A Theory of Corporate Governance for the EC: Assessing the economic and legal peculiarities as a starting point for policy making

Master thesis
10 points

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Field of study
Internal Market, Corporate Governance

Semester
Spring 2006
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Summary

This thesis provides a critical overview of the development of corporate governance practices in the EC. It seeks to determine if the Community should follow the US response to corporate governance fallouts or instead promote its own practices, taking into consideration the legal and economic backgrounds of the Member States. The analysis is supported with economic data, practical and doctrinal views and two important cases: the Enron case of the US, and the Parmalat case of Europe.

To illustrate the argumentation, the paper is divided into four sections. The first section presents a general brief of the American and European responses to recent corporate governance scandals. It highlights that whereas at the national level of the EC Member States there are increasing efforts to establish a coherent set of corporate governance practices; at the Community level the development has been rather muted.

The second section departs from two interdependent perspectives: the economic and the legal. The economic perspective shows that contrary to the US, the EC is rooted in a large-control system characterized by (i) high levels of shareholding concentration; (ii) close relationship between the major shareholders and the directors of the board and managers; (iii) implicit contracting between the directors of the board and the managers; (iv) illiquid capital markets, and (v) important role of the banks in corporate governance. The legal perspective shows that the degree of accountability and enforceability of governance codes is different between the US and the EC systems. This part of the paper concludes that different economic and legal backgrounds imply different governance problems and therefore, different rules.

The third section of the paper reviews the different governance mechanisms that can be implemented to deal with governance fallouts. It stresses that the traditional internal and external governance control mechanisms are not sufficient to deal with governance problems in large-control economies (such as that of most Member States). Instead the study shows that the most efficient mechanism to deal with governance problems is the establishment of general governance standards at the EC level.

This section of the paper is complemented by an analysis of the competences of the EC institutions in the area of corporate governance. The analysis concludes that a more dynamic participation of the EC institutions would not contravene the provisions of the EC Treaty, particularly the principle of subsidiarity. By running the “better achievement test” it is shown that a stronger involvement of the EC institutions would be more efficient to protect the internal market, than isolated efforts of the Member States.
The last section of the paper analyzes the measures issued so far by the Community. It highlights that while some of the measures do not reflect its true needs; other measures are well oriented but lack the proper strength. The study emphasizes however, that the proposals for the modification of the Accounting directives and the Statute of Societas Europeae, represent good examples of how future legislation should be passed in the area of corporate governance.
Preface

The inspiration to this paper came to me in a magazine store located in Lund. While reading an article of The Economist Magazine about the Parmalat scandal, I realized that making a comparison between the happenings of such scandal and the well known Enron scandal of the US, would be an interesting topic for my thesis.

My idea to do this thesis was also fostered by my increasing interest in corporate governance. As a law student back in Colombia, I studied the early approaches of the Colombian legislation in this field. I was particularly passionate with the fact that the study of corporate governance required both a legal and business background, since I have always been interest in enriching my legal knowledge with the business one. My interest in this field was also enriched during my working days as a lawyer in Colombia. There, I had the opportunity to participate in a global research, sponsored by the University of Yale and the World Bank, as one of the lawyers of the Colombian team that gave an opinion about the standing of Colombian law in matters related to this field. I have also chosen this topic because of my career plans, since I hope to be able to work in this field in the near future.

Drafting this thesis has been really intense and demanding. I appreciate the help of my supervisor Henrik Norinder who gave my necessary guidance to finish this thesis. I also would like to thank my wife Elise, my parents Jaime and Claudia, and my brother Andres, for all their support.

Last but not least, I would like to thank my fellow master friends at the University of Lund for this great year.
### Abbreviations

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<td>CEO</td>
<td>Chief Executive Officer</td>
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<td>Community</td>
<td>European Community</td>
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<td>EC</td>
<td>European Community</td>
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<td>ECGI</td>
<td>European Corporate Governance Institute</td>
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<td>ECO</td>
<td>Commission of the European Commission</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>HLGR II Report</td>
<td>High Level Group Report II of November 2002</td>
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<td>NASDAQ</td>
<td>National Association of securities Dealers Automated Quotation system</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<td>OECD</td>
<td>Organization of Economic Co-operation</td>
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<td>OECD Principles</td>
<td>OECD Principles of Corporate Governance of 2004</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>SOA</td>
<td>Accounting Industry Reform Act of 2002 (Sarbanes-Oxley Act)</td>
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<td>UK</td>
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<td>US</td>
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1 Introduction

Corporate governance is a topic that touches upon us all. Almost every day, newspapers and magazines in developed and developing countries include a reference to this field. In recent years corporate governance has got even more publicity due to astonishing corporate scandals of theoretically healthy companies around the world. The downfall of Barings Bank in 1995, one of England’s oldest Banks; the US Enron, Global Crossing and World Com collapses in 2001 and 2002, and the recent scandals of Vivendi in France, Royal Ahold in Netherlands and the gigantic Italian diary-products group Parmalat in 2002, have made shareholders realized that a constant monitoring of the company is required.¹

Shareholders have become conscious that in order to carry out a diligent scrutiny of the company’s status, sporadic shareholder meetings (hold in most cases only once a year) are not enough. It is neither sufficient to merely comply with the minimum requirements of the law or the accounting standards since they do not guarantee the health of the company.²

As a result, there is a growing interest by shareholders in having a defined set of governance good standards that help monitoring the company. But those standards do not only serve this purpose. They additionally provide for means of attracting investment opportunities that beneficiate a country’s economy; help the promotion of market efficiency and, enhance the confidence of local and foreign investors.

Indeed, in the globalize world of today, where international flows of capital enable listed companies to access financing from a larger pool of investors, corporate governance acquires even more importance. It has become crucial for companies to have a complete set of good governance practices credible and well understood if they are willing to beneficiate from a global capital market by attracting long term investments.³

In recent years, the study of corporate governance has gained an increase interest in the political, economical and legal arenas as it has become evident the enormous impact that distant corporate governance scandals may have in a country’s economy. Recent studies show that the measures taken by one country in order to tackle governance scandals echo in distant economies and legal systems because of the way listed companies operate globally.⁴

² By 2000 Enron was ranked as one of the ten healthiest companies in the USA’s Fortune Magazine, based on its turnover that year.
⁴ For Green and Gregory, "If an economic shock occurs in one country and the two countries are economically interdependent, then the shock will also affect the other
Particularly at the European level, the discussion in corporate governance has been subject to an intense debate with a twofold dimension. Whereas at the national level dimension there is an ever-growing amount of reports, norms and regulations addressed to define the best way to introduce corporate governance measures; at the Community level however, the discussion has been rather muted and only until recently was identified as one of the key topics in the Community Agenda.

The main reason of the parsimonious activity of the European Community (EC) is the diverse economic, political and legal basis in which it is cemented, which elongate the discussions and difficult the Community’s approach. However, although the diversity of systems increases the complexity of the discussion, it nonetheless nourishes the debate with interesting possibilities and perspectives that policy makers and academics of the Community should take advantage of.

This paper highlights that this diversity should be reflected in the rules passed by policy makers, and that the discussion of corporate governance in the Community should acknowledge the importance of a Community dimension. It is argued that, the corporate governance scandals in the US and Europe, that resulted from the market bubble collapse of 2001 (which affected both markets), differ greatly from one market to another since such markets are deeply rooted in different economic and legal structures.5

To illustrate these differences and facilitate the analysis, two cases will be used. The American Enron case of 2001 which shows the particularities of the US market (rooted on a market-control system)6; and the European Parmalat case of 2003 which evidences the specificities of the European model (rooted mostly on a large-control system).7

This paper also stresses that the Community should imitate the American response to the Enron scandal, but only where it is appropriate. While it is argued that the Community should not base its legislation on the Sarbanes-Oxley Act of July 2002 (SOA) because said legislation is addressed to tackle the fallouts of a market-control economy; the Community should, nevertheless, follow the actions taken by the federal government of the US and allow a more active participation and involvement of the EC institutions.

In this regard, a comparison is made between the scope of powers of the EC Institutions in the area of corporate governance, vis-à-vis the principle of

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6 See Supplement A.
7 See Supplement B.
subsidiarity, and the ongoing debate pertaining to the competences of the federal government of the US in issuing rules in company law.

1.1 Definition

The early studies of Berle and Means in the 1930’s identified the main dilemma of a company: the separation of ownership from control. Berle and Means demonstrated that because of this division, and due to the dispersion of share ownership, shareholders were not capable of controlling the direction of their corporation. They argued that the control of the company lied, instead, in the hands of the managers who assumed responsibilities and were vested with special powers.8

Since in their view companies were seen as key actors in the market, representing a method of property tenure and a means of organizing economic life, the actions of the managers did not only affect the shareholders, but also other interdependent groups such as stakeholders (e.g. employees, customers suppliers). Therefore, they concluded that a defined set of rules that smoothed the separation between ownership and control was required for the sake of the company and the market.9

The conclusions of Berle and Means have had transcendental repercussions in the development of corporate governance practices around the globe. Today, almost every nation has legislation providing for a set of good corporate practices. Accordingly, there are as many definitions of corporate governance as there are codes. Particularly in the case of the EC Member States, there is a wide variety of definitions relating to corporate governance:

- In the UK, corporate governance is defined as "the system by which companies are directed and controlled." 10

- The Italian Preda Report sees corporate governance as the “set of rules according to which firms are managed and controlled (...) the result of norms, traditions and patterns of behavior developed by each economic and legal system.”11

- The recently adopted Corporate Governance Code in Germany divides corporate governance in internal and external. Internal

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8 For Berle and Means, “the separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear.” Berle A. and Means G, "The modern corporation and the private property", New York, Harcourt, Brace and World, 1932.


corporate governance includes the "the responsible control and administration inside the Companies". The external refers to "the exercise of the voting and any additional shareholder rights by the Companies as institutional investors in the interest of their clients".  

The above examples show that the term corporate governance lacks a universal accepted definition. However, for the purpose of the analysis, this paper will depart from the definition provided by the OECD Principles that states that “corporate governance (...) involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

The OECD definition is instrumental in illustrating the importance of studying corporate governance. First it shows that corporate governance is an area that touches upon both the internal and the external aspects of a company. Second, it evidences that corporate governance mechanisms help a company pursue its corporate objectives by providing an adequate monitoring system to control the performance of the managerial bodies and the company in general.

While the OECD definition only represents the common denominator that OECD member countries consider essential for the development of corporate good practices, it will be use as the starting point of this study.

**1.2 Purpose**

The purpose of this paper is threefold. First, to highlight that there is an urgent need for a Community dimension in the area of corporate governance. To do so, the paper demonstrates that there should be a coherent set of standards of corporate governance at the Community level.

Second, to demonstrate that the different legal and economic backgrounds of the EC Member States, and of the Community as a whole, must be taken into account by EC policy makers when passing rules in the area of corporate governance. This is illustrated by a comparison between the US and EC markets, using as starting point the Enron and the Parmalat case.

Third, to analyze the extent to which EC policy makers should imitate the actions taken by the US government as a response to governance fallouts.

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12 Corporate Governance Code for Asset Management Companies of April 2005 (the "Crome Code"), modified by the Amendment to the German Corporate Governance Code of June 2005.

13 Preamble of the 2004 OECD Principles of Corporate Governance.
Such analysis is complemented by determining the scope of competences of EC institutions in this area vis-à-vis the principle of subsidiarity.

**1.3 Method and Materials**

This paper uses two different methods: the dogmatic and the comparative. The dogmatic method is used to describe, analyze, interpret and examine legal instruments, principles and doctrine of the Community and the Member States. The comparative method is used to analyze the legal and economical differences between the US and the Community.

Since the topic of study is not limited to the legal arena, the analysis is enriched by economic perspectives and data which are useful and necessary to illustrate the legal argumentation and the discussion. Nevertheless, the legal analysis remains as the core of this paper.

The study systematically analyses the current legal standing of corporate governance in the Community. A close look to the legal instruments and studies taken at the Community level is therefore presented. The analysis is complemented by a general overview of certain national measures. In addition, and to the required extent, the analysis touches up certain areas of American law, particularly the SOA and the role of federalism in corporate law.

With the purpose of avoiding a mere descriptive paper, and in order to make the analysis more dynamic, empirical data, doctrinal conclusions and personal comments are mixed along the lines of this paper. However, it should be made clear from the outset that the analytical part starts only from Chapter 3. Indeed, the purpose of Chapter 2 is to put into context the discussion for those readers that are not familiar with the topic.

Most of the materials used in this study were in English, and only few in Spanish and French. The main tool of research was the ELIN system provided by the University of Lund. To this extent, articles that were not accessible through this system or that were in another language were not analyzed. This limited the information obtained to only certain perspectives. However, I do not believe that this affected greatly the conclusions reached, since such conclusions are based on personal considerations and reputed sources.

**1.4 Delimitations**

Four delimitations have been identified. First, the paper would not specifically review the corporate governance practices of each of the EC Member States. Some examples of the legislation issued at the national level are presented but only for comparative purposes.
Second, the economical data used to illustrate the levels of ownership concentration at the Community level departs from studies made in 1999 and 2001. Therefore, some of the findings made not be completely accurate. Nonetheless, isolated researches complement the early studies and served as an actualized foundation for the analysis.

Third, the analysis is restricted to the securities market. Companies that are not listed (which are often exempt of corporate governance rules) are not taking into consideration for the purposes of this paper.

Fourth, no case law of the European Court of Justice is used. Despite the fact that there is a vast amount of literature in corporate governance, so far, there is no case law of the Court that complements the analysis and answers the purposes of the study. Therefore, the materials used in this paper are limited to doctrinal articles and studies.

1.5 Disposition

To carry out the analysis this paper is divided as follows:

Chapter 2 presents a brief review of the US and European responses to recent corporate governance fallouts. Special emphasis is made to the need of a Community dimension in this area. The chapter concludes that there is an urgent need for a Community dimension in the area of corporate governance.

Chapter 3 represents the analytical point of departure of this paper and sets the basis for the next two chapters. It analyzes the peculiarities of the EC vis-à-vis the US. In doing that two perspectives are taken into account. First, the economic, highlights that the EC Member States (with the exception of the UK) are rooted in a large-control system that requires a specific set of rules, different from those of a market-control system.

Second, the legal, analyzes the different degrees of accountability and enforceability between a large-control and a market-control system. It also shows the way boards of directors are structured in the different Member States of the EC.

The conclusion of the chapter is that the Community should not follow SOA-type of rules but instead, concentrate in issuing a set of rules that truly reflect its particularities and solve its problems.

Chapter 4 reviews the different mechanisms to solve governance problems. A review of the internal and external control mechanisms is followed by a discussion of other alternative mechanisms such as the establishment of a coherent set of corporate governance standards. A discussion on the scope of powers of the EC institutions, namely the European Commission vis-à-vis the principle of subsidiarity is also presented.
The conclusion of this Chapter is that the EC institutions should be empowered to pass general rules in the area of corporate governance to properly guarantee the stability of the internal market.

Chapter 5 analyses the measures taken so far by the Community. Firstly, it highlights that despite the apparent convergence of corporate governance rules, the actual practices of the Member States differ greatly. It further remarks that the OECD principles do not reflect the actual needs of the Community and as a result, a coherent set of corporate governance principles at the Community level is required. Secondly, it reviews if recent measures taken at the Community level reflect its needs and if such measures would be enough to reduce the probability of future corporate governance scandals.

The conclusion of this Chapter remarks that while some of the measures taken by the Community do not reflect its true needs; other measures are well oriented but lack the proper strength. The chapter emphasizes however, that the proposals for the modification of the Auditing Directives and the Statute of Societas Europeae, represent good examples of how future legislation should be passed in the area of corporate governance.

Chapter 6 presents a general conclusion of the paper.
2 Tackling governance fallouts: The US and EC Responses

Recent corporate governance fallouts have had a strong repercussion in the legal and economic arenas of the US and the EC. However, the responses taken by the US to tackle recent scandals, particularly the Enron downfall; and the response taken by the EC, to tackle European scandals, such as the collapse of Parmalat, have been completely different as it would be shown in the following paragraphs.

2.1 The American Response

The implosion of Enron in 2001 and the corporate scandals of World Com and Global Crossing in 2001 and 2002, showed that a close relationship between the managerial bodies and the external auditors was detrimental for the well-being of a company. As a result, the US Congress passed the Accounting Industry Reform Act of 2002, commonly known as the Sarbanes-Oxley Act (SOA).

The SOA is a far-reaching reform that applies to both US and non-US companies with listings in the US. As a direct response to the governance fallouts, the SOA seeks to strengthen the independence and responsibilities of the managerial bodies and the internal and external auditors of the company.

On the one hand, the SOA sharpens the duties of the directors and the composition of the boards. It mandates the Securities Exchange Commission (SEC) to impose several structural board reforms through the New York Stock Exchange (NYSE) and the National Association of Securities Dealers listing standards. It also imposes stricter rules to monitor the activities of directors, particularly in matters related to the financial statements. Nowadays directors are required to certify that quarterly and annual reports are in full compliance with securities laws so they properly reflect the status of the company. The penalties for noncompliance are severe: up to US$1 million fine or imprisonment up to 10 years, or both.\textsuperscript{17}

\textsuperscript{14} The SOA was once described as "the most far-reaching reform of American corporate practices since the time of Franklin Delano Roosevelt". See Bulmiller, Elisabeth, "Bush Signs Bill Aimed at Fraud in Corporations", New York Times, July 31, 2002, p. 1, column 2, available at <http://www.il.proquest.com.ludwig.lub.lu.se/proquest/> page visited on April 9, 2006 at 2:33 p.m.

\textsuperscript{15} For instance by the issuance of American Depositary Receipts (ADRs).

\textsuperscript{16} See Green, Scott and Gregory, Holly; supra note 4, p. 50.

\textsuperscript{17} SOA, Section 1520 (c) states: "Whoever knowingly and willfully violates subsection (a) (1), or any rule or regulation promulgated by the Securities and Exchange Commission..."
On the other hand, the SOA fosters the independence of the external and internal auditors of the company and establishes a more demanding and transparent approach to accounting practices as a direct reaction to the disappearance of one of the biggest accounting firms in the world: Arthur Andersen.  

Today, listed companies must have an audit committee comprised of only independent members. In addition, a new regulatory body for auditors of US listed companies, the Public Company Accounting Oversight Board (PCAOB) was created. Nowadays all independent auditors, including non-US audit firms, have to registered before said body.

### 2.2 The European Response

Although the term corporate governance was unknown to many EC Member States by the early 1990’s the spill over effect of the corporate scandals in the US economy modified this panorama dramatically. The initial American response to disturbing revelations of corporate malfeasances and frauds eventually derived in a governance revolution in the EC Member States. Today almost every jurisdiction has or is in the process of drafting a body of rules in this area.

Efforts to incorporate rules on corporate governance have been undertaken by a variety of bodies ranging from committees composed by representatives from the investment and academic community; governmental bodies and stock exchanges aiming at improving and reforming corporate governance rules in local markets.

The following sections present a general overview of the efforts taken by some Member States to foster good governance practices. They are complemented by a review of the efforts taken by the EC institutions in this area.

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19. The SEC also strengthened the rules towards auditors and issued a set of rules that prohibit the performance of accounting services in certain areas that might impair the independence of the auditors. There are nine areas that are now prohibited. (i) book keeping or other services related to the accounting records or financial statements; (ii) financial information services design or implementation; (iii) appraisal or valuation services, fairness opinions; (iv) actuarial services; (v) internal auditing and outsourcing services; (vi) impossibility to perform management or human resources functions; (vii) broker or dealer, investment adviser, or investment banking services; (viii) legal services or expert services not related to audit; (ix) any other service prohibited by the PCAOB.
20. Green, Scott; Gregory, Holly; supra, note 4, p.51.
21. For a review of the corporate governance codes issued so far by the EC Member States see <www.ecgi.org>.
2.2.1 The Cadbury Approach

In the case of the UK, the development of corporate governance was fostered by the early Polly Peck International scandal.\textsuperscript{22} In order to avoid similar downfalls, the Financial Reporting Council, the London Stock Exchange and the accountancy profession, established the Committee of Financial Aspects of Corporate Governance in May 1991.

The Committee was chaired by Sir Adrian Cadbury and on December 1992 delivered a set of recommendations known as the Cadbury Report.\textsuperscript{23} The Cadbury Report became a milestone in the development of corporate governance codes around the world since it introduced the famous "comply or explain" mechanism by means of which a company is required to annually state as to whether or not it has complied with the code provisions, and if not, it is required to explain in detail why it is unable to do so.

The Cadbury report was quickly complemented by the Greenbury Report of 1995\textsuperscript{24} that analyzed rules on disclosure of director’s remuneration packages; and the Combined Code of 1998. These reports were directly motivated by the spectacular Barings Bank downfall.\textsuperscript{25}

In July 2003, the UK issued a new version of the 1998’s Combined Code which introduced the recommendations of two other reports: the Smith Review on the role of audit committees\textsuperscript{26}, and the Higgs Review on the role and effectiveness of non-executive directors within the structure of a company.\textsuperscript{27}

2.2.2 The Viénot Approach

Similar efforts have been taken in France. The Viénot I and Viénot II Reports of July 1995 and July 1999 respectively, analyze in depth the

\begin{footnotesize}
\textsuperscript{25} The collapse of Barings, UK’s oldest merchant bank, in February 1995, resulted from massive losses (over £ 800 million) run up on derivatives trading by its chief Singapore trader, Nick Leeson. The bankruptcy of the Barings Bank was so dramatic that it end up been sold for £1 to the Dutch Bank ING. For a complete review of this case see: Stonham, Paul, "Whatever happened at Barings? Part Two: Unauthorized trading and the Failure of Controls", European Management Journal, Volume 14, No. 3, 1996, p.269-278.
\end{footnotesize}
powers, duties and scope of operation of the board of directors in French listed companies.

The Viénot reports were followed by the Bouton Report of September 2002 which establishes recommendations for promoting better corporate governance practices in listed companies in light of the conclusions of its two early predecessors.

The Bouton Report was subsequently followed by the Report of Corporate Governance of Listed Corporations of October 2003. Said report set out a body of recommendations inspired in the Bouton Report and both Viénot Reports and presented a detail analysis of the role of the board of directors.

A recent report, The Recommendations on Corporate Governance of March 2004 analyzes a general schema of the role of the board of directors and the Shareholders General Assembly.  

2.2.3 The Cromme Approach

Contrary to the situation in the UK and France, the situation in Germany is quite unique. This results because of the peculiarities of German company law that provides for a two-tier board system (supervisory board and management board). The board structure was the origin of a big debate, and a long discussion before the adoption of a generalized set of governance practices.

The important efforts of the Baums Commission of July 2001, which made a series of recommendations for the modernization of the company law in Germany, were finally comprised in the 2002 German Code of Corporate Governance (the Cromme Code) addressed to improve governance practices in listed corporations.

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28 The Viénot I Report was sponsored by the CNPF- Conseil National du Patronat Français- (French Employers’ Association) and the AFEP Association Française des Entreprises (French Association of Companies). The Viénot II Report was sponsored by the AFEP and the MEDF- Movement des Entreprises de France- (French Companies Movement). The Recommendations for Promoting Better Corporate Governance in Listed Companies of 2002 was sponsored by MEDEF, AEF and AGREF- Association des Grandes Entreprises Françaises (Association of major French Corporations). The Report of Corporate Governance of Listed Corporations was sponsored by MEDEF. The Recommendations on Corporate Governance was sponsored by L’Association Française de la Gestion Financière (French Asset Management Association). All reports are available at <www.ecgi.org>, page visited on April 5, 2006.


31 The German code of corporate governance has been recently modified by an amendment of June 2, 2005.


2.2.4 The Preda Approach

In Italy the *Testo Unico sulle disposizioni in material di intermediazione* (Unified Text on the dispositions on Intermediation) of 1998 introduced a specific set of rules for listed companies in the Italian Market. Following the *Testo Unico* the famous *Preda* Report of 1999 established the ground basis for the development of a corporate governance culture in Italy by launching the first code in this country.\(^{32}\)

The *Preda* Code led to the issuance of *Il Codice di Autodisciplina delle società quotate rivisitato* (Corporate Governance Code) issued by the Italian Stock Exchange in 1999 and its revised version of 2006 which established the basic framework of good corporate practices for listed companies in the Italian market.\(^{33}\)

2.3 Community dimension, a muted response?

As seen in the previous section, the efforts on corporate governance in some Member States have taken place for more than a decade. In contrast, there has been a lack of involvement of the Community institutions. This feature, results particularly strange considering that one of the underlying objectives of the Community is the promotion of an internal market free of boundaries.\(^{34}\)

It was only after the adoption of the Financial Services Action Plan in May 1999, that the Commission instructed the law firm Weil, Gotshal & Menges LLP to prepare a comparative study of the corporate governance codes in the Community.\(^{35}\) The study, delivered on May 2002, found a high degree of convergence among the national corporate governance codes and therefore, did not recommended the adoption of a unified code for the EC.

Said analysis concluded that in spite of the variation between the codes of the EC members, there was a little indication that that would affect the formation of a single European market. It remarked that instead of focusing on drafting a European-wide code, the EC should concentrate its efforts in the reduction of shareholders-participation barriers and the reduction of information barriers among companies domiciled within the EC.\(^{36}\)


\(^{33}\) All reports are available at <www.ecgi.org>, page visited on April 5, 2006.

\(^{34}\) See in that regard Articles 2 and 3 of the EC Treaty.

\(^{35}\) Gregory, Holly and Simmelkjaer, Robert, *Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States*, Weil, Gotshal & Manges LLP in Consultation with EASD (European Association of Securities and Dealers) and ECGN (European Corporate Governance Network), January, 2002.

\(^{36}\) Ibid, p. 6.
Said study further established that despite the diversity of cultures, financing traditions, ownership structures and legal origins, there was a remarkable similarity among the codes of the Member States particularly in matters pertaining to the responsibilities of the board of directors and the supervisory board, the rules on financial reporting, the role of the auditors, and the function of the Shareholders General Meeting.  

In light of these recommendations, the Commission of the European Communities (ECO) instructed a group of legal experts to make recommendations on a modern regulatory framework for company law in the EC. The instruction was further extended in April 2002 to cover corporate governance topics as a result of the corporate collapses in the US.

On November 2002, the group of experts presented the High Level Group Report II (HLGR II Report) which gave a series of recommendations as to the scope of community rules in corporate governance and its interaction with national rules. Among other things, the HLGR II Report recommended that the EC Institutions should:

- facilitate the creation of efficient and competitive business in the EC by establishing mechanisms to protect shareholders and creditors;

- modernize company law making and consider the use of broader use of alternatives to primary legislation (e.g. recommendations);

- increase the flexibility of rules and decrease tightening rules to avoid hindering the development and the use of efficient company law structures;

- increase rules on pre-meeting activities so shareholders are duly informed when they participate in the meetings;

- facilitate voting and participation mechanisms for shareholders.

The HLGR II Report was followed by the ECO’s Action Plan on the modernization of company law and the enhancement of corporate governance in the EC. The Action Plan established that the two main objectives of the Community in the area of corporate governance were:

1. Strengthening shareholders rights and the protection of third parties, and

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38 The recommendations contained in the High Level Group Report I were rejected by the European Parliament in July 2001.
(2) Fostering efficiency and competitiveness of business.

The ECO’s Action Plan has been recently followed by a series of recommendations and proposals addressed to protect the most problematic areas that were identified in such plan. Among others initiatives there has been (i) the introduction of an annual corporate governance statement; (ii) the development of a legislative framework to foster the protection of shareholders; (iii) the promotion of the role of independent directors; (iv) the adoption of measures on director’s remuneration, and (iv) the creation of a European Corporate Governance Forum to help encourage coordination and convergence of national codes and of the way they are enforced and monitored.\(^\text{41}\)

This brief summary shows the different approaches taken by the US government and the Community to deal with governance problems. Contrary to the vigorous response of the US Congress, the activities taken at the EC level seem rather muted. The proposals of both the HLGR II and the Action Plan envision a lengthily implementation period that often requires further development, as well as long periods of consultation and debate among company experts, Member States and interested EC Institutions, to the point, that some of the reforms will only be introduced at the end of this decade.

Thus, the question that arises is whether or not the Community is taking the appropriate measures, on a time, legal and economic parameters, to avoid the appearance of new unlawful governance activities that may jeopardize the stability of the internal market and the development of companies in the Community.

The answer to this question is complicated and requires a detail legal and economic analysis. Chapters 3, 4 and 5, will provide this analysis and attempt to answer this question.

\(^{41}\) Ibid.
3 Identifying peculiarities in the EC

As seen in Chapter 2, it was not until recently that the debate on corporate governance acquired a Community dimension. The adoption of the euro, the increase movement of capital, workers, goods and services, the globalization phenomenon, the privatization of formerly state-owned enterprises, the grow and diffusion (yet slow) of shareholding, and the increase of cross merger transactions among large European economic groups seemed to have increased the interest of the European investors, the Member States and the EC institutions in defining governance rules address to bring confidence to investors and ease investment practices within the EC. ⁴²

Although there is a clear tendency towards the creation of a single European market, EC members show a rich diversity in corporate governance practices, corporate structures, financing options and corporate ownerships concentration patterns. ⁴³ This diversity results from the different political, economic, legal and cultural backgrounds in which the EC Member States are rooted and therefore, should be taken into account (though should not be regarded overly-broad) when enacting rules and regulations that will be common to all Member States.

Accordingly, the implementation of new rules into a legal system cannot result from the mere transposition of alien rules of foreign systems. As the ECO has acknowledged, the EC should define its own European corporate governance approach tailored to its own cultural and business traditions. ⁴⁴

Thus, using the SOA as a departing point for drafting corporate governance rules at the EC level should be avoided. Even if it is advisable that the EC institutions engage in permanent regulatory discussions with US authorities (namely the SEC) in order to forestall legal arbitrage in the dynamic globalize market of today, the use of the SOA as guidelines for the EC policy makers is not advisable. The SOA reflects the needs of a totally different legal and economic environment, alien to the EC Member Stares, and thus, the adoption of a similar set of rules would ignore the economic and legal reality of the Member States and would be prejudicial for the stability of the internal market.

This Chapter provides the basis to illustrate this argument. To do so, a concise comparison between the economic and legal backgrounds of the US system and the systems of the Member States would be made. Said

⁴³ See also Gregory, Holly and Simmelkjaer, Robert; supra, note 35, p. 1.
⁴⁴ Gregory, Holly and Simmelkjaer, Robert; supra, note 35, p. 29.
comparison would show that different backgrounds imply different policy approaches.

3.1 Economic peculiarities: The large-control and the market-control systems

Corporate governance mechanisms differ depending on the way economies are structured. Over the years the literature has identified two major economic models: large-control systems and a market-control systems.45

The US economy is the typical example of a market-control system. The US system is characterized by a liquid capital market, with a develop market for corporate control and takeovers46; rigorous disclosure standards; high share turnover and high market transparency.47 In the US system, companies often fund themselves in the stock market and use either traditional funding market mechanisms, for instance public offers, or more innovative and cutting-the-edge mechanisms such as private equity funds. As a result, there is low influence and participation of the banks in the corporate structure.48

On the other side of the Atlantic the situation is very different. Contrary to the US, the EC (with the important exception of the UK49) is a traditional large-control system. Ownership is concentrated in the hands of large shareholders mostly banks, families and pyramidal structures of companies50 who exercise control over the board of directors commonly

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45 The literature provides for all types of classifications: bank-based system vs. market-based system; control oriented vs. arm’s-length oriented; outsider dominated vs. insider dominated; shareholder focused vs. stakeholder focused; Anglo Saxon vs. Rhineland, to name a few. For semantic reasons this paper departs from the classification provided by Shleifer and Vishny (large-control system vs. market-control systems) since in my view is the most accurate. Cf. Shleifer, Andrei. and Vishny, Robert "Large Shareholder and Corporate Control", Volume 94, Issue 3, Part 1, 1986, pp.461-488.
48 The lack of participation of the banks in the finance of US companies also results from the severe restrictions established in the US system. US commercial banks have a limitation to own shares in non-financial corporations and to engage in stock market activities such as underwriting, brokering, or dealing. For a complete review see Guillén, Mauro, Schneper, William D, "Stakeholder Rights and Corporate Governance: A Cross-National Study of Hostal Takeovers", University of Pennsylvania, Administrative Science Quarterly, Volume 49, No. 2, 2004, p. 22, in www.management.wharton.upenn.edu, page visited on April 21, 2006 at 1:13 p.m.
49 Similarly to the US, the UK is rooted on a market-based system.
50 Franks and Mayer noted that the ownership of Continental European companies is primarily concentrated in the hands of two groups: families and other companies. They found out that in more than 80% of the largest 170 companies listed on stock markets there
composed by representatives of such major shareholders. In addition, implicit contracting and close personal trust relationships among managers is common. Moreover, there is no active market for corporate control and neither the companies nor the managers are faced with hostile takeover bids.

The EC economy is also characterized by a relatively illiquid capital market. This is primarily because the EC companies do not see the stock market as the traditional funding mechanism. By 2004 there were only 4,404 listed companies in Continental Europe, a very small number if one considers that only the NASDAQ and the NYSE account for a total of 5,522 listed companies, and they do not represent the entire number of companies listed in the US. In addition, the total value of US bonds and equity outstanding in the securities market was twice as large in the US than in the Community.

Another interesting feature is the notorious participation of the banks in the economy of the EC, compared to that in the US. The total assets of the banking sector in the EC, measured as a percentage of the Gross Domestic Product (GDP), increased from a 161% in 1990 to a 239% in 2001. By way of contrast, the assets of such institutions in the US increased only 59% in 1990 and 78% in 2001.

Of particular importance are the different levels of ownership concentration in the US market and the EC market. While the US market-control economy is characterized by dispersed ownership shareholding; the EC large-control economy is characterized by concentrated ownership shareholding. Indeed, the percentage of listed companies under majority control in the NYSE was by 2001 of 1.7% compared to a 68% in Austria, 65.7% in Belgium and 32.6% in Sweden.

In spite of the immense differences between the US system and the EC system, recent studies show that none of them seem unequivocally better to increase economic growth in a country. While the EC system outperforms was a single shareholder owning more than 25% of the shares. In addition, in more than 50% of the companies, there was a single majority shareholder. Franks J. and C. Mayer, "Ownership and Control" in Barca, Fabrizio and Becht, Marco, "The Control of Corporate Europe", Oxford University Press, 2001, p. 2. See also Mallin, Christine; supra, note 42, p. 124.

Barca, Fabrizio and Becht, Marco, supra, note 50, p.31.

See the discussion of Chapter 4.

Buch, Marco and Röell, Alisa, "Block holdings in Europe: An international Comparison", European Economic Review, Volume 43, No. 4-6, 1999, p. 1051.

See Supplement C.


Ibid.

Chakraborty and Ray show that the growth of two countries with different financial regimes that have similar rates of economic progress does not depend on the financial system used (e.g. market-based or bank-based) but instead on the efficiency of the
that of the US in many dimensions (e.g. investment and per capita income are higher and income inequality lower)\textsuperscript{59}; the US market-based system is more efficient in other fields (e.g. market is not dominated by only few players and thus competitions is enhanced).\textsuperscript{60}

But then, what conclusions may be derived from the above analysis? Are those differences relevant? Should the economic differences be taken into consideration by policy makers in the area of corporate governance?

There is no simple answer to these questions. However, it is clear that the economic peculiarities of the EC should be taken into consideration by policy makers before enacting rules in the area of corporate governance. The following sections show that the structure of the market has major repercussions in the rules that are needed to properly run the market and in the governance problems that may emerge. Those differences suggest that EC policy makers should not follow the normative path of the SOA but instead, enact its own rules based on its own traditions.

### 3.1.1 Different markets imply different rules

The type of rules required for the proper functioning of a large-control system differ greatly from the rules required in a market-control economy. While in a large-control system the process of implementing regulations is simple and involves low costs; the body of rules required to obtain a well-functioning market-control system is more demanding, complex and requires longer periods for its implementation.

In the process of incorporating a company, the entrepreneurs of a large-control system, such as those in the EC, see as principal source of funding the long-term finance mechanisms offered by the banks (e.g. loans, mortgages, financial leasing). Alternative financial structures, such as venture capitals and private equity funds, proven successful in market-control structures, are rarely implemented, and often unsuccessful. Thus, to achieve a proper functioning of large-control systems, governmental authorities are only compelled to establish well-defined risk-weighting mechanisms to assess the risk level of companies. These mechanisms help determining the interest rates that banks would charge if they would lend money to companies.

In contrast, structuring a market-control system, such as the US, necessitates the active participation of market intermediaries (e.g. investment banks, accounting firms, pension funds, insurance companies and stock brokers)

\textsuperscript{59} Ibid.
\textsuperscript{60} For a complete summary of the differences between a large-control system and a market-control system see Supplement E.
who are key players in the functioning of the securities market. Most importantly, such system requires well-structured legal mechanisms for efficient dispute resolution, particularly to tackle "principal-agent" conflicts which often imply an enormous amount of litigations raised by shareholders against the managerial bodies.\footnote{Lannoo, Karel and Khachturyan, Arman; supra, note 55, p. 40.}

3.1.2 Different markets imply different governance problems

The differences between a large-control and a market-control system do not only have economic repercussions but have an immense effect in managerial behavior. While in a large-control system the governance problems result from the abuses of majority shareholders in prejudice of minority shareholders; in market-control economies, those problems emerge from the abuses of the managerial bodies. Since the ownership structure of a market-control system is atomized only few shareholders are capable (on a time and costly basis) to monitor the companies performance. For that matter, the board of directors plays an important role in the company as it is the body in charge of determining the corporate strategy of the company. These, plus the high level of powers enjoyed by the managerial bodies, often result in "principal-agent" conflicts solved under various types of corporate actions (e.g. derivative lawsuits).\footnote{Ibid, p. 40.}

A clear example is provided in the recent corporate scandals of the EC and the US. Contrary to what happened in the Enron case\footnote{See supplement A.}, the collapse of Parmalat is not associated with accounting and financial irregularities resulting from the actions of the low-monitored managerial, but instead from the actions taken by strong controlling shareholders over auditing bodies.\footnote{Melis, Andrea, "Corporate Governance Failures: to what extent is Parmalat a particularly Italian Case?", Corporate Governance Journal, Volume 13, Issue 4, p. 478-488, 2005. See also supplement B.}

Historically, the US listed companies have experienced an increase need to show their profitability before market players. During the 1990’s incentives to promote an image of a profitable company were created. As a result, executive compensation shifted from a cash-based system (where remuneration was only given in cash) to an equity-based system (where remuneration was given both in cash and in equity).\footnote{Coffee, John C, supra, note 5, p. 202.} Though the raison d’être of these incentives was to motivate the company’s high executives to perform well, they became a mechanism to pressure the CEO’s towards reporting healthy financial statements.\footnote{In September 1998, Arthur Levitt, then chairman of the SEC, stressed that the desire of executives to increase the value of their stock options gave them an incentive to manipulate}
the earnings with the purpose of obtaining a high value of their corporate options, and carried out aggressive accounting practices that resulted in financial statements restatements.\textsuperscript{67}

As a result, the amount of identified restatements announcements in publicly held companies in the US dramatically increased from 33 in 1990; 50 in 1995 and 330 in 2002.\textsuperscript{68}

Theoretical studies show a direct correlation between the amount of restatements and the increase of the compensation given to the high executives of the companies.\textsuperscript{69} While in 1990 a CEO of an S&P 500 industrial company\textsuperscript{70} was paid US$1.25 million a year, with 92% of the total amount paid in cash and 8% paid in equity, by 2001 the same CEO was earning US$6 million a year, out of which 33% was paid in cash and 66% was paid in equity.

The situation in the EC does not reflect the American compensation schemes. The CEO’s of companies located within the Community are rarely compensated in equity and make less money than American CEO’s. Moreover, the total amount of the compensation of a CEO in the EC does not even come close to the performance schemes of the US.\textsuperscript{71}

In addition, since EC companies show a high degree of concentration, blockholders do not need to rely on indirect mechanisms of control, as it occurs in the US.\textsuperscript{72} Thus, equity compensation is lower\textsuperscript{73} and stock options schemes are rare.\textsuperscript{74}
Instead, the way blockholders influence the managerial is by command and control mechanisms that help to monitor directly the management. As direct effect, the managers are not motivated to create restatements in the financial statements and similarly, are not interested in inflating the periodical results of the company as it occurs in the US. Equally, controlling shareholders are not interested in monitoring the daily operations of the managers since it is in only in rare occasions that such shareholders sell their shares.

In spite of all this, there are still many fraud mechanisms in concentrated ownership systems, but they involve different actors and means. Instead of involving misbehavior of the managerial and the audit bodies as it occurred in the US; fraudulent actions in the EC often involve the participation of the controlling shareholders and the managerial for the prejudice of minority shareholders.

Short term modifications to the financial statements by the managerial in order to obtain higher profits are instead replaced by devices addressed to affect the minority shareholders, for instance, controlling shareholders can re-invest periodical profits, compel the company to sell its output, create preferential ways of shareholding, etc. Controlling shareholders can also create operations to dilute or expropriate minority shareholders, or influence the auditors trough the managerial board (often controlled by the majority shareholders and often with a family link) for the prejudice of the minority shareholders.

In Parmalat, for example, all the members of the board were from the Tanzi family. Twelve were executive directors and one, Calisto Tanzi, the founder, was both CEO and chairman. In this case, the controlling shareholders used their influence in the board to expropriate considerable amounts from minority shareholders by implementing false accounting mechanisms. More than €17.4 billion of assets suddenly disappeared and where untraceable and more than €2.3 billion where used in related party transaction with other members of the Tanzi family.

Though this case may seem extreme, it is by no means rare in the EC Member States where it is not uncommon to find companies with limited or no representation of minority shareholders on the board of directors. In addition, while it is truth that these results cannot be generalized since there are various counterexamples such as the Vivendi and ABB cases in Europe and the Adelphia case in the US, they do reflect, in general

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9, European Corporate Governance Institute, 2003, at www.ecgi.org, page visited on April 3, 2006. See also the example of supra note 71.


75 Ibid, p.204.

76 Owen, Geoffrey, Kirchmaier, Tom and Grant, Jeremy "Corporate Governance in Europe and the US: Where are we now?", Palgrave Macmillan, 2006, p.6

77 In March 2002 Vivendi Universal, a French-based media giant, disclosed a corporate loss of €23.3 billion, the worst loss to date for a French company. The loss was presumably
matters that the potential fraudulent actions of the managerial will depend greatly on the ownership structure of the company.\textsuperscript{79}

This analysis suggests that companies located in the EC, predominantly rooted on a large-control system with a concentrated ownership structure, are most likely to confront fraudulent actions taken by the controlling shareholders against the minority shareholders. On the contrary, managerial bodies of companies located in the US, rooted on a market-control system with a dispersed ownership structure are most likely to carry out fraudulent actions, namely the alteration of the financial statements, for their own benefit. As a result, the rules that need to be passed to solve those governance issues must be radically different.

3.2 Legal Particularities

As seen in the previous section, the economic structure of the US differs greatly from that of the EC. However, this is not the only difference. There are two major legal differences that should be taken into account by EC policy makers when passing rules in the area of corporate governance: the different legal backgrounds of the Member States and the diverse approach to the composition of the board of directors.

3.2.1 Common Law and Civil Law systems

Contrary to the homogenous common-law structure in the US, the EC has a wide range of legal origins. In the UK and Ireland the dominant system is the common-law system. By contrast, in France, Italy, Spain and Portugal the dominant system is a civil-law system. Austrian and German systems also have civil-oriented laws but with a slightly variation. Scandinavian

\textsuperscript{78} In March 2002 Adelphia Communications, a leader in cable television media in the US admitted to have approved US$2.3 billion dollars in loans to the Rigas family, the founder family of the company. This information triggered a governmental investigation by the SEC which uncovered the misappropriation and theft of billions of dollars. The Department of Justice of the US claimed that Adelphia had misrepresented the company's financial status and had caused losses to investors of more than $60 billion. Moreover, the department alleged that the company had used $252 million to cover family investments and used fraudulent documents to obtain $420 million in Adelphia stock. Source, New York Times: "Adelphia is the next in Parade of Fraud Trials, Andrew Ross, February 23, 2004."

\textsuperscript{79} Coffee, John; supra, note 5, p.204.
countries, on the other hand, have a considerable influence from the German system but they are commonly seen as a separate legal family.

The legal backgrounds of the Member States have a mammoth effect in the way corporate law is structured and in the range of corporate control mechanisms. Although such countries have similar approaches on how companies should be regulated (e.g. minimum capital requirements, structure and composition of the boards, rights derived from the shares, duties and obligations of the managerial bodies) there are still deep-rooted differences in their systems that affect the way companies are seen in a society.

### 3.2.1.1 Stakeholder and Shareholder- oriented systems

The legal background of a country determines the role and the responsibilities of companies before its shareholders; the market, and the society. Equally, the legal framework of a country determines the rights and responsibilities of the managerial bodies and the shareholders, within the context of a corporation.  

Two classical perspectives have been identified by the literature on the role of companies in a society: a shareholder-based system and a stakeholder-based system.  

In shareholder-based systems the relationship of the company with its shareholders (owners) and its directors (managers) occupies the center of attention. Clear examples of shareholder-based systems are the common-law systems of the US and the UK.

A clear example is the UK’s Hampel Report of 1998, which establishes that "the single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment." Said Report further states that even if the managerial bodies are obliged to respect the interests of stakeholders, they are only accountable to the shareholders.  

On the other hand, stakeholder-based systems are commonly represented by Continental European countries rooted on a civil-law tradition, with Germany as the clearest example. Stakeholders-based systems focus more

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81 Another classification is the one provided by Wymeersch E. in "Elements of Comparative Corporate Governance in Western Europe" in Isaakson, M. and Skog, R (eds), "Aspects of Corporate Governance", Juristförlaget, Stockholm, who classifies these two traditions as company-based systems and enterprise-based systems.
83 It is worth noting that French-origin legal systems have had traditionally a stakeholder-system. However, in recent years, and due to governmental intervention, some countries
on company-society relationship where not only shareholders are important but also other players, that some way or another, are affected by the actions of a company (e.g. market, environment, employees, customers). In this system, there is a strong partnership between the investors and the workforce. Therefore, it is not rare to see employee’s representation at the managerial board level; and bank representation (in their role as major investors) at the supervisory board level. Furthermore, in this model companies are expected not to enter in high risk activities but instead, use up the capital to avoid market destabilizing measures such as the downsizing of the company.

From a corporate governance perspective the differences between these two systems are important. During the 1930’s professors Dodd and Berle identified these differences and started a debate around the question "for whom are corporate managers trustees". The debate gave rise to what is known today as the doctrine of Corporate Social Responsibilities that contains extensive literature as to which of those two systems is more beneficial for a society.

Although this discussion exceeds the scope of this paper it brings up an important governance issue as it helps determining the scope of responsibilities of directors. While in a shareholder-based system the scope of responsibilities would mostly be restricted to its investors; in stakeholders-based system the company’s responsibilities would be monitor by more market participants who would bring actions whenever they feel affected.

This is an important matter to take into account by EC policy makers when regulating corporate governance. Indeed, accountability of the board and the managerial bodies for the activities of the corporation is a core theme for corporate governance. The way such accountability is expressed and to whom it is directed varies, as seen, depending on which is the primary objective of the company: to promote the interest of the company and its shareholders and/or the current and future shareholders, lenders, employees, business partners and the general public.

like France and Belgium find themselves in a transition. For example the Viénot Report I observes that "The interest of the company may be understood as the over-riding claim of the company considered as a separate economic agent, pursuing its own objectives which are distinct from those of shareholders employees, creditors, including the internal revenue authorities, suppliers and customers. It nonetheless represents the common interest of all these persons, which is for the company to remain in business and prosper. The committee thus believes that directors should at all times be concerned solely to promote the interests of the company". Viénot Report I, p. 7.

Guillén, Mauro and Schneper, William, supra, note 48.

Ibid, p.10.


Gregory, Holly and Simmelkjaer, Robert, supra, note 35, p. 46.
3.2.1.2 Enforceability

The legal background also determines the level of enforceability of governance mechanisms, particularly the corporate governance codes. In common-law countries with codes of corporate governance (e.g. the UK), judges are capable and entitled to enforce the applicability of such codes in a direct manner. This occurs because governance codes become enforceable instruments once they are recognized as a part of the usual practices of an economy.

On the contrary, in countries rooted on a civil-law system such as the Continental European countries, judges are incapable of enforcing the application of these types of codes. This is because the laws that guide the behavior of the firm can only be enforceable once they overcome the tortuous path of codification process and are approved by the lengthy legislative process of the country.

This suggests that policy makers at the EC level cannot pass a mere set of soft law recommendations in the area of corporate governance. To truly increase good governance practices EC regulators should instead aim at enacting strong and fast-track mechanisms such as directives, which would acquire the force of law and hence, would be rapidly and effectively enforceable.

3.2.2 Structure of the Board of Directors: The One-tier, Two-tier Discussion

Another major difference between the US and the EC is the different types of board structures. While the US legislations are broadly homogenous; the structure of the board of directors in the EC Member States is quite heterogeneous. Over the years, different legal systems have found different solutions to enhance good governance practices within a country. Some legal systems contemplate the possibility of having a one-tier board of directors while others consider the possibility of having two-tier boards or a mix between both.

In the majority of the Member States (11 before the recent enlargement) the unitary board structure was predominant. The clearest example of a unitary board system is the UK. There the legislation entrusts both management and control to the board of directors. On the other hand, in Austria, Germany and the Netherlands the legislation provides for a two-tier

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88 This analysis would be complemented in the discussion of Chapter 4.
89 Cuervo, Alvaro, supra, note 46, p. 89.
90 Ibid.
91 Gregory, Holly and Simmelkjaer, Robert, supra, note 35, p. 43.
92 Hopt, Klaus and Leyens Patrick, "Board Models in Europe" in <www.ecgi.org> page visited on April 18, 2006 at 5:42 p.m.
structure. For instance the Public Companies Act (Aktiengesetz)\(^\text{93}\) establishes a co-determination system with a two-tier board that employs both a management board (Vorstand), in charged of the day-to-day activities of the firm and the setting of its strategy; and a supervisory board (Aufsichtsrat) in charge of monitoring the performance of the management board.\(^\text{94}\)

Other countries have included recent modifications in their legislations allowing the possibility of having a one-tier board or a two-tier board depending on the desire of the entrepreneur. For example, the rules in France and Italy allow for a choice between a one-tier, a two-tier structure or a mix of both.\(^\text{95}\)

The doctrine highlights that none of these two systems have proven to be more efficient than the other.\(^\text{96}\) While the one-tier systems allows the shareholders to be represented in the management bodies and permits a closer relation and better information flow between the supervisory and the managerial bodies; the two-tier board encompasses a clearer and formal division between the supervisory and the managerial board, and allows at the same time that it helps avoiding abuses in the managerial by the controlling shareholders since it grants employees the possibility to participate actively in certain discussions.

But then, what are the implications of these two different systems? Do they have implications in the way corporate governance is regulated?

This thesis remarks that the different board structures have an enormous implication in the way each country addresses corporate governance matters. One example is the role of the employees in the company.

While it is common that in companies located in Austria, Denmark, Germany, Luxemburg and Sweden employees have the right to appoint some members of the supervisory board; and in other Member States (e.g. France and the Netherlands) the employees have an advisory voice on certain issues in the supervisory board; the remaining EC countries, for instance the UK, limit the appointment of directors and the voting rights to the shareholders.\(^\text{97}\)

\(^{93}\) Public Companies Act of 1965.
\(^{95}\) See Hopt, Klaus and Leyens Patrick; supra; 92, p. 18.
\(^{96}\) Davies, Paul "On Board of Directors: the European perspective", Where are we now?", Palgrave Macmillan, 2006, p.43.
\(^{97}\) Gregory, Holly and Simmelkjaer, Robert; supra, note 35, p. 34.
Another major difference is the amount of non-executive directors in the boards of the EC. While in Germany and the UK there is a clear tendency towards independent directors in the board; in other countries of the Community such tendency does not exist. This happens particularly in companies with a high concentrated ownership structure, where boards are commonly composed by members with a close link to controlling shareholders. In Parmalat, for example, all the members of the board were from the Tanzi family.

Fortunately, the HLGR II acknowledged these differences considering them as beneficial to enhance corporate governance in the EC. In doing that, the HLGR II recommended that listed companies across Europe should have the possibility to choose between either one of these two systems, depending on their particular needs and circumstances.98

The HLGR II also acknowledged the importance of having independent member (or non-executive members) within a board of directors by establishing that such members have an important role on behalf of the minority shareholders. In this regard, the ECO has recently passed a recommendation on the role of independent directors which would be beneficial for the enhancement of good governance practices in the Community.

### 3.3 General Implications

The analysis presented in this Chapter highlights the enormous legal and economic differences between the US system and the EC system. It also shows that there is a lack of homogeneity among the systems of the Community. This has transcendental effects in the area of corporate governance since it is not clear which is the best way to approach governance issues within the EC.

While it is desirable to promote a homogenous system of corporate governance, the approach of the EC institutions should nevertheless be cautious. Introducing a set of "straight jacket rules", similar to those of the SOA, with the aim of unifying the corporate governance parameters, is not recommended. Such rules would diminish the development of corporate practices and destroy the efforts taken so far by the Member States. Moreover, such rules would totally disregard the different economic and legal backgrounds in which the EC is cemented.

It is thus suggested, that the Community takes a flexible approach that fosters diversity and recognizes the different approaches of the Member States. Though diversity and flexibility are mostly wanted, the approach of the Community should nevertheless oblige Member States to adopt a

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common set of measures in order to guarantee the existence of proper governance safeguards for all investors in the Community. This analysis is further extended in the following chapter.
4 How, when and who should regulate?

In general matters, the performance of a company depends on the efficient operation of *internal* and *external* corporate control mechanisms. This Chapter shows, however, that these two traditional mechanisms are inefficient to solve governance problems in companies located in large-control systems characterized by high levels of ownership control.

To this extent, it is argued that in large-control systems, such as those of the Member States (with the exception of the UK), governance problems are better handled through a defined set of enforceable corporate governance standards introduced by EC policy makers.

4.1 Internal Governance Mechanisms

Internal governance mechanisms are designed to align the interests of the managers and the shareholders of a company. In the modern listed corporations the duty to implement and develop these mechanisms lies in the head of the board of directors (or the supervisory board, as it might be the case for two-tier board systems) which is the ultimate center of control in a publicly held company.

In exercising internal control mechanisms the board of directors is obliged to conduct both a managerial and environmental assessment with the aim of determining the reason of the company’s inefficiency.

With the managerial assessment, the board undertakes an ability and effort analysis to determine the degree of proficiency of the managers in a company. The ability analysis is carried out through a close scrutiny of the capabilities of the managers in areas such as product knowledge, company knowledge and industry knowledge. Other areas like emotional maturity, leadership skills, and personal abilities are also revised. On the other hand, the effort analysis seeks to determine if the activities of the manager have led the company to an inefficient situation.

Following the managerial assessment, the board must conduct an analysis of the organization environment in order to determine if the inefficiencies of

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the company derive only from the management team or result from the whole organization. An analysis of the organization and the market where it operates is then carried out, for instance, by doing a comparative analysis of the company’s stock returns with its competitors.

Once the managerial and the environmental assessments are undertaken, the board of directors has two very limited possibilities. It can either dismiss the managers or create incentives (e.g. remuneration) to increase the efficiency of the company.\textsuperscript{102}

Thus, internal governance mechanisms have a clear limitation: they are implemented only against the managerial and only by the board of directors (or the supervisory board). As a result, certain of the company’s inefficiencies cannot be solved by internal control mechanisms. That is the case for example, of inefficiencies resulting from the actions of the board and not from the actions of the managers.

Moreover, in large-control economies, where the ownership control of the company is held by few shareholders, who in turn are capable of exercising control over the boards, internal control mechanisms are inefficient to solve governance problems. This is particularly the case of companies where there is a close family link between the shareholders, the board of directors and the CEO, as it occurred in the case of Parmalat. The influence of the Tanzi family in all the levels of the company and the way the ownership was divided impeded the implementation of internal governance mechanisms, thereby affecting the standing of minority shareholders.

Thus, promoting the implementation of internal governance mechanisms would not be efficient to solve governance problems in companies located within the EC, as many of those problems result from the actions of the majority shareholders.

\section*{4.2 External Governance Mechanisms}

External governance mechanisms are rooted in the market for corporate control.\textsuperscript{103} According to the economic theory\textsuperscript{104}, the outside managerial market exerts a great deal of pressure to the managers of a company. If top managers engage in self-interested behavior, the performance of the

\begin{footnotes}
\footnote{102}{Walsh, James and Seward, James, \textit{supra}, note 99, p. 430.}
\footnote{103}{Though some authors consider shareholders activism (particularly trough institutional investors) as another external force, this paper does not follow such classification. In my view, the pressure exercised by institutional investors would lead to either the use of an internal mechanism (e.g. dismissal) or an external mechanism (i.e. takeover). For the other perspective see Owen, Geoffrey, Kirchmaier, Tom and Grant, Jeremy \textit{"Corporate Governance in Europe and the US: Where are we now?"}, Palgrave Macmillan, 2006, p.14-17.}
\end{footnotes}
company will diverge from the maximum potential and thereby, the value of the stock will be reduced. In these circumstances it is likely that other management teams offer themselves to the shareholders as an alternative way of investment by providing an innovative model for the company’s survival.

Hence, the "market of corporate control" serves as means for the dialogue between the shareholders and the potential managers. The idea behind, is that the new appointed managers will be able to use in a better way the company’s assets, for the benefit of the market and more important, for the benefit of the shareholders.

External governance mechanisms often involve a drastic and serious process of restructuring the company which is normally carried out trough takeovers, or in the worse case scenario, hostile takeovers bids. For that matter, these mechanisms are seen as discipline of last resort that should be implemented in very exceptional cases and only when internal governance efforts have failed.\(^{105}\)

Similarly to the internal governance mechanisms, the external controls are not completely efficient. Even if from an outsider’s perspective a takeover operation may seem ideal; from an insider’s perspective these procedures often embody major problems.\(^{106}\) Over the years executive managers and CEO’s have created a variety of sophisticated mechanisms of defense addressed to entrench themselves in the company, which in some cases may thwart a takeover.\(^{107}\) Mechanisms such as golden parachutes, poison pills, supermajority requirements contained in the by-laws, standstill agreements, insurance agreements, among others, constitute a threat to the company and the shareholders since they often imply the assumption of many costs and may imply long periods of negotiation.

Additionally, takeover operations imply extra costs for the acquiring company, such as redesigning the organization’s image, bearing the costs to adequate the inefficiencies of the acquired company, creating compatible working systems, and firing or hiring people to increase the efficiency of the company.\(^{108}\)

Despite the costs and the tangible inefficiencies, the US and UK market-players still see takeovers as helpful instruments to discipline managers and maximize shareholder wealth.\(^{109}\) However, this is not the case of continental European countries where takeovers operate rarely and hostile takeovers have been pejoratively labeled as the worst example of predatory capitalism;

\(^{105}\) Ibid.
\(^{106}\) Walsh, James and Seward, James, \textit{supra}, note 99, p. 438.
\(^{107}\) Cuervo, Alvaro, "Corporate Governance Mechanisms: a plea for less code of good governance and more market control", \textit{supra}, note 46, p. 88.
as an instrument of capitalism without soul; as an aggression, or as an assault. This is reflected in the amount of hostile takeovers announced in the US and in the EC Member States. While between 1988 and 2003 the market announced 478 hostile takeovers attempts in the US and 273 in the UK; in the same period, there were only 19 in France and 7 in Germany.

One of the reasons of the lack of massive use of takeovers as external governance mechanisms results from the ownership structure of the companies located in continental Europe. Since corporate shareholding in continental Europe is highly concentrated in the hands of few shareholders who in turn have the possibility to control the board of directors, these mechanisms are often disregarded. Majority shareholders, having complete control over a company, are not interested in modifying the managerial bodies trough takeover operations because they imply high costs and may jeopardize the stability of their investment. Instead, large shareholders use internal mechanisms of reappointment and dispatching to modify the officers of the company.

Moreover, since there are often personal long-term relationships between the managerial and the shareholders which impede the use of these drastic governance measures there is no "market of corporate control". The managerial relationship with the company has a big subjective component (e.g. a family tie, lender-investor tie) and is not often related to an objective assessment. In this regard, the Parmalat case provides an interesting example of how family ties are often regarded as sacred despite the poor behavior of a company.

Another important reason of the poor level of hostile takeovers in continental Europe results from the role played by the banks in the corporate structure. Similarly to the large non-financial blockholders, a bank that has the control over a company and is capable of appointing and changing the directors as it pleases, is likely to oppose takeover operations. This is mainly due because of the reputation costs associated with negative public opinion which could easily outweigh any tangible financial gains from a hostile takeover.

Therefore, it is evident that the implementation of an EC measure addressed to increase the amounts of takeover bids would completely disregard the true needs of the Community market. Moreover, such mechanism would not be efficient to solve governance problems in the majority of companies located within the EC.

Thus, similarly to internal control mechanisms, external control mechanisms seem to be inefficient to deal with governance problems in the EC. As a

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110 Guillén, Mauro and Schneper, William D, supra, note 48, p.4.
112 See supplement B.
113 Guillén, Mauro and Schneper, William D, supra, note 48, p.23.
result policy makers must address their efforts towards the implementation of alternative governance control mechanisms.

4.3 Other ways of solving governance problems: General Corporate Governance Standards

As seen, neither the internal nor the external governance mechanisms provide for efficient ways of solving governance problems in economies rooted in large-control systems such as those of most EC Member States. The analysis shows that even if the major shareholders of a company located in a large-control economy are able to closely monitor the company’s directors in a more efficient way than in market-control economies; they often prevent the existence of active corporate control mechanisms that disciplines the poor behavior of the executive directors, affecting thereby the investment of minority shareholders.

In spite of this, there are two additional alternatives that EC policy makers may use for solving governance issues. On the one hand, they can direct their efforts towards the enhancement of a market-control economy; and on the other, they can promote a coherent set of corporate governance standards trough soft and hard law instruments.

Based on the conclusions reached in Chapter 3, it is clear that the promotion of a market-control system implies a multi-layer and costly structure that requires deep modifications to the legal, economic and political basis in which Europe is cemented. Moreover, such an immense modification does not guarantee that the EC market will become hermetic towards corporate bad practices. Firstly, recent US scandals show that the market-control economy is still far from having an adequate regulatory framework to prevent these behaviors. Secondly, on a cost/benefit basis a large-control system seem to be more efficient since it requires less regulatory efforts and can be run in less time. Thirdly, the imposition of alien principles and rules that do not reflect the needs of the Community would be a step back towards the accomplishment of a duly functioning internal market.

As a result, this paper argues that the most efficient mechanism to compensate for the lack of governance control in the EC is the adoption of corporate governance standards trough enforceable instruments, as such standards imply less time and costs for their implementation and can be adjusted to the legal, political and economic needs of the Community. In this regard, the role of EC policy makers in establishing minimum corporate governance standards and in defining the enforceability of such standards is of crucial importance.

Determining how far the EC institutions should go in enacting new rules in this field is not an easy task. This exercise turns even harder because it has
been overlooked by the EC literature. Despite this lacuna, the US discussion on the competence of the federal government vis-à-vis the powers of the states, offers interest guidelines on the way EC institutions should proceed to properly tackle recent corporate governance failures.

Indeed, with the issuance of the SOA the US doctrine embarked in an intense debate regarding the role of the federal government in regulating matters that were traditionally of exclusive competence of the states. A transposition of such debate into the EC context would help determine if the ECO should follow the path taken by the federal government of the US, or instead, allow Member States to have the exclusive competence to issue rules in the corporate governance field.

### 4.3.1 Federalism and the Corporate

Traditionally, the US legal system has granted primary responsibility to regulate corporate affairs to the states. Throughout the history of American company law, most of the laws that govern the activities of a company have steamed from the state where the company was originally incorporated.\(^\text{114}\)

The powers of the states have also been fostered by the findings of the US Supreme Court. In view of such Court, the states retain plenary powers to regulate company law and, in particular, corporate governance related-matters, as such powers constitute one of the fundamental principles of American corporation law.\(^\text{115}\)

In spite of the above, the monopoly of the states to regulate company law has been often reduced when there has been a problem that cannot be solved by the action of state authorities. By contrast, in such cases, the competences of federal state have been correlative increased. The increase of such competences is based in an American principle that declares that "if the states have failed to regulate an area adequately or have constantly permitted a regulatory void, the federal government is entitled to implement federal regulations in order to win back public confidence and fill the void with its own rules."\(^\text{116}\)

Clear examples of the increasing incursion of the federal government in areas previously regulated by the states are the Securities Act of 1933 and the Securities Exchange Act of 1934. These two acts further evidence the

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efforts of the US government to fill up regulatory gaps, promote market efficiencies and protect the shareholders.\textsuperscript{117}

The 1934 Act, for instance, was the American response to the abuses taken by the managerial bodies as a result of the various gaps left by state securities regulations. With such act, the US Congress introduced a well-defined set of provisions addressed particularly to prevent this behavior which included, among other things, the transfer of competences to pass securities regulations to a new specialized federal body: the SEC.\textsuperscript{118}

Similarly to the 1934 Act, the SOA gives a piquant example of the growing participation of the federal government in traditional state matters. It establishes precise and far-reaching corporate governance reforms, reserved in the past to the states as a result of the failure of market forces and state regulatory regimes to adequately protect shareholders and the public.\textsuperscript{119}

This brief discussion evidences that the powers of the federal government in the US endure whenever there are market problems that transcend the competition of the states. Market fallouts are usually followed by a strong and vigorous response of the federal authorities. In this regard, the SOA constitutes a clear example of an act addressed to tackle and eliminate from the root any problem affecting the well-being of the market economy in the US.

The question that follows this discussion is whether or not the EC institutions should follow the same path of action or instead allow the Member States to handle recent governance fallouts. Said question is answered in the following sections.

\section*{4.3.2 A rainbow approach? Diversity vs. Harmonization}

Over the years, the discussion as to the scope of competences of the EC institutions in the area of company law has been subject to an intense debate in both the academic and political arenas. The debate has focused in determining the areas of company law in which the EC institutions should take a high regulatory standard and pass directives and regulations (with the purpose of obtaining a high degree of harmonization); and in what others, they should merely adopt a general regulatory framework and issue soft law rules, leaving to the Member States the discretion to enact the specific rules.

While said discussion has not been as intense in the area of corporate governance it is nonetheless important. Indeed, it is still unsettle if the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{117} See Ayre, Lucian; \textit{supra} note 114, p. 1442
\item \textsuperscript{118} See Mills, Carl; \textit{supra} note 116, p. 446.
\item \textsuperscript{119} Jones, Renee, "Rethinking Corporate Federalism in the Era of Corporate Reform" Journal of Corporation Law, Volume.29, Issue 3, p. 629.
\end{itemize}
\end{footnotesize}
Community should aim at obtaining a unified set of rules, perhaps a unique code of corporate governance, by carrying a “SOA approach”, or instead protect the colorful diversity of the rules of each Member State by allowing such states to enjoy full/partial competence in this field (a rainbow approach).

A close reading to the EC Treaty and a historical review of the Community activities in the area of corporate law would be useful to determine the path to be followed by the EC institutions in the area of corporate governance.

4.3.2.1 Regulating company law

Article 249 of the EC Treaty establishes that EC institutions may choose from three basic legal approaches to regulate an area of the internal market (such as company law). One approach is the introduction of a uniform set of rules that supplement national law (i.e. regulations). With this approach Member States are compelled to create an environment in which the Community provision can operate, but do not have to take a formal action, and are ordinarily prohibited from doing so.\(^{120}\)

The second approach is the harmonization of national law through directives. Directives provide for merely a legislative template while leaving some choice as to form and method open to the Member States.\(^{121}\)

The third approach is the co-ordination of national laws through non binding provisions (i.e. recommendations). With this approach Member States are neither obliged to take an action nor punished from not doing so.

In the area of company law the EC institutions have used all three approaches. The initiatives taken at the EC level have mostly departed from article 44- 2 (g) of the EC Treaty which gives the Community institutions, to the necessary extent, the possibility to achieve the harmonization of community rules in general areas of company law and facilitates the enactment of common provisions for the development of intra community trade.\(^{122}\) The result is that as of today there are nine company law directives and five capital market law directives as well as complementing regulations

\(^{120}\) Swaine, Edward, "Subsidiarity and Self-Interest: Federalism at the European Court of Justice", Harvard Law Journal, Volume 41, Number 1, 2000, p. 11.


\(^{122}\) Article 44 2 (g) EC states: "2. The Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular: "(…) (g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and other, are required by Member States of companies or firms within the meaning of the second paragraph of Article 48 with a view to making such safeguards equivalent throughout the Community (…)".
and directives in company law taxation and a vast number of general recommendations.\textsuperscript{123}

In spite of the increasing efforts of the EC institutions in this field, the rules issued so far at the Community level have been limited to the establishment of a general framework for the protection of those involved in company matters, particularly stakeholders and shareholders, with the view of avoiding a "race to the bottom" by the Member States.\textsuperscript{124}

As a result it is argued that while the Community approach has been acceptable in certain areas; other areas still lack of a precise set of rules to facilitate the running of efficient and competitive enterprises across the EC.\textsuperscript{125} Indeed, while some areas of company law require only general approaches for the promotion of efficiencies and competitiveness of business within the community (e.g. disclosure of the company’s legal and financial situation; the raising of capital; mergers and acquisitions and the cross-border establishment of branches to name but a few); other areas require further involvement of the Community institutions which has so far not been undertaken or has been truncated by political restraints and pressures. An example is the European Company Statute comprised of more than 400 rules when it was first proposed, but of only 70 rules (out of which 30 were new and the remaining were only reproductions and references of national law provisions) by the time of its adoption in 2001.\textsuperscript{126}

4.3.2.2 What about corporate governance?

In the specific area of corporate governance, the Community has so far enacted very few rules. As seen in Chapter 2, early studies taken at the Community level concluded that the Community should not adopt a unified code of corporate governance. The conclusions remarked that the adoption of such code would not enable investors to obtain accurate information about the rules applicable to companies in each country as those rules would still differ from one country to another.\textsuperscript{127}


\textsuperscript{125}Ibid.


\textsuperscript{127}Report of the High Level Group of Company Law Experts supra, note 39, p. 76.
In that regard, the studies stressed that investment decisions in a specific capital market were based more on the liquidity of such market and very little in the existence of corporate governance codes\textsuperscript{128}; that there was a high degree of convergence among the codes of the Member States, and that issuing a EC code of corporate governance, even if it could add general awareness and understanding of governance issues throughout Europe, would merely be an extra layer of principles since the OECD standards already provided for a coherent set of principles and rules.\textsuperscript{129}

The studies also concluded that the most efficient approach to regulate corporate governance within the Community would be through soft law mechanisms (e.g. recommendations).

Consequently, as it occurred in the early US approach, the Community allowed Member States to take the initiative in enacting rules in corporate governance thereby limiting the powers of the EC institutions to monitor the evolvement at the national level and enacting soft law rules, as it was recommended by the initial studies.\textsuperscript{130}

In summary, a diversified regulatory system composed by the various rules of each of the Member States was protected. The idea behind was that diversity enhanced innovation and allowed experimentation at the national level.\textsuperscript{131}

However, although a diversify environment should be protected, it is nonetheless advisable, in light of recent corporate scandals, that the EC institutions undertake a stronger regulatory approach. Even if the conclusions of the studies recommended that the Commission had simply the task of promoting, facilitating and coordinating the efforts of the Member States by the mere issuance of sporadic recommendations\textsuperscript{132}, this paper argues that such co-ordination should not only be carried out by using soft law recommendations, but instead, by the use of binding rules that are enforceable in the Member States. It is therefore argued that the current status of corporate governance within the EC requires a stronger Community dimension.

It is worth noting that stronger community dimension does not mean the imposition of “straight jacket regulations” that eradicate the national efforts of the Member States. No, the involvement of the EC institutions in the area of corporate governance should be very cautious. Therefore, this paper stresses that the Community should use a flexible but binding mechanism to

\textsuperscript{128} Gregory, Holly and Simmelkjaer, Robert, \textit{supra}, note 35, p. 82.
\textsuperscript{129} Ibid, p. 81.
\textsuperscript{130} One example is the Commission Recommendation (2005/162/EC) of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, OJ L 52/51.
\textsuperscript{131} Grundmann Stefan, \textit{supra}, note 126, p. 616.
\textsuperscript{132} Report of the High Level Group of Company Law Experts \textit{supra}, note 39, p. 73.
regulate corporate governance. In that regard, article 249 EC provides an ideal instrument: the directives.

Accordingly, it is argued that the Community should permit a full diverse approach in areas where governance problems are better dealt by the national governments, but follow, to the required extent, the approach taken by the federal government of the US implementing stronger and binding rules in critical areas, in order to avoid future corporate collapses.

Even if the above statement may seem slightly presumptuous, it is nonetheless in compliance with the principles of subsidiarity enshrined in the EC Treaty as it is shown in the following paragraphs.

4.4 The Principle of Subsidiarity and Corporate Governance

Article 5 of the EC Treaty reads as follows:

"The Community shall act within the limits and powers conferred upon it by this Treaty and of the objectives assigned to it therein

"In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community

Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty".

Paragraph 2 of the article, which entails the subsidiarity principle stricto sensu, constitutes a test which facilitates the designation of the authority entitled to exercise the competence. The test, commonly referred as the “better attainment test” or “test of comparative efficiency”, was introduced by the Amsterdam Protocol following the parameters of the Edinburgh European Council of 1992 on the application of the principle of subsidiarity and proportionality.

Pursuant to this test, the Community should only take an action if it fulfills the following conditions: (i) the issue under consideration has transnational aspects which cannot be satisfactorily regulated by action by Member States; (ii) the actions of the Member States alone or the lack of Community action would conflict with the requirements of the Treaty or would

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otherwise significantly damage Member States interests; or (iii) the action at the Community level would produce clear benefits by reason of its scale or effects compared with an action at the national level.\textsuperscript{134}

Thus, since the area of corporate governance is an area of shared competences between the Community and the Member States,\textsuperscript{135} any action taken by the EC Institutions would necessarily have to comply with the above mentioned conditions. An analysis of each of such conditions is therefore required:

- **The issue under consideration has transnational aspects which cannot be satisfactorily regulated by an action of the Member States.** It should be clear from the outset that corporate governance is an area with transnational aspects. The increasing tendency of EC companies to carry out cross-border operations, and the interdependence of the securities markets in the Community show that companies require the presence of common safeguards (governance mechanisms) that guarantee the protection of their investors.\textsuperscript{136} Moreover, good governance mechanisms allow companies to benefit from foreign and local capital flows since they help promote and create trust in transnational relationships.\textsuperscript{137}

Thus, it is clear that corporate governance has transnational aspects. The question that needs to be solved is whether or not Member States can satisfactorily regulate this area or instead, a stronger involvement of the Community is required. This thesis stresses that the current status of the internal market claims an urgent participation of the Community in establishing a set of principles of corporate governance.

Contrary to what might be believed, governance scandals in companies located in the EC are not recent. They have been among

\textsuperscript{134}See to this effect the Protocol on the Application of the Principles of Subsidiarity and Proportionality, Treaty of Amsterdam amending the Treaty on European Union, the Treaties establishing the European Communities and certain related acts, 1997 OJ (C 340).

\textsuperscript{135}The wording of the first paragraph of article 5 EC establishes that it only applies to areas which do not fall within the exclusive competence of the Community. This has been complemented by the opinion of AG Fenelly who stated that "(...) the application of the principle in the present cases turns on the question whether harmonizing action pursuant to Articles 57(2) and 100A of the Treaty falls within the exclusive competence of the Community. If that is the case, the principle does not apply. On the other hand, the applicants in both cases appear to presuppose that the legal basis upon which the Directive was adopted did not fall within the exclusive competence of the Community. If that assumption is incorrect, as I think it is, it is unnecessary to consider whether the principle was, in fact, respected (...)". He then went by and concluded that "(...) the exercise of Community competence under Articles 57(2) and 100A of the Treaty is exclusive in character and that the principle of subsidiarity is not applicable. There can be no test of comparative efficiency between potential Member State and Community action (...)". Case C-376/98 Germany v. European Parliament and Council [2000] ECR I-8419; AG’s Opinion, paragraph 135 and 142.

\textsuperscript{136}Action Plan, supra, note 40, p. 6.

\textsuperscript{137}OECD Principles 2004.
us for more than a decade. Early cases like the Polly Peck International and Maxwell in the UK; Bremer Vulkan and Metallgesellschaft in Germany; Banesto and Seat in Spain; Feruzzi in Italy, and Navigation Mixte and Suez in France, to name but a few, were initial promoters of good governance practices in European countries.  

The difference with these cases and recent cases at the EC level (e.g. Parmalat, Adelphia and Vivendi) is the impact they have had in the market. In the early cases the accounting and governance frauds had, in most cases, mere national repercussions affecting only the legal and economic institutions of a country. For instance, in the UK, the Polly Peck and Maxwell scandals were followed by the Cadbury and Greenbury Reports only. Long time passed before other countries carry out a similar efforts and this only happened when corporate scandals actually affected their markets.

By contrast, in the globalize market of today, and due to the economic interdependence of the markets, almost every measure adopted in a county is felt in other markets, even in distant economies. The Enron scandal raised a wave of corporate governance codes around the world. Similarly, the Parmalat case launched an intense debate on the competences of the EC institutions in regulating the corporate governance area. Therefore, while in early stages of the Community it was acceptable for Member States to freely passed rules on corporate governance, the current situation of the market advices otherwise.

Moreover, the continuous appearance of governance scandals at the EC level (e.g. Parmalat in Italy, Vivendi in France, Volkswagen in Germany) and the effects those scandals have had in the stability of the common market, suggest the urgent need of a Community intervention. While an action of the Community would not, of course, avoid future corporate scandals, it would nonetheless reduce them.

- **Actions by the Member States alone or lack of Community action would conflict with the requirements of the Treaty or would otherwise significantly damage Member States interest.**
  
  There is a strong need for a standardized body of corporate governance rules at the Community level. National efforts have proven to be scarce in dealing with corporate governance problems, particularly when those problems touch upon multinational corporations. This is evident in the Parmalat case which shows that the early efforts taken by the Italian government to establish a coherent set of rules addressed to prevent governance fallouts were

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138 See Berglöf, Erik, supra, note 80, p. 93.
139 Green, Scott; Gregory, supra note 4, p.51.
poor, mainly because of the impossibility to monitor the cross-
national operations of Parmalat with its Cayman-island subsidiary.

Equally, the measures taken so far by such government to respond to
the collapse of the Italian diary colossal have been criticized for the
lack of coherence and strength. 140

Furthermore, the likely happenings of another Parmalat case in the
EC area are not restricted to only Italy. First, even if Italy has a
reputation for poor corporate governance mechanisms; pyramid
complicated structures and family own-companies, much of the same
can be said of other EC countries such as France, Spain and the
Netherlands. 141 Second, while the governance practices in Italy have
been debated by the academia, practitioners and governmental
bodies; in other countries of the EC the debate has just recently
begun. 142 This suggests that the long years of know-how gathered by
the Italian authorities and fostered by the intense debate are yet to
come in those countries. 143

As it illustrated by the Parmalat case, the actions taken by the
Member States alone are not enough to guarantee the stability of the
internal market. Similarly, a lack of action by the part of the
Community would conflict with the requirements of the Treaty and
damage the interest of the Member States. In this regard, the EC
Treaty is clear in establishing that whenever Member States are
incapable of handling matters on their own, and whenever such
matters have a Community dimension, the EC institutions should
take the necessary actions to bring back stability. 144

Moreover, the immense role of good corporate governance practices
in strengthening the internal market and facilitating the interaction of
companies and investors within such market, and the fact that one of
the Community’s main tasks is the promotion of a common market
free of obstacles, 145 suggests that the adoption of a coherent set of
good governance principles is of transcendental necessity. A lack of
Community action in this field would not only jeopardize the
stability of the internal market, but also affect the interest of the
Member States.

140 Segato, Lorenzo, “A Comparative analysis of Shareholders Protection in Italy and the
United States: Parmalat as a Case of Study”, Northwestern Journal of International Law &
141 Supplement F shows that the governance level of protection offered in Italy is superior
to other countries of the Community, namely Spain, Netherlands and France. The graphic
suggests that the likely happenings of another governance scandal in Europe are highly
plausible.
142 New Member States have just passed regulations on the area of corporate governance
(e.g. Estonia (2006), Lithuania (2004), Romania (2004)).
143 For more information see <www.ecgi.org>.
144 Article 5 EC Treaty.
145 Article 2 EC Treaty.
Action at Community level would produce clear benefits by reason of its scale or effects compared with action at the level of the Member States. Establishing a complete set of general principles of corporate governance would be beneficial for the protection of the internal market’s stability because it will be rapidly and vastly spread throughout the Community. While an action of the Community would be rapidly adopted by all Member States; an action of only one Member State would not have analogous consequences.

Although a measure taken at the national level may spread to other Member States, because of the interdependent character of the economies located in the Community and the mobility of the companies, said measure would lack of a Community effect. It is most likely that a national measure would only take into account the necessities of a specific country and ignore those of neighbor countries. It is also likely that the measures taken by a Member State would only solve the specific fallouts of the national system ignoring the problems of other neighbor systems. Therefore, the effects of a national action would merely be limited to the national level and would rarely be felt at the Community level. In other words, an action taken at the national level in the field of corporate governance would not serve as a guarantee for the protection of the internal market.

Proactive policy making is another argument that supports the need of a Community dimension in the area of corporate governance. In the past, the actions taken by the Member States have resulted mainly as a direct reaction to corporate scandals and in very rare occasions as a conscious initiative to enhance corporate governance standards. In this sense, it is most likely that the Community takes adequate measures to reduce the risk of corporate scandals than the Member States. This is because the Community is constantly monitoring all the companies located in the market. In other words, it has a complete view of the potential risks that may arise and affect the internal market as a whole.

Moreover, maintaining a national approach to solve corporate governance problems contradicts all the ideals of the Community. In an area such as the internal market, which has special preponderance in the Community no action should be left to the isolated efforts of the Member States. A strong regulatory approach has to be undertaken by the Community institutions whenever there is a negative impact on the free movement of workers, services, capital or establishment. Since corporate governance is an area closely related to all this freedoms it calls for a Community intervention.

\[146\] In the words of David Wright, Director of Financial Services Policy and the Internal Market at the European Commission, "(...) Regulatory action is only undertaken when it
The above test stresses that a strong collective approach of the Community is welcomed. It highlights that an intervention of the Community would foster the stability of the internal market and would reduce the likelihood of governance scandals in the EC. Accordingly, it shows that such intervention would comply with the rules enshrined in the EC treaty, particularly the principle of subsidiarity.\footnote{147} Nonetheless, the intervention of the Community should have certain limitations:

As seen in Chapters 2 and 3, corporate governance arrangements are deeply rooted in national legal and economical systems. This implies that any action taken at the Community level would have a tremendous effect in the national systems of the Member States. The possible effects of a Community measure in corporate governance has served as ground of discussion for some scholars who maintain that corporate governance matters should be best handled at the national level.\footnote{148}

These arguments, however, completely disregard the fragility of the internal market; the growing interdependence of the economies of the Member States; the fact that in the past the measures enacted by Member States have proven to be insufficient to deal with governance problems, and most importantly, the fact that national measures often lack a Community dimension.

However, even if the arguments put in the past to reject a Community intervention have neither legal nor factual basis, the Community should still be very cautious when passing measures in this field. While certain areas of corporate governance require a strong and urgent intervention of the Community; other areas are best handled at the national level. In other words, while it is desirable that Member States have an equivalent approach towards corporate governance, by departing from a harmonized set of standards defined through enforceable instruments, such as directives; a diversified approach should still be protected.

\footnote{impacts on the free movement, free movement of services or capital or (…) the freedom of establishment (…)", presentation held at the forum "Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective", Bibliothèque Solvay, Brussels July 12, 2004.\footnote{147} It is worth noting that the proportionality test is not necessary at this stage to evaluate the scope of actions of the Community. The proportionality test would only be necessary once a Community measure has been undertaken since such test enshrines an \textit{a posteriori} analysis.\footnote{148} See for example Berglöf, Erik, \textit{supra}, note 80, p. 91-123.}
5 Evaluating EC Measures

As we have seen in the previous Chapters, different legal and economical backgrounds require different policy approaches. While in the US governance problems may be solved by using a “straight jacket regulation” enforceable in all states of the union; the situation in the EC differs greatly. Though it is clear that there is an urgent need for a stronger Community dimension, there is still a lack of it. The approaches taken so far by the Community seem not enough and make one wonder if they would truly prevent future corporate scandals that may have a domino effect in the stability of the internal market.

This Chapter focuses on the measures taken so far at the Community level. It offers a critical view of the current status of the community measures in light of the analysis made in the precedent chapters.

It first analyses if the conclusions reached by the different studies taken at the EC level, that claim the existence of a high degree of convergence among governance practices of the Member States, are accurate.

Secondly, this Chapter analyses if the two main corporate objectives set out by the Action Plan of the ECO (i.e. strengthening shareholders rights and the protection of third parties; and fostering efficiency and competitiveness of business) have been duly observed by recent Community measures.

5.1 Towards Convergence?

Conventional wisdom holds that the high level of globalization is leading to a high degree of convergence in governance practices.\textsuperscript{149} The main hypothesis of the convergence theory is based in the role of the global capital flow in eliminating inefficient mechanisms of governance. It is argued that these inefficiencies can be avoided by adopting an Anglo-Saxon model of corporate governance that has proven (pursuant to this view) to be more efficient than the systems adopted in other countries.\textsuperscript{150}

The convergence theory also states that companies with atomized shareholding are more efficient than family firms, conglomerates, bank groups or worker cooperatives structures. It further highlights the high degree of worldwide standardization in governance practices fostered

mainly in the efforts of standards-setting bodies and multilateral institutions such as the World Bank and the OECD.\textsuperscript{151}

This view is contravened by those who believe that there is lack of convergence in corporate governance practices.\textsuperscript{152} According to this perspective, initial historical, social, cultural, economical, political and legal conditions are key factors that determine the corporate governance approach of a country (path dependence). Their argument is further based on a distinction between \textit{de jure} convergence and \textit{de facto} convergence. While \textit{de jure} convergence (the adoption of similar corporate governance laws across countries) may be achieved; \textit{de facto} convergence (convergence of actual practices) is not achievable. To illustrate their argument they highlight the fact that while countries may adopt similar rules, for instance by following the general standards of the OECD, those rules are not commonly accepted because they do not reflect the historical views of the country.\textsuperscript{153}

Although the convergence discussion is not the core study of this paper, it is nonetheless relevant since it evidences that there is an urgent need for a stronger participation of the EC institutions in defining general corporate governance standards.

The studies on corporate governance taken at the Community level concluded that there was a high level of convergence among the corporate governance practices of the EC Member States. They remarked that the trends toward convergence in corporate governance practices in the EC Member States appeared to be both more numerous and more powerful than any trends toward differentiation. They also stated that both the codes and the market pressures appeared to serve as a converging force, by focusing attention and discussion on governance issues, articulating best practice recommendations and encouraging companies to adopt them.\textsuperscript{154}

This paper remarks however, that these conclusions are not completely accurate. In spite of decades of globalization, there are still great variations in the essentials of governance rules among the EC countries which affect the internal market structure. As a result, this thesis argues that the current status of corporate governance in the EC shows merely a \textit{de jure} convergence instead of a \textit{de facto} convergence and that the traditional wisdom that pointed out towards the adoption of an Anglo-Saxon governance system is not present at the EC level.

\textsuperscript{152} In a recent study Khana, Tarun; Kogan, Joe and Palepu, Krishna, showed that while globalization has accelerated the adoption of common corporate governance standards there is little evidence that such standards have been implemented. Ibid, p. 71.
\textsuperscript{153} Ibid, p.75.
\textsuperscript{154} Gregory, Holly and Simmelkjaer, Robert, supra, note 35, p. 74.
There are two arguments that support this opinion:

- **Economical Dimension:** There are major economical differences among the Member States (i.e. large-control based, market-control based systems) which affect the way governance problems are approached. While the shareholders of a company domiciled in the UK would tackle governance problems by either internal or external control mechanisms such as increasing the CEO’s remuneration or forcing a hostile takeover; the shareholders of a large-control based systems would rarely use these mechanisms and will be compelled to use other less dynamic mechanisms such as reappointment of the CEO or opting out of the company.\footnote{See Chapters 3 and 4.}

Moreover, recent corporate scandals show that no economic structure is hermetic towards corporate governance problems. While the Enron scandal represents the fall of the Anglo-Saxon market system, the Parmalat scandal proves that the large-control based system is neither immune to governance problems. Thus, since no economic system seems more efficient than the other, the early convergence theory that pointed out that globalization would lead to the adoption of the most efficient system (being that the Anglo-Saxon) should be reformulated.

- **Legal Dimension:** As seen in Chapter 3, although the corporate systems of the Member States establish similar provisions for the proper functioning of the company (e.g. minimum capital requirements, rights of shareholders, duties of directors), there are still major differences that results from the way legal systems see the company within a society.\footnote{See the discussion in section 3.2.1.1.} This has direct implications in the degree of accountability of both directors and the company and thus, an enormous effect in the mechanisms that may be implemented to regulate governance practices.

In addition, following the discussion of Chapters 3 and 4, different ownership concentrations results in different governance problems. While agency problems are common in a disperse ownership company; the abuses taken by the majority shareholders for the prejudice of the minority shareholders are most common in highly concentrated systems. The Parmalat and Enron cases provide a piquant example on how the different ownership controls derive in different abuses by the managerial.

Thus, the different levels of ownership would determine the different mechanisms required to regulate corporate governance. In a large-control system, governance problems would be best handled at the internal level, whenever possible. On the contrary, on a market-
control system, governance problems would be best handled by effective mechanisms, such as hostile takeovers.

Accordingly, it is argued that even if the corporate governance approaches of the Member States seem to be similarly oriented, those approaches are limited to the formal ("paper") level and do not extend to the actual legal practice. In other words, although EC members have achieved a de jure convergence there is still a long way to go to achieve a true de facto convergence.157

The lack of convergence at the EC level would only be achievable with a stronger involvement of the EC institutions. This paper argues that the Community should pass a set of minimum standards that truly reflect the EC’s economical, legal and political peculiarities. These standards should establish general principles rather than far-reaching rules or merely detail recommendations of best practice. Such approach would be likely to protect diversity and experimentation at the national level.

In the past, the different studies taken at the EC level have argued that establishing EC standards would not be desirable as they would merely represent an extra layer of principles similar to those provided by the OECD that already set forth a coherent, thoughtful and agreed set of principles. It has also been said that the OECD principles are drafted with the participation and consultation of all Member States and that the issuance of new standards would be hard to achieve and may only end up expressing the lowest common denominator.158

This thesis stresses that this conclusions are erroneous. Since the OECD principles are the result of an extend process of consultation and formulation among the OECD members, they do not reflect the interests of only the EC Member States but also of other economies and legal systems, that do not have any connection with the Community. If the Community issues its own standards on corporate governance those standards would not become an extra layer of principles, as it has been held, but would represent the starting point for policy makers of the EC Member States.

It is worth noting that establishing a set of common principles at the EC level would not account the creation of “straight jacket” rules, as it occurred with SOA in the US, or as it would occur if a uniform code of corporate governance at the EC level is passed. No, instead they would provide a general framework that represent the interest of all Member States while

157 In words of Guillen, "(...) European integration has so far failed to generate enough momentum to bring about a convergence in corporate governance laws and practices (...)". See Guillen, Mauro, supra, note 150, p. 22.
158 Gregory, Holly and Simmelkjær, Robert, supra, note 35, p. 81. Prior to their publication, the OECD principles are subject to an intense discussion between the OECD officials and the different OECD member states. Even the ECO participates actively in these discussions (Article 13 of the OECD Convention of November 21, 1997).
protecting diversity and encouraging the different approaches at the national level in an environment of governance experimentation.

5.2 First Objective: Protecting Shareholders

As seen in Chapters 3 and 4, boards of directors of companies incorporated under a large-control system, regardless if they have a one-tier or two-tier structure, are often weaker and less effective in acting as the primary mechanisms for protecting the rights of minority shareholders than boards located in market-control economies.

Similarly, in concentrated ownership companies (most common in large-control economies), both the internal and external corporate governance mechanisms are less effective in protecting this type of shareholders, than in companies with a disperse ownership structure.

This situation is reflected at the level of the EC Member States. The studies of La Porta et al. show that while in common law countries, such as the UK, there is a high level of protection to minority shareholders; in the French civil-law countries, such as Belgium, Spain, Italy, France and the Netherlands, the level of protection is low. Accordingly, the protection given to minority shareholders in Germany and the Scandinavian countries is better than the French civil-law countries but worse than the UK.159

Thus, it is clear that the Community should address its efforts to strengthen the rights of minority shareholders. In this regard, the scope of the Community measures should not follow the path established by the SOA since such act is mostly addressed to control the managerial behavior and the activities of the auditing bodies.

The Action Plan seems to have acknowledged the importance of protecting shareholders. Said plan remarks that the protection of shareholders is one of the key policy objectives of the EC. It stresses the importance of a sound legal framework for protection of shareholders as a fundamental condition in achieving business efficiency and competitiveness. It further highlights the importance of new tailored initiatives to enhance the shareholders rights and clarify the management responsibilities.160

The following analysis reviews if the EC measures, that have been recently passed, follow the policy objectives identified by the Action Plan. It also reviews if such measures reflect the current Community needs.

159 La Porta, Rafael; Lopez- de-Silanes, Florencio; Shleifer, Andrei; Vishny, Robert, "Law and Finance", The Journal of Political Economy, Volume 106, Number 6, pp.1113-1155.

See also the study concluded by the Association of Private Client Investment Managers and Stock Brokers- APCIMS, "Shareholders Rights, A legal Comparison", October 2002.

160 Action Plan, supra, note 40, p. 4 and 5.
5.2.1 Cross-border voting

Recently the ECO launched two public consultations (September 2004 and May 2005) to determine the minimum standards that should be introduced in order to protect the voting rights of shareholders’ in listed companies. The consultations served as basis for a recent ECO proposal of a directive (Directive 2004/109 EC)\textsuperscript{161} which seeks to establish the appropriate governance mechanisms that would be required to facilitate the practical exercise of cross-border voting rights in listed companies.

The main objective of said directive is to enhance the exercise of cross-border voting rights for shareholders. The mechanisms provided therein allow those shareholders that participate in a general shareholders meeting, to obtain the relevant corporate information on time and to vote without encountering any obstacles.

The directive imposes the following obligations to the company: (i) ensure that general meetings are summon sufficiently in advance and that all documents therein submitted are available in time in order to allow all shareholders, no matter where they reside, to take a reasoned decision and to cast their votes in time; (ii) abolish all forms of share blocking; (iii) permit the addition of additional items to the agenda of the meeting without imposing significant thresholds; (iv) remove all legal obstacles to electronic participation in general meetings, and (v) offer non-resident shareholders simple means of voting without attending the meeting (voting by proxy, in absentia and by giving instructions).\textsuperscript{162}

It is indisputably that the referred measures will enhance good governance practices by facilitating the cross-border voting and participation of shareholders and by establishing transparent rules on document disclosing in the general meetings. However, those measures would not serve the purpose of tackling the main governance problem in the EC: the abuses of controlling shareholders in the prejudice of minority shareholders.

Hypothetically, a group of minority shareholders of a company structured in a similar way to Parmalat would confront the same governance issues they faced in the past, with or without this directive. They would still have no voice at the board of directors. They would be powerless in challenging the actions of the manager or attempting his dismissal. They would still be subject to the volatility of a family organized company. In a nutshell, they would still be submerged in a bad governance structure.

Thus, it is argued that despite the initial efforts of the Community, there is a latent need for a stronger policy making approach for the protection of


\textsuperscript{162} Ibid.
minority shareholders in the EC. Whilst the initial step has been taken, there is still a long way to go.

5.2.2 Executive Payments: a sui-generis approach?

As observed along this paper, principal-agency problems differ greatly depending on the market in which a company is located. On the one hand, in a market-control system (where ownership is commonly dispersed) problems result from the limited possibilities of shareholders to properly monitor the managers. In this type of system, unobserved actions of the managers can result in prejudice for shareholders. Thus, the theory suggests that the extent to which managers would fulfill the agenda of shareholders depends on the type of incentives given to them. As a result, it is commonly suggested that a payment mechanism capable of linking payment to shareholders wealth, would make managers more sensitive to shareholders interests.\(^{163}\) To put it bluntly, paying managers with an equity portion (shares) and a monetary portion would motivate such managers to act in pro of the shareholders.\(^{164}\)

This type of payment has however various problems. First, in dispersed ownership companies, the payment is not set by the shareholders but instead by the board of directors. Thus, a conflicting board may manipulate directors’ payments to prejudice the shareholders. By taking the incentives down managers would be unmotivated to perform due to poor payment.

Another problem from this type of payment, highlighted in section 3.1.2, is that managers would be motivated to inflate the financial statements with the aim of obtaining a higher payment. This was precisely what happened in the Enron case.\(^{165}\)

To deal with these problems, the core of regulations should aim at controlling the management bodies and create further controls and standards to the audit bodies. The SOA shows an example of this type of normative approach. Such act establishes new standards for auditor independence, creates new controls for the managerial bodies in certifying the financial statements and enhances the disclosure requirements for both the management and the audit bodies.

On the other hand, in a large-control system (where ownership is concentrated in the hands of banks, pyramidal company structures and big blockholders groups), the principal-agency problems are very different, and in most cases inexistent. In this type of systems shareholders are capable of

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\(^{163}\) Notably, the US and UK systems provide for this type of mechanism.


\(^{165}\) Coffee, John; supra, note 5, p.203.
monitoring the company on a constant basis. Moreover, in certain companies, managers are frequently related to shareholders (e.g. family-links; debt-financing links) and therefore no monitoring is needed. This suggests that the most common problem regarding executive compensation does not arise from a principal-agency conflict but rather from the relationship between the controlling shareholders and the minority shareholders. A clear example was the analysis presented in section 3.1.2 for the case of Parmalat, which evidences that the abuses of the managerial bodies may be sponsored by the controlling shareholders.

To deal with these problems, the core of the regulations should address the conflicts of both the management and controlling shareholders against the minority shareholders, for instance by establishing rules for the appointment of independent directors at the supervisory level.

**Current State of the Community**

Despite the fact that the Member States of the Community are mostly rooted on a large-control system, that in theory would not necessitate of equity payments to motivate the managers, recent studies show that executive payment systems at the Community level are following the models established in the US and the UK (in both the amount of money paid and the level of corporate bonds and shares given to directors as a portion of their payments).[^166]

Thus, none of the traditional solutions provided by large or market-control systems seem to fit the current peculiarities of the Community market. However, theorists[^167] have identified that a body of rules that obliges the disclosure of the compensation of the managers would be the most efficient way in solving payment problems, as it would oblige the board, irrespectively of the system, to justify the payment choices.

In this regard, the recent ECO Recommendation on the remuneration of executive directors provides a useful tool to control the structure and level of executive payments within a company.[^168] Said recommendation properly acknowledges the different types of executive remuneration systems in the Community by allowing Member States to retain their freedom to establish regulatory measures in this field.

The ECO Recommendation provides for general standards instead of straight jacket rules, allowing proper experimentation and diversity at the national level. It follows the American model of best practices, requiring companies to disclose general information on remuneration policies for the

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[^166]: FTSE Eurotop 300, cited by Ferrarini, Guido and Moloney, Niamh, *supra*, note 164, p. 316. See also, Murphy, Kevin, *supra*, note 71, p.61-64.


following financial year, in an independent remuneration report, or in the annual reports of the company (e.g. annual accounts).

In general matters, the information presented would allow shareholders to monitor the increases in the remuneration levels from one year to another; revise the different variables that composed the executive payment, and understand the pay/performance link, as individualized disclosure is recommended and shareholder remuneration requires prior approval.

While the above recommendation will increase the transparency of executive payments and pay-setting choices and enhance good governance practices, the efforts of the Community are nonetheless subject to one critic: they are contained in soft law mechanism that is not enforceable. Although the use of a soft law mechanism, such as a recommendation, allows a flexible approach in this field, there is a big risk that Member States ignore the mechanism and continue to permit blurry payment systems in the companies, thereby rendering the efforts of the Community meaningless.

### 5.2.3 Independent Directors

Another Community instrument that is closely related to executive payment is the ECO recommendation on the role of non-executive or supervisory directors. The recommendation follows the American trend towards maintaining boards of directors with a high number (if not a majority) of independent members. It is a great step towards the enhancement of the level of protection of minority shareholders of companies located within the Community.

In general matters, the ECO recommendation focuses in three areas, remuneration, nomination and auditing, and suggests the creation of one committee per each of such areas. It also recommends that the administrative, managerial and supervisory bodies of a company include a sufficient number of independent non-executive directors to ensure that any material conflict of interest is properly dealt with. Further, it suggest the separation of the role of the CEO from the chairman, in the cases of unitary board systems; the inclusion of directors with diversity of knowledge, judgment and experience to properly complete their tasks; and that directors devote enough time and attention to their duties.

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170 Rules enacted by the NYSE and the National Association of Securities Dealers (NASD) require companies to maintain boards of directors that are composed of a majority of outside independent directors as well as requiring companies to fully independent audit committees. For a full review see: Petra, Steven "Do Outside Independent Directors Strengthen Corporate Boards?", Journal of Corporate Governance, Volume 5, Issue 1, pp. 55-64.
This thesis stresses that the ECO recommendation would foster the protection of shareholders (particularly minority shareholders), employees and the market by tackling potential conflicts of interests between the managerial bodies and directors.

Conventional wisdom establishes that the appointment of independent directors in the board level results beneficial for the company since it reduces the likelihood of conflict of interest between the members of the board and the managers in the three areas covered by the ECO recommendation: remuneration, nomination and auditing. In first place, the inclusion of independent directors in the board would help strengthening corporate governance good practices by controlling CEO’s compensation, and judging performance-remuneration schemes in the shareholder’s interest. In second place, independent director would help maintaining the confidence of the public in the financial statements of the company, by providing a neutral overview to the real status of a company. Lastly, independent directors would reduce the subjective value of family links or other types of links, when nominating directors.

Thus, it is argued that if the recommendation is properly implemented by all Member States, it would reduce future Parmalat-type of cases by guaranteeing that proper governance actions are taken at the higher levels of the managerial. However, if the recommendation is not properly implemented by all Member States, the level of protection offered to minority shareholders would still be insufficient.

In that regard, it is stressed that the legal instrument used by the Community was not the most appropriate. While it is true that a recommendation allows a flexibility of approaches it nevertheless restricts the proper level of enforceability as it is a non-binding provision.

Protecting minority shareholders against the abuses of the stronger blockholders and the managerial is an area of extreme fragility at the EC level. The approach taken by the ECO lacks certain strength and does not guarantee that a proper level of protection would be achieved. As it was suggested in the preceding section, Member States may ignore the mechanism and continue to allow opaque governance structures within their companies, thus prejudicing the rights of minority shareholders.

Thus, it is emphasized that a stronger Community approach would have been more convenient for ruling in this important governance area. A directive, for example, would have permit flexibility and experimentation at the national level, at the same time that it would provide for a strong enforce mechanism against such abuses.
5.2.4 Responsibility of the Board of Directors

The recent ECO directive proposal for the modification of the EC accounting directives is a good example of a measure that truly reflects the problems of the Community and illustrates the way future EC corporate governance legislation should be enacted.\textsuperscript{171}

First, the proposed directive reaffirms the position sustained along the lines of this paper, in connection with the principle of subsidiarity and the extension of competences of the Community institutions in the area of corporate governance. The proposal expressly acknowledges that it is in compliance with such principle establishing that "(...)The objective of the action is to improve public confidence in financial statements. A central element in this is that financial statements must be comparable across the EU to benefit integration of capital markets. In ensuring equivalent transparency and thereby contributing to completion of the internal market, the proposed measures are in line with the subsidiarity principle"(stress added).\textsuperscript{172}

Second, the ECO proposal reflects the peculiarities and lacunas of the Community legislation since it is inspired in recent corporate governance scandals, namely Parmalat.\textsuperscript{173}

The proposal is divided into four main recommendations. The first recommendation aims at establishing a collective responsibility for the members of the board of directors in connection with financial statements and other important non-financial information. It further instructs Member States to establish sanctions and liability rules to punish the board members that do not comply with the accounting rules.

The second recommendation refers to related-party transaction. It brings a Community dimension to the accounting principles set under the International Accounting Standards (IAS) which require the disclosure of transactions entered into with related parties (e.g. family members, company managers). The idea of the recommendation is to extend the obligations set forth in the IAS to unlisted companies, in order to oblige them to disclose related-party transactions that are not undertaken under the usual commercial conditions.


\textsuperscript{172} Ibid, p.7.

\textsuperscript{173} The internal market Commissioner, Frits Bolkestein said: "Recent financial scandals show that investors and the public need more protection against cheats. (...)We want to kill four birds with one stone, by ensuring that company boards are responsible for what they tell the markets, that transactions with related parties are explained, that accounts reflect off-balance sheet arrangements and that markets know how companies are governed. That will build confidence in EU capital markets and reduce malpractice."
Although this recommendation is address to unlisted companies it nonetheless shows that in certain areas of corporate law, it is appropriate that Community standards go further than international standards. In this regard, the proposal complements the discussion presented in section 5.1 since it shows that the addition of a Community dimension to already defined international principles is sometimes needed.

The third recommendation, which is perhaps the most important one, is inspired in the Parmalat scandal and its relationship with its Cayman island subsidiary, Bonlat. The proposal seeks to ensure that all companies disclose full information about off-balance sheet arrangements, including the financial impact in the consolidated annual account statements. This far-reaching recommendation extends to all companies (listed or not) and obliges them to disclose operations with Special Purpose Entities (SPEs), even if they are located off-shore, like in the case of Bonlat.

The last recommendation creates the “annual corporate governance statement”. It obliges companies to issue a governance statement on a yearly basis in order for such companies to disclose the extent to which, and the manner in which they comply with the corporate governance code. Further information about the risk management system, the operation of the shareholders’ meetings, the shareholders rights and the operation of the board and its committees, should also be disclosed.

5.3 Second Objective: Fostering Efficiency and Competitiveness of business

As established by the HLGR II Report the main purposes of EC company law is providing a legal framework "for those who wish to undertake business activities efficiently, in a way they consider to be best suited to attain success". Similarly, the Action Plan provides as one of the two main objectives of the Community, the promotion and fostering of business efficiency and competitiveness within the EC as key factors of economic growth and job creation. Thus, company law should facilitate the running of efficient and competitive business enterprises.

Efforts, such as the enhancement of the market of corporate control and the Societas Europaea are cultivating a truly modern company law system in the Community.

But what are the effects of such efforts within the field of corporate governance? Do they represent the actual needs of the Community? These questions would be answered in the following sections.

175 Action Plan, supra, note 40, p. 5.
5.3.1 Enhancing the “market for corporate control”, is this the way to go?

As seen in the discussion held in chapter 4.2 the “market of corporate control” is an excellent mechanism that shareholders may use to monitor the activities of the managerial bodies. Indeed, said mechanism promotes a more dynamic market environment since managers would be pressured to do well, not only by insider forces (shareholders), but also by outsider forcers (manager’s market). Said mechanism is commonly implemented by the use of takeover bids, popular in market-control systems but very rare on large-control systems, such as the majority of the systems of the Member States.

With the aim of promoting the use of takeovers within member States, the EC recently passed a directive on takeover bids.\textsuperscript{176} In view of the ECO, the directive brings more certainty to cross-border takeover bids in the interest of all people concerned (e.g. employees, shareholders). When the first draft of the directive was proposed by the ECO, the internal market commissioner qualified the directive as "an essential step towards the objective of fully integrating European capital markets by 2005; it is a key element in our drive to make Europe the most competitive economy in the world by 2010".\textsuperscript{177}

Though it is clear that the takeover directive would enhance the market of corporate control, by providing transparent mechanisms for the implementation of takeover bids, it is nonetheless inexplicable why the Community invests time and effort in regulating an area that is not of primarily interest for the promotion of the internal market.

As highlighted in chapter 4.2, the poor implementation of takeover bids in Continental Europe results from (i) high levels of ownership structures in the companies located in continental Europe; (ii) the personal long-term relationships between the managerial and the shareholders and (iii) the role played by the banks in the corporate structure. Since these 3 limitations are deeply rooted in the economical and legal systems of the EC and are not easily alter, it is presumed that the applicability of a takeover directive in the large-control European market would be minimal.

In addition, and following the words of the internal market commissioner, if Europe is to become the most competitive economy by 2010, it will not do so by imitating measures of an alien market-control economy, but by fostering the current legal and economic institutions, with innovative measures that truly reflect the needs of the Community.

\textsuperscript{177} Commission of the European Communities, Press Release IP/02/1402, Brussels, October 2, 2002.
5.3.2 Societas Europaea: Opening the door

Perhaps the most attractive step taken by the Community institutions to enhance business efficiency is the recently passed Statute for the European Private Company (Societas Europaea)\(^ {178} \). Said Statute allows companies that perform activities in more than one Member State, the option of being incorporated as a single company under Community law without the costly and time-consuming obligation of having to set up a network of subsidiarities.

The Societas Europaea provides a fascinating example on how the Community can tackle the various obstacles resulting from the different legal and economical backgrounds of the Member States, with a measure that reflects the economic and legal particularities of the Community. It also opens the door for future policy making in the area of corporate governance and disregards *in limine* the arguments build up by certain EC policy makers and scholars, who often over-dimension the diverse approaches of the EC Member States as an excuse for not passing corporate governance rules.

6 Conclusions

This thesis shows that there is an urgent need for a Community dimension in the area of corporate governance. It highlights that the Community should take a stronger approach in such area by setting rules and standards that guarantee an adequate level of protection for market players. Only with such approach, the EC institutions would efficiently manage to reduce the probability of new corporate governance fallouts in the Community.

The analysis contained in this paper suggests that the stronger approach of the Community should be carried out taking into account three factors of important consideration:

- **First, the EC institutions should acknowledge that different legal and economic backgrounds imply different approaches.** It has been shown that there are major economic differences between the US and the EC markets. Contrary to the US, rooted on a market-control system; the Member States of the EC are mostly cemented in large-control systems. Such difference has a strong repercussion in the type of governance problems that may arise. As shown, in a large-control system the governance problems result from the abuses of majority shareholders in prejudice of minority shareholders (cf. Parmalat case); on the contrary, in market-control economies, those problems emerge from the abuses of the managerial bodies (cf. the Enron case). This demonstrates that the types of rules required for the proper functioning of each of such market is completely different and that therefore, the mere transposition of alien rules from other systems, is not advisable.

On the other hand, the study also recognizes the existence of major legal differences. It shows that contrary to the US, the approach taken by the EC Member States to regulate the structure of the board of directors is heterogeneous. In that regard, the analysis suggests that the EC institutions should take into account the different approaches of the Member States when passing policy rules.

In addition, the analysis highlights that since the majority of the Member States are rooted in a civil-law tradition, EC policy makers should not only issue soft law recommendations to tackle governance problems. It is argued that, in order to increase good governance practices, EC regulators should instead aim at enacting strong and fast-track mechanisms such as directives, which would eventually acquire the force of law and hence, would be rapidly and effectively enforceable at the national level.

- **Second, the Community should follow the steps taken in the US, but only where it is appropriate.** The EC institutions should avoid
passing "straight-jacket" regulations similar to the SOA as that would diminish the different approaches of the EC Member States. A diversified environment of corporate governance is mostly wanted, as it allows different preferences to be better served; encourages experimentation, and leads to innovative solutions. Thus, the Community should take a “rainbow” approach and protect the colorful efforts taken at the national level.

Though the protection of a diversified environment is particularly important, the Community should nonetheless seek at obtaining a higher degree of harmonization. The use of directives, as middle-point instruments between recommendations and regulations, would rapidly and efficiently achieve a higher level of harmonization. First, they would demand a stronger commitment by the Member States, as they would be forced to rapidly pass laws at the national level. Second, they would avoid uniformity and promote a flexible environment of experimentation at the national level.

Therefore, a directive providing general standards would help harmonization by establishing a common denominator of governance standards at the Community level. All the efforts of the Member States would depart from the same point and divert with innovative solutions at the national level.

In addition, the Community should imitate, to the required legal extent, the US response and empower the EC institutions (namely the ECO) to deal efficiently and speedily with governance problems. Empowering the EC institutions would be in compliance with the principle of subsidiarity enshrined by Community law. This is demonstrated by the results obtained from the “better attainment test”.

After running the test, it was evidenced that a strong action at the Community level would be the most efficient way to deal with governance problems. First, the interdependence of companies among the EC, shows that any action taken at the national level would not be sufficient to tackle governance problems. Second, the efforts taken at the national level by the EC Member States would not serve the purpose of avoiding future corporate governance scandals, such as those seen in Parmalat, ABB, Vivendi and Royal Ahold, to name but a few. Third, any action taking at the national level would not guarantee the stability of the EC internal market as such actions would only solve the specific fallouts of the national systems ignoring the problems of other neighbor systems.

- Third, the approach taken by the EC institutions should reflect the current state of the Community. In a large-control market the traditional internal and external control mechanisms are not efficient to properly deal with governance problems. This implies that the EC
institutions have two options: they can either foster the creation of a market-control system or, issue governance standards while preserving the current system. In light of the high costs and lengthily periods required for the implementation of a market-control system, the most efficient way to improve and foster good governance practices would be through governance standards.

While the paper highlights the fact that there is no need for a unified corporate governance code, as such code would eliminate experimentation and diversity at the national level; a coherent set of corporate governance standards is nevertheless required.

In this respect, the results of this analysis do not follow the conclusions reached by the studies taken at the Community level, which considered that the OECD principles provided a coherent set of governance practices and therefore, a European set of governance standards would merely provide an extra-layer of principles.

Contrariu sensu, the Community should promote the issuance of governance standards that reflect the peculiarities of the Member States. In that regard, the study shows that the OECD principles of corporate governance do not serve the purpose of achieving a de facto convergence among the governance practices of the Member States. This is because the OECD principles do not depart from the specificities of the EC Member States and therefore, the actual practices among the Member States of the Community do not reflect the standings of such principles.

The Community has taken initial steps to establish a coherent level of corporate governance standards, but that there is a still a long way to go. While some efforts seem rather useless (e.g. takeover directive) as they clearly disregard the necessities of the Community; other efforts, like the recommendation on executive payment and the recommendation independent directors seem well oriented, but it is dubious the level of harmonization they will achieve.

Critics a part, the proposals to modify the Accounting Directives and the recently passed Societas Europaea Statute, are efforts from which future proposals of the ECO should take example of. Only with the use of similar instruments, the Community will effectively reduce the probability of future corporate governance scandals and achieve true internal market stability.
Supplement A: The Enron Case

Enron Corporation, an energy-trading company domiciled in Houston Texas employed approximately 21,000 people and was the world’s leading electricity, natural gas and communications companies. As of December 31st 2000 the financial statements of Enron showed a profit of US$ 979 million. That year Enron Fortune Magazine named Enron "America’s most Innovative Company" and was ranked as one of the top ten companies in the US. The apparent healthy financial statements of Enron were seen as an example of success of America’s market-based economy. However, the panorama was totally different the next year. By October 2001, Enron declared a non-recurring loss of US$1 billion and was force to disclose write-off operations\textsuperscript{179} against shareholders for US$1.2 billion. On November 30, 2001 Enron filed for bankruptcy and two days later for Chapter 11 protection in the US.

Enron’s financial problems began to flourish in early 2001. Its financial instability resulted from its activities in the energy market and the setting of special purpose entities (SPEs), which were mere extensions of Enron. Enron used these vehicles to transfer funds to some of Enron’s directors and to protect itself from large loses in the market showing that those loses were covered by third parties (the SPEs).

The core problem in Enron was the activities undertaken by Enron’s directors (Mr. Skilling and Mr. Lay). Firstly, the accounting treatment of the SPEs was not duly scrutinized by Enron’s auditors. The now disappeared Arthur Andersen had certain concern on the way the SPEs were managed, but they failed to questionise the activities of the directors. Secondly, directors led a wide-ranging conspiracy to deceive investors about the true state of Enron's businesses. Mr. Skilling and Mr. Lay propped up Enron's share price from US$20 in early 1998 to more than $80 by January 2001, making thereby a profit of more than US$89 million from stock options between 1998 and 2001 and than US$217 respectively\textsuperscript{180}.

The Enron case highlights the need for integrity in business: for directors, to fulfill their duties and act loyally and in good faith, and for the external audit firm, to comply with its endeavor and scrutinize the activities of the directors. It also draws attention to the need of independent non-executive directors in the supervisory board\textsuperscript{181}.

\textsuperscript{179} A reduction in the value of an asset or earnings by the amount of an expense or loss. Companies are able to write off certain expenses that are required to run the business, or have been incurred in the operation of the business and detract from retained revenues. See <http://financial-dictionary.thefreedictionary.com>, page visited on May 2, 2006 at 8:20 p.m.


\textsuperscript{181} Mallin, Christine, supra, note 42, p. 2.
Supplement B: The Parmalat Case

Parmalat was Europe’s biggest diary corporation which employed approximately 36,000 employees around the world. It was founded in 1961 in Parma, Italy by Mr. Calisto Tanzi who was also the CEO and the chairman of the company when it collapsed. The Tanzi family was the holder of 51% percent of the shares by time the crisis hit the company. In addition, all the members of the board were from the Tanzi family. Twelve were executive directors and one, Calisto Tanzi, the founder, was both CEO and chairman.

The controlling shareholders used their influence in the board to expropriate considerable amounts from minority shareholders by implementing false accounting mechanisms. More than €17 billion in assets suddenly disappeared and where untraceable and more than €2.3 billion where used in related party transaction with other members of the Tanzi family. By late 2003, the financial scandal came to light when a hole of €8 billion was discovered in Parmalat’s accounting records.

The heart of Parmalat’s problem was a Cayman Island subsidiary called Bonlat. Said subsidiary was used to made deposits in the Cayman Islands and to carry out high-risk speculative swap operations. By the time of Parmalt’s collapse Bonlat had deposited approximately €4 billion in the Bank of America and undertaken operations for over €8 billion.

The Parmalat crisis became public in November 2003 when questions were raised about transactions with a mutual fund called Epicurum, another Cayman-based company linked to Parmalat. The crisis became worse with a chain of CFO’s resignations and appointments, a total of four during a one year period.

Following the Tanzi’s resignation Mr. Enrico Bondi, a turnaround expert was appointed. He quickly discovered that €4 billion were missing, and that €8 million in bonds of investors' money had evaporated as well.

These findings were complemented by a document released by the Bank of America in mid-December 2003, showing €3.95 billion in Bonlat’s bank account as a forgery. The bank’s officials stated that the cash simply did not exist and that the Bonlat deposits were made of thin air.

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182 Owen, Geoffrey, Kirchmaier, Tom and Grant, Jeremy "Corporate Governance in Europe and the US: Where are we now?", Palgrave Macmillan, 2006, p.6
184 Ibid.
The Parmalat case highlights the problem of family-owned business. It shows the overriding need of independent directors and draws attention to the fact that in certain cases neither internal nor external governance mechanisms are sufficient.
Supplement C: Number of listed companies

<table>
<thead>
<tr>
<th>Exchange</th>
<th>Total</th>
<th>2004 Domestic Companies</th>
<th>Foreign Companies</th>
<th>Total</th>
<th>2003 Domestic Companies</th>
<th>Foreign Companies</th>
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<tr>
<td>Nasdaq</td>
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<td>2,889</td>
<td>340</td>
<td>3,294</td>
<td>2,951</td>
<td>343</td>
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<td>NYSE</td>
<td>2,293</td>
<td>1,834</td>
<td>459</td>
<td>2,308</td>
<td>1,842</td>
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<td><strong>Total region</strong></td>
<td>5,522</td>
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<td>5,602</td>
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<td>Borsa Italiana</td>
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<td>271</td>
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<td>Budapest SE</td>
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<td>49</td>
<td>1</td>
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<tr>
<td>Copenhagen SE</td>
<td>183</td>
<td>176</td>
<td>7</td>
<td>194</td>
<td>187</td>
<td>7</td>
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<tr>
<td>Deutsche Börse</td>
<td>819</td>
<td>660</td>
<td>159</td>
<td>866</td>
<td>684</td>
<td>182</td>
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<tr>
<td>Euronext</td>
<td>1,333</td>
<td>999</td>
<td>334</td>
<td>1,392</td>
<td>1,046</td>
<td>346</td>
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<tr>
<td>Irish SE</td>
<td>65</td>
<td>53</td>
<td>12</td>
<td>66</td>
<td>55</td>
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<tr>
<td>Ljubljanca SE</td>
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<td>0</td>
<td>134</td>
<td>134</td>
<td>0</td>
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<td><strong>London SE</strong></td>
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<td>2,486</td>
<td>351</td>
<td>2,692</td>
<td>2,311</td>
<td>381</td>
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<td>Luxembourg SE</td>
<td>234</td>
<td>42</td>
<td>192</td>
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<td>Malta SE</td>
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<td>OMX Helsinki SE</td>
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<td>OMX Stockholm SE</td>
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<td>Oslo Bors</td>
<td>188</td>
<td>166</td>
<td>22</td>
<td>178</td>
<td>158</td>
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<td>Warsaw SE</td>
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<td>Wiener Börse</td>
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<td>99</td>
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<td>125</td>
<td>104</td>
<td>21</td>
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<tr>
<td><strong>Total region</strong></td>
<td>7,241</td>
<td></td>
<td></td>
<td>7,193</td>
<td></td>
<td></td>
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<tr>
<td><strong>Total region excluding the London Stock Exchange</strong></td>
<td>4,404</td>
<td></td>
<td></td>
<td>4,501</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Source OECD)
Supplement D: Ownership Structure

Ownership Structure: Percentage of listed companies under majority control

## Supplement E: Financial Systems

<table>
<thead>
<tr>
<th></th>
<th>Type of Financial System</th>
<th>Large-control</th>
<th>Market-control</th>
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</thead>
<tbody>
<tr>
<td>Share of control-oriented finance</td>
<td></td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Financial markets</td>
<td></td>
<td>Small, less liquid</td>
<td>Large, high liquid</td>
</tr>
<tr>
<td>Share of all firms listed on exchanges</td>
<td></td>
<td>Small</td>
<td>Large</td>
</tr>
<tr>
<td>Ownership of debt and equity</td>
<td></td>
<td>Concentrated</td>
<td>Disperse</td>
</tr>
<tr>
<td>Investor Orientation</td>
<td></td>
<td>Control-oriented</td>
<td>Portfolio-oriented</td>
</tr>
<tr>
<td>Use of mechanisms for separating control and capital base</td>
<td></td>
<td>Frequent</td>
<td>Limited (often by regulation)</td>
</tr>
<tr>
<td>Dominant agency conflict</td>
<td></td>
<td>Controlling vs. minority shareholders</td>
<td>Shareholders vs. management</td>
</tr>
<tr>
<td>Role of board of directors</td>
<td></td>
<td>Limited</td>
<td>Important</td>
</tr>
<tr>
<td>Role of hostile takeovers</td>
<td></td>
<td>Very limited</td>
<td>Potentially important</td>
</tr>
</tbody>
</table>

(Source: Berglöf, Erik "Reforming Corporate Governance in Europe", Journal of Economic Policy, Volume 12, Issue 24, p. 97)
Supplement F: Governance Ranking

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