Corporate Governance in Europe

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I. INTRODUCTION

Corporate governance in Europe is an interesting and timely subject for this Symposium because European corporate governance is where American corporate governance was five to seven years ago. There are several reasons why the European corporate governance movement has been slower to develop than it did in the United States. Europe, as a continent, is still a number of sovereign countries, has a variety of languages, and a significant number of different corporate laws.[1] The shareholder structure is different from that of the United States.[2] Corporate shareholder structures in Europe consist of holding companies, government holdings, wealthy families but a relatively small institutional shareholder base.[3] In reaction, the American institutions are trying to implement the governance system that has been so successful here, but they recognize that there is still a long way to go.

II. NEEDED CHANGES IN SHAREHOLDER STRUCTURE

I think European shareholder structure is the most resistant to change. A holding company holding five to eighteen percent of a corporation can exercise control of a corporation because of the non-activism of the other shareholders. Institutional shareholders are changing, but they still continue to use the Wall Street rule — "If I do not like the company, I walk" — rather than voice their opposition. Although they

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* This speech was part of a symposium held at Fordham University School of Law on March 13, 1997 entitled **Reshaping Corporate Governance & Shareholder Activism for the 21st Century.**

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[1] *See* Eric Berglof, *Company Reforms Must Shed More Light*, INDEPENDENT, Aug. 10, 1997, at B5 (discussing the reform of corporate governance in various European countries).

[2] *See* Mark J. Roe, *Some Differences in Corporate Structure in Germany, Japan, and the United States*, 102 YALE L. REV. 1927, 1977 (1993) (discussing the differences between the corporate structure of Germany, Japan and the United States).

are starting to voice their grievances, they are still a long way from the level of activism now in the United States.

For example, there was an article in *The Economist* about international institutional investors ousting Carlo DeBenedetti from the board of directors of Olivetti SpA. In that case, it appeared that the shareholders succeeded in removing Mr. DeBenedetti from the board of directors.[4] Mr. DeBenedetti, however, was replaced by one of his lieutenants and the international institutional investors only obtained four out of seventeen seats on the board of directors.[5]

In my opinion, it could take five to seven years for the European corporate governance movement to attain the level of success it has in the United States.

III. NEW FORCES IN CORPORATE GOVERNANCE

The European system of corporate governance will change for several reasons. First, European institutional shareholders, such as pension funds, are becoming larger and more numerous such as those in the United States which are traditionally large institutional shareholders.[6] Many pensions funds in Europe represent government employees because key sectors of the economy, including the telephone companies, railways, and airlines, are government owned. These government owned companies do not have the large pension funds that are seen in the United States, because they do not receive the same funding.[7] When the government-owned corporations of Europe undergo privatization, the newly private companies will have

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[3] *See* Gary L. Bergstrom, *Europe's Coming Pension Revolution,* WALL ST. J. EUR., Nov. 6, 1991 (stating that the European Community Commission approved draft legislation for a uniform pension fund industry throughout Europe).

[4] *See Ciao, Carlo,* ECON., Sept. 7, 1996, at 7 (reporting that Carlo DeBenedetti quit after pressure from the current CEO Francisco Ciao, and institutional investors); *see also Olivetti Self-Destructs,* ECON., Sept. 21, 1996, at 16 (stating that a meeting of the foreign fund that controlled 25% of Olivetti triggered his resignation).

[5] *Id.* at 16 (stating that DeBenedetti's successor, Fransico Ciao, resigned).

[6] Bergstrom, *supra* note 3; Michael Useem, *Shareholders As A Strategic Asset,* 39 CAL. MGMT. REV. 8, 28 (stating that during the 1980s, because of the growth of pension funds and mutual funds, the market was moving more toward institutional investors).

[7] Tim Congdon, *Europe's Pensions Time Bomb,* TIMES LONDON, Mar. 1, 1997 (stating that most of Europe's pensions are public and unfunded).

to fund their pension plans.[8] There is a discernible trend of growth in the number of pension funds in Europe.[9] Most of the governments of Europe have decided to privatize some or all of their holdings,[10] and the existing pension funds which are traditionally invested in fixed income securities are increasing the equity share of their portfolios.[11]

The same thing is happening in Eastern European countries.[12] The Eastern European countries are going to play an increasingly important role in accelerating the changes in corporate governance in Europe because of the extensive privatization process they are going through. Contrary to the model in Western Europe, the Eastern Europeans rely mostly on foreign capital and foreign investors, a majority of whom are American. These Americans are trying to shape the corporate governance system the same way it has been shaped in the United States.[13] Thus, privatization is a major factor in the changing of the system of corporate governance in Europe.

IV. TWO-TIER BOARD IS AN ALTERNATIVE TO CLASSIC MODEL

Some Europeans are resisting change by claiming that a corporate governance model that utilizes a

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[8] *France Announces Plans to Set Up Pension Funds*, REUTER BUS. REP., Dec. 2, 1993 (stating that the French government, which relies on the pay-as-you-go, or distribution system, where pensions are paid out from payments made by today's workers, plans to set up pension funds in order to guarantee pensions for the aging population and divert billions of francs into the stock market and newly privatized companies); *see also* Norma Cohen, *Imro Chief Urges New Pensions Regulator*, FIN. TIMES, Feb. 25, 1993, at 10 (noting that the Commons' social security committee plans to examine the handling of the pension funds of a number of formerly state-owned companies, as part of an inquiry into the government's plans for the pension funds of soon-to-be-privatized businesses); *Privatise Europe's Pension System, Says Manager's Report*, GLOBAL MONEY MGMT., Oct. 3, 1994, at 6 (describing a Manager's Report which shows that European countries will need to privatize their pension system, or face insurmountable deficits under their current system).

[9] *France Announces Plans*, *supra* note 8 (showing that France is creating pension funds).

[10] *See, e.g., id.* (noting that France is privatizing their pension system); *see also Privatise Europe's Pension System*, *supra* note 8, at 6 (arguing the need for European countries to privatize their pension systems).

[11] Jennifer M. Freedman, *EMU Is Likely to Free Up Pension Funds*, MANAGED INVESTING, Oct. 22, 1996 (stating that, in 1993, U.K. pension funds invested 80% of their assets in equity interests); *see also Privatise Europe's Pension System*, *supra* note 8, at 6 (stating that pension funds must be given the right to invest in equity, since there is little point in privatizing a pension system, then forcing it to invest in domestic government debt).

[12] *See* Lucjan T Orlowski, *Social Safety Nets in Central Europe: Preparation for Accession to the European Union?*, COMP. ECON. STUD., Summer 1995, at 29 (stating that the Czech and Slovak Republics and Hungary have made efforts to separate the pension funds from the stage budget); *see also* Paula Hawkins and Rupert Wright, *Financial Institutions – Czech Republic*, CENT. EUR., 1995, at 8 (stating that the Czech government foresees 40% of Czechs over 18 years old injecting about Kr125 billion into pension funds by 1997).

[13] Hawkins, *supra* note 12, at 8 (stating that 3 billion dollars of foreign capital has flowed into the Czech Republic in the first half of 1995).

two-tier board, such as in Germany or in Holland, is a better model.[14] The reason for the resistance in Germany is that banks are the largest shareholders and they are on the boards of almost every large corporation. The banks, however, are more than just shareholders, they are also stakeholders. Since banks are creditors, they may have different goals than pure shareholder value in terms of pure profitability.[15] They want long-term stability and they want to keep their credit valuable. This may mean less aggressive growth and a different corporate policy than simply maximizing the profit as would be done for a pure financial shareholder.[16]

The German model consists of two boards: the management board and the supervisory board.[17] Half of the members of the supervisory board represent the shareholders who really own the company; the other half of the board represents the personnel of the business.[18] Seven out of ten personnel representatives are employees of the company and three are union representatives.[19] The supervisory board appoints the management board.[20]

The different board members may have different values in mind. Because employees are represented on the board, when the board needs to discuss divestiture, the discussions may take a different turn than they would in the United States.[21] If half the members of your board are employee representatives, different social and financial responsibilities are considered.[22]

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[14] Benjamin T. Lo, *Improving Corporate Governance: Lessons from the European Community*, 1 IND. J. GLOBAL LEGAL STUD. 219, 239-44 (1993) (reviewing the two-tier board model and advocating its adoption in the United States); *Jardine Fleming Group Reorganizes Officials, Creates Two-Tier Board*, WALL ST. J., Sept. 27, 1997 (noting that Jardine Fleming Group, Ltd. adopted a two-tier board in order to "reassure clients" after an investigation discovered regulatory violations in the company's big-fund management division).

[15] *See* Marlene Givant Star, *Shareholder Activism Picks Up in Europe*, PENSIONS & INVESTMENTS, June 8, 1992, at 43 (noting that many shareholders in Europe are also creditors and providers of financial services).

[16] *Id.*

[17] *See, e.g.*, Geoffrey Mazullo, *Significance of BMW Plant in U.S.*, FIN. TIMES, Aug. 3, 1992, at 11 (discussing the supervisory and management boards).

[18] *Id.* (discussing the fact that German Co-Determination Law requires employee representation on supervisory boards).

[19] *Id.*

[20] Lo, *supra* note 14.

[21] Mazullo, *supra* note 17.

[22] *See* Geoffrey Owen, *Lessons for Britain from German Corporate Governance*, ACC., Apr. 1995, at 75 (discussing German corporate governance and having employees on a board); *see also Two-Tiers Won't Work*, ACC., Mar. 1995, at 18 (noting that in Germany the involvement of employees and long-term shareholders, such as banks, in supervisory boards may discourage rash decisions, but it also makes it difficult for companies to change direction quickly).

Aside from the rhetoric, the German model has been effective and has worked for years. Generally, German companies are profitable, well managed and, over the long-term, have served their shareholders well.[23] They have also worked under greater social pressure than their American counterparts.

The importance of corporate governance will increase as new pension funds are created. These funds will become larger because of longer life expectancy of the beneficiaries, the need to fund the pension plans of former government-owned companies and the need for better funding of private corporations' pension funds.[24]

The growing influence of the pension fund in Europe will surely lead to changes in the European corporate governance models. It may result in a governance model more like the one used in the United States, even though some people in the United States, particularly scholars, believe that the two-tier model is a better model.[25] I tend to think that is yet to be decided.

V. SHIFTING TO MORE SHAREHOLDER ACTIVISM IN EUROPE

Europe is changing slowly. What was supposed to happen in 1992 is still not done in 1997.[26] I think, however, that within the next five to seven years we will see more shareholder activism. Presently, shareholders are very passive, but the trend is moving toward shareholders being interested in participating in the life of the company.

In 1978, Morrow & Company, a proxy solicitation firm, opened a London office in an attempt to get the European institutions to vote for our American clients at their Annual Meetings. The Europeans were

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[23] Janet Matthews, *Barclays Bank Country Report: Germany*, BARCLAYS BANK COUNTRY REP., Apr. 1, 1997, at 1 (reviewing the business cycle in Germany for the last three years and making predictions on Germany's businesses).

[24] Andrew Burchill, *Redefining Europe's Pension Market (Money Management)*, INST. INVESTOR, Oct. 1, 1996, at 191 (following the developments and changes in European pension funds); Andrew Burchill, *Quantum Leap. (Quantitative Fund Management)*, INST. INVESTOR, Feb. 1, 1996, at 42 (discussing the evolution of the private retirement and pension fund system in Europe).

[25] Lo, *supra* note 14 (reviewing the two-tier board model and advocating its adoption in the United States); *contra* Audrey Choi, Maureen Koine and Peter Truell, *West European Managers Lose Footing*, WALL ST. J., Aug. 29, 1994, at A7 (criticizing the European corporate governance model and noting that many European corporations are considering adopting the American model).

[26] C. Michael Aho, *Fortress Europe: Will the EU Isolate Iteself from North America and Asia?* 29 COLUM. J. WORLD BUS. 32 (1994) (noting that the efforts to create a unified Europe, originally called EC 1992, have yet to succeed); *see also*, Paul A. Volcker, *The United States, Japan, and a Changing Global Economy*, WASH. Q. Spring, 1993 at 18 (stating that the vision of a truly unified Europe, with a common currency and greater political unity, was set back just as the final elements were put in place).

absolutely not interested. They said, "Look, we may have 2 or 3 percent, but it is not enough to change something. These companies never ask for our opinion. So if we do not like a company, we sell the shares."

Europeans are not accustomed to exercising their influence as shareholders.[27] In Europe, it is difficult to vote your shares. For the annual meeting invitation, companies publish a small-sized advertisement in a financial newspaper giving notice of the meeting.[28] If shareholders want to vote, they have to bring their shares, or deposit them in a bank, because European shares are bearer shares. Shares are seldom registered as they are in the United States.[29] European shareholders do not get proxy statements.[30] They seldom get an agenda of issues to be discussed at annual meetings.[31] Often, it there is an agenda, it is distributed at the meeting, or sometimes it is printed with the items but with no details.[32] The disclosure to shareholders in Europe is far from what shareholders are accustomed to in the United States.[33] Without extensive disclosure, it is difficult to make an educated decision. The only educated decision shareholders can make is to assess the value of the shares. This ordinarily leads shareholders to take the approach that: "if we like them, we invest in them; if we do not, we walk."[34]

This is changing. Recently, we have been calling British portfolio managers and they will gladly

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[27] David Thomas, *Class Struggle: Companies are Gradually Abandoning Dual Class Share Structures, But For Non-Voting Holders Conversion Can Be Pricey*, FIN. POST, July 5, 1997, at 12 (discussing the changes in the European equity markets and the development of corporate governance and shareholder franchise); Roger M. Kunz and James J. Angel, *Factors Affecting the Value of the Stock Voting Right: Evidence from the Swiss Equity Market (Special Issue: European Corporate Finance)*, FIN. MGMT., Sept. 1, 1996, at 7 (reviewing shareholder voting rights on the European continent); *see also* Anthony Poole, *Baltic Board Bungles Quick Bid for Change: Directors Suffer Embarrassing Loss of Face and Confidence After Shareholder Defeat*, LLOYDS LIST, July 1, 1996 (noting a milestone in European corporate governance, a decisive shareholder vote).

[28] Michael R. Sesit, *Montedison Group Seeks to Split Firm; Dissidents' Move May Send Signal to Managements Throughout Continent*, WALL ST. J., Apr. 13, 1996, at A16 (discussing the action of a group of disgruntled shareholders and their actions to change the corporation's policies).

[29] Christopher Watts and Benjamin Wootliff, *The Rise of the Euro Activist*, INST. INVESTOR, June, 1997, at 41 (discussing voting of minority shareholders in European corporations, and the adoption of U.S. style proxy voting); *see also* Commission on Tax'n of Int'l Fin. and Inv., Tax Sec., N.Y. State Bar Ass'n, *Report on International Finance Subsidiaries*, 28 TAX L. REV. 439 (1973) (noting that European disclosure requirements are less stringent).

[30] *See* Watts, *supra* note 29, at 41 (discussing proxy statements in Europe).

[31] *Id.* (noting the less stringent rules for shareholder meetings).

[32] *Id.*

[33] *See* Commission on Tax'n, *supra* note 29 (discussing the lax disclosure requirements in Europe).

[34] Paula Dwyer and Stewart Toy, *Investors Culture Shock for Europe's Board: Shareholder Activism Is Crossing the Atlantic*, BUS. WK., Jan. 30, 1995, at 50 (noting that, until recently, Europeans have not been activist investors).

vote. It was much tougher a few years ago to get votes from European, British, Dutch and Swiss institutions.

Another reason why European shareholders are not more active is because some individual shareholders, due to the high taxation, keep their shares in a different jurisdiction from where they live and they want to stay incommunicado.

This will not change until new shareholders come into the picture, such as pension funds or American institutions, and provide pressure to change the corporate structure and the system of corporate governance. The American Institutions, such as the California Public Employees' Retirement System ("CalPERS") and Institutional Shareholder Services ("ISS") are making inroads by attending AGMs.[35] ISS opened an office in Paris to try to change the culture of the enterprise and make the boards understand that shareholders can, and in fact, want to vote.[36] I think that the biggest factor is that the banks, holding companies, and crossholders (companies that own each others shares) put cross-members on the board.[37] That means you have a club of board members, which is really limited to a few people, who sit on each other's boards.[38] Change, however, will be slow because European corporations still have a huge amount of money and capital, and because they have been working for hundreds of years that way. Through cascade holdings, a relatively small amount of capital is managing the entire company.

A few years ago there was a large holding company in Belgium called Societe Générale de Belgique, which has since been acquired.[39] It had holdings in up to 1,400 different companies and almost always had

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[35] *French Corporate Governance Issues Far From Being Resolved*, AFX NEWS, July 7, 1997 (discussing internal guidelines on how CalPERS will vote at a foreign company's AGM); *see, e.g.*, *Ciao, Carlo, supra* note 4 (describing a situation where U.S. institutional investors voted at a European companies shareholder's meeting).

[36] *ISS Forms Link with French Firm*, PENSIONS & INVESTMENTS, Feb. 6, 1995 at 18 (noting that Institutional Shareholder Services, Inc. ("ISS") formed an alliance with Franklin Global Investors Services, Paris, the French shareholder advisory firm).

[37] *See Olivetti Self-Destructs, supra* note 4 (noting how many Italian companies, rather than raising capital from foreign investors, shield themselves from hostile scrutiny by cross-shareholdings).

[38] *Id.*

[39] Andrew Jack, *Trouble Behind the Facade: The Four Billion Franc Losses at Paribas Reflect Challenges Facing the Entire French Banking Sector*, FIN. TIMES, Mar. 1, 1996, at 15 (noting that Suez, a large French holding company, has been coping with heavy losses incurred by takeovers which brought Societe Generale de Belgique and Victoire under its control).

representatives on the board of directors of each of those companies.[40] Sometimes the holding size was not more than 5 percent and the rest of the shares were dissipated in the public, but ownership of merely 5 to 20 percent gave it control of a company. The possibility of control by a minority is still the case today. For change to occur, the diversification of the shareholder profile is needed. That is happening, but it is happening slowly.

VI. UNITED STATES INSTITUTION'S INFLUENCE ON SHAPING CORPORATE GOVERNANCE

Diversification will happen more rapidly in the Eastern European countries where of the corporations were state-owned. These countries are now in search of capital and are looking to the United States' institutions.[41] The institutions' answers are, "Fine, we want to take a stake in your capital, but we want it our way." Therefore, the corporate governance models will shift sooner in those countries than in the old, more placid Western European countries like France, Germany, and the Netherlands.[42]

United States' institutions are increasing their stakes in Europe.[43] For instance, between 1990 and 1994 they doubled their investment in Sweden,[44] and American ownership of French companies increased from 15 to 25 percent.[45] The change from fifteen to twenty-five percent occurred in only four years. In another five years, I believe they will be able to have it their way as far as corporate governance is concerned. That is what I believe will happen.

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[40] *Id.*

[41] William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in Formerly Central Planned Economies*, 25 LAW POL'Y INT'L BUS. 565 (1994) (noting rarity of domestically generated working capital and the need for foreign institutions to invest in domestic Eastern European companies).

[42] Mary Lowengrad, *Much Ado? Influencing of U.S. Investors Over Corporate Governance in Europe*, INST. INVESTOR, Jan. 1, 1997, at 35 (noting growing influence of U.S. institutional investors on European corporate governance).

[43] Sara Calian, *Review of Money and Markets: Europe's Stock, Gains May Be Slow in 1997*, WALL ST. J. EUR., Jan. 6, 1997 (surveying U.S. institutional investors' asset allocations for Europe despite sober outlook).

[44] OECD ECONOMIC SURVEY, Aug. 1, 1995 (noting dramatic changes in Swedish economy, making it very attractive to foreign investment).

[45] Joel Chernoff, *French Investor's Institutions Boost Equity*, PENSIONS & INVESTMENTS, Aug. 4, 1997, at 16 (noting strong U.S. institutional ownership).

I predict the move to American style corporate governance will take five to seven years in Western Europe. But you never know, things are starting to accelerate. The need for capital is increasing, mergers are occurring, and the internationalization of companies requires more capital.[46] In Europe, the classical sources of capital are the holding companies and families. There are still a lot of family-owned or partially family-owned companies and they still have people on the board. Even if they only own 2 or 3 percent, they still have a lot of power. These companies will have a difficult time meeting the never-ending demand for capital. They will want to grow and become more international as trade barriers fall; therefore, they will need more capital. To get that capital they will have to go to the capital markets which means working with institutional investors and governance-oriented shareholders.[47]

VII. CONCLUSION

Europe is very diverse. The two-tier board system is not everywhere in Europe.[48] Some European companies have classical boards, some have outside directors, some do not.[49] Because of market pressure,[50] I believe that European corporations will move toward the classical American model of corporate governance. But that change will occur slowly.

As a reference, the European Community authorities started discussing corporate status in 1956 in order to create a cross-border corporate status and they are still discussing it today. European unification was supposed to occur in 1992, yet it has not been completed. Maybe it will be done by the year 2000.

[46] Susan Milligan, *What Price Eastern Europe?*, INST. INVESTOR, May 1, 1997, at 19 (noting history of capital intense mergers and other internationalization).

[47] *No Clear Answers on Governance*, BUS. L. EUR., Apr. 30, 1997 (discussing European capital markets).

[48] Mazullo, *supra* note 17 (reviewing the use of two-tiered boards in Europe).

[49] *Id.*

[50] Audrey Choi, Maureen Kline and Peter Truell, *West European Managers Lose Footing*, WALL ST. J., Aug. 29, 1994, at A7 (noting that many European countries are considering corporate governance structures and may be moving toward the Anglo-American model); *see also* Lowengrad, *supra* note 42 (noting study of 140 European companies' corporate governance achievement rankings).