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Jose Miguel Mendoza

Christoph Van der Elst

Erik P. M. Vermeulen

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ENTREPRENEURSHIP AND INNOVATION: THE HIDDEN COSTS OF CORPORATE GOVERNANCE IN EUROPE

Jose Miguel Mendoza, Christoph Van der Elst,**
& Erik P. M. Vermeulen****

INTRODUCTION

In the aftermath of the financial crisis, European policymakers and academics are once again concerned with designing a regulatory framework that protects investors from misbehavior by self-interested managers and controlling shareholders. To be sure, no company ever survived by ignoring the interests of other stakeholders such as employees, customers and suppliers. The academic and policy debate, however, focuses generally on the principal-agent relationship between those with actual control of the firm and outside investors. This is hardly surprising given the importance attributed to the idea that greater effectiveness of common law legal systems in regulating agency relationships, compared to their civil law (and mostly European) counterparts, explains the success of Anglo-American capital markets.¹

* Visiting lecturer, Tilburg Law School and doctoral candidate at the University of Oxford.

** Professor of Business Law and Economics, Tilburg Law School and Ghent University. Visiting Professor at the Torino University (CLEI) and the College of Europe (Bruges).

*** Professor of Business Law, Tilburg Law School, Professor of Financial Market Regulation, Tilburg Law & Economics Center, Visiting Professor, Faculty of Law, Kyushu University, and Vice-President Corporate Legal Department of Philips International B.V. (Corporate and Financial Law Group), The Netherlands. The authors would like to thank the participants in the roundtable meeting on Corporate Governance in listed companies organized by the European Commission on 23 June 2010 (Brussels), the participants of the European Association of Law and Economics Annual meeting on 24 September 2010 (Paris), the participants of the Insol Europe Annual Congress on 16 October 2010 (Vienna), and the participants of the Takeover Seminar organized by the The Panel of Takeovers and Mergers, Central Chamber of Commerce of Finland in Helsinki on 28 October 2010.

¹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta,

Yet, civil law countries in Europe have sought to catch up with common law systems during the past decade by implementing a vast array of corporate governance reforms and takeover regulations.² Arguably, these reforms were necessary to better protect “passive” equity investors in listed companies, as asymmetric information and collective action problems prevent close monitoring of firm performance and enable controlling parties to tunnel assets and extract profits from the company for their own interests.³

The corporate governance reforms that followed in the wake of the 2001-2002 corporate failures were initiated to alter, among other things, the role of non-executive directors, disclosure, the internal and external audit process, risk-management systems, and penalties for managerial misconduct. Moreover, under the assumption that a market for corporate control could be set in motion in Europe, a series of takeover rules and regulations were introduced and fine-tuned to restore investors’ confidence in the integrity of capital markets and address deficiencies in the relationship between the shareholders and managers of listed companies. An active market for corporate control was expected to align the interests of managers and public, often passive, investors.⁴ Although it is acknowledged that many of these specific corporate governance developments have created minimum standards and guidelines that actually improved the functioning of listed companies, it is far from clear whether more stringent and detailed rules would have a similar effect. Still, policymakers and lawmakers

Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

² John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems & Ajit Singh, *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343 (2009).

³ To be sure, managerial abuses have been around for as long as widely-dispersed investors poured their money into risky ventures, such as the Dutch East India Company; and, as always, policymakers and lawmakers have attempted to mitigate the underlying governance failures and errors. However, corporate governance discussions have never been of this magnitude in both academic and geographic sense. JOSEPH A. MCCAHERY & ERIK P. M. VERMEULEN, *CORPORATE GOVERNANCE OF NON-LISTED COMPANIES* (Oxford University Press, 2008).

⁴ It is widely assumed that a robust takeover market creates a powerful incentive for managers to refrain from self-dealing transactions by providing a constant and credible risk of hostile acquisitions. Jaap Winter, *Corporate Governance Regulation and Enforcement in the US and EU*, in TOPICS IN CORPORATE FINANCE: THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW (Amsterdam Center for Corporate Finance, 2006).

seem to believe that a more regulatory approach in the area of corporate governance will only enhance the accountability of directors, managers and controlling shareholders. Their efforts are based on the assumption that these parties will better serve the interest of passive investors if they embrace rules and regulations that offer them clear guidance about the best way in which to discharge their duties to investors and other stakeholders. To this effect, the argument that corporate governance rules can clarify and supplement these duties has often been used to support the idea that firms do not really bear high costs from reform measures in this area.

Opponents of the regulatory view, who believe that corporate governance should not be considered as a goal in itself, but rather as a tool to improve firm performance, argue that corporate governance initiatives are far too overreaching.⁵ In fact, the current reform movement has spawned many cumbersome rules that do not seem to prevent corporate failures and, more importantly, appear to have a relatively small effect on investment decisions.⁶ Unchecked, this development could jeopardize entrepreneurship, innovation and long-term economic growth.⁷ For instance, corporate governance regulations have induced small firms to rethink their stock exchange listing.⁸ In this respect, corporate governance rules and regulations act as an entry barrier for high-potential companies. More troubling still is the notion that stringent corporate governance rules and the stiff penalties for top

⁵ For a particularly interesting take on how the recent overreaching corporate governance reforms tend to erode the competitiveness of US capital markets, Stephen M. Bainbridge, *Corporate Governance and U.S. Capital Market Competitiveness* (UCLA Working Paper, 2010).

⁶ Abe De Jong, Professor, Erasmus Univ. Rotterdam, Inaugural Lecture: De Ratio van Corporate Governance (Oct. 6, 2006).

⁷ Pauline Skypala, Commentary, *Managers' Lives Getting (a Bit) Harder*, FIN. TIMES (July 4, 2010, 09:27) <http://www.ft.com/home/us> (search "Financial Times" for "Managers' Lives Skypala") ("There is a perceived danger that regulation could be extended further, if codes prove ineffective. Mr Borges, who is also chairman of the European Corporate Governance Institute, says what is needed is better market discipline. Britain has probably the most sophisticated corporate governance model in the world, yet companies underperform for years and nothing happens to them. The same is true in Europe.").

⁸ Ehud Kamar, Pinar Karaca-Mandic & Eric L. Talley, *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, USC CENTER L. (Economics & Organization Research Paper No. C06-5 RAND Working Paper WR-300-1-ICJ, 2006).

executives make start-up companies reluctant to use an initial public offering (IPO) as a financing vehicle and arguably hamper the performance and development of listed firms. Strict rules and regulations encourage managers to seek high return on investment and shareholder value, which eventually could lead to short-termism in the boardroom and the adoption of an adversarial management style.⁹ Aside from these problems, corporate governance reforms can also bring significant confusion to the market. Managers or controlling parties could, for instance, adopt corporate governance measures to conceal underperformance, thereby deceiving investors. According to the Corporate Governance Quotient (CGQ), a rating system provided by Institutional Shareholder Services (ISS), Lehman Brothers Holdings Inc. outperformed its peers by 87 percent.¹⁰ Its CGQ was better than 42 percent of the S&P 500 just a few days before its collapse.¹¹ Of course, advocates of more detailed regulation see the Lehman case as just another example of why there is a need for policymakers and lawmakers to develop more effective measures that prevent opportunistic behavior in the corporate setting. However, the case could also be made that Lehman merely demonstrates that there is no clear-cut correlation between a “good” governance system on paper and firm performance in practice. More detailed regulation, which arguably encourages box-ticking and places more emphasis on the compliance process, would only widen the gap between corporate governance on paper and in practice.

In the wake of the most recent economic downturn, these competing views have rekindled questions about the ‘one-size-fits-all’ mentality of policymakers, lawmakers, rating agencies, and gatekeeper institutions, and the alleged success of rules and regulations that can be

⁹ Symposium, CFA Centre for Financial Market Integrity & Business Roundtable Institute for Corporate Ethics, *Breaking the Short-Term Cycle: Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value* (2006).

¹⁰ CGQ assesses the strengths, deficiencies and risks of a firm’s corporate governance system by looking at “(1) board of directors, (2) audit, (3) anti-takeover provisions, [and] (4) executive and director compensation.” *Corporate Governance Quotient (CGQ)*, YAHOO! FIN., http://help.yahoo.com/l/us/yahoo/finance/news_and_opinion/fitacgq.html (last visited Oct. 22, 2010).

¹¹ *Corporate Governance: Redefining Independence*, GREENEWABLE’S WEBLOG (Sept. 20, 2008), <http://greenewable.wordpress.com/2008/09/20/corporate-governance-redefining-independance/>.

detrimental to the operation and development of listed companies.¹² The answers to these questions will most likely affect the current reviews of corporate governance initiatives concerning listed firms.¹³ Despite awareness of the need to reign in misconduct, the media attention regarding corporate scandals arguably discourages policymakers from undertaking a deep enough study concerning the effectiveness of new corporate governance initiatives. The case has never been stronger for policymakers to rethink corporate governance mechanisms and analyze the effect of the reforms undertaken over the past decade. The goal of this paper is to understand the organizational needs of listed companies and assess arguments for and against the introduction of stricter corporate governance measures for publicly held firms. Moreover, it suggests a legal framework that can have a positive impact on firm performance and development.

In addressing which legal framework can enhance good governance and improve the performance of listed companies across the board, this paper distinguishes between different strands of reform arising worldwide and addresses problems with the one-size-fits-all approach. Section Two looks at the effect of takeover regulation in the European Union (EU). It argues that although the market for corporate control aligns the interests of managers and investors, a one-size-fits-all approach may be inappropriate for most listed companies. In Section Three, we canvass recent trends in corporate governance discussions. Our analysis shows that the new wave of reforms can have a detrimental effect on the innovative and entrepreneurial initiatives that spur economic growth and job creation in a global context. Indeed, the exemplars in Section Four show that corporate governance reforms are often misguided and ill-informed. Section Five identifies alternative legal mechanisms that could be employed by policymakers, lawmakers, as well as courts in solving corporate governance problems in listed companies and enhancing firm performance. Section Six concludes.

¹² *A New Idolatry*, *ECONOMIST* (Apr. 22, 2010), <http://www.economist.com/node/15954434> (noting that the economic crisis has again started the discussion about a listed company's focus: should the interests of shareholders, customers or workers prevail in the corporate governance framework of a listed company). *See also* Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, *FIN. MARKET TRENDS*, Vol. 1 (OECD, July 2009), <http://www.oecd.org/dataoecd/32/1/42229620.pdf>.

¹³ For instance, the European Commission plans to launch a broader review of corporate governance, which may result in the publication of a green paper.

I. THE TREND TOWARDS FLEXIBLE TAKEOVER REGULATION

One of the most debated issues of the past decade involves the mandatory enforcement of the 'one-share-one-vote' rule.¹⁴ Under this rule, a listed company must grant its shareholders an equal measure of voting and cash flow rights. One-share-one-vote is commonly enforced through limitations on the issuance of different classes of shares, such as multiple voting shares, non-voting preferred stock, and similar specimens. This restriction can take the form of absolute bans on dual-class structures or, as is still the case in many countries, limits on the percentage of shares with asymmetrical voting rights that can be issued by a listed firm.¹⁵ The ultimate purpose of the one-share-one-vote rule is (1) to reduce the incentives of controlling parties to expropriate minority investors and (2) to stimulate the emergence of a market for corporate control. One-share-one-vote seems to provide a simple and effective way to accomplish these goals, making it the preferred recipe of policymakers in both developed and emerging countries.¹⁶ Nevertheless, controlling parties have innumerable other ways of separating voting and cash flow rights in listed firms, including pyramid structures, cross-holdings, derivative products, and shareholder coalitions.¹⁷ Absent an adjudicator that can determine

¹⁴ For a detailed discussion of this issue, see Jose M Mendoza, *The Challenge of Disproportional Ownership*, in READINGS IN LATIN AMERICAN COMPANY LAW (F Reyes ed., University of Arizona, National Law Center for Inter-American Free Trade 2011). Historical records also show that this issue has been in vogue for quite some time. For an account on the one-share-one-vote rule and the use of dual-class shares and pyramids in the US during the 19th and early 20th centuries. Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445 (2008). Collen A. Dunlavy, *Corporate Governance in Late 19th-Century Europe and the U.S.: The Case of Shareholder Voting Rights*, in COMPARATIVE CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH (Klaus Hopt et al. eds., Oxford: Clarendon Press 1998).

¹⁵ Shearman & Sterling LLP, *Proportionality Between Ownership and Control in EU Listed Companies: Comparative Legal Study* (May 18, 2007), available at ec.europa.eu/internal_market/company/docs/shareholders/study/study_report_en.pdf.

¹⁶ Hayden and Bodie, *supra* note 14, at 480-83.

¹⁷ Avner Kalay & Shagun Pant, *One Share-One Vote is Unenforceable and Sub-optimal* (NYU Stern Sch Bus., Working Paper, 2008), available at <http://w4.stern.nyu.edu/emplibrary/Kalay%20Pant%20-%20One%20share%20one%20vote.pdf>.

whether these other schemes are being used to circumvent one-share-one-vote, this rule is usually unenforceable in practice.

In the context of takeovers in Europe, one-share-one-vote is partially responsible for the creation of the breakthrough rule included in the EU Takeover Bids Directive.¹⁸ The breakthrough rule endorses the view that an offeror, upon the acquisition of 75% of the outstanding share capital, can convene a general meeting of shareholders at short notice with the purpose of eliminating any pre-bid defenses deployed by the target firm. In this respect, the breakthrough rule imposes a one-share-one-vote approach in offeree companies, which has been deemed necessary to create a level playing field for takeover bids.¹⁹ In addition, the Takeover Bids Directive also introduced the board neutrality rule to create space for a European market for corporate control. Under this rule, the management board of a target firm cannot thwart a successful takeover bid by adopting post-bid defensive measures, such as poison pills or issuing multiple voting shares to white knights, without the approval from the general meeting of shareholders.²⁰ The breakthrough and board neutrality rules attempt to prevent opportunistic behavior by the parties in control of a listed firm.²¹

The board neutrality and breakthrough rules sparked much controversy among EU member states. For example, in the United Kingdom one-share-one-vote is more accepted than in Sweden, where it is common for companies to issue shares that carry multiple voting rights.²² In order to strike a balance between views as opposite as these, EU lawmakers adopted opt-in and opt-out provisions that allow

¹⁸ Directive 2004/25/EC, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 9, 10, 12.

¹⁹ Joseph A. McCahery & Erik P. M. Vermeulen, *Does the Takeover Bids Directive Need Revision?*, TILEC Discussion Paper 2010-006 (Feb. 4, 2010), available at <http://ssrn.com/abstract=1547861>.

²⁰ Directive 2004/25/EC, of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 O.J. (L 142) 8.

²¹ *Id.* The Takeover Bids Directive also contains other rules that are designed to protect minority shareholders against opportunism on the part of the offeror: (1) a mandatory bid rule that ensures that an offeror cannot obtain a controlling stake without making a controlling bid; (2) disclosure rules according to which the offeror must announce his intention to make an offer and make public an offer document containing at least a minimum of information; and (3) 'squeeze-out' and 'sell-out' rules that would have to be implemented at a fair price.

²² DAVID KERSHAW, *COMPANY LAW IN CONTEXT: TEXT AND MATERIALS* (Oxford Univ. Press 2009).

member states to exempt companies from applying the board neutrality and breakthrough rules. Under these provisions, companies can choose to opt-in to the breakthrough rule regardless of the member states' decision to implement the rule. Furthermore, member states may reserve the right to opt-out of the implementation of the board neutrality rule. The fact that most European jurisdictions already required a board of directors to abstain from adopting defensive measures without shareholders' prior approval explains why only a few member states made use of this option.²³

Table 1 shows that the options approach in the Takeover Bids Directive is appropriate when there are significant variations in firm ownership and governance regimes across member states.²⁴ Some might argue that the European Commission should encourage takeovers by (1) making the provisions of the Takeover Bids Directive harder to avoid and (2) creating new provisions to make corporate control more contestable.²⁵ In this view, takeovers are encouraged to discipline managers and reallocate control.²⁶ However, even if the Takeover Bids Directive is imperfect in that it does allow suppression of takeover bid activity, it arguably offers minimum standards of disclosure and transparency that appear to have had a positive effect on the European takeover market.²⁷

²³ Some member states, such as the Netherlands, had satisfactorily addressed the board neutrality issue at the national level. McCahery & Vermeulen, *supra* note 19, at 12-13.

²⁴ *Id.* (table 1 at 14). See also Gerard Hertig & Joseph A. McCahery, *A Legal Options Approach to EC Company Law*, in *INVESTOR PROTECTION IN EUROPE* (G. Ferrarini ed. 2006) 15-17.

²⁵ Luca Enriques, *European Takeover Law: The Case for a Neutral Approach* (UCD Working Papers in Law, Criminology & Socio-Legal Studies, Research Paper No. 24/2010), available at <http://ssrn.com/abstract=1523307>.

²⁶ For instance, the reciprocity provision, which may apply in cases where an offeror itself makes use of defensive measures, has led to new obstacles on the European takeover market. See *Commission of the European Communities Report on the Implementation of the Directive on Takeover Bids*, 8-9, Annex 1 at 12, SEC (2007) 268 (Feb 21, 2007), available at http://ec.europa.eu/internal_market/company/docs/takeoverbids/2007-02-report_en.pdf. Annex 1 shows that member states explicitly opted into the reciprocity provisions.

²⁷ Joseph A. McCahery & Erik P. M. Vermeulen, *The Case Against Reform of the Takeover Bids Directive*, 22 *EUR. BUS. L. REV.* (forthcoming 2011). It is noteworthy that in the United Kingdom, which arguably has bidder-friendly takeover regulation, the Takeover Panel recently proposed new rules that protect target companies against hastily prepared takeover bids. Code

Table 1: Implementation of the Takeover Bids Directive

	Board Neutrality	Breakthrough Rule	Reciprocity
Austria	Yes	No	
Belgium	No	No	X
Cyprus	Yes	No	X (breakthrough)
Czech Republic	Yes	No	
Denmark	No	No	X (board neutrality)
Estonia	Yes	Yes	
Finland	Yes	No	
France	Yes	No	X (board neutrality)
Germany	No	No	X
Greece	Yes	No	X
Hungary	Yes	No	X
Ireland	Yes	No	
Italy	No	No	X
Latvia	Yes	Yes	
Lithuania	Yes	Yes	
Luxembourg	No	No	X
Malta	Yes	No	
The Netherlands	No	No	X
Poland	No	No	X

Comm., U.K. Panel on Takeovers & Mergers, *Review of Certain Aspects of the Regulation of Takeover Bids*, PCP 2010/2, available at <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2009/12/2010-2.pdf>.

	Board Neutrality	Breakthrough Rule	Reciprocity
Portugal	Yes	No	X
Slovakia	Yes	No	
Slovenia	Yes	No	X (board neutrality)
Spain	Yes	No	X
Sweden	Yes	No	X (breakthrough)
The United Kingdom	Yes	No	

Adapted from J. A. McCahery and Erik P. M. Vermeulen, Does the Takeover Bids Directive Need Revision?, in S. Grundmann et al., Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010, Unternehmen, Markt und Verantwortung, Band 2, De Gruyter, (2010) 12.²⁸

The implementation and discussion of the provisions of the Takeover Directive has strengthened shareholder rights and enforced checks and balances within listed companies. Still, the Directive has not yet sparked an active market for corporate control capable of preventing misbehavior by managers and controlling parties. This has prompted policymakers to embark on an even more ambitious agenda: “strengthening” corporate governance frameworks. Under this strategy, the refinement of transparency and investor protection rules is prescribed to regulate relations between principals and agents. These measures ultimately seek to promote long-term business success and enhance investor confidence. In the next section, we evaluate and compare the corporate governance frameworks that were introduced to solve conflicts between controlling shareholders, managers, investors and other stakeholders. We also provide an update of recent trends and prospects in the fast-changing area of corporate governance.

²⁸ See Commission of the European Communities, *Report on the Implementation of the Directive on Takeover Bids*, Commission Staff Working Document, Brussels, SEC (2007) 268. Table 1 shows the popularity of the Directive’s opt out provisions. Member states that imposed the board neutrality had already adopted a similar rule at national level. Most member states were not familiar with the breakthrough rule, which explains its unpopularity.

II. WHAT DO CORPORATE GOVERNANCE DEVELOPMENTS TELL US?

A. WHY CARE ABOUT CORPORATE GOVERNANCE?

The past years have seen unparalleled change in corporate governance practices worldwide. Several finance scandals in the beginning of this century provided new momentum for introducing important legal and regulatory reforms. The scandals were not only instrumental in moving corporate governance up the policy agenda, but also in making it an integral part of the daily decision-making process of listed firms. Corporate governance reforms emerging in the aftermath of these scandals slowly settled in the global business environment creating a new set of minimum governance standards. Although the corporate governance movement necessarily raised firm's awareness of the decision-making process and internal control mechanisms, it never evolved much more beyond an exercise in "box-ticking."²⁹

Consequently, when analyzing different corporate governance approaches, it is necessary to be aware that underperforming companies may have a financial incentive to mislead the market by focusing on good governance instead of growth, performance and innovation. This is best illustrated by the use of "precatory signals" that can deceive investors into believing that the insiders of a firm are willing to restrain their diversionary activities. Precatory signals are those that are not tied to effective commitments to reduce expropriation by managers or controlling parties.³⁰ In many cases, firms that adopt corporate governance codes and measures of best practice ostensibly restrict the opportunistic activities of controlling parties. Whilst the controlling parties in listed firms will not bear significant costs by following standard corporate governance arrangements, there may be considerable financial rewards in their adoption if investors are willing to pay a premium for shares of allegedly "well-governed" companies.

The U.S. automotive industry provides an example of deceiving appearances.³¹ While General Motor's (GM) corporate governance

²⁹ Dennis C. Carey & Michael Patsalos-Fox, *Shaping Strategy from the Boardroom*, 3 MCKINSEY Q. 90-94 (2006), available at <http://www.mckinseyquarterly.com>.

³⁰ John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Evaluation*, 149 U. PA. L.R. 2151, 2175 (2001).

³¹ See generally Robert A. G. Monks & Nell Minow, *CORPORATE GOVERNANCE* (Wiley, 2008).

model failed to raise any alarms about the firm's success, Ford's management structure was often considered to be a disaster with respect to enhancing shareholder value.³² For instance, multiple-voting shares Class B gave the Ford family—with 31 votes for every share—40% of the voting power with less than 40% of the equity.³³ This undemocratic governance structure was made worse by the Ford family's veto power over any resolution impacting the firm's corporate structure.³⁴ It must have come as a surprise to corporate governance advocates that Ford's internal organization was effective not only in detecting problems in the business model, but also in taking timely action to remedy them.³⁵ Conversely, the recent GM bailout was caused in part because problems were denied and solutions delayed, despite GM's alleged commitment to a proper corporate governance system.³⁶ These contrasting examples support the view that “sound” corporate governance on paper does not guarantee firm growth and value.³⁷

It is argued that if managers use “good” governance statements opportunistically to conceal performance it is only because

³² Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control, and Management Affect Firm Value?*, 80 J. FIN. ECON. 385 (2006).

³³ Ford Motor Company, 2008 Annual Report, available at <http://corporate.ford.com/microsites/annual-reports>.

³⁴ Paul Ingrassia, *The Lessons of the GM Bankruptcy*, WALL STREET J. (June 1, 2010). See also Belen Villalonga & Raphael Amit, *Family Control of Firms and Industries*, FIN. MGMT 863 (2010).

³⁵ Problems and successes in the automotive industry are often linked to corporate governance issues. For example, Toyota's safety crisis is largely attributed to corporate governance failures. It's assumed that its traditional board, which is large and hierarchical, would not be able to deal adequately with internal and external changes. Surprisingly, however, its position as a global market leader could be overtaken by Volkswagen, which was recently involved in one of the biggest German corruption scandals ever. The scandals have not initiated change in the governance structure of Volkswagen. It remains to be managed by a cozy network of workers, politicians and executives (despite increasing criticism corporate governance proponents). See Daniël Schäfer, *VW: Protective Layers*, FIN. TIMES (June 17, 2010, 9:33 PM), <http://www.ft.com/home/us> (search “Financial Times” for “Schäfer, VW: Protective Layers”); see also Bruce Aronson, *Learning from Toyota's Troubles - Where's the Board?*, JURIST (Feb. 23, 2010), <http://www.jurist.org/forumy/2010/02/learning-from-toyotas-troubles-wheres.php>.

³⁶ See Ingrassia, *supra* note 34.

³⁷ N.K. Chidambaran, Darius Palia & Yudan Zheng, *Does Better Corporate Governance “Cause” Better Firm Performance*, (2006) (on file with authors).

shareholders have failed to act as “responsible owners.”³⁸ To be sure, investors have increasingly cast their votes at the annual general meetings of their portfolio companies.³⁹ The emergence of electronic proxy and voting platforms provided necessary impetus to solve complex and cumbersome voting procedures.⁴⁰ Proxy services firms assist listed multinationals in communicating with shareholders by distributing electronic proxy agendas to institutional investors and collecting and processing votes for the annual general meeting of shareholders. Activist investors, such as hedge funds, have increasingly engaged portfolio companies directly to demand changes or improvements in the governance structure of a firm.⁴¹ These active investors often contact a portfolio company’s management to seek financial information or to influence decision-making and disclosure. This increased level of involvement can lead to by mergers and reorganizations, increased leverage, dividend recapitalizations, and the replacement of management and board members. Activism by hedge funds has even been regarded as the driving force behind the next corporate governance revolution. Yet, even though activist shareholders have the potential to impose discipline on boards and managers, these equity funds are mostly shrouded in mystery, obscurity and complexity. In addition, these funds are said to neglect long-term goals and pursuing short-term pay-offs.⁴² There now seems to be some consensus among policymakers about the need for responsible long-term investors instead of short-term activists. Institutional investors and large shareholders are under a growing pressure from official agencies and other networks, such as the Financial Reporting Council in the United

³⁸ Kate Burgess & Miles Johnson, *FRC Offers Blueprint for Investor Engagement*, FIN. TIMES (July 1, 2010, 22:56), <http://www.ft.com/home/us> (search “Financial Times” for “FRC Offers Blueprint Burgess”).

³⁹ See Section IV.B for a more detailed discussion on the behavior of shareholders during the general meeting.

⁴⁰ Michael C. Schouten, *The Political Economy of Cross-Border Voting in Europe*, 16 COL. J. EUR. L. 1 (2009).

⁴¹ Janet H. Marler & Christophe Faugère, *Shareholder Activism and Middle Management Equity Incentives*, 18 CORPORATE GOVERNANCE: AN INTERNATIONAL REVIEW 313 (2010) (defining shareholder activism as a range of actions taken by shareholders to influence corporate management and boards).

⁴² Joseph A. McCahery & Erik P. M. Vermeulen, *Private Equity and Hedge Funds Activism: Explaining the Differences in Regulatory Responses*, 9 EUR. BUS. ORG. L. R. 535 (2008).

Kingdom and the International Corporate Governance Network, to become actively engaged in their portfolio companies.⁴³

The above discussion offers a brief glimpse of some past trends in corporate governance. The picture that emerges is one of ambivalence. Policymakers and lawmakers introduced “sensible” rules and best practices that, with the possible exception of minimum standards geared towards improving business performance, may sometimes have lead to unexpected results. On the one hand, companies may adopt a corporate governance framework that leads them astray because they (and their advisors) are merely engaged in box-ticking to satisfy auditors, analysts, and other financial market watchdogs. On the other hand, companies can opportunistically adhere to “high standards” of governance to signal trustworthiness to the market without a concurrent internal commitment toward improving value. The bottom line, in our view, is that introducing more detailed corporate governance regulation on a one-size-fits-all and ad-hoc basis is less desirable than a flexible principle-based framework. Stricter rules and less flexibility arguably result in higher compliance costs and more box-ticking. Moreover, without empirical research it is hard to predict whether imposing more detailed rules on firms will prevent fraud, let alone an economic downturn. Section IV contains several exemplars to illustrate that the introduction of stricter corporate governance regulation, based mostly on intuitive hunches, can have a negative spill-over effect on the performance and development of firms. Since companies have different corporate governance needs depending on the culture and other firm-specific features such as size, scope, and firm-ownership, it is difficult to make a case for the introduction of more generally defined corporate governance rules.⁴⁴ This can be seen in the most recent trend in corporate governance, as explained below.

⁴³ International Corporate Governance Network, ICGN STATEMENT OF PRINCIPLES ON INSTITUTIONAL SHAREHOLDER RESPONSIBILITIES (2010), available at http://www.icgn.org/files/icgn_main/pdfs/best_practice/inst_share_responsibilities/2007_principles_on_institutional_shareholder_responsibilities.pdf.

⁴⁴ Bernard S. Black, Antonio Gledson de Carvalho & Érica Gorga, *Corporate Governance in Brazil*, Northwestern University Law and Economics Research Paper No. 09-18 (2009), available at <http://ssrn.com/abstract=1152454>.

*B. CONVERGENCE OR DIVERSITY IN CORPORATE
GOVERNANCE SYSTEMS*

The corporate governance framework of listed companies is drawn, roughly, from three different sources. The primary source is corporate law; the second, securities regulation; and the third is codes of best practice and guidelines.⁴⁵ This framework is concerned with similar issues across jurisdictions: (1) an active and fair protection of the rights of all shareholders, (2) an accountable management board and effective monitoring mechanisms, and (3) transparent information about the financial and non-financial position of the firm.⁴⁶

In the United States, each state has its own corporate law governing the companies that incorporate in that state.⁴⁷ Most listed companies incorporate in Delaware due to the modern, flexible and effective nature of its legal framework.⁴⁸ Delaware General Corporation Law grants shareholders a say on the most important corporate matters, such as significant mergers and acquisitions, amending the articles of association, and electing directors. Since a significant part of Delaware's corporate law mainly consists of default rules, firms are given latitude to establish specific corporate governance features in their articles or by-laws, such as designating classes of securities, authorizing securities with different voting rights, and the mode of appointing directors. Two broad fiduciary duties offer an ex-

⁴⁵ These codes do not intend to enshrine absolute principles and norms, but merely offer a recommendation. In this respect, they serve several functions: (1) they provide business participants with recommended solutions to compliment corporate law rules and securities regulations; (2) they provide focal point solutions to corporate governance problems; and (3) they are meant to assist business parties in the interpretation and implementation of good governance practices. Paul Coombes and Simon. Chiu-Yin Wong, *Why Codes of Governance Work*, 2 THE MCKINSEY Q. 48-53 (2004), available at www.mckinseyquarterly.com.

⁴⁶ Erik P. M. Vermeulen, *The Role of the Law in Developing Efficient Corporate Governance Frameworks*, in CORPORATE GOVERNANCE OF NON-LISTED COMPANIES IN EMERGING MARKETS (OECD 2006).

⁴⁷ Securities exchanges, through their listing rules, impose additional mandates. The New York Stock Exchange, for instance, requires that the majority of the directors are independent.

⁴⁸ 63% of the Fortune 500 companies are incorporated under the Delaware General Corporation Law. See Del. Div. of Corps., 2009 Annual Report, available at <http://corp.delaware.gov/>. In this article, we focus on the Delaware General Corporation Law, since the statutes and its interpretation are influential in other states.

post mechanism to fill gaps in the corporate articles or by-laws. The duty of care requires board members to perform their duties as a prudent person in comparable situations under similar circumstances, and the duty of loyalty requires board members to act in good faith and in the best interest of the corporation and its shareholders.⁴⁹

Statutory corporate law in continental Europe (and most other civil law jurisdictions) lacks the flexibility of Delaware law.⁵⁰ Relationships between shareholders and management are primarily governed by the articles of association and the law of European civil law countries. In contrast to Delaware General Corporation Law, these corporate laws are more mandatory in nature in that parties have no option but to conform to the corporate law rules.⁵¹ The involvement of the European legislature in developing a harmonization program designed to create a degree of uniformity in the law regarding creditor and investor protection through the EU has arguably tended to restrict flexibility in corporation law in general.⁵² Incorporation formalities and capital requirements abound in order to protect shareholders and creditors.⁵³ Furthermore, firms are required to disclose deviations from default rules, including capital structure, objectives, the system of voting, supervision, and conduct governing general shareholder meetings, in filed articles of incorporation.

In 2002, the U.S. adopted the Sarbanes-Oxley Act, which imposed new independence obligations and restrictions on directors and required internal control mechanisms to restore investor confidence.⁵⁴ Upon adopting the federal Sarbanes-Oxley Act, U.S. corporate law became more mandatory in nature, giving listed U.S. firms less room to maneuver around existing corporate law rules.⁵⁵

⁴⁹ Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

⁵⁰ Katharina Pistor, Yorman Keinan, Jan Kleinheisterkamp & Mark D. West, *Innovation in Corporate Law*, 31 J. OF COMP. ECON. 676 (2003).

⁵¹ Reinier Kraakman *et al*, *THE ANATOMY OF CORPORATE LAW, A COMPARATIVE AND FUNCTIONAL APPROACH* (2d ed. 2009).

⁵² Joseph A. McCahery & Erik P. M. Vermeulen, *Does the European Company Prevent the "Delaware Effect?,"* in *EUROPEAN CORPORATE GOVERNANCE, READINGS AND PERSPECTIVES* (Thomas Clarke & Jean-Francois Chanlat eds., 2009).

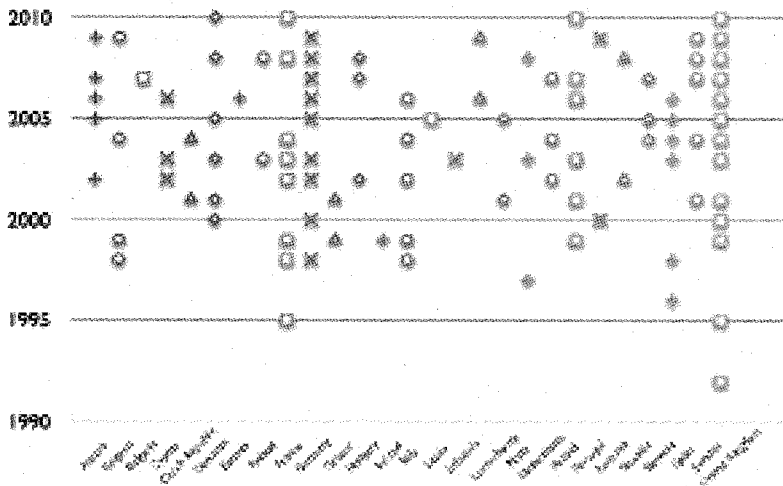
⁵³ Erik P. M. Vermeulen, *THE EVOLUTION OF LEGAL BUSINESS FORMS IN EUROPE AND THE UNITED STATES: VENTURE CAPITAL, JOINT VENTURE AND PARTNERSHIP STRUCTURE* (2003).

⁵⁴ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

⁵⁵ Henry N. Butler & Larry E. Ribstein, *THE SARBANES OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT* (2006).

Sarbanes-Oxley strongly influenced the development of corporate governance in European and Asian-Pacific markets, leading to the emergence of corporate governance codes.⁵⁶ Contrary to the provisions of Sarbanes-Oxley, these codes allegedly offered greater flexibility by following the comply-or-explain rule. Firms should adopt and comply with the boilerplate and standardized provisions of the codes or explain non-compliance. Thus, comply-or-explain gives companies the necessary room to maneuver. It also provides policymakers with more leeway when adjusting codes to meet changing social and economic circumstances. This view is supported by the fact that the drafters of corporate governance codes have been actively introducing, revising and updating these codes since the accounting scandals at the beginning of the century (see Figure 1).

**Figure 1: Updates of Corporate Governance Codes
(per year)**



Source: Adapted from www.oxfordjournals.org

⁵⁶ Paul U. Ali & Greg N. Gregoriou, *INTERNATIONAL CORPORATE GOVERNANCE AFTER SARBANES-OXLEY* (2006); *See also AFTER ENRON: IMPROVING CORPORATE LAW AND MODERNISING SECURITIES REGULATION IN EUROPE AND THE US* (John Armour & Joseph A. McCahery eds., 2006).

Even though there is wide consensus among European policymakers that the flexibility of codes prevails over inflexible, hard law rules and regulations,⁵⁷ firms tend to adopt and comply with the boilerplate and standardized provisions of the codes rather than explain—even though more optimal—non-compliance.⁵⁸ In fact, since the principle-based best practices framework tends to be overly detailed and complex,⁵⁹ companies often find it difficult to deviate from the codes.⁶⁰ It is therefore fair to say that the comply-or-explain approach has encouraged companies to abide by the “letter” of the code, emphasizing the mandatory nature of corporate law in Europe.

It is only to be expected that the recent global financial crisis will lead to more mandatory rules and convergence in the corporate governance systems around the globe. Policymakers and lawmakers on both sides of the Atlantic are starting to focus once again on tightening corporate law rules and enacting best-practice provisions to protect investors and creditors. Similar to previous financial crises, visible market failures and perceived corruption sparked public outrage that has forced the hand of legislators in the United States and the European Union.⁶¹ We can distinguish five emerging regulatory responses. First, the crisis gave new life to some old debates on the internal governance of listed firms, primarily on the topic of heightened board independence. The independence of prospective candidates to the board is traditionally determined by reference to a ready-made checklist

⁵⁷ *Commission Communication to the European Parliament and the Council Concerning Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM (2003) 284 final (May 21, 2003).

⁵⁸ Joseph A. McCahery & Erik P. M. Vermeulen, *Corporate Governance Crises and Related Party Transactions: A Post-Parmalat Agenda*, in *CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN, AND THE US 215* (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda & Harald Baum eds., 2005).

⁵⁹ Principle-based codes emphasize the need to foster standardization and awareness. The drafting committees of the corporate governance codes consist mainly of experienced individuals (making best practice principles more accessible to customization). Yet, experts cannot always be viewed as disinterested persons. They may have political or other agendas, only tangentially related to encouraging business growth and innovation.

⁶⁰ Sridhar Arcot, Valentino Bruno & Antoine Faure-Grimaud, *Corporate Governance in the U.K.: Is the Comply or Explain Approach Working?*, 30 *INT’L REV. L. & ECON.* 193 (2010).

⁶¹ Stephen M. Bainbridge, *Corporate Governance and U.S. Capital Market Competitiveness*, (UCLA Sch. of Law, Law-Econ Research Paper No. 10-13, 2010), available at <http://ssrn.com/abstract=1696303>.

included in the bylaws or in codes of good practice, without any real scrutiny about other critical qualities such as experience, knowledge, and diligence. The shortcomings of these checklists have in the past facilitated the appointment of directors who were only ostensibly independent.⁶² Presently, policy makers are in the process of designing better bright-line rules, which should ideally ensure the independence of prospective candidates to the board, as well as their commitment and expertise.⁶³

The second item on the law reform agenda is executive compensation. There are a number of general principles that lawmakers have used to draft proposals to mitigate excessive compensation and curtail the opportunistic behavior of managers: (1) compensation should be based on measurable performance objectives, and (2) the decision-making process regarding compensation schemes should be more transparent (see Table 2). The latter principle has led U.S. lawmakers to consider measures to increase the involvement of shareholders and even workers in determining executive compensation, the so-called “say-on-pay” provision. After much deliberation, the U.S. Securities and Exchange Commission (SEC) decided on January 25, 2011 to give shareholders the right to participate in the process of setting the compensation levels of management.⁶⁴ The say-on-pay approach has its roots in Europe, where a number of reforms in this

⁶² Listed companies in Japan are not obligated to appoint independent directors. Generally, Japanese firms believe there is no place for outsiders in supervising a domestic company. The evidence provided by the sparse examples of outside directors in Japan is inconclusive regarding a possible correlation between independence and firm performance and value. In Seiko, the influence of an outside director proved decisive in solving a time-consuming and costly conflict in the boardroom. Fujitsu shareholders have a different story. Independent directors were unable to stop a conflict between board members that seriously affected Fujitsu’s share price. Jonathan Soble, *How Seiko Dissidents Called Time*, FIN. TIMES (Aug. 30, 2010, 22:11), <http://www.ft.com/home/us> (search “Financial Times” for “Seiko Soble”).

⁶³ European Commission Staff, *Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices* (European Commission Staff Working Document, COM (2010) 284 final).

⁶⁴ The new SEC rules implement Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and add Section 14A to the Securities Exchange Act of 1934. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011) <http://sec.gov/news/press/2011/2011-25.htm>.

field were already introduced in response to the corporate governance scandals of the beginning of this century. In the United Kingdom, for instance, the shareholders of listed firms have an advisory vote on the remuneration report issued by the company.⁶⁵ In the Netherlands, Norway and Sweden, it is required to obtain a binding shareholder approval for the executive remuneration policy.⁶⁶ Jurisdictions are also increasingly inclined to mandate compensation committees to review executive compensation separate from and in addition to audit committees and nominating committees that also have power over aspects of executive oversight.⁶⁷

Table 2: Executive compensation

Country	Rule
U.S., Canada	Disclosure of salaries for the CEO, CFO and the three next highest paid executives
Britain, Germany, France	Disclosure of salaries for all executives
Finland, Sweden	Disclosure of CEO salary
Japan	Old rule: Disclosure of total pay to all executives. Individual amounts not disclosed. New rule (31 March 2010): Disclosure of salaries of more than 100 Million Yen

Source: adapted from *The Daily Yomiuri*, June 12, 2010.

Even if these proposed compensation rules follow global trends, they might not provide a definitive solution to the problems caused by excessive pay of executives in underperforming firms. The proposed rules could prove impractical by protracting and complicating the decision-making process with listed firms. For example, it may be difficult for shareholders to respond to proposed salaries with informed

⁶⁵ Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK* (Mar. 11, 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1420394>.

⁶⁶ Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does it Create Value?* (Drexel Coll. of Bus., Research Paper No. 2008-06), available at <http://ssrn.com/abstract=1030925>.

⁶⁷ Guido Ferrarini, Niamh Moloney & Maria Cristina Ungureanu, *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis* (ECGI Law Working Paper No. 126/2009), available at <http://ssrn.com/abstract=1418463>.

and meaningful criticism. Executive pay schemes are complex, often linked to both financial and non-financial targets. Moreover, even though the disclosure of executive salaries is supposed to restrict excessively high salaries, it may in practice have the opposite effect. In Japan, for instance, the salary disclosure rule required companies to reveal the total aggregate pay of all the executives in a company.⁶⁸ On March 31, 2010, an additional requirement became effective requiring disclosure of individual annual salaries that exceed 100 million Yen (approximately US\$ 1.1 million). It would not be surprising if this rule eventually leads to higher pay levels in Japan,⁶⁹ which have traditionally been lower than the executive salaries in the United States and Europe, but have already more than doubled over the last ten years.⁷⁰ In 2009, less than 300 executives of 3,813 companies listed at Japanese stock exchanges had to disclose their salary.⁷¹ The average salary of a CEO in Japan is US\$ 580,000. However, the non-Japanese CEOs of Nissan Corp. and Sony Corp. crushed the expectations of observers that their salary would not exceed US and European levels. Both men received 890 million Yen (US\$9.8 million) and 816.5 million Yen (US\$9 million), respectively, which is considerably higher than the average CEO pay of US\$ 3.5 million at listed companies in the United States.⁷² The expectation is that the gap between the salary levels of non-Japanese and Japanese executives will disappear with the new

⁶⁸ Michiyo Nakamoto, *Japan Turns Spotlight on Executive Pay*, FIN. TIMES (June 10, 2010, 19:29), <http://www.ft.com/home/us> (search “Financial Times” for “Japan Turns Spotlight on Executive Pay Nakamoto”).

⁶⁹ *Japanese Executive Pay: Spartan Salarymen*, ECONOMIST: NEWSBOOK (June 30, 2010, 17:05), http://www.economist.com/blogs/newsbook/2010/06/japanese_executive_pay (concluding that Japanese firms should offer more generous incentives to reward talent and effort).

⁷⁰ Minoru Nakazato, J. Mark Ramseyer & Eric B. Rasmusen, *Executive Compensation in Japan: Estimating Levels and Determinants from Tax*, 20 J. ECON. & MGMT STRATEGY (forthcoming 2011) (manuscript at 3-4), available at <http://www.rasmusen.org/papers/nakazato-ramseyer-rasmusen-exec.pdf>.

⁷¹ Jason Clenfield, *In Japan, Underpaid—and Loving It*, BLOOMBERG: BUSINESSWEEK, July 1, 2010, http://www.businessweek.com/magazine/content/10_28/b4186014341924.htm.

⁷² Yoshio Takahashi, *Nissan CEO Made \$9.8 Million*, WALL ST. J., June 23, 2010, <http://online.wsj.com/article/SB10001424052748704853404575323780460252438.html>.

disclosure rules,⁷³ putting more emphasis on compensation as a driver to enhance firm performance.⁷⁴

As previously mentioned, some EU Member States have also focused on a third trend: encouraging shareholders to be more responsible and active in preventing misbehavior and excessive risk-taking by the firm's insiders. The best example of this approach is the U.K.'s Stewardship Code prepared by the Financial Reporting Council in July 2010,⁷⁵ which contains recommendations to help institutional investors better exercise their rights as shareholders of listed firms.⁷⁶ This Code appears to be contributing to efforts to rebuild trust in the financial sector in light of the fact that sixty-eight institutions have already published statements of support less than six months after its publication.⁷⁷ However, it seems too early to predict with certainty whether the adherence to this code will encourage long-term growth. The question arises, for instance, whether institutional investors should be actively engaged with investee companies if they lack the time, knowledge, and a financial incentive to do so.⁷⁸ Further complicating

⁷³ Executive compensation levels of Japanese executives are viewed as a historical and cultural legacy of Japanese corporations. In Japan, salary was generally viewed as a cost compensation mechanism and not as a performance driver. Daisuke Wakabayashi, *Japan's Executives to Reveal Compensation Under New Rules*, WALL ST. J., June 9, 2010, <http://online.wsj.com/article/SB10001424052748703890904575296390830444072.html>.

⁷⁴ See e.g., *Executive Pay on the Rise at Top Japanese Firms*, ASAHI SHIMBUN, July 27, 2010, <http://www.asahi.com/english/TKY201007260410.html>.

⁷⁵ The U.K. Stewardship Code, FINANCIAL REPORTING COUNCIL, available at <http://www.frc.org.uk>.

⁷⁶ These principles can be described as follows: (1) Institutional investors are prompted to disclose their engagement policy regarding monitoring, intervening, and voting; (2) a conflict of interest policy is available; (3) institutional investors actively monitor investee companies (e.g., they attend shareholder meetings); (4) institutional investors have an escalation procedure that sets out the circumstances under which they actively intervene in a listed company; (5) if necessary institutional investors act in concert; (6) a policy on voting and disclosure of voting activity is available; and (7) a periodical report informs the market of the stewardship activities, such as voting.

⁷⁷ U.K. Stewardship Code Statements, FINANCIAL REPORTING COUNCIL, available at <http://www.frc.org.uk/corporate/stewardshipstatements.cfm>.

⁷⁸ Anthony Goodman, *Investors Should be Careful What They Wish for*, FIN. TIMES (July 5, 2010, 18:34) <http://www.ft.com/home/us> (search "Financial Times" for "Investors Should be Careful Goodman"). However, it has been argued that the Stewardship Code is "unlikely to foster substantially greater

matters is the fact that institutional investors owe a fiduciary duty to their own investors which may conflict with corporate governance policies of the investee companies.

A fourth fashionable topic doing the rounds in corporate governance circles is gender parity in the boardroom. Traditionally, women have been underrepresented in the higher managerial echelons of listed firms. A recent report found that amongst Fortune 500 firms only 15.2 percent of all directors are women.⁷⁹ The situation in the European Union and elsewhere is similar.⁸⁰ Policymakers across the globe have taken notice and are now attempting to close the boardroom gender gap. Gender parity initiatives are already in effect in Australia, France, Norway, and Spain with different degrees of success. An initial examination of the relationship between board composition and firm performance shows that diverse boards enhance firm performance.⁸¹ Furthermore, gender diversification positively affects corporate social responsibility ratings, which in turn improves the reputation of a company.⁸² Some authors have argued, however, that board diversity may restrict the ability of firms to adapt to changing business circumstances.⁸³ In sum, the research conducted so far does not provide a clear-cut answer to the question of whether gender and ethnic diversity has a positive, neutral, or negative impact on firm performance.⁸⁴ Before measures mandating board diversity are

shareholder investment in U.K. corporate governance.” Brian R. Cheffins, *The Stewardship Code’s Achilles’ Heel*, 73 MODERN L. REV. 1004 (2010).

⁷⁹ Catalyst, *Census of Women Board Directors of the Fortune 500* (2008), available at http://www.catalyst.org/file/242/08_census_wbd_jan.pdf.

⁸⁰ See, e.g., Charlotte Viliers, *Achieving Gender Balance in the Boardroom: Is it Time for Legislative Action in the UK?*, 30 LEGAL STUDIES 533 (2010); Siri Terjesen et al., *Women Directors on Corporate Boards: A Review and Research Agenda*, 17 CORPORATE GOVERNANCE: AN INT’L REV. 320 (2009), available at <http://www.som.cranfield.ac.uk/som/dinamic-content/media/documents/CGIR.pdf>.

⁸¹ Melsa Ararat, Mine H. Aksu & Ayse Tansel Cetin, *The Impact of Board Diversity on Boards’ Monitoring Intensity and Firm Performance: Evidence from the Istanbul Stock Exchange* (April 2010) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1572283.

⁸² Stephen Bear, Noushi Rahman & Corinne Post, *The Impact of Board Diversity and Gender Composition on Corporate Social Responsibility and Firm Reputation*, 97 J. OF BUS. ETHICS 207 (2010).

⁸³ Jerry Goodstein, Kanak Gautam & Warren Boeker, *The Effects of Board Size and Diversity on Strategic Change*, 15 STRATEGIC MGMT J. 241 (1994).

⁸⁴ David A. Carter et al., *The Gender and Ethnic Diversity of U.S. Boards and Board Committees and Firm Financial Performance*, 18 CORP.

introduced at a European level, further empirical research is warranted.⁸⁵

Finally, the fifth trend followed by policymakers and lawmakers requires training and coaching for executive and non-executive board members. Even though these soft techniques may sometimes prove effective deterrents for some high-risk strategies pursued by certain executives, they are unlikely, in the long run, to form the basis of a coherent and effective corporate governance regime that provide executives and managers with sufficient incentives while protecting the interests of passive investors and other stakeholders.

In the next section, we will show that extended and detailed corporate governance rules and regulations, which are based on a one-size-fits-all approach and encourage box-ticking, may actually lead to higher net costs for companies and their stakeholders. We will challenge the one-size-fits-all mentality of policymakers by describing three exemplars illustrating the negative effects of more detailed measures, and argue that the effect of corporate governance rules on listed companies should be further examined before engaging policymakers and lawmakers to implement inappropriate measures too forcibly and hastily.

III. THE CASE AGAINST ONE-SIZE-FITS-ALL CORPORATE GOVERNANCE RULES

A. EXEMPLAR 1: HIGH GROWTH COMPANIES

The first exemplar frames our view that the strengthening of corporate governance rules, which is high on Europe's political agenda, may have a detrimental effect on firm development and performance.⁸⁶ If this holds true, there is a perceived danger that Europe's drive for more corporate governance regulation will eventually jeopardize entrepreneurship and job creation. European policymakers have committed themselves to create an environment in which high-potential

GOVERNANCE: AN INT'L REV. 396 (2010) (showing there is no significant relationship between gender or ethnic diversity of the board and firm performance); Renee B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. OF FIN. ECON. 291 (2009).

⁸⁵ Some authors have even expressed "an urgent need for more scholarship in this field." See Terjesen et al., *supra* note 80.

⁸⁶ See *supra* Section I.

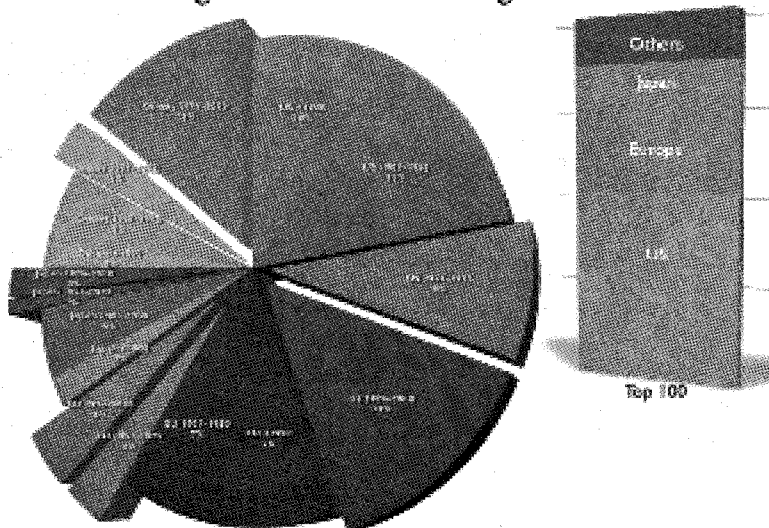
growth companies are able to flourish into large, world-leading companies in a relatively short period of time.⁸⁷ This is important, especially in dealing with the lingering consequences of the economic downturn as listed high growth companies contribute disproportionately to the creation of jobs and wealth.⁸⁸ In this respect, it is interesting to see that when we compare the ranking of the world's largest companies in the Financial Times Global 500 list (see Figure 2),⁸⁹ the number of relatively young listed high-growth companies in the United States is remarkable, (2) U.S. high-growth companies dominate the top 100 of the ranking, and (3) starting (or moving) a high-growth company into the United States seems to increase the chances of success.⁹⁰ Table 3, which compiles data from the U.K.'s Department for Business, Innovation and Skills, shows that the United States indeed has more listed high-growth companies than the United Kingdom.

⁸⁷ *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, Europe 2020 Flagship Initiative, Innovation Union*, COM (2010) 546 final, Brussels, June 10, 2010. The Innovation Union is one of the seven flagship initiatives defined by the European Commission in its Europe 2020 Strategy. There are seven flagship initiatives: (1) Innovation Union, (2) Youth on the move, (3) A digital agenda for Europe, (4) Resource efficient Europe, (5) An industrial policy for the globalization era, (6) An agenda for new skills and jobs, and (7) European platform against poverty.

⁸⁸ *High Growth Firms in the UK: Lessons from an Analysis of Comparative UK Performance* (Dep't for Bus. Enter. & Regulatory Reform, BERR Econ. Paper No. 3, Nov. 2008), available at <http://www.bis.gov.uk/files/file49042.pdf>.

⁸⁹ Please note we have excluded energy, oil and gas producers, and financial institutions from our research.

⁹⁰ Ashlee Vance, *Shapeways and Its 3-D Printing Comes to New York*, N.Y. TIMES (Sept. 23, 2010, 5:53 AM), <http://bits.blogs.nytimes.com/2010/09/23/shapeways-and-its-3-d-printing-comes-to-new-york/?ref=technology>. This is also exemplified by the recent move of Shapeways, which is a spin-off company of Royal Philips Electronics in the Netherlands, to New York. After Shapeways secured a \$5 million investment from Union Square Ventures, a New York Venture Capital Fund, and London-based Index Ventures, the high-growth company reincorporated as a Delaware corporation in the United States. Besides business considerations, the flexibility and stability in corporate governance also played a role in making the reincorporation decision.

Figure 2: FT 500 Ranking

Source: FT Global 500 2009 and individual companies' rankings. All of the numbers and percentages are rounded.

One might wonder why Europe is lagging behind in terms of the creation of listed high-growth companies. The answer is of course not straightforward and depends on factors such as the access to capital, the entrepreneurial mindset, the existence of networks and relationships, and the experience of intermediaries.⁹¹ Yet, the availability of the Delaware corporate form that combines strong management and control characteristics with contractual flexibility also plays a pivotal role in the emergence of listed high-growth companies.⁹² The flexibility and

⁹¹ Joseph A. McCahery & Erik P. M. Vermeulen, *Venture Capital Beyond the Financial Crisis: How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)*, 5 CAPITAL MARKETS L. J. 471 (2010).

⁹² The National Venture Capital Association has posted model legal documents on its website. The model certificate of incorporation is set up for a company incorporated in Delaware. Delaware corporate law is preferred for four reasons: (1) it offers a modern and internationally recognized statute, (2) it offers a well-developed body of case law, (3) the Delaware Court of Chancery's understanding of running a business, and (4) the user-friendly Secretary of State. *Model Legal Documents*, NAT'L VENTURE CAPITAL ASS'N, http://www.nvca.org/index.php?option=com_content&view=article&id=108:model-legal-documents&catid=43:resources&Itemid=136 (last visited Apr. 13, 2010).

stability of the Delaware General Corporation Law allows managers—often the entrepreneurial founders—and shareholders to set up an organizational structure that best meets their special business needs as a growth company.⁹³

Table 3: Large listed high growth firms in the US and the UK

	UK (2007)	US (2007)	UK (2006)	US (2006)
Number of firms with 2007 turnover over £1 billion	186	915	186	915
Number of high growth companies less than 10 yrs old	-	• Google	-	• Google • NII Holdings
Number of high growth companies less than 15 yrs old	-	• Google • Cognizant Technology Solutions • Netapp • Amazon.com • Western Refining • NII holdings	-	• Google • Cognizant Technology Solutions • eBay • Yahoo! • NII holdings

Source: Adapted from Department for Business Enterprise & Regulatory Reform, High growth firms in the UK: Lessons from an analysis of comparative UK performance, BERR Economics Paper No. 3, November 2008.

The importance of flexibility for high-growth companies is illustrated by the data that show how the migration of U.S. growth companies gained pace after the Sarbanes-Oxley Act allegedly imposed stiff legal requirements on corporations listed on a U.S. stock exchange, particularly with regard to their auditing processes. A study published in 2008 includes evidence suggesting that the Sarbanes-Oxley Act had

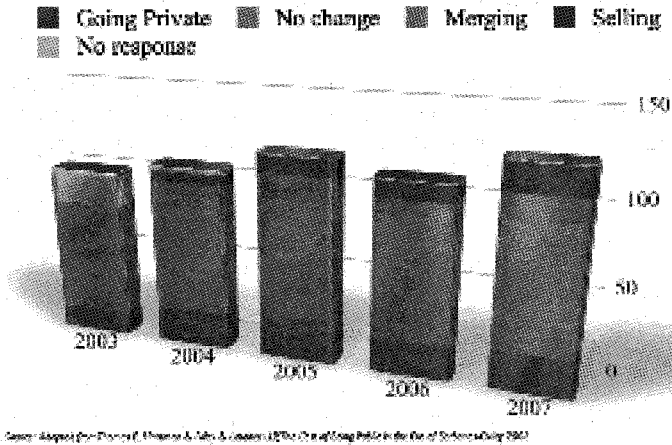
⁹³ See *supra* Section III.B; see also Richard Waters, *Why Tech Companies Need the Discipline of a Dividend*, FIN. TIMES (Nov. 3, 2010, 20:30), <http://www.ft.com/home/us> (search “Financial Times” for “Why Tech Companies Need the Discipline Waters”).

disproportionately affected small U.S. publicly-held firms.⁹⁴ Because significant costs were imposed on companies that intended to float their shares on U.S. capital markets, some of these firms decided to use other listing venues, such as the Alternative Investment Market (AIM) in London, which features principle-based rules that allow firms to tailor listing requirements to their needs. The decision by U.S. firms to quote on AIM enhanced the reputation of this market venue and led companies from other jurisdictions to seek AIM listings. The Sarbanes-Oxley Act also spurred some directors and managers to consider going-private (see Figure 3).⁹⁵

⁹⁴ Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Sarbanes-Oxley and Small Firms: What is the Evidence?* in *IN THE NAME OF ENTREPRENEURSHIP?: THE LOGIC AND EFFECTS OF SPECIAL REGULATORY TREATMENT FOR SMALL BUSINESS* (Susan M. Gates & Kristin Leuschner eds., 2008).

⁹⁵ The average costs of being public in the U.S. for companies with annual revenue under \$1 billion before the reform amounted to approximately \$1,052,000. In 2002, the costs increased by 80% (to an estimated amount of \$1,891,000). In 2005, the average costs dropped by 16% from \$3,437,000 (2004) to \$2,881,000 (2005). Thomas E. Hartman & Foley & Lardner LLP, *The Cost of Being Public in the Era of Sarbanes-Oxley 2006*, available at http://www.foley.com/files/tbl_s31Publications/FileUpload137/3420/ndi%202006%20public%20study%20FINAL.pdf. Note that delisting is not always a pragmatic reaction despite the high costs attached to implementation of corporate governance measures. Although the rules for delisting vary among stock exchanges, exorbitant costs and regulatory restrictions prevent firms across the board from taking the delisting step. For instance, on the New York Stock Exchange and NASDAQ, the delisting process is only set in motion when a minimum on firm size, price, publicly held shares, number of shareholders, and trading volume has been reached; thereby making going private initiatives for small firms impracticable. More importantly, delisting decisions could seriously damage a firm's reputation and cause financial difficulty if it causes creditors to call in loans or downgrade the firm's credit rating.

Figure 3: Reaction of listed firms to SOX



Yet, despite some antipathy to corporate governance rules and regulations, business leaders in the United States have started to accept the Sarbanes-Oxley measures as an obligatory set of minimum standards necessary to warrant business success and revenues on a global scale. Firms are increasingly convinced that improving board structures, financial transparency, and disclosure policies is imperative to attract prospective investors. This conclusion is drawn from interviews conducted with lawyers, business leaders, and other insiders familiar with the compliance trends associated with the Sarbanes-Oxley Act.⁹⁶ The growing number of initial public offerings (IPOs) of companies in the United States in 2010 seems to confirm this view.⁹⁷

⁹⁶ Confidentiality and anonymity arrangements prevent us to mention the names of the interviewees. Relevant records are on file with the authors.

⁹⁷ David Gelles & Tellis Demos, *NYSE Woos Silicon Valley to Catch Next Wave of Listings*, FIN. TIMES (Jan. 23, 2011, 19:16), <http://www.ft.com/home/us> (search "Financial Times" for "NYSE Woos Silicon Valley Gelles"). The decision of CBaySystems Holdings to cancel its AIM listing for NASDAQ is just another example that firms consider a NASDAQ listing to be more beneficial in terms of (1) attracting additional capital, (2) providing more liquidity to investors, and (3) improving the firm's reputation. In addition, CBaySystems intends to change its corporate seat from the British Virgin Islands to the State of Delaware. No consideration is given to the stricter listing rules. See CBaySystems Holdings Limited, Notice of General Meeting (on file with the authors).

The number of IPOs more than doubled in 2010: there were 63 IPOs in 2009 and 154 IPOs in 2010.⁹⁸ It is fair to say that, despite the increase in the cost of entry due to Sarbanes-Oxley, U.S. financial markets again offer an attractive exit strategy for founders and venture capital investors.

The growing acceptance of Sarbanes-Oxley is arguably due to the fact that it has become clear that the federal intervention in corporate law has not affected Delaware's lawmaking supremacy and, more importantly, that high-growth companies still have the option to deviate from Delaware's enabling statute.⁹⁹ Consider the case of Google: Google, Inc., a Delaware corporation, decided not to abide by global trends towards one-share-one-vote structures,¹⁰⁰ but instead to extend the "Google way" of doing business to its corporate governance framework.¹⁰¹ Founders, Sergey Brin and Larry Page, together with Chairman/CEO, Eric Schmidt, own approximately 90 percent of the outstanding class B shares, giving them 68% of the firm's total voting rights while their economic interest is only approximately 20%.¹⁰² This structure clearly deviates from the one-share-one-vote principle. Still, Google's dual-class share structure may be considered good practice during the growth stage of the company because it gives controlling shareholders an incentive to monitor the firm closely and exposes the

⁹⁸ Matt Kranz, *IPO Market Showing Sign of Life as 2011 Looks Promising*, USA Today, January 26, 2011.

⁹⁹ William B. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006); see also Chief Justice Myron T. Steele, *Sarbanes-Oxley: The Delaware Perspective*, 52 N.Y. L. REV. 502 (2008).

¹⁰⁰ See *supra* Section II.

¹⁰¹ Bernard Girard, *THE GOOGLE WAY: HOW ONE COMPANY IS REVOLUTIONIZING MANAGEMENT AS WE KNOW IT* (2009); see also Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581 (2006) (explaining that Google's unusual IPO structure had a branding effect).

¹⁰² The Board of Directors of Google, Inc. has authorized two classes of common stock, Class A and Class B. On December 31, 2009, there were 6 billion and 3 billion shares authorized respectively; additionally, there were 243,611,368 and 74,160,683 shares legally outstanding of Class A and Class B common stock. The rights of the holders of Class A and Class B common stock are identical, except with respect to voting. Each share of Class A common stock is entitled to one vote per share. Each share of Class B common stock is entitled to ten votes per share. Shares of Class B common stock may be converted at any time at the option of the stockholder and automatically convert upon sale or transfer to Class A common stock. See http://investor.google.com/pdf/2009_google_annual_report.pdf.

founders personally to the firm's public shareholders and other stakeholders.¹⁰³ That is not to say that Google completely foregoes corporate governance obligations. Google's board of directors established corporate governance guidelines that provide a flexible framework rather than binding obligations. The fact that Google ranks 30th on the Financial Times Global 500 largest companies of 2010 indicates that the "Google way" of corporate governance does not necessarily have a detrimental effect on firm value.¹⁰⁴

The U.S. approach to corporate governance primarily seeks to ensure that companies disclose their organizational structure and financial conditions to investors. With some exceptions, no substantive and costly corporate governance requirements are imposed on listed companies. We argue that flexible corporate law and governance principles that create a low access level to financial markets are more successful for high-growth companies in the long run. Certainly, at a time of corporate scandals and economic stagnation, it is hard to make the case that companies in jurisdictions with a flexible corporate governance structure eventually outperform companies in countries with strict and rigid corporate governance rules and regulations. Most commentators explain that if Europe were to replicate the entrepreneurial environment of the United States, it should give priority to establishing high labor mobility and risk tolerance, a well-developed stock market, and large, independent sources of venture-capital funding.¹⁰⁵ However, despite these arguments, the Google exemplar seems to indicate that flexible and adaptable corporate governance frameworks also play an important role in the development of high-growth companies in Europe.¹⁰⁶ Certainly, the exemplar suggests that

¹⁰³ Lemonjuice.biz, *Corporate Governance Rating of Google, Inc.*, available at <http://lemonjuice.biz/sites/default/files/Google%20Corporate%20Governance.pdf> (accessed on January 26, 2011). The same conclusions can be drawn from Apple Inc.'s contract with Steve Jobs, which states that he is entitled to receive a salary of one U.S. dollar per year. See Fleischer, *supra* note 101.

¹⁰⁴ The Financial Times Global 500 ranking is based on market capitalizations. The fact that the ranking contains a forward-looking element, as share prices include a view of investors' expectations, makes it an interesting study for comparisons of different corporate governance models.

¹⁰⁵ McCahery & Vermeulen, *supra* note 91.

¹⁰⁶ William W. Bratton, Joseph A. McCahery & Erik P. M. Vermeulen, *How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis*, 57 AM. J. COMP. L. 347, 347-85 (2009). In strict regulation jurisdictions, such as Germany and Austria, the Societas Europaea offers an alternative to companies

the mandatory nature of European corporate law and its trend towards a one-size-fits-all approach does not accommodate the flexible governance needs of high-growth companies, which often stand out by doing things differently.¹⁰⁷

*B. EXEMPLAR 2: THE CASE FOR “RESPONSIBLE”
SHAREHOLDERS*

The past few years have seen an exponential increase in the rights of shareholders in listed firms.¹⁰⁸ One of the goals underlying these changes is the idea that investors can be nudged into exercising their corporate rights in order to counteract opportunism by insiders. However, reforms undertaken in several jurisdictions have seemingly failed to encourage a more hands-on approach by shareholders. This failure is particularly worrisome in light of the increased operational costs that enhanced investor rights generate for listed firms. The efforts of policymakers to encourage “responsible behavior” by shareholders may actually lead to adverse economic consequences.

Evidence gathered from participation in shareholder meetings shows that investors are still reluctant to actively exercise their improved rights. The general assembly of shareholders, which allows shareholders to submit proposals and vote on the items included in the agenda, is perhaps the most important mechanism through which investors can make their voices heard. Despite the importance of general assemblies for governance, policymakers have long struggled to stimulate more active attendance and participation in these meetings.¹⁰⁹ Our research indicates these efforts have not had the coveted effect of significantly increasing attendance at these shareholders meetings. To test whether improvements in the rights of

that need to circumvent the strict regulations. For instance, Mensch und Machine Software SE, a high-tech company that focuses on Computer Aided Design and Manufacturing (CAD/CAM) solutions employed the SE to implement a one-tier board structure. This provided the founders with more control and influence of the decision-making processes (compare the earlier Google example).

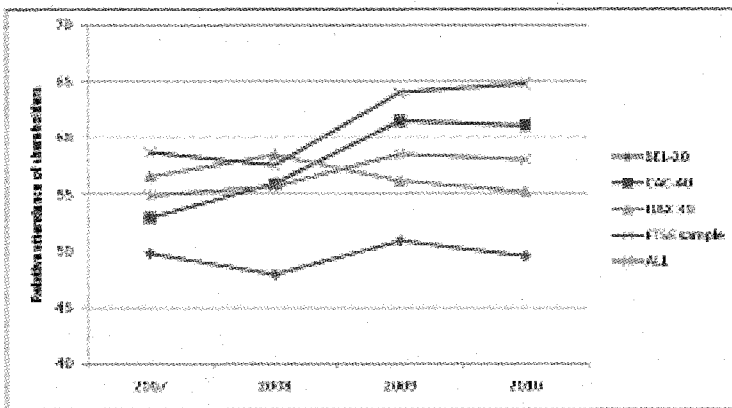
¹⁰⁷ Cf. *Guide to Starting a Corporation*, Fenwick & West LLP (2009) (stating that listed companies prefer Delaware General Corporation Law for its flexibility and prestige).

¹⁰⁸ See *supra* Section III.B.

¹⁰⁹ As explained above, these efforts flow from the belief that shareholder participation can offset managerial opportunism and improve the performance of listed firms.

investors have any influence on the behavior of shareholders, particularly with regard to their willingness to attend general assemblies, we sampled turnout at meetings in Belgium, France, Germany, and the U.K. between 2007 and 2010.¹¹⁰ Our research shows that during this period the average attendance of shareholders slightly increased from 55% to 58% overall. This increase was largely driven by France and the U.K., where turnout increased from 53% to 61% and from 59% to 65%, respectively. As shown in Figure 4, average attendance rates remained unchanged in Germany and Belgium. Given the effect of exogenous factors, including the recent financial crisis, the evidence does not conclusively support any relationship between the improvement in the rights of investors and turnout at general meetings of shareholders.¹¹¹

Figure 4: Evolution of shareholder turnout in European firms



Source: U. Van den Gucht, *Shareholder activities in Good and Bad Economic Days*, working paper, 2010.

We also tested the influence of shareholder rights by looking at shareholder meeting attendance in a sample of twenty-one large German firms between 1998 and 2010.¹¹² According to the information gathered in our sample, included in Figure 5, attendance at shareholder

¹¹⁰ In Belgium, France, and Germany we looked at available voting turnout for all index-listed companies, BEL-20, CAC-40 and DAX-30. In the U.K. we looked at twenty FTSE-100 companies with available voting turnouts.

¹¹¹ See *supra* Section III.B.

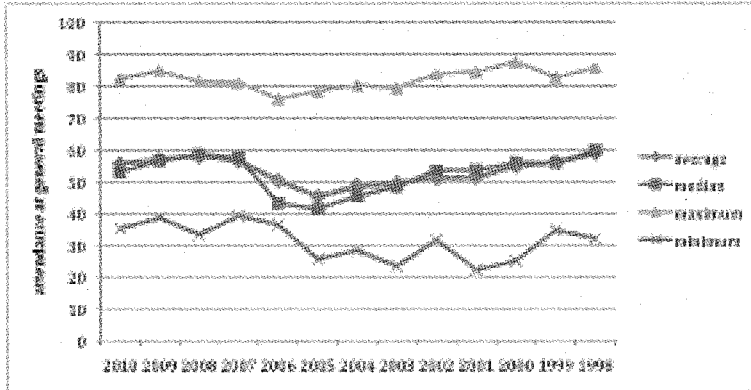
¹¹² This information was obtained from the *Deutsche Schutzvereinigung für Wertpapierbesitz* and is on file with the authors.

meetings was at an all time high in 1998. On average, 59% of all shares were represented at the general meetings of the firms included in our sample during that year. By 2005, however, attendance had dropped to 45%. While there was a 5% increase in shareholder turnout in 2006 and 2007, this trend stopped by 2010. Crucially, these fluctuations do not correspond with the developments in German corporate governance over the past decade. In fact, shareholder turnout actually *decreased* after the turn of the century, when the first corporate governance codes were adopted in Germany (*see also* Figure 1). This does not support a relationship between the improvement of investor rights and their participation at shareholder meetings. However, other legislative measures, such as the 2005 UMAG (*Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts*) appear to have had a positive impact on turnout. In fact, after this law introduced a record date system and facilitated electronic proxy voting and voting *in absentia*, commentators reported significant increases in shareholder attendance to general meetings.¹¹³ Still, this appears to have been a temporary phenomenon as turnout decreased toward the end our sample, even though further corporate governance measures were enacted.¹¹⁴

¹¹³ Ulrich Noack & Dirk A. Zetsche, *Germany's Corporate and Financial Law 2007: (Getting) Ready for Competition* 32 (Ctr. for Bus. & Corp. Law, Working Paper No. 0028, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=986357.

¹¹⁴ In 2009, the *VorstAG – Gesetz zur Angemessenheit der Vorstandsvergütung* granted shareholders a shareholder vote on remuneration policies. According to our research 90% of all DAX companies provided the item on the agenda of the 2010 general meeting. In two companies, one of which was a bank, serious opposition was expressed and the policy was approved by majorities between 50% and 60%. In one company, which was hit hard by the financial crisis, the majority of shareholder turned the policy down. All the other companies had their remuneration policies approved by overwhelming majorities. Earlier legislative initiatives such as *NaStraG – Gesetz zur Namensaktie und zur Erleichterung der Stimmrechtsausübung NamensAktiengesetz* (2001) – and *TransPuG - Transparenz- und Publizitätsgesetz* (2002) – also provided more rights for shareholders and general meetings, but this is not reflected in the data of the attendance of shareholders at general meetings.

Figure 5: Evolution of shareholder turnout in German firms



Source: C. Müller-Glitz, *Shareholder turnout in European firms*, working paper, 2010.

It turns out that the behavior of shareholders that actually attend general meetings does not support the conclusion that enhancing investor rights compels them to behave more “responsibly.” A 2008 study on voting trends in large European firms showed that most resolutions presented at general meetings were approved with an overwhelming majority of more than 90% of attending shareholders.¹¹⁵ As shown in Table 4, we have complemented this study with data gathered from four European firms during 2010, which shows a similar picture. In fact, opposition to the resolutions brought before the general assembly of shareholders in these companies was not substantial. This may suggest that proposals brought before the shareholders of these firms are uncontroversial, which might in turn indicate that these firms are exceptionally well-managed. Nonetheless, the evidence could also suggest that, despite the ongoing improvements in the rights of investors, shareholders are still hesitant when it comes to actually exercising these prerogatives.

¹¹⁵ The average approval ratio lies between 92% in Germany and 98% in Spain. All items on all agendas were approved by overwhelming majorities: 45% of the items with more than 99% of the votes; 39% of the items with more than 95% of the votes; and 10% with more than 90% of the votes. Furthermore, only 35% of the agenda items were opposed by 10% to 20% of the votes, and only 2% of the items were opposed by more than 20%. One item on the agenda of Air Liquide was opposed by 36% of the attending votes.

Table 4: Agenda items discussed in four European firms

Agenda item	Vodafone (UK)	Siemens (G)	Air Liquide (FR)	General Electric (US)
report of the (supervisory) board		p		
company's accounts (and reports of the directors and the auditor)	x	x	x	
consolidated accounts			x	
dividend (evtl. approving the profits of the company)	x	x	x	
discharging board members		x		
discharging supervisory board members		x		
directors (re)election	x		x	x
remuneration report	x			
remuneration policy		x		
related party transaction (board and senior management)			x	
auditor (re)election	x	x	x	x
deputy auditor (re)election			x	
auditor remuneration	x			
shares to be allotted by board	x			
disapply pre-emption rights	x*			
authorization to trade in own shares			x	
purchase own shares	x*	x		
purchase own shares via equity derivatives		x		
annulment of shares			x*	
authorization to issue convertible bonds		x		

Agenda item	Vodafone (UK)	Siemens (G)	Air Liquide (FR)	General Electric (US)
new articles of association	x*	x		
settlement agreement former board		x		
settlement agreement D&O		x		
term to call meeting	x*			
approve share incentive plan	x		x*	
authorization for capital increase via retained benefits			x*	
authorization for capital increase via beneficiaries of savings plan			x*	
authorization for capital increase for specific group of beneficiaries			x*	
authorization share option plan			x*	
authorization to issue equity instruments in case of takeover bid			x*	
authorization of power to execute AGM decisions			x	
Total items (election considered as 1 item)	12	13	16	2
shareholder proposals		2 (rejected)		6 (rejected)
notice of the meeting (pages) provided to shareholders	16	100	28	press release

x: item voted; p: informative item; * extra-ordinary part of combined meeting (FR) or special resolutions (UK)

By looking at the results presented in this Section, we have not been able to find conclusive evidence to support the existence of a strong relationship between corporate governance reforms and

responsible shareholder behavior in Europe. In other words, the efforts deployed by policymakers during the last decade may not have had the desired effect. The problem is that these reform programs impose additional costs on listed companies arising from more paperwork and higher administrative expenses, which are necessary to comply with an increasingly tangled web of rules.¹¹⁶ This may create a hostile environment for firms in the European Union.

C. THE ROLE OF REPUTATION IN LISTED FIRMS

In both developed and emerging countries, the reputation of controlling shareholders—outside expectations of their future behavior—can have a large affect on the firm's economic outlook.¹¹⁷ As the firm's trading counterparties observe the actions of controlling shareholders, they will readjust the conditions under which they deal with the firm to match the expected behavior of these insiders.¹¹⁸ This readjustment can increase or decrease the firm's cost of trading in product and capital markets. In product markets these costs are mainly represented by the firm's trading volumes, its commercial opportunities, and its need to provide executable guarantees or costly bonding mechanisms.¹¹⁹ In capital markets, the readjustment of trading conditions can affect the firm's cost of capital, since outside expectations concerning the behavior of insiders leads investors to increase or discount the price paid for shares.

¹¹⁶ In a typical European corporation, for instance, the notice required to call a meeting of the shareholders can take up to one hundred pages, including all the required preparatory material.

¹¹⁷ For discussions on the importance of reputation in the field of corporate law, see John Armour et al., *Regulatory Sanctions and Reputational Damage in Financial Markets* (Oxford Legal Studies Research Paper No. 62/2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1678028; Jonathan Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANT. ANAL. 581 (2008); Benjamin L. Liebman & Curtis J. Milhaupt, *Reputational Sanctions in China's Securities Market*, 108 COLUM. L. REV. 929 (2008); Cindy Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence Penalties: Public and Private*, 42 J. LAW ECON. 489 (1999).

¹¹⁸ John Armour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (Eur. Corp. Governance Inst. - Law, Working Paper No. 106/2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133542.

¹¹⁹ Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633 (2007).

When insiders have no established reputation or are known to renege on their obligations, the firm will have high trading costs. Conversely, a firm with an insider renowned for fair dealing will reap financial benefits through a reduction in its trading costs in product and capital markets. These effects, positive and negative, feed back to majority equity shareholders and their prospects for private benefit extraction. All value flowing from the firm to these insiders is ultimately tied to the company's economic performance. If the firm's financial situation deteriorates due to increased trading costs, insiders will bear most of the resulting losses through lower dividends and reduced benefit extraction. The same is true for monetary gains tied to reductions in the firm's trading costs that redound to the benefit of controlling shareholders.¹²⁰

As this system of reputation-based trading is tied to the expected actions of insiders, these parties act as reputational intermediaries between the firm and its counterparties.¹²¹ This role can be significant in certain settings. In corporate groups, for instance, the financial effects of reputation have the potential to spread across several firms under the control of a single shareholder. This follows naturally when outsiders rely on the actions of an insider in one firm as a proxy for her behavior in conducting the affairs of other firms within the same group.¹²² Reputation is also valuable in family firms, as their controlling parties often have a specific interest in securing trans-generational wealth.¹²³ The succession process between founders and heirs extends the number of potential interactions between controlling shareholders, in their capacity as reputational intermediaries, and the firm's counterparties, which boosts the positive or negative financial effects of reputation-based trading. Finally, highly-visible controlling parties are also proficient bearers of reputation. Entrepreneurs

¹²⁰ Jose M. Mendoza, *The Untapped Potential of Alternative Markets*, 6 CAPITAL MARKETS L. J. (forthcoming 2011).

¹²¹ Armour, *supra* note 118.

¹²² The "transmission" of reputation would reach listed firms within the group, as well as unlisted affiliates trading in local product markets. This would have a multiplying effect on the financial gains or losses tied to the variations in the costs of trading for all firms within a single group.

¹²³ On the interest of family firms to preserve trans-generational wealth, see Timothy G. Habbershon & Joseph Pistrui, *Enterprising Families Domain: Family-Influenced Groups in Pursuit of Transgenerational Wealth*, 15 FAMILY BUS. REV. 223 (2002); Andrew Ellul, Control Motivations and Capital Structure Decision, (Jan. 2008) (unpublished manuscript), available at <http://ssrn.com/abstract=1094997>.

renowned for their sound business acumen or, conversely, notorious for unfair dealing will have a direct effect on the firm's cost of trading.¹²⁴

Consequently, reputation-based trading can have a significant impact on the financial prospects of listed firms. This creates incentives for the controlling shareholders of these firms to bolster their reputational capital, which may ultimately redound to the benefit of minority investors.¹²⁵ However, the overproduction of mandatory rules can have a negative effect on the ability of these parties to leverage reputation to their advantage. As a country's legal framework is saturated with corporate governance rules, the effect of reputation is diminished. Market participants may in fact be more inclined to rely on objective measures (i.e. compliance with codes of best practice) when negotiating dealings with the firm, rather than on the reputation of its controlling parties. This may crowd out the positive effects tied to the reputational incentives of the firm's majority shareholders.¹²⁶ The problem with this lies with the notion that, as discussed above, adherence to rigid corporate governance rules is not always a true indicator of whether the firm is being run properly. Accordingly, the effect of these rules may be to replace a mechanism that can effectively increase overall welfare with a system that may not.

IV. THE IMPORTANCE OF THE JUDICIARY AND JUDICIAL PROCEDURES

If we accept the idea that a flexible and adaptable governance structure could enhance welfare by promoting best practices that most firms prefer, then the task of policymakers and lawmakers is to create institutions that contribute to the production of acceptable minimum standards of corporate governance. The work of standard-setting institutions, such as the Delaware legislature and corporate governance committees, is successful if they produce legal standards and best

¹²⁴ Compare the Google-example in Section IV.A.

¹²⁵ The loss of reputation can act as a constraint on the appropriation of firm value by controlling shareholders. Observed misbehavior or unfair dealings towards the firm's counterparties can prompt the latter to change the conditions under which they will deal with the firm in the future. This will most severely impact controlling parties, who will see a reduction in the overall wealth they derive from the firm. Gains in reputation can also encourage value-maximizing behavior, as controlling shareholders that cultivate a reputation for sound management and fair dealing can benefit from improvements in the firm's performance through reductions in its costs of trading. See Mendoza, *supra* note 120.

¹²⁶ Vermeulen, *supra* note 53.

practices that meet firms' needs, while adopting provisions that reflect the ever-changing environment in which firms operate. The process also serves to limit the effects of lock-in obsolescence when the standard-setting institutions are engaged in continuous revision of the corporate governance model against the background of changing market conditions. The implementation of the Takeover Bids Directive, discussed in Section Two, led to an apparent consensus about the behavior of companies in a takeover situation. Corporate governance codes that emerged in Europe certainly have the potential to add to the standard-setting process of corporate governance best practices in member states. However, due to the mandatory nature of these codes, corporate governance committees should be careful not to introduce overly rigid rules. Fiduciary duties, such as the duty of loyalty, arguably prove more effective in protecting minority shareholders and other stakeholders. Such a fiduciary duty could be viewed as a backstop mechanism that makes the application of the corporate governance framework contingent on circumstances verifiable by an adjudicator *ex post*, but prohibitively costly to identify *ex ante*.

In a business environment in which corporate governance issues are increasingly debated, judges are not only important to enforce corporate governance mechanisms, but also to develop them through the common law. In this respect, the role of the judiciary appears to be conducive for the development of an effective corporate governance framework.¹²⁷ Notwithstanding the *stare decisis* doctrine, which may impede innovative corporate governance approaches, judges can respond faster and more easily to economic and social change than lawmakers or regulatory institutions.¹²⁸ Courts continuously develop innovative interpretations and clarifications of the existing corporate governance rules and principles.¹²⁹ Obviously, the downside of judicial involvement is litigation costs (see Figure 6) and uncertainty with respect to the outcome. The common view is that judicial intervention is costly, time-consuming and, more importantly, prone to error due to the fact that conflicts in the business sphere are often difficult to observe by general courts *ex post*. This might be different for specialized business courts, which are characterized by the following six key factors: integrity and speed; business experience; level of

¹²⁷ Erik P. M. Vermeulen & Dirk A. Zetsche, *The Use and Abuse of Investor Suits, An Inquiry into the Dark Side of Shareholder Activism*, 7 EUR. COMPANY & FIN. L. REV. 1, 13 (2010).

¹²⁸ La Porta et al., *supra* note 1.

¹²⁹ Steele, *supra* note 99.

deference to insiders (which should be low); ability to focus on key issues; the degree of formalism in its decisions (which should also be low); and the concern it has for the effect of its decisions on other corporate actors.¹³⁰ Aside from these specialized venues, it appears that very few courts are able to respond effectively to business conflicts.¹³¹

Figure 6: Adjudication costs

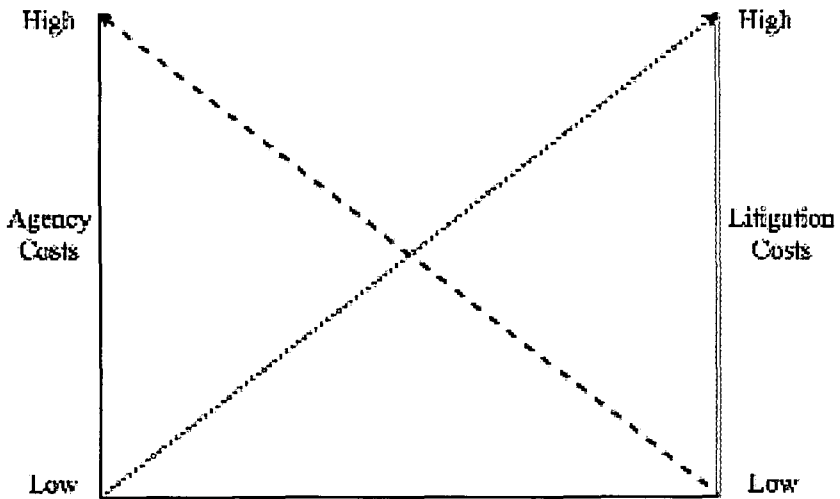


FIGURE 6: AGENCY COSTS AND LITIGATION COSTS. THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES (LOUIS BOUCHEZ ET AL. EDs., 2006). SEE ALSO JACK J. JACOBS, *THE ROLE OF SPECIALIZED COURTS IN RESOLVING CORPORATE GOVERNANCE DISPUTES IN THE UNITED STATES AND IN THE EU*, in THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES (LOUIS BOUCHEZ ET AL. EDs., 2006).

An example of a specialized corporate court that often bases its decisions on clarifications of fiduciary duties is the Delaware Court of Chancery.¹³² In Europe, there is also at least one specialized business

¹³⁰ Luca Enriques, *Do Corporate Law Judges Matter? Some Evidence from Milan*, in THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES (Louis Bouchez et al. eds., 2006). See also Jack J. Jacobs, *The Role of Specialized Courts in Resolving Corporate Governance Disputes in the United States and in the EU*, in THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES (Louis Bouchez et al. eds., 2006).

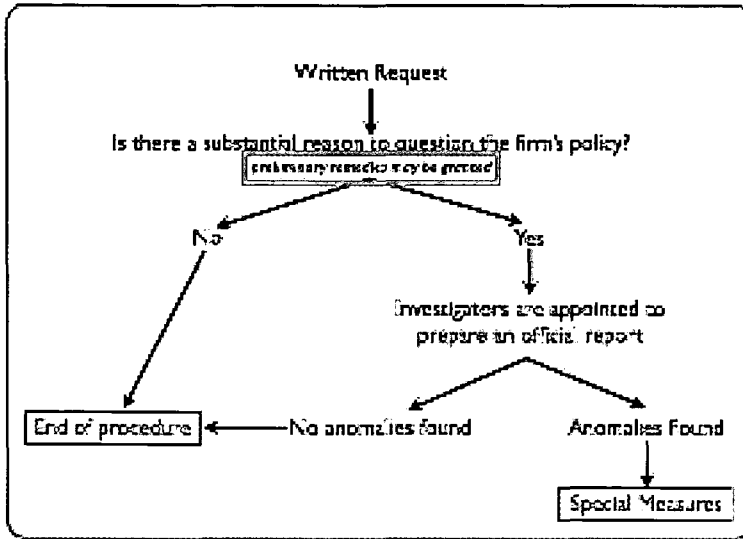
¹³¹ Louis Bouchez & Alexander Karpf, *The OECD's Work Programme on Corporate Governance and Dispute Resolution*, in THE QUALITY OF CORPORATE LAW AND THE ROLE OF CORPORATE LAW JUDGES (Louis Bouchez et al. eds., 2006).

¹³² Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 CINCINNATI L. REV. 1061 (2000).

court: The Enterprise Chamber, a division of the Amsterdam Court of Appeals. Similar to Delaware's court, it provides parties with a speedy, predictable, and low-cost procedure for obtaining relief from governance conflicts. Through the possibility to order temporary measures in its Inquiry Proceeding (see Figure 7), shareholders benefit from the fast decision-making process of the Chamber.¹³³ During the period 2002–2008, the average number of days elapsed before a temporary measure was granted was five days for listed companies and seventy-two days for non-listed companies. The difference between the listed and non-listed companies is arguably due to the amount of media attention and greater pressure that can be exerted by the institutional investors involved. Still, the level of deference to insiders, with regard to claims, is relatively low. Empirical evidence shows that most inquiry procedures are heavily tilted against the interests of controlling parties.¹³⁴

¹³³ Dutch company law mandates that only a narrow range of individuals are entitled to request an inquiry procedure. Besides the public prosecutor (for reasons of public interest) and trade unions (for employees' interests), the most important constituency allowed to request an inquiry procedure are shareholders (or depository receipt holders) who alone or collectively own at least 10% of the outstanding shares or depository receipts of a company or shares with a nominal value of EUR 225,000, or such lesser amount as is provided by the articles of association. See Book 2 BW Articles 344-359 (Burgerlijk Wetboek - Dutch Civil Code).

¹³⁴ Joseph A. McCahery & Erik P. M. Vermeulen, *Conflict Resolution and the Role of Courts: An Empirical Study*, in COMPANY LAW AND SMES, 207 (Mette Neville & Karsten Engsig Sørensen eds., 2010).

Figure 7: *The Dutch Inquiry Procedure*

Source: Adapted from "The Enterprise Chamber: The Effect of Shareholder Suits under Book 2B of the Dutch Civil Code on the Control of the Firm" by J. Vermeulen, 1998, 10 J. Int'l Bus. & L.

Because the Enterprise Chamber usually relies on the fiduciary duty of “reasonableness and fairness,” it is highly flexible in its use of remedies and procedures.¹³⁵ Moreover, the Enterprise Chamber has full discretion to order any temporary measure as it sees fit. The Enterprise Chamber typically uses three measures for listed companies: (1) appointment of independent board members, (2) the prohibition of voting on particular agenda items, and (3) deviation from the articles of association.¹³⁶ This list shows that the Inquiry Proceeding is not limited to mere after-the-fact adjudication, but it offers conflicting parties—through its possibility to order non-formalistic temporary measures—an additional, low-cost, round of after-the-fact bargaining, either by themselves or under the supervision of independent observers.¹³⁷ A fast

¹³⁵ See Book 2 BW Article 8 (Burgerlijk Wetboek - Dutch Civil Code) (stating that shareholders and managers should conduct themselves in relation to each other in accordance with the dictates of reasonableness and fairness).

¹³⁶ The list is derived from our dataset including both listed and non-listed companies that were not involved in bankruptcy proceedings. In the period 2002-2008, the Enterprise Chamber granted more than 130 temporary measures.

¹³⁷ Vermeulen, *supra* note 53.

and informal “judge-initiated” mediation or conciliation procedure is a very attractive corporate governance mechanism.¹³⁸

Some jurisdictions have attempted to address the shortcomings of their local judiciaries by delegating enforcement to public agencies or other independent bodies.¹³⁹ This solution has been particularly effective where adjudicating experts specialize in corporate affairs.¹⁴⁰ Nonetheless, adjudication of this nature often faces certain hurdles. Public officers often lack sufficient incentives to discipline misbehavior. In some cases, political pressure from influential insiders can neutralize prospective inquiries.¹⁴¹ Scarcity of funds or of qualified personnel can further aggravate the situation.¹⁴²

What can policymakers and lawmakers in Europe learn from this? The contemporary economic crisis has set the regulatory train in motion. Corporate governance frameworks tend to become increasingly detailed and rigid. The rules and regulations that were introduced in the wake of the scandals at the beginning of the century arguably set minimum standards of corporate governance that were needed to offer listed companies a more effective checks-and-balances system. Instead of pursuing a one-size-fits-all approach, policymakers should focus on introducing an open-ended duty of loyalty, along with the possibility to bring claims before a specialized court. Experiences in the United States and the Netherlands indicate that shareholders and other stakeholders in a listed company would in fact prefer low-cost specialized business court proceedings that enable them to solve their governance problems in a more informal setting.¹⁴³

¹³⁸ Leo E. Strine, Jr., “Mediation-Only” Filings in the Delaware Court of Chancery: Can New Value Be Added by One of America’s Business Courts?, 53 DUKE L.J. 585 (2003).

¹³⁹ This is certainly the case in Latin American countries such as Mexico, Chile, Brazil, and Colombia, all of which rely heavily on administrative enforcement by public agencies to discipline market players.

¹⁴⁰ Strine, *supra* note 138.

¹⁴¹ A notorious example of this trend may perhaps be found in Italy, where the controlling heads of large conglomerates wield significant political power. See Luca Enriques, *Modernizing Italy’s Corporate Governance Institutions: Mission Accomplished?*, (Eur. Corp. Governance Inst. – Law, Working Paper No. 123/2009), available at <http://ssrn.com/abstract=1400999>.

¹⁴² Gilson, *supra* note 119.

¹⁴³ Jacobs, *supra* note 130 (arguing that the Delaware Court of Chancery and the Dutch Enterprise Chamber serve as models for a specialized business court at a European level).

V. CONCLUSION

This paper challenges the current trend towards more detailed regulation in the field of European corporate governance. For a variety of reasons, policymakers have been actively discussing the introduction of measures to further regulate the activities of listed firms. Some examples of this trend include the rules and regulations meant to promote the involvement of independent directors and long-term shareholders in the decision-making process of firms. In addition, certain policymakers have argued that changing the composition and compensation of corporate boards will deter fraud and abuse in the boardroom and, at the same time, foster firm performance. This paper casts doubt on the effectiveness of these regulatory trends as they arguably generate considerable costs for listed firms in Europe. Supported by three exemplars, we argue against imposing one-size-fits-all rules on listed firm governance. Our analysis supports the need to implement regulatory configurations tailored to meet the diverse needs of companies and changing economic conditions. Specifically, we argue in favor of minimum corporate governance standards and more flexibility for courts. To this end, perhaps policymakers should consider a framework for introducing a business court at the European level specializing in corporate governance and conflict resolution. These measures, which are meant to boost the potential of high-growth firms, may move Europe closer to its long-held ambition of becoming the most competitive economy in the world.