in relation to minority shareholders) and avoids free-riding. The critics of the principle point out that there may be situations in which deviations may be justified such as when the company is particularly important for a region (it is essential to maintain the power of a shareholder whose interests are bound to a particular region) or when it performs such important functions in the economy to the point that it becomes justified to limit the potential greed or negative externalities of a group of shareholders. The discussion is not ended and the (dis)advantages of a direct proportionality between shareholding and control rights must be considered in the concrete case.²⁷⁶

Germany has recently introduced considerable reforms to its Corporate Law that eliminated most (albeit not all) of the restrictions to the principle of

²⁷⁶ Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press, Kraakman, R., P. Davies, et al. (2004). The Anatomy of Corporate Law: a Comparative and Functional Approach, Oxford, Ferrarini, G. (2006). One share - One vote: a European rule?, European Corporate Governance Institute, Hopt, K. J. (2007). "Feindliche übernahmen, protektionismus, one share one vote?" Europäische Zeitschrift für Wirtschaftsrecht 18(9): 257. See also the study elaborated by the European Commission entitled Commission, E. (2007). Report on the proportionality principle in the European Union, European Commission.

proportionality between ownership and control rights. In this sense, it appears to have followed the current of thought that evaluates positively the principle one share/one vote. The introduction of the one share/one vote principle in German company law was achieved by four main points of intervention: (a) the elimination of multiple voting rights (*mehrstimmrechten*), (b) the elimination of voting caps (*Hochstimmrechten*), (c) the restriction of the exercise of voting rights in situations of cross-shareholdings (*wechselseitigen Beteiligungen*) and (d) the voluntary elimination by companies of preferential non-voting shares (*Vorzugsaktien*).²⁷⁷ As regards multiple voting rights, the previous version of §§12(2) AktG admitted the existence of multiple voting rights in public companies as long as they were necessary to guarantee “predominant macro-economic concerns” (*überwiegender gesamtwirtschaftlicher Belange*) and they were subject to an administrative approval. The authorisation for the issue of multiple voting shares in a public company was destined to guarantee that the disproportion of voting power in relation to the investment in the company was exceptional and issued only in circumstances where the public interest demanded it. That would be the case, for instance, of companies that were the core centre of the economic life of the administrative division and where there was a public interest in ensuring that the company was administered in the interest of the controlling shareholders, whose interests were inextricably tied to those of the administrative division. The legal thinking claimed that this administrative approval was not extensive to other deviations from the one share/one vote principle, such as the one that occurs in situations of voting caps and preferential non-voting shares.²⁷⁸ The KonTraG eliminated this last paragraph of §§12(2) AktG and banned outright the issue of multiple voting shares. The inspiration for this solution lay in the ever postponed proposal for a 5th Company Law Directive on the structure of public companies and in the recent company law scholarship that has insistently criticised the issue of multiple voting shares on account of the agency costs that the disproportion between investment and voting power raise in relation to the other shareholders and the capital market in general; it is said that it discourages

²⁷⁷ This refers to shares deprived of voting rights but providing their holder with a *special benefit*, namely in terms of dividends. They continue to exist in law although many companies have eliminated them in practice.

²⁷⁸ Hüffer, U. (1995). *Aktiengesetz Kommentar*, C.H Beck.

investments in capital markets and encourages other shareholders to act in a self-interested way (instead of the interest of the company) because they are aware that the dominant decisions of the company will be in the hands of a few investors that did not invest as much as them in the company. The KonTraG imposed that the existing multiple voting rights be eliminated until 2003 and that the affected shareholders should only be compensated for the loss of their voting power when the multiple voting rights were granted as a consideration (*gegenleistung*) for a special investment in the company, namely when they were the initial promoters of the company. In all other situations, they will simply be deprived of their voting rights, a solution that raised several constitutional doubts in Germany.²⁷⁹

The elimination of multiple voting rights was completed by the elimination of voting caps (*Höchstimmrechten*). Voting caps consist in another type of deviation from the one share/one vote principle that reduces the influence (*Wirkungsmacht*) that an investor may have over the company by means of the restriction of the number of votes that it may cast at a certain deliberation. Merely as an example even if an investor holds 30% of the company's capital, voting caps allow it to exercise only 10% of the voting rights attached to those shares. The main function of voting caps is to serve as a defence mechanism against hostile bids because even if the shareholders accept to sell their shares to the bidder, they will never exercise sufficient influence over the company in order to justify the acquisition of the shares; they equally serve the interests of the managers, who find it attractive to exercise their duties free from the influence of the majority shareholders. Nevertheless, voting caps might equally perform a protective function of shielding minority shareholders from the overwhelming power of the majority shareholders and provide room for manoeuvre for the management in the running of the affairs of the company. These considerations led the German government to reduce their extinction of voting caps to listed companies (§§134(1) AktG). Since voting caps carry negative externalities only in listed companies because they discourage the investment in capital markets, they were forbidden only in companies trading their shares in capital markets and left to the contractual

²⁷⁹ Saenger, I. (1997). "Mehrstimmrechte beim Aktiengesellschaften." *ZIP*(42): 1813-1821. ; Kluth, W. (1997). "Abschaffung von Mehrstimmrechtsaktien verfassungswidrig?" *ZIP*(28): 1217-1224.

autonomy of non-publicly traded companies the judgement of the convenience of their admission.

A third element in the progressive move towards the one share/one vote principle consisted in the restriction of the exercise of voting rights in situations of cross-shareholdings (*wechselseitigen Beteiligungen*) in listed companies. German company law considers that two public companies are in a situation of reciprocal shareholdings when each one of them holds directly or indirectly more than 25% of the shares in the other company. German company law is particularly demanding with these situations because they carry with them the danger of mixing the shareholdings and indirectly leading a company to own its own shares by means of the other. This has several negative externalities in terms of the market because the management of both companies will be capable of electing themselves and thus reduce shareholder influence. This is particularly serious in listed companies where the general meetings are usually characterised by a reduced presence. This led the German legislator to introduce several restrictions to the exercise of voting rights in companies engaged in a situation of reciprocal shareholdings (§328 AktG). The KonTraG introduced a further restriction applicable only to listed companies by forbidding companies engaged in a situation of reciprocal shareholdings of exercising their voting rights in the election of the members of the Aufsichtsrat (§328(3) AktG). This means that the members of the supervisory board will be elected only by the “*true shareholders*” of the company, which provides a further contribution to the introduction of a one share/one vote principle in German company law and expose the management of the company to the pressure of the shareholders.²⁸⁰

A final word must be given to the progressive elimination on preferential non-voting shares (*Vorzugsaktien*). This represents an interesting evolution towards the one share/one vote principle because, in contrast to the previous modifications, it has not been introduced by an act of law (it still continues in the AktG) but by the companies themselves who are increasingly seeing them as a negative factor in their internal governance structures. Preferential non-voting shares (§139-141AktG) consist presently in the only exception allowed

²⁸⁰ Lingemann, S. and D. Wasmann (1998). "Mehr Kontrolle und Transparenz im Aktienrecht: Das KonTraG tritt in Kraft" Betriebsberater 53(17): 853-862.

to the principle of one share/one vote in publicly traded companies (§12(1) AktG). These shares may be issued up to 50% of the company's capital and provide their holder with the same rights as any other shareholder with the exception of the right to vote. The compensation for the absence of the right to vote consists in a preferential dividend; the holder of these shares will have a cash-flow right in excess of the proportion of its shareholding. The idea underpinning the issue of preferential non-voting shares consists in the gathering of capital without giving up of control rights. Preferential non-voting shares are a double-edged sword however because their potential impact over the value of the company is subject a considerable degree of variation. Preferential non-voting shares may have potential advantages in concentrated ownership systems because the disproportionate voting power that the voting shares granted to their non-preferential shareholders reduced the agency costs that there could occur between the management vis-à-vis the shareholders and the preferential cash-flow rights would compensate the non-voting shareholders. The underlying idea was to trust the supervision of the management of the company to a group of controlling shareholders, who would have all the incentives to monitor on account of their disproportionate voting power, and expect that the non-voting shareholders would be compensated by their preferential cash-flow rights. This increasingly became the subject of criticism however. Some literature claimed that the excessive voting power granted to a small group of shareholders could potentially lead to the alignment of interests between the management and that small group of controlling shareholders to the detriment of the other minority and non-voting shareholders. This created incentives for the extraction of private benefits of control that were usually detrimental to the minority and non-voting shareholders. This led several authors to rethink the position of preferential non-voting shares in publicly traded companies. Considering that the ownership structure of German publicly traded companies is considerably concentrated, the extensive of preferential non-voting shares curtailed the development of capital markets and the collection of capital from small investors since not many were willing the pay the price of abdicating from control. This has a negative effect over the performance of the company because this creates incentives for the extraction of private benefits of control from the controlling shareholders, endanger the liquidity of the capital markets and further erode

the position of small shareholders within large publicly traded companies, which might discourage the collection of investment from small shareholders. The market value of companies will necessarily suffer from such a situation. Empirical studies have demonstrated that, in the German case, voting shares are twice as expensive as preferential non-voting shares and the preferential dividend that non-voting shares provide has no positive impact over their market liquidity; in contrast, investors were willing to pay a substantial premium in order to get control rights instead of preferential dividends.²⁸¹ That is the reason why publicly traded companies decided to increasingly eliminate from their stock the existence of preferential non-voting shares. The main technique used to perform this is through the buy-back of the shares from the preferential investors and then sell them in the market. This operation is expected to increase the market value of companies by several ways. The granting of voting rights to the minority shareholders will entitle them to syndicate a minority blockage and hence reduce the scope for the extraction of private benefits of control from the majority shareholders. In addition, this will create incentives for the investment in capital markets and increase the market value of companies. Finally, the granting of control rights to minority shareholders and the attachment of their cash-flow rights to the proportion of their investment will create incentives to monitor the management with the consequential reduction of the agency costs that may occur between the management and the minority

²⁸¹ Pellens, B. and F. Hillebrandt (2001). "Vorzugsaktien vor dem Hintergrund der Corporate Governance-Discussion." *Die Aktiengesellschaft* 46(2): 57-67.

shareholders. This is expected to improve the governance of the company in the sense of the international trend towards shareholder value.²⁸² ²⁸³

The introduction of the one share/one vote principle - albeit extremely influential - was not the only action undertaken in the revival of the general meeting in German joint stock companies. The reform was finally completed by two very important innovations: (1) the reduction of the influence of banks and (2) some surgical modifications to the functioning of the general meeting. The traditional importance of banks in the German system of corporate governance has been repeatedly stated throughout the thesis. This overwhelming influence derived essentially from three sources: (a) their direct shareholdings in major companies, (b) the extensive use of proxy votes and (c) their position as Hausbank. These three pillars underpinning bank influence in German companies, which provided a very solid ground for their stakeholder economy, are progressively being eroded. The key provisions here are §§125, 128 and 135AktG. §125AktG allows as a general rule the representation of the shareholders by means of a proxy at a general meeting. The Vorstand is even obliged to inform the shareholders of that possibility in the notice of the summoning of the general meeting. The practice says however that the exercise of proxy vote is seldom used and banks have taken advantage of that possibility to act themselves as proxys for their clients in the general meetings of public companies. Having this in mind, the law-maker decided to limit their influence in general meetings and encourage a more active shareholder

²⁸² Pellens, B. and F. Hillebrandt (2001). "Vorzugsaktien vor dem Hintergrund der Corporate Governance-Discussion." *Die Aktiengesellschaft* 46(2): 57-67. ; Hillebrandt, F. and R. Schremper (2001). "Analyse des Gleichbehandlungsgrundsatzes beim Rückkauf von Vorzugsaktien" *Betriebs-beräter* 56(11): 532-538.

²⁸³ One may question if the negative effects that *preferential non-voting shares* (*Vorzugsaktien*) may have over the value of publicly traded companies does not justify their outright ban, such as the one that occurred with multiple voting shares. The answer is a negative one: although preferential non-voting shares have a negative impact over publicly traded companies they still perform a significant role in the capital of small and medium sized companies (normally family run businesses) because it allows them to gather capital from outside sources (banks and prospective partners) without opening hands of control. If we consider the fiduciary ties that underpin the relationships between the partners of these companies, preferential non-voting shares are a useful instrument to gather capital: they may more easily collect money from banks in the form of an investment in the company, providing banks with preferential dividend rights, or serve as an entry level for prospective partners, who invest in the company first and may be later given control rights in the event that they share the same fiduciary relationships that underpin the remaining members of the company. Since these companies do not collect money from capital markets, the same reasons justifying their elimination in publicly traded companies are not present.

participation. The duties imposed over the banks were extensive: §128 AktG imposes upon banks, among other duties: (a) the duty to inform the shareholder of the banks position concerning every point that is going to be discussed at the general meeting, (b) the duty to vote in the interest of the shareholder and undertake all measures so that its own interests no not affect the exercise of its right to vote as a proxy, (c) the duty to ask the shareholder for instructions concerning how it should exercise its voting rights and inform the shareholder of its concrete position in relation to every point voted at the general meeting if the shareholder fails to do so, (d) the duty to inform the shareholder of interlocking supervisory boards and shareholdings or consortia with the company. In addition, §135AktG commands banks to (a) inform the shareholder of the possibility to provide a proxy to another person rather than the bank (including shareholder syndicates), (b) the restriction of the possibility of transmission of the proxy from the bank to another person and (c) the binding of the bank's voting policy to the interest of the shareholder; the bank is obliged to inform the shareholder of the proposals at the general meeting, ask the shareholder for its opinion and vote in accordance with the interests of the shareholder when the shareholder fails to provide its opinion on the subject that is going to be discussed. In addition, the bank is forbidden to vote in companies in which it has a direct shareholding of more than 5% or in which it has an indirect controlling shareholding if the shareholder fails to provide indications concerning the voting policy of the bank.²⁸⁴

The combined effect of these provisions is easy to understand: the proxy votes held by banks were a powerful instrument of influence within companies that often was exercised in the interests of the banks and only indirectly in the interests of the shareholders. These provisions (§§128 and 135AktG) drew a fatal blow to that influence by bidding the voting policies of banks to the interests of the shareholders. This means that the shareholders found in these provisions a strong reinforcement of their rights because the powerful influence that the banks exercise in the management of the companies will have to be

²⁸⁴ Beyer, J. and M. Höpner Alle macht den Aktionären? Unternehmenskontrolle in Deutschland, Max Planck Institute für Gesellschaftsforschung, Maul, S. (2005). Gesellschaftsrechtliche Entwicklungen in Europa - bruch mit deutschen traditionen. Rechtsfragen der europäischen integration. Bonn, Zentrum für europäisches wirtschaftsrecht, Nietsch, M. (2005). "Corporate Governance and Company Law Reform - a German perspective." Corporate Governance 13(3): 368-376.

made in accordance with the interests of the shareholders. The reform of the functioning of the general meeting was completed by some provisions of the Law for the Integrity of Companies ad Modernisation of Shareholder suits (*Unternehmensintegrität und Modernisierung des Anfechtungsrechtsgesetz* - UMAG). This act, which will be analysed further on, reformed the system of participation in the general meeting and the process for legitimisation for the exercise of voting rights in order to approximate German Company Law closer to international standards. The main innovations consisted in the obligations to register the shareholders (*anmeldung*) and the participation of the shareholders (*Frage- und Rederecht*) in the general meeting. As regards the obligation to register the shareholders, the UMAG introduced a significant innovation to §123(1)AktG: whereas previously the same provisions allowed the statutes of the company to demand the deposit (*Hinterlegung*) of the shares before the registry of the shareholder in the general meeting, this possibility was eliminated. The statutes now may only require the shareholder to register itself before the general meeting as such (i.e: as a shareholder) within a certain deadline so that the company knows who is going to participate in the meeting. This elimination of the possibility to oblige to deposit the shares in the general meeting is of utmost importance because it allows shareholders to freely bargain the shares from the point of the summoning of the general meeting to the point of mandatory registry. It increases the liquidity of the shares and encourages further the investment in the capital markets. In the case of holder shares (*Inhaber aktien*) the innovations were equally extensive: §123(3)AktG merely obliges the holder of the shares to inform (*nachweis*) the general meeting of its quality as a shareholder, providing the statutes with sufficient liberty to determine the conditions of information for the participation in the general meeting and the exercise of voting rights. Nevertheless, for the case of publicly traded companies, the §123(3)AktG provides that it is sufficient for the participation and voting in the general meeting that the holder deposit its shares in a custodian institute (*depotführende Institut*) within a deadline of 21 days before the general meeting and present a written statement from the institute that the person effectively holds the shares; the presentation of the information is a precondition for the exercise of shareholder rights. The combination of these provisions ensures a wide degree of liquidity of the shares in the capital markets and the reduction of the obstacles for the participation in the general

meeting. In addition, the UMAG equally reformed the right to speak and ask information (*Frage- und Rederecht*) in the general meeting: in order to avoid excessive speeches, the UMAG introduced a new line to §131(2)AktG allowing the statutes of the company or a deliberation of the general meeting to grant powers to the president of the general meeting to restrict the shareholders' right to speak in timely and objective terms: this is made to ensure that the shareholders' right to demand information is exercised only in accordance with their own interests and to the extent necessary to pursue their interests. The purpose of this restriction of the right to speak and ask questions derived from the abusive behaviour of some shareholders who prolonged general meetings indefinitely in order to avoid any practicable discussions or deliberations; this, tied to the abusive use of the *Anfechtungsklage* (a shareholder suit for rendering void deliberations from the general meeting on account of the insufficient provision of information) that usually ended with a monetary "conciliation" with the minority shareholders, justified the restriction in order to ensure that the general meeting is adequately used to appreciate the situation of the company and fulfil its functions and not serve the purposes of frivolous shareholders.²⁸⁵

As we can see, the reforms of German company law led to a direct empowerment of the shareholders and reinforced the position of the general meeting *vis-à-vis* the remaining organs of the company. The introduction of the one share/one vote principle in German corporate law (both statutory and voluntary) by means of the progressive elimination of multiple voting rights, voting caps (in listed companies), the introduction of restrictions to voting in situations of cross-shareholdings (thus eliminating the German system of indirect ownership by means of cross-shareholdings) and the progressive voluntary elimination of preferential non-voting shares appear to be clearly directed towards the encouragement of investment in capital markets because shareholders will be able to exercise voice in the companies in which they invest. If we combine this with the progressive elimination of the role of banks

²⁸⁵ Lingemann, S. and D. Wasmann (1998). "Mehr Kontrolle und Transparenz im Aktienrecht: Das KonTraG tritt in Kraft" *Betriebs-beräter* 53(17): 853-862. Bachmann, G. (1999). "Die Geschäftsordnung der Hauptversammlung." *Die Aktiengesellschaft* 44(5): 210-215, Schmidt, K. (2002). *Gesellschaftsrecht*, Carl Heymanns ; Casper, M. (2007). *Informationsrechte der Aktionäre. Aktienrecht im Wandel - Grundsatzfragen des Aktienrechts*. W. Bayer and M. Habersack, Mohr Siebeck. II: 546-578.

in German corporate governance, obliging them to exercise their proxy voting rights in the benefit of their principals (the persons who deposit their savings in the bank) and the several means to reactivate the general meeting, it becomes clear that there appears to be an attempt to modify the traditional stakeholder orientation of German corporate governance towards a more shareholder oriented regime. The general meeting will be able to exercise an increased and more effective control over the *Aufsichtsrat* and indirectly over the Vorstand therefore encouraging a more shareholder oriented regime.

The UK also undertook an extensive reform of its company law with the purpose of revitalising the general meeting of its companies. The main points of intervention consisted in the facilitation of the exercise of shareholders' rights at the general meeting and in the reform of the functioning of the general meeting (in particular extraordinary general meetings) in order to make them a more effective instrument of control of the management's behaviour. As mentioned in the previous paragraph, one of the main innovations introduced by the Company Act 2006 consisted in the obligation for public companies to hold an annual general meeting (s.336(1)), which was linked to the reporting cycle in order to allow the shareholders to evaluate the accounts and the management report of the company. This obligation was completed with the express recognition of the right of the shareholder to elect a proxy or proxies (for companies with share capital and distinct classes of shares held by the same person) to exercise all the rights recognised to the shareholder at the general meeting. This is an extremely important innovation because the proxies will be entitled to exercise, on behalf of the principal, all the rights that the principal enjoys, namely: the right to attend and speak at meetings, demand a poll and vote on a show of hands or on a poll (s.324-330). These are however the minimum requirements because the company's articles may provide proxies with more extensive rights than those granted by the act (s.331). The exercise of rights through proxies was completed with a specific set of provisions destined to enfranchise indirect investors (s.152-153). The Act provides that whenever a registered shareholder holds shares on behalf of more than one person, the shareholder is not only entitled to exercise all the rights attached to those shares as he is equally entitled not to exercise them or exercise them in different ways, in accordance with the interest of the persons on account of whom he holds the shares. This is intended to make it easier for indirect

investors to exercise their governance rights and achieve a greater parity of treatment in law between the two types of investors. In addition, the act also established some provisions destined to promote shareholder engagement at the annual general meeting. S.338-340 of the Companies Act provides that a company may be obliged at its own expenses to give notice of the resolutions that the members of the company will propose at the annual general meeting as long as the request is addressed by shareholders holding individually or collectively 5% of the company's share capital or by 100 shareholders, independently of the proportion of the share capital that they own. The company will then be entitled to send notice of the resolution to each member entitled to participate in the annual general meeting.²⁸⁶

The Companies Act also made important provisions concerning the functioning of the extraordinary general meetings. The Company Act 2006 eliminated the requirement that previous notice be given to the members present at the extraordinary general meeting in order to pass a resolution by a 75% majority; this means that a resolution may be passed by a 75% majority at a extraordinary general meeting independently of any previous notice to the shareholders on the proposed resolution.

The final innovation concerns the written resolution procedure. The Company Act 2006 was extremely innovative in this aspect allowing for the approval or resolutions by signature as long as a simple majority approves it at ordinary meetings or a 75% majority approves it at extraordinary meetings (s. 288-300). This was an extremely important innovation destined to empower the general meeting and facilitate the engagement of the shareholders in the company in which they invest because the main innovation consisted in dispensing the members of private companies to be present in a place and vote at general meetings in order to participate in the life of the company. Nevertheless there are limitations to this possibility, namely the impossibility of using the written resolution procedure to dismiss a director or auditor before its terms of office terminate (s.288(2)).²⁸⁷

²⁸⁶ Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish, Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.

²⁸⁷ Viswanathan, A. (2007). "The Companies Act 2006: towards shareholder engagement and streamlining the decision-making process " International Company and Commercial Law Review 18(6): 199-202.

The combination of these provisions is capable of bringing some considerable innovations to British corporate governance because its main effect is to encourage the use of the general meeting of the shareholders as a monitoring device of the management board and create incentives for a more relational type of investment in contrast to the traditional strategy of portfolio investments. The main idea is to attempt to tie the interests of the shareholders to a concrete company and encourage them to become involved in the running of the affairs of the business.

France equally followed these international trends towards the empowerment of the general meeting and introduced some substantial modifications to its company law. Chapter II of the LNRE, which intended to improve shareholder information and facilitate their participation in general meetings, introduced the main modifications. The main beneficiaries were the non-resident shareholders, who held important shareholdings in French public companies and that complained often of the impossibility to exercise the rights attached to their shares. The main focus of the reform consisted in (1) the use of electronic means in the functioning of the general meeting, (2) the facilitation of the proof of the quality of shareholder and (3) the use of financial intermediaries (proxy voters).

As regards the use of IT in general meetings, this was one of the main focus of attention of the LNRE. The objective of the statute was to create incentives for the use of the Internet as a means of encouraging the participation of shareholders in general meetings. The use of the word “incentives” was not unintentional; the use of IT is never an obligation neither for the company (that needs to provide it expressly in its internal charters) nor for the shareholder (who cannot be deprived of the traditional means of communication with the company). The main innovations introduced by the LNRE in terms of IT were the following: (1) the transmission of documents and communications by electronic means, (2) the transmission of the general meeting and participation by the shareholder by videoconference, (3) the electronic vote and (4) the electronic registration of projects of resolutions at the general meeting. In the event that both the company and the shareholder accept to participate in the life of the company by electronic means, one should have in mind that the LNRE surrounded the participation by several precautions: the company should have a website for that specific purpose, the

website should be used only for the convocation of general meetings, the transmission of the debates in the general meetings should be made in a continuous way and the voting procedure should be anticipated by a password that would ensure the true identity of the person casting the vote. There is no need to see the details of these provisions; it is merely necessary to have in mind that the combined effect of these provisions is to encourage the participation of shareholders in the general meetings without having the need to be physically present in them. The benefits for the internal governance of companies are more than evident: they encourage the collection of foreign capital and the engagement of shareholders in the life of the company because they will be able to monitor the management and the results of the investment that they have undertaken in the company without having to be physically present at the general meetings or trust blindly the reports made by proxy voters. It facilitates direct supervision of the activities of the management board.²⁸⁸

The use of IT in general meetings was completed by the facilitation of the proof of the quality of shareholder. The previous regime obliged the holders of holder shares (*titres au porteur*, i.e non-nominative shares) to deposit their shares in a financial intermediary up to 5 days before the general meeting in order to prove their shareholding. The shares were not transferable from the moment until the end of the meeting. This discouraged investment in French companies particularly by foreign (i.e: anglo-saxon) investment funds that oppose strongly all kinds of restrictions to the free transferability of shares. The LNRE intended to provide an answer to the needs of these funds by establishing a softer identification mechanism that does not damage the transferability of the shares. The charters of the company may provide that a financial intermediary who is the holder of these shares prove by means of a certificate the identity of the shareholder within a deadline that may not be superior to 5 days. This means that the holder may require a financial intermediary to prove its shareholding in the day before the general meeting. In addition, the shareholder may transfer its shares even in the day that the

²⁸⁸ Guyon, Y. (2001). "Présentation générale des réformes apportées au droit des sociétés par la loi du 15 mai 2001 relative aux nouvelles régulations économiques" *Revue des Sociétés* 119: 503-515. Guyon, Y. (2002). "Les dispositions du décret du 3 mai 2002 relatives aux assemblées générales d'actionnaires." *Revue des Sociétés* 120: 421-429.

general meeting takes place as long as the shareholder correctly communicates that situation to the general meeting by means of a specific procedure. This is the only means to combine the demands of the capital markets (who praise the liquidity of the shares) and the demands of company law (who are preoccupied with ensuring the engagement of shareholders in the life of the company).²⁸⁹

This picture was completed by means of a number of provisions concerning the identification and vote of non-resident shareholders of publicly traded companies. The LNRE introduced a number of modifications concerning the exercise of voting rights by means of financial intermediaries (*intermédiaires financiers*) of non-resident shareholders. In principle, French Law allows only proxy votes between the shareholders of a company; this means that a shareholder may be represented in the general meeting of a company only by another shareholder (L.225-106 Code du Commerce). Although the French Law does not recognise certain anglo-saxon legal constructions such as trustees and nominees, the reality proved that it was common that foreign shareholders trusted their titles to a number of financial intermediaries who were supposed to exercise their rights at the general meeting. The LNRE intended to regularise this situation while at the same time ensuring that the exercise of voting rights by means of financial intermediaries was made in accordance with a number of preconditions destined to ensure its transparency. The first and most important obligation consists in the declaration of financial intermediary. Whenever a person (legal or natural) holds on account of a third party shares in a publicly traded company, the person is obliged to register itself as a financial intermediary within the shareholder structure of the company and declare expressly its quality as an intermediary (L.228-1 Code du Commerce). Nevertheless, this possibility is admitted only for shareholders resident outside the territory of France; for national shareholders, financial intermediaries may not represent them. This is a definitive proof that this regulation was thought to capture foreign investment to France. But the obligation of declaration is not the only obligation imposed upon financial intermediaries. If the company requests it, the financial intermediary will be obliged to disclose the identity of the beneficial owners (L.228-2 and 3 Code du

²⁸⁹ Valuet, J.-P. (2001). "Identification et vote des actionnaires non résidents des sociétés cotées." *Ibid.* 119(571-581).

Commerce); the expression beneficial owners should be interpreted *cum grano salis* because in the situation of a chain of indirect shareholdings it may be impossible for an intermediary to know the ultimate beneficial owner of the shareholdings; therefore, the financial intermediary is required only to disclose the list of its direct clients. There are several sanctions for breach of the duty to disclose to “encourage” the beneficial owner to disclose its identity. The sanctions go from a simple *astreinte* (a compulsory order from the court whose inobservance carries with it the duty to pay a cumulative fine – e.g: € 500 for each day without disclosing), to the not counting of the vote, the deprival of the right to vote and even the deprival of dividends for a period up to five years (L. 228-2 and 3 Code du Commerce). Despite all of these obligations, the financial intermediary is requested only to declare its quality of intermediary in order to be able to exercise the right to vote at the general meeting; it is subject to the obligations of disclosure only in the event that the company requests it directly.²⁹⁰

This analysis of the French reform of shareholder meetings makes it easy to observe that these modifications appear to be directed towards capital markets. The purpose of the modifications introduced is simply to facilitate investments and participation in general meetings, which is of particular importance in capital markets. The reforms of the French system therefore appear to be thought expressly to attract foreign direct investment into their listed companies. On the other hands, as regards the existing national shareholders, they provide an increased protection to minority shareholders therefore reducing the agency costs vis-à-vis majority shareholders and encouraging the managers to act in the benefit of the company as a whole (and reducing the scope for the extraction of private benefits of control of majority shareholders). This is capable of making the French system more market oriented.

These international trends towards the empowerment of the general meeting reached **Portugal**, which undertook some reforms of its company law in order to give it expression. The main innovations consisted in the reform of

²⁹⁰ Guyon, Y. (2002). "Les dispositions du décret du 3 mai 2002 relatives aux assemblées générales d'actionnaires." *Revue des Sociétés* 120: 421-429. Valuet, J.-P. (2002). "Les dispositions du décret du 3 mai 2002 relatives à l'identification et au vote des actionnaires non résidents des sociétés cotées." *Revue des Sociétés* 120.; Valuet, J.-P. (2001). "Identification et vote des actionnaires non résidents des sociétés cotées." *Revue des Sociétés* 119(571-581).

proxy voting, the admission of voting by mail and in the use of IT in general meetings. The reform of company law undertaken in 2006 did some very extensive modifications to the possibility to use a proxy to represent the shareholder at the general meeting of joint-stock companies. Whereas the previous regime allowed the internal charters of the company to limit the possibility of representation to the maximum extent possible,²⁹¹ the current legal regime eliminated all restrictions to the possibility to elect a proxy to represent the shareholder in the general meeting. The current version of the company statute claims that the shareholder may freely make himself represented at the meetings of the joint stock company and that the charters of the company may not restrict this possibility to any extent possible (art.380(1) CSC). This is an extremely important innovation because it eliminates all restrictions to the possibility to elect a proxy; the shareholder may make himself represented at the general meeting of the company at all times by however (s) he feels convenient. Nevertheless, in the event that a person requires voting as a proxy for more than 5 shareholders, the company statute surrounded the exercise of voting power by precautions. In this situation, the proxy is granted only for one meeting, it is freely revocable at all times and it should contain all the relevant information concerning the subjects to be discussed at the meeting; besides that, there is also the concern to bind the interests of the proxy to those of the principal: the principal may give instructions on how to vote to the proxy and, in the event that it fails to do so, the proxy is obliged to vote in accordance with the interests of the principal and should communicate to the principal its vote and the reasons why it decided to do so (art.381 CSC). In the event that the proxy fails to abide with any of these preconditions, it may not vote for more than 5 persons (i.e: its vote will represent a maximum of 5 shareholders – art.381(7) CSC). The reasons behind this regime are easy to understand: the law intended to revitalise the general meeting by allowing shareholders to represent themselves in general meetings without restrictions (art.380 CSC) but it was concerned with the concentration of voting power in the hands of a few proxies, who could use that voting power to their own

²⁹¹ The previous legal regime allowed all restrictions to the right to nominate a proxy up to the point in which the minimum content was hit. This means that the charter could prohibit all possibilities of representation except for the representation by a *relative*, another *shareholder* or a *member of the management board*. This was considered the *minimum content of representation* that could not be restricted by the charter.

benefit instead of the benefit of the principal. Since it is much more difficult for the principal to monitor the proxy in situations of concentration of voting power, the law limited the possibility to concentrate votes in the hands of a few persons.²⁹²

Another significant innovation consisted in the admission of the possibility of voting by mail (art.384(9) CSC). Voting by mail was generally allowed in publicly traded companies, although the stock market authority allowed publicly traded companies to restrict that possibility. The current legal regime departs from the plain possibility of voting by mail, although (1) the charters of the company are under an obligation to regulate its exercise and (2) the charters of the company may prohibit it altogether. Therefore, the current legal regime states that mail voting is admissible (and the charter must regulate its exercise) unless the charter expressly prohibits it from doing so. This possibility of outright ban is not available to publicly traded companies, who must allow it at least in two specific situations (the election of the management/supervisory board and in modifications of the charters of the company) and explain the option undertaken (comply or explain).

The final innovation consisted in the admission of the use of IT in general meetings. The Portuguese law was extremely innovative in this aspect providing for the direct admissibility of the possibility of use of IT as a means to hold general meetings unless the charter prohibits it from doing so (art.377(6), b) CSC). This means that all companies that oppose the use of IT as a means of conducting their general meetings will be obliged to undergo a procedure for modification of the statutes of the company; if they don't do it, they will be obliged to admit the possibility of IT meetings and regulate their exercise. Nevertheless, the use of IT is limited to the transmission and participation in the

²⁹² Cunha, P. O. (2007). Direito das Sociedades Comerciais. Lisboa, Almedina, Menezes Leitão, L. (2007). Voto por correspondência e realização telemática de reuniões de órgãos sociais. A reforma do Código das Sociedades Comerciais: jornadas em homenagem ao Prof. Raul Ventura. A. Menezes Cordeiro and P. Câmara. Lisbon, Almedina.

meeting; there is no provision for electronic vote, which in my view must be submitted to the same requirements as voting by mail.²⁹³

This short description of the modifications introduced by the reform of company law undertaken in Portugal in 2006 reveals that they were undertaken in consonance with the general trend towards the reinforcement of the role of the general meeting in companies. The purpose was to encourage the participation of the shareholders by providing them with more means to make their voices heard (proxy vote, voting by mail and electronic participation); this is particularly important for the protection of minority shareholders in a country with a concentrated ownership system and encourages foreign investment in capital markets because foreign investors will have a means of making their voices heard.

2.5.3 increased reliance on shareholder litigation – the courts as an external governance mechanism.

the final part in which almost all the regulations under study revealed a significant degree of convergence consisted in the increasing reliance on shareholder litigation as a means of reducing the agency costs that occur between shareholders and management and of creating incentives to monitor the management. The judicial activism of shareholders may be an important governance mechanism in the reduction of the agency costs. The first part of this thesis referred that the contractual conception of the company would be used throughout the thesis; this nexus of contracts raises a considerable number of agency costs between distinct constituencies, namely: (1) management *vis-à-vis* shareholders, (2) majority shareholders *vis-à-vis* minority shareholders and management and shareholders *vis-à-vis* third parties. The following lines will attempt to explain that the regulation of the derivative action was designed in a way as to reduce these three types of agency costs, thus avoiding that the activism of the shareholders would be moved by selfish considerations and cause any negative externalities towards the other

²⁹³ Cameira, M. A. (2006). "Portuguese companies and the new e-commerce environment." International Company and Commercial Law Review 17(3): 108-113. ; Menezes Leitão, L. (2007). Voto por correspondência e realização telemática de reuniões de órgãos sociais. A reforma do Código das Sociedades Comerciais: jornadas em homenagem ao Prof. Raul Ventura. A. Menezes Cordeiro and P. Câmara. Lisbon, Almedina. ; Cunha, P. O. (2007). Direito das Sociedades Comerciais. Lisboa, Almedina., pp.583 ff, 597 ff, 603 ff.

constituencies. The final result will be the reinforcement of the position of the company *per se* within the nexus of contracts that composes it with positive externalities towards all the constituencies.

2.5.3.1 general overview of shareholder litigation

Before engaging into the analysis of the solutions adopted by each jurisdiction under study, it is useful to begin with a short description of the objectives and problems evolving shareholder litigation. The derivative lawsuit consists in a judicial mechanism by means of which a shareholder acts on behalf of the company with the purpose of getting compensation for damage done to the company by the managers that they refuse to redress. It consists in a means of shareholder control over the management board and fulfilment of the claims of the shareholders on behalf of the company. The usual motivation of such action consists in a violation of the fiduciary duties of managers in relation to the company that caused damage to the company. It is worth noting that the compensation goes to the company (who suffered the damage and to whom the managers owe fiduciary duties) and not to the shareholders. The benefit of shareholders comes indirectly in the form of an increase of share prices and a deterrence effect of further harmful behaviours in the future. The benefits of this suit consists essentially in overcoming free-rider and collective action problems because one single shareholder or small group of shareholders will be entitled to bring a suit on behalf of the entire corporation. Therefore it consists in a governance mechanisms to overcome the agency costs of managers *vis-à-vis* shareholders.²⁹⁴

The capacity of the shareholders to engage in litigation in order to overcome the agency costs that they suffer in relation to managers is widely perceived as one of the most effective governance mechanisms together with the regulation of management boards (including fiduciary duties). The confidence in the activism of shareholders and in the ability of courts to overcome agency costs of managers *vis-à-vis* shareholders enjoys such a wide consensus that Kraakman even coined it as “*the most important governance*

²⁹⁴ Macey, J. R. (2008). *Corporate Governance - promises kept, promises broken*, Princeton University Press.

mechanism to enforce the fiduciary duties of shareholders".²⁹⁵ It is important to stress that this is not the sole governance mechanism however and its due position must be seen within its wider context in the governance mechanisms. Internal and external governance mechanisms equally perform an extremely important role in reducing the agency costs of managers *vis-à-vis* shareholders; examples of internal governance mechanisms may be voting rights, internal controls (non-executive directors, mandatory dual-boards, duty to hold an annual general meeting and answer questions among others); examples of external mechanisms may be the market for corporate control, mandatory auditing, disclosure among other mechanisms. Shareholder litigation must be seen within these set of mechanisms; its purpose is not to substitute them or be an alternative but to complete them.²⁹⁶

Shareholder litigation appeared and had its biggest expression in countries with dispersed ownership structures: its direct objective consists in overcoming the collective action costs and the temptation of free-riding that the necessary syndication of shareholders demanded to exercise effective control over the management board via voting power; its indirect objective consists in encouraging a good management of the company because it is capable of functioning as a deterrence and compensatory mechanism for potential wrong-doing. Therefore it appeared as a substitute for the concentration of ownership and the coalition of controlling blocks. This does not mean however that they are meaningless in companies with concentrated ownership structures; although they are generally meaningless for controlling shareholders, who may exercise voting power in order to control the management board, they perform an essential role for minority shareholders, in particular as a means of tackling the agency costs *vis-à-vis* majority shareholders who may attempt to extract private benefits of control. This latter dimension is so important for the objectives of the derivative action that it was even recognised at an early stage in the UK. The ruling *Foss vs Harbottle* established the principle of legal personality implies a separation between the shareholders of the company and the company itself; this means that the proper plaintiff to bring an action to any

²⁹⁵ Kraakman, R. (1994). "When are shareholder suits in shareholder interests?" *Georgetown Law Journal* 82: 1733 ff.

²⁹⁶ Kraakman, R., P. Davies, et al. (2004). *The Anatomy of Corporate Law: a Comparative and Functional Approach*, Oxford.

harm done to the company is the company itself. Since this would leave minority shareholders in a very weak situation because they will have considerable difficulties summoning the general meeting and approving a resolution to bring a suit against the directors. The exceptions to the rule were developed in the ruling *Edwards vs Halliwell*, which laid out a very important exception named as *fraud on the minority*. “Fraud” is to be understood here as any kind of abusive behaviour by the persons on control of the company that bring them undue benefits. This covers not only situations in which the shareholders appropriate themselves of the goods of the company as well as there is a collusion between the majority shareholders and the managers and when the managers abstain from undertaking actions against the wrongdoing of the majority shareholders in their own personal benefit (of the managers). This reveals that the derivative action is an important means of protecting the rights of shareholders as a class in companies with dispersed ownership structures (in which control via voting power is difficult) but equally of the rights of minority shareholders in companies with concentrated ownership structures in which the margin of manoeuvre for the extraction of private benefits of control is large.²⁹⁷

There are also problems associated with shareholder suits. The major problems raised by shareholder suits consist in (1) the problem of shareholder egoism, (2) the problem of frivolous litigation, (3) the fact that it only acts *ex post*, (4) the fact that it deters risk-taking and makes the external market for managers more difficult. The first problem refers to a situation in which the shareholder does not pursue the interests of the company but indirectly its own interests with the suit. The excuse of the “*company interest*” will be nothing but a means of pursuing its own interest in obtaining a share of the compensation that will go to the company. The second problems refers to a situation that occurred in the US in which law firms encourage litigation for frivolous reasons in an attempt to extract large amounts of compensation from the management, a large part of which will remain in their pockets in the form of contingency fees; this is a situation of agency costs vis-à-vis managers. The US has devised distinct governance strategies in order to tackle this agency problem such as

²⁹⁷ Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press. pp.498-580; Reisberg, A. (2007). Derivative actions and corporate governance, Oxford pp.88-97

auctions (in which an auction is used as a means of selecting the plaintiff's lawyer), the Private Securities Litigation Reform Act (which consists fundamentally in a "*follow the leader*" approach, particularly useful in companies with an active institutional investor) and a judicial scrutiny of settlements.²⁹⁸ The third case refers to the legitimate doubt as to the correct place of derivative actions in these governance strategies. The derivative action acts *ex post* (i.e: after the wrong has been committed) and is essentially destined to compensate for a wrong done to the company when the main objective of internal governance strategies consists essentially in encouraging *ex ante* good corporate governance (as in the case of fiduciary duties). One may always say that the deterrence effect acts *ex ante* and therefore encourages good corporate governance;²⁹⁹ but the efficiency of this effect *ex ante* is doubtful because it depends on the probability of getting caught, the activism of the shareholders (since the compensation goes to the company and not to the shareholders, they may simply think that the indirect benefits do not compensate for the trouble) among other procedural issues. Finally, derivative actions discourage risk-taking and may make more difficult the finding of qualified managers; business activity does not go without risks and even if the business judgement rule provides managers with a valid safeguard against excessive litigation, the reputational effects may be devastating and discourage risk taking.³⁰⁰

Each jurisdiction has attempted to devise distinct governance mechanisms to address each one of the problems associated with derivative actions mentioned in the former paragraph. As a preliminary word, one must state that the conferral of a right to a shareholder litigate in respect of wrongs done to the company should remain an exceptional solution. This is in itself desirable for a number of reasons: firstly, litigation is costly and involves a number of interests (such as the fees of the attorney) that are not always on the interest of the company; secondly, the decision to sue involves a cost-benefit analysis and should only be made in serious situations; in other cases, the

²⁹⁸ Macey, J. R. (2008). *Corporate Governance - promises kept, promises broken*, Princeton University Press.

²⁹⁹ Calabresi, G. (1961). "Some thoughts on risk distribution and the law of torts." *Yale Law Journal* 70: 35-46.

³⁰⁰ Reisberg, A. (2007). *Derivative actions and corporate governance*, Oxford pp.45-54.

preference should be given to internal and external governance mechanisms that address these issues in a more effective way; finally, individual shareholders (in particular minority shareholders) may not act in the interest of the company because the size of their shareholders is so small that the potential benefit of the company will end in a very small indirect benefit for them. The solutions found in which jurisdiction must be seen within its due context but they seem to follow three distinct paths: (1) the limitation of the derivative suit to exceptional circumstances and maintain as a general rule that the action must be brought by a deliberation of the majority of the shareholders; (2) the reduction of collective action costs of minority shareholders to initiate the suit and (3) the connection of the suit with the fiduciary duties of directors. It is worth seeing each one of these developments in closer detail.³⁰¹

2.5.3.2 comparative analysis - national reforms of shareholder suits

It is now time to analyse the developments registered in the subject of derivative suits in each one of the jurisdictions under study. **Germany** introduced extensive modifications to its legislation in 2005 with the Law on the integrity of companies and modernisation of shareholder suits (*Unternehmensintegrität und Modernisierung des Anfechtungsrechts Gesetz - UMAG*). The modifications introduced by the legislation focused on two fields: on the one hand, it intended to facilitate shareholder suits against the management and supervisory boards as a means to make them more shareholder responsive; on the other hand it intended to avoid the abusive use of the suit against the deliberations of the general meeting.

The underlying principle behind these modifications consists in the protection of the rights of minority shareholders. Although the agency costs perspective that has been adapted throughout the thesis tends to see corporate governance structures as a means to reduce the agency costs between shareholders and management, it is nonetheless evident that the concentration of ownership structures in Germany places considerable pressure upon management boards and opens room for the extraction of private benefits of

³⁰¹ Macey, J. R. (2008). *Corporate Governance - promises kept, promises broken*, Princeton University Press. pp.130-154.

control. Having this in mind it become easily understandable that the reform of *Klagerecht* (law for shareholder suits) is understood as an instrument to further enhance the protection of minority shareholders.³⁰² By facilitating the use of derivative suits against the behaviour of the management and supervisory boards, the reform intended to limit the room for the extraction of private benefits of control from majority shareholders because the suit will not need a majority decision by the general meeting but it may be initiated by a coalition of minority shareholders. On the other hand, the reform of the suit against deliberations for the general meeting was limited to the deliberations that were not preceded of sufficient information rights for minority shareholders; although this is an apparent restriction to minority shareholders' rights, it has the paradoxical convex effect of improving their rights to information.

The German case law and statute law has achieved considerable advances in the recognition of an Anglo-Saxon style of fiduciary duties and in the consequences for their breach. The current version of §93AktG claims that the management is under a duty of care (*Sorgfaltspflicht*) and of a duty of loyalty (*Treuepflicht*) in relation to the company and that it is entitled to use the business judgement rule as a defence against abusive suits because the entrepreneurial activity always demands a certain margin of risk. The question to be analysed now consists in the enforcement of these fiduciary duties. The previous version of the AktG attributed to the Aufsichtsrat the competence to begin the suit for breach of fiduciary duties the management board; alternatively, the general meeting could start a suit against the management and supervisory board by means of a simple deliberation (§147AktG). Both of these systems proved to be unreliable: the Aufsichtsrat often refrained from undertaking actions against the Vorstand on account of fear of letting

³⁰² Some proposals were made to distinguish the protection of the shareholder in publicly traded companies and in non-publicly traded companies. The underlying principle was the view of the shareholder in *publicly traded companies* as an *financial investor* in the company (identical to a loan-giver) and in *non-publicly traded companies* as a *co-owner* of the company. This view was refused because the dominant literature claimed that all shareholders make an investment in the company (whether or not publicly traded) and that their *influence rights* (*Mitwirkungsrechte*) against all illegal behaviours should be protected to the furthest extent possible. See Bayer, W. (2002). *Aktionärsrechte und Anlegerschutz - kritische Betrachtung der lex lata und Überlegungen de elge ferenda von der Hintergrund des Berichts der Regierungskomission Corporate Governance und des Entwurfs eines 4. Finanzmarktförderungsgesetzes Corporate Governance*. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer, Recht und Wirtschaft Verlag.

themselves be made liable for insufficient or inadequate supervision; the general meeting did not undertake any actions against the management and supervisory boards because the majority shareholders could control them to the fullest extent possible by means of voting rights. Since German company law did not recognise a general *actio pro socio*, the meaning of §93AktG was essentially void because there were no enforcement mechanisms.³⁰³

The first reaction against this situation came in the KonTraG, which introduced some extensively criticised modifications to §147AktG. The KonTraG allowed the derivative suit to be started by shareholders who owned 10% of the company's capital; at the request of shareholders who owned 20% of the company's capital or a participation of €500.000, the court could nominate a special representative for the investigation of the grounds of the derivative suit but only when there were circumstances that supported a reasonable opinion (*fumus bonus iuris*) that the company had suffered damages on account of the violation of duties or other irregularities. This regime suffered severe criticisms because the costs of the action had to be borne by the shareholders (while the compensation went into the reserves of the company) and the majorities required both in the first and in the second alternative (the nomination of the special representative) were extremely high in order for the law to be effectively enforced because minority shareholders face considerable collective action problems in German companies.³⁰⁴

The answer came in the UMAG, which introduced some far-reaching modifications to the regime of the shareholders' derivative suite. The most important modification consisted in the reduction of the necessary thresholds to initiate a derivative suit against the management and of the collective action costs that the shareholders faced to syndicate the necessary thresholds. The new regime maintained the rule that the general meeting is, in principle, competent to begin the shareholder suit against the management or supervisory boards by means of a simple majority (§147AktG). In the event that the general meeting fails to do so, shareholders owning 1% of the capital of the company or who have a shareholding of €100.000 may initiate the derivative

³⁰³ Schmidt, K. (2002). *Gesellschaftsrecht*, Carl Heymanns pp.629-644. and 815-819.

³⁰⁴ Hommelhoff, P. and D. Mattheus (1998). "Corporate Governance nach dem KonTraG." *Die Aktiengesellschaft* 43(6): 249-259, Lingemann, S. and D. Wasmann (1998). "Mehr Kontrolle und Transparenz im Aktienrecht: Das KonTraG tritt in Kraft" *Betriebs-beräter* 53(17): 853-862.

suit in their own name as long as there are circumstances that support the convenience of the suit.³⁰⁵ In order to facilitate the action of the shareholders, the UMAG introduced an innovative article in the AktG that is destined to reduce the collective action costs that shareholders face: this novelty is inserted in §127a AktG and is named as *Aktionärsforum* (*shareholders forum*). This consists in an electronic webpage in which shareholders or groups of shareholders may contact other shareholders in order to syndicate the necessary majorities to exercise any right recognised to the other shareholders. Although this shareholders' forum is not limited to syndicate the necessary majorities to initiate a shareholder suit, it is nonetheless a useful instrument to initiate liability actions against the boards. Similarly, the UMAG also reduced the necessary thresholds for the nomination of a special representative (*Sonderprüfer*) to investigate the grounds for a derivative action to occur. In accordance with the new version of §142(2)AktG, in the event that the general meeting fails to request a sonderprüfer by means of a deliberation to be undertaken by a simple majority, shareholders holding 1% of the capital of the company or a shareholding of €100.000 may request the court to nominate one to undertake the necessary investigation. In addition, the costs are to be borne by the company (§146AktG).³⁰⁶

The UMAG also undertook an extensive reform of the shareholders' right to render void a deliberation of the general meeting for insufficient information rights (*Anfechtungsklage*). The previous version of the law allowed ample Anfechtungsklage in two situations: (1) violation of the law or statutes of the company or (2) in situations of abusive deliberations, i.e. when the general meeting adopted a deliberation destined to grant special advantages to the shareholder of third party at the expense of the company or the other shareholders. The first provisions opened room for frivolous bargaining because the extensive information rights (*Auskunftsrecht*) granted in §131AktG to the shareholders opened room for all kinds of self-interested suits based

³⁰⁵ The law places severe constraints on this suit. The shareholder must have been a holder of the shares at the time of the careless/disloyal behaviour, the company must not have exercised any diligences in due time, there are circumstances that support the action (*fumus bonus iuris*) and that the action will not bring any damage to the wellbeing of the company. These provisions are destined to ensure that the suit is exercised in the interest of the company and not in the interest of a dictatorial minority (§148(1)AktG).

³⁰⁶ Schäfer, K. (2005). "Die Binnenhaftung von Vorstand und Aufsichtsrat nach der Renovierung durch das UMAG." *Zeitschrift für Wirtschaftsrecht* 26(29): 1253-1259.

upon an erroneous interpretation of sufficient information. This led courts to be more reticent to the use of shareholder suits based upon these fundaments and to adopt less shareholder friendly attitudes. The new version of §243(4)AktG has the paradoxical effect of contributing to the protection of the shareholders while restricting the possibility of using an *Anfechtungsklage* based upon information rights. This provision claims that shareholders may only initiate an *Anfechtungsklage* based upon insufficient information when the information transmitted to the shareholder was erroneous, incomplete or denied and the shareholder proves that that information was essential to the exercise of its *Mitwirkungsrechte*.³⁰⁷ This regime, while reducing the margin of manoeuvre for shareholders, obliges the management and supervisory boards to be extremely correct and complete on the type of information that they provide to shareholders and to be particularly responsive to any request of information on the part of the shareholders; on the other hand, it creates incentives for shareholders to monitor more closely the activities of the management because they are aware that deliberations from the general meeting may only be avoided when the elements under which they voted were essential to them. This creates incentives for the further engagement of the shareholders in the life of the company and a closer monitoring of the management board because the grounds for litigation against the general meeting under the grounds of information became exceptional.³⁰⁸

The UK also undertook a reform of its derivative suits in the Companies Act 2006 although under much criticism of the extent of the reform. In contrast to the approach followed in common law regulations other than England and Wales, prior to the Companies Act 2006 there was almost no possibility for the shareholders to bring an action against the management board for breach of

³⁰⁷ Noack, U. and D. Zetsche (2006). "Die Informationsanfechtung nach der Neufassung des §243Abs4 AktG." *ZHR*(218-246). Raiser, T. (2007). *Aktionärsklagen. Aktienrecht im Wandel - Grundsatzfragen des Aktienrechts*. W. Bayer and M. Habersack, Mohr Siebeck.

³⁰⁸ For the general discussion, see Reichert, J. (2000). *Aktionärsrechte und Anlegerschutz - Stellungnahme zu den Vorschlägen der Coporate Governance Kommission Corporate Governance*. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer. Heidelberg, Recht und Wirtschaft, Bayer, W. (2002). *Aktionärsrechte und Anlegerschutz - kritische Betrachtung der lex lata und Überlegungen de elge ferenda von der Hintergrund des Berichts der Regierungskomission Corporate Governance und des Entwurfs eines 4. Finanzmarktförderungsgesetzes Corporate Governance*. P. Hommelhoff, M. Lutter, K. Schmidt, W. Schön and P. Ulmer, Recht und Wirtschaft Verlag, PriceWasserHouse Coopers and BDI (2005). *Corporate Governance im Deutschland. Entwicklungen und Trends von Internationalem Intergrund*,

fiduciary duties. The leading case was *Foss vs Hartbottle* in which the courts established that the necessary distinction between the shareholders and the company that the doctrine of legal personality entails implied that the shareholders were not proper claimants to bring actions directly against the members of the board for harm done to the company. The action had to be established by the company itself (i.e: the company had to go to court and claim compensation for the damages incurred under the faulty behaviour of the management) and depended of an ordinary resolution of the shareholders taken in a general meeting.

This raised considerable agency costs in relation to minority shareholders, who faced considerable collective action costs to summon a meeting (on account of the dispersed ownership structure of UK companies) and were exposed to the private benefits of control of the majority shareholders. This led the courts to alleviate the doctrine laid down in *Foss vs Hartbottle* in order to diminish the agency costs incurred by the minority shareholders. The leading case is *Edwards vs Halliwell* that identified the following exceptions to the rule laid down in Harbottle: (1) fraud on minority by wrongdoers in control and (2) invasion of members' personal rights.³⁰⁹ The first exception concerned a situation in which a company has suffered harm but in which the general meeting is unable to pass an ordinary resolution because the majority shareholders used their voting power in such an outrageous way that resulted in a loss to or discrimination of the minority shareholders; although negligence is not enough to prove the abuse (*Pavlides vs Jensen*) there is no need for a clear intention (*dolus*) to bring damage to the minority shareholders. It is enough that the loss of discrimination of the shareholders is evident and that is not derived from pure negligence. As regards the second exception, the shareholder is always entitled to go to court whenever the actions of the management board bring damage to them personally based upon breach of

³⁰⁹ This case identified four restrictions to the rule laid down in Hartbottle: (1) *fraud on minority by wrongdoers in control*, (2) *invasion of members personal rights*, (3) *violation of ultra vires doctrine* and (4) *material procedural irregularities*. In reality only the first one is truly an exception because the others are cases in which the rule has no application: if the management damages the personal rights of any member it is the member who is entitled to go to court; the violation of the ultra vires doctrine could always be claimed by any shareholder and the shareholders are always legitimated to court and claim against other shareholders the violation of procedural requirements. See Davies, P. (2002). Introduction to Company Law, Clarendon Law series., pp.225 ff.

contract or tort (*Wood vs Odessa Waterworks co. and Salmon vs Quinn & Axtens Ltd*).³¹⁰

This explanation of the legal framework reveals that the common law had a very limited room for shareholder litigation. These shortcomings were addressed in the Companies Act 1985 and in the Companies Insolvency Act 1986 but they were very limited in scope: s.459 Companies Act 1985 allowed shareholders to petition the court whenever the company was being managed in a way prejudicial to some of its members (as long as its interest as a member was personally affected) and s.122(1)(g) Insolvency Act 1986 allowed shareholders to claim a court to wound up the company whenever the court considered this to be just and equitable. These exceptions to the rule laid down in *Foss vs Harbottle* were not sufficient however to ensure an adequate protection of shareholders in a country that exhibits a dispersed ownership structure such as a UK.³¹¹

These difficulties were addressed in s.260 ff Companies Act 2006. The origin of this provision lies in a report made by the Company Law Review steering group who, after reviewing the rule laid down in *Foss vs Harbottle* and the exceptions laid down in further case-law, considered it as extremely complex and inadequate to the fulfilment of the duties of managers, which is to enhance the well-being of the company as a whole - and not of the short-term interests of the shareholders. The commission considered that the derivative action should be put in statute, be restricted to the breaches of the fiduciary duties of managers (including duties of care and skill) and should not be confined to cases of self-serving negligence and fraud. The purpose of the reform was to create incentives for the use of the derivative action as an internal governance mechanism to enforce the fiduciary duties of managers - which is to manage the company in the long term interests of the shareholders and taking into account the interests of the relevant stakeholders, including employees - and not as a simple means of protection of minorities against the abuse of the majority.³¹²

³¹⁰ Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press. pp.498-535.

³¹¹ Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish. pp.177-193.

³¹² Reisberg, A. (2007). Derivative actions and corporate governance, Oxford pp.125-132.

S.260 Companies Act 2006 allows any shareholder to bring an action based upon the violation of the fiduciary duties by a director when the cause of action is vested in the company (*i.e.* when the company was the one to suffer a damage and not the individual shareholder) and the shareholder is seeking relief on behalf of the company (*i.e.* the compensation will go to the company and not to the shareholder). The action is subject to a preliminary control however: the shareholder must ask the court permission to continue the derivative claim, presenting the court with sufficient evidence that there may be a breach of fiduciary duties and that the action is likely to be successful (s.261). The court is granted a wide margin of discretion when appreciating the claim: it is entitled to grant it, dismiss it altogether or request further evidence. The regulation is particularly concerned with guiding the reasoning of the judge: the judge is to appreciate the claim as if would be the manager of the company, judging whether the duty to promote the success of the company implies that the claim be allowed or dismissed; whether the shareholder is acting in good faith in the interest of the company as a whole (and not in its own selfish interest); whether the company authorised or ratified the faulty behaviour; whether this faulty behaviour is sufficient to fundament an individual suit of the shareholder against the management for damages suffered in its own property rather than on behalf of the company (s.263). The Companies Act finally provides that another shareholder may continue the derivative claim in the event that the other shareholder fails to conduct the claim in a proper way (s. 264). The objective of this preliminary control procedure is to ensure that the action is made in accordance with the interests of the company and that the interests of the company advise its continuation.³¹³

This is a curious regulation that stands in a marked contrast with the activist view of British company law that the literature tended to caricaturise. The regime laid down in s.260-264 of the Companies Act must be seen at the light of the objectives of the reform of company law undertaken by the Act. There are two main ideas that we need to retain to understand this regime: the codification of the fiduciary duties of managers and the objectives of shareholder engagement. The fiduciary duties of directors in British company law are owed to the company and not to the shareholders; if we take into

³¹³ Sealy, L. and S. Worthington (2008). Cases and Materials in Company Law, Oxford University Press.pp.525-539.

consideration the fact that the directors are under a duty to promote the success of the company under the enlightened shareholder value theory, it becomes clear that the derivative suit of the shareholders must be made in accordance with the interests of the company (and not their own interests). On the other hand, one of the concerns of the Act was to terminate the traditional attitude of exit instead of voice within companies and promote shareholder engagement.³¹⁴

Having this in mind, the regime becomes relatively easy to understand. The legislator wanted to avoid that the recognition of the derivative claim on behalf of the shareholders would trigger frivolous or self-righteous litigation; therefore it surrounded the action with precautions to ensure that it was made in the interest of the company. That is the reason why it is subject to a preliminary court procedure destined to appreciate (1) whether the shareholder is acting on behalf of the company or under its own interest, (2) whether the action is on the best interest of the company and (3) whether the company authorised or ratified the behaviour of the management in any way. This is a clever way to enforce judicially the fiduciary duties of directors.

But a question remains: what are the incentives of shareholders to initiate the action since they have to borne the costs and the compensation goes to the company? There may be two main reasons for the activism: the protection of minority shareholders and the indirect increase in share prices. As regards the former reason, the action is thought to preserve the rights of minority shareholders against abusive behaviours of the majority or to overcome the passive attitude of British investors. Since the majority shareholders have a decisive word in the election of the management it becomes clear that this opens room for the extraction of private benefits of control; the recognition of the right to other shareholders to initiate a derivative claim serves as a balancing mechanism destined to enforce their rights to have the company managed in the long-term interest of all shareholders (and not just the majority) while at the same time avoiding that it become a pitch weapon of oppressed minorities, thus forgetting the interest of the company as a whole. In this sense, it is a mechanism for the enforcement of the fiduciary duties of

³¹⁴ Barry, P. (2005). Company Law Reform White Paper, Department for Trade and Industry, Ferran, E. (2005). Company Law Reform in the UK: a progress report, European Corporate Governance Institute.

directors. As regards the latter reason, considering that the ownership structures in British companies are still considerably dispersed when compared to continental patterns, shareholders still face considerable collective action costs to make an ordinary resolution to initiate an action against the management; this mechanism may be used as a means to overcome these collective action costs and reduce the agency costs that occur between the management and the shareholders. This is expected to have a positive externality in terms of share prices because the improvement of the governance in the company and the entry of a new management board is capable of triggering interest in the company of investors. The combined effect of these two conditions (defence of the rights of minority shareholders and overcoming collective action costs) creates the necessary incentives for shareholders to become engaged in the life of the company and reduce the agency costs *vis-à-vis* the management. In this sense, it is equally a mechanism for the promotion of the engagement of shareholders in the life of companies.³¹⁵

Portugal also introduced some modifications to its regulation of shareholder suits. The Portuguese company statute contains a very detailed regulation concerning the liability of the management, supervisory and auditing organs: in synthetic terms, the management, supervisory and auditing organs are liable in relation to the company for the wrongful setting up and administration of the company, independently of being liable in the terms of general tort law towards damages directly caused to the shareholders or any third parties (arts.71-74 and 79 CSC) and in relation to the creditors of the company, when they disregarded the provisions destined for their protection (art.78 CSC); in addition, controlling shareholders may be held vicariously liable under certain conditions together with the management organ (art.83 CSC) and in companies reduced to only one member, the solitary shareholder may be held directly liable for the debts of the company when he disregarded the separation between their personal and company assets (art.84CSC). The

³¹⁵ Lawlor, D. G. (2007). "Reform der englischen Limited und ihre praktischen Auswirkungen "ZIP 47(2002-2005).; Cheffins, B. R. (1997). Company Law. Theory, structure and operation Clarendon Press, Davies, P. (2002). Introduction to Company Law, Clarendon Law series, Lee, J. (2007). "Shareholders' derivative claims under the Companies Act 2006: market mechanism or asymmetric paternalism." International Company and Commercial Law Review 18(11): 378-392.

reform of Company Law undertaken in 2006 also introduced a considerable number of modifications to the regime of liability of management/supervisory/auditing organs. Some of its innovations were sketched above, namely the codification of the fiduciary duties of directors, the introduction of a business judgement rule and all the consequences attached to it. The other innovations important for this chapter consisted in the reduction of the necessary majorities to initiate a derivative suit and in the vicarious liability of controlling shareholders.³¹⁶

The CSC maintained as a rule that the proposal of a derivative suit against the management/supervisory/auditing organs of the company depends of a deliberation of the shareholders taken in a general meeting by a simple majority (art.75CSC); in the event that the general meeting fails to approve such a deliberation (because there is a coalition between the management and the majority shareholders for instance) the CSC allow shareholders holding 5% of the capital of the company (or 2% in the case of listed companies) to initiate the derivative suit in order to claim compensation for the benefit of the company (and not to their own benefit – art.77(1)CSC); there is a concern in ensuring that the derivative suit initiated by the minority shareholders is in fact made in the interest of the company and not in their own interest; in the event that the company claims that the shareholders are not pursuing the interest of the company, the company may request the judge to make a preliminary deliberation on the convenience of the suit for the interests of the company, in a procedure similar to the one adopted in the British Companies Act 2006 (s. 260). This is an important provision destined to reinforce the fiduciary duties of directors because they are owed to the company (and not to the shareholders, whose interest must be regarded within an enlightened shareholder value theory). Therefore, this benefit granted to the minority shareholders is not destined to protect their interests as minority shareholders but the interests of the company as a whole; it is best viewed as a counter-balance to the

³¹⁶ Carneiro da Frada, M. (2007). "A Business Judgement Rule no quadro dos deveres gerais dos administradores." *Revista da Ordem dos Advogados* 67(1). Menezes Cordeiro, A. and P. Câmara, Eds. (2007). *Jornadas de Homenagem ao Prof. Raúl Ventura. A Reforma do Código das Sociedades Comerciais*. Almedina, Câmara, P. (2008). O governo das sociedades e a reforma do Código das Sociedades Comerciais *Código das Sociedades Comerciais e Governo das Sociedades*. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.

excessive weight that the majority shareholders enjoy in a country of concentrated ownership structures such as Portugal.

In addition, Portugal has equally introduced the concept of shadow director in its company Law. The British Companies Act 2006 defines a shadow director as a person in accordance with whose directions or instructions the directors are accustomed to act (s.251). Parent companies and professional advisory bodies are not to be regarded as shadow directors. The purpose of the provision is to make the persons holding a decisive influence in the course of the affairs of the company liable in relation to it because they are the ones exercising a de facto control of the company; the directors must be mere puppets of the shadow director.³¹⁷ The new redaction of art.83(4)CSC intended to implement this theory in Portuguese Company Law. The new provision is thought for shareholders who enjoy the power to resign a member of the management or supervisory organs of a company on account of the special advantages granted to him in the corporate charter or on account of the voting power that he has isolated or together with other shareholders to whom it is bound by contractual agreements (*patti parasociali*); in the event that that shareholder leads the director breach its fiduciary duties in relation to the company using that same power, that shareholder will be held vicariously liable in relation to the company or shareholders for the tortuous act in which it is directly implied.

This is a complicated provision that may be summed up in a few words: in the event that a person enjoys a decisive influence over the director of a company and leads that director to breach its fiduciary duties in relation to the company in a certain act or number of acts, that shareholder will be held liable in the same terms as the director because he was directly implied in the adoption of the act. In order for the provision to be effective the same concept of shadow director that was adopted in British law must be applied: the directors must be mere puppets of the shareholder on account of the special advantages recognised to him by the corporate charter or its disproportionate voting power. It is worth noting that this disproportionate voting power may trigger the liability only when the shareholder holds it himself or bound by *patti parasociali*: in the event that a coalition of shareholders syndicates to exercise

³¹⁷ Bourne, N. (2008). *Bourne on Company Law*, Routledge-Cavendish., pp.122-123

a direct influence over the management of the company and lead it to breach its fiduciary duties, the only possibility of the shareholder is to render void the deliberations taken in the general meeting and then claim damages to the syndicate of shareholders (art.58(3)CSC).³¹⁸

The general conclusion that one may extract from the reform of the Portuguese legislation of derivative suits is the following: the existing regulation was already sufficiently protective and the modifications introduced were destined to enforce it even further by means of the protection of the minority shareholders. Considering that Portuguese ownership structures were and still are considerable concentrated, this opened room for considerable agency costs of both management and majority shareholders *vis-à-vis* the minority shareholders because the alignment of interests between the former rendered the existing regulation ineffective (because it depended on a decision taken by a simple majority). The means to overcome these agency costs consisted in the reduction of the thresholds to initiate a derivative suit and the introduction of the vicarious liability of the shadow director. This appears to be the best means to enforce the fiduciary duties of directors because it serves as a counterbalance to the power that majority shareholders have in deciding the destinies of the company while ensuring that the activism of minority shareholders is made in the interest of the company (and not in their own interest).

Only **France** failed to introduce any innovations to its regime of shareholder suits because the LNRE considered that it was sufficiently protective in accordance with international standards and preferred to use other means – mentioned above – to make management boards more responsive to the interests of shareholders (namely by means of information rights).

³¹⁸ Calvão da Silva, J. (2007). "Responsabilidade civil dos administradores não-executivos, da comissão de auditoria e do conselho geral e de supervisão." *Revista da Ordem dos Advogados* 67(1), Cunha, P. O. (2007). *Direito das Sociedades Comerciais*. Lisboa, Almedina, Fernandes de Oliveira, A. (2008). Responsabilidade Civil dos Administradores. *Código das Sociedades Comerciais e Governo das Sociedades*. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina.pp.717-721.

2.5.4 comparative perspectives – reinforcement of shareholder monitoring of companies

This comparative analysis of the evolution of the rights of shareholders in companies may allow us to extract the following conclusions. It appears that the evolution just described demonstrates that each country is attempting to reinforce the control rights of shareholders in companies (particularly public companies), although always having in account the specificities of the national governance system. The shareholders may exercise control over the management board essentially by two means: (1) by means of the general meeting and (2) by means of the derivative action. Having this in mind, the trend underpinning the evolution becomes relatively easy to understand.

An extremely important innovation consisted in the reinforcement of the rights of shareholders to **information**; this is an aspect that should not be underestimated because the exercise of the control rights (vote + derivative suit) depends on the knowledge of the situation of the company. France and the UK, where the legislation intended to expose the activities of the management board to the scrutiny of the shareholders by means of a number of extensive reports that should disclose their activities and decision-making procedures, introduced the main innovations. Although their governance structures vary to a great extent, it is curious to see that both of them intended to achieve the same result by means of the right to information; France intended to protect the minority shareholders from the pressure of the majority shareholders by exposing the activities of the management board to the scrutiny of the market and obliging the companies to be more transparent and better governed in order to attract capital; the UK intended to achieve the engagement of the shareholders in the company by means of information by subjecting the behaviour of the management board to the scrutiny of the general meeting. If we connect this to the reform of fiduciary duties undertaken in both countries it becomes easy to understand that the disclosure of information was a means to enforce the enlightened shareholder value view that is seen as the better way to govern the companies: in France because it obliges the management board to take into account the interests of the minority shareholders in the governance of the company (reducing the margin for the extraction of private benefits of control); in the UK because it encouraged voice

instead of exit strategies and granted the management board sufficient margin to pursue more long-termed strategies of growth.

The disclosure of information must be connected to the revival of the **general meeting**. The main innovations common to all the countries consisted in the use of proxys and IT in general meetings in order to attract foreign capital and encourage the participation of shareholders in meetings even when they are not present; in addition, each country also undertook a number of measures destined to reduce the prevalent agency costs in their national governance structures. **Germany** introduced some far-reaching modifications to its proxy regime, allowing an almost unrestricted use of proxy voting in publicly traded companies. This was coupled with some measures destined to reduce the influence of banks in their use of proxy voting (such as limited proxies and the binding of the interests of the bank to the instructions of the principal). This is an extremely important innovation if we take into account the role of banks in the German governance system because the final result will be the empowerment of the direct shareholders. This is expected to introduce some considerable modifications to the German governance system and make it increasingly more shareholder oriented while at the same time attracting foreign investments. The intention to attract foreign investments is patent in the other modifications introduced, namely: (1) the dismantling of its deviations from the one share/one vote principle in publicly traded companies; (2) the shorter speaking rights (destined to make the general meeting more effective) and (3) the elimination of the obligation to deposit the shares before the meeting (this increasing their liquidity). The combination of all of these features is expected to bring about some considerable modifications to the German system of governance and dismantle the traditional standard of bank-sustained stakeholder economy that characterised it for more than 50 years. The **UK** did not lay behind in its reinforcement of the general meeting by means of the Companies Act 2006. The UK made an extensive use of the proxies in order to encourage the participation and engagement of shareholders in the company, in particular as regards indirect investors; in addition, public companies are required to have a annual general meeting that is linked to the reporting cycle of the management board (so that the behaviour of the management may be analysed) and some provisions were made in order to facilitate the passage of resolutions (particularly written resolutions and extraordinary resolutions). The

objective is to encourage the use of the general meeting in the governance structure of the company and reduce the agency costs that there are between management and shareholders, thus creating incentives for a voice strategy of governance and approximating the British governance system close to European Continental standards. **France** and **Portugal** undertook the same path in the revival of the general meeting although the modifications were not so extensive. The main innovations consisted in the almost unlimited use of proxy voting and IT in the general meetings. This was particularly important for France that used this possibility as a means of attracting foreign capital; nevertheless it failed to eliminate double-voting shares and introduce a strict one share/one vote principle, opening margin for the maintenance of control on the part of some shareholders.

The disclosure of information must equally be connected to the increased reliance on **shareholder litigation**. With the exception of France - a country that already exhibited a very detailed and protective regime of liability with its *action sociale en responsabilité* (L.225-252 *Code du Commerce*) - virtually all countries reformed their regulations concerning derivative suits in order to use the judiciary as a governance mechanisms destined to control the management board. The three countries that introduced modifications to their regime of derivative suits appear to have been guided by three points: (1) the protection of minority shareholders, (2) the reduction of collective action costs and (3) the enforcement of the fiduciary duties of directors.

As regards the protection of minority shareholders one should begin by stating that all three regulations maintained as a default regime that the derivative suit should be initiated by a deliberation of the shareholders; the special regimes, that allowed the suit to be initiated by a small threshold of shareholders, was destined to protect the minorities in countries with concentrated ownership and in reducing collective action costs in the UK, thus reducing the margin for the extraction of private benefits of control.

As regards the reduction of the collective action costs, all regulations introduced measures to facilitate the syndication of shareholders, such as the *aktionärsforum* in Germany and in the recognition of the right to initiate a derivative suit to any shareholder in the UK.

Finally, all three countries seemed to have been concerned with the possibility that the derivative suit would be used as an instrument for the

dictatorship of the minorities and not in the interest of the company. That is all three jurisdictions introduced control procedures (particularly the UK) in order to guarantee that the suit was made in the interest of the company. This is a very important governance mechanism because this control procedure prevents the use if the suit as a mean of shareholder blackmailing and ties the judiciary and the management to the interests of the company, thus reducing the agency costs that the abusive use of this suit could pose to the interests of the majority shareholders or stakeholders.

The combination of these three trends in the governance structures of all countries under analysis (reinforcement of the right to information, revival of general meeting and reliance on shareholder litigation) provide shareholders with a much stronger position than the one that they enjoyed before and contributes significantly to the reduction of the agency costs within the nexus of contracts that composes the company. In addition, it provides further evidence of the convergence of the governance standards of each country under analysis: the UK is increasingly closer to the European Continental model by providing incentives for strategies of voice instead of exit whereas the continental governance structures are increasingly closer to the anglo-saxon model by reducing the margin of manoeuvre of the management and empowering the activism of the shareholders.

2.6 The European Dimension and Strategy in Corporate Governance

A final point that must be addressed consists in the impact of EU Law on the governance of public companies. Company law and Corporate Governance became a key concern of the EU in the early years of the XXIst century after the traditional regulatory approach by means of directives – which were destined to remove restrictions to the functioning of the common market – led the regulatory activity of the EU to a halt. The corporate collapses of Enron, Parmalat and other large companies and the unprecedented degree of regulatory activity on the other side of the Atlantic by means of the adoption of the Sarbanes-Oxley Act raised concerns that a modern competitive economy depended on the adoption of a number of a number of measures in the framework of company law and corporate governance in the EU. The key idea was to make European companies more competitive with a view to attract investments and underpin confidence in European companies in other markets. Encouraged by the success in the adoption of the European Company Statute (*Societas Europeae Regulation- SER*) in the follow up of 30 years of negotiations, the Commission decided to set up in 2001 a Corporate Governance Forum and trust a number of renowned company law experts to draw up a plan for the regulatory activity of the EU in the years to come. This plan came out in 2003 and became known as the Commission's Action Plan for Company Law and Corporate Governance, which listed a number of 24 measures that were to be implemented in the following years. A large number of these measures have already been implemented either in the form of legislation (Directives) or in the form of recommendations that are expected to function as guinea pigs for future legislative action. The following points will attempt to address the results of the activity of the EU in the area of corporate governance. The following lines will argue that the EU seems to have followed the international trends towards the hybridisation of the governance structures of companies and that the most likely result in the future will be an approximation of relational systems towards market systems and vice-versa. This paragraph will focus on the activity of the EU in the subjects of (1) management boards, (2) disclosure, (3) shareholder rights and (4) auditing.

2.6.1 Regulating Corporate Governance at the EU level

The analysis of the recent developments in EU Law must initiate with a short illustration of the discussion concerning the regulation of Corporate Governance at the EU level. This analysis must begin with a review on the former discussion concerning the harmonisation of company law in the EU. The EU has long attempted to harmonise company laws throughout Europe; art.50 (1), f) and g) ECT provided the community with the necessary powers to implement the necessary measures to facilitate the setting up of agencies, branches or subsidiaries and by co-ordinating the necessary safeguards for the protection of the interests (agency costs?) of shareholders and stakeholders of companies within the EU. This apparently far-reaching provision did not provide outstanding results however: despite the undeniable harmonisation effort carried out by the EU in several subjects of company law, the majority of the Directives were enabling and the difficulty to reach a consensus on the hardcore matters of company law prevented the formation of the necessary majorities to adopt further directives.³¹⁹

The difficulties felt during the harmonisation efforts are due to a number of factors. A preliminary factor bets upon the embeddedness of national company laws into national environments and interest groups; national company laws resulted from a consensus between the national politics and interest groups and the introduction of alien elements into the system would alter the delicate balance reached within it; on the other hand, the transaction costs associated with the adoption of distinct types of rules contributed to the crystallisation of certain types of rules even if they were deemed inefficient by certain sectors of the society.³²⁰ A second reason is connected with certain doubts concerning the benefits connected with the centralisation of company laws at the European level. The regulatory activity of the EU is bound to the

³¹⁹ The harmonisation effort touched the following points: (1) Formation and Validity of Obligations Entered into by Companies (First Company Law Directive), (2) Simplification and Capital Maintenance Rules (Second Company Law Directive), (3) Restructuring Directives (Third, Sixth and Tenth Directive), (4) Company Accounts (Fourth and Seventh Directives), (5) Company Auditors (Eighth Company Law Directive), (6) International Company Forms (*Societas Europeae* Regulation) and (7) Secondary Establishments (Eleventh Directive). The Shareholder Rights Directive and Takeover Directive will be analysed further on. See Habersack, M. (1999). *Europäisches Gesellschaftsrecht*, C.H. Beck.

³²⁰ Bebchuk, L. A. and M. J. Roe (2004). A theory of path-dependence in corporate ownership and governance. *Convergence and persistence in Corporate Governance*. J. N. Gordon and M. J. Roe, Cambridge University Press.

principle of subsidiarity meaning that the EU is entitled to act only when the national level is not sufficient to reach the desired results. The debate concerning company law has long been divided between two pressure groups, the centralists and the advocates of legal federalism: the centralists argue that the harmonisation of company laws at the European level would reduce transaction costs (the laws would be equivalent across Europe and investors would be able to count with a minimum core of rights), eliminate distortions in competition and internalise significant spill-overs; the legal federalists claim that company laws should remain an issue of national laws and politics and that any changes in law should arise from the regulatory competition between distinct jurisdictions; the protection afforded by each jurisdiction to the distinct interest groups that compose the company functions as a public good and only regulations for which citizens and firms will be willing to pay for will have chances of surviving.³²¹

Despite these difficulties, the truth is that the EU has managed to enact a scattered body of law attempting to harmonise company laws across the EU that have brought a limited degree of harmonisation in national company laws. This harmonisation effort was carried out not only by means of Directives but also by other means that have triggered reflexive movements of reform in national company laws such as the Centros Case Law (to be analysed further on) and the Group of Experts in Company Law in Europe, which function as a type of open method of coordination in company law.³²² The conclusion may be that the task of harmonising company laws is difficult but not altogether impossible and that there is room for a flexible and varied approach to harmonisation.

This discussion serves as an introduction to understand the difficulties concerning the regulation of corporate governance at the European Level. Corporate Governance appeared recently in the European agenda: the beginnings must be traced to a communication made by Paul Davies to the European Commission concerning “*Issues in Corporate Governance*” in 1998

³²¹ Hertig, G. and J. A. McCahery (2004). An Agenda for Reform: Company and Takeover Law in Europe. *Reforming Company and Takeover Law in Europe*. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch, Oxford.

³²² See the interesting article by Deakin, S. (2007). Reflexive Governance and European Company Law. U. o. C. Centre for Business Research.

in which he explained why the issues of accountability and control of companies had received so much attention lately in some countries and the reasons why it should be discussed at the European level. The author believed that the current process of internationalisation of financial and capital markets, the blurring between the public and private sectors and the entry of institutional investors in European capital markets could demand a regulation of Corporate Governance at the European level namely in the subjects of (1) principal-agent and minority protection, (2) accountability of managers, (3) voice and exit, (4) buy-out and squeeze-out rights and (6) disclosure.³²³ The cases of Enron and Parmalat and the general movement of reforms of national company laws in Europe that they triggered led the European Commission to extend the mandate of the High Level Group of Company Law Experts (initially concerned with the Takeover Directive) to:

“issues related to best practices in corporate governance and auditing, in particular concerning the role of non-executive directors and supervisory boards, management remuneration, management responsibility for financial statements and auditing practices.”

The Expert Group was trusted with an extremely difficult task: the identification of the key components and the most desirable reforms for corporate governance was in itself sufficiently difficult but the attempt to make a EU-wide regulation was substantially more complicated. This thesis has attempted to outline the differentiation between the practices in Corporate Governance in Europe - having identified three basic models - and the fact that one rule is appropriate to a particular system of corporate governance does not mean that it is appropriate for the other or that the issue should even be regulated at the European level. The group decided then to take an extremely cautious approach: considering that each country developed a national corporate governance system that is more appropriate for its individual needs and that the diversity and competition between the systems should be respected, the Expert Group rejected the idea of a Pan-European Corporate Governance Code or a far-reaching harmonisation of core company law. The group preferred to focus on key areas and issues that affect the interests of investors

³²³ Hopt, K. J. (2002). Common principles of Corporate Governance in Europe. Corporate Governance Regimes - convergence and diversity. J. A. McCahery, P. Moerland, T. Raaijmakers and L. Renneboog, Oxford.

and that may hinder the functioning of the common market by establishing a barrier to the investment across European borders and therefore raise confidence in the internal governance of European companies - independently of the system in which they were imbedded - and therefore contribute to the integration of the internal market. The idea was to improve the internal and external governance of European Corporations by respecting national diversity.³²⁴

The result of the work of the group was published in the Action Plan for Company Law and Corporate Governance of 2003. The following paragraphs will attempt to analyse the activity of the EU in the area of Corporate Governance against the background of the objectives of the group laid out above and the current movement of convergence in the practices of Corporate Governance in each one of the jurisdictions under study.

2.6.2 Management Boards

The functioning of the management boards was one of the areas in which the EU was most active in the area of corporate governance. The EU implemented a number of measures concerning the functioning of the management boards that appears to confirm the movement of convergence in Corporate Governance. The following lines will attempt to analyse the activity of the EU in (1) the choice between single tier/ dual tier board structures, (2) the recommendation on the remuneration of directors, (3) the function of independent directors/committee work and (4) the liability of the board to investors by financial statements.

³²⁴ Hertig, G. and J. A. McCahery (2006). Company and Takeover Law Reforms in Europe: Misguided Harmonisation Efforts or Regulatory Competition. After Enron : improving corporate law and modernising securities regulation in Europe and the US. J. Armour and J. A. McCahery, Hart, Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart.

2.6.2.1 choice between single tier/dualist board

Traditionally, the single tier board structure is associated with the anglo-saxon model of the company and the dualist board structure is associated with the Germanic model. An important instrument issued by the EU that deals with these subjects is the *Societas Europeae* Regulation (SER).³²⁵ The SER provided shareholders with the choice between either model as they deem fitter to their needs and/or their national traditions (art.38(b) SER). This is in itself a significant element because it clearly lays down that no model is superior *per se* and that distinct regulations correspond to distinct interests and the shareholders should be given the legal framework that defends their own interests to the furthest extent.³²⁶

As regards the dualist board structure, a simple analysis of the provisions of the SER reveals that the regulation followed closely the Germanic model of organising firms: there is a management and a supervisory organ with clearly defined roles (arts.39 and 40 SER); the management organ is in principle to be appointed and removed by the supervisory organ; the supervisory organ is to be elected by the general meeting, in order to ensure an adequate representation of the diversified interests of the shareholders. It is interesting to observe that the SER suffered the same evolution in its dualist structure as the one described in Germany by means of the strengthening of the role of the supervisory board and the increased dependency of the activities of the management board from the supervision of the supervisory board. There is a concern, similar to the one found in Germany, to supervise the activities of the management board more closely in order to render the management board more accountable to the interests of the shareholders by means of their representatives on the management board. The key provision in this aspect is art.41SER: this rule provides that the management organ shall report to the

³²⁵ The story concerning the adoption of the SER, its atypical structure (it is more of a private international law instrument destined to coordinate the activities of pre-existing companies than a proper substantive instrument) and the means to set up a SER will not be repeated here. For that point, please see: Kellerhals, A. and D. Trüten (2002). "The creation of the European company." Tulane European and Civil Law Forum(17): 71-80.; Aguiló Piña, J. F. (2002). "La sociedad anónima europea: constitución, órganos y otros aspectos." Revista de Derecho Mercantil(246): 1795-1892.

³²⁶ Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart.

supervisory board at least once every three months on the progress and foreseeable development of the activities of the SE and, in addition, promptly every information liable to have an impact over the activities of the SE. The supervisory organ is equally entitled to demand at any time all information it deems fit to the conduct of its business and is entitled to conduct all investigations it finds necessary to exercise its functions of surveillance of the management organ. This article is a key provision that reveals that, although the companies that form the SER may opt for the Germanic model, the management board will not be given full discretion to run the business and will be under a heavy supervision of the management board. Finally, art.48 SER opens up the possibility that a number of transactions pre-determined in the statutes by subject to the approval of the supervisory organ. It is worth repeating that this amounts to an evolution similar to the one found in Germany as regards the improvement of the supervision of the functioning of the management board, in order to make managers more accountable to the interests of the shareholders, therefore improving the internal governance of dual-board companies.³²⁷

As regards the single-tier board structure, the regulation is sparser and it allows for a great degree of flexibility in accordance with the national traditions. The SER simply lays down that a company may have a single tier board structure elected by the general meeting (art.43(3) SER) and that that board must elect a chairman among its members (art.45SER). It is silent on two key aspects: firstly, as regards the separation of the roles of chairman and CEO; secondly, as regards the role of independent directors in the board. The only openings for these provisions consist in the possibility of distinguishing the roles when it is simultaneous with national law (art.43(1) SER) and the role of employee directors (art.43(2) SER) . It appears that one may infer from the statute that the SER does not impede the adoption of a French style structure of PDG in contrast to the international tendencies for avoiding unfettered powers of decision. The member state of registration of the SER may regulate these matters but a clear signal from the EU that it favours those developments

³²⁷ Braendle, U. C. and J. Noll (2004). The Societas Europaea – A Step Towards Convergence of Corporate Governance Systems?, SSRN, Braendle, U. C. and J. Noll (2005). "On the convergence of national corporate governance systems." *Journal of Interdisciplinay Economics* 16.

is wanting. Nevertheless, the board will have a substantial autonomy to run the affairs of the business unhampered by the supervision of independent directors (apart from employee directors) or by means of the separation of the roles of CEO and chairman. This is a pure anglo-saxon approach (there is a management board elected by the general meeting of the shareholders with full discretion to run the business) although not in harmony with the international tendencies in the UK, as demonstrated above.³²⁸

2.6.2.2 Directors' remuneration – transparency and efficiency in remuneration

A second area in which the EU has been active consists in the remuneration of directors of public companies. The recommendation of the EU is a clear response to a line of cases that swept Europe concerning excessively high remuneration set for directors by means of stock options, direct remuneration, pension payments and gold parachutes which were seen as rewards for failure. The EU considered that this would raise agency costs in relation to both shareholders and other stakeholders; as regards shareholders, inadequate remuneration policies may deprive them from earning that were deviated towards pornographic remuneration packages and discourage investment in listed companies; as regards stakeholders, the main stakeholders concerned with excessive remuneration policies are employees because excessively high levels of remuneration might come at the expense of wages within the firm. That was the reason why the Commission decided to address this question and propose a recommendation for the remuneration of directors of listed companies.³²⁹ The Commission decided to adopt a recommendation and not a directive on two grounds: firstly, the diversity of national regimes of remuneration within the EU should be *prima facie* respected; secondly, the Commission wished to do an impact assessment of the effects of the recommendation before undertaking more mandatory actions. The recommendation is divided in three main parts: (1) disclosure of remuneration

³²⁸ See Rose, C. (2007). "The new corporate vehicle *Societas Europeae*: consequences for European Corporate Governance" *Corporate Governance Review* 15(2): 112-121.

³²⁹ Commission recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

policy, (2) shareholder vote on remuneration policy and (3) accounting issues of remuneration (including stock options.). It is worth reviewing each one of these issues in detail.

The Commission places strong trust upon disclosure as a means of reaching an adequate remuneration policy. Each listed company is commanded to make a statement on the remuneration policy of the company that should be a part of an independent report. This remuneration report should focus on the current financial year but also make a comparison with the previous years and a foresight of the prospective years. There are four extremely important points that should be the focus of the report: firstly, the relative weight of the variable and non-variable components of the remuneration policy; secondly, the links between remuneration and performance; thirdly, sufficient information on share options, shares, bonus schemes and other non-cash benefits and the fundamental characteristics of supplementary pension or early retirement schemes for directors; fourthly, the total remuneration and other benefits granted to individual directors should also be disclosed both in the annual accounts of the company and in the remuneration report. A simple reading of these provisions reveals that the disclosure obligations imposed upon companies are extensive and that the EU places a strong confidence in it as a means of regulating the remuneration in listed companies. Full faithful and audited disclosure is useful as a basis for shareholder decision-making and as a conduit for information on the stock market, which may react to it in one way or another. There are doubts on the merits of individual disclosure, because it is said to raise envy because outsiders are generally not aware of the contribution that each individual director gives to the company. The EU seems to have been insensitive to these criticisms and demanded a disclosure of the remunerations of individual directors, perhaps in order to avoid the usual trick of presenting an average reasonable level of remuneration that hid great discrepancies between the individual members of the group.³³⁰

The role of the general meeting of shareholders in the determination of the remuneration policy of directors also came out reinforced. Although it is agreed that board remuneration is a matter best left to the audit committee and

³³⁰ Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart.

non-executive directors, the recommendation advises an annual vote on the principles and limits of the board (and senior officers') remuneration as a means of acting as a brake, even if shareholders rarely dissent from what is proposed. This is the solution that has been enacted in the UK. Further on, an express vote of the general meeting of the shareholders was recommended as regards all elements of share remuneration. Schemes under which directors are remunerated in shares, share options and any other right to acquire shares or be remunerated on the basis of share options should be subject to the approval of the shareholders in the annual general meeting. This is an important innovation: although share options are the key element in the alignment of the interests of managers with the shareholders, there is the concern that inadequate remuneration packages might create incentives for short-termism (which might be detrimental to shareholders), open way for insider dealing (making transactions that increase the prices of shares in the short-term in order to sell them even if it is detrimental to the long term) or hide other forms of remuneration. That is the reason why the share options are subject to an approval of the general meeting and extensive disclosure requirements.

A final issue concerns accounting. The recommendation imposes that the remuneration of directors be a distinct part of the annual accounts of the company so that one may clearly observe what is the remuneration of the board and the individual directors within the balance sheet of the company. This is an important development because it will bring more transparency as regards the adequacy of the remuneration policy of the directors in relation to the financial situation of the company, instead of diluting them within a number of costs.

The balance of the recommendation³³¹ of the Commission may be synthesized in the following points: firstly, there is a great degree of trust upon the market and upon disclosure as a means to tackle the agency costs that the remuneration of directors might raise vis-à-vis shareholders and stakeholders; the main approach is one of disclosure and a referral to the market as a means of evaluating the costs and benefits of the remuneration policy pursued by the company; secondly, the shareholders were considerably reinforced within this

³³¹ Commission recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

framework; the remuneration policy must be subject to their annual vote and share options must be subject to their specific vote; thirdly, the modifications to the accounting practices are destined to bring about a greater degree of transparency to the remuneration of directors. These innovations are expected to improve the internal governance of European companies by using the market as a means of reducing the agency costs of managers vis-à-vis shareholders.³³²

2.6.2.3 independent directors and commitology - improving management supervision

A third area of intervention of the EU in the framework of the structure of the boards of listed companies consisted in the promotion of the role of independent non-executive or supervisory directors. The Action Plan 2003 envisaged that the minimum standards on the creation, composition and role of the nomination, remuneration and audit committees should be defined at the EU level and enforced by the member states at least on a comply-or-explain basis. In a way similar to the remuneration of directors, the Commission came up in 2005 with a recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board.³³³ The Commission decided to take the approach of a recommendation instead of a Directive due to the fact that a Directive might face significant political opposition and the recommendation better reflects the reality of the issues at stake. Considering that the question of independent directors is a complex matter of the governance of the member states, the adoption of prescriptive binding legislation was seen with suspicion because it might not reflect the specificities of the governance of each sector in each member state. The preferred approach was one of comply-or-explain basis: the Commission

³³² Hopt, K. J. (2005). European Company Law and Corporate Governance: where does the Action Plan of the Commission lead?, ECGI - European Corporate Governance Institute. Ferrarini, G. and N. Moloney (2004). Executive remuneration and Corporate Governance in the EU: convergence, divergence and reform perspectives. Reforming Company and Takeover Law in Europe. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch, Oxford.

³³³ Commission recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC).

recommended a number of best practices and allowed companies to deviate from those best practices in accordance with their own national specificities under the condition that they explained the reasons for doing so. This ensured both the possibility of adapting to the national practices and ensuring a wide degree of transparency of the governance structure of companies trading on the market.

The recommendation begins by emphasising the importance of the presence of independent representatives on the boards of listed companies (§7). These representatives should be present on the management board in companies that follow the single-tier model and in the supervisory board in companies that follow the dualist model. The presence of independent directors capable of challenging the decisions of the management board is seen as a means of protecting the interests of the weaker constituencies in the company: shareholders in widely owned companies, minority shareholders in concentrated ownership companies and the stakeholders independently of the ownership pattern.

In order to achieve this aim, the recommendation makes the following advices: firstly, the company is asked to set up a number of independent non-executive directors within its (supervisory) board so that no individual or small group of individuals may dominate the decision-making within these bodies; secondly, companies are asked to separate the role of chairman and CEO: in single-tier board structures this will be achieved by the prohibition of the setting up of an entity similar to a PDG, i.e. the roles of chairman and CEO must be occupied by two distinct persons; in dualist board structures this will be achieved by the prohibition of the CEO occupying the position of chairman of the supervisory board immediately after its terms of office ended; thirdly, companies are asked to set up within their (supervisory) boards a number of committees: audit, nomination and remuneration committees. These committees should be composed exclusively or be dominated by independent directors in such a way that their judgement should really be considered independent from the pressures of the board. The role of these committees is seen as essential because they are active in the areas in which there is greater room for conflicts of interest to occur between the management and the shareholders. Their activity ensures a degree of independence in the composition, remuneration and scrutiny of the board. The committees are

charged with making recommendations aimed at preparing the decisions to be taken by the (supervisory) board itself, in order to ensure that the decisions are taken free from any substantive conflicts of interest. A final word must be given to the profile required from the independent non-executive directors. Besides the general requirements of the necessary qualifications and commitment for the performance of their functions, the recommendation places a serious focus on independence: a director shall only be deemed independent when it is free from any relationship that might impair its judgement, such as business, family and other relationships with the company, controlling shareholders or management. This is quite a strict standard of independence that echoes the ones found in the Viénot and Higgs reports.

A simple reading of the recommendation reveals that the EU has followed the international trends described above concerning the improvement of the supervision of the functioning of the management board. The key points consist in specialisation and independence: specialisation because the fundamental features that raise conflicts of interest that are most likely to give origin to agency costs *vis-à-vis* (minority) shareholders and stakeholders are delegated towards specialised bodies whose functions is to assist the preparation of those decisions; independence because these specialised bodies must be composed exclusively or mainly by independent non-executive directors that ensures that these decisions are taken to the greatest extent possible free from any conflicts of interest. The final effect is an increase in the transparency of the functioning of the board that might create incentives for investment.³³⁴

³³⁴ For an excellent description of the difficulties raised by the regulation of non-executive directors at the EU level see Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart.

2.6.2.4 Disclosure - transparency as an external governance mechanism

Another important area in which the EU issued some very important legal instruments consisted in the control of the management board via disclosure. The benefits of disclosure were already laid out above and they will only be briefly summoned here: disclosure consists in an affiliation rights governance strategy that attempts to reduce the agency costs of managers *vis-à-vis* shareholders and stakeholders by means of the provision of information concerning the functioning of the board; public exposure may be an extremely effective governance device to control the autonomy of managers.³³⁵ Disclosure may be an ideal subject to be regulated at the European level for the following reasons: this type of regulation is completely compatible with a market economy in which several governance structures are active because it has a minimum interference with the freedom and competition of companies in the market; the only thing that is required of companies is that they make public their governance structures without any kind of interference in their substantive arrangements; the investors will then evaluate in their investment decisions the appropriateness of the chosen governance structure at the light of alternative investments.

The High Level Group of Company Law Experts made some recommendations concerning disclosure. The group initiated by recommending that listed companies be required to fully disclose their capital and control structures, in particular possible defensive structures, in order to allow the market to react by means of the price to those internal governance arrangements. The Group went even further and recommended that listed companies should be required to describe the key elements of their internal governance structures and practices independently of their origin - mandatory law, default provisions, articles of association or particular codes. Failure to disclose or false disclosure should equally have consequences to act as a deterrent device for faulty managers.³³⁶

³³⁵ Easterbrook, F. and D. R. Fischel (1996). The Economic Structure of Corporate Law, Harvard University Press.

³³⁶ Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart.

The EU appears to have followed the recommendations of the expert group in three extremely important statutory instruments: (1) Directive 2003/71 (*Prospectus Directive*) and Regulation 2004/809 (*implementing the Prospectus Directive*), (2) Directive 2004/109 (*Transparency Directive*) and (3) Directive 2006/46 (*concerning board liability for the annual and consolidated accounts of certain types of companies*). The following lines will attempt to analyse each of these individual regulations before laying out the conclusions to be extracted from the set composed by them.

The Prospectus Directive and its complementing Regulation were enacted in the framework of the Financial Services Action plan and its object consists in the introduction of a Europe-wide transit of Prospectus for sale and admission to stock-markets. The Prospectus Directive reforms Directives 89/298 (on the coordination of the issue of prospectus for the admission to stock markets) and modifies considerably Directive 2001/34 (on the admission of securities to stock markets). The purposes of Directives 89/298 and 2001/34 consisted in the coordination of the provisions for the issue of prospectus and admission to stock markets. Since these latter directives provided member states with a wide degree of discretionarity in the issue of prospectus and admission to stock markets, the Financial Plan concluded that this diversity of national regulations could raise considerable difficulties for the development of European stock markets. The object of the Directive consisted in attempting to overcome these difficulties by harmonising the formal and substantial content of the Prospectus to be issued upon admission to the stock market and in the introduction of a unitary authorisation procedure. The final purpose of the Prospectus Directive consists in the protection of investors by requiring them to be informed to such an extent on the situation of the company issuing the securities so that they may make an informed decision on the risks associated with its investment. The legal technique used was one of disclosure of certain characteristics of the issuer and the risks associated with the investment.³³⁷

The content of the Prospectus Directive and complementary regulation is extremely complex and far-reaching: for the purposes of this thesis, this paragraph will be concerned with three main issues: (a) the duty to issue a Prospectus, (b) the content of the Prospectus and (3) the liability connected to

³³⁷ Daelen, M. M. A. v. (2008). Risk management solutions in business law: Prospectus Disclosure Requirements, Tilburg University.

it. As regards the duty to issue a prospectus, the Prospectus Directive took an extremely far-reaching option: it is applicable to any offer of securities made in the EU or in the admission to trading in any regulated market (art.3 Prospectus Directive). The term “*offer of securities*” was equally given an extremely wide reach being defined as any communication presenting sufficient information on the terms of the offer and the securities offered so as to enable an investor to decide to purchase or subscribe the shares, even if by means of an intermediary (art.2(d)). This definition was however considerably limited in its scope by excluding a number of transactions that assume the nature more of a private transaction than the purchase by means of a public offer of securities.³³⁸ The Prospectus Directive is equally applicable to any admission to a regulated market: this term “*regulated market*” is improper however because its definition was made by means of a reference to Directive 93/22 (*Investment Services Directive*), which leaves a wide margin of manoeuvre to the member states in the definition of a regulated market. The most important thing to retain is that whenever a company is admitted to trading securities (transferable equity and non-equity securities) in a member state or is admitted to a regulated market as defined in that member state, it is under a duty to issue a prospectus to the public. This is an extremely important thing to retain because that means that all securities markets that do not assume the characteristics of private transactions will be subject to the issue of a prospectus.³³⁹

The Prospectus Directive took the further approach of attempting to reach an extensive harmonisation of the formal and substantial content of the Prospectus to be issued in the situations enunciated in the former paragraph. The Prospectus Directive took the option of simply declaring that the issuer is under a duty to publish a prospectus and left the practical content of the prospectus to be defined at the complementing Regulation. The type and extent of the information to be disclosed in the Prospectus varies in accordance with the issuer and the securities to be offered. The Regulation took the option of setting up a *building block approach* in accordance to which the issuer is

³³⁸ There is a number of exceptions to this duty when the issue is directed only to qualified investors or to a small number of individuals; in this situation it is more of a private law deal than a proper offer to the public. See art.3(2) and art.4 Prospectus Directive.

³³⁹ König, K.-M. (2004). "Die neue europäische Prospektrichtlinie. Eine kritische Analyse und Überlegungen zur Umsetzung in das deutsche Kapitalmarktrecht." *Zeus*(2): 251-288.

obliged to comply with the duties contained in special situations. For instance, the Regulation differentiates the disclosure requirements in accordance with the identity of the issuer (credit institutions, investment funds, etc) and in accordance with the type of business in which the issuer is active (real estate, investment, start-up companies, etc). The concrete information to be disclosed depends of the combination between these two elements (identity and type of business). The Regulation also provides for a certain mandatory minimum information requirements to be included in the Prospectus. Art.7 of the Prospectus Directive places a number of minimum requirements in the Prospectus so that the investor is able to make the best informed option concerning the securities in which he wishes to invest. These minimum requirements vary substantially but they cover issues such as the information concerning risk factors, the description of the markets in which it is active, the professional career of the members of the management (and supervisory) boards (including formerly occupied positions and sanctions), information of businesses with related parties, the record of financial data in essential modifications in the business of the issuer, information on the staffing and staff-committees and the compliance with Corporate Governance codes, among others. A particularly important point consists in the information concerning the financial relations of the issuer. The key point here consists in the compliance of the national accounting standards used by the issuer with the International Accounting Standards demanded by Regulation 1606/2002, concerning International Financial Reporting Standards. The Regulation applying the Prospectus Directive admits that the issuer uses its own national accounting standards as long as they are in compliance with the International Financial Reporting Standards.³⁴⁰

The last relevant point concerning the Prospectus Directive consists in the liability for the issuer attached to the Prospectus. This liability is contained in art.6 of the Prospectus Directive but it does little for harmonisation. This provision simply states that the member state is obliged to - in accordance with its own national tort law - provide for liability for the damages caused by the failure to issue the prospectus or false informations contained in it at least for least to the issuer (or its administrative, management or supervisory bodies),

³⁴⁰ Ibid.

the offeror, the person requesting admission to trading on a regulated market or the guarantor - as the case may be. The person liable for the information must be clearly identified in the prospectus and the responsible person must make a statement that the information contained in the prospectus is in accordance with the facts and that it contains no omission likely to affect its import. This provision provides member states with a wide margin of manoeuvre in the determination of the persons liable for the Prospectus and ensures a nice endowment into national law by admitting that member states use their own national tort laws. This may be a double edged sword: if one the one hand it guarantees a nice fit in accordance with national laws and practices, on the other hand it might endanger the purpose of the construction of a single market for securities because the persons liable for false or inaccurate information contained in the Prospectus and the conditions for liability vary considerably among the member states (in particular as relates to the causation and calculation of the tortious damage).³⁴¹

The Prospectus Directive must be seen in conjunction with another instrument named as the *Transparency Directive* (Directive 2004/109). This Directive requires the disclosure of annual, periodic and ongoing information by issuers whose securities (equity or debt) are admitted to trading on a regulated market (art.1). Although it is more limited in scope than the Prospectus Directive, it nonetheless fulfils an important role completing it because it provides additional information concerning the actual situation of companies. The Transparency Directive imposes the disclosure of three types of information: (a) periodic information (yearly, half yearly and interim management reports), (b) ongoing information (concerning major holdings and operations affecting them) and (c) information for holders of securities.

The periodic information imposed by the Directive consists in the disclosure of some key data concerning the situation of the company to its investors and potential investors. The *annual report* consists in a report relating to the former financial year comprising: (1) the audited financial statements, (2) the management report (made in accordance with art.46 Directive 78/660) providing for a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the

³⁴¹ Daelen, M. M. A. v. (2008). Risk management solutions in business law: Prospectus Disclosure Requirements, Tilburg University.

consolidation taken as a whole, together with (3) a description of the main risks and uncertainties that they face and a statement from the persons responsible within the issuer that the financial and management reports correspond to the reality of the situation of the company (art.4(2) Transparency Directive). This is a particularly demanding document that comprises a three-folded control of the activity of the undertaking (management, auditor and third party responsible for supervising the former two) and that must be made public as soon as possible for a period of five years. This annual report is to be completed by a *half-yearly financial report* with substantially the same content covering the first six months of the year. The last mandatory type of report consists in the *interim management report*, which consists in a report to be made every six months providing for (a) an explanation of the material events and transactions that took place during the six months period and their impact on the financial position of the issuer and its controlled undertakings and (b) a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period. Art.7 of the Transparency Directive imposes a similar rule concerning liability; member states shall ensure that administrative, management and supervisory organs will be made liable in accordance with national tort laws by the issue and content of the report.

A simple reading of the provisions concerning the duties to issue a management report contained in the Transparency Directive reveals that the EU has followed the same path concerning the improvement of the control of the activities of the management board describe above in this chapter on occasion of the analysis of the evolution of the national regulations. The EU opted to use disclosure as an adequate means of control of the management board by imposing a system of disclosure of the activities of the management board and the financial situation of the company together with tight rules imposing liability of the persons responsible for the issue of those reports in the hope of using it as a deterrence device against the issue of false or inaccurate statements. This system of reports appears to be designed as a means of reducing the agency costs of managers *vis-à-vis* shareholders by imposing a tighter control over their activity. It is worth noting that these reports cover not only the financial situation of the company (to be audited by a third party) but equally the compliance with the strategy of the company and the events affecting the financial situation of the company and its strategy of growth.

Therefore, these reports are not incompatible with longer term strategies of growth: they are simply a means of monitoring the management board and not imposing shorter-term strategies of shareholder value.³⁴²

The Transparency Directive also imposes a system of ongoing information. This system is particularly directed towards major holdings and operations affecting them. The Transparency Directive begins by imposing the notification of the acquisition or disposal of major holdings stating that whenever a shareholder acquires or disposes of shares admitted to trading on a regulated market that reaches, exceeds or falls below certain thresholds of voting rights, the shareholder is obliged to notify the issuer (art.9).³⁴³ The Directive further states that the same applies whenever the shares are held by a third party (proxy - art.10). The notifications required under arts.9 and 10 of the Transparency Directive shall include some information such as (a) the resulting situation, (b) the pyramidal structure of control (if that is the case), (c) the date on which the thresholds were reached or crossed and (d) the identity of the beneficial shareholder. Finally, art.16 of the Transparency Directive imposes a duty upon the issuer to inform the holders of equity and non-equity based securities of any changes in the rights, terms and conditions attached to those securities and the issue of new loans.

The purposes of this system of ongoing information also become relatively easy to ascertain. The underlying intention appears to be the disclosure of the true control structure of the company for the issuer and third parties in order for the investor to be able to ascertain the type of governance structure that it may find in that particular company and make an informed judgement concerning the convenience of the investment. The analysis made above concerning the evolution of the ownership structures of companies in each one of the countries under jurisdiction attempted to demonstrate that the identity of the shareholder (dispersed/concentrated ownership, presence of institutional investors, banks, families, etc) influences to a great extent the type of governance strategy that the company is likely to pursue. The disclosure of these elements contributes to a great extent to the transparency of companies

³⁴² Karmel, R. S. (2005). "Reform of Public Company Disclosure in Europe." University of Pennsylvania Journal of International Economic Law 26(3).

³⁴³ The thresholds are 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%

and the protection of investors, who will be in possession of all the elements to make a reasonable investment decision.³⁴⁴

A final point that should be analysed concerns the liability of the board for financial statements. This liability is provided for in Directive 2006/46/EC, concerning the annual and consolidated accounts of certain types of companies. This directive simply provides for the collective liability of the members of the board for the financial statements contained in the annual accounts and consolidated accounts of companies. The Directive is scarce however since it leaves to the member states the determination of the conditions under which such liability may arise. This is to be made in accordance with the national tort law of the member states. The only perquisites that the Directive places are that the liability be personal and collective.

The liability for financial statements must be seen in this context as the other side of the coin for disclosure. Since the members of the board are required to disclose a number of elements in their annual accounts and in the corporate governance report that they are required to publish, the liability of them towards the company for the lack or inaccuracy the data disclosed must be seen as to create incentives for the disclosure of accurate elements. The overall objective is to create incentives for investment in European capital markets.

This section appears to provide sufficient evidence that the EU has been using a strategy of disclosure as a means of protecting investors, controlling the management board and improving the internal governance of companies in Europe. The combination of these four legal instruments reveals that investors are currently protected via disclosure in the following situations: (a) when a company decides to issue securities into the market or is admitted to trade securities in a regulated market (the content of the information to be disclosed via the prospectus varies in accordance with the type of company and industry in which it is active but is considerably extensive); (b) in the concrete operation of the company, by means of the disclosure of yearly or half-yearly financial and management reports and any operations affecting major shareholdings

³⁴⁴ Golden, J. B. and D. Fischer-Appelt (2004). The EU Prospectus and Transparency Directives - towards a unified European Capital Markets Regime. Corporate Law and Practice Handbook, Practice Law Institute.

and (c) concerning the liability for financial statements. It is interesting to observe that these legal instruments follow fully the recommendations made by the expert group that insisted in avoiding a substantive interference in the internal governance structures of companies by EU Law (given the diversity of national governance structures and the types of interests underpinning their development), disclose to the market their internal governance and control structures (made by the Prospectus and Transparency Directive) and attach liability rules for failure to disclose or disclosure of inaccurate information. The liability rules serve as a deterrence device for the temptation to breach the disclosure rules; although the legal solution of reference to the national tort law rules ensures a considerable degree of integration into national statutes, it may interfere with the functioning of the common market because the pre-conditions for tortious liability are distinct across member states. The disclosure of the remaining elements of internal governance structures appears to be laudable because it performs an important function in protecting the interests of investors: they will be in possession of all the necessary elements to make a reasoned investment decision and it does not interfere with the internal governance of companies. If the internal governance structures sufficiently protect the interests of investors then the share prices will reflect that trust; if not, then the internal governance structures will have to be reformed towards a more market approach in order to attract investors. This protects the position of shareholders as residual claimants of the company and reduces their agency costs *vis-à-vis* managers without making a substantive intervention that could endanger well-functioning internal governance structures. A question remains however: will disclosure be a means of introducing a more shareholder-value approach in European companies? This is a question that only the future will answer but for the time being it seems a negative answer: the cases of Enron and Parmalat reveal that neither market nor relational systems *per se* are superior in the protection of the interests of shareholders; each one of them is capable of having internal governance failures. The objective of disclosure appears to be to fight those internal governance failures by exposing them to public judgement so that the position of investors in each system comes out reinforced. The purpose does not appear to be the imposition of one system or another but to address the internal governance failures of each one of them.

2.6.2.5 Conclusion - EU Law has accompanied and fomented the international trends

A simple reading of the activities of the EU in the subject of the management structure of companies reveals that the EU has been lined up in accordance with the international trends towards the hybridisation of national corporate governance models. Although the Societas Europeae recognises the diversity of internal governance structures of public companies in the EU by allowing the choice between one tier/two tier models, the reality shows that its main concern is to introduce a model of accountability of the members of the management board in relation to the shareholders; the two tier board structure of the SE places a great degree of pressure upon the management board in order to be accountable to the supervisory board; the idea is for the supervisory board to effectively exercise its supervision of the management board and not be a simple intermediate structure between the general meeting and the management board. It is curious to observe that the same requirements placed in the SE were also used in the reform of the public corporations in Germany in order to revitalise the supervisory board and make managers more accountable to the shareholders. The one tier model is much more scarcely regulated; this might be due to the fact that they are under the direct control of the general meeting and that there appears to be no need for further measures to ensure the reduction of agency costs.

As regards the remuneration of directors, it is clear that the EU equally tended to reduce managerial autonomy and introduce further elements of control: the focus was on disclosure, shareholder approval and discrimination within the annual accounts as a means of leaving to the market the evaluation of the adequacy of the remuneration and the shareholder vote in order to reinforce the confidence in the company. The role of independent directors and committology equally follows the international trends towards the improvement of the supervision of the management board observed first in the anglo-saxon model by means of the delegation of the delicate tasks where conflicts of interest might arise to specialised bodies composed of persons free from any personal interest in the company. This strongly reinforces the supervision of the company.

Finally, the liability scheme attached to disclosure appears to be destined to create incentives for the disclosure of accurate information over which investors might base their investment decisions. The evolution in the management boards by means of the pressure of the EU might be synthesized in three key points: (1) disclosure, (2) transparency and (3) improved control and supervision. It is worth noting that these trends were equally observed in each one of the jurisdictions under study independently of the influence of the EU revealing that it appears to be an internationally recognised need to reduce managerial autonomy and improve the supervision of management boards. This does not reveal a convergence towards the shareholder model but simply an hybridisation of the patterns of corporate governance towards greater levels of internal and external controls.

2.6.3 improving the rights of shareholders

Another area in which the EU has been extremely active consists in the rights of shareholders. The EU issued recently two extremely important legal instruments lately concerning the rights of shareholders: Directive 2007/36/EC, on the exercise of certain rights of shareholders in listed companies and Directive 2004/25/EC on takeover bids. The first legal instrument is destined to create a climate favourable for investment by facilitating the exercise of the rights of shareholders in listed companies, in particular where the company is active in several markets. The second legal instrument is a curious legal instrument that is said by many to be a Trojan horse for the harmonisation of the structure of companies in European listed corporations. Although the precise impact of these measures is yet to be seen, it appears to be clear that both of them are designed to reduce the agency costs that arise between shareholders and to reinforce the position of shareholders in companies as residual claimants. A detailed analysis of each one of these provisions might elucidate the statements.

2.6.3.1 Shareholder rights directive (Directive 2007/36/EC)

The shareholder rights directive is one of the most important legal instruments on company law issued in the last years. In contrast to the other current approaches to company law (which essentially took the form of recommendations, to scout the terrain for more binding action in the future or to allow national companies to maintain their internal governance structures as long as they corresponded to a genuine interest), the EU's approach to the rights of shareholders took the form of a binding legal instrument; this seems a serious evidence that the EU is quite certain of the paths that it is going to take in the future. The objective of the Directive appears to be to resuscitate the general meeting of listed companies and reinforce its role as a controlling organ of the management board: it intends to provide shareholders with the most effective means of exercising the rights contained in their shares in the general meetings of companies so as to improve the control of the management board by the general meeting of the shareholders. The Directive was particularly concerned with investors residing in a member state other than the one in which the company is listed; this amounts to serious evidence that the Directive is intended to encourage Europe-wide investments by means of the facilitation of the exercise of the rights connected with those investments in companies. A closer look at the provisions of the Directive will elucidate us further of its purposes.

Shareholders had - until the recent wave of reforms of Corporate Governance in Europe - always been regarded as investors by European Law. The main concerns of the harmonisation of company law by means of Directives had been to ensure the financial health of organisations (Second Company Law Directive, on the capital of companies and the Fourth, Seventh and Eighth Company Law Directives, concerning the accounts of companies).³⁴⁵ The position of the shareholder as a participant (*Mitglieder*) in the company had always been left aside the discussions due to difficulties in reaching an agreement concerning the harmonisation of national company laws. This diversity in national regulations posed an impediment to the development of an internal market for investments and financial services because the pre-conditions and the rights attached to shareholdings in each

³⁴⁵ Habersack, M. (1999). Europäisches Gesellschaftsrecht, C.H. Beck.

country were distinct and they occasionally made it difficult to exercise the rights attached to the shareholdings. This caused considerable agency costs of managers *vis-à-vis* shareholders (particularly foreign minority shareholders), which led the EU to take action and attempt to harmonise the minimum requirements attached to shareholdings in listed companies in the EU in order to foster cross-border investments.³⁴⁶

The Directive merely focuses on the exercise of certain rights of shareholders in listed companies. This has two distinct consequences: firstly, the Directive is not applicable to non-listed companies (although member states may do so if they find it reasonable in order to harmonise statutory requirements); secondly, the Directive does not intend to fully harmonise the position of shareholders in listed companies; its reach is much more limited as it is restricted to certain rights connected with the general meeting of shareholders. This is in itself an element of significant importance because it is a clear indicator of the purpose of the Directive: it seems that the intention of the Directive is to reinforce the position of shareholders in the general meetings in listed companies by means of the harmonisation of certain rights connected with their shareholdings and to strengthen the use of the general meeting as a control mechanism in the reduction of agency costs of shareholders *vis-à-vis* managers and in the position of shareholders as residual claimants in the company.³⁴⁷

A closer look at the provisions of the Directive will elucidate us further of its purposes. The Directive begins by enunciating a fundamental principle that consists in the equal treatment of shareholders (art.4). Although the principle of equal treatment of shareholders was formerly recognised in art.42 of the Second Company Law Directive and is also a principle recognised either by statute or by case law in the general regulations of the member states, it is nonetheless important to stress the significance of the introduction of this principle: it provides an adequate guarantee that national and foreign investors,

³⁴⁶ Hopt, K. J. (2006). Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron. After Enron: improving corporate law and modernising securities regulation in Europe and in the US. J. Armour and J. A. McCahery, Hart, Noack, U. (2006). "Der Vorschlag für eine Richtlinie über Rechte von Aktionären börsennotierter Gesellschaften" Neue Zeitschrift für Gesellschaftsrecht: 321 ff.

³⁴⁷ Baums, T. (2007). "Aktuelle entwicklungen im Europäischen Gesellschaftsrecht." Der Aktiengesellschaft 52(3): 57-65.

individuals and institutional investors that acquire the same types of shares will be treated equally with regard to participation and the exercise of voting rights in the general meeting. Although the Directive is silent as regards the violation of that principle, it appears that the duty to effectively implement directives commands member states to make provisions for the actual violation of that principle.³⁴⁸

The Directive then grants a great deal of importance to the information of the shareholders prior to the general meeting (art.5). The Directive places upon companies very detailed obligations concerning the disclosure of all the elements necessary for shareholders to be aware that there is a general meeting, the issues that are going to be discussed there and the conditions under which the shareholders are entitled to participate in the general meeting. The main concern of the Directive is one of disclosure and transparency: the company is obliged to transmit to all of its shareholders all the necessary elements for them to be aware that there is a general meeting and prepare adequately for that general meeting. For that purpose the Directive commands: (1) a minimum period of 21 days (that may be reduced to 14 days when the company offers to its shareholders the possibility of voting electronically); (2) in addition, public disclosure of the event that is going to take place for shareholders to have access to it on a non-discriminatory manner; (3) detailed communication concerning: (a) the agenda of the meeting; (b) the rights available to the shareholders and the means to exercise them adequately; (c) the mechanisms for proxy voting and electronic voting. This is an extremely important provision because it often happens that in public companies with dispersed ownership structures, the shareholders are unaware of the right to vote or even of the possibilities to exercise proxy voting. This duty incumbent upon the company serves to elucidate the shareholders of all the possibilities offered to them to vote and encourage their participation in the general meeting.

The Directive then dedicates a number of provisions to the participation in the general meeting. This is, perhaps, the hard-core of the Directive and the

³⁴⁸ The ECJ has recently issued a ruling concerning the principle of equal treatment contained in the Second Company Law Directive. See the ruling Commission vs Spain (C-338/06) and the comment made by Hamann, D. (2009). "Iura novit Curia and the Principle of Equal Treatment of Shareholders." *European Law Reporter*(4): 152 ff.

subject in which its impact over national regulations is likely to be greater. The Directive contains three types of provisions on the rights of shareholders to participate in the general meeting: (a) the rights to ask questions and to participate, (b) the right to vote and (c) voting results.

The rights to ask questions and to participate are provided for in arts.9 and 6. Art.9 grants shareholders with the right to ask questions on items related to the agenda of the general meeting. A significant innovation is the fact that the right to ask questions has the correspondent duty to answer on the part of the company; in fact, the company is obliged to answer the questions placed by the shareholders. The only limitations to this right are those emanated from the necessity to ensure the good order of the general meetings and the protection of the confidentiality and business interests of companies. These appear to be strict provisions that should limit to the least extent possible the duty of the company to provide an answer to the questions of the shareholders. Art.6 provides shareholders with another significant right, the right to put items on the agenda of the general meeting and table draft resolutions. This is an extremely important right because the shareholders may act collectively and the minimum threshold for this right shall not exceed 5% of the capital of the company. This means that individual shareholders deprived of the right to vote might syndicate to reach the maximum threshold of 5% of the share capital of the company and place items in the agenda of the general meeting and table draft resolutions. This is a provision strongly protective of the shareholders as a whole but also of the minority shareholders in particular.³⁴⁹

The provisions concerning the right to vote are equally important and are capable of having a wide-ranging repercussion in the governance of listed companies in Europe. The key provisions here are arts.7, 8, 10, 12 and 13. The Directive commands member states to eliminate all requirements to deposit shares or transfer them to any other legal or natural person before the general meeting. Equally, the Directive also commands member states to eliminate all restrictions to the transmission of the shares between the convocation of the general meeting and the date of the general meeting that are not enforced before. The key idea here is to allow shareholders to freely exercise their rights as shareholders and transmit their shares after the summoning of the general

³⁴⁹ Noack, U. (2006). "Der Vorschlag für eine Richtlinie über Rechte von Aktionären börsennotierter Gesellschaften" Neue Zeitschrift für Gesellschaftsrecht: 321 ff.

meeting in the same terms as they did before that convocation; the summoning of the general meeting shall not any kind of effect whatsoever in the exercise of the rights attached to the shares and to the transmission of those shares (art. 7).

An extremely important provision capable of having a far-reaching consequence consists in the commandment to eliminate all restrictions to proxy voting. This provision is of an extreme importance for foreign investors because it is not uncommon that they have only small shareholdings in each company and delegate the duty to exercise their rights to qualified intermediaries who will make an extensive use of proxy voting. The reinforcement of the possibility of electing a proxy in listed companies is an element of extreme importance in the building of a common stock market because this will help reducing the agency costs of managers *vis-à-vis* foreign minority shareholders (who are usually in a delicate position because they are absent and have only minority shareholdings) and therefore encourage investments in listed companies.

The Directive entitles shareholders with the right to elect a proxy to exercise the same rights as the shareholder in the general meeting, as long as they do not do a blank proxy and provide the proxy with voting instructions. The only limitations that the member states may place to the exercise of voting rights by means of proxy are the following: (a) where the proxy is in a situation of conflict of interest with the company; (b) the proxy holder holds votes without specific voting instructions in relation to each resolution and (c) the proxy be obliged to disclose all circumstances that give rise to a conflict of interest. The limitations to the exercise of voting rights by means of proxy are scarce and shareholders now have a powerful instrument to represent themselves at general meetings and be capable of influencing the deliberations to be taken (art.10).

The purpose of this regulation of proxy voting is easy to understand and is clearly laid out in §10 of the preliminary remarks of the Directive. The Shareholder Rights Directive starts by claiming that proxy voting is an essential element in good corporate governance because it allows absent shareholders to have a voice in the decision-making in the company and it equally allows badly-informed shareholders of being represented in companies by means of qualified intermediaries. Proxy voting carries however considerable agency costs within it: there is the possibility that the proxy acts in its own self-interest

rather than in the interest of the principal and there is equally scope for conflicts of interest. An effective regime of proxy voting should mitigate these agency costs and ensure that proxies act in the interests of the shareholders that they represent and that there is no scope for conflicting transactions. This explains the solutions proposed in the Directive: the prohibition of the blank proxy and the imposition of instructions in the document serves the purpose of reducing the agency costs of the proxy *vis-à-vis* the shareholder and ensure that the beneficial owner of the proxy (*i.e.* the shareholder as residual claimant) will have its rights dully represented. The limitations allowed to the use of proxies in the general meeting mentioned above are designed to overcome the second type of agency costs and avoid all possible conflicts of interest in the exercise of the proxy vote. This means that member state are not only entitled but equally under a duty to implement measures against the abuse of proxy voting. This is particularly important because §10 opens the possibility of regulating the activity of financial intermediaries to the member states in order to avoid these abuses in the collection of proxies and the resulting voting power.³⁵⁰

A situation that carries similar risks to proxy voting consists in voting by financial intermediaries (*Treuhänderische intermediäre*). These financial intermediaries are to be distinguished from proxy holders because they have an active shareholding in the company; their shareholding is however to the benefit of the beneficial owner who provides the financial intermediary with resources to acquire the shareholdings. The Directive places two distinct requirements upon member states: firstly, it commands member states not to demand from those shareholders more information rather than disclosure of the identity of each client and the number of shares held on its behalf (the beneficial owner); secondly, these shareholders are also exempt from the obligation of single vote, meaning that they may vote differently in accordance with their shareholdings to the same resolution (art.13). This regulation is extremely sparse however; this is in itself a strange element because the agency costs that occur between the proxy holder and the principal equally occur between the financial intermediary and the beneficial owner. The answer

³⁵⁰ For the question of the recent reforms of proxy voting, see the interesting comparative study of Schmidt, J. *Ibid.*"Stimmrechtsvertretung und stimmrechtsansübung "in absentia" in Deutschland und Großbritannien - speziell von der Hintergrund der aktuellen Gesellschaftsrechtsreform in Großbritannien sowie der geplanten EU-Aktionärsrechts-Richtlinie." (13): 487 ff.

to the scarcity in the regulation can be found in §11 of the preliminary considerations to the Directive. The Directive states that the EU is going to take action in the future concerning the internal governance of financial intermediaries and therefore that is a matter to be dealt with in future recommendations. The most important thing to retain in the Directive is designed to encourage cross-border investment via financial intermediaries by imposing them a duty to disclose their quality as financial intermediaries and the identity of beneficial owners and allowing them to vote differently in accordance with the instructions of the beneficial owners independently of the unity of the shareholding. The latter provision is strongly protective of investors because it grants them with the possibility of forcing the intermediary to vote in their interest (and not in the interest of all the beneficial owners of those that invested more money in the financial intermediary and therefore are capable of exercising more pressure over him).³⁵¹

The protection of shareholders was taken one step further by the imposition to the Member states to provide shareholders with the possibility to vote by correspondence. The protection was not so effective as in the case of proxy voting however because this is a possibility open to companies and not a duty. This means that member states are simply obliged to allow companies to implement in their internal charters and bylaws the possibility of voting by correspondence but it does not require companies to admit it; this remains a possibility open to companies and not a duty

The Directive also contains provisions concerning the disclosure of the voting results. Companies are required to establish for each resolution the number of shares for which votes have been validly cast and the proportion of shares represented by those votes, as well as the proportion of votes for and against. This is an important provision concerning the transparency in the functioning of the general meeting because it will allow analysts to determine with precision the effective control of the company.

A final word must be given to the use of information technologies in the exercise of shareholder rights. The Directive was not so vanguardist as it could have been here: the Directive simply states that member states must offer companies the possibility of using information technologies in the exercise of

³⁵¹ Noack, U. Ibid."Der Vorschlag für eine Richtlinie über Rechte von Aktionären börsennotierter Gesellschaften ": 321 ff.

shareholder rights in the general meeting but it is not obliged to do so; the use of these technologies is left to the discretion of the individual companies, who may choose to use them or not.

A final balance of the directive may provide sufficient evidence to support the conclusion that this is a strong shareholder-protective instrument that is capable of having a great impact in the governance of listed public companies in Europe. The motto for the directive could well be "*power to the shareholders*" because this is designed specifically to lift all restrictions that they may face in the exercise of their rights in the general meeting. The provision of an express duty of equal treatment of the shareholders in the Directive is not likely to bring any substantial modifications to the national regulations of the member states; nevertheless, it is good to observe that this principle received positive recognition in addition to the obscure command contained in art.42 of the Second Company Law Directive. The provision of extensive rights to information and participation in the general meeting to the shareholders, in particular to be acquainted with the issues that are to be discussed and to insert items and draft resolutions, are extremely important provisions. They are specifically designed to encourage the use of the general meeting as a control mechanism of the management board and reduce the agency costs of managers vis-à-vis shareholders. This is capable of bringing about some substantial modifications to the governance of listed companies for two reasons: firstly, the Directive is specifically targeted to encourage cross-border investment and this is expected to inject foreign capital into the governance of listed companies; secondly, the Directive equally creates incentives for engagement in the company (by means of the rights to ask questions, participate, etc), which provides some evidence to sustain the assumption that the reinforcement of shareholder rights will not end in the introduction of shareholder value in listed companies but simply a reinforcement of the supervision of the management board vis-à-vis shareholders. An extremely important last element consists in the lifting of all restrictions to the concrete exercise of the votes, namely: no mandatory share deposits and restrictions to the transfer of shares before the general meeting and the facilitation of the voting by proxy and financial intermediaries. This is where the biggest impact of the Directive is to be felt because absent shareholders will have effective means - the intermediaries - to participate in

companies and make their voices and interests heard. Finally, the mandatory disclosure of the voting results provides all those who want to see it with a concrete picture of the functioning of the general meeting and the control of the company. This is a strongly shareholder-protective instrument that reduce the agency costs of managers *vis-à-vis* shareholders and create incentives for a more relational investment in the company.³⁵²

2.6.3.2 Takeover Directive (Directive 2004/25/EC)

This thesis must equally address the developments in the external governance devices of companies, in particular the market for corporate control. The EU has equally been extremely active in this area by means of a much debated legal instrument that is expected to bring about a number of developments to the governance of European companies: the Directive on Takeover Bids (TOD). This legal instrument was based on the anglo-saxon approach to takeovers and appears to be intended to create a Europe-wide market for corporate control, in order to foster investment across national borders. In fact, the influence of the Directive is expected to be so extensive that a number of commentators have claimed that this legal instrument will function as a Trojan horse for the introduction of: (1) the one share/one vote rule in European listed companies; (2) a more dispersed ownership structure in Continental Europe; (3) the alignment of the interests of managers with those of the shareholders.³⁵³ This is expected to bring about a great deal of modifications to the governance of listed companies, although the initial impact of the Directive is not so severe as it is expected to be on account of the possibility of opt-out of some provisions

³⁵² For a systematic overview of the Directive, see Baums, T. (2007). "Aktuelle entwicklungen im Europäischen Gesellschaftsrecht." Der Aktiengesellschaft 52(3): 57-65. and Wand, P. (2006). "EU-Richtlinievorschlag zur Erleichterung der Ausübung von aktionärsrechten." Der Aktiengesellschaft 51(12): 443-450.

³⁵³ Hertig, G. and J. A. McCahery (2004). An Agenda for Reform: Company and Takeover Law in Europe. Reforming Company and Takeover Law in Europe. G. Ferrarini, K. J. Hopt, J. Winter and E. Wyneersch, Oxford, Rickford, J. (2004b). "The emerging european Takeover Law from a British perspective." European Business Law Review: 1379-1421, Goergen, M., M. Martynova, et al. (2005). Corporate Governance Convergence: evidence from takeover regulation, European Corporate Governance Institute, Hirte, H. (2005). "The Takeover Directive - a mini-directive on the structure of the corporation: is it a Trojan horse?" European Company and Financial Law Review(1): 2-14, Hertig, G. and J. A. McCahery (2006). Company and Takeover Law Reforms in Europe: Misguided Harmonisation Efforts or Regulatory Competition. After Enron : improving corporate law and modernising securities regulation in Europe and the US. J. Armour and J. A. McCahery, Hart.

granted to the member states and the great deal of pressure that the Directive places upon listed companies to abide by its rules. In order to understand the impact of this Directive, this section was schematised in three parts: the first part will attempt to address the agency problems that occur during takeovers and the so-called anglo-saxon model that is said to foment takeover activity; the second part will attempt to expose the provisions of the Directive; the final part will attempt to argue in which terms the Directive is expected to bring about the three modifications mentioned above to the governance of companies. The purpose of this section is to attempt to outline rationale underlying the Directive and the expected impact in the governance of European companies.

A takeover consists in a public offer made to the shareholders of the target company to acquire all or some of those shares, which follows or has as its objective the acquisition of control of the target company (art.1(a)TOD). Although the exact nature of the role of takeovers in corporate governance is debated, the most commonly accepted explanation consists in their acceptance as an efficient external mechanism of corporate governance on account of their disciplinary effect on the management of the company. The conceptualisation of corporate governance as a set of mechanisms to address the agency costs that occur between managers and shareholders classifies takeovers as an external means to reduce these agency costs; in the event that the shareholders feel that management is not acting in accordance with their interests, they will simply sell their shares to the bidder, who will acquire control of the company and dismiss the management. It is therefore a governance mechanism preponderant in countries with dispersed ownership structures in which shareholders prefer strategies of exit instead of voice. The analysis of the evolution of ownership structures of the regulations under study made above claimed that one of the reasons for the concentration of ownership in continental Europe consisted in the protection against takeover, as a means to safeguard the investments that a number of large shareholders had done in the company and promote a longer term perspective of investment with a direct control over the management of the company. But there is equally room for a market for corporate control in concentrated ownership systems. The main agency costs that the takeover wishes to address in concentrated ownership systems consist in those that occur between minority and majority shareholders; although the concentration of ownership reduces the agency

costs between managers and shareholders, it gives room to opportunistic behaviour towards minority shareholders, who face significant collective action problems to have a voice in the internal governance of the company and whose shareholdings may be impotent towards those of the major shareholders. The takeover regulation addresses these issues by providing minority shareholders with a possibility of exit on fair terms: provisions such as sell-out rights, mandatory bids and equal treatment ensure exit opportunities for minority shareholders.³⁵⁴

There are two types of agency costs that may arise during a takeover bid: firstly, those that occur between managers and shareholders; the incumbent management may be tempted to frustrate the takeover bid by means of a number of defensive measures (poison pills, white knights and the like) that have the effect of neutralising the acquisition of the control of the offeree company; secondly, there might also be agency costs between the shareholders themselves; the acquisition of control by the bidder might transform incumbent shareholders into minority shareholders and frustrate their investments. Any takeover regulation must necessarily address these agency costs in order to create an efficient market for corporate control.

Before advancing further, it is useful to write a few lines concerning the “anglo-saxon” model of takeovers. The anglo-saxon model is contained in the City Code on Takeovers and Mergers that is destined to regulate the takeover activity occurring in the UK. The City code places a strong degree of confidence on takeovers as an efficient corporate governance mechanism to discipline management and ensure the rights of shareholders (in a country where ownership structures are dispersed and normally few companies have a controlling shareholder or group of shareholders capable of constraining managerial autonomy). The City Code is an extensive regulation that bets on three key principles: the duty of board neutrality, the principle of equal treatment and the protection of minority shareholders. The duty of board neutrality is a duty incumbent upon the board of the target company that, essentially, forbids it from taking defensive measures against takeovers and deprive shareholders of the benefits of the bid. The main concern here is to

³⁵⁴ Easterbrook, F. and D. R. Fischel (1996). *The Economic Structure of Corporate Law*, Harvard University Press.

ensure that shareholders receive the full benefits from the bid. The principle of equal treatment obliges the bidder to treat all the shareholders of the same class of shares equally. The main concern of the duty is to forbid the bidder from acquiring only a number of shares from certain shareholders and deprive the remaining shareholders from the benefits of the bid. Therefore, when the bidder offers to buy a certain amount of shares of a certain type, it must be aware that potentially it will have to acquire the totality of the shares of that class. Finally, the protection of minority shareholders is made essentially by means of the mandatory bid. When a bidder acquires a controlling stake in a firm – defined in the threshold of 30% - it is obliged to offer to acquire the remaining shares. The objective of the provision is to allow the minority shareholders of the possibility of exit from a company that suddenly became subject to the control of a single investor. This might endanger their perspectives on investment and it is fair that they be offered a way out of a company in which their position is considerably altered. This also increases to a great extent the potential costs of the acquisition of a controlling shareholding by a bidder, which is the reason why it is said to encourage the dispersion of ownership.³⁵⁵

The TOD appears to have addressed each one of the agency costs that occur during takeovers and attempted to approximate the takeover regulations in Europe closer to the anglo-saxon model described in the former paragraph. As regards the agency costs between managers and shareholders, the TOD took the following options: the TOD imposed upon the board of the target company a duty of neutrality in relation to the takeover bid (art.3(1), c)TOD). This means that the board of the target company is under a statutory duty to act in the interest of the company as a whole and not deny to the shareholders the opportunity of deciding on the merits of the bid, even if it means to make a substantial modification to the ownership structure of the company. For that end, the board of the target company is obliged to draw up and disclose a document setting out its views on the merits of the bid and the reasons on

³⁵⁵ Slinger, G. and S. Deakin (1999). Company Law as an instrument of inclusion: re-regulating stakeholder relations in the context of takeovers, ESRC Centre for Business Research, University of Cambridge, Johnston, A. (2003). Theories of the Company, Employees and Takeover Regulation Law. Florence, European University Institute. **Doctor of Laws**.

which it is based, including its perspectives on the effects of the acquisition of control of the company (including employment) (art.9(5)TOD).

The board of the target company is also not impeded to take defensive measures to frustrate the bid; however, these defensive measures need an express authorisation of the general meeting of the shareholders for those measures to take place, The only exception of this duty of the authorisation of the general meeting to adopt defensive measures consists in the calling for alternative bids; the reason for it is straightforward: the shareholders will benefit from alternative bids because the premium paid by the other bidder will advantage the investors and raise capital markets.

Finally, the TOD equally mandates the disclosure of the powers of the board; the board is under a duty to disclose, in particular: (a) the rules on the appointment and replacement of members; (b) the powers of board members (in particular to issue or buy back shares); (c) any agreements between the company and the board providing for compensation if they are dismissed without a valid reason, in particular following a takeover bid. The functions of disclosure have been analysed before: it serves as a means of allowing the market to evaluate the internal arrangements of the company and serves as a means of pressure to dismantle them in the event that the company wants to attract capital.

As regards the agency costs that occur between the shareholders, the TOD also addressed these issues in a detailed way. The TOD commanded companies to disclose the following information: (a) the ownership structure of the company (including the significant direct and indirect shareholdings, securities not admitted to trade in a market, different classes of shares and the rights and obligations attached to it and special control rights) and (b) all deviations from the one share/one vote principle (including restrictions on the transfer of securities, restrictions on voting rights (mainly by multiple voting shares, non-voting shares and voting caps) and all agreements between the shareholders restricting the transfer of securities and voting rights) – art. 10TOD. This provision must be read in conjunction with the breakthrough rule contained in art.11 TOD. This is a very important provision that renders ineffective all deviations from the one share/one vote principle *vis-à-vis* the bidder and allows it to acquire control and if that principle were enforced in plain terms. And in the event that the bidder acquires a super-majority control of

the company (75% >), all deviations from the one share/one vote rule will be ineffective in relation to it in the general meetings of the shareholders that are to take place in the follow up of the bid.

Finally, the TOD also made some important provisions for the protection of minority shareholders: the right of squeeze-out and the sell-out (art.15 and 16TOD). These provisions are two sides of the same coin. In the event that, following a bid, an acquirer holds 90% of the shares and voting rights, the bidder has the right to acquire potestively (*i.e:* independent of the will of the seller) the remaining shares and consolidate its position; on the other hand, the minority shareholders have a right to sell potestively their shareholdings to the acquirer. The bidder is obliged to pay the same price offered during the bid.

In order to understand this regime, a final word must be given to the optional arrangements. When transposing the Directive, member states may exempt companies from the board's obligation to have the authorisation of the general meeting to adopt protective measures (art.9(2)TOD) or from the breakthrough rule (art.11TOD), provided that they may have a mandatory opt-in (*i.e:* companies may be subject to those rules if they wish so) and disclose adequately the opt-out (art.12TOD). A more mitigated solution consists in the exemption of a company of applying those provisions when it becomes the object of a bid of a company that does not apply the same provisions (art.12(3) TOD).³⁵⁶

What is the balance to be made from this regime? The analysis should initiate with the question of the neutrality of the board and anti-takeover measures. A simple reading of the regime suffices to prove that the TOD intended to stimulate the takeover market and use it as a means to align the interests of managers and shareholders. The board is in itself forbidden to take any defensive measure that might frustrate the success of the bid and is under a statutory duty to inform the shareholders of the pros and cons of the bid; nevertheless, there is room for the adoption of anti-takeover measures as long

³⁵⁶ Johnston, A. (2003). *Theories of the Company, Employees and Takeover Regulation Law*. Florence, European University Institute. **Doctor of Laws**, Hertig, G. and J. A. McCahery (2004). An Agenda for Reform: Company and Takeover Law in Europe. *Reforming Company and Takeover Law in Europe*. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch, Oxford, Rickford, J. (2004b). "The emerging european Takeover Law from a British perspective." *European Business Law Review*: 1379-1421, Goergen, M., M. Martynova, et al. (2005). Corporate Governance Convergence: evidence from takeover regulation, European Corporate Governance Institute.

as they are approved in a general meeting of the shareholders. The need for a shareholder approval to frustrate the bid is a strong shareholder-oriented measure that grants shareholders with the best of both worlds: if shareholders are dissatisfied with the performance of the management, they may simple sell; if not, the management is free to ask them for a further opportunity and grant them with the adequate incentives not to sell. The implications of this regime will be a stronger protection of shareholders in listed companies.

The breakthrough rule also deserves a special consideration. The intention of this measure is to render ineffective all deviations from the one share/one vote rule in listed companies. In the event that member state choose to apply this rule, the takeover activity in their markets is likely to boost and the ownership structures of companies are likely to be modified in the medium to long term, since controlling shareholders will be deprived of the means to secure their power without investing in the company. In the likely event that the member states where deviations from one share/one vote are allowed choose to opt-out of this rule, companies will always have the possibility of opting-in and will be obliged to disclose adequately and in great detail all the information concerning the deviations from the one share/one vote rules.

In conjunction with the former idea, the TOD places a great degree of confidence in disclosure. All listed companies (and not only those subject to takeover bids) will be obliged to disclose all sensitive information, mainly: ownership structures, deviations from the one share/one vote rule and powers of the board. This comes in line with the approach of anglo-saxon capital market law of using the market as a means to reflect the real value of companies. Since companies contain in them substantial deviations from the one share/one vote regimes and complex mechanisms to secure the incumbent management, they will be obliged to make them public and leave to the investors the evaluation of the worth of those mechanisms in the investment decision. In the event that the investors consider the company to be so well run that they are willing to pay the price of letting go of control rights in exchange for the revenues to be extracted from their investment, then the control-enhancing mechanisms will be efficient; if not, the company will suffer a loss in its share prices and the attraction of investment and will be forced to reconsider the economical value of its control mechanisms. This is, once again, a strongly shareholder-protective orientation.

Finally, as concerns the measures to protect the minority shareholders, this is equally a strongly shareholder protective governance mechanism because it encourages investment in the capital markets; shareholders know that, in the event that they become minority shareholders, they will have a means of getting rid of their shares and will not be stuck with their investments.³⁵⁷

The last point concerns the likely impact of the TOD in the governance of listed companies. Although it is early to do an impact assessment of the TOD in listed companies, one may attempt to make a projection. The most likely projection was made by Heribert Hirte, who claimed that the TOD could be clearly perceived as a Directive on the structure of the corporation that functioned as a Trojan horse, by introducing through the back door what the EU has failed to harmonise.³⁵⁸ It is clearly modelled in the anglo-saxon model of corporate governance that is going to become the dominant model in European listed firms in the future. Firstly, as regards the duties of the board, it is worth mentioning that, although member states may exempt the board from the obligation to have the authorisation of the general meeting to apply anti-takeover measures, it is still under a duty of neutrality and of informing the shareholders of the possible consequences of the bid for the company. This limits the discretion of the board in the event of a takeover and creates strong incentives for the board to act in the interests of shareholders at all times in the event that it wants to preserve its jobs. This is expected to bring about a certain degree of concentration of ownership in countries with dispersed ownership because the incumbent management will want some shareholders with whom to dialogue in the event that their company becomes the object of a takeover bid. Secondly, the detailed provisions concerning the deviations from the one share/one vote rules (disclosure in all situations; breakthrough as a rule with optional opt-out and mandatory opt-in) serve to introduce this matter as a rule in European listed companies; in the event that listed companies wish to

³⁵⁷ Callaghan, H. and M. Höpner "European Integration and the Clash of Capitalisms: political cleavages over takeover liberalisation." *West European Politics* 26(4): 179-198, Coates IV , J. (2003). Ownership. takeovers and EU Law: how contestable should EU Corporations be?, Harvard Law School, Goergen, M., M. Martynova, et al. (2005). Corporate Governance Convergence: evidence from takeover regulation, European Corporate Governance Institute.

³⁵⁸ Hirte, H. (2005). "The Takeover Directive - a mini-directive on the structure of the corporation: is it a Trojan horse?" *European Company and Financial Law Review*(1): 2-14.

preserve their control rights, they will be subject to the evaluation of the market. Considering that the market – particularly institutional investors – is strongly in favour of such a rule, the company has to present strong incentives to preserve those rights under penalty of loosing investment. Thirdly, the provisions for the protection of minority shareholders (squeeze out/sell out) are expected have two effects: firstly, to encourage takeover activity because it mitigates the free-rider problems that some shareholders may be tempted to explore in order to gain from the share price appreciation that normally follows a bid; secondly, it is expected to bring about a more dispersed ownership structure in companies with concentrated ownership because it increases the prices of bids and discourages the concentration in ownership. Most likely, bidders will bid only for a part of the capital of the company and controlling shareholders might be tempted to sell them a part of their investments, this dispersing the ownership of the company.³⁵⁹

In conclusion, the impact of the TOD in the governance of listed companies is expected to be the following: board are under a duty of neutrality and will need in principle the authorisation of the general meeting of the shareholders to implement anti-takeover measures; the one share/one vote rule will be eradicated or subject to the pressure of the capital market; the provisions for the protection of minority shareholders are expected to bring about a certain degree of dispersion of ownership in countries with concentrated ownership. The combined effect of these measures is to approximate the governance pattern of listed companies closer to the anglo-saxon model.³⁶⁰

³⁵⁹ See the arguments of Hopt, K. J. (2007). "Feindliche übernahmen, protektionismus, one share one vote?" *Europäische Zeitschrift für Wirtschaftsrecht* 18(9): 257.

³⁶⁰ For this question, see the interesting studies of: Hirte, H. (2005). "The Takeover Directive - a mini-directive on the structure of the corporation: is it a Trojan horse?" *European Company and Financial Law Review*(1): 2-14. ; Callaghan, H. and M. Höpner "European Integration and the Clash of Capitalisms: political cleavages over takeover liberalisation." *West European Politics* 26(4): 179-198, Rickford, J. (2004b). "The emerging european Takeover Law from a British perspective." *European Business Law Review*: 1379-1421, Goergen, M., M. Martynova, et al. (2005). Corporate Governance Convergence: evidence from takeover regulation, European Corporate Governance Institute.

2.6.4 Auditing – Auditor independence and liability in external Corporate Governance

Another area in which the EU has been active consists in auditing, although the advances made in this area are extremely shy in comparison with those registered in other areas. The advances in auditing were made essentially by the recent approval of Directive 2006/43/EC, on statutory audits of annual accounts and consolidated accounts. This Directive intends to regulate the activity of auditors of the accounts of companies. However, despite its good intentions, its substantive regulation is very sparse and adds very little to the existing national regulations. The majority of the Directive is concerned with the methods to determinate the access to the auditor profession. There are however three substantive questions of relevance to this area: the dismissal of auditors, the regulation of the independence of the auditor and the liability of the auditor.

As concerns the regulation of the dismissal of auditors (art.38), the Directive provides that the auditor in principle shall not be dismissed during the terms of service, unless there are proper grounds for it (being that divergence of opinions on accounting standards or procedures are not to be considered as proper grounds); in the event that the auditor is dismissed or resignates, the audited firm has the statutory duty of informing the supervisory entity of the event and the reasons for the dismissal or the resignation of the audited firm. The objective of this regulation is clear: to prevent auditor-shopping, in terms of choosing the auditor that presents the desired accountancy picture.

The Directive also contains a strict obligation of independence of the auditor in relation to the audited firm. Although this obligation essentially mimics the ones found in the regulations already existing in the member states, it is always good to have European standards of independence. A significant element consists in the possibility for the Commission to adopt a principle-based approach to the definition of standards of independence (art.22).

Finally, the Directive leaves open the question of liability of the auditor (art.31). The study made by the Commission on national rules of auditor liability and reached the following conclusions: although it is clear that a regime of unlimited auditor liability would be detrimental to competition in the market because only a small number of very large companies could set up the adequate risk management systems to face up those claims and that would, in

the long term, lead to risks of cartelisation in the market. Since it is desirable to have competition in the audit market, the Commission will propose a limitation of liability to allow access to new audit firms, in particular those designed for small and medium sized business. Nevertheless, it is not certain concerning the measures for the limitation of liability of the auditors; future legislative action will introduce those limitations, although the types of limitation (liability caps, proportionate liability, mandatory insurance) are not yet known.

It is easy to observe that, despite the scarcity of the substantive measures concerning the auditing services at the EU level, the EU has been active and in accordance with the international trends. The main points concern auditor independence, auditor-shopping and liability of auditors; the EU has followed the same approach as the one analysed before. In particular, it followed the same approach as in Germany and the UK of limiting the possibilities of audit-shopping and the envisaged limitation of auditor liability. This provides further evidence of the protection of shareholders and of the improvement of the internal governance of companies by means of external auditing.³⁶¹

2.6.5 Conclusion - EU Law has fomented internal control mechanisms and shareholder power in European companies

This analysis may allow us to conclude that the EU has followed the international trends of the improvement of the internal governance structures of companies towards a regulation more protective of the rights of shareholders. One needs to distinguish in these points between the internal and the external governance mechanisms.

As regards the internal governance mechanisms, it appears that the shareholders are increasingly protected because management boards will have

³⁶¹ These questions have been partially addressed in a number of studies. See the studies of Stevenson, J. E. (2002). "Auditor Independence: A Comparative Descriptive Study of the UK, France and Italy

." International Journal of Auditing 6(155-182), Ebke, W. (2004). Corporate Governance and Auditor Independence. Reforming Company and Takeover Law in Europe. G. Ferrarini, K. J. Hopt, J. Winter and E. Wymeersch. Oxford, Oxford University Press, De Poorter, I. (2008). "Auditor's liability towards third parties within the EU: A comparative study between the United Kingdom, the Netherlands, Germany and Belgium." Journal of International Commercial Law and Technology 3(1): 68-75, Ferreira Gomes, J. (2008). A responsabilidade civil dos auditores. Código das Sociedades Comerciais e Governo das Sociedades. P. Câmara, R. d. Oliveira Neves, A. Figueiredo, A. Fernandes de Oliveira and J. Ferreira Gomes, Almedina, Figueiredo, A. Ibid. Auditor Independence and the Joint Provision of Audit and Non-Audit Services.

to be more responsive to their interests in the future. This may be seen in structure of companies (SER: choice between single tier/dualist board structure), in the remuneration of directors (which intends to provide a greater degree of power of the shareholders in their determination) and in the accounting issues (which intends to disclose the weight of the remuneration of directors in the accounts of the company). The increased accountability of managers *vis-à-vis* shareholders does not amount to the introduction of a shareholder value philosophy of management but simply to an increased control of the activity of the management board that is in no way incompatible with longer-term perspectives of growth. The question is not to condition the behaviour of the management board but to increase its monitoring and reduce the scope for self-dealing or detrimental investments.

As regards the rights of shareholders, it appears to be more than clear that the EU is in line with the current international tendencies for the reinforcement of their rights in companies and it increasingly betting in the resuscitation of the general meeting (namely by means of the permission of proxy voting) as a means of controlling the discretion of the managers. This does not amount to the introduction of a “shareholder-value” governance style in Europe however. The example of the reform of the general meeting in the UK revealed that the reinforcement of the rights of shareholders is not incompatible with a more relational investment; this appears to have been the guiding line in the Shareholder Rights Directive because the reinforcement of the rights of shareholders and the use of the general meeting as a control mechanism of the activity of the management board creates incentives for a more relational type of investment by encouraging the active participation of shareholders in the internal life of companies. The reinforcement of the rights of shareholders in the general meeting and the reduction of agency costs of managers *vis-à-vis* shareholders does not necessarily amount to the introduction of shareholder-value philosophies.

As regards the external governance devices, it appears to be equally clear that the TOD is modelled in accordance with the City Code and intends to promote takeover activity in Europe as a means of controlling the management of European companies. Despite the possibility of opt-out of the breakthrough rule and the prohibition of defensive measures, the negative impact that the extensive disclosure requirements might have on the market value of these

companies obliges them to provide great results to the shareholders if they want them to pay the price of investing without control. In any case, the benefit goes entirely to the shareholders.

Only the auditing directive is very scarce in its regulation. The only significant improvements consist in the measures to prevent auditor-shopping, in line with the international tendencies described in Germany and the UK. There are signs that the EU wishes to introduce a measure of limitations to auditor liability as a means of promoting the auditing market but there are no concrete solutions. For the time being it appears to be more correct to think of the Directive as a “Framework Directive” laying down the basic standards concerning the exercise of the auditing activity and await for more substantive improvements in the future.

These developments may allow us to extract the following conclusions: the EU has been following the same trends towards the improvement of the internal governance of companies as those that were verified in the national regulations. These trends consisted in the improvement of the supervision of the management board, the use of disclosure and auditing as external governance mechanisms and in the improvement of the rights of shareholders. As regards the improvement of the supervision of the management board, the same trend towards the hybridisation of corporate governance could be observed at the EU level: boards are increasingly becoming dual-boards (in particular by means of the introduction of independent directors and specialised committees and by the introduction of the option of the dual-board structure in the SE) and the remuneration of directors is increasingly being subject to the control of the shareholders either by means of the requirement of shareholder approval or by means of the disclosure of remunerations in prospectus and the company accounts. The improvement of the rights of shareholders by means of the Shareholder Rights Directive and the Takeover Directive appear to be clearly thought to improve the use of the general meeting and the market for corporate control as a control mechanism of the activity of management boards. Finally, the auditing Directive is sparse in its regulations although it commands member states to make some important decisions concerning the necessary reliability of auditors (such as auditor independence and the requirements to dismiss an auditor) and leaves the door open to further action, in particular as concerns auditor liability. This does not amount to an overall

convergence towards the shareholder or stakeholder value models; there appears to be simply an hybridisation of the standards of corporate governance by means of the collection of the best elements of each system and in the improvement of the situation of shareholders as residual claimants of the firm without placing management boards excessively under their influence. The underlying intention appears to be the following: the diversity of the national structures of Corporate Governance is respected on account of their imbeddedness within a national context and culture. The modifications occurred obliged national systems of Corporate Governance to adapt however in particular to foster investment. This raised a number of new types of agency costs and internal and external Corporate Governance failures. These costs had to be addressed independently of the type of governance and the position of shareholders had to be strengthened in order to foster cross-border investment in Europe.

Chapter 3

The current revolution in SMC (small and medium sized companies)

The study of the evolution of the governance structures in Europe could not be completed if a word was not given to the revolution in small company forms that is currently taking place in Europe. The majority of the jurisdictions in Europe are currently undertaking a reform of their regulations for small and medium sized companies in accordance with a philosophy that appears to follow a number of patterns. These patterns consist in: (a) the reduction or relativisation of minimum capital requirements, (b) the flexibilisation of internal governance structures and (c) the discovery of new ways to protect creditors. The combination of these features may be a means of maximising the efficiency of the close corporations, which face specific agency problems of their own that distinguish them from their large public counterparts. This reform movement can be considered to be a direct consequence of a phenomenon of regulatory competition in Europe sparked by the *Centros* case law. The conclusions to be extracted from this phenomenon may be the same as those that one extracted from the evolution in large company forms: although there is a movement of convergence in the internal governance of closely held companies in Europe, path dependencies condition the scope for evolution and the most likely final result will be one of hybridisation: the fundamental features of the close company forms will be maintained although there is a clear path of evolution towards the promotion of more efficient forms of governance of closely held companies.

3.1 The governance of closely held companies - distinct sets of agency problems

Up to this point, this thesis has been using an agency costs approach to determine the evolutions in the governance of companies. This same approach will be used to explain the evolution in the governance of closely held companies. Nevertheless, one should begin by stating that the governance of closely held companies differs to a great extent from the governance of public

companies because they are subject to a whole new set of agency costs. This point will attempt to explain the governance problems that closely held companies incur (namely majority vs minority and minority vs stakeholders) and argue that the best way to overcome those agency costs may consist in (1) the contractualisation of their internal governance structures, (2) the prevention of *non pro rata* distributions and (3) the vigorous enforcement of rights to information.

The agency costs that the majority of public companies incur in may be reduced to two large groups (shareholders vs management and majority shareholders vs minority shareholders). The evolution in the rights of shareholders described in point 3 attempted to explain how the different regulations have evolved in the sense of reducing these agency costs and strengthening the position of shareholders in public companies. Closely held companies incur in a completely distinct governance structure: the main characteristics of closely held companies consist in a limited number of shareholders frequently bond together by family or personal ties and in the overlapping between shareholding and management; closely held companies are normally set up by persons having a close relationship between them and they also manage the company (they are managers-shareholders), with the residual claims being distributed in the form of salaries to the managers. These characteristics of the closely held corporation have substantial consequences that distinguish its internal governance structures to a great extent from the public corporation: the foremost characteristic is the lack of specialisation; close company's charters or statutes normally contain several restrictions to the transfer of shares (normally subject to the agreement of the remaining shareholders) that prevents investors from pursuing strategies of portfolio investments or exit instead of voice. Investors are normally locked-in the company by means of these restrictions and are forced to intervene more actively in the life of the company; in addition, this lack of specialisation has the consequence of the absence of a market for corporate control. Since shareholders are impeded from selling their shares freely on the market and managers must have a substantial proportional of their wealth invested in the company (because there is an overlapping between shareholding and management and the residual of the company is distributed in the form of salaries), the job market for managers is considerably reduced. The

combination of these provisions distinguishes the internal governance of closely held companies considerable from their publicly held counterparts.³⁶²

These characteristics of the closely held company have a number of advantages and disadvantages. The foremost advantage of the closely held company consists in the reduced scope for agency costs between shareholders and between shareholders vs management. The limited number of shareholders and the personal relationships that underpin their engagement into a venture reduce the scope for agency costs to occur between the shareholders: the reduced number facilitates mutual monitoring of the consequences of each shareholder's actions over the others; the personal relationships might serve as a deterrence mechanism against opportunistic behaviour because the sanctions for opportunistic behaviour are not limited to the company but are capable of a wider social impact. In addition, considering that there is a considerable overlapping between management and shareholding, the scope for agency costs between shareholders and management is also considerably reduced. This combination of features has an extremely important function in the reduction of agency costs because it ensures the alignment of interests between all the participants in the company: since shareholders are equally managers, there is a limited number of shareholders bound together by personal ties and investors are locked in the company with their investments, managers have strong incentives to maximise the value of their shareholdings (because their remuneration depends of the profits of the company) and weak incentives to engage in disloyal behaviour on account of the social sanctions that that might implicate and the difficulties in selling the shareholding. This is an excellent governance mechanism because the ultimate consequence is that what is good for one shareholder is equally good for the other shareholders, the management and the company. This creates incentives for each participant in the company to maximise the value of their shareholdings and bring positive externalities to the other participants.³⁶³

³⁶² Hetherington, J. A. C. (1969). "Special characteristics, problems and needs of the close corporation." University of Illinois Law Review: 1-29, Easterbrook, F. and D. R. Fischel (1986). "Close corporations and agency costs." Stanford Law Review 38(2): 271-301.

³⁶³ Armour, J. and M. J. Whincop (2004). An economic analysis of shared property in partnership and close corporation law. The governance of close corporations and partnerships. US and European perspectives. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford.

The governance of closely held companies also brings a number of disadvantages in relation to their public counterpart. The primary consequence consists in the high transaction costs that the participants in these corporations incur. Since the lock-in devices make it extremely difficult both to enter and to leave the firm (because it depends of the consent of the other shareholders), the valuation of the residual claims is extremely uncertain. This discourages investment in closely held companies, which might be highly detrimental to the public welfare because it prevents the allocation of know-how and capital to closely held companies that could be profitable if their were better managed. Another disadvantage that arises as a consequence of the high transaction costs consists in the impossibility to rely on public monitoring. External governance mechanisms (market for corporate control) are known to be effective disciplinary devices in creating incentives for managers to maximise the value of the company; it might occur that the shareholders/managers are simply not sufficiently ambitious and are not extracting the best possible value of the company. The market for corporate control and the threat of a modification in shareholding structures creates incentives for the best management of the company, which might come to the benefit of shareholders and the public welfare as a whole. This is extremely important even for share transfers that are admitted by the other shareholders: if there were external governance devices, the share prices would encourage investment and provide signals to the purchaser of the effective value of the company. Finally, the last disadvantage of the closely held corporation consists in the possibility for the creation of distributional conflicts. It often occurs that the personal relationships that underpin the shareholders in a closely held company deteriorate with time and the majority adopts behaviours detrimental to the interests of the minority. That is the case when two majority shareholders collude to dismiss the minority shareholder and then agree on dividing between themselves a disproportionate amount of the minority's share in the form of increased salaries (remember that the residual in closely held companies is normally distributed as salaries); or when the majority shareholders force the firm to buy back a proportion of the majority's shares without given an identical opportunity to the minority

shareholders.³⁶⁴ The distributional conflicts (also known as majority-minority conflicts) are the major agency costs in close corporations and deserve a special consideration.

The distributional conflicts occur whenever a majority colludes to expropriate the minority's share in the residual of the corporation. This is an opportunistic behaviour that arises from the fact that the minority may not sell his shares freely on the market but is subject to the majority's consent (that will never be given). Therefore, the lock-in effect of the close corporation is a double-edged sword that might bring benefits (it obliges the shareholder to engage in the life of the company) or disadvantages (it encourages opportunistic behaviours from the majority vs the minority). There are several solutions that the law and the legal thinking have proposed to this agency cost, although the costs and benefits of none of them are peaceful. One solution makes an analogy with the partnership form and simply provides the minority shareholder with the same right to dissolve the partnership by means of exit as the partner. This is an extremely criticised solution however because its ultimate effect is to dissolve the distinction between partnerships and corporations: if the participants in the company wanted the benefit of limited liability they must discharge the advantages of the partnership (which does not have limited liability). In simple words: one may not have the best of both worlds. Another solution provides the minority shareholder with the right to withdraw capital from the company. The minority might be granted with the right in the law or charters of the company to withdraw its investment either by obliging the remaining shareholders to buy its share or by reducing the capital of the company. Both of these solutions have met criticism because they are said to open way for the possibility of creation of new agency costs themselves: dissolving the company or reducing its capital raises agency costs in relation to creditors, who might see their credits endangered by opportunistic behaviours of the participants in the firm; it also raises the fear of a minority tyranny that occurs whenever minority shareholders use the oppression argument in order to get a disproportionate share of the residual of the firm under the threat of exit

³⁶⁴ Examples taken from Rock, E. B. and M. L. Wachter (2004). Waiting for the omelet to set: match-specific assets and minority oppression in close corporations. The governance of close corporations and partnerships. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford: 93-133.

(because salaries reflect effective the contribution to the activity of the firm and not the shareholding). The most convincing answer to the majority/minority conflict resides in contractualisation: the court should imagine the bargain that the parts would have reached if they had foreseen the conflict and enforce this hypothetical contract. In doing so the court must (1) prevent all *non pro rata* distributions of the residual of the company and (2) vigorously enforce the minority's rights to information. By doing so the court will oblige the majority to maximise the value of its shareholding and, ancillarily, the value of the minority's shareholding.

The contractualisation solution deserves further consideration. The contractarian conception of the company used in the beginning of this thesis is equally valid for the closely held company. The function of the law is to reduce the transaction costs and not to impose unnecessary burdens upon the parties. This is particularly true for closely held corporations because their function as a means to promote the free allocation of resources in the market and the limited number of parties normally involved in them recommends that the parties should be given maximum freedom in order to determine their best internal governance arrangements. This stands in stark contrast to the attitude in public corporations, where the large number of parties involved and the dimension of the enterprise obliged lawmakers to adopt a more regulatory approach to the public corporation because the scope for agency costs is much wider. Therefore there is an increasing recommendation for contractualisation within closely held companies.³⁶⁵This has implications for the role of the court: advocates of this approach consider that the court should regard the arrangements that the parties should have reached if they had foreseen the circumstances and enforce those same agreements. In the case of closely held companies, the legal thinking advocates that the courts should be guided by two main principles in determining this presumptive agreements: the first consists in the prohibition of all *non pro rata* distributions; the second consists in the enforcement of minority shareholders' right to information. The *pro rata* distribution principle is prevalent in close corporations and considers that each

³⁶⁵ Eisenberg, M. A. (1976). *The structure of the corporation: a legal analysis*. Boston, Little Brown, Eisenberg, M. A. (1999). "The Conception that the Corporation is a Nexus of Contracts and the Dual Nature of the Firm." *Journal of Corporate Law* 24: 819-816, Hansmann, H. (2004). Corporation and Contract. *Annual Meeting of the American Law and Economics Association* Yale.

party should receive a percentage of the residual that corresponds to its effective contribution to the firm. In the event that there is a majority/minority conflict, the courts should prevent all attempts to go around the pro rata principle. The courts should use the fiduciary duties owed to the corporation by the managers in order to challenge the business decisions of moving aside the minority shareholder. In the event that the courts consider that the decision was not made in the interest of the firm but in the interest of the majority shareholders, they should undertake all remedies to overcome that decision and grant the minority shareholder a fair share of the residual. When the majority shareholders are confronted with this situation, they will be obliged to maximise the value of the firm in order not to lose money; in doing so they will also maximise the value of the minority shareholders' part. The minority's right to information plays an extremely important part in this case by granting him with the possibility of monitoring the actions of the majority and providing him with sufficient elements to challenge the loyalty of their business decisions in courts. In addition this solution also stands to the best interest of the creditors of the firm who see the legal capital of the firm left untouched (no withdrawal rights) and do not face the fear of dissolution. The combination of these three elements (contractualisation, prohibition of non pro rata distributions and right to information) may be the best way to maximise the efficiency of the close corporation and overcome distributional conflicts and agency costs in relation to stakeholders that may occur within it.³⁶⁶

³⁶⁶ Closely held companies have not received such a wide degree of attention by the corporate governance literature as their publicly held counterparts. There are a number of studies however that should be pointed out because they provide excellent *food for thought* and were in the origin of this paragraph: see Armour, J. and M. J. Whincop (2004). An economic analysis of shared property in partnership and close corporation law. The governance of close corporations and partnerships. US and European perspectives. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford.; Rock, E. B. and M. L. Wachter (2004). Waiting for the omelet to set: match-specific assets and minority oppression in close corporations. The governance of close corporations and partnerships. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford: 93-133.; Vanderloo, J. C. (2004). "Encouraging corporate governance for the closely held business." Mississippi College School of Law Review 24: 39-48.; Steele, M. T. (2007). "Judicial scrutiny of fiduciary duties in Delaware limited partnerships and limited liability companies." Delaware Journal of Corporate Law 32: 1-32. Hetherington, J. A. C. (1969). "Special characteristics, problems and needs of the close corporation." University of Illinois Law Review: 1-29, Easterbrook, F. and D. R. Fischel (1986). "Close corporations and agency costs." Stanford Law Review 38(2): 271-301.

3.2 The existing close company statutes - comparative overview of national regulations

Before proceeding to the analysis of the developments occurred in closely held companies by means of a phenomenon of regulatory competition in Europe, it is worth analysing briefly the existing legal frameworks for closely hold companies in the jurisdictions under study and observe to which extent they promoted the governance model described in the former paragraph.

Germany, France and Portugal provide entrepreneurs with several legal forms for starting up companies: entrepreneurs may choose to set up a commercial partnership (OHG (*offene Handelsgesellschaft*); SNC (*société en nom collectif; sociedade em nome colectivo*)), limited partnership (KG (*kommanditgesellschaft*)) SC (*société en commandite; sociedade em comandita*)), limited liability company (GmbH (*gesellschaft mit beschränkter Haftung*)); SARL(*société à responsabilité limité*) or SAS (*société par actions simplifiée*); SpQ (*sociedade por quotas*)) or as a GmbH & CO KG (a special form of limited partnership in which the unlimited partner is a closely hold company - GmbH). The main characteristics of these business organisation forms are common across jurisdictions and well known; therefore they will merely enunciate here briefly: commercial partnerships are a special form of civil partnerships set up for commercial purposes; they have the advantage of being easily set up (all that is needed is an agreement between the partners and a registration in the company registry) and provide partners with a wide degree of flexibility in determining their internal governance arrangements; in principle, all partners are responsible for the management of the business and may represent the company in outer relationships; in contrast, they do not provide their members with limited liability and the partnership may be wound up by the simple declaration of one of the partners (*Kündigung*).

Limited partnerships consist in an evolution from the simple partnership and are characterised by the following internal governance arrangements: a partner assumes unlimited liability and the remaining partner thrust him with a number of assets for the unlimited partner to administer in the company; in the event that the company succeeds, each partner will be entitled to share in the profits in proportion to its contribution; in the event that it fails, the unlimited partner will assume full liability and the limited partners will see their liability

reduced to their contributions; several countries (Germany and Portugal) know a special form of limited partnership in which the unlimited partner is a limited liability company (GmbH; sociedade por quotas).

Limited liability companies consist in a hybrid form of business that originated from the German GmbH and share characteristics both from partnerships and public companies; each partner must make a contribution until they reach a mandatory minimum capital;³⁶⁷ the voting power of each partner is determined by its contribution to the capital; in principle, partners also manage the company, although they are free to choose outside managers; each partner may decide to sell its shareholding to another person or simply to terminate its shareholding in the company without putting at risk the continuity of the company (unlike in partnerships), although they are subject to the consent of the other partners; in addition, in contrast to partnerships, limited liability companies have an extremely detailed regulation of its internal life: they are subject to minimum capital and capital maintenance rules, investors are locked-in the company with their investments (by means of restrictions to share transmission or termination of shareholding), the voting power is determined by the shareholding and not per capita, they are subject to extensive disclosure requirements and internal controls by means of the general meeting. This reveals that limited liability companies are hybrid creatures that share characteristics both from partnerships and corporations (AktG; SA) and that serve as a legal vehicle for the close company statutes referred in the former paragraph.³⁶⁸

UK company law differs to some extent from this state of the world because its menu for business forms is much smaller: the British company fauna was limited to two business forms: (a) the partnership and (b) the company. The partnership shared the same characteristics of those mentioned in the former paragraph and they will not be repeated here. The company is a curious legal form because although it is primarily thought for the large public company it is also widely used as a legal vehicle for closely held companies because it contains no mandatory minimum capital and provides entrepreneurs

³⁶⁷ Prior to the recent company law reforms, the minimum capital for limited liability companies was the following: Germany (€25000); France (€ 7500); Portugal (€5000).

³⁶⁸ Hueck, G. (2007). Gesellschaftsrecht, C.H Beck, Merle, P. (2008). Droit Commercial. Sociétés commerciales, Dalloz.

with some advantages in relation to the partnership: the main advantage is the benefit of limited liability, although the absence of mandatory minimum capital, the free transferability of shares and the easy incorporation procedures have also been praised as substantial advantages. This combination of characteristics made the British company an extremely attractive legal vehicle for business start-ups. Nevertheless the regulation of British companies prior to the Companies Act 2006 was not without critics: since it was primarily thought for the large corporation, it imposed some extensive disclosure requirements (obliging the company to keep detailed records at its office for an extensive period of time) and a burdensome internal governance (it had to contain both a management board and a company secretary, hold mandatory annual general meetings (with very burdensome provisions concerning the approval of deliberations) and elect an auditor).³⁶⁹

This menu of business forms is not without critics. If we focus our attention on the closely held company (GmbH, SARL, SpQ) – the most widely used form for small companies - the critics of the continental model of regulation of small businesses claimed that the extensive regulatory burdens that those statutes placed upon entrepreneurs limited business start-ups and created agency costs in relation to minority shareholders and creditors: minority oppression was a constant in closely held companies and the major remedy provided for the law consisted in the right to withdraw capital, a solution that is inefficient for the reasons mentioned above. In addition, the extensive capital maintenance requirements were largely ineffective: the majority of companies simply could not abide by the legal requirements (undercapitalisation was seen as normal) and creditors increasingly demanded additional guarantees for their transactions. This was thought to bring negative externalities to the public welfare because it constrained business start-ups and did not create incentives for an efficient internal governance of companies. The outcome of the *Centros* decision – to be analysed further on – led to a “race to the British limited” accelerating incorporations of foreign companies in the UK. Nevertheless, the British company law was not without critics: the Companies Act 1985 was enacted in a time of financial capitalism and intended to promote an investment culture (characterised by portfolio investments, exit instead of voice and

³⁶⁹ Bourne, N. (2008). *Bourne on Company Law*, Routledge-Cavendish.

reliance on external governance mechanisms) as a means of governance of companies. This was increasingly regarded as undesirable because – as we saw above – one of the main advantages of the closely held company is the reduction of the agency costs that the overlapping between management and shareholding and the lock-in effects of the restrictions to share transfer provide. Since the Companies Act 1985 was primarily designed for large companies, it did not promote an efficient governance of closely held companies.³⁷⁰

This menu of business forms has been under considerable evolution lately on account of a phenomenon of regulatory competition triggered by the *Centros* case law. Before we advance to the analysis of the concrete consequences of that evolution it is worthwhile seeing the framework for regulatory competition in Europe.

3.3 The market for incorporation in Europe: *status quo* and current developments

The comprehension of the current developments in the revolution that is taking place in close company forms and the causes of that evolution depends of the consideration of the evolution undertaken by the ECJ in the framework of the freedom of establishment by the *Centros* case law. Much has been written about the precise impact of this case law; the main points consists in (1) the reinterpretation of the scope of the freedom of establishment, (2) the impact on the member states' private international law rules and (3) the resulting phenomenon of regulatory competition. The following lines will attempt to address each one of these points.

3.3.1 Freedom of establishment for companies in Europe: a short overview

The understanding of the scope of the freedom of establishment for companies in Europe depends of the analysis of the compatibility of member states' international private law (IPL) rules with the freedom of establishment enshrined in the ECT. Arts.43 and 48ECT provide for the fundamental freedom of establishment, which enjoys *vertical* and *horizontal* direct effect in

³⁷⁰ McCahery, J. A., E. P. M. Vermeulen, et al. (2006). The new company law: what matters in an innovative economy, European Corporate Governance Institute.

accordance with the case law of the ECJ.³⁷¹ In accordance with the fundamental freedom of establishment, *restrictions* (whether or not discriminatory) on the exercise of the right of establishment shall be deemed contrary to the free movement provisions of the ECT and therefore preempted. The definition of establishment is simple: it consists in the actual pursuit of a self-employed economic activity in another member state either by means of the actual establishment in a host member state (*primary establishment*) in the same conditions as its nationals or in the setting up of *agencies*, *branches* or *subsidiaries* (*secondary establishment*). This apparently simple provision must be understood with a grain of salt as regards companies. Since companies are not *natural* but *legal* persons and their existence depends of the conditions laid out in the regulation of the member state where they were set up, the ECT provided for special rules for companies. In accordance with art.48ECT, any profit-making company formed in accordance with the law of a member state *and* having their *registered office*, *central administration* or *principal place of business* within the community shall be deemed equal to a natural person national of a member state for the purposes of the exercise of the right of establishment. This apparently simple provision demands further explanation: this provision recognises autonomy to the member states in the determination of the conditions under which companies may be set up in accordance with their laws. It simply claims that a company validly formed in accordance with the law of a member state (where it has its *registered office*) and having its *central administration* or *principal place of business somewhere* in the community shall be deemed equivalent to natural persons for the purposes of the exercise of the right of establishment. They will be able to set up *secondary establishments* anywhere in the community without restrictions.³⁷²

The former paragraph mentioned that the member states are autonomous in determining the *connecting factor* of companies to their territory, *i.e* they are free to determine to whom its law shall apply. The connecting factors may be fundamentally reduced to two theories, the *incorporation* and the *real seat* theories. The *incorporation theories* originated in the UK and consider that the company is a creation of the law; it is sufficient for a company

³⁷¹ See cases *Van Gend en Loos* (C-26/62), *Reyners* (C-2/74), *Gebhard* (C-55/94) and, more recently, *Viking* (C-438/05).

³⁷² Craig, P. and G. De Búrca (2002). *EU Law. Texts, Cases and Materials* Oxford.

to be incorporated under a certain statute (i.e: to have its *registered office* there) to be governed by that statute, independently of the place where it carries out its business (*head office*). The *real seat* theories take a more Savignynian approach of *law as the expression of sovereignty over a territory* and consider that all companies whose *central administration* or *principal place of business* is located in their geographical territory should be subject to the laws enforced in that place. The conciliation between these theories and the freedom of establishment was, apparently, simple: as long as a company was formed in accordance with the law of one member state (whether it followed the incorporation or the real seat theory) and it existed under the law of that member state, it could establish *secondary establishments* in the Community free from any restrictions.³⁷³

The compatibility between member states' IPL rules and the freedom of establishment were questioned in the last years with a number of rulings from the ECJ that apparently introduced the incorporation theory in Europe. The rulings were *Centros*, *Überseering*, *Inspire Art*, *Daily Mail* and *Cartesio*.³⁷⁴ The groundbreaking *Centros* ruling (and complementary jurisprudence) initiated the debate concerning the compatibility of the real seat theory with EC Law. In *Centros*, a Danish couple incorporated a letter-box company in the UK and intended to register a subsidiary in Denmark solely with the purpose of evading Danish minimum capital rules. The ECJ decided that the rules governing the *formation of companies* were distinct from the rules governing the *exercise of activities* (whose evasion is fraudulent) and that European citizens could choose the legislation most appealing to them. In a reasoning similar to a previous ruling - *Segers*³⁷⁵ - the company did not need to prove actual pursuit of an economic activity in the member state of incorporation. Certain *mandatory requirements* for the protection of the *public interest* (such as *creditor protection* or *deterrence of fraud*) were not deemed legitimate justifications because the rules had been partially *harmonised* and there were *equivalent mechanisms* for the protection of those interests in the member state of incorporation. This reasoning was completed in *Überseering* and *Inspire Art*. In *Überseering*, the

³⁷³ Frenz, W. (2004). *Handbuch Europarecht*, Springer.

³⁷⁴ *Centros* (C-212/97), *Überseering* (C-208/00), *Inspire Art* (C-167/02), *Cartesio* (C-210/06)

³⁷⁵ *Segers* (C-79/85)

ECJ struck down the generally accepted theory of refusal of recognition of legal personality to companies whose *head office* (but not *registered office*) is in the host member state and is not incorporated in the host member state; in *Inspire Art*, the ECJ struck down the Dutch legislation on *formally foreign companies* that imposed the rules of *minimum capital* and *directors' liability* to letter-box companies incorporated abroad but active in the Netherlands. The conclusion to be extracted from these rulings is the following: *there is actually a market for corporate charters in Europe and European citizens may choose the most appealing law to govern their companies even if they have no connection to the member state where their companies are incorporated. The mandatory requirements pointed by the member states have generally failed to be accepted and the tendency of the ECJ seems to have been to provide citizens with the greatest margin of choice of law possible.*³⁷⁶

Up to this point, all cases have a common denominator: all concerned the *setting up (=incorporation)* of new companies in member states that follow the *incorporation* theory. The cases *Daily Mail*³⁷⁷ and *Cartesio* concern a distinct problem: the transfer of *head office* and *registered seat*. In *Daily Mail*, a British company wished to transfer its *head office* to the Netherlands in order to gain some tax advantages. The British tax authorities conditioned the exit to the liquidation of some taxes that had the effect of eliminating the envisaged tax advantage. The ECJ, surprisingly, upheld this behaviour and considered that *companies were creations of the law under wish they were incorporated and that, therefore, it would be the law in which they were incorporated to decide their existence after the transfer of the head office or registered office*. In *Cartesio*, an Hungarian limited partnership decided to transfer its *head office* to Italy; Hungary follows the *real seat* theory and the Companies Registry demanded that *Cartesio* be liquidated and re-incorporated as a company governed by Italian law. The partners of *Cartesio* objected to this decision and considered that the *Centros* case law had introduced the incorporation theory in Europe by jurisprudential means. The ECJ rejected the claims and adopted a salomonic solution: it considered that Hungary could not require the company

³⁷⁶ Trefil, B. (2003). Die Niederlassungsfreiheit für Gesellschaften in der Rechtsprechung des EuGH und ihre Auswirkungen auf nationales Recht Law Working Papers. Florence, European University Institute.

³⁷⁷ *Daily Mail* (C-81/87)

to enter into liquidation proceedings; the *legal personality of the company would be maintained but as a company governed by the laws of the host member state if the rules of conflict of laws of the host member state so accept.*

The question is: how to reconcile *Centros*, *Daily Mail* and *Cartesio*? The logical conclusion from these rulings seems to be the following:

(1) *companies are creations of national law and member states have full competence to decide the relevant connecting factor (incorporation and real seat theories);*

(2) *the exercise of that competence must nonetheless be made in accordance with EC Law:*

(2.1) *in case of the setting up of new companies, a real seat member state cannot refuse to recognise a company validly incorporated in an incorporation theory member state, even if the company was incorporated there to evade national regulations;*

(2.2) *in the case of the transfer of head office, a national cannot impose the incorporation theory to a real theory member state; nevertheless the State cannot oblige the company to go into liquidation: the legal personality of the company will be maintained as long as the rules of the host member state accept to subject the company to their laws; it will then become a company governed by the law of the host member state.*

The solution proposed in the former paragraph deserves further explanation. Firstly, the ECJ provided an answer to those who claimed that the real seat theory was killed. That is not the case, it was merely conciliated with the free movement provisions of the ECJ. Each member state remains free to determine the relevant connecting factor: however, it must respect the choices of the others. If a company incorporated in an incorporation theory regulation decides to transfer its head office into a real theory regulation, then the latter regulation cannot refuse the recognition of the company; if a company moves between two real seat regulations (the situation in *Cartesio*), then the company will become governed by the law of the host-regulation, without being obliged to be wound up or liquidated; there will simply be a change in the applicable law; if a company moves from a *real seat* to an *incorporation theory* regulation, then the home member state may require liquidation because no regulation accepts

to govern the company.³⁷⁸ Secondly, the solution laid down in Daily Mail seems to have been partially defeated. The question in Daily Mail was the compatibility of what was in reality an *exit tax* with art.43ECT and the ECJ answered as if it had been a *conflict of laws*. This measure equivalent to an exit tax imposed upon Cartesio was struck down by the ECJ. This is in fact a great conquest to the mobility of companies in Europe because it removed all restrictions to the transfer of the head office as long as the host-member state accepts to govern that company. In this sense, Cartesio closed the gap opened by Centros.³⁷⁹

3.3.2 Regulatory competition in Europe ?

This discussion raises the spectre of a market for incorporations or of a Delaware-effect in Europe. The Delaware effect consists in an historical phenomenon that occurred in the late XIXth century when an American state – Delaware – decided to create optimal company law for managers in order to attract investment. Since the US private international law rules are dominated by the incorporation theory, the result was a race to re-incorporation in Delaware; major firms began to trade as companies subject to Delaware law. The remaining states then followed the example and initiated a competition of company law rules in order to attract the reincorporation of companies and thus benefit from franchise fees and work for the local law firms and judiciary. There are two distinct perspectives on this Delaware effect: the critics claim that the result will be a race to the bottom, in which the states with the most managerialist statutes and lower shareholder rights will prevail in the market for (re)incorporations; they claim that this phenomenon raises a number of agency costs vis-à-vis shareholders and stakeholders that only a public policy not hampered by competition may resolve; the defendants of the market for incorporations claim that there is no evidence of a race to the bottom and that the market for rules may effectively benefit shareholders and stakeholders to a

³⁷⁸ Edwards, V. (1999). EC Company Law, Clarendon Press.

³⁷⁹ The impact of *Centros* has gone beyond IPL and the regulatory competition that it triggered has sparked a number of innovations in European Law that are potentially far reaching: from law-making procedures to the actual evolution of the law. See the studies of Deakin, S. (1999). Two types of regulatory competition: competitive federalism vs reflexive harmonisation: a law and economics perspective on *Centros*. Cambridge Yearbook of Legal Studies, Hart Publishing: 231-260, Deakin, S. and A. Hughes (1999). Economic efficiency and the proceduralisation of company law, ESRC Centre for Business Research, University of Cambridge , Deakin, S. (2007). Reflexive Governance and European Company Law. U. o. C. Centre for Business Research.

greater extent; since publicly traded firms must compete for capital and clients, the incorporation in a state that does not adequately defend their interests raises suspicion about the company that may be effectively detrimental to their business; if companies want to be competitive and attract capital and clients, they must adequately defend their interests; the state that creates the optimal company law for the protection of all of these interest groups will win in the market for (re)incorporations because their legislation will be recognised by all as excellent and will be a competitive factor in the business.³⁸⁰

There are currently signs that the regulatory evolution registered at the European level has set the path to a certain degree of regulatory competition in Europe, particularly in small and medium companies. Although one should not expect a phenomenon similar to the one that occurred in the US with the Delaware effect, there is currently evidence of a certain degree of regulatory competition. The regulatory approach of the EU towards company law has increasingly taken into consideration the advantages of variety of national company forms. The early years of the European community witnessed an intensive degree of harmonisation of company law in Europe, in which the fundamental aspects of companies in which variety could pose an obstacle to the functioning of the common market were made equivalent by means of the use of Directives.³⁸¹ This harmonisation effort gave place to a less intensive approach from the 1990s onwards, in which the EU set only framework measures that determined a number of standards according to which the national regulations had to abide with and left member states with the discretion to apply them at a later stage. This favoured the articulation of general principles or standards rather than the promulgation of rigidly prescriptive rules. The aim was to achieve policy goals by linking regulatory intervention to the activities and processes of autonomous rule-making bodies, such as self-governing professional organisations in the financial sector and

³⁸⁰ See the seminal work of Romano, R. (1985). "Law as a Product: some pieces of the incorporation puzzle." *Journal of Law, Economics and Organisation*; also Easterbrook, F. and D. R. Fischel (1996). *The Economic Structure of Corporate Law*, Harvard University Press. For the concept of regulatory competition in Europe, see Frada de Sousa, A. (2009). "Cartesio: regresso a Daily Mail e encerramento de um ciclo." *Cadernos de Direito Privado*.

³⁸¹ For a systematic overview of these directives and a perspective of the Corpus Iuris of European Company Law, see Habersack, M. (1999). *Europäisches Gesellschaftsrecht*, C.H. Beck.

professional associations. The best example of this approach is the Takeover Directive, which provides member states with a combination of measures to be chosen in accordance with local specificities but are designed to achieve a common goal. The last development of the approach of the EU consisted in the pure recognition of regulatory competition. Member states are given the right to prescribe their own company law regulations in accordance with the public interests they deem fitter; however, they cannot impede the recognition of alternative measures of protection devised by other member states and they may not impede the opt out of national companies by means of the mobility within the common market; this is nothing but the *Cassis de Dijon* principle applied to company law.

There are currently two distinct forms for companies to take advantage of the possibilities of mobility within the common market: firstly, by means of start-up companies, taking advantage of regulations where the perquisites relating to minimum capital or the incorporation procedure are less burdensome: this is exactly the situation in *Centros*, although its exact reach following Cadbury-Schweppes is yet to be seen; secondly, by means of the transfer of registered seat within the common market towards regulations where the operational demands are less burdensome. The latter type of regulatory competition is more or less established in Europe, mainly by means of the cross-border mergers directive (CBMD - Directive 2005/56): if a company wishes to evade a national regulation, it may do so by setting up a shell-company in the regulation where it wants to migrate and then merge with it.

The combined result of these measures imposes a conclusion: that European company law is an increasing part of the company law of the member states and that the remaining spaces of national authority left to the discretion of the member states will be subject to a certain degree of jurisdictional competition, in the sense of allowing national companies to opt out of those provisions in favour of less onerous provisions in other countries. The efficacy of those provisions for the protection of the public interest will be left to the market. Companies are under a duty of disclosure by means of a public register containing all the necessary information concerning minimum capital, the legislation to which it is subject and other elements (First Company Law Directive). If companies are capable of trading successfully disregarding those provisions, then it seems that the public interest is not very well served by

them; if not, the market will punish those companies by means of a refusal to recognise them commercial credit.

A related question consists in knowing to which extent companies will effectively want to take advantage of those possibilities of jurisdictional competition. The main possibilities appear to be offered essentially for start-up companies. The main incentive for a person to register a company in another regulation consists in the evasion of minimum capital requirements, which often do not act as a means to protect creditors but rather as a means to foreclose the market to new ideas and protect those that are already established; the ruling *Caixabank*³⁸² of the ECJ is a clear example of how apparently neutral rules in reality are a means of foreclosure of the market to new competitors, both national and foreign. Companies that are already installed on the market and wish to evade burdensome national regulations are subject to a number of procedural safeguards that limit the scope for jurisdictional competition in the market for re-incorporations. Considering that it is established that a company may transfer its registered seat within the common market by means of a cross-border merger with a shell company, the CBMD contains a number of procedural safeguards to reduce agency problems vis-à-vis the weaker constituencies, mainly minority shareholders and employees. Firstly, mergers are subject to a number of disclosure obligations – namely independent expert reports – that are destined to elucidate shareholders of the consequences of the merger. This means that managers may not reincorporate in pro-managerial jurisdictions without the conscious vote of the shareholders. Art.3(2) CMBD also opens the possibility for member states to adopt provisions to safeguard the rights of minority shareholders who decide to oppose the merger. Secondly, there are also a number of mechanisms to safeguard employee participation procedures that limit the scope for the evasion of more employee-friendly regulations; the merger may not be used as a means to escape from co-determination. This means that the biggest impact to be expected from regulatory competition in Europe will be in start-up companies because they are the ones that may benefit the most from the scope of regulatory competition; there are a number of procedural safeguards that limit the freedom

³⁸² *CaixaBank France v Ministère d l'Économie, des Finances et de l'Industrie* (C-442/02)

of action of the already existing companies to take advantage of the possibilities of the common market.

A final question concerns the possible impact of this phenomenon of regulatory competition for European company law: the task of European company law is currently twofold: to facilitate the mobility of companies around the common market and to fight the negative externalities that that mobility may bring to a number of stakeholders: minority shareholders, employees and creditors. As regards the first question, the rulings of the ECJ and the final chapter of the free movement novel to be brought about by *Cartesio* provide a sufficient legal framework for the mobility of companies across national borders and serve as the basis for a Directive on the Transfer of Registered Seat (14th Company Law Directive). In this sense, the legal bases for regulatory competition in Europe have been set. As regards the second question, the EU has taken a more cautious approach. The protection of minority shareholders is left essentially to the discretion of the member states, as the CMBD proves. Considering that member states have distinct ownership patterns and distinct company law forms, it appears to be wiser to recommend the protection of their interests and leave to the member states the task of devising the best means to achieve that aim; the protection of employees has taken a stronger regulatory approach because the strong tradition of employee participation in some member states could be endangered by the mobility of companies; the best solution is a procedural safeguard to ensure that the mobility of companies is not used as a means to escape co-determination, as the CBMD exemplifies; finally, the protection of creditors is made essentially by means of the instrument of disclosure; there is the preoccupation to ensure transparency on the market for creditors to know exactly with whom they are trading and devise mechanisms alternative to minimum capital to ensure the protection of their interests. For that end, the EU is currently revising its disclosure obligations with the intention of facilitating the access to information across the EU. This is nothing but the idea of regulatory competition à la européenne.

One may attempt to draw some conclusions from this phenomenon: firstly, there is room for regulatory competition in Europe and this is the most likely approach to the future of EU company law; secondly, the phenomenon of regulatory competition will essentially benefit start-up companies of small size because they are the ones who may benefit the most from the more flexible

requirements of other regulations in relation to minimum capital, incorporation procedures and internal flexibility; thirdly, the scope for jurisdictional migration within EU law is not likely to be very wide because there are a number of safeguards to the interests of other stakeholders – namely employees – that remove incentives for jurisdictional migration; fourthly, that the EU has taken a number of safeguards to the interests of stakeholders in order to combat the impact of regulatory competition.³⁸³

3.4 The evolution of SMC

The biggest impact of the phenomenon of regulatory competition in Europe is to be seen in small and medium sized start-up companies. There appears to be currently evidence that the distinct regulations under study have undertaken a number of measures to combat the general tendency for small entrepreneurs to incorporate their companies abroad – mainly in the UK – and attempt to keep control of the companies trading within their country. This evolution was made by means of an adaptation of the existing structures of small and medium companies (GmbH; SARL/SAS; SpQ) to the competition from the UK. The main modifications concern: (1) the facilitation of the incorporation of companies; (2) the flexibilisation of internal company forms and (3) the discovery of new ways to protect creditors. In contrast, the UK has equally acknowledged the advantages of the continental regulation of close companies and has undertaken a number of modifications to its company law in order to bring into its company fauna the considerable reduction of agency costs that the continental regulations proportionate. The result appears to reveal that, as in large public companies, the same phenomenon of hybridisation of the existing models of governance also occurred in small and medium companies: that there is an evolution in continuity, an hybridisation of the existing models towards a model closer to the anglo-saxon pattern in some dimensions; in contrast, the UK has equally introduced a number of company law reforms in

³⁸³ For all the discussion of regulatory competition in European company law, see the interesting texts of: Armour, J. (2005). Who should make corporate law? EC legislation vs regulatory competition, European Corporate Governance Institute. ; Deakin, S. (1999). Two types of regulatory competition: competitive federalism vs reflexive harmonisation: a law and economics perspective on Centros. *Cambridge Yearbook of Legal Studies*, Hart Publishing: 231-260. ; Deakin, S. (2007). Reflexive Governance and European Company Law. U. o. C. Centre for Business Research. ; Wouters, J. (2000). "European Company Law: quo vadis." *Common Market Law Review* 37: 257-307.

order to make its business catalogue more attractive for smaller-firms in a trend that, in my view, tends to approximate the governance patterns of British small-business forms towards the continental pattern.

3.4.1 The ideal close company statute - maximum efficiency in SMC

Before advancing into the analysis of the concrete modifications introduced, it is worthwhile analysing the ideal close company statute in the eyes of the law-makers. The traditional business organisation forms for small companies became increasingly under criticism because they are said not to meet the needs of small entrepreneurs. The partnership has the advantage of an almost unrestricted internal flexibility, allowing partners to bargain for the arrangements that best fit their needs; in addition, there are no lock-in devices, low scope for agency costs between managers and partners and between partners (because since managers are also shareholders, the interest of the firm is their interest), decision-making based on consensus and no minimum capital; nevertheless it contains three great disadvantages: (1) it does not provide partners with limited liability; (2) no lock-in devices does not constrain opportunistic behaviours in relation to other partners and (3) the exit of the partner (and consequential dissolution of the company) raises a considerable degree of agency costs in relation to creditors. The limited liability company has the advantage of limited liability, the standard regulation offered in the statutes reduces the scope for transaction costs and it contains several lock-in devices (such as restrictions to the transmission of shares and the right to withdraw capital) that ensure the alignment of interests with the company and reduce agency costs vis-à-vis creditors. The main disadvantages normally pointed out to the limited liability company are threefold: (1) the protection of creditors is essentially based upon the minimum capital, which constrains business start-ups and is essentially a fiction because creditors usually demand other guarantees; (2) the internal regulation is seen as too extensive and burdensome, creating incentives for evasion; (3) the combination of management and majority voting opens way for distributional conflicts; the burdensome regulation of the internal governance of companies prevents judges from enforcing the hypothetical arrangements that the parties would have reached if they had foreseen the solution and then

maximise the internal governance of companies in accordance with the solution proposed above in the analysis of the governance of closely hold companies.³⁸⁴

The ideal statute for a closely hold company would be one that could combine the benefits of partnerships and companies and avoid the agency costs that each one of them raises. This statute would have: (a) no minimum capital for a business start up; (2) maximum internal flexibility; (3) lock-in devices to prevent opportunistic behaviours. It appears that all the jurisdictions under study have reformed their closely hold company statutes towards these premises revealing a further sign of convergence in the governance of company law in Europe. The reform was achieved by means of an upgrade in the existing company law or by means of the introduction of alternative business forms. This convergence may be regarded as a direct result of the phenomenon of regulatory competition in Europe initiated by the *Centros* case law in which the UK became the primary state for incorporating small businesses in Europe.³⁸⁵

3.4.2 Current reforms

The modifications introduced in the statutes regulating closely hold companies may be summoned in three great categories: the countries under study have facilitated the setting up of companies, increasingly flexibilised their internal organisation, providing participants with more contractual freedom and devising new ways to protect creditors.

³⁸⁴ Hetherington, J. A. C. (1969). "Special characteristics, problems and needs of the close corporation." *University of Illinois Law Review*: 1-29, Easterbrook, F. and D. R. Fischel (1986). "Close corporations and agency costs." *Stanford Law Review* 38(2): 271-301, Armour, J. and M. J. Whincop (2004). An economic analysis of shared property in partnership and close corporation law. *The governance of close corporations and partnerships. US and European perspectives*. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford.

³⁸⁵ For a systematic overview of the reform of close company statutes that is currently taking place in Europe see McCahery, J. A., E. P. M. Vermeulen, et al. (2006). The new company law: what matters in an innovative economy, European Corporate Governance Institute. For the current trend towards *wealth maximising legal rules* for close corporations, see McCahery, J. A. and E. P. M. Vermeulen (2004). The evolution of closely held business forms in Europe. *The Governance of Close Corporations and Partnerships. US and European Perspectives*. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford.

3.4.2.1 facilitating the setting up of companies

one of the first innovations that span across all the jurisdictions under study consisted in the facilitation of the setting up of new companies. The British experience with easy and low-cost incorporation of companies was seen as an advantageous element that attracted numerous incorporations from other countries where the administrative procedures were substantially more costly. This facilitation of the incorporation was achieved by two means: the reduction of the minimum capital and by means of the simplification of the administrative procedures.

Germany is an interesting example of this trend. Germany decided to follow a strategy of upgrade of its company law; instead of creating new business forms it decided to modify its statutes for closely held companies (*maxime*: the GmbH) and allow it to be incorporated more easily. The innovations were introduced by the MoMiG (*Gesetz zur Modernisierung des GmbH-rechts und bekämpfung von Missbräuchen*: Law for the modernisation of the GmbH and the fight against abuses); this statute introduced two great modifications: it eliminated in practice the need for a minimum capital for a GmbH to be incorporated and it provided for a low-cost accelerated incorporation procedure that facilitates the setting up of companies.

As regards the modifications introduced to the minimum capital, the innovations introduced by the MoMiG were two fold: it reduced the mandatory minimum capital of the GmbH from the amount of €25.000 to only €10.000 (of which only 50% must be paid at once; this means that a normal GmbH may be incorporated with a share capital of €5000); in addition, it created a new type of light-GmbH: this new type of GmbH is named as limited liability entrepreneur-company (*Haftungsbeschränkte Unternehmergeellschaft* (UG)) and may be set up with a minimum capital of €1 and a maximum capital of €9.999 (§5a GmbHG-E). This UG should not be understood as a new type of company but merely as a subspecies of GmbH. The purpose of the elimination of the minimum capital requirement for the setting up of a GmbH was thought to compete directly with the British Limited in the advantage of facilitating business start-ups. This means that two entrepreneurs may initiate a venture together and enjoy the benefits of limited liability and the internal governance of the GmbH without having to pay the minimum capital required of a normal

GmbH. Nevertheless this comes at a cost: in the event that the entrepreneurs decide to incorporate a UG they will be obliged to retain 25% of their distributable profits until the assets of the company reach the amount of €10.000 (§5(3)GmbHG-E). When they reach that situation, they may convert the UG into a normal GmbH simply by means of a deliberation of the general meeting and the correspondent registry in the companies' register (§57GmbHG-E). In addition, in contrast to the normal GmbH, the minimum capital of the UG must be paid in full in the setting up of the company and contributions in goods are not admitted (§5(2)GmbHG-E). This means that the members of a UG are in fact in a more onerous position than their normal GmbH counterparts because they are obliged to pay in cash the full amount of the minimum capital that they decide to attribute to the company. Nevertheless, unlike their GmbH counterparts, the capital maintenance provisions that oblige the shareholders to undertake measures in the event that 50% of the legal capital is lost do not bind them (§5(4)GmbHG-E). The combination of these provisions makes it easy to understand that the UG is not a new type of company form but in fact simply a preliminary stage of a GmbH: it consists in a normal GmbH deprived of some of its more onerous provisions (namely minimum capital) and that is subject to particularly stringent obligations until its capital reaches the minima prescribed in the law, a point in which it has strong incentives to convert to a normal GmbH.

The MoMiG also introduced a number of modifications to the normal GmbH in order to make its incorporation easier. The great novelties consisted in the introduction of model articles of association (*Musterprotokollen*) and in the acceleration of the registry. In the event that the parties to the GmbH opt to choose one of the model articles of association provided for in the law, they will not need any official document (made by a notary) in order to incorporate the company. In addition, the procedures for the registration of companies were made easier: the registration may be made electronically and it is made independently of the administrative permit (*genehmigungspflicht*) for the exercise of certain activities.³⁸⁶

³⁸⁶ Freitag, R. and M. Riemenschneider (2007). "Die Unternehmergesellschaft - "GmbH light" als Konkurrenz für die Limited? ." *Zeitschrift für Wirtschaftsrecht* 32: 1485-1492, Joost, D. (2007). "Unternehmergesellschaft, Unterbilanz, Verlustanzeige." *ZIP* 48: 2242-2248.

France followed the same trends of upgrade of its existing company law in order to cope with the competition from the British Limited. France decided to introduce a number of modifications concerning the minimum capital and incorporation procedures of its two business organisation forms for closely held companies: the SARL and the SAS. The SARL is the French transplant of the German GmbH; initially it demanded a minimum capital of €3050 (that was raised to €7500 in 1984) to be set up. The 2003 statute for economical start-ups (*Loi pour l'initiative économique*) accepted the criticisms that were generally made to the demand of an excessively high-minimum capital to these types of companies: it was said that it constrained economic initiatives (particularly in high-risk sectors) and that the legal capital did not offer sufficient guarantees towards the protection of the interests of creditors. That was the reason why the 2003 statute decided to eliminate the demand of a minimum capital for a SARL to be set up and allowed it to be freely set up with a minimum capital of €1. The objective of the reform was the same as the one underpinning the UG or the reduction of the minimum capital for the GmbH: to encourage entrepreneurship and avoid that minimum capital requirements could refrain the economical advances. But the legislator and the courts were aware that this could raise considerable agency costs in relation to creditors, who saw themselves deprived of the protection of minimum capital, no matter how feeble it was. That was the reason why the judiciary and the creditors decided to create alternative vehicles to safeguard their credits. The judiciary used the open clause provided for in art.L.223-22 of the Code du Commerce that made the management liable in relation to third parties by all the faults in the management of the company. In the view of the French courts, in the event that the parties faultily initiate a business by means of an SARL without providing for the necessary funds for its adequate functioning, they may be made directly

liable in relation to third parties.³⁸⁷ This amounts to an awkward solution that approximates the French regime closer to the British wrongful trading rule, in which the manager of a company may be made personally liable in relation to third parties when he continues to trade after the point of insolvency knowing (or having a duty to have known) that the company would not be able to support its credits. In addition, the French banks and creditors have developed sophisticated credit regimes for small companies that limit their risk (such as relational financing or the demand of an insurance). The most important thing to retain from the reform undertaken in the SARL consists in the relativisation of the importance of minimum capital as a means to initiate a business.

The most important reform to the French statute for closely held companies focused in the SAS however. The SAS (*société par actions simplifiée*) consists in an extremely flexible form of public company (*société anonyme; Aktiengesellschaft*) that was introduced in French company law in 1994. Although it was originally intended as an instrument for cooperation between public companies (because the other legal forms for company networks were either too rigid (such as the setting up of another public company) or did not offer their members the benefit of limited liability (Economic Interest Grouping – GIE – *Groupement d'Intérêt Economique*)) in 1999 it was extended to private individuals to the furthest possible extent. Its main advantage – its far-reaching internal flexibility – will be analysed in the following point. For this point it is important to retain that the *Loi pour l'initiative économique* extended the same advantages as regards minimum capital to the SAS. Therefore, at this point in time, a SAS may be freely set up just by one or more physical or legal persons with the minimum capital of €1. This minimum capital provides the shareholders with the benefit of limited liability in the conduction of the affairs of the business.

³⁸⁷ It should be mentioned that this case law is not yet pacific in French courts because these decisions are isolated and their wider impact is yet to be seen. The French courts follow the same approach that the British courts followed in the ruling Solomon, of using the legal personality to separate the liability of the managers in relation to third parties only in situations in which they acted outside their normal competences. The action should be brought against the company and then the company could claim compensation from the manager. This radical understanding of the principle of legal personality has had some detours over the time; one common path was to file a criminal complaint against the manager and then demand compensation as a civil part in the criminal proceedings. There are voices claiming that the modifications introduced by the *Loi pour l'initiative économique* should bring about modifications to this case law. See Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz., pp.204 and the case law quoted there.

The UK has equally facilitated to a great extent business start-ups. The issue of minimum capital was not a question in the UK because it has long had a liberal approach to minimum capital, allowing companies to be set up with no minimum capital. The main modifications focused on the procedural requirements for the setting up of companies. One of the major innovations consisted in the termination of the traditional distinction between the memorandum of association and the articles of association. Traditionally, British company law demanded that the partners of a company agree on a memorandum of association to determine the relationship of the company with third parties and on the articles of the association that would regulate the relationships between the shareholders of the company and the shareholders and directors. S.17 and 18 Companies Act 2006 attributed the provisions that were previously in the memorandum of association to the articles of association; the memorandum of association was limited to a simple deliberation of the shareholders of the company stating their will to set up a company and the assumption of the duty to take at least one share each (s.8 Companies Act 2006); it has merely a procedural meaning; this represents a convergence in relation to Continental Law where the charters of the company contain all the information demanded by the law. In addition, the articles of association will in the future contain certain deliberations of the shareholders affecting the constitution of the company that may be undertaken by means of a special deliberation (s.29 Companies Act 2006) and the shareholders will be dispensed from indicating the object of the company in the articles of the association (s.31 Companies Act 2006). In order to make the incorporation of companies even easier, the Companies Act 2006 will equally provide shareholders with model articles of association and with the possibility to set up companies directly online.³⁸⁸

Portugal equally introduced a number of significant legislative reforms in order to facilitate the start-up of companies, although unfortunately the reforms had a major impact in procedural matters and not so much in substantive matters. The Portuguese legislator introduced in 2006 a number of modifications to the procedural regime of setting up of companies. Firstly, the

³⁸⁸ Lawlor, D. G. (2007). "Reform der englischen Limited und ihre praktischen Auswirkungen" ZIP 47(2002-2005). Bourne, N. (2008). Bourne on Company Law, Routledge-Cavendish., pp. 50-88.

requirement to have a public document was eliminated; the articles of association may be set up by means of a private document (made by the parties or an attorney at law) and the control of the legality of the clauses is to be made by means of the administrative registry services. Secondly, the Government provided the parties with model articles of association; in the event that the parties do not have any special demands from the law, they may simply subscribe to some model articles of association to be provided for by the registry. Finally, although the requirement to have a minimum capital of €5000 to set up a closely held company was not eliminated, its regime was overtly simplified: the shareholders of the company do not need to deposit any minimum capital but they will be personally liable in their own personal assets to the maximum of €5000. In addition, the Government also introduced an electronic means to set up a company in a similar fashion to the one set up in other countries.

3.4.2.2 Flexibilising the internal organisation

Another significant innovation registered in all the jurisdictions under study consisted in the flexibilisation of the internal organisation of companies. The former paragraphs mentioned that the legal thinking and judiciary have encouraged providing shareholders of closely held companies with a greater degree of contractual autonomy because the types of agency costs that might occur within closely held companies (which consist essentially in majority/minority distributional conflicts) can only be fought by means of the enforcement of the optimal agreements that the parties would have reached in the event that they had contracted for the situation. The legislators seemed to have followed this path because there seems to be a greater margin for contractual autonomy within closely held company statutes and an alleviation of the bureaucratic costs that these companies incur.

The UK is a primary example of this tendency with the introduction of a new type of business organisation form – the *Limited Liability Partnership* – and the provisions designed for small closely held companies in the Companies Act 2006. The limited liability partnership consists in a new corporate form that is expected to bring about a considerable modification to British company law by granting small firms with a new business organisation form that is tailored to

their specific needs. Up to the enactment of the Limited Liability Partnerships Act 2000, British company law granted entrepreneurs with three distinct forms to carry out their businesses: the partnership (without limited liability or legal personality), the limited partnership (in which the managing member assumed full liability and the other members risked only the amount of their contributions) and the company. Although the company was primarily thought for large scale enterprises, the private company (i.e: one that did not offer its shares to the public) prevailed as the preferred business form for small companies for a number of reasons: the absence of a mandatory share capital meant that it did not impede business start-ups; it did not have the requirement of a minimum number of members; lawyers used shareholder agreements as a means to regulate the internal organisation of the company and adapt it to the specific needs of their members, providing that care was taken not to modify the statutory organisation of powers within the firm (i.e: the competences of the organs). The prevailing attitude of courts to recognise the specificity of private closely held companies and enforce whatever shareholder agreements that did not alter the distribution of power within the firm made the private company the most attractive business organisation form for small companies.³⁸⁹ Despite its success, there were several criticisms to the private company's adaptation to the needs of small companies. The major criticism consisted in the separation between ownership and control that underpinned the design of the Companies Acts enforced before 2006, which is not present in closely held companies. The acts required, for instance, unanimous consent for written resolutions to be approved, burdensome requirements for the approval of deliberations in extraordinary meetings and costly disclosure and audit. These elements led the lawmaker to undertake to extensive modifications to British company law: the enactment of a new company form – the Limited Liability Partnership – and the exemption of unnecessary burdens in the Companies Act 2006.

The Limited Liability Partnership (LLP) consists in a curious hybrid business organisation form for closely held companies. The LLP is a corporate body gifted with limited liability and unrestricted legal personality; it is incorporated by registration with an incorporation document filling the requirements of a memorandum of association; it is equally subject to many of

³⁸⁹ Gower, L. C. B. (1997). Gower's Principles of Modern Company Law, Sweet & Maxwell.

the accounting and disclosure requirements and other controls applicable to private companies (s.1 and 2 LLP Act 200). It is equally treated as a company for insolvency purposes. Therefore, externally the LLP is not different from any other corporate body and it is indifferent for a creditor to contract with a private company or with a LLP. But internally, the LLP is a completely different thing: it has no shareholders or share capital, no directors and no specific requirements for meetings or resolutions. The directors of the partnership are the shareholders themselves because the statute clearly states that the member of the LLP is the agent of the LLP (meaning that it has authority to act in the name of the partnership and the effects of the act will be felt in the legal sphere of the partnership) and that any restrictions to the powers of the members are ineffective towards third parties unless the third party is aware of the limitation (s.6 LLP Act 2000); therefore, there is a complete overlap between management and “control”. In addition, the LLP contains several lock-in devices designed to constrain opportunistic behaviours and protect the interests of the creditors: the entrance of new members to the LLP depends of the agreement of the other members, in order to ensure compatibility between membership and management; the exit from the LLP depends of the agreement of the other partners or, in the absence of agreement, upon giving reasonable notice. In contrast to the general partnership, the LLP is not dissolved by the exit of the member (in a similar way as to a corporate body). This is an extremely important provision because it prevents the opportunism of the partner without constraining excessively its freedom: it depends of the agreement of the other partners in order not to betray the purpose of the partnership; it allows the exiting member sufficient freedom as long as the other partners are aware of the fact and are given sufficient time to undertake any actions to prevent damages from the opportunistic exit from the partner; it safeguards the interests of creditors because the LLP – as a corporate body – will be able to subsist independently of the change in membership (s.4 LLP Act 2000). But the most important provision of the LLP consists in its maximum internal flexibility: partners are not bound by any kind of predetermined internal governance structure; the rights and duties of the members between themselves and in relation to the LLP are to be governed by agreement between the members or, subsidiarily, by default regulations to be enacted by an administrative body. This means that absolute primacy is given to the

agreement of the members of the LLP; this is nothing but an extreme example of a trend of contractualisation of the internal governance structures of closely held companies (s.5 LLP Act 2000). In addition, the Limited Liability Partnership Regulations 2001 follow closely the corporate form: they provide, for instance, for an equal division of profits in the absence of shareholder agreement (*a pro rata* distribution). This is an important element as regards the fiduciary duties of the members of the LLP; the legal thinking and the case law have almost unanimously declared that there are no fiduciary duties between the members of the LLP (unless some specific circumstances give rise to a duty of good faith) and that all fiduciary duties are owed to the LLP itself as a corporate body. The protection of creditors will be analysed in the following point. For this point it is sufficient to say that the combination of these provisions made the LLP an interesting hybrid creature between a partnership and a company that follows the international recommendations towards the contractualisation of closely held companies.³⁹⁰

The Companies Act 2006 also introduced a number of significant innovations in general company law in order to render the company form attractive for small companies. The main innovations were introduced under the motto “*think small first*”: some requirements of the Companies Act were eliminated in order to make the life of private companies easier. The main modifications introduced were the following: private companies are no longer required to have a company secretary (s.270); this person now will only be required for public companies, although private companies may elect to have one; the decision-making process was considerably simplified; private companies are no longer required to have annual general meetings (unless they opt to do so or a minority of 10% requests one); and the passage of written resolutions was made considerably easier: as regards ordinary resolutions, written resolutions may be passed by a simple majority of a simple majority of the total members of the right to vote actually vote favourably for the resolution; as regards extraordinary resolutions, written resolutions may be

³⁹⁰ Freedman, J. (2004). Limited Liability Partnerships in the United Kingdom: do they have a role for small firms. The Governance of Close Corporations and Partnerships. Us and European perspectives. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford, Morse, G. (2004). Limited Liability Partnerships and Partnership Law Reform in the United Kingdom. The Governance of Close Corporations and Partnerships. US and European Perspectives. J. A. McCahery, T. Raaijmakers and E. P. M. Vermeulen, Oxford.

passed by a 75% majority (whereas before it required unanimity); this approximated the regime of presential and written resolutions and made the internal life of private companies considerably easier. The act equally eliminated the need for the approval of shareholders for the allotment of shares subject to the condition that the company will have only one class of shares after the proposed allotment and the respect of the pre-emption rights of the existing shareholders (s.549 ff). The combined effect of these provisions is expected to facilitate the internal organisation of the life of British private companies.³⁹¹

France also introduced some important modifications to its company law in order to make its company law more flexible. The main modifications occurred in the French SAS. The SAS is an extremely flexible form of company that provides its members with absolute contractual freedom; there is no mandatory governance structure and the partners to the SAS are expected to create their own internal arrangements that best represent their interests (L. 227-(5) Code du Commerce). The only mandatory organ of the SAS is the President, who has all the powers that the law confers to the President of public companies – in particular the representation of the company before third parties (L227-(6) and (7) Code du Commerce). Despite the considerable margin of manoeuvre that the law provides to shareholders, some regulations concerning the regulation of public companies are still applicable to the SAS (L.227(1)§3 Code du Commerce): that is the case of the increase/reduction of social capital, the nomination of an auditor (*commissaire aux comptes*), among others. This means that the SAS was also affected to a great extent by the reform undertaken by the LNRE: in particular, the following provisions are still applicable to the SAS: (1) the reduction of thresholds from 10% to 5% to (a) require the nomination of an *expert de gestion* (to evaluate the situation of the company in the event that the management failed to provide a reasonable answer to a written question within the deadline of one month – L.225-231 Code du Commerce); (b) exercise an *ut singuli suit* against the management (L.225-252 Code du Commerce); (c) enforce the refusal or dismissal of auditors

³⁹¹ Lawlor, D. G. (2007). "Reform der englischen Limited und ihre praktischen Auswirkungen " *ZIP* 47(2002-2005), Viswanathan, A. (2007). "The Companies Act 2006: towards shareholder engagement and streamlining the decision-making process " *International Company and Commercial Law Review* 18(6): 199-202.

(L.225-230 and 233 Code du Commerce); (d) application of the regime of the *conventions réglementées* (subjection of agreements celebrated between the president of the company and shareholders holding more than 5% of voting rights to the approval of the shareholders). This means that, despite its internal flexibility, the SAS is still subject to a considerable number of internal controls that distinguish it to some extent from the British LLP. Finally, the LNRE also allowed professional partnerships (*sociétés d'exercice libéral*) to be set up as SAS (*SELAS* – *sociétés d'exercice liberal en actions simplifiée*) and, from 2008, also as *entreprises unipersonnelles à responsabilité limitée* with a minimum capital of €1.³⁹²

Germany and **Portugal** also undertook some modifications of their regulations for closely held company forms, although the impact was less extensive and largely reduced to the elimination of unnecessary controls.

Germany has also been introducing from 2005 onwards some chirurgical modifications to its company law in order to make the GmbH more attractive as a legal form. The measures concerned the (a) private international law of companies; (b) the rules of shareholder loans (*Eigenkapitalersatzrecht*), (c) the legalisation of the practice of cash-pool financing and hidden non-case contributions (*Verdeckte sacheinlage*) and (d) the bona fide purchase of GmbH shares.

As regards the modifications introduced in the private international law of companies, one should begin by stating that revolutionised its century old doctrine dating from Savigny by permitting their companies to have head-offices (*verwaltungssitz*) located abroad; this modification, which came as a direct consequence of the *Centros* case law and gave the mercy blow to the real seat theory, allowed German GmbH to enter the game of regulatory competition and make the GmbH attractive as a business vehicle; this means that it is possible now for an entrepreneur to set up a GmbH and trade abroad, keeping himself under the *imperium* of German legislation.

Another serious modification consisted in the modification of the regime of shareholder loans (*Eigenkapitalersatzrecht*); this regime distinguished between two types of loans from shareholders to the company: the normal

³⁹² Merle, P. (2008). *Droit Commercial. Sociétés commerciales*, Dalloz., pp.727-744; La Nabasque, H. (2001). "La SAS et la loi sur les nouvelles régulations économiques." *Revue des sociétés* 119: 589-616.

loans (to be treated as if they were given by a third party) and the equity-substituting loans (given by the shareholders in times of crisis to substitute for the social capital). The consequences were dramatic because the shareholders were likely to have their credits lost in insolvency proceedings in the event that the court considered the loan as an equity-substituting loan (therefore the loan to the company would serve to pay the credits of the remaining shareholders). The MoMiG eliminated the distinction between the two types of loans and considered that both loans could be claimed in insolvency proceedings (§39 InsolvenzOrdnung). Loans given in the period of one year before the commencement of the insolvency proceedings will be voidable in order to protect the shareholders of the company in insolvency proceedings. The subject of shareholder loans was equally the object of other measures as regarded the practice of cash-pool financing. This referred to a practice common in normal companies and in groups of companies of providing shareholders and affiliated companies with loans taken from the reserves of the company. A devastating ruling from the German Supreme Court of November 2003 classified these distributions as unlawful distributions (even if the right to full repayment was ensured) and subjected their recipients to the most extreme consequences. The MoMig introduced a new sentence to §30(1)GmbHG and stated that these kinds of business operations should not be considered as unlawful distributions but subject to the requirements that it only touches the active of the company and the right to full repayment is ensured.

In the subject of unlawful distributions, one should equally mention the reform of the rules on hidden non-cash contributions (*Verdeckte sacheinlage*): these rules refer to the value of the non-cash contributions to the capital of the company: the consequences of the previous regime were catastrophic because the shareholder could be obliged to repay the contribution twice on account of the duty to enter with cash into the legal capital (§19 GmbH Gesetz). These rules were alleviated and the shareholder is now allowed to enter into the capital of the company with objects although he has the onus of proving the true value of the objects. Finally, some rules were equally enacted in order to facilitate the transmission of shares; in the event that someone acquires shares in a GmbH and that person is registered in the company register as a shareholder, the sale will be valid independently of the fact that the person whose name is in the registry is no longer a shareholder (e.g: because he sold

the shares to another person before without registering the sale). This is a provision destined to protect third parties to the maximum extent possible. The combination of these provisions is expected to alleviate the burdens placed upon the GmbH as a legal form and make it more flexible and attractive as a business organisation form.³⁹³

Portugal also introduced in 2006 some modifications to its regime of closely held companies. The modifications were however almost procedural and did not reach the extension of the reforms undertaken in other countries. The major modification consisted in the elimination of the requirement for the intervention of a notary in some aspects of the business life (such as sale of shares, increases of capital, that may be made by a simple private document) and the transfer of some of the competences for business life from the courts to the company registries (such as the winding up of companies). There were no substantive modifications to the regime of closely held companies because the current legal framework is seen providing a sufficient margin of manoeuvre for the needs of individuals.³⁹⁴

3.4.2.3 Creditor protection

A final word must be given to the reform of the protection of creditors in closely held companies. The former paragraphs mentioned that the major agency costs that these companies face are essentially majority vs minority shareholders and shareholders vs creditors. There are several governance mechanisms to ensure the protection of the interests of creditors such as: (1) affiliation rights (limitations to the exit from companies) and (2) agent constraints (prohibition to undertake certain actions). Each country under study adopted a different governance strategy in order to consider the interests of creditors in their business organisation statutes.

³⁹³ Happ, W. (2005). "Deregulierung der GmbH im Wettbewerb der Rechtsformen." *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* **169**(1): 6-34, Justiz, B. d. (2008). Schwerpunkte des Gesetzes zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Mißbräuchen (MoMiG). B. d. Justiz.; Schmidt, K. (2002). *Gesellschaftsrecht*, Carl Heymanns , Schmidt, J. (2007). "German Company Law Reform: makeover for the GmbH, a new mini-GmbH and some important news for the AG " *International and Comparative Corporate Law Journal* **18**(9): 306-311.

³⁹⁴ Cunha, P. O. (2007). *Direito das Sociedades Comerciais*. Lisboa, Almedina, Menezes Cordeiro, A. and P. Câmara, Eds. (2007). *Jornadas de Homenagem ao Prof. Raúl Ventura. A Reforma do Código das Sociedades Comerciais* Almedina.

Germany introduced in its MoMiG some provisions concerning a practice prevalent in Germany known as silent burials (*Bestattungsfälle*) of buying insolvent companies and then prevent insolvency proceedings by means of bureaucratic operations: changing the name of the company, removing the directors, etc. The most important reform consists in the direct liability of the manager of the company: in the event that the manager of the company makes distributions to the shareholders that caused the inability if the company to meet its debts and he violated its duties as a prudent businessman, he will be directly liable towards the creditors of the company (§64GmbH-G). In addition, the legal capital has not lost its meaning in Germany as a means to safeguard the interests of creditors: although its meaning has been substantially reduced in start-up companies, they are subject to considerable legal reserve requirements until they reach the minimum capital of €10.000. This means that the absence of a minimum capital should not be an impediment to start-up a company but it should be maintained as a guarantee of the interests of creditors and a signal of the financial health of the company. This amounts to a pure agent constraints strategy.

The UK followed a pure affiliation strategy: as the former mentioned, in contrast to the general partnership, there are several limitations for a partner of a LLP to leave the company; and in the event that he leaves, the LLP will be maintained independently of the permanence of its associates. This lock-in device is destined to avoid the dissolution of the company by means of the exit of a partner and preserve its integrity as an ongoing undertaking in order to ensure the rights of creditors. In addition, both LLP and private companies are subject to considerable disclosure requirements (such as annual accounts, registration, etc) that is destined to make public the financial situation of the company. Creditors will have the onus of checking those accounts in order to evaluate the reliability of the persons they are contracting with.

In **France**, the law allows the shareholders of the SAS to introduce in them lock-in devices destines to restrict the transferability of shares; in addition, they are subject to the same disclosure and accounts requirements as the public company (with the exception of the commissaire aux comptes, that is required only if certain thresholds are exceeded).

In **Portugal**, the general provisions for the protection of creditors (legal capital, lock-in devices and manager liability for company insolvency in the event that the manager disregarded rules destined to the protection of creditors) were maintained as before.

3.4.3 comparative perspectives

The understanding of the evolution of closely held business forms depended of the taking into account of two distinct phenomena: the (optimal) governance structure for a closely held company and the current phenomenon of regulatory competition that is occurring in Europe. As regards the latter phenomenon, the mere existence of a race to the UK as a state of incorporation is clearly indicative of the inadequacy of the existing statutes for closely held companies, that were seen as constraining business start-ups and too burdensome in some aspects. As regards the former phenomenon, the optimal governance structure for closely held companies consists – as demonstrated – in a combination of (a) easy incorporation, (b) flexible internal structure and (c) lock-in devices. All four jurisdictions under study appear to have evolved towards the maximisation of the efficiency of their closely held business statutes in accordance with these criteria; the only difference is the methodology (some have preferred to upgrade their company law, others to create new business forms) and in the concrete focus of the reforms.

As regards the incorporation of companies, all jurisdictions have facilitated the incorporation. This was achieved either by procedural means (easier incorporation procedures) or by means of the relativisation of minimum capital as a requirement to start-up a company. **France** is the most extreme case in this aspect because its menu for closely held business forms (the SARL (*société à responsabilité limitée*) and the SAS (*société par actions simplifiée*)) are currently satisfied with the minimum capital of €1. This is an extremely important reform because its likely impact will be to promote entrepreneurship in France by providing individuals with the **Germany** decided to follow an intermediate approach of creating a mini-GmbH (*Gesellschaft mit Beschränkte Haftung*) as a first-stage GmbH and reducing to a great extent the mandatory minimum capital of a full scale GmbH (which is currently €10.000).

The **UK** and **Portugal** have followed a minimalist approach of simply reducing the administrative burdens to set up a company.

As regards the flexibilisation of the internal governance structure, the path towards contractualisation is more than evident as statutes are increasingly providing partners with a wider degree of contractual autonomy. The **UK** and **France** stand as the most extreme cases of this trend. The UK not only decided to create a new hybrid company form - the LLP (*Limited Liability Partnership*) - but it also reformed extensively its own company law. As regards the LLP, one should mention that it works internally as a partnership and externally as a corporate body. This is a curious evolution that reminds us to a certain extent the GmbH (which combines characteristics of partnerships and companies) and more closely of the SAS. As regards its reform of company law, the modifications introduced were destined not only to make internal life easier for companies, in order to create incentives for the clearer involvement of shareholders in the life of companies. **France** decided to flexibilise even further the regime of its SAS in order to transform it into the main vehicle for closely held companies. **Germany** decided to alleviate the regulatory burdens placed upon shareholders of the GmbH in order to render the internal life of the company more shareholder friendly. Only Portugal failed to introduce a profound modification and limited itself to the removal of unnecessary administrative burdens.

A word must be given to lock-in devices: these lock-in devices are extremely important because they align the interests of shareholders with the company and reduce agency costs in relation to creditors. It is curious to see that all jurisdictions admit the existence of lock-in devices in closely held companies: in the **UK**, the partners of the LLP are limited in their right to exit by the need to have the agreement of the other shareholders and the duty to give reasonable notice in the absence of agreement; in **France**, the lock-in devices of the SAS are to be freely determined in the statutes of the company (the SARL contains several statutory restrictions to share transfers); in **Germany** and in **Portugal** there are equally restrictions to the transfer of the shares that bind the interest of shareholders to those of the company.

These developments may allow us to extract the following conclusions: the current phenomenon of regulatory competition in closely held company forms that is currently taking place in Europe has led to the improvement of the

statutes for closely held company forms in accordance with the doctrinal indications of maximum efficiency. These indicators (easy incorporation, internal flexibility and lock-in devices) are said to be the best form of reducing the agency costs that the specificities of the internal governance of closely held companies produce and be the best vehicle for the promotion of maximum public welfare. Nevertheless the countries under study have not altered radically their company statutes; some have provided some new optional business organisation forms, others have upgraded their own company law towards making it more shareholder-friendly and other have made a bit of both. Therefore, one conclusion imposes: there is also currently a phenomenon of hybridisation of the governance patterns also in closely held companies: countries are evolving towards some common trends but always maintaining their own national specificities.

Conclusion

This description of the developments of the evolution registered in the patterns of Corporate Governance in Europe may allow us to understand to which extent is currently taking place a phenomenon of hybridisation of structures of Corporate Governance in Europe. The study of the evolution of the structures of corporate governance must not be disconnected from the macro-economic environment. The economical conditions in Europe went across two distinct stages in the last century: *coordinated capitalism* (concentrated in long-term investments, vertical integration and incremental innovation) and *financial capitalism* (concentrated in generating profits, outsourcing and radical innovation). Companies had to develop adequate governance structures to deal with the economical imperatives of the times. In times of coordinated capitalism, companies bet on (a) concentrated ownerships, (b) long-term management tenures focused on expansion and (c) wide degree of sector-level collective bargaining. The ownership patterns examined in each one of the jurisdictions analysed reveal these objectives. Germany exhibited a great degree of ownership concentration in which banks played a pivotal role, management educated in technical functions that had gone up the promotion ladder in internal labour markets and extensive system of co-determination; France and Portugal exhibited similar patterns with just two exceptions: firstly,

the role of the state in corporate governance; secondly, the weaker position of labour; only the UK was clearly outside this picture with a radically distinct pattern of governance betting on dispersed ownerships, financially oriented management and low degree of collective bargaining.

The passage from coordinated capitalism to financial capitalism led to a modification of the pre-existing governance patterns. Surprisingly, instead of evolving towards a single model – which would be the anglo-saxon model – all jurisdictions under study appear to reveal a surprising degree of hybridisation of their governance patterns. Although it is clear that the continental countries are evolving towards the anglo-saxon model, strong path-dependencies condition all scope for evolution and the final result appears to be more one of hybridisation: the fundamental characteristics of the system will be maintained, although there is a certain degree of convergence towards the anglo-saxon model. This trend may be observed in the points this thesis has been attempting to describe: as regards the management boards, there is currently a trend of (a) the improvement of the supervision of the management board, (b) stricter internal controls, (c) fiduciary duties in relation to the company and to the shareholders and (d) greater role for auditing. As regards the evolution in the ownership structures, there appears to be at present (a) a phenomenon of entry of institutional investors in the governance of companies, (b) a phenomenon of dispersion of ownership and (c) an extensive trend of privatisation. As regards the evolution in the rights of shareholders, there appears to be nowadays a movement towards the reinforcement of their protection, namely by means of (a) the resuscitation of the general meeting, (b) protection of the rights of minority shareholders and (c) improvement in the rights to information. Finally, EU law has equally been extremely active in this area, promoting the approximation to the much-applauded anglo-saxon model of governance. The same phenomenon occurred in closely held company forms, although the specificities of the governance of these types of businesses have distinguished the trends of evolution: the common trends of evolution in closely held business forms consist in: (a) easier setting up of companies, (b) flexibilisation of internal governance structures and (c) lock-in devices as a means to protect creditors.

The final conclusion may be one of hybridisation: although the fundamental governance features of companies will not be modified, there is

undeniably a trend towards the improvement powers of shareholders and in the accountability of the management board towards the interests of shareholders; in parallel, in the UK the evolution goes in the sense of approximating the governance of companies closer to the continental standards, by promoting a greater degree of supervision of the board and relational governance (voice instead of exit) as a means of tackling agency costs. This means that all countries managed to provide an answer to the passage to the financial economy without killing their established governance patterns.