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Enhancing Corporate Governance in the New Member States: Does EU Law Help?

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INTRODUCTION

AFTER THE FALL of the Berlin wall in 1989 the former socialist countries of CEE that are now set to become members of the European Union faced the formidable task of transforming their economies from centrally planned economies to economies that were primarily based on market principles. This entailed the privatisation of the former state owned sector and the implementation of legal and institutional reforms to enhance corporate governance.[1] The EU has admitted eight of the transition economies as new Member States (TEMS)[2] after having attested that they have fulfilled the necessary conditions. The country reports completed prior to the Council meeting in Copenhagen in December 2002[3] confirmed that these countries are now functioning market economies and able to withstand the competitive pressures of market forces once they join the EU.[4] According to data available from the European Bank for

[1] M Aoki and H-K Kim, *Corporate Governance in Transitional Economies* (Washington, The World Bank, 1995); R Frydman *et al*, *Corporate Governance in Central Europe and Russia* (Budapest, Central European University Press, 1996); E Berglöf & E-L von Thadden, 'The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries' (1999) *Proceedings of the Annual Bank Conference on Development Economics*.
[2] See the Treaty Concerning the Accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic to the European Union, signed in Athens on 16 April 2003 [2003] OJ L236/46.
[3] The reports for the different countries are available at: — 'Towards An Enlarged Union' Enlargement and Phare Information Centre <http://europa.eu.int/comm/enlargement/report2002/#report2002> (21 August 2003).
[4] The report on Poland, for example, states in s 2.1 (p 33) that 'Poland is a functioning market economy.' Further that 'Poland has completed transition reforms in terms of trade and price

Reconstruction and Development (EBRD) private sector share of GDP is on average 75.6 per cent.[5] The country reports also state that these countries have complied with the *acquis communautaire* (AC), in particular that they have brought their corporate laws and core financial market regulation in line with existing EU law.[6]

The question these reports do not address, however, is the relation between compliance with the AC on the one hand, and the quality of emerging corporate governance systems in the TEMS on the other. This paper seeks to explore this gap by identifying the challenges TEMS face today for creating effective corporate governance systems and compare these challenges with the solutions offered by the AC. For the purpose of this analysis, the paper distinguishes between two levels of corporate governance. The first level comprises the classic problems of corporate governance, ie the allocation of substantive and procedural rights among different stakeholders of the firm (ie shareholders, creditors, employees, management) in a manner that enhances a firm's ability to use resources efficiently and thereby enhance its position in competitive markets (firm level governance). The second level, the institutional foundation for corporate governance (institutional corporate governance), refers to enforcement mechanisms such as judicial recourse and regulatory oversight, which underpin firm level governance. Empirical evidence has corroborated the importance of institutional corporate governance. In a study that replicates and expands on earlier studies by La Porta *et al*[7] for transition economies, Pistor, Raiser and Gelfer found that there was little correlation between changes in the law on the books that strengthened shareholder and creditor rights on the one hand, and indicators for financial market development on the other. By contrast, indicators that capture the effectiveness of legal institutions were strongly correlated with financial market development.[8] In short, the paper

liberalization, is well advanced in privatisation, and has made considerable advances in second generation reforms' (the latter referring to the introduction of health care, education and pension systems). Concerning structural reforms, the report states on p 39 that 'More than 3 million private sector firms now produce over 70% of GDP, compared to about 65% five years ago, and employ more than 70% of the workforce.' Moreover, 'there are no significant legal or institutional barriers to the establishment of new firms in Poland' and 'in general property rights are established and transferable.' (*ibid*).

[5] Data from the end of 2003. The data range from 65% in Slovenia and Lithuania to 80% in the Czech Republic, Poland, Hungary, and Slovakia.

[6] The EU report on Poland attests that since the last report was made the country has witnessed 'further progress with regard to company law...', even though 'legislative progress had been greater than progress in enforcement and implementation.' The report concludes that despite 'some inconsistencies' with the AC, in particular the level of court fees charged for copies from the company register, 'company law could not provide an obstacle to accession.' See EU Regular Report on Poland, 9 October 2002 at 62.

[7] R LaPorta et al, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113.

[8] K Pistor *et al*, 'Law and Finance in Transition Economies' (2000) 8 *The Economics of Transition* 325.

addresses two closely related questions: First, does the AC enhance firm level corporate governance in light of the major governance problems faced by firms in TEMS today? And second, does the AC further institutionalize corporate governance for firms that originate in TEMS?

CORPORATE GOVERNANCE CHALLENGES IN TEMS

The key challenge for any economy is to optimise corporate governance mechanisms given the agency problems firms in that economy face. A widely accepted definition of corporate governance is that it is 'a system that provides a set of mechanisms designed to control the fundamental agency problem between management and shareholders.'[9] More broadly, Shleifer and Vishny define corporate governance 'as ways in which suppliers of finance to the corporation assure themselves of getting a return on their investment.'[10] These definitions make two important assumptions. First, they assume a separation of ownership and control[11] where shareholders as owners of the corporate enterprise try to control their agents, ie management, which exercises de facto control. Second, they assume that shareholders are the primary providers of firm finance.

These assumptions reflect the experience of the U.S. corporate governance system, but may not be quite as pertinent where ownership structures look quite differently and firms receive financial resources through other channels. For a comparative analysis of corporate governance systems it may therefore be useful to broaden the definition and define corporate governance as a system of mechanisms that reduces major agency costs in the firm wherever they may arise, and ensures that suppliers of crucial inputs to the firm obtain a return on their investments. This definition is open to a broader stakeholder model and captures agency problems not only between management and shareholders, but also between minority shareholders and blockholders, creditors and shareholders, or even employees and shareholders. It follows Hansmann's analysis of the ownership of enterprise.[12] As Hansmann has shown, depending on the relative costs of market-based contracting for various inputs, the optimal allocation of control rights to different stakeholders (or patrons) may well differ not only from sector to

[9] E Berglöf and A Pajuste, 'Emerging Owners, Eclipsing Markets?' ch 13 in this volume, following M Becht and A Röell, 'Corporate Governance and Control' *European Corporate Governance Institute* (ECGI Working Paper Series in Finance no 2, 2002).

[10] A Shleifer and RW Vishny, 'A Survey of Corporate Governance' (1997) LII *The Journal of Finance* 737.

[11] A A Berle and G Means, *The Modern Corporation and Private Property* (New York, Columbia University, 1932).

[12] H Hansmann, *The Ownership of Enterprise* (Massachusetts, Belknap Press of Harvard University Press, Cambridge, 1996).

sector, but also from country to country and firm to firm. This approach also has the benefit of accounting for the possibility that corporate governance is a moving target. The relative costs of different inputs and/or the costs of monitoring may change, and as a result a reallocation of control rights to different stakeholders may be warranted. If, for example, the value of human capital in a particular firm is higher than financial capital, as posited by Zingales in his account of the 'new firm'[13], a governance structure that focuses exclusively on ensuring high returns to financial investors may be misplaced. Closer to the experience of many transition economies, when ownership is highly concentrated and there is little separation of ownership and control, legal rules that attempt to solve the agency problem between shareholders and managers may be of little relevance.

To assess the relevance and likely impact of the governance system established by the AC, it is therefore important to take a closer look at governance problems in TEMS. We posit that TEMS face three major governance problems today: Blockholder control, continuing state ownership, and weak institutional governance.

Blockholder Control

Evidence from TEMS suggests that the location of the major agency problem today is between blockholders who typically control management, and minority shareholders. As Berglöf and Pajuste[14] show in their contribution, the corporate landscape in TEMS is characterised by highly concentrated ownership. The median stake held by the single largest owner in the biggest companies for which data is available in the eight TEMS amounts to 45.4 per cent on average.[15] The three largest shareholders together hold on average over 67 per cent of the companies in their sample. Moreover, voting blocks may often exceed the concentration of ownership stakes.

This ownership structure does not suggest a serious separation of ownership and control between major shareholders and management. It does, however, suggest that minority shareholders are frequently at the mercy of blockholders. Indeed, there is substantial evidence that blockholders have used their de facto control in newly privatised companies to expropriate minority shareholders by looting company assets or diverting them to newly established subsidiaries under the control of management, which in turn serves the interests of management and/or the dominant blockholder — a

[13] L Zingales, 'In Search of New Foundations' (2000) 55 *Journal of Finance* 1623.
[14] E Berglöf and A Pajuste, n 9.
[15] Note that data are typically available for listed companies. In unlisted companies, which may include some of the larger firms in an economy, ownership concentration tends to be even higher.

practice referred to as tunneling.[16] Blockholder control is not unique to TEMS, but is also a core feature of the ownership structure in most continental European economies.[17] Measuring the ultimate voting block rather than ownership stakes, Becht and Roell show that in seven continental European jurisdictions (Austria, Beglium, France, Germany, Italy, Spain and the Netherlands), the median concentration of voting rights is 45.7 per cent. Given the prevalence of block ownership in current Member States of the EU, it is worth exploring whether existing EU law on corporate governance addresses the problems that arise from this ownership structure. If that was the case, the AC could greatly contribute to improving corporate governance in TEMS.

A slightly more unique feature of TEMS is that the new shareholders have often contributed little or nothing to the firm's finances. In countries where mass privatisation programs were implemented, shareholders obtained vouchers for free or for a nominal amount from the state and could use these vouchers to acquire shares in companies. Of the eight TEMS, six have used mass privatisation programs to a greater (Czech Republic, Latvia, Lithuania, Slovenia, Slovakia) or lesser (Poland) extent, while only Hungary and Estonia have relied almost exclusively on traditional forms of privatisation. Where shareholders have not contributed to firm financing in the past, there are few incentives for those who control the firm's affairs to serve the interests of shareholders, as their future contribution to the firm is uncertain. An important task of corporate governance systems in these countries is not to ensure current shareholders a return on their investment (as from the firm's perspective they have not invested anything), but to prevent looting by some at the expense of others. While some have argued that looting is simply part of the process of reallocating property rights and that once 'real owners' have emerged, they will demand better protection of their property rights,[18] looting may seriously undermine investors' confidence in financial markets and thus have longer term detrimental effects for corporate governance and financial market development.

So far, most firms in transition economies have avoided the use of external sources of funds. Available evidence suggests that firms finance new investment projects primarily through retained earnings.[19] Initial public offerings as well as secondary offerings have been rare, and equity, and — to a

[16] J Coffee, 'Privatisation and Corporate Governance: The Lessons from Securities Market Failure' (1999) 25 *Journal of Corporation Law* 1; S Johnson et al, 'Tunneling' (2000) 90 *American Economic Review* 22. For even more dramatic accounts of tunneling practices, cf below Black, n 24 and below Fox, n 36.
[17] M Becht and A Roell, 'Blockholdings in Europe: An International Comparison' (1999) 43 *European Economic Review* 1049.
[18] P Boone and D Rodionov, 'Rentseeking Russian Style' (Unpublished manuscript 2001).
[19] The European Bank for Reconstruction and Development (EBRD), 'Transition Report — Financial Sector in Transition' (London, EBRD, 1998); E Berglöf and A Pajuste, ch 13 in this volume.

somewhat lesser extent – debt markets in most transition economies remain underdeveloped when compared with countries at similar levels of GDP.[20]

This evidence does not imply that firms do not have a greater demand for outside sources of finance than they currently reveal, ie that they would not be better off if they were making greater use of outside sources of finance. The lack of external sources of funds for companies in transition economies as further evidenced by the absence of a vibrant IPO market, appears to be as much a demand as a supply problem.[21] While outside investors may be reluctant to invest in firms absent better protection of their rights,[22] an alternative explanation may be that those currently in control of firms may have little desire to access capital markets for fear that this might dilute their control rights. Moreover, they may gain more from looting existing assets than investing in future performance with uncertain outcomes.[23] The primary task therefore is to create incentives or mechanisms for existing blockholders to reduce their control rights (ie by making control rights costly) as a prerequisite for greater demand for outside sources of finance. At the very least, the creation of additional incentives to further the concentration of ownership and voting control should be avoided.

State Ownership

A second important feature of TEMS is continuous state ownership and state control over partially privatised firms. While privatisation has made substantial headways in TEMS over the past 13 years, the process is by no means complete. In many 'privatised' companies the state retains a substantial ownership stake of about 20–25 per cent and in key industries this may be accompanied by veto rights for major changes, including change in control. State ownership is likely to remain comparatively high for some time to come. The process of privatisation has slowed down and the case for privatisation today is less forcefully made than in the early years of transition.[24] While there is substantial evidence that privatised firms perform

[20] K Pistor, *et al*, above n 8.
[21] K Pistor, 'Law as a Determinant for Stockmarket Development in Eastern Europe' in P Murrell (ed), *Assessing the Value of Law in Transition Economies* (Ann Arbor, University of Michigan Press, 2001).
[22] A Shleifer and R W Vishny, above n 10.
[23] B Black *et al*, 'Russian Privatisation and Corporate Governance: What Went Wrong?' (2000) 52 *Stanford Law Review* 1731.
[24] According to data obtained from the EBRD Transition Reports, the average private sector share of GDP increased between 2000 and 2002 only marginally in the acceding new Member States, from 73% to 75.6%. Compare transition indicators in the 2001 and 2003 reports.

better than state owned firms,[25] privatisation has not proved to be a miracle cure for ailing state owned companies and this has dampened the appetite for continuing privatisation programs at a rapid pace.

State ownership may affect firm level governance in various ways.[26] Even if the state has relinquished majority control, it may reserve veto rights over key decisions for state agents and ensure that state representatives sit on company boards so that they can influence corporate decision-making. Moreover, passive state ownership may also influence corporate decision making by providing insurance against misguided corporate strategies. The state will have to assume its share of the costs of high risk strategies that other shareholders or management may adopt, knowing that they will have to foot only part of the bill. Finally, the state as owner is likely to bail out firms in case they face insolvency. As a result, continuing state ownership may distort investment decisions. These distortions should be minimised.

Law Enforcement

One of the most pressing problems in transition economies is lack of effective law enforcement. All transition economies have made substantial progress in reforming their laws on the books. Actual progress in financial market development, however, has hinged more on the effectiveness of law enforcement than on changes in the law on the books.[27] Survey data compiled by the EBRD on the extensiveness and effectiveness of law reforms document that the two indices continue to diverge.[28] While most of the Central and Eastern European countries have implemented extensive legal reforms in areas relevant for the corporate and financial sectors, the actual implementation or effectiveness of these reforms frequently lags behind.[29]

The most important legal mechanisms for enforcing corporate governance are judicial review and regulatory oversight. So far, courts have not played an important role in specifying the obligations of relevant stakeholders in

[25] R Frydman *et al*, 'When Does Privatisation Work? The Impact of Private Ownership on Corporate Performance in Transition Economies' 114 *Quarterly Journal of Economics* 4: 1153. For a comprehensive survey of the empirical evidence on privatisation compare W Megginson and J M Netter, 'From State to Market: A Survey of Empirical Studies on Privatization' (2001) 39 *Journal of Economic Literature* 2: 321.
[26] K Pistor and J Turkewitz 'Coping with Hydra — State Ownership in Central Europe and Russia' in C Gray, R Frydman and A Andrzej Rapaczynski (eds), *Corporate Governance in Central and Eastern Europe* Vol 2 (Budapest, CEU Press, 1996) 192-246.
[27] K Pistor, *et al*, above n 8.
[28] EBRD, *Transition Report: Energy in Transition* (London, EBRD, 2001).
[29] The EBRD uses a scale from 1 to 4 with '+' and '-' For the Czech Republic, the extensiveness is rated '3+', effectiveness '3'; for Estonia the equivalent data are '4' and '3', for Lithuania '3+' and '4-', for Poland '4' and '3', and for Slovenia '4' and '4-'. For Hungary, Latvia, and the Slovak Republic the ranking is identical for both categories.

the corporation. Case law has been rare or absent for most TEMS.[30] The performance of regulators as monitors and law enforcers differs substantially from country to country. The most widely studied cases are Poland and the Czech Republic and commentators overwhelmingly agree that the Polish financial market regulator has been more effective than the Czech Regulator - with notable effect on market performance.[31]

Whatever the causes for the — relatively[32] — weak track record of TEMS in law enforcement, the phenomenon gives rise to the question of whether a possible solution to this problem is to encourage firms to opt out of the weak domestic governance system and opt into more effective rules and enforcement mechanisms elsewhere. International financial market integration has facilitated cross-listings and migration of firms from home to host markets. While cross-listing could be primarily driven by the desire to benefit from greater liquidity in the host market, there are strong arguments and empirical evidence to support the proposition that 'migration' is used to, or at least has the effect of, signaling to investors at home and abroad that firms wish to bind themselves to more rigorous regulatory standards.[33] More generally, some scholars have suggested that firms should be allowed to freely opt into securities regulations of different jurisdictions and thereby piggyback on the superior enforcement systems in other countries.[34]

Even if one does not subscribe to these suggestions in general, given the importance of institutional governance for firms' costs of raising capital, it is at least conceivable that migration may enhance institutional governance for firms from TEMS. An alternative strategy is to induce domestic governments to enhance their law enforcement institutions. This strategy is supported by those who advocate allocating regulatory control to a firm's country of origin.[35] Whatever the preferred strategy on theoretical grounds, institutional governance in TEMS is in need of reform. This paper will therefore scrutinise the harmonisation of financial market regulation embodied in the AC for strategies that may advance this goal.

[30] K Pistor and C Xu, 'Fiduciary Duties in (Transitional) Civil Law Jurisdictions — Lessons from the Incompleteness of Law Theory' in C Milhaupt (ed), *Global Markets, Domestic Institutions: Corporate Law and Governance in a New Era of Cross-Border Deals* (New York, Columbia University, 2003) 77.
[31] J Coffee, above n 16; S Johnson and E Glaeser *et al.*, 'Coase vs. Coasians' (2001) 116 *Quarterly Journal of Economics 3: 853*; K Pistor (2001) above n 22.
[32] To be sure, law enforcement in most Central and Eastern European countries is substantially better than in those of South-Eastern Europe or the former Soviet Union. See Pistor *et al.* above n 8.
[33] J Coffee, 'Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance' (2002) 102 *Columbia Law Review* 1757; J Coffee, 'The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control' (2002) 111 *Yale Law Journal* 1; E Rock, 'Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure' (2002) 23 *Cardozo Law Review* 675. See also L Klapper and I Love, 'Corporate Governance, Investor Protection and Performance in Emerging Markets' *World Bank Policy Research* (Working Paper 2818 March 2002), who show that firms from 'bad' governance regimes can escape the negative shadow of such a regime by voluntarily complying with superior governance standards, including voluntary codes of conduct.
[34] S J Choi and A T Guzman, 'Portable Reciprocity: Rethinking the International Reach of Securities Regulations' (1998) 71 *South California Law Review* 903; R Romano, 'Empowering Investors: A Market Approach to Securities Regulation' (1998) 107 *The Yale Law Journal* 2359.

FIRM LEVEL GOVERNANCE UNDER THE AC

Firm level governance includes all mechanisms designed to lower agency costs among different stakeholders of the firm, and to ensure adequate returns for those providing major inputs to the firm. The following discussion will focus on three major aspects of firm level governance: internal governance, transparency, and external governance. Internal governance refers to the allocation of control rights inside the corporate enterprise, including the allocation of rights between management and shareholders and among different shareholder groups, which is commonly achieved by quorum requirements, majority voting rules, or veto rights. Transparency includes disclosure requirements of listed and unlisted firms that enhance the ability of investors to assess company performance and thus the risks of their investment decisions. Finally, external governance refers to governance mechanisms that strengthen the market for corporate control. The discussion will focus only on mechanisms that are explicitly provided for in EU directives on undertakings or financial markets and will select only those for more detailed discussion that appear to be relevant for TEMS in light of the corporate governance challenges identified above.

Internal Governance

EU community law has not produced a coherent legal framework for internal governance — despite major efforts that have been devoted to the harmonisation of company law over the past 35 years.[36] The core features of such

[35] MB Fox, 'U.S. Perspectives on Global Securities Market Disclosure Regulation: A Critical Review' (2002) 3 *European Business Organization Review 337;* MB Fox, 'Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment' (1999) 85 *Virginia Law Review* 1335.
[36] The First Council Directive of 9 March 1968 was based on Art 54 (3) (g) (now Art 44 (2) (g) of the TEU), which provides for the 'coordination of safeguards, which, for the protection of the interests of members and others, are required by Member States of companies or firms (...) with a view to making such safeguards equivalent throughout the Community.' Council Directive 68/151/EEC of 9 March 1968 on Co-ordination of Safeguards which, for the Protection of the Interests of Members and Others, are Required by Member States of Companies within the Meaning of the Second Paragraph of Art 58 of the Treaty, with a View to Making Such Safeguards Equivalent Throughout the Community (First Company Law

a system were included in the 5th Council Directive, which failed, mostly because it called for a mandatory two-tier management structure and, even more importantly, employee co-determination along the lines of the German model. These features have failed to find sufficient support among the other Member States. Other parts of the directive, which address the internal allocation of control rights in the firm, including voting rights, quorum and majority requirements for shareholder votes, rules on the appointment and dismissal of the members of the corporate board(s), and the respective functions of the management and supervisory boards, were doomed together with these highly contentious parts of the directive.

Some internal governance devices can now be found in the regulation of the Societas Europaea (SE), which was adopted after an over 40-year gestation period in October 2001. These provisions, however, have no direct bearing on any company, unless and until it joins another corporation located in a different Member State to establish an SE.[37] While some commentators have suggested that the SE may change the landscape of corporations in the EU in the future and introduce substantial amount of competition,[38] there are reasons to be more cautious about this assessment. The SE regulation does not offer a fully developed governance structure, but refers in many instances to the national law of the Member State where the SE is registered. Moreover, the SE must be located within the Community in the same Member State as its head office and Member States may require the SE to have their head office and place of registration in the same state (Article 7).[39] The SE statute provides that in case a company fails to comply with the requirements of Article 7, the relevant registration authorities may demand that it either moves its headquarters or its registered office in accordance with the SE statute and may sanction any infringement of said provisions (Article 64). The implication of these provisions for companies from TEMS is that they may benefit from whatever superior governance structure the SE has to offer, only if they become part of an SE that is registered in and therefore subject to the law of a different Member State with a better governance structure. Finally, establishing an SE can be a protracted process. An SE can be established only when the

Directive) [1968] OJ L 65/8. For an overview of the history of company law harmonisation in the EU, see Doralt and Kalss, chapter 11 in this volume.

[37] For the formation of an SE, cf Art 2, which sets forth that an SE can be formed only by at least two corporate entities from at least two different Member States.

[38] See J Plender, 'Continental capitalism à la carte' *Financial Times* (London, UK, 21 February 2003) 13. See also L Enriques (2003) 'Silence is Golden: The European Company Statute as a Catalyst for Company Law Arbitrage' *European Corporate Governance Institute* (ECGI Working Paper Series No 7 2003).

[39] This endorsement of the seat theory appears at odds with recent ECJ case law that seems to curtail the scope of the so-called seat theory. See in particular Case C-208/00 *Ueberseering BV v Nordic Construction Company Baumanagement (NCC)* [2002] ECR I-9907.

employees of the companies that will constitute the SE have come to an agreement with the management of the respective companies about the future participation of employees.[40] While the Statute on the SE sets a time limit of six months and a maximum of one year for the negotiations, this does not include the time it takes to establish the 'special negotiation body' of employee representatives. Moreover, these requirements may dampen the interest of companies from countries with less comprehensive employee representation to form an SE.

Elements of internal firm governance can, however, be found in other directives. The 2nd Council Directive on capital adequacy,[41] for example, stipulates that the shareholder meeting shall decide on changes in corporate capital (Article 25). Decisions to increase capital or to authorise capital to be issued by directors over not more than five years may be taken by simple majority vote. Decisions concerning capital decreases and waiver of pre-emptive rights, however, require a super majority vote (Articles 40, 29, 30). More generally, the directive mandates that shareholders be given pre-emptive rights when new shares are issued or authorised (Article 29). A pre-emptive right can be waived only by a super majority vote of at least two-thirds of the shareholders, although a simple majority may suffice, if at least 50 per cent of the shareholders are present. The impact of pre-emptive rights on corporate governance is ambiguous. While La Porta et al consider pre-emptive rights as one of the core protections for minority shareholders,[42] depending on the ownership structure of a given firm, the rule may work primarily to the benefit of blockholders.[43] The reason is that pre-emptive rights allow blockholders to retain their control structure, perhaps even at below market price.

The second directive also contains a number of provisions that are widely regarded as creditor protection devices, including the concept of legal capital and minimum capital requirements, as well as provisions that bar a company from buying its own shares except on enumerated conditions (Article 22), or to extend loans for the acquisition of its own shares (Article 23). The level of minimum capital is pitched at 25,000 Euro for publicly traded corporations — an amount which even under the conditions

[40] The procedure for this, including the rules governing the election of employee representatives can be found in: Council Directive 2001/86/EC of 8 October supplementing the Statute for a European company with regard to the involvement of employees [2001] OJ L 294/22.

[41] Second Council Directive EC 77/91/EEC of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Art 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent [1977] OJ L 026/1 (2nd Company Law Directive).

[42] R LaPorta, above n 7.

[43] K Pistor, (2001) above n 21.

of TEMS hardly raises serious concerns regarding barriers to entry. Not surprisingly, the latest Winter Report II regards reforms in this area as superfluous,[44] even though earlier reports on simplifying company law in the EU have toyed with the idea of raising minimum capital requirements.[45]

More troubling than the amount of minimum capital the 2nd Directive requires is the concept of legal capital as such, and the system the directive has put in place to enforce the concept. As Enriques and Macey suggest, the major beneficiaries of this concept of legal capital may be management, not creditors.[46] Creditors — as they argue and as the Winter Report II confirms — do not pay much attention to legal capital. They are more interested in the firm's future cash flows and tangible assets that could be used as collateral. Yet, firms do not only comply with minimum capital requirements, but set aside large proportions of their retained earnings. The German company Siemens prides itself with legal capital in the amount of € 2.655 billion, and Beiersdorf of € 215 million.[47] This is money the company could have, but has not, paid out to its shareholders.

The concept of legal capital is buttressed by provisions that prevent the use of firm funds to acquire its own shares or, in the case of a subsidiary, of those of its parents (Article 24, 2nd Directive). While there may be good reasons to regulate a firm's ability to freely acquire its own shares, the stringent regulations found in the 2nd Directive make it difficult for firms to use their own assets as collateral for financing acquisition strategies.[48] In fact, these provisions have already caused problems in TEMS when structuring acquisition transactions.[49]

In sum, the AC's record on internal governance is rather mixed. A full blown structure of internal governance does not exist, leaving it to the Member States to design those aspects not explicitly covered by the directives described above.[50] While there are voices that the EU should reconsider

[44] 'Press Release High Level Group of Company Law Experts' *European Commission* <http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/press-comm-group_en.pdf> (Winter Report II of November 2002) (21 August 2003).
[45] E Wymeersch, 'Company Law in Europe and European Company Law' (Financial Law Institute Working Paper Series 2001).
[46] L Enriques and J Macey, 'Creditors vs. Capital Formation: The Case Against the European Legal Capital Rules' (2001) 86 *Cornell Law Review* 1165.
[47] P Mülbert and M Birke, 'Legal Capital — Is there a Case Against the European Legal Capital Rules?' (2002) 3 *European Business Organization Law Review* 695.
[48] T Baums, 'Corporate Contracting Around Defective Regulations' (1999) 155 *Journal of Theoretical and Institutional Economics* 119–27.
[49] I am grateful to Petr Panek for alerting me to such cases. In US merger practice, for example, using a firm's assets to collateralise the financing of an acquisition or buy out is quite common, but such strategies are ruled out by the Directive. In fact, they have been extended to subsidiaries so that they cannot use their own funds or assets to collateralise loans used to acquire the parent either. On the incompatibility of European corporate laws with a vibrant merger market, see also above Baums n 48.
[50] For a positive assessment of the flexibility the harmonised EU thus leaves to old and new Member States, compare Soltysinski in this volume.

regulating the internal governance system of corporations,[51] the recent Winter Report II on the modernisation of European company law cautions against such an approach, and instead advocates the use of more flexible tools, including soft laws, recommendations and standards.

The absence of mandatory rules for the internal governance structure of firms has both costs and benefits for TEMS. On the one hand, it allows them to experiment with different solutions and develop one that best fits their circumstances. On the other, it alleviates the pressure to reform aspects of the internal governance structure, which may be regarded as problematic. The relevant company laws of Hungary[52] and the Czech Republic,[53] for example, provide that both the management board and the supervisory board are elected at the shareholder meeting. This raises doubts about how much leverage the supervisory board has over the management board, as it can neither hire nor fire the members of the management board. Given that the AC has mandated many costly adaptations in TEMS's corporate laws, for which there might be a less strong case, the failure to address actual problems in the design of governance structures is unfortunate.

Transparency

Publicity and disclosure of company information to shareholders and the public at large has been a repeated theme of harmonisation measures at the EU level. The first Council Directive on undertakings standardised the information each corporation had to disclose upon its formation as a corporate entity, and required annual financial reports to be filed with the company register, irrespective of whether the company was listed. Another device to enhance transparency of the corporate sector is the so-called 'Large Holdings Disclosure Directive,' which was adopted in 1988.[54] According to the directive, any acquisition by which the buyer acquires voting rights in a company in excess of 10 per cent, 20 per cent, 1/3, 50 per cent, and 2/3 must be disclosed. Voting rights include not only direct, but also indirect voting

[51] K J Hopt, 'Modern Company and Capital Market Problems — Improving European Corporate Governance after Enron' *European Corporate Governance Institute* (ECGI Working Paper Series 1, 2002).
[52] The Hungarian Law on Enterprises stipulates in Art 233 that the shareholder meeting elects and dismisses the members of the management board, the supervisory board, and the auditors.
[53] See Arts 194 (election of the management board by the shareholder meeting) and 200 (election of the supervisory board by the shareholder meeting) of the Czech Commercial Code.
[54] Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of [1988] OJ L 348/62 (Large Holding Disclosure Directive, or LHDD). The directive has meanwhile been incorporated into Council Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities [2001] OJ L 184/01.

rights, including rights held by another entity, which the acquirer controls.[55] The purpose of the directive is to bring some transparency into Europe's corporate landscape, which is characterised by pyramidal ownership and control structures. TEMS, whose corporate structure resembles that of Western Europe, should therefore also benefit from the directive. In fact, all eight TEMS have transposed the large holdings disclosure directive in one way or another.[56] This major success notwithstanding, the experience with the transposition of a measure that can arguably enhance corporate governance illustrates the difficulties of legal harmonisation more generally. All eight TEMS have adopted the directive piecemeal by incorporating it into different statutes that address issues related to the directive. While this ensures that pre-existing differences in all relevant domestic statutes are addressed, it slows down the process of transposing the directive and makes monitoring of proper implementation more difficult. Interestingly, the TEMS were not reluctant in ensuring disclosure of direct voting rights. By contrast, the various forms of indirect voting rights envisaged by the directive and subjected to the same disclosure requirement, have only imperfectly been incorporated in the laws of TEMS. The reason for this may be that in light of the existing control structures of firms in these countries, lawmakers may have seen little justification for the complex set of rules set forth in Article 4 LHDD. Alternatively, they may have wished to signal formal compliance with the directive without displeasing domestic interests that might benefit from less disclosure. More generally, a strategy of formal compliance while acquiescing to domestic interest groups is to include the relevant rules on the books, which can be achieved by adopting laws, but ensuring that law enforcement will not be effective. Indeed, Olsson suggests that lax enforcement is common, which may indeed be part of a conscious 'comply but don't enforce strategy.'[57] Alternatively, lack of enforcement may only reflect objectively weak enforcement institutions in TEMS. In either case, failure to fully comply with a directive is a problem not unique to TEMS, as the delay by Germany to enforce the annual disclosure requirements against privately held corporations for over 20 years suggests.[58] The more general lesson from this experience is that the harmonisation of company law in Europe has been a slow and complex process. While TEMS are forced to adhere formally to the AC, because this is an entry condition for joining the EU, substantive compliance is not assured and will require a combination of efforts by the domestic governments and monitoring by the EU.

[55] See Art 4 LHDD for the scope of indirect control rights captured by the directive.
[56] M Olsson, 'Adopting the acquis communautair in Central and Eastern Europe: A Report on the Transposition and Implementation of the so-called Large Holding Directive (88/627/EEC)' *European Corporate Governance Institute* <http://www.ecgi.org/research/accession/lhd_paper_cee10.pdf> (21 August 2003).
[57] *Ibid.*
[58] See Case C-191/95 *Commission v Germany* [1998] ECR I-5449.

The EU has also adopted several directives that enhance transparency of information for companies that are listed on an organised exchange. In May of 2001, a consolidated directive on the admission of companies for official listing on organised exchanges and the applicable disclosure regime was adopted,[59] which has been amended in 2003 by a new Prospectus Directive.[60] Whereas under the 2001 Directive only companies that seek admission to official listing on a stock exchange were subjected to the disclosure rules, under the new Directive 'any offer of securities to be made to the public' is subject to disclosure requirements (Article 3). This has greatly enhanced the standards for disclosure and reduced the likelihood that firms may avoid stock exchanges when issuing shares to the public in order to avoid transparency.

Continuous disclosure requirements currently demanded under the 2001 directive include the obligation of companies to inform current shareholders of annual meetings, dividend payments (Article 65.2), as well as changes in the corporate charter (Article 66). In addition, the public must be furnished with ad hoc information of major events that may impact the assets or liabilities of the firm (Article 68) and the publication of semi-annual reports on activities, profits and losses (Article 70). Member States may increase the frequency of the reporting requirements, provided that they treat alike all companies or all companies of a given class (Article 71). A new transparency directive, which is currently under discussion, may, among other things, increase reporting frequency to quarterly reporting.[61]

Several TEMS had already increased their standards to the requirements of EU law. Poland, for example, subjects all securities issued to more than 300 investors, not only firms admitted to trading on official exchanges, to registration and basic disclosure requirements.[62] Similarly, the Czech Republic attaches registration and disclosure requirements to publicly tradable securities.[63] The first 10 years of highly volatile market development have driven home the point that financial market regulation is crucial for the development of sustainable financial markets. The Czech Republic has witnessed the most dramatic turnaround. After earlier policies had favoured a laissez faire approach, a securities regulator was finally established

[59] Council Directive 2001/34/EC of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities [2001] OJ L184/01 (consolidated admissions and listing Directive).
[60] See Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the Prospectus to be Published when Securities are Offered to the Public or Admitted to Trading and amending Directive 2001/34/EC [2003] OJ L345/64 (Prospectus Directive).
[61] See the proposal for a 'Directive on the harmonisation of transparency requirements with regard to information about issuers whose securities are admitted to trading on a regulated market' of COM (2003) 138 final (26 March 2003) 2003/0045 (COD).
[62] See Law Arts 2, 61 of the Public Trading of Securities of 1997 as last amended in 2001, *Komisja Papierów Wartosciowych i Gield* 21 August 1997 (available from ISI Emerging Markets Data Base, 30 January 2004).
[63] Art 70, Securities Act of the Czech Republic (available on ISI Emerging Market Data Base).

in 1997 and the rules governing financial markets were revised subsequently.[64] Hungary and Poland had both started the transition period with a much stronger set of regulations in place, which seems to have paid off.[65] In other words, local demand rather than external imposition has driven law development in this area. The most important added value that comes from EU financial market regulation is mutual recognition and the European passport principle, which will facilitate access by companies from TEMS to European markets. However, as will be discussed below, the same mechanisms imply that companies will have a hard time escaping weak domestic regulators by opting into different governance regimes.

External Governance

Governance mechanisms consist of mechanisms that ensure stakeholders a 'voice', as well as of mechanisms that give them an 'exit' right.[66] The most important exit right in a publicly held corporation is the right to freely sell one's shares. The right of shareholders to freely sell their shares is in principle recognised in the company laws of most current Member States. Still, many Member States allow restrictions in corporate statutes. The Winter Report I lists such restrictions among those that can be used as defences against takeovers.[67] A number of TEMS have similar provisions on the books. The Czech Commercial Code, for example, stipulates that registered shares must be freely transferable, but permits that the transfer of bearer shares is made conditional upon approval by one of the 'organs' of the corporation, ie the management board, the supervisory board, or the shareholder meeting.[68] By contrast, the Hungarian Company Law allows restrictions only for closely held corporations.

EU corporate law harmonisation has made little progress over the past 30 years in eliminating or at least reducing corporate law mechanisms that limit exit rights, which arguably protect existing management.[69] The scope

[64] J Coffee, above n 16.
[65] K Pistor (2001) above n 21.
[66] A O Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, Mass, Harvard University Press, 1970).
[67] See app 5 of the Winter Report I: 'Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids' European Commission <http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf>(21 August 2003).
[68] Art 156 V Czech Commercial Code.
[69] The Winter Report lists five different categories of pre-bid defenses currently available under the domestic company law of existing Member States, including (1) barriers to the acquisition of shares in the company, such as ownership caps, restrictions to the transferability of shares, etc; (2) barriers to the exertion of control in the general meeting, including voting caps, shares with double or multiple voting rights, binding voting arrangements and some times of golden shares; (3) barriers to exertion of control in the board of directors, including co-determination, shares with special rights to appoint the directors, supermajority requirements to dismiss and/or elect the board; (4) barriers to exertion of control over the assets of the company, including provisions that permit the lock-up of corporate assets; (5) creation of financial burdens as a consequence of the transfer of control, such as poison debt and golden parachutes.

of these mechanisms came to the attention of European law and policy makers in the battle over the 13th Directive on takeovers. Germany ultimately voted against the directive, stressing that the strict board neutrality rule the proposed 13th Directive established, which — absent explicit shareholder approval — limits defensive actions by the target's board to seeking a white knight, would expose German companies to greater takeover threats. The reason was that other countries afforded better pre-bid defenses than Germany did, in particular after it revised its corporate code in 1998. The logic of this argument is that absent a level playing field for companies in all countries of the Union, no company should be exposed to the threat of takeovers without being allowed to defend itself. Getting rid of all pre-bid defenses over a short period of time, however, was impossible – not the least in light of the history of company law harmonisation in the EU. The solution the Winter Report I (January 2002), proposed was a breakthrough rule: Once a bidder had acquired 75 per cent of a target's shares, any legal or statutory provision could be set aside, if it undermined the principle that all shareholders who participate equally in the risk of the company have equal voting rights.

This rather broad rule did not find much support. The proposal for the 13th Directive published in October 2002 now includes a provision that makes only some of the pre-bid defences the Winter Report listed unenforceable vis-à-vis the bidder. In particular, any restriction on the transfer of securities cannot be enforced against the offeror during the period for acceptance of the bid (Article 11.2). Moreover, any restriction on voting rights shall cease to have effect when the general meeting decides any defensive measures after an offer has been made (Article 11.3); or at the meeting following a successful bid, at which the offeror attempts the amend the company's charter (Article 11.4). The most hotly disputed aspect of the new rule is, whether it is appropriate to exclude multiple voting rights from this partial breakthrough rule. Germany and the UK oppose the exclusion, while France, Italy and some of the Scandinavian countries, where multiple voting rights are more common, have lobbied hard for their exclusion. The EU Commission has so far sided with the latter. The introductory commentary states that the provisions about the unenforceability of certain pre-bid defences '... do not concern securities carrying double or multiple voting rights. It can be argued that securities with multiple voting rights form part of a system for financing companies and that there is no proof that their existence renders takeover bids impossible ... .'[70]

[70] Commission Communication on the proposal for a Directive of the European Parliament and the Council on takeover bids COM (2002) 534 final (2 October 2002) (Proposal) at 9.

The pros and cons of a strict neutrality rule are subject to much debate.[71] In countries without a long history of case law dealing with complicated conflict of interest situations in directors' and officers' decision making, such a bright line rule may indeed be superior to a more nuanced approach to anti-takeover devices.[72] Moreover, a strong case can be made on theoretical grounds for giving more power to the courts to address matters that in Anglo-American systems are labelled fiduciary duty cases, as legislatures are inherently unable to regulate these cases ex ante.[73] However, the European Union has abstained from addressing the related issue of law enforcement in the takeover directive. In fact, the commentary to the directive notes that litigation is undesirable. Moreover, the directive explicitly protects the Member States' prerogative over matters of law enforcement by assuring them that the directive 'shall not affect the power of the Member States to designate judicial or other authorities responsible for dealing with disputes (...) or the power of Member States to regulate whether and under which circumstances parties to a bid are entitled to bring administrative or judicial proceedings.' (Article 4.6 proposed Takeover Directive).

While the case for a break-through rule as general as the one proposed by the Winter Report I may indeed not be overwhelmingly strong,[74] more important for the argument developed in this paper are the lessons the debacle over the 13th Directive holds for corporate governance in the new Member States. In December 2003, the European Parliament finally brought an end to the, more than fourteen year, struggle over the takeover directive by endorsing a compromise suggested by the Portugal.[75] The directive now allows Member States to make it optional for its companies to subject themselves to the above-mentioned takeover regime. In particular, it allows companies to refuse to abide by it should the bidding companies not be bound by similar rules. By implication, a common level playing field for takeovers in Europe has not been established and it will be interesting to observe the Member States' coming out on their commitment to the takeover regime of the 13th directive.

[71] C Kirchner and R W Painter, 'European Takeover Law — Towards a European Modified Business Judgment Rule for Takeover Law' (2000) 1 *European Business Organization Law Review* 353; P O Mülbert and M Birke, 'In Defense of Passivity — On the Proper Role of a Target's Management in Response to a Hostile Tender Offer' (2000) 1 *European Business Organization Law Review* 445.

[72] J Gordon, 'An American Perspective on the New German Anti-takeover Law' *European Corporate Governance Institute* (ECGI Working Paper Series, 2002).

[73] K Pistor and C Xu, above n 30.

[74] See L Bebchuk and O Hart, 'A Threat to Dual-Class Shares' *Financial Times* (London, UK, 31 May 2002), arguing that the rule would reallocate control rights to holders of securities who have acquired them at a discount because they have weak voting rights.

[75] D Dombey, 'European parliament backs takeover directive compromise', *Financial Times* (London, UK, 17 December 2003) 4.

An important lesson from this process is that when it comes to critical issues, corporate governance enhancement in the EU means convergence on the lowest common denominator. Improving domestic governance rules may backfire, as Germany's experience with corporate law reform suggests, because moving ahead of the pack might be a disadvantage, if other countries do not follow suit. A better strategy is to keep all options open until the EU makes the next move and to use these options to mitigate any impact this move might have on domestic interest groups.[76] Viewed in this light, European harmonisation may result in a 'bargain for', rather than a 'race to' the bottom.

For proponents of regulatory competition, this scenario may seem implausible. After all, countries should benefit in the medium to long term by writing corporate laws that will attract companies to incorporate under their jurisdiction.[77] Whether this type of regulatory competition actually works in practice has been seriously challenged by recent empirical studies.[78] Assuming that a case can be made for companies choosing corporate law that best suits them in pursuit of objectives other than maximizing management interests,[79] regulatory competition presupposes that companies can choose their place of incorporation. This has not been the case in large parts of the EU – the Treaty's commitment to the free movement of persons, including legal persons (Articles 43-48 TEU), notwithstanding. A number of current Member States still follow the so-called seat theory, which requires companies to incorporate where their headquarters are. This rule has been reaffirmed by the statute on the SE (see above), but has been seriously challenged by recent case law of the ECJ. In *Centros*,[80] decided in 1999, the court argued that any company that was duly formed under the law of any Member State, had the right to establish branches, subsidiaries, etc in another Member State. The court explicitly denied a Member State

[76] Some TEMS already learnt from experience. Being good students, they incorporated earlier aspects of the 13th Directive into their domestic laws, only to witness the elimination of such provisions from the directive before it even reached the Parliament. Poland, for example, adopted the 33% threshold for mandatory takeover bids in an early revision of its corporate law. See S Soltyskinski, 'Transfer of Legal Systems as Seen by the "Import Countries": A View from Warsaw' in U Drobnig, KJ Hopt, H Kötz and EJ Mestmäcker (eds), *Systemtransformation in Mittel- und Osteuropa und ihre Folgen für Banken, Börsen und Kreditsicherheiten* (Tübingen, Mohr Siebeck, 1998) 69. The draft proposal of the directive now states that it should be up to the individual Member States to determine this threshold.

[77] R K Winter, 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 *Journal of Legal Studies* 251; R Romano, *The Genius of American Corporate Law* (Washington, AEI Press, 1993).

[78] R Daines, 'The Incorporation Choices of IPO Firms' (2002) 77 *New York University Law Review* 1559-1611; M Kahan and E Kamar, 'The Myth of State Competition in Corporate Law' (2002) 55 *Stanford Law Review* 679.

[79] R Daines, 'Does Delaware Law Improve Firm Value?' (2001) 62 *Journal of Financial Economics* 525.

[80] Judgment of the Court of 9 March 1999. Case C-212/97 *Centros Ltd v Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459.

the argument that the parent company established in another Member State with more lenient rules was only a shell and that in fact the branch office was the real parent under disguise. Similarly, in *Ueberseering*,[81] the ECJ held that a country following the seat theory could not deny legal personality to a company that had been duly established in another Member State, but had moved its headquarters to that country without re-incorporating. Most recently, the ECJ struck down a law in the Netherlands, which imposed minimum capital and reporting requirements on quasi-foreign companies, ie those registered in another Member State, but doing business primarily in the Netherlands.[82]

These decisions by the ECJ, rather than the highly politicised process of company law harmonisation, may help avoid the bargaining for the bottom in European company law and encourage jurisdictions to move forward with reforms that may make them more competitive in attracting companies for incorporation.[83] More importantly, in order to be able to compete, TEMS must develop and perfect expertise in lawmaking that is both innovative and responsive to business needs. This expertise will also be in demand, if the second Winter Report on Modernizing European Company Law has its way. The report defines the purpose of company law to 'provide a legal framework for those who wish to undertake business activities efficiently, in a way they consider best suited to attain success.' This is quite different from the harmonisation strategy the EU has pursued so far, which was based primarily on the need to safeguard 'members and others' (read 'shareholders and other stakeholders,' Article 44 (2) (g) TEU) and on making these safeguards equivalent throughout the Community. The report proposes standard setting, soft law, and greater flexibility as means to achieve these new goals. Unfortunately, the ability of TEMS to take part and excel in lawmaking that is innovative and responsive to business needs has not been furthered by the 'legislative tornado' imposed on them by the mandate to comply with the AC.

STATE OWNERSHIP UNDER THE AC

Despite the fact that the European Community has been firmly committed to the creation of a common market and thus implicitly to a market based economy, the EC Treaties did not commit Member States to a particular ownership form, ie to private ownership. Article 295 TEU states explicitly that the Treaty 'does not prejudice the rules in Member States governing the system of property ownership.' Maintaining a large private sector or privatising state owned enterprises was therefore never a pre-condition for membership in the EU (provided, of course, that state ownership would not stand in the way of a functioning market economy). The scope of the Treaty's neutrality concerning ownership has, however, been recently put to a series of tests. The European Court of Justice argued in three parallel rulings in June 2002 that golden shares held by the state in privatised companies would be subjected to review under provisions of the Treaty that commit members to the free movement of capital (Article 56 TEU).[84] In two of the three cases, the ECJ declared that golden shares held by the state in privatised companies were in fact in violation of the free movement of capital. The decisions concerned actions brought by the Commission against three Member States: Belgium, France, and Portugal.[85] The Portuguese case was the most straightforward of the three, as the relevant law stated that the state could exercise veto rights against foreigners acquiring a substantial stake in the privatised companies. This smelled of discrimination against foreign capital, which was in clear violation of Treaty provisions unless there was a compelling public interest. The French law did not include an explicit provision against foreign ownership, but resembled in other ways the Portuguese law. Under the French law, any acquisition of shares in the privatised company had to be approved by the relevant Ministry. The law did not stipulate under what conditions approval would be granted or denied, and did not establish explicit procedures for review of ministerial decisions. It was thus left to the discretion of the Ministry to either approve or deny the acquisition of shares. The French government defended its law by arguing that it did not discriminate between French and foreign acquirers of shares and therefore did not violate the principle of the free movement of capital. Moreover, Article 58 (1) (b) allows governments to restrict the fundamental freedom of capital on public policy grounds. The relevant company in which the state held a golden share was Elf Acquitaine, the oil company. The government argued that securing sufficient oil supply in times of crisis justified these restrictions. The ECJ acknowledged in principle that protecting a Member State's oil supply may indeed be a public policy ground to restrict the free movement of capital. The court emphasised, however, that the measures taken must be proportionate, ie that they must be effective

[81] Case C-208/00 *Ueberseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-09919.

[82] Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd.* This judgment of 30 September 2003 is not yet published in ECR, but is available at <http://curia.eu.int> (5 March 2004).

[83] What the likely benefits of competition for incorporation are, is another matter. As Kahan and Kamar suggest, above n 78, only Delaware benefits from franchise taxes in a tangible manner.

[84] P Camara, 'The End of the "Golden Age" of Privatisations? The Recent ECJ Decisions on Golden Shares' (2002) 3 *European Business Organization Law Review* 503.

[85] Case C-367/98 *Commission of the European Communities v Portuguese Republic* [2002] ECR I-04731; Case C-483/99 *Commission v France* [2002] ECR I-04781; Case C-503/99 *Commission v Kingdom of Belgium* [2002] ECR I-04809.

and proportionate to the kind of threat that is envisaged. In the French case, the court argued that the broad discretion granted to the Ministry without any guidance for investors about the conditions for approval or denial was not proportionate and therefore in violation of the free movement of capital.

By contrast, the ECJ accepted the Belgian variant of veto rights regarding the acquisition of shares in the relevant companies, in this case the major gas and electricity companies of the country. Unlike the French solution, Belgium did not require approval, but just notification of the ministry. Once notified, the ministry could take actions to halt the transaction, but any such action taken had to be explained in detail to the parties concerned. Even though the law did not specify under what conditions the state would exercise its veto right, the fact that detailed reasoning was required by law and that action had to be taken by the state to veto, instead of giving the ministry a flat approval right as in the French case, made this measure 'proportionate' to the potential threat.

These three decisions were only the beginning of an attack by the Commission on Member States' use of extensive control rights in partially private firms. Two additional golden share decisions were handed down in May 2003 against Spain and the UK.[86] In both cases, the court affirmed its previous golden shares rulings, the stark critique by the General Advocate who invoked Article 295 TEU notwithstanding. In addition, the Commission has initiated actions against the German 'lex Volkswagen', which ensures the state of lower Saxony in Germany a veto right against the transfer of control in the car company.[87]

These ECJ decisions hold important lessons for the new Member States. They create the possibility that not only golden shares, but other measures taken by governments in only partially privatised firms, may be measured against the core principles embedded in the Treaty. Governments will be forced to choose to either retain full ownership of firms or have their control rights over partially privatised firms subjected to greater scrutiny. On the positive side, the ECJ rulings are likely to enhance the transparency of government actions with regard to companies they still control directly or indirectly. This is a welcome trend in TEMS where, despite strong commitments to privatisation and market economies, governments have not always refrained from the temptation to use control rights they have retained to pursue industrial policies. As the ECJ decision on the Belgium case suggests, control rights are not prohibited per se, but they must be proportionate to the threat posed. On the negative side, the decisions may create disincentives

[86] Case C-463/00 *Commission v Kingdom of Spain* [2003] ECR I-04581 and Case C-98/01 *Commission v United Kingdom* [2003] ECR I-04641.

[87] See European Commission *Free Movement of Capital: European Commission asks Germany to justify its Volkswagen law* — European Commission Press Release IP 03/410 (19 March 2003).

to privatise in the first place. However, given the scope of privatisation that has already been accomplished in the TEMS, this danger seems less serious at this point in time. Even if this was different, there is an inherent logic to the ECJ decisions. Governments that want to obtain the benefits from privatisation, ie immediate revenue in form of the purchase price and relief from potential future liabilities, must commit to allow the market to run its course, unless they have good reasons to intervene. If they cannot or do not want to make this commitment, they should also bear the full costs of ownership.

What is to be noted, however, is that the positive impact EU membership may have on (partial) state ownership is the result of actions taken by the Commission and ECJ rulings, not standards agreed upon by the Member States. In fact, some of the ECJ's case law may be said to over-rule the implicit agreement by Member States that market integration would be conditional on mutual agreement among them on core issues, such as their choice over property regime.

INSTITUTIONAL GOVERNANCE UNDER THE AC

Institutional governance is an integral part of corporate governance. The allocation of rights and responsibilities to different stakeholders is typically not sufficient to ensure that these rights will be enforced. Coasian bargaining assumes a utopian world without transaction costs, but even financial markets do not come close to such a world, certainly not financial markets in the post-socialist countries.[88] The most commonly known institutional governance mechanisms in this area are courts and regulators. A little over 10 years ago, financial market regulators did not exist in TEMS, and courts were in the middle of lustration proceedings, scrambling to come to terms with their past under the socialist system, and trying to redefine themselves as independent agents for the rule of law with the competence to handle complex commercial matters. Not surprisingly, these institutions are still perceived to be rather weak, although there is substantial variation across countries, as discussed above.

For companies trying to hide assets from investors and in the business of circumventing investor protection law, weak governance institutions are attractive. Such institutions will not pose a challenge to their business practices. By contrast, for companies hoping to attract investors and in need of raising outside capital, weak governance institutions are a great disadvantage. While such companies may adopt voluntary governance codes and commit in words to respecting investor rights, the words of new entrants to

[88] S Johnson, E Glaeser et al, 'Coase vs Coasians', above n 32.

the market do not carry much weight, as they have little reputation to lose. Moreover, these new entrants come from an environment where investor rights were violated quite frequently. Weak governance institutions thus exacerbate the signaling problem these companies face.[89]

One strategy to help these companies is to strengthen local governance institutions. A strong argument has been made for ensuring good local institutions even in a world of integrated financial markets. As Fox argues, the real beneficiaries of effective domestic institutions are stakeholders who are relatively immobile, such as employees, or the communities where companies are located.[90] Investors can diversify their risk, but other stakeholders of the firm and the domestic economy will suffer from the lack of effective investor protection. It should therefore be in the interest of local policy makers to ensure that sufficient protections are in place to enhance future growth and productivity of domestic companies. This argument is supported by recent empirical data, which suggest that even when companies migrate to other markets the quality of investor protection in their home jurisdiction has a positive impact on their share performance.[91] Improving domestic institutions is therefore a primary task for TEMS.

The accession agreements with TEMS stress the importance of legal institutions, including courts and regulators and explicitly reject legal reforms that are focused exclusively on the law on the books. Judicial reform has been an accession condition and progress has been monitored by the EU. This may have contributed to the gradual strengthening of these institutions in TEMS. By contrast, the relevant directives on company law and financial market regulations do not contribute much to the strengthening of governance institutions. In most instances they only require Member States to establish a regulator endowed with sufficient power to enforce the directive in question, leaving the choice of enforcement devices (civil liability, criminal or administrative sanctions, etc) to the Member States. The new Market Abuse Directive for the first time spells out that Member States should employ not only criminal, but also administrative sanctions, in order to enforce the directive.[92] The rest is left to the Member States and their ability and willingness to endow regulators with the necessary resources and powers to fulfill this task.

The fragmentation of, and differences in the capacity and quality of, law enforcement has been recognised as a key problem in the harmonisation of

[89] Nonetheless, some companies have been able to overcome this problem. See L Klapper and I Love, above n 33.
[90] Fox, above n 35.
[91] S Claessens, D Klingebiel *et al*, 'The Future of Stock Exchanges: Determinants and Prospects' (2002) 3 *European Business Organization Law Review* 2: 403.
[92] See Art 14 of Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [2003] OJ L096/16.

financial market regulations by the Lamfalussy Report,[93] which reviewed the EU's achievement in financial market regulation. Variations in the effectiveness of law enforcement is of concern especially in the area of financial market regulation, where mutual recognition is the guiding parameter. While Member States have refuted the idea of mutual recognition in the area of corporate law, in the area of financial market regulation a combination of minimum standard harmonisation and mutual recognition has been pursued. Thus, a company that has issued shares in one Member State may use the same documentation to issue shares in a different Member State. Compliance with the standards established by the EU and adopted in the home country thus provides companies with a 'European passport.' In theory, the passport could be issued by any Member State, irrespective of the origin of the company. In practice, however, EU regulations have allocated regulatory responsibility to the company's home Member State.[94] To ensure effective monitoring and law enforcement, the directive calls upon Member States to ensure that competent authorities of different Member States cooperate with each other and exchange information for that purpose.[95]

This approach has drawn substantial critique from the financial community, because it does not pay tribute to the reality of financial market integration and leaves many companies without effective regulation. A company from a TEMS, for example, that wishes to issue and trade securities exclusively on the London Stock Exchange, will remain under the regulatory authority of its home jurisdiction, rather than the British Financial Services Authority. This allocation of regulatory authority may prove disadvantageous for companies from TEMS, where enforcement institutions are weak and reforms are only slowly taking hold. They simply cannot opt out of a weak regulatory environment by listing elsewhere in the EU. If they want to use cross-listing as a commitment device, cross-listing within the EU won't do — ie they may not accomplish this by staying in Europe. This may increase their incentives to migrate across the Atlantic.

In sum, the governance structure established by current and future EU directives on financial market regulations is one that is based on home country regulation combined with coordination among regulators of different Member States where a company may issue and/or trade its shares. Companies from TEMS are thus 'locked in' with their current regulators. This may induce these companies to lobby for more effective regulation should they deem this advisable — and this may ultimately benefit other

[93] A Lamfalussy, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (Brussels, European Union, 2001).
[94] See Art 13 of Prospectus Directive, above 60.
[95] See Art 22 of Prospectus Directive, *ibid*.

constituencies in their home jurisdiction — but this process will take time. In the meantime, companies must find other ways to escape the trap of weak institutional governance in their home jurisdiction.

CONCLUDING OBSERVATIONS

The AC required TEMS to adapt their existing legislation to incorporate directives aimed at harmonising aspects of company law and financial market regulations. The impact of the legislative changes mandated by the AC have been described as a 'legislative tornado.' TEMS passed these laws by the meter, often copying laws wholesale from current EU Member States to avoid costly adaptations. Compliance with the AC thus imposed substantial costs on TEMS. This chapter has asked to what extent the AC actually benefits TEMS, in particular whether it helps resolve some of the basic corporate governance issues these countries face today. The analysis suggests that the benefits are ambiguous. Only a few of the directives directly address the major corporate governance issues TEMS face today. Many harmonisation requirements have been recognised by current Member States as outdated and not furthering the ultimate purpose of company law to enable a competitive process among companies from different Member States. A series of reports on modernising European company law and revamping the structure and process of issuing financial market regulations in the European Union has been launched over the last few years. These reports have already triggered new proposals for directives, which will need to be transposed into national law by Member States, including the TEMS. From their perspective, this means that even before any of the previous laws and regulations have been tested in practice, they will be changed once again. Legal change for the better is certainly desirable. But frequent legal change has its own costs as it creates substantial legal uncertainties. This is not to say that companies from TEMS will not benefit from their home countries joining the EU. However, the main benefits arise from the ECJ's interpretation of the Treaty provisions, not the harmonisation as embodied in the AC.

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