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Some Recent Trends and Developments in Company Law

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Abstract

This paper summarises some of the findings of the research report that was presented to the December 2000 Stockholm conference. Four topics, on which further activities within the OECD can be recommended, deserve special attention: the functioning of the board of directors, the functioning of the general meeting, the issue of ownership and control, and finally the meaning of the legal capital. These topics are briefly developed, with a recommendation for future regulatory action.

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Some Recent Trends and Developments in Company Law

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Background

1. Company law is increasingly being perceived as an important building block in the organization of well-functioning economic systems. Several aspects of company law have a direct or indirect impact on the functioning of economic systems.

In the recent past the OECD has deployed considerable efforts to develop research and recommendations that could contribute to a better framework for the deployment of business. The most visible and widely celebrated document is the "OECD Principles of Corporate Governance". In these endeavours, "Corporate governance" is viewed not only in a narrow perspective, as a guarantee for protecting the interests of shareholders and stakeholders. It is also conceived in a wider context, as a significant instrument for ensuring the quality and efficiency of the overall economic organization. This macro perspective of corporate governance has recently been highlighted by international financial organizations imposing governance guidelines as conditions for granting loans, or other forms of financial assistance[1].

Following the OECD Principles of Corporate Governance, one should complement the analysis of economically relevant legal issues to related subjects that are likely to affect the optimal functioning of the business enterprises. These new challenging perspectives will be sought in the interaction between the financial markets and the traditional company law rules. The increasing reliance on the capital markets for attracting capital and the heightened competition for finance can be considered the main vectors of developments in the company law field. Here lies a fundamental role for the legal system: by correctly organizing the relationships between suppliers and users of capital, or allowing the parties to optimally frame their relationships, the legal system should attempt to secure that firms can function at the highest Pareto optimum. In the field of financing this criterion is relatively simple: the legal system should secure the best (the least expensive) financing

[1] See IFC governance plan for loans, FT 21 February 2001, 8; Peter Woicke, exec. vice president: "We want to push for corporate governance, transparency and particularly minority shareholder protection in our loan agreements". The Brazilian Government is reported to have agreed to IFC 's conditions.

conditions. By decreasing the cost of capital, one will enhance the firms' competitiveness and therefore their ultimate survival.

The efficiency of business firms and their financing is not only related to direct factors, e.g. the conditions at which securities may be floated. Indirect conditions such as the rights attached to the securities play an equally important role. This particularly applies to the ways investors can exercise influence on the companies they invest in. The possibility to efficiently exercise their voting rights is a key consideration for institutional investors' willingness to purchase the stock of certain companies. This is increasingly significant if institutional investors are obliged by regulation to exercise the voting rights attached to portfolio securities and are accountable to their investors for the way they have defended the value of their portfolio.

Transparency in the power relationship that stands behind the companies is, in continental European companies more than in Anglo-Saxon ones, a key factor in assessing the position of the outside investor and the benefits he can reap from participating in that company. Therefore, most regulations have attached great importance to the disclosure of the ownership and control of these companies. This knowledge also influences the position taken by both regulators and investors on the effects of a change of control. The corporate control market in Europe has been the subject of regulation that is fundamentally different from the American one. This difference is due to the presence of concentrated or "control" ownership in the European markets and the possibility for large block-holders to extract private benefits, both during the existence of the company, but more visibly upon a change of control. Control changes are a major event for unleashing the hidden value of the company, to the benefit of the outside investors. This is the meaning of the mandatory bid rule.

2. Four subjects will be dealt with in this paper. They were all subject to analysis during the recent OECD conference on company law reform in OECD countries and have been identified as areas where an active discussion is going on in the member countries, in several cases leading to new laws or regulations

The four subjects that were investigated by the survey related to

- the functioning of the board of directors
- the functioning of the general meeting of shareholders
- the issue of ownership and control.
- the meaning of the legal capital

1 The functioning of the board of directors.

3. In all member countries the corporate governance discussion has not subsided: after a first wave of debate was triggered by the enactment of formal governance codes, the second wave is now going on in the business firms themselves. These have become increasingly aware that the absence of strong governance practices may lead to a weakening of the company or its image[2]. A weaker image may influence the market valuation of their shares, as it seems that companies with well-established governance practice are more readily attracting institutional investors. Especially in cases of crisis, the poorly governed company would not be able to fall back on strong leadership and control by its board. Therefore, and although there is no formal regulatory pressure for doing so, companies are constantly looking for improving their governance practices.

It is amazing that at least up till now, the legislative or regulatory interventions in the field of corporate governance have not been very intense. The reasons for this prudent attitude by the regulators are several, and well justified. Good corporate governance, such as independence of directors is not so much a question of regulation, but of attitude, of character and of stamina. The governance practices are very diverse and often related to local legislation, traditions and use: it would be futile to try to streamline these differences. More convincing is the difference in ownership structure: with concentrated ownership, as is the case in much of the world, the Anglo-Saxon countries excepted, the governance model will necessarily express - and if necessary balance - some of the influence of the dominant shareholder.

4. Recently however, statutory provisions that are related to governance are being enacted: France has done away with the authoritarian regime of the PDG, the CEO that is also heading the board of directors[3]. Belgium prepares a draft law on corporate governance, containing the possibility to introduce a management structure close to a two tier board in the Belgian public companies, while the strict provisions on conflict of interest would prevent auditing firms to take up any business from the audited company. Italy has introduced new measures in the Draghi Reform (Testo Unico)[4].

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2 McKinsey and Company: Investor Opinion Survey on Corporate Governance, June 2000, 20 p., to be found at www.mckinsey.com/features/investor_opinion.pdf, see also "Furthering the Global Dialogue on Corporate Governance", 1998 International Survey of Institutional Investors, Russell Reynolds Associates.

3 See project loi relatif aux nouvelles régulations économiques (now in the French Senate for a second reading).

4 See art. 136 a.s. D.L .24 February 1998, nr. 58 (Testo unico). For a commentary, see MARCHETTI, P. AND BIANCHI, L. (eds.) *La Disciplina delle Società Quotate*, Milan, Giuffrè, 1999.

5. In these corporate governance reforms, a certain number of issues are dealt with in most jurisdictions.

One of the more visible features in much of the governance discussion is the idea of checks and balances in the exercise of power in large companies: decision making should be balanced and no single party, be it a large shareholder or a dominant CEO, should invariably have the ultimate say. The interest of minority shareholders, especially of institutional investors, although not represented on the board, should be duly respected. If not, they will exercise pressure on the board by intervening in the general meeting, or by voting with their feet, putting the share price under strain.

Another aspect that is repeatedly mentioned in governance matters is the increasing awareness of conflicts of interest: conflicts of individual directors[5], of members of the supervisory board, of controlling shareholders, auditors, of financial analysts, of institutional investors and so on. Conflicts normally trigger a duty to abstain, and, if significant, call for special procedures aimed at making the decision making more objective. These rules are often complied with without any statutory basis.

6. It is striking that *the* governance issue that has been occupying the best minds in Europe for the last 25 years has almost entirely been left unmentioned: co-determination is less frequently discussed these days, at least in those states that have not made it mandatory in the 60s and 70s, while in the other states its abolition has even been considered.

The phenomenon may be attributed to the introduction in several legal systems of better protections for the workforce, and better consultation techniques outside the ultimate decision-making process at the head of the company. By freeing the board from the obligation to negotiate with the labour representatives as part of its decision-making, the board has been able to focus on the interests for which it has been appointed. The interests of the stakeholders, mainly the employees, have been adequately secured by other means and through other organs, especially the Workers Council.

The recent agreement on co-determination in the European Company statute may lead to renewed interest for the issue. However, on the longer term the trend seems rather in favour of stronger consultation and information rights, less for more participation at the board level.

Very recently the discussion has flared up again in the Netherlands, where, after some public debate, there seems to be a renewed consensus for maintaining the existing framework[6].

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5 In Denmark all members of the board must declare to the supervisory board the number of shares they own in the company and in group companies as well. The information has to be kept up to date and is kept in a special register (s.53 Danish Act). The register is not accessible to the public.

6 See DE KLUIVER, H.J., 'Het structuurregime en beursvennootschappen: de feiten', *Ondernemingsrecht,* 2000, 453.

2 THE GENERAL MEETING OF SHAREHOLDERS

7. Five to ten years ago, the general meeting was not a subject that was considered very interesting, at least on the European continent. Most decisions taken at the general meeting were prepared by the large shareholders, leading the general meeting to rubber stamp matters decided elsewhere. Small shareholders usually abstained, not only from attending the meeting, but even from sending in proxies. Considerable efforts were deployed by the public authorities, e.g. in France to support the companies that tried to revitalize the general meeting. In the legal literature, voices were heard predicting, or calling for the abolition of the general meeting as a senseless ceremonial.

Business leaders do in general favour a reinforcement of the function of the general meeting, not as a decision making body, but as a communication and public relations instrument. The legal functions are generally considered less significant, except in exceptional cases, as a contested take-over, or more rarely, the election of directors.

The revival of the general meeting is the result of the changes in the ownership structure: shares are increasingly being held by institutional investors, and in some cases even by private individuals. Their interest for the general meeting is derived not from their will to exercise power, even less control in the company, as was the case in the former ownership structure, but from their will to be informed about the evolution of the company and to be involved in its development, in order to maximize the value of their investment.

As institutionalization of ownership progressed, the question of the effective exercise of voting rights gained interest. The organization of the general meeting, the right to submit questions, to put motions on the agenda, and especially to vote by proxy, or in some countries by mail, received more attention. As more and more foreign institutions are holding shares, new measures have to be taken to allow these important shareholders to take part in the voting mechanism.

8. Proxy voting could have been an interesting instrument to increase shareholder involvement. The model for the proxy voting mechanism is usually found in the US regulation: hardly any European state[7] has enacted a regulation similar to the US proxy solicitation rules.

[7] Italy (Art. 136 a.s. Testo unico, allowing for public solicitation of proxies) and Belgium (Art. 549 Companies Act previously art. 79 § 3, according to which the request for proxy must be presented to the Banking Commission no later than three days before its announcement.) In Belgium, the technique has rarely been used.

There are several fundamental answers to the question why proxy voting is different in Europe from the US: on the one hand, proxies usually are given to the members of the board, or to the chairman, often a confident of the controlling shareholders. On the other hand, small shareholders do not bother to cast their votes as the outcome of the decision has most of the time been reached in advance. As the identity of shareholders is not known, shares usually being issued in bearer form, shareholders have no possibility to know or reach each other, and the banks, depositories of these shares, invoke their professional secrecy to refuse to communicate the name of the shareholders, whether to other shareholders, or to the company.

More fundamental is the feature of proxy voting in Germany, Austria and Switzerland: in these states shares are deposited with a bank, on a mandatory or on a customary basis. The bank exercises the voting rights attached to these shares on the basis of a general proxy contained in the depository contract. As a consequence, general meetings in these states often are composed of a vast majority of the shares issued. However, with internationalization and institutionalization of ownership, the attendance is decreasing[8].

The main difficulties with proxy voting is the consequence of the cumbersome procedures that have to be followed for casting an informed vote: the agenda and the accompanying information is not always available, or cannot be consulted in time (also taking into account the need for translation); more or less complicated forms have to be sent in both directions, often over several layers of financial intermediaries. The entire procedure has to be rendered more efficient and more flexible. Only the use of modern information technology (ICT) allows adequate procedures and information flows to be put in place[9].

9. Voting by mail has been attempted in several states but obviously is not very successful, as the cumbersome procedure for registration as a voting shareholder and the insecurity of the identity of the mail voters remain. Therefore more efficient techniques have to be devised.

10. In several jurisdictions attention has been paid to the more intense use of ICT in the functioning of the general meeting in general and the voting procedures in particular[10].

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[8] SCHNEIDER UWE, 'Auf dem Weg in den Pensionkassenkorporatismus? Zehn Thesen zu den Auswirkungen der zunehmenden Beteiligung institutioneller Anleger an den Publikumsaktiengesellschaften', *A.G.*, 1990, 317.

[9] For details, J. WINTER, "Stemmen op afstand via het Communicatiekanaal Aandeelhouders" in *Corporate Governance voor juristen*, Kluwer, 1998, p.162.

[10] See NOACK, U., Modern Communication Methods and Company Law, www.jura.uni-duesseldorf.de/dozenten/noack/eblr.htm , who considers this restriction inconsistent with the first directive. However, traditional access remains general. See also NOACK, U., 'Modern Kommunikationsformen vor den Toren des Unternehmensrechts', *ZGR*, 1998, 592-616. SPINDLER,

Certain applications of electronic voting may be considered a variant of mail voting. Both are forms of distance voting. In each case, it is the shareholder directly who casts his vote. If all shareholders would be voting this way, the general meeting would be limited to counting the votes: no presentations, no discussion, in fact no need for a meeting.

Several states have allowed initiatives to go forward relating to the disclosure of the agenda, the accompanying information and the proxy form: these could be electronically retrieved by any person. Communications with shareholders would be handled in electronic form, at least if the shareholder agrees. Appropriate identification procedures will be necessary.

The voting procedures themselves are more difficult to handle: to allow the use of electronic devices for voting by the shareholders present at the meeting is not particularly controversial. More doubts arise with respect to distance voting. As electronic voting, for a certain number of years at least, will run parallel to the physical meeting, one should differentiate between the voting during the meeting itself, and voting in advance of the meeting. While the latter does not participate in the dynamics of the general meeting, the interaction is much greater for the first mentioned. The difficulties, whether technical or legal, to organise the latter are still manageable. These are increased considerably when the voting takes place simultaneous with the meeting. For the latter, a procedure could be worked out whereby the shareholders registered with a bank would send in their electronic votes with a declaration of the bank as to ownership, or the number of shares registered in their name. These votes would be stored in an "electronic ballot box" which would be opened only during the meeting. To organise a similar procedure during the meeting, simultaneous with the votes cast at the meeting, seems much more difficult, at least under the present stage of development of electronic communication.

11. From the angle of policies to be developed it is clear that multinational initiatives should be developed to ensure that the voting procedures be largely equivalent in the different legal systems, and that the minimum requirement for non-resident voters be laid down in an international instrument. The existence of these international procedures is an important tool for assuring the continuous interest and involvement of institutional investors in companies world-wide.

'Internet und Corporate Governance - ein neuer vitueller (T)Raum, Zum Entwurf des NaStraG', *ZGR*, 2000, 420-445, at 429; ANSA, *L'utilisation des moyens de télétransmission et les assemblées générales d'actionnaires* (Jan. 2000) www.ansa.asso.fr/site/rap1.htm ; Cook, "Information and Communication Technology: The Internet and Compay Law", in *Literature Survey on Factual, Empirical and Legal Issues - The ERSC centre for Business Research*, University of Cambridge (Cambridge1999) 1-39, see also www.dti.gov.uk.cld.review.htm

3. Ownership and Control

12. The increased importance attached to the position of the shareholders, expressed in terms of voting rights and participation in the general meetings has also lead to more attention to the structure of ownership. Several lines of reasoning converge in this renewed interest in ownership issues[11]. First, there are substantially different ownership structures around the world: concentrated ownership, whereby one of a few shareholders hold shares in the company which they therefore dominate, or control, while the remainder of the shares is in the hands of numerous investors, creates specific issues of control, of abusive exercise of this control power, but also of the relationship between these controlling shareholders and the company itself, its creditors and other stockholders. According to another pattern, found especially but not exclusively in the Anglo-Saxon countries, ownership is dispersed with no single shareholder being able to dominate the company. As a consequence the board of directors is more powerful. It is well known that corporate governance rules have been developed originally to deal with the latter case, although they have proved to be useful in the former case as well.

Knowledge of the precise ownership structure is therefore essential. Information on ownership, and on its changes was generally not available in the markets. Therefore disclosure duties were imposed in all systems, urging significant shareholders to report their acquisitions or divestments to the market authorities. The reporting thresholds are much linked to the prevailing ownership structure: relatively high in the US (10%) lower in most European states (10% in the directive, but de facto 5% in most states) or in some even lower (3% in Italy and in the UK). At present, one has a fairly comprehensive view of ownership of shares in most of the listed companies.

The system should however be further refined: the information is not always easily accessible; it is often reported with a certain time lag. More importantly, it does not confer a good insight in the ownership structure, especially when intermediate institutions, like trusts, holding companies, fiduciaries such as "administratiekantoren" intervene, behind which the beneficial owners can hide their interests. Therefore, the legislators should be invited to make the system more efficient.

[11] In general see: ROE, M., 'Strong Managers, Weak Owners, The Political Roots of American Corporate Finance', 1994; Comp Law and Finance, *J. Political Economy*, 1113-1155 (1998); See LA PORTA, R., F. LOPEZ-DE-SILANES, A. SHLEIFER en R. VISHNY, "Legal determinants of External Finance", *Journal of Finance* 1997, 1131-1150; LA PORTA, R., F. LOPEZ-DE-SILANES, A. SHLEIFER en R. VISHNY, *Law and Finance*, Journal of Political Economy 1998, 1113-1155; LA PORTA, R., F. LOPEZ-DE-SILANES en A. SHLEIFER, "Corporate Ownership Around the World", *Journal of Finance* 1999, 471-517; LA PORTA, R., F. LOPEZ-DE-SILANES, A. SHLEIFER en R. VISHNY, *Investor Protection and Corporate Governance*, working paper Harvard University, 2000, 39 p.

Reporting on changes in ownership is not only of interest to identify significant transactions in shares: the reports on their transactions are equally significant as the ones published by directors of companies. In some systems - but not in all - directors and or officers have to disclose their interest in the shares of the company they direct. Third parties, i.e. the markets, find valuable indications in these reports about the attitude of the directors as to the future prospects of the company. The issue is also linked to the matter of insider trading. In this respect too, the system could be made more transparent.

13. Another aspect of ownership reports is related to the market for corporate control. Two aspects require attention: first the regulation of take-overs and other control acquisitions, secondly the consequence of a control acquisition for the other shareholders.

Most jurisdictions have now been well acquainted with take-over bids, and have enacted mandatory rules or self-regulation. For EU Member countries, these will have to be adapted after the enactment of the 13th EU company law directive on take-overs. Most regulations are based on the general principles that can also be found in the EU directive:

- rules on the announcement of the bid
- rules on disclosure by the bidder
- rules on disclosure of the position of the target's board
- rules on higher and competing bids
- rules on parallel transactions by the parties involved
- rules on defensive actions undertaken by the target board: the neutrality rule for the board of directors

In addition, the EU directive contains important regulations on conflict of laws issues, opposing different legal systems and their supervisors. In case of diversity of jurisdiction, the transaction itself will mainly be regulated according to the rules of the market where the securities are listed, and will also by supervised by the authorities of that market, but some aspects will necessarily be governed by company law rules[12].

14. In most European systems, but not outside Europe, shareholders who acquire control, as defined, in listed companies have not only to report their acquisition, but are bound to bring a bid for all the remaining shares. This is the much-discussed "mandatory bid", a rule that is planned to be introduced in the 13th EU directive on take-overs.

The philosophy on which this rule is based has been the subject of much controversy in Europe.[13] In the US and in Canada, mandatory bids are

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[12] See for a first analysis: WYMEERSCH, 'Regulating European Markets: the Harmonisation of securities regulation in Europe in the New Trading Environment', Cambridge conference, July 2000, to be published.

[13] L. BEBCHUK, "Efficient and inefficient sales of corporate control", *The Quarterly Journal of Economics* 1994, 957-993; also M. KAHAN, "Sales of corporate control", *The Journal of Law,*

not known, and in Australia, although the usefulness of the rule had been discussed, the parliament finally declined to introduce it as a legal device.

In Europe, with its concentrated ownership structure, the original idea was to insure that upon a change of control, when the controlling shareholder sells his block to another group, the control premium will be shared by all shareholders and will not be cashed exclusively by the selling controlling shareholder. Later the rule developed as a powerful exit device upon changes in the group structure: it is increasingly seen as an ex ante minority protection upon transfer of the company into a group context[14]. Shareholders that would be left behind after the company is included in a larger group would be allowed to leave the company, or exchange their shares for the acquiring parents' shares, thereby eliminating all possible conflicts of interest with the parent, and allowing the parent to manage the subsidiary without the restrictions flowing from the presence of minority shareholders.

Therefore the mandatory bid rule has been considered as useful in both systems with a dispersed and with a concentrated ownership.

The way the rule has been framed is still subject to further refinement, and harmonization: presently in several European countries, the rule has a statutory character, but in the UK, Germany and in the Netherlands, it is self-regulatory or voluntary. Germany has however announced plans to introduce legislation on take-overs, including mandatory bids. The thresholds also vary: a bid is mandated on acquiring control, but how a "control acquisition" is defined differs considerably. In most jurisdictions it is fixed as a stated percentage (often 30%[15], or 1/3rd[16], in some case even 50%[17] a complicated system persists in Spain[18]) while in others it depends on the individual control situation[19].

Economics and Organization, 1993, 369-379. In the Netherlands: see Timmerman, L. 'Tegen het verplichte bod', in *Corporate governance voor juristen*, Kluwer, 1999, 105; DE KLUIVER, H.J. 'Voor het verplichte bod', *Ondernemingsrecht* 1998, 253; WYMEERSCH, The mandatory bid, a critical view, in HOPT and WYMEERSCH (eds) *European take-overs, law and practice*, Butterworth 1992, 362. SKOG, 'Does Sweden Need a Mandatory Bid Rule? A critical Analysis', Corporate Governance Forum, 1995.

14 See the proposal formulated in the study report: Forum Europaeum, Konzernrecht für Europa, *ZGR*, 1998, 72; in English: Corporate Group Law for Europe, Corporate Governance Forum, Stockholm, 2000, 111 p.. For an analysis, see HOPT, K. J., 'Common Principles of Corporate Governance in Europe?', paper prepared for the Millennium Conference in London, 7 April 2000, to be published in MARKESINIS (ed.), *The Coming Together of the Common Law and the Civil Law*, Oxford 2000.

15 Italy (TUF), Ireland (Rule 9.1 Take-over Panel Rules).

16 Switzerland (art. 32 § 1 SESTA), France.

17 Greece.

18 In Spain, the bid should aim at acquiring an additional 10 % once the 25 % threshold is crossed, and 75 % upon crossing in 50% threshold.

19 In Belgium, "control" is defined on a case-by-case basis, often at less than 33%, if the bidder acquires the shares at more than the market price.

Take-over transactions are usually structured as uncontested take-overs but sometimes changes into a regular take-over fight, especially when the threshold triggering the obligation to offer has been fixed at a relatively low level, leaving room for other parties to launch a competing bid. In practice most mandatory bids are the result of a full change of control: the bid for the remaining shares leaves no room for competing bids. In order to avoid this lack of competition, some legal systems have declared the initial transfer of the controlling block non-binding: the seller of the control block can still tender his shares in a subsequent higher bid.[20] This restores the public auction philosophy on which the take-over bid is based.

15. Another set of rules relates to the going private technique that often constitutes the third step on the way to de-list the target company. If the public bid has yielded a percentage of shares exceeding 90% to 95%, the bidder may be obliged to launch a bid for the remainder of the shares at the same price. In some jurisdictions, minority shareholders can oblige the bidder to launch the bid, either before or after the bid period[21]. This remedy is often supplemented by squeeze-out remedies, whereby 90% or more of the shareholders can oblige the minority to transfer its shares to the controlling shareholder[22].

16. Apart from mandatory bids, the two most frequently discussed topics in relation to take-over bids concern the position of the board in case of a contested take-over and the attitude to be taken vis-à-vis anti-take-over defences.

As to the first issue the EU directive takes a very strict position: the board should not engage in any action likely to frustrate the bid. This is also the UK rule that has been duplicated in several other jurisdictions. One will notice that the US position, as decided in Delaware case law, takes a very different stand. There the board may oppose the bid, in the interest of the shareholders. These differences in philosophy could in part be related to differences in the ownership structure. On the European continent, the board is the direct confident of the significant shareholders, at least in companies that are not fully controlled.[23] The neutrality principle therefore avoids the board taking an independent position, and eventually thwarting the course of action taken by the significant shareholders. In the UK the same rule is

[20] See Paris, 1st Ch., sect. CBV, 27 April 1993, *La Mutuelle du Mans Assurance-Vie et autres c. Office Commercial Pharmaceutique-OCP: Bull. Joly bourse,* 1993, 396.

[21] E.g. in France: art. 5-6-1 of the Règlement général of the Conseil des marchés financiers; See Forum Europaeum, nt. 15, who advocated this remedy as an instrument to solve group problems.

[22] See Forum Europaeum, footnote 22.

[23] In these cases, it is unlikely that the issue of a revolting board would arise, and if it does, the case will be decided against the board.

followed for different, but ultimately similar reasons: the shareholders should remain free to act.

The issue of defences is more controversial[24]. Post-bid defences were frequently found in all jurisdictions. Many of these were laid down in the company's act: issuing of additional shares in favour of a specific shareholder, repurchases of shares from a shareholder, clauses limiting the transfer on the shares, or reducing voting rights, or allowing voting caps, to name but a few. In several jurisdictions, several of these subsist, while in others (especially France and Germany) the law has removed them from the statute book. There is a general trend to do away with defences. This trend is supported by the above mentioned provision in the 13th EU directive, according to which any intervention of the board after the bid has been announced would be forbidden. In the US, defences would normally be reviewed in light of the fiduciary duties to which the directors are held: directors may oppose a bid, in the interest of the shareholders.

Pre-bid defences are not governed by any of the EU directives: some rules would have been stipulated by the planned, but never adopted fifth EU directive. Here national law continues to present a very diverse picture.

Post bid defences are most of the time structural: holding companies, Dutch administratiekantoren, voting agreements, etc. Dutch companies have made an extensive use of these techniques, some being both post-bid (and hence forbidden under the forthcoming EU directive) and pre-bid.

The markets exercise increasing pressure on companies to abandon their defences. Recent research in the Netherlands has indicated that there are clear negative abnormal returns on share certificates issued by "administratiekantoren", a technique that can be compared to voting trusts, but not on shares issued by companies attempting to defend themselves by issuing special classes of shares to which control rights in case of a contested take-over are attached[25].

17. The issue of anti-take-over defences is much richer than the mere use of legal techniques: in some states structural features have more or less powerful defensive effects. So is there an argument being developed according to which co-determination techniques constitute a defensive

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[24] K.J. HOPT, Präventivmassnahmen zur Abwehr von Übernahme und Beteiligungsversuchen, *WM*, 1991, n° 5, 22-30, as to the directive: E. WYMEERSCH, "Les Défenses Anti-OPA après la Treizième Directive. Commentaires sur l'Article 8 de la future Directive", Mélanges en l'honneur de Jean Stoufflet, *L.G.D.J.*, 2000, 397; FERRARINI, G., 'Le difese contro le O.P.A ostili: Analisi economica et comparazione', *Rivista delle Società*, 2000, 737. For a comprehensive overview of anti-takeover defences, see MAEIJER and GEENS, *Defensive measures against hostile takeovers*, Dordrecht, Nijhoff, 1990.

[25] DE KLUIVER, H.J. 'Het structuurregime en beursvennootschappen: de feiten', *Ondernemingsrecht* 2000, 453, referring to the research undertaken by Honéee and Timmerman, and by the Tilburg group, directed by Moerland.

technique, at least in the Dutch case, but less in the German case. In Dutch company law, the entire supervisory board is appointed by way of co-optation, excluding any influence of the shareholders on board appointments. In the German system, the shareholders appoint half the board of the largest companies: here control can be acquired by successfully bidding for the shares.

Other structural techniques are based on the intervention of the banking system in the exercise of voting rights for which the banks have received proxies from the shareholders.

The issue of regulating take-over and dealing with defences against take-over is clearly going to be on the agenda of regulators for the next years to come.

4 The legal capital

18. The rules on and the function of "legal capital" present radically different features depending on the legal system analysed. In the US, Canada, and Australia[26], legal capital plays only a limited role: the notion of shareholders' equity, aggregating capital, surplus or reserves and other elements of own funds is the criterion used for determining the position of shareholders versus creditors. Creditor protection is based, not on the notion of the capital, but on other techniques, such as covenants imposed by creditors, or rating techniques.

In Europe, as a consequence of the Second directive, but also in other jurisdictions, such as Japan, the legal capital of a company continues to play a central role, both in terms of creditor protection and for determining the relative position of the shareholders. Strict rules on capital go along with provisions on disclosure of annual accounts, even for the smaller companies. But numerous other rules are linked in one way or another to the concept of the capital as the central yardstick for creditor protection and for safeguarding the position of the shareholders and investors.

The European concept has recently been criticised in legal writing[27]. It is considered too rigid, sometimes superfluous, and counterproductive for the efficient managing of modern companies, especially of the listed ones. Part of this criticism has been taken into consideration at the level of the European Union: the SLIM working party that was commissioned for reviewing the first and second EU directives made a number of proposals that would reduce the

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[26] FORD, AUSTIN AND RAMSAY, *Ford's Principles of Corporation law*, § 20310 (Butterworths, 9th ed).

[27] See KÜBLER, 'Aktienrechtsform und Unternehmenverfassung', *AG*, 1994, 141; KÜBLER, MENDELSON AND MUNDHEIM, 'Die Kosten des rechtsökonomische Analyse des amerikanischen Erfahrungsmaterials', *AG,* 1990, 461; E. FERRAN, 'Legal Capital Rules under the Pressure of the Securities Markets - The Case for Reform, as illustrated by the UK Equity Markets', in Siena Conference, to be published. Also: L. ENRIQUES, 'As simple as it may be: the case against the Second Company law directive Provisions on legal Capital', Bologna 2000.

relative burden of the capital provisions in the second directive (see for the report of the SLIM working party: www.law.rug.ac.be/fli/WP/SLIM). These proposals have been well received in several member states and are now the subject of further discussion at experts level.

Whatever the outcome of these discussions, the usefulness of the legal capital itself will continue to be contested. The driving engine behind this development is once more the increasingly important role of the securities markets and the comparison with the regulation and requirements as applicable or practised in the United States. In most US jurisdictions, companies function without a legal capital, at least without this capital being a reference point for any regulation. Therefore this debate can also be situated on the background of the drive for more convergence in the regulatory requirements especially for larger companies.

It seems useful to try to develop a few of these points of criticism and attempt an evaluation of their relative value. The second EU directive will be followed as a guide.

4.1 The technique of the minimum capital

19. The amount of the minimum capital, fixed at 25.000 euro is widely considered too small for offering any protection to creditors. In cases of compulsory liquidation, such as bankruptcy, creditors most of the time find little relief in so small an amount of capital. Banks usually request additional guarantees, whether from the company itself, or from its shareholders. Commercial creditors increasingly use reservation of title or similar techniques. In the financial sector, the notion of capital as such is not used, but the larger notion of "own funds" is used instead, and there the requirements are fixed in function of the company's business. If own fund requirements are imposed for firms engaged in other business, the markets, both the share markets as the creditors, will determine their position in function of other criteria, among which the legal capital rarely plays any role. In addition, only the publicly traded limited liability companies, supposedly the largest companies, are subject to this rule, but not the privately held companies. This difference leads to regulatory arbitrage with is best highlighted in the Centros case[28].

[28] See Centros case, ECJ, Case C-212/97, § 35, 9 March 1999; only a few comments can be mentioned: DE WULF, H., 'Brievenbusvennootschappen, vrij vestigingsrecht en werkelijke zetelleer' (1999) *Vennootschap en Fiscaliteit*, 3; DE WULF, H., 'Centros: vrijheid van vestiging zonder race to the bottom (1999) *Ondernemingsrecht*, 321; WYMEERSCH, 'Centros: a Landmark Decision in European Company Law' in TH. BAUMS, K.J. HOPT & N. HORN (eds.), *Corporations, Capital Markets and Business in the law*, Kluwer Law international 1, 2000, 629; SANDROCK, 'Centros, ein Etappensieg für die Überlagerungstheorie' (1999) *ZGR*, 732; EBKE, 'Das Centros-Urteil des EUGH und seine Relevanz für das deutsche Internationale Gesellschaftsrecht' (1999) *JZ*, 656; J. SEDEMUND/F.L.HAUSMANN, note in *Betriebsberater* 1999, 810; W. MEILICKE, note in *Der Betrieb* 1999, 627; H.W. Neye, Kurzkommentar in *EwiR* 1999, 259; G.H. ROTH, "Gründungstheorie: ist der Damm gebrochen?", *ZIP*, 1999, 861; E. WERLAUFF, "Centros

This criticism may however be further refined: for small companies, the requirement of an initial capital may be an obstacle, not for setting up new businesses, but for shielding the businessman from shifting the risks of his business to his creditors. There is some evidence that the absence of capital is reflected in a higher propensity to become insolvent[29]. Therefore, an argument could be made for requiring an initial capital that would only be applicable to the smallest firms organised in the form of a limited liability company. The larger firms would in that hypothesis be exempted. At present the Second EU directive requests exactly the opposite.

4.2. Shares with nominal value.

20. Companies in most European states have shares with a nominal value, being the amount of the initial contribution that has, in accounting terms, been booked to the capital account. It does not even reflect the shareholder's contribution. At the initial formation, the significance of this figure is doubtful, as it merely serves to determine the relative position of the shareholders. After some time it becomes misleading, as the actual value of the shares has no relationship with the nominal value. Stating the nominal value confers the wrong message: at some time in the past the market prices on some stock exchanges were quoted in percentages of the original nominal value. This confusing technique has fortunately been abandoned.

The EU directive allows shares without nominal value: here the concept of nominal value is not stated in the company's charter but is the result of a calculation, dividing the nominal capital by the number of shares issued. This figure is not disclosed, so that it cannot be considered misleading. But the actual meaning of the "accountable par" is far from clear.

In both cases there are considerable problems of a technical nature: when additional shares have to be issued, these cannot be sold under the nominal value, [30] or under the "accountable par". If due to a fall in market price the new shares have to be placed under the nominal value, the said prohibition would request that the capital first be reduced, exposing the company to claims from creditors to be paid right away[31]. The regime is less

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aus dänischer Sicht", *ZIP* 1999, 867; J.C. CASACANTE, noot in *RIW* 1999, 450; R. FREITAG, "Der Wettbewerb der Rechtsordnungen im internationalen Gesellschaftsrecht" *EuZW* 1999, 269; P. ULMER, "Schutzinstrumente gegen die Gefahren aus der Geschäftstätigkeit inländischer Zweigniederlassungen von Kapitalgesellschaften mit fiktivem Auslandssitz", *JZ* 1999, 662; B. HÖFLING, "Die Centros-Entscheidung des EuGH- auf dem Weg zu einer Überlagerungstheorie für Europa", *Der Betrieb* 1999, 1206; P. KINDLER, "Niederlassungsfreiheit für Scheinauslandgesellschaften?", *NJW* 1999, 1993; J.-P. DOM, "Société à l'étranger et succursale chez soi: le *law shopping* communautaire", *Bull. Joly soc.* 1999, 708.

29 WYMEERSCH, 'Kritische benadering en synthese van de besproken vennootschappen', in *Miskende vennootschapsvormen*, Kluwer, 1991, at 170.

30 Art. 8 (1) of the Second directive.

31 According to art. 32, Second directive.

stringent for shares with an “accountable par”, depending on the states that have introduced that technique[32].

The situation becomes more complicated if the voting rights attached to the shares are linked to the capital contribution these shares represent, as is the case in some statutes. Here it has been argued - and whether that argument convinces is beyond the ambit of the present paper - that the voting rights remain fixed, once and for all, in relation to the proportion the share represents in the capital. In case of increase of the initial capital contribution, or issue under the par value, the rule would lead to recognising different voting rights depending on the contribution of each share to the capital.

The discussion on the usefulness of nominal value and accounting par value as legal techniques was also put on the agenda of the SLIM working party, but due to time constraints, these items had to be postponed for further analysis.

The technique followed in other legal systems is much simpler: the shares are valued, irrespective of their contribution to the capital, in terms of a percentage of the overall value of the company. Each share representing a certain percentage of the company, the price at which additional shares could be floated will be used as a basis for calculation the market value of the company, divided by the number of shares. Voting rights will be equal, unless the law allows derogating from the one share, one vote rule. In that case, the charter provision will determine the number of shares, irrespective of any reference to the capital.

4.3 Pre-emptive rights

21. Pre-emptive rights give present shareholders a priority for acquiring newly issued shares. This is useful if - as is often the case - the new shares are issued at a discount in relation to market value, as otherwise the financial value of their shares would be diluted. Significant shareholders also have an interest to be first offered the shares: they will be able to maintain their relative position in the company. In theory at least, controlling shareholders could take a more distant attitude: as they can decide whether new shares will be issued, they could in any case influence to whom the shares would be offered for subscription.

In today’s financial markets, the attitude taken towards pre-emptive rights is rather differentiated. If the shares are issued to institutional investors, in a block, at full market value, there is no need to protect the investors, as there will be no dilution. If the shares are issued at a discount, or

[32] E.g. Belgium, art. 606 2° (ex art. 33 bis, § 6) Companies Code; Luxembourg, art 26-5, L. 10 August 1915; France: art. 225-128 Companies Code.

if there is no readily available market price, there are good reasons for applying pre-emptive rights.

The SLIM working party proposed to simplify the rules on pre-emptive rights, and render issues by listed companies possible at full market value without having to apply the expensive and cumbersome procedures of the pre-emptive offering of securities.

4.4. Valuation by experts

22. The EU directive provides that contributions in kind should be valued by an independent expert: this expert shall value the contribution and "state whether the values arrived at [...] correspond at least to the number and nominal value, or where there is no nominal value, to the accountable par and where appropriate, to the premium on the shares to be issued for them".[33] This independent third party valuation constitutes a safeguard against the founding shareholders inflating the value of their contribution, to the detriment of the creditors. The procedure is cumbersome, and expensive.

Apart from the theoretical argument whether any valuation of the contribution will protect creditors[34], it has often been argued that in some cases these expert valuations add no value to the formation process, and therefore should be abandoned. This is especially the case if the assets contributed have been fully and effectively valued at regular market prices. In case of listed or regularly traded securities being contributed, one could be doubtful of any expert valuation that would arrive at a figure different from the one appearing from the market price. Therefore it has been proposed to do away with the expert valuation requirement if the assets can be valued on the basis of a price as determined in liquid and regularly functioning markets. This point is of special importance in the case of share for share take-over bids, when a listed company offers its shares in exchange for the target's shares.

The rationale of the rule could be extended to other cases, when assets are valued at their market price, e.g. in the accounts of a company. Contribution of these assets would not necessarily call for an additional valuation, if the accounting valuation is reflecting their fair value and has been regularly audited. It might be useful to check to what extent this simplified valuation requirement would converge with the IAS valuation rules.

The SLIM working party formulated a proposal in the stated sense: if assets have been valued in a recent financial statement of a company, is there a reason for proceeding to an additional expert valuation if these assets are

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33 See art. 10, Second directive.

34 And whether that protection should not more readily be pursued by the valuation in the annual accounts.

being contributed, provided the valuation has been effected in the same perspective? [35]

4.5 Share buybacks.

23. In today's financial markets, share buy backs are among the standard tools for companies disposing of their excess cash, and avoid the market sanctioning the company for not returning the cash to the shareholders. In financial terms buybacks are merely an alternative to dividends: in both cases the funds are returned to the shareholders, so a to enable them to freely diversify their risks better than any company management could ever do. Therefore, buybacks should follow the same rules as applicable to dividends: if one adheres to the technique of legal capital, shares can be bought back - as dividends can be distributed - up to the amount of the distributable net assets.

Traditionally the legal requirements for being authorised to repurchase own shares are very strict: the idea behind this restrictive attitude is that by repurchasing shares, the company may jeopardise the creditors' rights against the company, and indirectly annihilate the legal capital as a guarantee for creditors. However that reasoning would not apply if the maximum amount that could be used for buying back shares is limited to the distributable net assets, which - save for the tax consequences - could be distributed under the form of dividends as well.

As buybacks may conflict with equal treatment of shareholders, one has widely admitted that repurchasing on the open securities market should take account of that requirement. Unanimous consent of the shareholders could be considered as equivalent.

The SLIM working party made a proposal in that sense, mainly limited to listed companies.

4.6. The prohibition of "financial assistance"

24. The rules prohibiting financial assistance by a company to a shareholders or to a third party in order to enable these beneficiaries to acquire shares of the company have been introduced all over Europe as a consequence of their inclusion, at the demand of he United Kingdom, in the Second directive. The rule applies to direct credit, or to guarantees given by the company for loans to purchasers of its shares.

[35] SLIM Report: "no expert opinion is necessary if the assets have been the subject of an independent valuation provided that these valuation reports are sufficiently recent and reliable (e.g. not older than 3 months), these reports have been established in the same perspective of valuation and there have occurred no major changes with respect to the assets contributed".

These rules have been a drag on numerous transactions, especially management buy-outs. Lawyers have been called upon to imagine techniques to avoid the rule to be applicable: it has been reported that this practice represents a considerable sum of lawyers' income in the London city. In some jurisdictions, apart from the nullity of the transactions, the rule is enforced even by criminal sanctions. Banks are very loath to engage in transactions that might come close to a violation of this provision.

The rule is amazing in many respects: if the board would be granting a loan to an insolvent debtor, this might constitute a breach of its duty of care but the loan itself would not be prohibited. If the debtor of the loan is solvent, there is no reason for prohibiting the beneficiary acquiring shares. Does it make difference if he substitutes own funds with money obtained from the company?

If the beneficiary of the loan would be a director of the company, there is reason to apply the rules on conflicts on interest, if any. But according to the prevailing regulation, the prohibition applies even if the directors of the company are acting in perfect good faith, or without any conflicting interest.

If the funds were distributed by way of a dividend or a share buyback, there would be no objection. Why then deal with loans more harshly, the more as these maintain the creditors' asset base?

25. The attitude of the EU member states towards this prohibition is quite diverse**.** Some states apply the prohibition to all companies, both public and private. Other states limit the rule to public companies and fully or partially exempt private companies. By converting the company into a private company, one could easily escape the prohibition. In some jurisdictions, adhering to the creditor protection argument, the prohibition is limited to the non-distributable own funds. If the company could have distributed by way of a dividend the same sums, there is - a fortiori- no reason for imposing restrictions if the funds are to be repaid by the recipient.

A more radical attitude would be to abolish the prohibition outright: it is a stump stick, attacking what may be a problem in certain cases with a remedy that is by no means proportionate to the objective. The rules on director's duties could more adequately solve this type of problems, rather than any blunt prohibition.

26. The conclusion of this overview of the issues arising under the heading of the legal capital is a relatively simple one: it is necessary to revise the rules on legal capital and to assess their relevance in terms of economic benefits or burdens. In any case a considerable simplification is necessary. A guiding thought might be that in today's financial markets the guarantees that were supposed to be derived from the rules on legal capital are largely achieved by the sanctions of the markets. But also for unlisted shares, question marks can be put to many of the strict regulations on legal capital. These issues are often more related to the national implementing regulations than to the European directive.