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Shareholder Protection Across Countries – Is the EU on the Right Track?

Mathias M. Siems*

Since the beginning of the new century harmonisation of company law has once again been on the European agenda.[1] Its cornerstone is the 2003 Commission's Action Plan on Modernising Company Law and Enhancing Corporate Governance (COM (2003) 284). This Company Law Action Plan distinguishes between short-term, medium-term, and long-term actions. The short-term measures have been adopted or will be adopted soon, and the Commission has just launched a consultation on the implementation of the medium and long-term measures.

One of most important aims of the ongoing harmonisation is the protection of shareholders. There are different ways to achieve this. The Draft Directive on Shareholders' Rights (COM (2005) 685) will harmonise some topics in relation to the general meeting. For instance, general meetings are to be convened with at least one month's notice, share blocking will be abolished, and proxy voting will not be restricted. Conversely, the proposal to change the European Accounting Directives (COM(2004)725 amending Directives 78/660/EEC and 83/349/EEC) focuses on the conduct of the directors. This Directive will clarify the collective responsibility of directors for financial publications and introduce new disclosure requirements (e.g. for related parties transactions and corporate governance statements). Finally, the EU Commission has issued two non-binding recommendations. The first addresses directors' remuneration, in particular its disclosure to shareholders (2004/913/EC). The second recommends that companies appoint independent directors and set up committees (2005/162/EC).

In discussing these legal instruments, various observations can be made. For instance, one can focus on the policy question of whether it is necessary to harmonise these issues in the EU. In this respect, Siems (2005a) has already put forward the case against harmonisation of shareholder rights by means of a new company law directive. It is also interesting to consider that harmonisation is not the only method of legal convergence in shareholder law. Siems (2005b) has, inter alia, suggested that there may be two types of "convergence forces": Firstly, as the social, political and economic conditions that form the background to shareholder law come closer together internationally, the law itself will also grow more similar ("convergence through congruence"). Secondly, individual interest groups will press for a greater approximation of laws ("convergence through pressure").

This article focuses, however, on a "leximetric analysis" of the different ways in which shareholders can be protected. At the outset, it will be explained what "leximetrics" is. Using this methodology, it will then be shown how different parts of shareholder protection have developed in Germany, France, the UK and US in the last 35 years.

Shareholder protection – Leximetrics

Usually lawyers follow a qualitative approach because apart from the citation of statutes or cases they do not use numbers and do not make calculations. Leximetrics[2] refers to the opposite, namely the quantitative measurement of law. The problem is, however, how to do it properly. In particular, when this quantitative methodology is used to compare the laws of different countries, one could suggest that such a "numerical comparative law" approach only leads to a superficial understanding of different legal systems (see Siems 2005c and 2005d).

With respect to shareholder protection, the most famous attempt to quantify the law is the study by La Porta et al. (1998) on "Law and Finance". La Porta et al. used eight variables as proxies for shareholder protection in 49 countries. These variables coded the law for "one share one vote", "proxy by mail allowed", "shares not blocked before the meeting", "cumulative voting", "oppressed minorities mechanism", "pre-emptive rights to new issues", "share capital required to call an extraordinary shareholder meeting", and "mandatory dividend". In a second step, they draw on these numbers as inde-

* Mathias M. Siems (siems@fulbrightweb.org), Centre for Business Research, University of Cambridge. I thank Priya Lele for her useful comments on this article and for her excellent collaboration on the shareholder protection index.

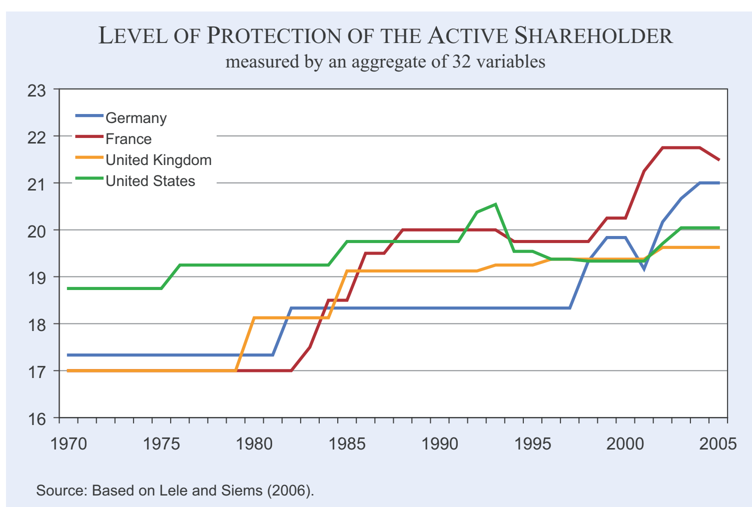
[1] All materials mentioned in the next two paragraphs are available at http://europa.eu.int/comm/internal_market/company/index_en.htm.

[2] This term was first used in Cooter and Ginsburg (2003).

pendent variables for statistical regressions. Their main finding was that good shareholder protection leads to more dispersed shareholder ownership, which can be seen as a proxy for developed capital markets.

In the last few years many studies have used the La Porta et al. variables on shareholder protection (e.g., Dyck and Zingales 2004; Licht et al. 2005; Pagano and Volpin 2005). Furthermore, the EU Commission's impact assessment on the Draft Directive on Shareholders' Rights explicitly refers to the La Porta et al. study.[3] However, it is doubtful whether the findings of La Porta et al. are accurate. Various studies have identified numerous coding errors (e.g., Cools 2005; Braendle 2006; Spamann 2006). But the main problem is that the limited number of variables hardly provides a meaningful picture of the legal protection of shareholders. The choice of variables by La Porta et al. not only suffers from a US bias but is also a poor proxy for shareholder protection in general, because their eight variables do not capture the most significant aspects of the law (see Lele and Siems 2006 and already Coffee 2001, p. 4).

Figure 1



Source: Based on Lele and Siems (2006).

Lele and Siems (2006) made a fresh start on the quantification of shareholder protection. We built a new and, hopefully, more meaningful shareholder protection index for five countries (Germany, France, UK, US, and India) and coded the development of the law for over three decades. In particular, we took into account that different legal instruments can be used to achieve a similar function. This approach made it necessary to extend the number of variables significantly, namely to 60. Furthermore, we addressed the various problems related to the coding of legal provisions. For instance, we made clear to what extent we coded non-mandatory and soft law and how we dealt with ambiguous legal provisions. Subsequently, our paper gave examples of the interesting possibilities that diligent quantification of legal rules provides for comparing variations across time and across legal systems. For instance, it was found that shareholder protection has been improving in the last three decades; that the protection of minority against majority shareholders is considerably stronger in blockholder countries and that convergence in shareholder protection has been taking place since 1993 and increasing since 2001.

The following parts tie in with the Lele and Siems coding of shareholder protection for Germany, France, the UK, and the US. The figures shown below are, however, new. They refer to aggregates of specific groups of variables, namely legal rules which are significant for "the active shareholder", "the passive shareholder", and the regulation of boards. These categories are of particular interest, because – as mentioned – in all of these three areas European harmonisation of shareholder protection is on its way.

The active shareholder

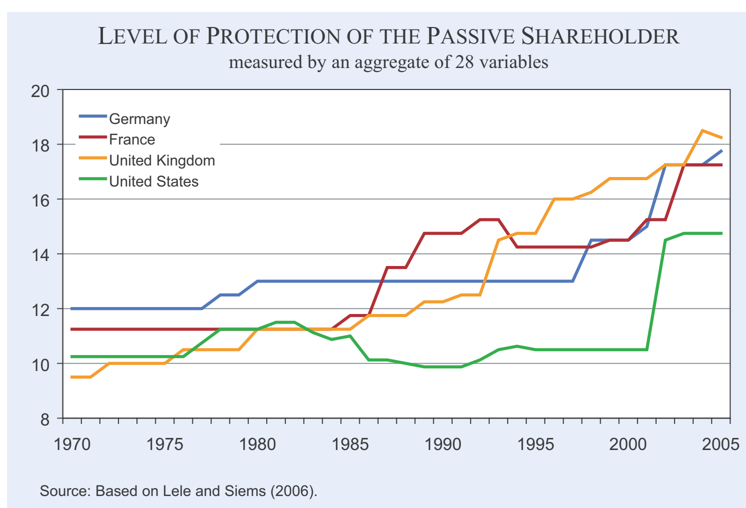
The variables which have been aggregated in Figure 1 deal with everything which is related to the general meeting. For instance, these variables code the powers of the general meeting, the involvement of the shareholders in its run-up (e.g., agenda setting, proxy solicitation, right to call a meeting), voting rules (e.g., one share one vote, cumulative voting, supermajority requirements), and individual information rights.

In analysing Figure 1, one may suggest that it is no surprise that Germany and France perform better than the UK and the US. In the latter countries dis-

[3] Impact assessment on the proposal for a directive on the exercise of shareholders' voting rights, SEC (2006)181, pp. 7, 53; available at http://register.consilium.eu.int/pdf/en/06/st05/st05217-ad01.en06.pdf.

persed shareholder ownership is more common than in Germany and France. Thus, shareholders in the UK and US may be "rationally apathetic" because the small stakes they hold may not justify active involvement. However, the time series reveals that until the mid-1980s the US had the best law on the "active shareholder". Thereafter the situation has changed because the three European countries have made their law more shareholder-friendly, whereas the US law has not changed significantly.

Figure 2



Source: Based on Lele and Siems (2006).

This development is also interesting because the German, French and British law on the "active shareholder" has improved without European directives. It can therefore be doubted whether the Draft Directive on Shareholders' Rights is really necessary. This Directive will also not significantly change the score of the three European countries, because many of its suggestions already correspond to the law of the Member States. An exception may be the right to ask questions at the general meeting. In this respect, UK company law does not contain a special right but leaves it to the best practice of each company (see Siems 2005a, p. 551). The UK score will therefore improve slightly after the adoption of the Directive. Whether this is a significant step forward is, however, doubtful because for public companies it makes sense to disclose information publicly, whereas extensive disclosure at the general meeting is only a poor substitute (see also Siems 2006b).

The passive shareholder

The variables of Figure 2 code for the aspects of shareholder protection that are not related to the general meeting. For instance, they address the board structure, duration of directors' appointment, directors' duties and their private or public enforcement, appraisal rights, the mandatory bid, and limits to amendments of the articles.

These legal rules may be more important than active involvement of the shareholders. The "rational apathy" of shareholders is often related to the modern public company with dispersed shareholder ownership (see above). It is, however, by no means a new phenomenon. Adam Smith already described the practice as follows: "The trade of a joint stock company is always managed by a court of directors. This court, indeed, is frequently subject, in many respects, to the control of a general court of proprietors. But the greater part of those proprietors seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend as the directors think proper to make to them" (Smith 1776, p. 741).

The awareness of the importance of the rules that protect the "passive shareholder" can also be seen in the development of the last 35 years. In all four countries shareholder protection has increased significantly. In particular, the UK score has almost doubled. In contrast to the "active shareholder", the US score has also improved considerably in the last few years, mainly caused by the Sarbanes Oxley Act. This may, of course, raise the objection that the Sarbanes Oxley Act is not an actual improvement but "quack corporate governance legislation with mismatched means and ends" (Romano 2005). Thus, there is no escape from admitting the general limit that aggregates of legal variables have. In order to get a deeper understanding it is therefore necessary to "open the box" again and analyse the details of the law. This is also important for Germany. Although Germany performs well in Figure 2, its law on the "passive shareholder" is far from perfect, not least because – despite recent changes to the law – derivative suits are only allowed in a restricted way (for a criticism, see Siems 2005e).

Boards

Figure 3 graphically represents the values of all variables that deal with boards. It therefore overlaps with the variables used for Figures 1 and 2. In detail, Figure 3 takes into account, for instance, the power of the general meeting to elect directors and to decide about their remuneration, as well as the rules on board composition, duration of appointment, directors' duties and their enforcement.

The reason for the importance of these provisions can be based on the reasoning that not the shareholders but the directors are typically regarded as the most important body of the company. In the past the general meeting was generally able to intervene in the normal operations of the business. At least since the second half of the 20th century this is no longer possible. Only in the framework of the ordinary general meeting are shareholders given influence over "their company". These developments have arisen because conducting business by the general meeting was regarded as inefficient and also no longer desired by the shareholders. The efficiency of the division of powers presupposes that for business decisions a rapid, informed and expert response can be made. Since shareholders as a rule cannot manage this, everyday questions of running the business are handled autonomously by the firm's specialised, expert management. This division also corresponds to the basic idea of those shareholders who see themselves primarily as investors. Shareholders in large public companies want to supply only capital, not personal commitment, since they lack the interest or the ability to act as managers themselves.[4]

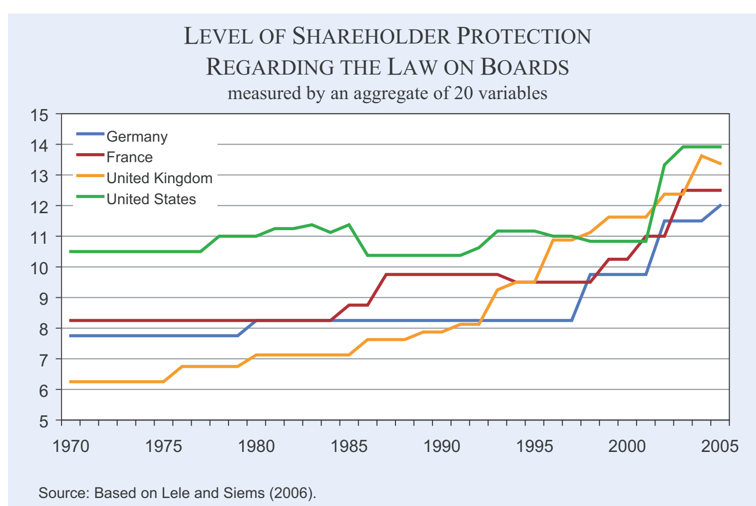
In Figure 3 it is striking that, in contrast to Figures 1 and 2, the US performs best. But, here again, it can also be seen that even without European directives the laws of the three European countries have improved significantly in the last decades. For a German lawyer it may, however, be surprising that the German score is, for the most part, worse than that of the other countries. Germany is the only country of the four that has a mandatory two tier structure, and this division between supervisory and management board is seen as a key advantage in monitoring the conduct of business and representing the firm in the event of conflicts of interest. This has indeed been taken into account in Figure 3. However, in other respects the German law is weaker than the law of the other countries. This is true, for example, for the duration of directors' appointments, because members can be appointed for up to five years and dismissal usually requires an important reason or a high majority.[5]

Concluding remarks

The discussion of Figures 1 to 3 has shown that shareholder protection has been improving in the countries in question in recent decades. This is notable because it indicates that the involvement of the EU may not be necessary to strengthen shareholder protection in Europe. It is further remarkable that this common development, as well as the differences between the four countries, does not confirm the conjecture that there is a division between the Anglo-Saxon world and Continental Europe. Although there is more dispersed shareholder ownership in the US and the UK, this commonality is not reflected in the law on shareholder protection. With respect to the law, generalisations about (Anglo-Saxon) common-law countries and (Continental) civil-law countries are therefore doubtful (see generally also Siems 2006a).

With respect to the differences between countries, the foregoing observations have not yet analysed which parts of the law are most important for financial

Figure 3



Source: Based on Lele and Siems (2006).

[4] On this paragraph, see Siems (2005b) 198–200.

[5] For a comparative overview, see Siems (2005b) 200–7.

development. This will, however, be done in the future. As already indicated in Lele and Siems (2006), our new indices on shareholder protection will constitute a basis for an econometric study combining financial data to find statistical relationships between legal and economic data.

Another point that has not been addressed in this article is the role of the European Court of Justice (ECJ) for shareholder protection in the EU. In the last few years there has been increasing activism on the part of the ECJ in company law matters. This, however, does not have to do primarily with substantive law but with questions of conflict of laws (but see also Gelter and Siems 2005). Here, one can see the tendency for companies to choose freely their place of incorporation, a development which is also fostered by statutory European company law (see Siems 2004a and 2005f.). If this choice leads to a "race to the top" – which is a matter of debate – harmonisation of shareholder protection may also not be necessary.

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