CORPORATE CONTROL IN EUROPE

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Abstract

Control devices are a common practice in Europe, used to increase the influence of a dominant shareholder upon the firm beyond his/her cash flow rights. They are often very powerful devices which limit the effective control of corporations to a small group of shareholders, and can be utilised to extract private benefits of control. In this paper, we aim to provide an understanding how these devices work in principal and then examine how they are used in the main Western European economies (France, Italy, Germany, Spain and the UK), in light of the recent changes of legislation and despite improvements in the efficiency of capital markets.

Keywords: corporate control, capital markets, shareholders

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I. Introduction

Control devices are used to increase the influence of an investor upon the firm beyond his/her cash flow rights. While the existence of blockholders are not necessarily beneficial for the share price of the firm, an investor must be confident that his private control benefits (both pecuniary and non-pecuniary – see Gilson, 2003) outweigh the costs of such an action in terms of lower return on investment and higher risk (Grant and Kirchmaier, 2004).

There are significant differences in ownership structures and control devices between Europe and the United States, and within Europe itself. One major conclusion that we draw is that Continental European corporations are often controlled by large shareholders such as families or the State, in contrast with the Anglo-American model of capitalism where the majority of equity is held by dispersed institutional investors. The average size of the latter's shareholding is significantly smaller.

Moreover, in Continental Europe, owners can retain control of corporations, by holding the majority of voting rights, in excess of the cash flow rights they own.[55] In this paper we outline the basic control devices deployed across Europe. With this work, we want to fill the void about a comprehensive catalogue of control devices which also incorporates the latest changes in legislation.

II. Devices of Corporate Control

Multiple share classes, pyramids and cross-shareholdings are the three main control devices that are employed in Continental Europe to create the distinction between voting rights and cash flow rights. We discuss them here in turn:

Multiple Share Classes: These confer a percentage of votes that are disproportionate to cash flow rights on certain classes of equity.

Traditionally, companies issued shares with no or low voting rights to allow a controlling shareholder to maintain control while issuing equity to which they did not subscribe. The table below demonstrates how widely these are deployed in some of the major European countries.

[55] This effect can also be achieved in the US and UK, but is much rarer. This partly due to the strength of institutional investors, and to the UK listing rules, which generally prohibit 30%+ block holders.

Table 1. Number of firms with dual-class stock in Europe in 2002

Country	Number
Germany	88
Italy	54
Sweden	13
France	12
Austria	11
Switzerland	9
Others	7
Spain	7
Netherlands	5
Greece	3
UK	3

Source: JP Morgan (2002), Thomson Financial (2002)

Golden shares, which are not represented in the table, are a subset of multiple share classes which generally allow governments to maintain special control rights. Often, they are used in newly privatised industries. "Governments have claimed that this is necessary when they see their strategic interests at stake, and they fear that those interests would be compromised if some outside shareholder gained control of the business. An alternative to actual shares are laws that are passed to limit the number of shares or votes any one outside shareholder can control." (Gaughan, 2002, p. 190). However, in three judgements delivered in June 2002, the European Court of Justice declared all such measures illegal, due to incompatibility with the free movement of capital in the European Union (Adolff, 2002). Ironically, Golden Shares were later exempted from the long delayed European Takeover Directive, finally passed by the European Parliament in December 2003 (Freshfields, 2004).

Pyramids: These are a form of corporate control structure whereby a company holds shares in another company, which in turn holds shares in another one. Control of the corporation at the top of the pyramid combines with the stakes all the way down for outright control of the chain. Dividends, transfer pricing and management fees (often used for tax purposes) are employed to funnel cash up the control chain. Collectively these are "tunnelling" devices, intercompany dealings whose terms benefit the controlling shareholder at the top of the pyramid, often at the expense of minority shareholders (Johnson *et al.*, 2000).

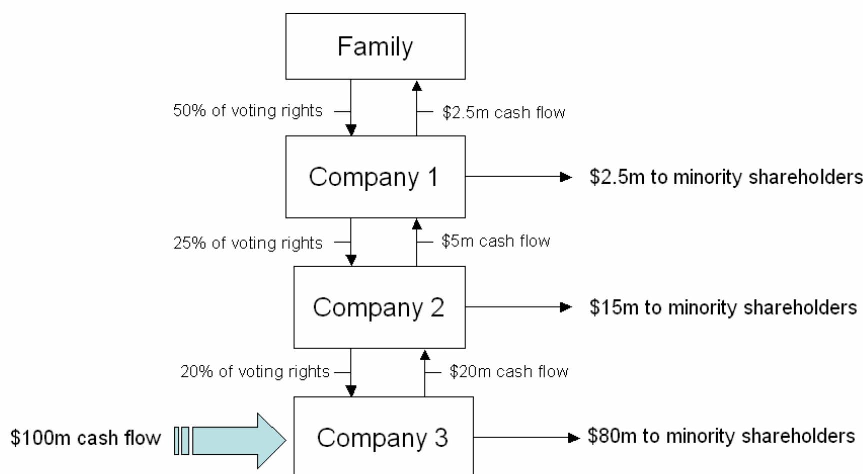


Figure 1. Stylised pyramid structure

Cross-Shareholdings: This is a defensive arrangement whereby two companies buy stakes in each and other, and senior managers/owners sit on each others boards and vote their shares together

defensively. In addition, there are a number of other control devices and defence mechanism that are widely used in Europe. These include:

Partnerships Limited by Shares: These are used in France (Sociétés en Commandite par Actions), Italy (Accomandita per Azioni) and Germany (Kommanditgesellschaft auf Aktien). This device is common for example in the European tire industry, having been deployed by both Michelin and Pirelli (although Pirelli changed its corporate structure in May 2003). Henkel, the consumer goods company uses this structure in Germany. The partnerships function with a small number of unlimited liability partners exerting control, while outside shareholders provide the majority of the capital, but have little influence over the strategic direction of the business.

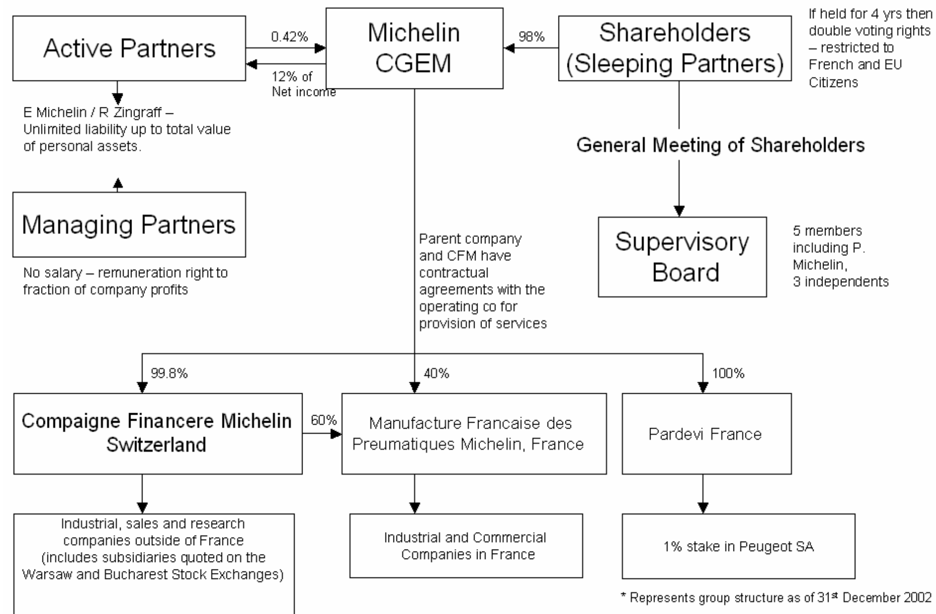


Figure 2. Michelin's ownership structure as an example of a limited partnership

Corporate Charter Provisions: The primary purpose is to ward off interference from outsiders, and ultimately hostile takeover bids. In the US such devices are known as shark repellent. Ones common in Europe include provisions such as staggered boards, voting caps and poison pills which allow new stock to be issued and placed with friendly shareholders in the case of a hostile takeover bid. However, these devices usually shield incumbent managers from general shareholder pressure, rather than re-enforce the dominance of block holders. Corporate charters can also contain share transfer restrictions. For example, in Germany, Allianz and Munich Re retain the right, via their corporate statutes, to block any share transfers, although for practical purposes they have restricted this right to "extraordinary circumstances when considered essential for the company." National airlines in Europe, such as Lufthansa, also often have share transfer restrictions to comply with European aviation regulations.

Embedded Defences: There are also company/industry specific devices. These have been defined as "Embedded Defences" by Arlen and Talley (2003) and include change of control provisions in leases, licenses, joint ventures, employment contracts and debt instruments, as well as the issuance of preferred stock with puts. Examples include that of LVMH as outlined below, which is owned by Bernard Arnault through the holding company Christian Dior. LVMH's major assets, its brands, are owned at the holding company level over which Arnault has absolute power. In the Appendix we include the example of Donna Karen, which was acquired by LVMH in 2000.[56] In general, the array of embedded defences have never been catalogued, so it is difficult to determine how far they have been deployed. However, Arlen and Talley conclude that embedded defences have not been utilised extensively for defensive purposes.

Finally, there are also country specific devices from European jurisdictions that we do not cover in this study. One such example would be the non-voting depository receipts in The Netherlands. They are issued by the corporate offices of publicly listed Dutch companies such as ING Group. In this case, the trust office holds the underlying shares and issues

[56] Although Donna Karen was an American company – its serves as an excellent illustration of the use of embedded defences.

the receipts stripped of voting rights to its shareholders (see Becht 1999 for more details).

In the following we examine the major categories of control devices at country level for the five major European countries under analysis (France, Italy, Germany, Spain and the UK). We also provide illustrative examples to clarify complex corporate structures. A number of these employ multiple devices to maintain control and provide defences against hostile takeover bids.

III. Control at the Country Level

1) France

Devices of Control

Multiple Share Classes: These were legalised under the French Business Law of 1966. Equity shares available in France consist of ordinary or preference shares, voting and non-voting shares, and shares with single or double voting rights. Preference shares are entitled to a greater proportion of the company's earnings, or priority in the distribution of these earnings. They can come with or without voting rights attached. Non-voting preference shares (Actions a 'Dividende Prioritaire') usually have priority over dividends, with no-voting status contingent on payment of the preference dividend. If dividends are not paid in full for 3 years, this class regains voting rights. Non-voting shares cannot account for more than 25% of the capital of a company. Muus (1997) found "non-voting shares have never played an important role in equity finance in France since the companies have different alternatives". This is line with the finding of Banerjee *et al.* (1997) that the control premium of dual class shares in France is 5%, and Dye and Zingales (2004) finding of 2% for sale of control blocks. Direct evidence suggests that the number of significant public companies utilising dual share classes in France is limited. Two recent studies of share classes of major European public companies, Gibbs (2002) and Bennedsen and Nielsen (2001), found 12 and 15 French companies in their respective samples. In a survey for the World Bank, Nenova (2000), found nine.

However, it should be noted that French corporate charters can also impose voting caps and double the voting rights of 'faithful' shareholders who hold the stock for over 2 years. The holders must be French, although the right has now been extended to all EU citizens. These measures were introduced to limit the influence of foreign shareholders (see Servan Schreiber, 1967). Ironically, Calpers (the California State Employees Retirement Fund), has held as much as 5% of France's equity markets (Yergin and Stanislaw, 2002), while Anglo-American institutions hold over 40% of the CAC 40 (Monks and Minow, 2003). These rights relate to ordinary shares, and are not defined legally as a special category. According to Faccio and Lang (2002, p. 384), "most firms grant 2 votes for each ordinary share". For example, LVMH and its holding company Christian Dior demonstrate disparities of voting rights within a pyramid structure. Moreover, Christian Diors's ownership of LVMH's major brands including Louis Vuitton, Givenchy, Lacroix and Kenzo, acts as a potential takeover defence and re enforces Bernard Arnault's control by allowing him to retain complete control over the major assets of the company.

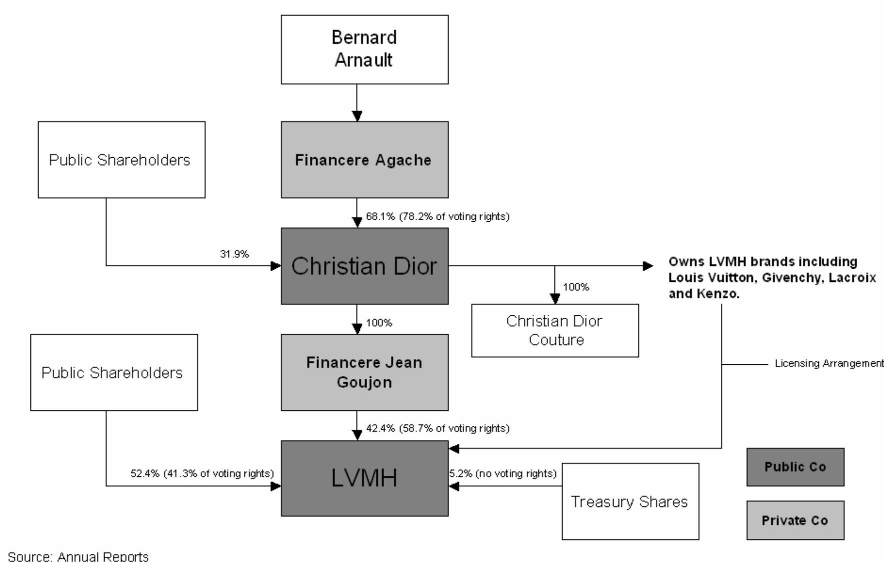
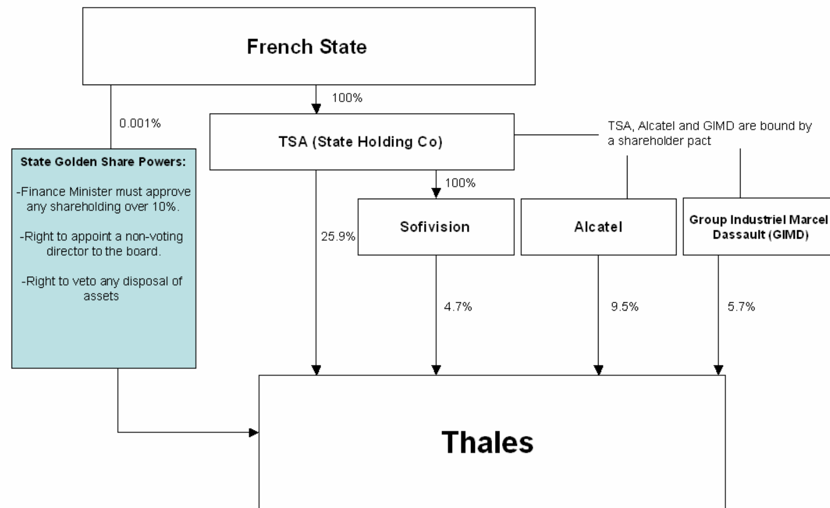


Figure 3. LVMH ownership structure

Golden Shares: Golden Shares are another related control mechanism. These are minority shareholdings, retained by governments in privatised companies, which have special control rights includ-

ing exclusive rights attached to a single share to appoint board members and veto certain management decisions such as asset sales. Adolff (2002) extends the definition of "golden shares" to all devices employed by governments to retain special control rights over privatized corporations. This includes limits on the shareholdings of 'foreigners' and approval of shareholders over a defined threshold. However, as stated earlier, the European Court of Justice declared such measures illegal. The French case regarded caps limiting shareholdings, exclusive veto and appointment rights to the board that existed in 1993 in the corporate charter of Societe Nationle Elf-Acquitaine. However, the French government still retains a golden share in the industrial company Thales.

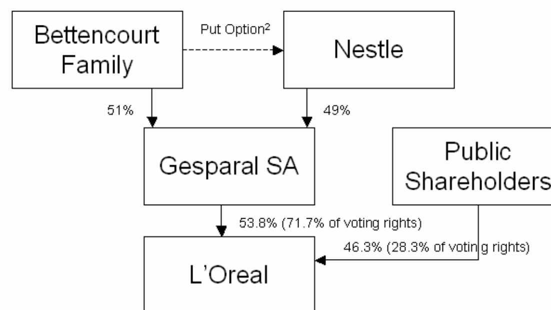
4. Thales Ownership Structure



Source: Annual Report 2002

Figure 4. Thales ownership structure

5. L'Oreal Ownership Structure[1]



[1] Bettencourt family and Nestle agreed to dissolve Gesparal and cancel double voting rights in February 2004.
[2] Allows Bettencourt family to put their control stake to Nestle. Would trigger a mandatory bid to minority shareholders under the French takeover law of 1989 (presuming no concept of grandfathering exists).

Source: Annual Report, JP Morgan Research, Financial Times

Figure 5. L'Oreal's ownership structure as an example of a simple pyramid structure

Pyramid Structures: These are also deployed in France, but according to Bloch and Kremp (2001, p. 106), they "have not been systematically and precisely measured. However, a recent study shows that the number of groups have exploded in France from 1,300 in 1980 to 6,700 in 1995." It should be noted that France does not tax inter-corporate dividends, which normally favours the development of pyramid structures (Morck, 2003). The corporate structure of the cosmetics giant L'Oreal is a good example of a simple pyramid.

Cross-Shareholdings: These have traditionally been a prominent element of French corporate structure, particularly since the first wave of privatisations in 1986. In essence, two companies buy a stake in each other, and the management sits on each others boards. Such arrangements, as well as core shareholdings by friendly French institutions (noyaux durs), were justified in 1988 by Jean Marie Messier, then head of the Privatisation Programme when he stated: "We are privatising companies that are small and weak compared with their international competitors. We must give them a minimal level of protection when we throw them into the bath." (Johnson and Orange, 2003, p.25) However, many of these cross-shareholdings have been subsequently unwound. As Bloch and Kremp (2001, p. 106) state, "at present foundations of this model seem to be weakened". Our ownership data backs this up, as today there are few significant cross-shareholdings among the top 100 public companies in France (see Grant and Kirchmaier, 2004). However, core shareholdings are still a feature of the corporate landscape, albeit a declining one. This is due in part, to a "deliberate strategy of firms to sell their cross-holdings in an effort to convince foreign investors that they would be responsive to shareholder concerns." (Monks and Minow, 2003, p. 333).

2) Italy

Devices of Control

Multiple Share Classes: There are three classes of shares that can be listed on public markets in Italy. These are ordinary, preference and savings shares. Preference shares have limited voting rights, but also a right to the distribution of a greater portion of a company's earnings, or priority in distribution of these earnings. Savings shares are non-voting shares which have a fixed dividend of 5% of par value. They were originally issued to attract retail investors, conditioned to investing in Italian government bonds to the equities markets. These shares also have a liquidation preference over other share classes. However, savings shares can only be issued to an amount equal in par value to the ordinary shares outstanding. The evidence suggests that a significant number of public companies in Italy utilise dual share classes. Gibbs (2002) and Bennedsen and Nielsen (2001), found 54 and 85 Italian companies have them in their respective samples. Nenova (2000) found 62.

Golden Shares: The Italian government has also used 'golden shares' in privatised companies like ENI SpA and Telecom Italia SpA to retain special powers. However, in 2000 these were declared incompatible with European law by the European Court of Justice in a case that was not contested by Italy. ENI and ENEL also have ownership ceilings of 3%.

Pyramid Structures: This is a common control device in Italy, which has historically been favoured because of its neutral tax status and the lack of protection for minority investors. For example, dividends are taxed only once despite the number of levels of the control chain. This has the effect of encouraging long and complex chains of control (see the example of Telecom Italia below).

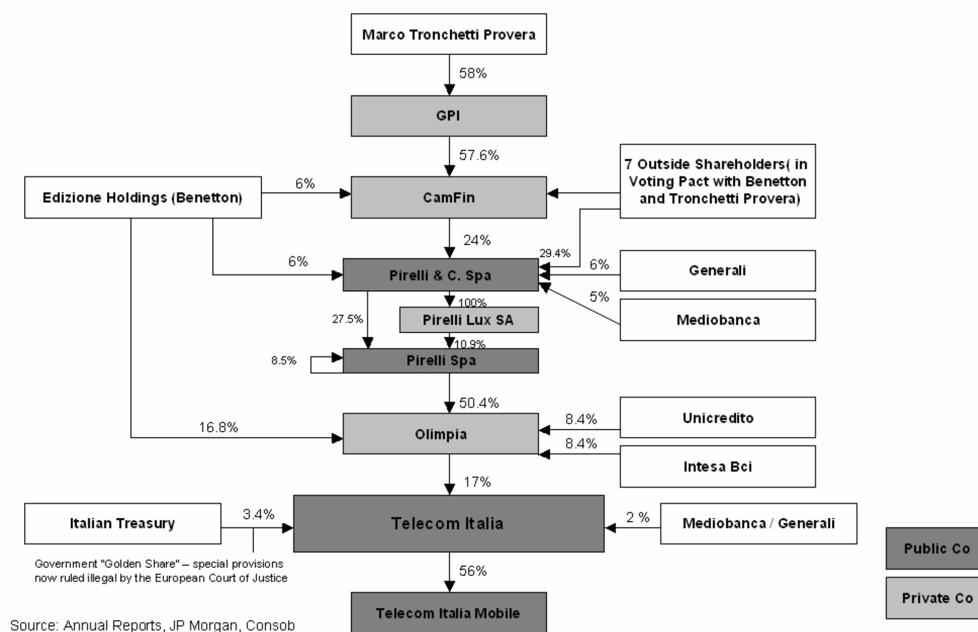


Figure 6. Telecom Italia ownership structure

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Cross-Shareholdings: There are legal limits to direct cross shareholdings in Italy. This limit is 5% if both companies are public. If either holds a stake above 5%, they cannot exercise the voting rights above the limit. However, there are no restrictions on circular control, where company A holds a stake in company B, which holds a stake in company C. In turn, company C holds a stake in company A. As a result of the lack of restrictions, it is not surprising that Italian cross shareholdings take this form and are quite prominent overall. Bianchi *et al.* (1998), found circular holdings of over 2% connected 20 groups of companies equal to 36% of the capitalisation of the Milan stock exchange.

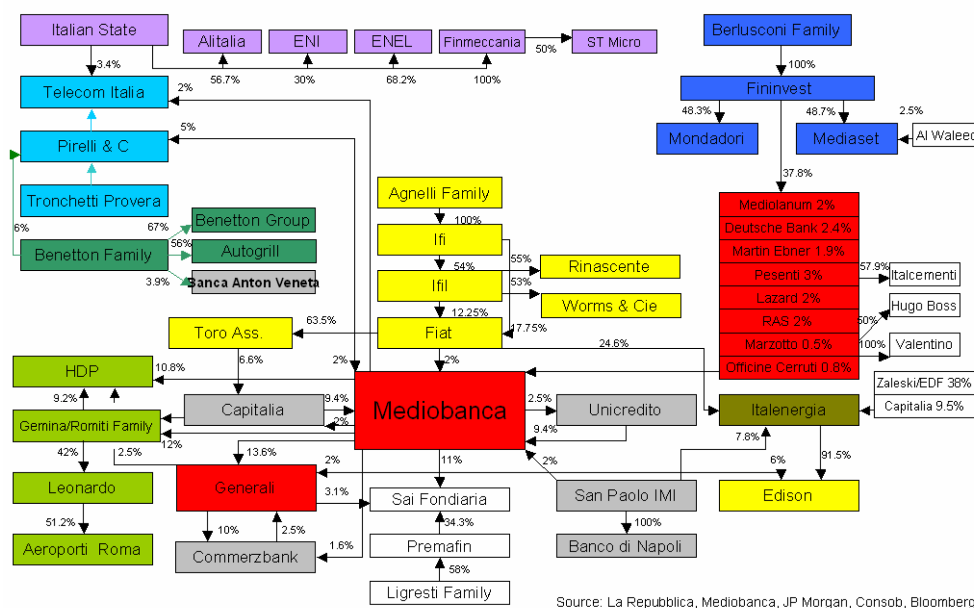

Figure 7. Structure of Italian capitalism

3) Germany

Devices of Control

Multiple Share Classes: There are three classes of shares in existence in Germany. These are ordinary, restricted and preferred shares. Restricted shares have multiple voting rights. For example, RWE had issued restricted shares to the Land of Nord-Rhein Westphalia with 20x the voting rights of the ordinary share class. Siemens issued shares with 6x the voting rights to the Siemens family. (Examples from Becht M and Bohmer E – Ownership and Voting Power in Germany in Barca and Becht (2001). However, after a change in the law in 1998, multiple voting rights and voting restrictions on publicly listed ordinary shares are being phased out. (According to the KonTraG Law, effective May 1998 multiple voting rights for listed companies must be phased out over 5 years, while voting caps had to be abolished in 2 years). Preferred shares can be issued with or without voting rights, but have priority in the distribution of dividends. Shares without voting rights can equal up to 50% of the share capital of a company.

The evidence suggests that a significant number of public companies in Germany utilise dual share classes. Gibbs (2002) and Bennedsen and Nielsen (2001) found 88 and 123 German companies have them in their respective samples. Nenova (2000) counts 65. Gibbs also points out that there are only a few companies where both classes of stock are listed, and in most of his sample the voting shares were not public but privately held by families and/or foundations. See the Porsche illustration below. Therefore, this makes the abolition of publicly listed low voting shares much less effective. Golden Shares: Germany has also come under criticism from the European Commission over "golden shares". For example, the ownership structure of Volkswagen contains arrangements that give the Land of Lower Saxony special provisions of ownership. While it only holds 13.7% of the shares, it controls 20% of the voting rights.[57] Cross-Shareholdings, Pyramids and Deutschland AG: These devices have traditionally been a prominent feature of the German corporate landscape. In 2000, JP Morgan estimated that 31% of the market capitalisation of German equity markets was represented by strategic and industrial shareholdings and cross-shareholdings. (Harris, 2000) For example, Allianz AG and Munich Re historically held 25% of each others equity, which prevented

[57] These include the ability to limit others shareholders voting rights, exclusive rights of both the Land of Lower Saxony and the Federal Government to appoint board directors outside of the shareholders assembly and supermajority provisions of 80% of the share capital to transfer production and facilities (see Adolff, 2002).

"outsiders" exercising significant influence over them. The two insurers have mutually agreed to lower their cross holding to 15%. To this end, Allianz has dropped its stake in Munich Re to 20% and Munich Re has lowered its stake in Allianz to 15%. However, they remain, with Deutsche Bank, the most important holders of ownership blocks in other German companies.

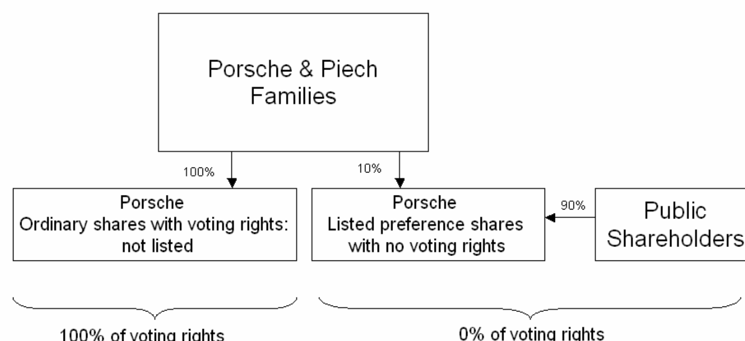

Figure 8. Porsche's ownership structure

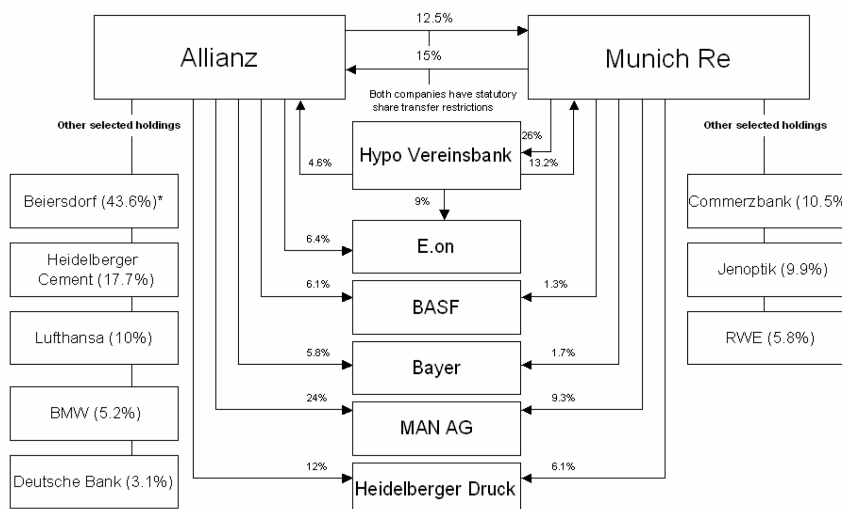

Figure 9. Deutschland AG – ownership structure

4) Spain

Devices of Control

Multiple Share Classes: Under Spanish law, company's can use non-voting shares for up to 50% of their outstanding equity. These shares must yield a minimum dividend of 5%. However, the evidence suggests that few public companies in Spain utilise dual share classes. Gibbs (2002) and Bennedsen and Nielsen (2001) found 7 and 1 Spanish companies with them in their respective samples. Nenova (2000) found none.

As pointed out above, subsequent to the Spanish government's privatisation programme, the state has retained golden share powers in a number of entities through legislation. These include Telefonica SA, Endesa SA and Repsol SA.[58] In a 2003 judgement, the European Court of Justice ruled that the Spanish

[58] Others companies were Tabacalera SA, Corporacion Bancaria de Espana (Argentaria) and Telefonica Servicios Moviles SA.

golden shares were illegal under European law. However, the government continues to maintain these powers at the time of writing through slow enforcement of the European law.

Cross-Shareholdings and Pyramids: Do not appear to be prominent in Spain. However, it should be noted that many companies like Telefonica have voting caps and staggered boards in their corporate charters, which seriously effect governance and control of the firm. For example, the Spanish telecommunications provider imposes a 10% voting cap on any single shareholder despite the size of his shareholding. Deminor, the European Corporate Governance Consultancy, reported that over half the public companies in Spain had voting rights ceilings. Moreover, "the boards of most privatised groups, including Telefonica, Spain's largest company, continue to be peopled by government appointees" (Crawford, 2004). However, it should be noted that these provisions appear to be used to protect incumbent management rather than perpetuating control by blockholds. (That said, former Telefonica CEO Juan Villalonga, was removed from his job. However, this required the intervention of then Spanish Prime Minister Jose Maria Aznar).

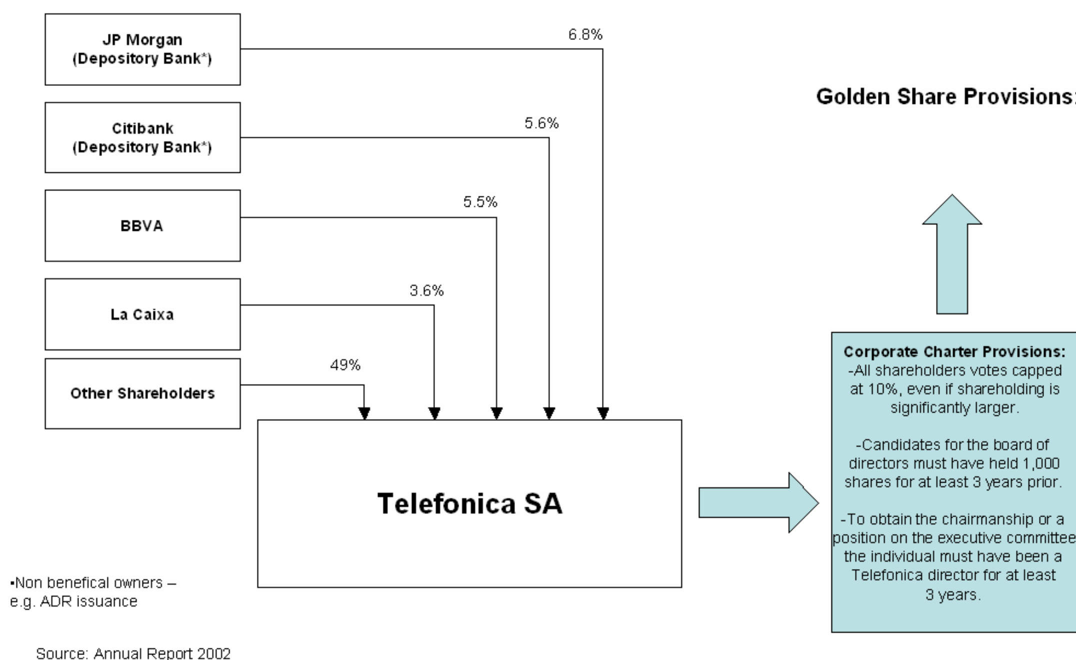

Figure 10. Telefonica's ownership structure

5) United Kingdom

Devices of Control

Multiple Share Classes: The evidence suggests that few public companies in UK utilise dual share classes. Gibbs (2002) found 3 cases in his sample. Surprisingly, Bennedsen and Nielsen (2001), found almost 500 in their sample. However, the majority of the companies were medium and small cap stocks, and Bennedsen and Nielsen conclude that in the UK, "even firms with dual share classes tend to have dispersed ownership and to a large extent proportionality between control and cash flow". Non-voting ordinary shares were outlawed in 1968. While non-voting preference shares, which pay a fixed dividend and rank below debt but above ordinary shares, are still a feature of the capital structures of UK corporates, new issues are rare. Many still listed were issued decades ago by companies that have since merged into new entities, and have not de listed due to the fact that these shares only represent a small percentage of outstanding equity and the regulatory complexity (see Harris 2003). They also have limited voting rights in relation to issues that directly effect them under London Stock Exchange Listing Rules. Moreover, Renneboog and Goergen (2001) state that in the UK, "as dual-class shares are rare, percentages of ownership (or of cash flow rights) and voting rights concentrations tend to coincide". The UK government also has a golden share judgement against it from the European Court of Justice. (Commission of the European Communities vs. the United Kingdom (2003): C-98/01 – Interestingly, the British government argued in this case that dual share classes and unequal voting rights were legal under UK private company law, so therefore as they were standard practise, European Treaties did not apply to such mechanisms. This relates to one company, British Airports Authority. However, Deminor (2004), also

lists BAE Systems, Rolls Royce, National Grid Transco, Scottish Power and Scottish and Southern Energy as having Golden Shares.

Cross-Shareholdings and Pyramids: While the use of cross shareholdings is limited, a handful of large public UK companies have dual listings which function in a similar manner. For example, Shell, Reed Elsevier and Unilever are listed on both the London and Amsterdam Stock Exchanges.

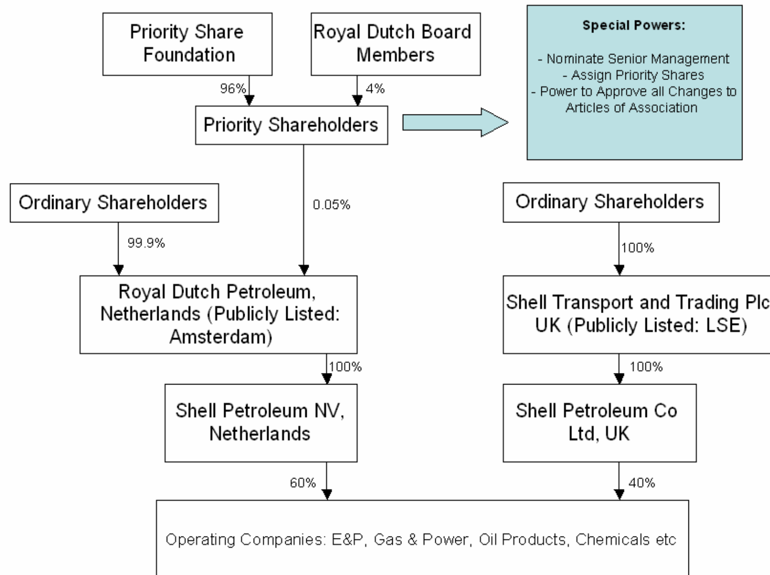

Figure 11. Royal Dutch Shell's ownership structure

These companies are protected from hostile takeover bids, which clearly enhance the discretionary power of the management.

Summary and Conclusion

In this paper, we have catalogued the devices that European firms and their dominant shareholders deploy to maintain control of corporate resources. Ultimately, these continue to be used to extract private control benefits, both pecuniary (monetary) and non-pecuniary (psychological), despite improvements in the efficiency of capital markets. Overall, these devices affect the management and valuation of the firms concerned. A clearer understanding, provided by this paper, of the array of devices and how they work (both on their own and together) is an important step in determining a future research agenda.

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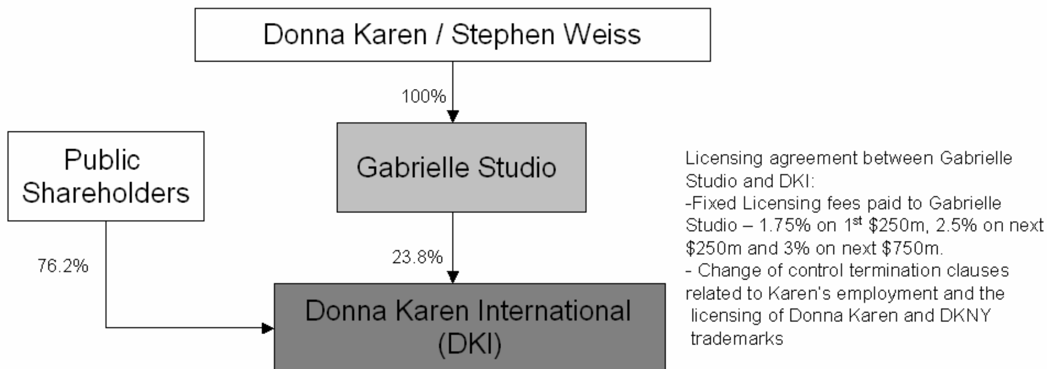
Appendix: Donna Karen



Source: Givhan (2003), Mauer vs. Karen (2000)

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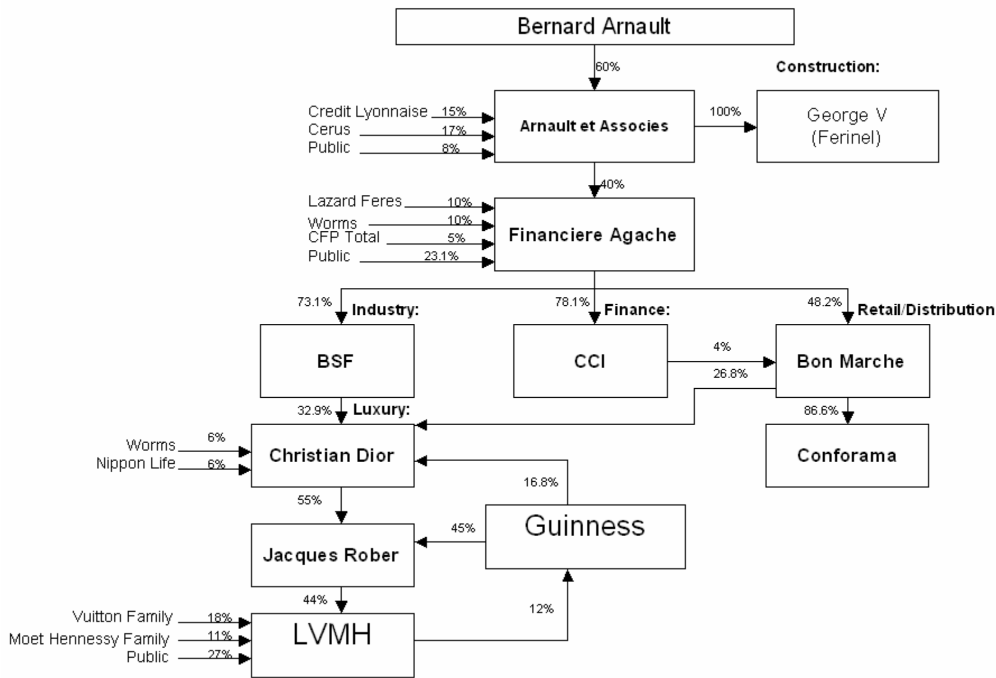
Appendix 2: LVMH Corporate Structure 1987



Source: Forestier and Ravai (1992)