NEW ORIENTATIONS FOR A EUROPEAN FRAMEWORK OF CORPORATE GOVERNANCE*

Viviane de Beaufort**

Abstract

The comparative study of Corporate Governance Codes relevant to the European Union and its Member-States[1], finalised in March 2002, establishes that differences remain at a national scale on corporate governances issues. Beyond the identities of national firms in European Union lies the question: is there a European corporate governance identity? At the present time, European legislation does not cover certain essential aspects of the firm: that is where the shoe pinches! What a company is and what its aims are remain a national question; in the same time transparency requirements are established on a global dimension at least for quoted companies and some new projects of Directives and Recommendations dealing with corporate governance issues attempt to create common rules or principles. This article tries to synthesise the European action in this field and to a certain extend to criticise it not to have a more ambitious project.

Keywords: corporate governance, EU, board committees

**This article is essentially based on a critical review on corporate governance issues and proposals coming from the European Commission.*

*** Doctor in EEC Law, Professor at ESSEC Business School, Member of ECGI*

Introduction

What is a good governance: to act in the name of shareholders interest or to act in the name of the interest's company?

Corporate governance involves the mechanisms by which a business enterprise is directed and controlled, by which corporate managers are held accountable for corporate conduct and performance. But the notion refers also to "frameworks which regulate the interaction between the managers, the owners and the stakeholders (employees, creditors, suppliers, customers and the local community."[2]

The means by which we consider what a company is and what its aims are, have direct consequences on management structure and the way it defines strategies to reach corporate goals. In the European Union, this debate is currently underway, particularly now that EEC proposals are pursuing a liberal way and linked with the achievement of an integrated financial market more than a social project.

Between the Anglo-Saxon approach and the 'Rhineland' model, despite a real convergence, difference today concerns the role and liabilities of management, shareholders and other parties. The power of managers and their responsibilities are not the same in a dual system where representatives of employees and other corporate bodies are represented than in the board system where shareholders have a direct role. When managers are "required to act in the best interests of the company taking into consideration the interest of shareholders, employees and the general public", it is not the same view of corporate governance, than in a company where managers are required to create value for shareholders. The variety of management systems applicable demonstrates that it is difficult to define the company's best interest or even to establish who should be entitled to define it.

All parties can agree on the aim of a better transparency and on a better protection of minority shareholders, but is not sufficient to work on these two main issues. Some others questions are raised: a good example of this phenomenon is the previous debate on the Directive on takeover bids adopted in 2003 after more than ten years of compromises: should everyone accept the dogma of positive effects of hostile bids [3] and thus accept the idea of a neutralisation of anti-takeover defences? What is the mission of the management of the target? Those questions were at the heart of the discussions on the text between the European Commission and the European Parliament. Finally, a bad compromise was find in the name of subsidiarity principle: to

leave Member-States decide if they want to apply or not the rule of the neutralisation of the management which appears in the *Article 9* of the Directive: this article prohibits the board of the target company from taking any defensive measures during the period of acceptance of the bid, once it had received formal notice of the bid; unless it had authorisation from a general meeting of shareholders convened for this specific purpose. Thus, the Management Board may not take any actions outside the ordinary course of business. In the same view, the article 11 requires that restrictions on title transfers, whether in the articles of association or in agreements, will be unenforceable against the offeror, as well as voting rights restrictions, specific rights to nominate or revoke directors…The European Parliament adds an article 12 which allows Member States to authorise companies not to apply article 11 and 9 if they choose it and when they choose to apply it, to avoid to do so if the offeror is a company well protected by the national or a sectorial law or its bylaws (principle of reciprocity).

By evidence, such a debate is not closed, it is not to keep a big risk of mistake to affirm that Member-States will adopt a national legislation linked with their previous habits. In France, the project of October 2005 keeps word by word the European directive with the rule of neutralisation and exceptions, which mean all, will depend on national choices, thee is no harmonisation on this topic of corporate governance.

What about the content of previous European regulations on corporate governance issues?

Most of the initiatives taken at EU level in the area of company law have been based on Article 44 (2) g of the Treaty establishing the European Community which requires to attain freedom of establishment *by a coordination of the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms... Furthermore, the* integration of capital markets giving both issuers and investors the opportunity to be active on other EU capital markets creates a need to have confidence that the companies they invest in have equivalent corporate governance frameworks.

In several of European adopted texts, the inspiration of corporate governance principles can be identified, namely the search for transparency and shareholder protection.

Transparency

The first one, a Recommendation: "the European code of conduct relating to transactions in transferable securities"[4] contains principles for complete and accurate information, equality of treatment for shareholders… Moreover, all the Directives on requirements for admission on the Stock Exchange, disclosure requirements to be published by listed companies on large holdings, on information that investors would consider important [5], etc. and the IFRS Regulation are going towards more and more transparency which is certainly a good thing.

Minority shareholders' protection

OECD Principle II sets forth the general proposition that "the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders." In this view, the Directive on take overbids requires a mandatory bid extended to 100% of the securities carrying rights of vote at a fair price. This mechanism is unanimously considered as the best way of protecting minority shareholders in financial market laws. The text encourages also competing offers and establishes a squeeze-out procedure and a sell-out procedure to entitle minority shareholders to force the majority shareholder to buy the shares back. All these procedures are under the control of national authorities which are supposed to have sufficient powers.

What are the new European proposals on CG?

On 21 May 2003, the Commission adopted an Action Plan announcing measures to modernise company law and enhance corporate governance in the European Union. The Commission's Action Plan follows the recommendations that the "High Level Group of Company Law Experts" presented in its report: "A modern regulatory framework for company law in Europe", on 4 November 2002. Given recent corporate scandals previous Commissioner Bolkestein announced to the European Parliament on 11 February 2004 that work would be accelerated. At the present time some proposals are ready at the Internal Market Directorate General. (Recommendation of May 2004 on Independent directors, project of directive on an appropriate regime for shareholder's rights,

The main objectives of the European Commission works: fostering efficiency of business and strengthening shareholders rights require a fully integrated approach where the *shareholder democracy is the heart of the system. Some texts are dealing with* the comprehensive information on existing rights and the development of the facilities necessary to make sure that these rights can be exercised. Another important subject is how to *modernise the board of directors and the way it works? In this perspective are successively evocated: the board responsibilities and*

information required board's composition and non executive directors.

Board responsibilities

With regard to the responsibility of board members, the prevailing principle in Europe is – in contrast to the US - collective responsibility for the financial statements. The main idea of the proposals is to revise the EU regime of the responsibility of board members for financial statements and key non-financial information.

The collective responsibility of board members for financial but also key non financial statements should be confirmed as a matter of EU law.

a) Special investigation right: whereby shareholders holding a certain percentage of the share capital should have the right to ask a court or administrative authority to authorise a special investigation into the affairs of the company;

b) Wrongful trading rule: directors would be held personally accountable for the consequences of the company's failure, if it is foreseeable that the company cannot continue to pay its debts and they don't decide either to rescue the company and ensure payment or to put it into liquidation;

c) Directors' disqualification for misleading financial and non-financial statements and other forms of misconduct by directors.

Listed companies should be required to include in their annual report and accounts a statement covering the key elements of their corporate governance structure and practices, which should include the following items:

Table 1.

The Annual Corporate Governance Statement proposed by the Commission in the Communication May 2003
Listed companies should be required to include in their annual report and accounts a coherent and descriptive statement covering the key elements of their corporate governance structure and practices, which should at least include the following items:
a) the operation of the shareholder meeting and its key powers, and the description of shareholder rights and how they can be exercised;
b) the composition and operation of the board and its committees;
c) the shareholders holding major holdings, and their voting and control rights as well as key agreements;
d) the other direct and indirect relationships between these major shareholders and the company;
e) any material transactions with other related parties;
f) the existence and nature of a risk management system;
g) a reference to a code on corporate governance, designated for use at national level, with which the company complies or in relation to which it explains deviations.

Improving financial and corporate governance information transparency in intra group relations and transactions with related parties and disclosure about corporate governance practice is absolutely required to obtain that all board members be held accountable for their actions and proper conduct of their responsibilities. This means to realise amendments to the 4th and the 7th Company Law Directives, to comply with IFRS regulation, to modify the 8th directive on statutory audit.

Board composition and non executive directors:

If some items are evocated such as the need for a separation of the roles of chairman and CEO, the proposals are focusing on independent directors to strengthen their role.

Independent directors

In some areas where executive directors should have conflicts of interests such as the remuneration of directors and the supervision of the audit of the company's accounts, decisions should be made by non-executive or supervisory directors who are in the majority independent. For this purpose, a number of independent directors should be elected to the board of companies that is adequate in relation to the total number of non-executive or supervisory directors and significant in terms of representativeness.

What profiles for independent non-executive or supervisory directors?

They should have proper competences: what constitutes proper qualifications should be left to the company itself but all new directors should follow a formal formation on company's organisation and activities and his responsibilities as a director and an sessions to update skills and knowledge. They should in the same time have enough time to work efficiently: which means to reduce the numbers of mandates. Any purely mathematical approach would not make sense in a Recommendation at EU level, thus the text proposed a statement about the need for availability of all directors to ensure the proper performance of their duties.

Independence

The Recommendation includes a general statement "to be free from any business, family or other

relationship - with the company, its controlling shareholder or the management of either – that creates a conflict of interest such as to jeopardise exercise of his free judgement."; accompanied by a list of minimum criteria[9].

But, independence is not simply a matter of absence of certain relationships; it is a matter of approach in fulfilling one's responsibilities. There should be here something to add to ensure that non executive will maintain in all circumstances this independence of analysis, decision and action. The Institut Montaigne proposed recently to require from each independent administrator to sign a personal engagement of behaviour, which could engage his personal responsibility.

Nomination, Remuneration and Audit Committees

The supervisory board has the power to determine the number and structure of the committees which it deems to be appropriate to facilitate its own work; these committees are in principle not to be a substitute for it. The European commission's Recommendation invite Member States to foster the creation by companies of the 3 committees, at a minimum on a "comply or explain". A special emphasis is placed on the audit committee with a view to fostering the key role it should play, on 16 March 2004, the Commission adopted a proposal for a Directive modernising the 8th Company Law Directive on statutory audit which requires that "public interest entities" set up an Audit committee composed exclusively of non-executive or supervisory directors. Committees ensure that they regularly report to the board about their activities and results.

The Audit Committee

The audit committee should be composed exclusively of non-executive or supervisory directors, who are in the majority independent.
The audit committee should at least:

Monitor the integrity of the financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting methods used by the company and its group;

Review the internal control and risk management systems;

Ensure the effectiveness of the internal audit function;

– Make recommendations in relation to the selection, appointment, reappointment and removal of the external auditor, and to the terms and conditions of his engagement;

Monitor the external auditor's independence and objectivity,

Review the effectiveness of the external audit process, and the responsiveness of management to the recommendations made in the external auditor's management letter;

The management should inform the audit committee of the methods used to account for significant and unusual transactions.
The audit committee should make available its terms of reference, explaining its role and the authority delegated to it by the (supervisory) board. The committee should also make a statement in the annual report about its membership, the number of its meetings and attendance over the year, and its main activities.

The Nomination Committee

Generally speaking, the role of the nomination committee should essentially be to make sure that the appointment and removal process is organised in as objective and professional a way as possible. The nomination committee should therefore make recommendations to the (supervisory) board with respect to the appointment and removal of directors by the body competent under national company law. The Committee should be composed of a majority of independent non-executive or supervisory directors; the CEO should be properly involved in the discussions;

The Remuneration Committee

The remuneration committee should be composed exclusively of non executive or supervisory directors, who are in the majority independent.

With respect to executive or managing directors, the committee should at least:

Make proposals to the (supervisory) board on the remuneration policy for executive or managing directors.

Make proposals to the (supervisory) board on the individual remuneration to be attributed to executive or managing directors, ensuring that they are consistent with the remuneration policy adopted by the company and the evaluation of the performance of the directors concerned.

Make proposals to the (supervisory) board on a standard form of contract for executive or managing directors;

Oversee the process whereby the company complies with any existing provisions regarding disclosure of remuneration.

Make recommendations to the executive or managing directors on the level and structure of remuneration for senior management;

Monitor the level and structure of remuneration for senior management;

Debate the general policy regarding the granting of options

Make proposals to the (supervisory) board concerning the choice between granting subscription or purchase options.

The committee should also make a statement in the annual report about its membership, the number of its meetings and attendance over the year, and its activities.

Directors' remuneration

The Commission considers that an appropriate regulatory regime should be composed of four items:

- disclosure of remuneration policy in the annual accounts;
- disclosure of details of remuneration of individual directors in the annual accounts;
- prior approval by the shareholder meeting of share and share option schemes in which directors participate;
- proper recognition in the annual accounts of the costs of such schemes for the company.

Thus the works of the Internal Market General directorate are directly linked with the first Communication of 21 May 2003: "Modernising Company Law and Enhancing Corporate Governance in the European Union" and in all proposals, some efforts are made to improve the quality of transparency, to precise the mandatory or voluntary requirements…But something is missing: there is no mention of any stakeholders interests, there is no mention of their place in the company.

Conclusion: how to enlighten the view of European CG?

Every one could agree on the fact that good governance practices leads to enhanced performance. In this view a lot of elements proposed by the European Commission are interesting but. But again why the field of the Corporate Governance should be reduced in such a way? When, the OECD Principles insist on the fact that "active co-operation between corporations and stakeholders is essential in creating wealth, employment and financially sound enterprises; when several national codes of governance insist on this wider view of corporate governance. [6] It seems that there is a lack of ambition in the texts, especially on company social responsibility.

The attempts to establish a high level of transparency are important. It is the best way to leave management takes his responsibilities, much better than to request mechanical rules such as an ideal proportion of independent administrators. See again, on take over bids, the Directive in the article 10 requires that companies would have to disclose their ownership structure and pre bid defences in a report which should be approved by shareholders at the General Meetings. It seems very appropriate to let European companies make their own choices and assume the consequences on the market.

The creation of a single market in Europe implies that social concerns should be integrated. In the Communication of 21 May 2003: "Modernising Company Law and Enhancing Corporate Governance in the European Union", the Commission proposed a view on corporate governance which is not including any aspect of social responsibility, the word stakeholder is just not written.

This orientation does not fit with the efforts to build a European social model and already existing texts such as the one establishing European Company Committee or the Communication on Corporate Social Responsibility of 2002[8], which addresses the social and environmental dimension of business in a global economy and led to the setting up of a European Multi-Stakeholder Forum with a view to promoting voluntary social and environmental practices of business, linked to their core activities, which go beyond their existing legal obligations. What we need is a well-informed harmonization of national rules at the European level, which would integrate a wider sense of social responsibility. It would be wrong to say that both concepts have nothing in common. Corporate governance represents to the internal organization of the company what sustainable development represents to the external activities of the company. Both dimensions should be commingled inside the notion of company social responsibility. The works of the Internal Market GD are developed in total disregard to the social concerns of the European Union, which is strongly regrettable. In the works of the European Commission, a rule of reason must be found to integrate cultural differences on these issues and to develop a view of social responsibility. This is not the case: corporate governance harmonisation leads to better transparency and to minority shareholder protection but to a certain extent fails to obtain consensus on management mission.

Notes:

1] Comparative Study of the corporate Governance codes relevant to the European Union and its Member-States prepared for the Commission by Weil, Gotshal & Manges LLP,: http://europa.eu.int/comm/internal_market/en/company/news/corp-gov-codes-rpt_en.htm

2] Nørby Report & Recommendations, (Denmark)

3] Simon Deakin research in UK, ECGI paper on October 2002 by M.Becht, P. Bolton and A.Röell: www.ecgi.org/wp, Eg.HansBieshaar, J.Knight, A.vanWassanaer, McKinsey Quarterly 2001,N01 establish that hostile bids have negative implications

for the company, employees and sometimes even destroy shareholder value.
4] Commission Recommendation of 25 July 1977: 77/534/EEC/OJ L 212 20.08.1977 p.37.
5]] Directive 2001/34/EC of the European Parliament and of the Council of COM(2002) 460 final of 28 May 2002 on the prospectus to be published when securities are offered to the public or admitted to trading, Directives 80/390 et 89/298 & Directive 2003/71/CE (4November 2003, JOUE L345,31rst December 2003 p.64) which contains new elements & Directive 82/121/EEC of the Council of 15 February 1982, regarding regular information to be published by companies whose shares are allowed official stock exchange quotation: OJ L 048 20.02.1982 p.26 (OJ L 001 03.01.1994 p.403) & Directive 88/627/EEC of the Council of 12 December 1988 regarding information to be published in case of the acquisition and transfer of relevant participation in a listed company (OJL 348 17.12.1988 p.62).
6] OECD principles of CG (May 1999); Statement 9 on global corporate governance principles by IGCN (July 1999); the European Association of securities Dealers (Recommendation V.1.b.)
7] Directives 94/45/EC on European Company Committee, 98/59/EC on mass layoffs, 2001/86/CE on the implication of employees in the SE and 2002/14/EC on information for employees.
8] Corporate Social Responsibility: A business contribution to Sustainable Development, Communication of the Commission, COM (2002) 347, 02.07.02.
[9] criteria: Not to be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years;
– Not to be an employee of the company or an associated company, and not having been in such a position for the previous five years;
– Not to receive, or have received, additional remuneration from the company or an associated company apart from a fee received as non executive or supervisory director (such additional remuneration covers in particular any participation in a share option or any other performance related pay scheme);
– Not to be or to represent the controlling shareholder(s) (control being determined with due account of the shares held by natural persons or legal entities which cooperate under an express or tacit, oral or written, agreement);
– Not to have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group;
– Not to have been partner or employee of the external auditor of the company or an associated company within the last three years;
– Not to be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director, and not to have other significant links with executive directors of the company through involvement in other companies or bodies;
– Not to have served on the board for more than 12 years (at most);
– Not to be a close family member of an executive or managing director, or of persons in the situations referred to above;