# Financial Law Institute

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**Future priorities for the Action Plan on Modernising Company law a response to the consultation document**

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# FUTURE PRIORITIES FOR THE ACTION PLAN ON MODERNISING COMPANY LAW
## A RESPONSE TO THE CONSULTATION DOCUMENT


## Abstract

*This document contains the response of the Financial Law Institute to the consultation document of the European Commission on* Future Priorities for the Action Plan on Modernising Company Law and Enhancing Corporate Governance*. It is the fruit of a debate about the direction of European company law within the Financial Law Institute. The consultation document to which this is a response is available at* http://europa.eu.int/comm/internal_market/company/consultation/index_en.htm.
*Two important points we've tried to make, among many others, are that a) more transparency is needed about ownership of shares and who can exercise the voting power attached to shares, esp. in view of developments on the capital markets such as stock lending b) the introduction of a mandatory "one share one vote" rule is not supported by the available evidence on the efficiency of such a rule. Such a rule could on the contrary be a strong incentive not to take firms public even where this would be efficient for them.*

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### *Question 1*

Other issues that may be relevant: there still are some items relating to cross border establishment that could usefully be tackled. So e.g. the regime of the branches, which under the 11th Directive continues to be too complicated and too burdensome (e.g. why refile information that should be available in the home state and can be retrieved electronically; why require translations of documents to be filed if the information is available in the home state in a widely used language; why require multiple filings in the same member state). It would be useful to compare the EU system with the regime of branches in the US.

A future simplification of the Second Directive would also be very useful, without doing away with all the provisions. The present draft amendment (“SLIM Plus”) is rather timid, and in places muddled, e.g. where it contains a very complicated rule on whether it is necessary to draft a new valuation report for contributions in kind where previous valuations exist. The proposed new rule on financial assistance may in its practical effect be more restrictive for management buy-outs than the present version of art. 23 of the Directive. The introduction of shares without any indication of value would also be a simplicfication and would allow states to abandon the antiquated systems of shares with nominal value, or the like. The feasibility study which has been announced at the Commission website is urgently needed. In the meantime, further work should be halted.

### *Question 2*

To open a webpage where on a continuous basis, remarks about EU company law – also about topics to which no directives are applicable – could be filed, a continuous consultation so to say.

### *Question 3*

The term “shareholder democracy” is a misnomer and conveys the wrong message. Votes are cast according to the relative financial stake, not a very democratic principle. The issue is that of distributing power in the company, and to make the checks and balances function optimally. Here simple ideas will not do.
The objective of this exercise should be made clear: it consists of identifying the most efficient governance system that creates the best performing companies. It is not clear that “one share one vote” is a panacea in this respect, at least empirical studies should be undertaken to determine which companies have performed best in the past.

A one share one vote rule should at least differentiate between listed and unlisted companies. In unlisted companies, where the founding partners can negotiate with each other about the allocation of power within the company and there is no investing public that needs protection, it’s unclear why a one share one vote rule should be imposed. It may further be necessary to differentiate according to the degree of development of the company. In high tech start ups, more complicated ownership structures are often necessary.

A strong case can be made against “dual class recapitalizations”, i.e. the introduction, through a majority vote in the general assembly, of deviations from one share one vote *after* a company has listed on an exchange. This should be banned, and it should make no difference whether the company wants to attach special voting rights to the listed or to the unlisted shares. Both sorts of transaction defeat the expectations of investors.

If, on the other hand, a company already deviated from the one share one vote-principle before it became listed, it probably should be allowed to maintain this dual (or multiple) class share structure, as long as investors are properly informed, through disclosure (prospectus) of what kind of company they are investing in. It is undoubtedly true that deviations from one share one vote are sometimes used to create a controlling block of shareholders who may try to extract private benefits (“rents”) from the company. The extraction of private benefits to the detriment of the company and investors should be attacked through all sorts of corporate governance rules, e.g. rules on intra-group transactions and on executive compensation. There is also the matter of abusive exercise of voting rights, which can already be attacked under national, often court-developed doctrines on “abus de majorité”. There is no need to replace those subtle and flexible national doctrines by a uniform statutory European rule. To conclude: the introduction of one share one vote seems like a form of overkill to solve the problem of rent extraction.

In continental Europe, only a small proportion of companies are listed- a far smaller proportion than in the US. There is ample anecdotal evidence that one of the reasons why controlling shareholders are reluctant to list a company on an exchange is the fear to lose control. Allowing companies to list while special rights attached to the non-listed shares ensure the incumbents of retaining control could convince these controlling shareholders to take their companies public. This could be a development which contributes to an increase in the competitiveness of the European corporate sector as a whole, since it will prevent that companies for which it would be efficient to finance themselves through an IPO shy away from this option because of the fear of controlling shareholders to lose control and the accompanying benefits.

In any case, the main conclusion from the existing theoretical and empirical literature seems to be that there is no clear cut case in favour of the one share one vote rule (see also the excellent recent paper by G. Ferrarrini “One share- one vote: A European rule?”, available at www.ecgi.org/wp) The Commission could usefully study the American debate on the question that raged twenty years ago, when the SEC unsuccessfully tried to introduce the rule. It may be noted that several American companies went public over the past few years without forsaking their dual class structure (Google is an example).

As a matter of principle, therefore, there are good reasons to allow different schemes to compete, without requiring all companies, or all legal systems, to adhere to the single philosophy of “one share, one vote”.

If the EU does decide to take action in this area after all, it should be careful to avoid creating new distortions by e.g. only banning certain techniques that deviate from one share one vote (e.g. multiple votes) but still allowing others (e.g. voting caps).

In this respect, it may be noted that increasingly, practices on the financial markets lead to a decoupling of share ownership and voting power, e.g. through stock lending and the exercise of voting power through all sorts of intermediaries and proxies that are not the owners of the shares. Clearer and enforceable rules on disclosure of voting – and ownership positions seems to us to be a subject that deserves higher priority than introducing "one share one vote" as such. Here substantial progress is still possible. At least it would seem inconsistent to on the one hand attack deviations from one share one vote but on the other leave alone the practices of hedge funds and others that vote with shares they do not own or only own on a very short time basis.

***Question 4***

The principle of nomination and more importantly of dismissal by the AGM is essential. For nomination, there should be a procedure for allowing external nomination, outside the initiative of the board. However to allow submissions for nomination without more to the AGM is not called for, as often one may be faced with "voluntary" directors that only stand up to serve their own interests.

The right of investigation should be mandatory at the level of EU regulation. Procedures and required voting power are national matters, possibly with an EU minimum. In most companies laws these matters are already addressed.

***Question 5***

Institutional investors (IIs) should first be more clearly defined, as this class covers a very wide and ill defined group.

IIs should be bound to state their policy on attending and voting at AGMs and this policy should be published.

As to actual exercise of voting rights, it is of importance to their constituencies to know how votes have been cast. E.g. the votes by a pension fund will differ from the one cast by a speculative investment fund, and beneficiaries should know. It is not always evident that shareholder activism organised by institutional investors is in the best interest of investors in the light of a cost-benefit analysis, i.e. it may not be a profitable way of investing the II's resources. Additionally, some II's are plagued by conflicts of interest which mean that the decision whether and how to exercise voting rights may be influenced by considerations other than the interest of the investors.

It is also important for the companies themselves (and for their management and directors) to know who the institutional investors are that hold shares in them and how they vote. Without such knowledge, company boards and management cannot fulfil their role as agents of the shareholders: it is difficult to take the interests of principals into account if you don't know who your principals are and what their preferences are.

These are all level playing field issues, and regulation should avoid regulatory arbitrage in this respect.

***Question 6***

Wrongful trading and director's disqualification are useful instruments and should be introduced by a European directive, as major techniques to support responsible management of the companies. In fact these instruments are probably stronger creditor protection instruments than the capital rules of the second directive, and might contribute to balance a possible review of the 2nd directive.
As to specific elements, one could consider that wrongful trading not only applies in case the director trade with actual or constructive knowledge of the imminent failure of the company, but also in other cases where he has committed gross negligence or has acted recklessly. Liability should be limited however, to avoid a lack of directors. Insurance issues should also be given due consideration: if a director can be insured at the company's expense against this sort of liability, the incentive effect of the rule may be lost, unless flanking measures are taken, such as a right for the insurance company or the company to claim back (at least under certain conditions and limited to a certain amount) the amounts paid by it to creditors. Even in the unlikely event that company directors would be required (by their companies, or by national legislation) to pay the insurance premiums themselves, a rule on liability for wrongful trading may not give rise to efficient incentives if insurance companies do not discriminate between company directors when setting premiums.

Transparency of ownership – or of voting rights – is one of the topics that need urgently to be tackled. At present, companies do not know their shareholders, cannot engage any dialogue with them, and shareholders may hide under several techniques (trust, securities lending, etc). A strict transparency regime whereby important shareholders should notify their holdings to the company, and companies have the rights to learn about the identity of all their shareholders should be introduced. This is an important element of stability of our economic structure. Also, it might avoid possible risk of money laundering.
Companies should therefore have access to the securities registers that are available at custodian banks, with the obligation for non EU- banks to make the information available within a short time period.

***Question 7***

One may indeed doubt whether a separate directive on the seat transfer as such is still necessary after the adoption of the Tenth Directive and the recent SEVIC judgment of the ECJ (though the latter is already being construed in an overly restrictive manner by some German scholars). On the other hand, such a directive would probably make the EU the first region in the world where cross border transfers of registered office without interruption in legal personality are possible. Even within the US companies have to use a merger technique to transfer their registered office from one (US) state to another. Transferring your seat through a merger is still more complicated than a direct transfer would be- there is, e.g., the cost of first setting up a foreign company with which to merge. Therefore, a directive on such transfers may still be useful- but it is less urgent than in the past. Some will no doubt argue that a 14th directive would make seat transfers *too* easy and would lead to undesirable regulatory arbitrage. Those fears would be exaggerated- because cross border mergers make an indirect seat transfer possible anyway- and unjustified- because such a directive would merely facilitate one way of exercising one's freedom of establishment, a fundamental freedom enshrined in the Treaty.

In any case, under the present state of national legislations, a cross border seat transfer triggers considerable tax liabilities. As these would probably not arise in case of a merger, this path will usually be followed by firms. Therefore a directive that only deals with the company (and codetermination) law aspects of seat transfers would probably not have a big impact: an additional directive on the tax aspects would be required. But since it would seem very difficult to get the member states to agree on such a tax directive, the  the Commission should not consider the issue of seat transfers as a high priority.

***Question 8***

The question of board structure is much more complicated that the mere choice between a one and a two tier board. There are in practice at least in some jurisdictions, many intermediate solutions, and the subject is of great complexity and full of nuance. Also there is no need to press all companies in one and the same mould: the dividing line between the two governance bodies often deserves to be modified along fine lines of individual appreciation. There is no evidence for the superiority of one of the existing systems over another. The important question is the composition of the managing and esp. supervisory organs, not so much their structure as such. But rules on this (e.g. rules on the number of independent directors, the definition of independence and related matters) are not suitable for harmonisation in view of differences between individual companies and the typical companies of different member states. Recommendations are as far as the EU should go in this field.

The EU should mainly focus on the objective that companies should have adequate structures and mechanisms in place to insure efficient supervision of their activities including those of their management.

Eventually there seems to be no need for further intervention in this matter. Moreover, as a consequence of the SE Regulation, member states are in effect already forced to offer at least SE's incorporated on their territory the choice between a unitary or dual board structure. It is only when the Commission notices that member states try to subtly restrict this choice that it should consider  an intervention.

***Question 9***

Both remedies may be useful, and many states already practice the squeeze out in a satisfactory way.

However, the existing rules are related to listed companies for which there is at least some form of price determination in the market. For unlisted companies the exercise is much more perilous: experts should intervene, designated by an independent third party, and deciding on at least three different evaluation methods. Experience shows that this remedy is rarely used by non listed companies. Moreover, in spite of subtle arguments to the contrary, one cannot in our view deny that a squeeze-out is a form of expropriation. This form of expropriation can be justified in "public", open companies that are trying to delist or lose their legal status as public companies that are subject to additional rules (e.g. on disclosure, or accounting): in this way, regulatory and other costs for the company may diminish considerably and a small minority of shareholders should not be allowed to block this transaction provided they get a just and equitable compensation for their shares.  In unlisted companies, by contrast, it is far harder to find a justification for squeeze-outs, since there this form of expropriation may benefit majority shareholders, but it is not clear how it might be useful for the company as such.

Sell-outs are more difficult to handle as they may lead to blackmailing the majority shareholder. If one wants to introduce sell out rights at all, they probably should be a balanced in a certain way by squeeze-out rights: e.g. that in response to a sell out request, the majority shareholder may respond with a squeeze out at a price determined by an independent expert. To avoid abuse, one may stipulate that in response to a sell out request, the majority shareholder may offer payment in instalments. Also it should be provided that the company itself may offer to acquire the shares, and that, if several parties hold the majority block, the shares that are acquired should be allocated among these parties proportionate to their pre-existing holdings.

***Question 10***

The Commission's position in its Action Plan still seems to be the right one. Protection of the interest of shareholders and creditors is necessary, but is a subject not directly related to pyramids, but of a more general application. As this subject is not on the agenda as such, it is not further dealt with here. The case law on "abus de majorité" or similar techniques could offer useful guidance.

On group law in general, under the assumption that the Commission does not want to undertake a large scale exercise, it might be useful to consider a soft solution where certain group internal transactions are mandatorily subject to a specific procedure of valuation and review by a committee of independent directors. The opinion of these directors would have to be published. A similar system exists in the Belgian Companies Act (art. 524), and has proved to be quite effective. Moreover, the approach fits well into present corporate governance thinking.

"Abusive pyramids" should be dealt with in different ways. In the Take-over fields, a look through rule would be welcomed whereby the acquisition of a controlling block in some pyramids would lead to the requirement to make a bid for the underlying subsidiaries. One could frame the rule as follows: if the holding company's assets consists for more than 50% of the stock of another, listed company, acquiring control in the holding company should trigger the mandatory bid obligation for the listed company. The rule should be extended to multiple layer structures, following the same criterion. The rule is to be formulated in terms of relative "value", and here additional analysis has to be undertaken on how this "value" has to be defined.

Another technique could consist of neutralising voting rights for pyramid structures: e.g. if the holding company hold 75% in a listed company, the voting rights of the 51% shareholder of the holding company could be reduced to 51% of 75%, in fact neutralising the effect of the voting leverage. There are some drawbacks to this approach: pyramids will be structured in a different way, e.g. relying more on debt than on equity. The cliff effect of fixing specific thresholds will be considerable. Blocks in listed companies will be lodged at diversified holding companies. The rule may be difficult to apply if non-EU holding companies are interposed.
Notwithstanding these negative aspects, it would at least avoid the most blatant cases, in terms of control, without touching on the possibility to create pyramids. The recent past (failure of the first version of the take-over directive) has shown that it is politically extremely difficult to attack pyramids. In the US, such structures are said to be non-existent and the reason seems clear. The US had as many pyramidical structures as any country until President

Roosevelt decided, for political reasons, to destroy these groups by introducing (in 1933) a 7% tax on intra-group dividends. This led to the disappearance of these structures within a few years. It is doubtful however, whether it is advisable to follow a similar path in Europe, apart from the fact that it is politically utterly unfeasible. We mention this only to bring home the point that it is very difficult to regulate pyramids: either you more or less allow them, or you try to ban them outright, directly or through tax measures.

If the EU would act in the field of pyramids, only a directive or regulation would be able to tackle the issues. A recommendation is likely to have no effect.

***Question 11***

There are many reasons why the SE has not yet been frequently used in practice, the main one being the absence of a tax incentive.
But apart from that it will take some time before the mood changes. There are some groups actively studying the subject and e.g. Suez has committed itself to create an SE. Among the difficult questions is the issue of the location of the seat. A multi-seat approach might be considered provided it is severed from the applicable legal regime that should remain unitary and determined in the company's articles of incorporation. It may be added that there can be little doubt that the present rule in the SE Regulation, that registered and head office of an SE should be in the same member state, is incompatible with the Treaty provisions on freedom of establishment as construed by the ECJ in Centros, Inspire Art and especially Überseering.

Whether other merger techniques than those presently allowed under the 3rd directive would facilitate the creation of SEs could also be considered.

More generally, the Third and Sixth Directives have restricted the possibility of national legislators to allow new merger techniques that some firms would like to use in practice and that are widely used in the US. Reverse triangular mergers are a case in point. The EU should consider whether there are good policy reasons (e.g. protection of minority shareholders) why such techniques are not allowed under EU law. If no such reasons exist, the merger directive should be amended.

***Question 12***

The EPC as envisaged by the Heidelberg/ Paris Chamber of Commerce working party would be a very useful instrument. SME's are usually not very interested in cross-border cooperation. What they want is to establish themselves through a subsidiary- due to the 11th directive, a branch often is as expensive while at the same time it is less trusted by local creditors and customers, especially governments- in the markets that they want to penetrate. The cost of legal and other advice that is needed to set up such subsidiaries in several EU countries, all with slightly different rules on closed companies, can be substantial and SME's would benefit if a European closed limited liability company type were available that could be used throughout the EU and that would only be subject to some harmonised basic company law rules set forth in a Regulation. These harmonised rules would then have to be supplemented by the articles of incorporation of the company. At present, however, it is to be feared that member states would, regrettably, view such a flexible European Private Company as an undesirable substitute/competitor for their existing national company law forms. Therefore, it may be unwise for the Commission to spend too much political capital on this as such excellent idea in the near future. It should therefore not be treated as high priority and it may be wiser to wait until some large firms have adopted the SE form, which may take away some of the national fears and create more political support for other forms of European company statutes.

***Question 13***

Similar answer as to Q. 12 but with this important difference that whereas many representative organisations of SME's are clearly in favour of an EPC, there seems to be no real demand for a European Foundation. It is unclear what its added value would be. Certainly it would be a bad idea to use a future Regulation on a European Foundation to at the same time do away with the richness of differences between national foundation laws and the wide variety of possibilities these differences offer to the users of foundations. Don't replace the biodiversity of the present jungle with an asphalt highway no-one has asked for.

***Question 14***

Modernising and simplifying needs to be pursued. Two cases have been mentioned here: the 2nd and the 11th directives need further simplification. One could add the 3rd and 6Th as well. Whether that should result in making it mandatory for national states to adopt the directive's mould, is doubtful and will sometimes be controversial, as the simplification of a directive will by some be considered to amount to a scaling down of the protection of shareholders and investors. Therefore, whether the national rules will be simplified could be left to the regulatory competition among the states, that has become more vigorous these last years after the ECJ decisions in Centros and other cases. In other words: the aim of simplification of existing directives should not (necessarily) be to force new harmonised (albeit also simplified) rules on member states, but to allow more competition between different regulatory regimes. This approach could be especially useful to make a thorough simplification of the 2nd directive palatable to all, especially Germany.

Making a European Company Code is attractive for the public opinion, but would be rather disruptive for the specialists, who have not been used to referring to the directives by mentioning their numbers. One should not forget that in the wider public opinion, company law does not consist of the directives, but is first and foremost national company law. Therefore merely recasting the existing directives does not bring much added value.

On the other hand, a systemic review of the directives as to their actual value and internal coherence might be undertaken. Inconsistencies with the securities field might appear. It is especially important to avoid overlaps or, worse, inconsistencies in the area of disclosure requirements for listed companies. These companies should be able to ascertain what their disclosure requirements are from as few EU legal instruments as possible. It is, for instance, unfortunate, that the proposed directive on shareholders' rights would supplement and thereby also change some disclosure requirements imposed by the Transparency Directive. In any case an integrated disclosure framework should be aimed for, rather than proceeding in a disorganised way through company website disclosure, centralised financial information, etc. Although we realize that for practical and political reasons piecemeal regulation is sometimes unavoidable, it should be avoided as much as possible.

Ghent, March 29 2006

# Financial Law Institute

The **Financial Law Institute** is a research and teaching unit within the Law School of the University of Ghent, Belgium. The research activities undertaken within the Institute focus on various issues of company and financial law, including private and public law of banking, capital markets regulation, company law and corporate governance.

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