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What do we know about different systems of corporate governance?

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Abstract

Over the last few years, national and international regulators have taken conscious steps to make capital markets – especially those based in Europe – more shareholder-oriented. On one side, these are welcome initiatives as the recent spectacular corporate failures and anecdotal evidence suggest that managers' attitudes definitely need to change and more weight needs to be given to shareholders' concerns. On the other side, there is as yet very little research on the benefits and shortcomings of alternative systems of corporate governance. Evidence from the few existing studies is inconclusive as to whether there is an optimal system of corporate governance and whether such a system already exists in a particular country. The move in one particular direction may therefore be far too premature. Further, some of my own research suggests that very similar changes in regulation – such as changes in takeover regulation – may have very different outcomes depending on the initial corporate ownership and control that prevails in a given country.

Keywords: Corporate governance, shareholder value, stakeholder model

JEL Classifications: G32, G34, G35

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A. Introduction

The generally accepted definition of corporate governance is that of Andrei Shleifer from Harvard Business School and Robert Vishny from the University of Chicago. According to their definition, *"corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment"*.[1] They justify the focus on shareholders by stating that, contrary to other stakeholders, the former have a sunk investment in the company. If the firm runs into financial difficulties, shareholders are likely to lose their investment whereas other stakeholders such as employees can walk away relatively easy.

The OECD, the World Bank, the European Association of Securities Dealers – the EASD – and the European Commission, have adopted the essence of Shleifer and Vishny's definition. For example, the EASD states in its "Corporate Governance Principles and Recommendations" that:

"[...] governing organs of companies cannot be held accountable to all stakeholders in the company – shareholders, staff, clients, suppliers, credit providers, as well as the communities and the environment in which they operate – lest accountability be fragmented, subjected to contradictory aims and thereby diluted. The Committee therefore espoused the view that corporate governing organs should be accountable to the shareholders, the more so since they are the residual bearers of risk of the company as owners of its equity. [...]".[2]

On one hand, the proponents have a valid point and managerial attitudes towards shareholders definitely need to change, especially after the recent wave of corporate scandals. If one compares the infamous statement made by Carl

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[1] A Shleifer and R Vishny, "A Survey of Corporate Governance" (1997) 52 *Journal of Finance* 737-783.

[2] European Association of Security Dealers (EASD), *Corporate Governance – Principles and Recommendations* (Brussels, EASD, 2000).

Fürstenberg, a German Banker, at the turn of the 19th to the 20th century, to that made by Conrad Black, the Canadian tycoon, only a few years ago, little seems to have changed over the last one-hundred years. The former is famous for stating that: *"Shareholders are dumb and obnoxious; dumb because they buy shares and obnoxious because they expect to receive a dividend."*[3] The latter called his shareholders *"a bunch of self-righteous hypocrites and ingrates"*.[4]

On the other hand, by putting all the emphasis on shareholders one ignores that other types of stakeholders – such as employees and suppliers – frequently make sunk investments in the firms they deal with. For example, employees may specialise their human capital in ways that better suit the needs of the particular firm they work for. Obviously, this will be beneficial to their firm, but it may also make their human capital less marketable to other firms. Hence, one can argue that stakeholders other than shareholders are not that different from the latter and should therefore be treated in a similar way.

What is worrying about the endorsement of the shareholder or capital-markets based system by political and bureaucratic elites across the world is the lack of sound academic evidence on the superiority of this system over alternative systems such as the stakeholder-based system. This paper reviews what we know to-date on the advantages and shortcomings of both systems. The paper is organised as follows. Section B explains the arguments used by those who advocate the superiority of the shareholder-based system. Section C highlights the lack of research that exists on the alternative, stakeholder-based system, and reviews the sparse research that exists. Finally, Section D concludes.

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[3] http://de.wikipedia.org/wiki/Carl_F%C3%BCrstenberg accessed on 11 September 2006.

[4] T Barker, T Burt and S Kirchgaessner, "A Court Case Opening Next Week Will Shed Light on the Bitter Dispute between the Tycoon, Directors and Shareholders", *Financial Times*, 10 February 2004, 17.

B. The superiority of the shareholder-based system

During the 1980s and first half of the 1990s, Germany and Japan were heralded as the model economies that other countries should follow. Companies in both countries were believed to benefit from being controlled by stable, large shareholders who made long-term investments possible and were able to commit other stakeholders over the long run.[5] At the time, nobody predicted that circumstances would change very quickly. Nowadays, most countries look up to the UK and US for their flexible labour markets, highly liquid stock exchanges and rapid growth in high-tech industries. Germany and Japan are no longer the models to follow.

There is now a strand of the literature started by Rafel La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (LLSV hereafter).[6] This strand of the literature argues that the shareholder-based system is superior given that it provides better protection of minority shareholders.

More precisely, LLSV divide countries into two groups according to the origin of their legal system: common-law countries and civil-law countries. Common law is based on case law. It is essentially the judges who make the law by creating precedents in court. Conversely, civil law is based on codified rules and the judges' function is limited to interpreting the law texts in court.[7] Basing themselves on a range of legal devices, LLSV construct an index of shareholder protection. They conclude

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[5] See e.g. L Correia da Silva, M Goergen and L Renneboog, *Dividend Policy and Corporate Governance* (Oxford, Oxford University Press, 2004). See also D Miles, "Testing for Short Termism in the UK Stock Market" (1993) 103 *Economic Journal* 1379–1396.

[6] See: R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113-55. R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, "Corporate Ownership around the World" (1999) 54 *Journal of Finance* 471-517. R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, "Investor Protection and Corporate Governance", (2000) 58 *Journal of Financial Economics* 3-27. R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, "Agency Problems and Dividend Policies around the World" (2000) 55 *Journal of Finance* 1-33.

[7] Some argue that a categorisation based on legal families is too simple, and even simplistic. Company law and securities regulation are statutory even in common-law countries. In addition, jurisprudence is becoming an increasingly significant source of law even in civil-law countries. For a useful overview,

that the common-law system provides better investor protection than the civil-law system and therefore is better at promoting the development of capital markets and economic growth in general. It did not take long for other, similar studies to emerge. All of these studies are based on the same index – and underlying data – and on exactly the same classification of countries into civil-law countries and common-law countries. However, there is now a growing number of papers that question the classification and the range of factors that make up the index.[8]

C. The lack of research on the stakeholder-based system

Although most of the finance theory focuses on the Anglo-American case, characterised by large and highly liquid stock markets, dispersion of ownership and a buoyant (hostile) takeover market, the situation in most of the world could not be more different. Indeed, most of the Continental European companies – as well as most companies from the rest of the world – have large shareholders and go public much later than their Anglo-American counterparts.[9] As Figure 1 illustrates, only about 2 percent of listed UK and US firms have a majority shareholder compared to 68 percent of Austrian firms, 64 percent of German firms and 56 percent of Italian firms.

[Insert Figure 1 About Here]

Large shareholders tend to be families, other companies, banks and the government.[10] Large shareholders may be beneficial. Given the size of their investment, it is in their interest to monitor the firm's managers and to make sure they perform well.[11] Such monitoring should be beneficial to all the firm's shareholders,

see M. Siems, "Legal Origins: Reconciling Law & Finance and Comparative Law" (2006). Available at http://ssrn.com/abstract=920690.

[8] See e.g. H Spamann, "On the Insignificance and/or Endogeneity of La Porta et al.'s 'Anti-Director Rights Index' under Consistent Coding" (2006) *ECGI Law Working Paper No. 67/2006*.

[9] M Goergen and L Renneboog, "Why are the Levels of Control (So) Different in German and UK Companies?" (2003) 19 *Journal of Law, Economics and Organization* 141-75.

[10] L Correia da Silva, M Goergen and L Renneboog, *supra* n.5.

[11] *Ibid.*

including its minority shareholders. However, the concentration of control does come with its own dangers. A stake of 51% gives its holder control over the firm (firm A). Power is always open to abuse. For example (see Figure 2), the majority shareholder may own 100% of another company (firm B). He could then transfer the assets of firm A to firm B. For every pound he steals from firm A, the effective loss to him is only 51 pence. However, this loss is more than cancelled out by the gain he makes at the level of firm B, one pound. His net gain from each pound will be 49 pence. This amount is identical to the loss per pound that the minority shareholders of firm A will have to bear. By leveraging control via a pyramid of ownership, the main shareholder can further limit his investment in firm A. This can be done by setting up an intermediate holding company which will hold his majority stake (see Figure 3). The large shareholder can then sell off 49% of the holding company's shares without compromising his control of firm A. However, his investment in firm A is now reduced to 51% of 51%, which is roughly 26%. Thus, the net gain to the large shareholder from expropriating the minority shareholders has increased to 74 pence in a pound.[12] To summarise, for most of the world, conflicts of interests are not likely to emerge between the management and the shareholders, but between the major shareholder and the minority shareholders.

So what do we know about the Continental European system? First, contrary to the UK or US, firms do not experience a separation of ownership and control after they have obtained a listing on the stock market.[13] The initial shareholders of German firms manage to keep control – defined as majority control – for as much as five years

[12] Some call this type of expropriation of minority shareholders tunnelling. For examples of tunnelling, see L Renneboog, "Ownership, Managerial Control and the Governance of Poorly Performing Companies Listed on the Brussels Stock Exchange" (2000) 24 *Journal of Banking and Finance* 1959-95; S Johnson, R La Porta, F Lopez-de-Silanes and A Shleifer (2000), "Tunneling" 90 *American Economic Review* 22-7.
[13] M Goergen and L Renneboog, *supra* n.8.

after going public. Conversely, the initial shareholders of UK firms lose control already two years after going public. Second, for those German firms that experience a change in control, control normally tends to be transferred to a new shareholder rather than being diluted via the stock market.[14] More importantly, the evolution of control and ownership within each country and across the two countries seems to be determined not only by legal rules and devices (as LLSV imply), but also by economic factors such as the firm's size and its past performance.[15]

Second, there is now an extensive literature on the link between shareholder value and control.[16] Some studies[17] have found a non-linear relationship between firm value and managerial ownership, suggesting that, at low levels, managerial ownership aligns the interests of the managers with those of the shareholders. However, at intermediate levels of ownership managers seem to become entrenched and may succeed in shielding themselves from disciplinary actions taken by the other shareholders in the wake of poor performance. Finally, at high levels of managerial ownership, the positive link between firm value and ownership returns.

One of the major criticisms of these studies is that they assume that a firm's ownership and control structure is exogenous. This seems a strong – and rather unsubstantiated – assumption as some studies have found ownership to be determined by past performance, risk and growth in assets.[18] For example, there is evidence that highly profitable UK firms that have recently gone public are more likely to be taken over by widely held firms. Conversely, firms with a low profitability tend to be taken

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[14] M Goergen, *Corporate Governance and Financial Performance – A Study of German and UK Initial Public Offerings* (Cheltenham, Edward Elgar, 1998).
[15] M Goergen and L Renneboog, *supra* n.8.
[16] See M Goergen, *supra* n.6, and L Correia da Silva, M Goergen and L Renneboog, *supra* n.5 for an overview of this literature.
[17] See e.g. R Morck, A Shleifer and R Vishny, "Management Ownership and Market Valuation. An Empirical Analysis" (1988) 20 *Journal of Financial Economics* 293–315. See also J McConnell and H Servaes, "Additional Evidence on Equity Ownership and Corporate Value" (1990) 27 *Journal of Financial Economics* 595–612.

over by other firms with concentrated ownership. In addition, there have been a handful of studies that have explicitly addressed the issue about the direction of causality between firm value and control.[19] Virtually all of these studies have found that current levels of control are determined by past performance, and not the converse. These results imply that studies that analyse the link between current financial performance and control, but fail to adjust for the possible endogeneity of control, may draw the wrong conclusions as to the direction of causality between the two.

Third, there is now mounting evidence that corporate governance devices do not act in isolation, but may be substitutes to each other or even complements. For example, some of my research suggests that there is a link between dividend policy and control. In what way is dividend policy a corporate governance device? First, (unexpected) changes in dividends convey new information to the capital market.[20] These changes may act as signals about an improvement or deterioration in future performance in situations where managers tend to have better information on the prospects of their firm than outsiders. The underlying assumption here is that dividends are sticky to some extent, that is, dividends will only react to permanent (and not temporary) increases or decreases in performance. I shall come back to this later. Second, forcing managers to stick to high dividend payouts reduces the amount of cash in the company. A high dividend payout will oblige the managers to raise additional capital regularly via the stock exchange. Each time they do so, the

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[18] M Goergen and L Renneboog, *supra* n.7.

[19] See S Kole, "Managerial Ownership and Firm Performance: Incentives or Rewards?" (1996) 2 *Advances in Financial Economics* 119-49. See also A Agrawal and C. Knoeber, "Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders" (1996) 31 *Journal of Financial and Quantitative Analysis* 377-397.

[20] See L Correia da Silva, M Goergen and L Renneboog, *supra* n.8. See also M Miller and K Rock, "Dividend Policy Under Asymmetric Information" (1985) 10 *Journal of Finance* 1031-1051.

managers and the firm will be subjected to the scrutiny of outsiders, such as investment bankers, financial analysts and the press.[21]

So why should there be a link between dividend policy and the ownership and control structure? Dividend policy is likely to be of much more importance in firms whose managers have a high degree of discretion in terms of their decision-making. Conversely, there may be less of a need to impose high dividend payouts on managers who are already subject to the monitoring by a large shareholder. Findings from empirical research confirm these arguments.[22] First, UK firms – which tend to be widely held – are much more reluctant to decrease or omit their dividend in the wake of a temporary drop in their earnings. On the contrary, German firms are more inclined to reduce or even omit their dividend if performance is just down for a year or two. They then tend to revert to their initial dividend level within a couple of years. This suggests that in the UK – where managerial discretion tends to be higher given the separation of ownership and control in most firms – dividends play a much more important role than in Germany – where most companies are controlled by large shareholders. Second, German firms that are controlled by banks are even more likely to drop or omit their dividend in the wake of poor performance than German firms with other types of control structures. This suggests that dividend policy assumes a less important role as a corporate governance device in bank-controlled German firms.

So why does all this matter? Why should we worry about dividend policy? First, dividends are costly. In most countries, dividends tend to be taxed more heavily

[21] See M Rozeff, "Growth, Beta and Agency Costs as Determinants of Dividend Payout Ratios" (1982) *Journal of Financial Research* 249-259; F Easterbrook, "Two Agency-cost Explanations of Dividends" (1984) 74 *American Economic Review* 650-659.

[22] See M Goergen, L Renneboog and L. Correia da Silva, "When Do German Firms Change their Dividends?" (2005) 11 *Journal of Corporate Finance* 375-399; and L Correia da Silva, M Goergen and L Renneboog, *supra* n.8.

than capital gains.[23] Second, high dividends reduce the amount of internal financing a company would otherwise have access to. If capital markets penalise certain types of firms – such as high-tech firms – by requiring excessive returns on their securities, then a high dividend policy generates another cost by forcing these firms to raise more external financing than they would otherwise have to do or to cut down on their research and development expenses.[24]

In 1994, the then financial secretary to the UK Treasury, Stephen Dorrell, argued that '*dividend payouts by British Companies may have become too high and inflexible*.'[25] Although Dorrell's statement dates back to more than ten years ago, it has lost none of its relevance. For example, in October 2002, Michael McLintock, the CEO of M&G, one of the main institutional investors in the UK, managing a total of £126 billion, wrote a letter to the largest UK companies about the importance of maintaining dividends despite shrinking profits. The letter stated that '*the investment case for dividends in the majority of circumstances is a strong and well-supported one, has stood the test of time, and is likely to be increasingly appreciated in the economic and stock market conditions which we seem likely to face for the foreseeable future*'.[26] Hence, there is some evidence that the shareholder-based system does not come without its drawbacks. Obviously, the stakeholder-based system is not without drawbacks either. Earlier on, I mentioned the potential danger of minority shareholders being expropriated by the large shareholder.

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[23] See R Brealey, S Myers and F Allen, *Corporate Finance* (Irwin, McGraw-Hill, 2006)
[24] See J Mulvey, "Letters to the Editor: R&D the Victim of High Dividend Policies", *Financial Times*, 9 June 1994, 22.
T Barker, T Burt and S Kirchgaessner, "A Court Case Opening Next Week Will Shed Light on the Bitter Dispute between the Tycoon, Directors and Shareholders", *Financial Times*, 10 February 2004, 17.
[25] P Coggan, "Dorrell Critical of High Dividends", *Financial Times*, 19 May 1994, 10.
[26] M Dickson, "M&G Stresses Need to Maintain Dividends", *Financial Times*, 8 October 2002, 1.

LLSV's view on dividends is substantially different.[27] They claim that dividend payouts are higher in countries of the common-law tradition than in those of the civil-law tradition. They conclude that, because common-law countries provide higher levels of investor protection, minority shareholders are able to extract more dividends from the corporate insiders. However, their conclusions are not as clear-cut as they make out.[28] In detail, they study the dividend policy of 4,103 firms from 33 countries. They use three different measures for the dividend payout: the ratio of dividends over cash flows, the ratio of dividends over earnings and that of dividends over sales. The median for each of the three measures is significantly lower for the civil-law countries. However, there are a number of countries that do not conform to this simple pattern. For example, Germany and Japan, which are both civil-law countries, have dividend payouts – as measured by dividends over cash flows and dividends over earnings – that are higher than the median payouts of the common law countries. Yet another civil-law country, Taiwan, has a dividend payout which – depending on the measure used – is between 2.5 and 6 times the median dividend payout of the common-law countries. Finally, Canada, a common-law country, has a dividend payout which is lower than the median dividend payout for the civil-law countries. Hence, the link between dividend payouts and legal tradition is not that simple.

Contrary to LLSV, Mark Roe, professor at Harvard Law School, argues that it is politics that is the driving force behind corporate governance, and in particular corporate ownership and control.[29] Roe argues that left-wing governments favour

[27] R La Porta, F. Lopez-de-Silanes, A. Shleifer and R. Vishny, "Agency Problems and Dividend Policies Around the World" (2000) 55 *Journal of Finance* 1-33.
[28] See L Correia da Silva, M Goergen and L Renneboog, *supra* n.8.
[29] M Roe, *Political Determinants of Corporate Governance*, (Oxford, Oxford University Press, 2003). See also M Goergen, "Review of Political Determinants of Corporate Governance, by Mark J. Roe." (2004) 12 *Corporate Governance: An International Review* 116-117.

employees over investors and that they back this up by regulation which increases the power of employees within corporations. In addition, one of the conflicts of interests that exist between the managers and the shareholders tends to increase the leverage employees possess in this kind of political environment even further. Managers have a tendency to focus on assets growth rather than on profitability. It is in their interest to run large firms as this will increase their status and power. Similarly, employees prefer bigger firms over smaller ones as bigger firms tend to provide better job security and working conditions. In this kind of environment, shareholders may accumulate large share stakes to reduce managerial discretion and to avoid the pursuit of growth to the detriment of shareholder value. Conversely, right-wing governments tend to favour investors over employees. They will introduce legislation that reduces the conflicts of interests between managers and shareholders. In turn, this will encourage ownership dispersion. Roe tests his theory by regressing ownership concentration for 16 OECD countries on an index which measures the political orientation of the government in power. He finds evidence supporting his theory: countries with right-wing governments have higher ownership dispersion than countries with left-wing governments. Further, by combining both politics and the legal origin in his regressions, he finds that politics has explanatory power over and above LLSV's legal origin of countries.

So how do dividends enter the equation? We have already seen that dividends can act as a corporate governance device. Further, according to Roe, under a left-wing government, the traditional conflict of interests between managers and shareholders will be even more exacerbated. Steve Bank, Brian Cheffins and Marc Goergen argue that, in this kind of political environment, managers are likely to advocate low

dividend payouts.[30] A low dividend payout will increase the proportion of the earnings that will be retained by the firm. More slack cash gives managers higher discretion and facilitates their pursuit of assets growth. Increasing the amount of retained profits is also beneficial to the employees as the retained profits will act like a cushion during bad times. On the contrary, companies that operate under right-wing governments – who favour investors over employees – are more likely to have high dividend payouts.

They test the link between politics and dividends for the UK over the period of 1950 to 2003. The UK provides a great national laboratory to test Roe's theory in the context of dividend policy. Indeed, the 'Westminster Model' characterised by majority governments gives the government in place a sufficient power base to implement their preferred policies. Further, the UK has experienced extended periods of both left-wing and right-wing governments over their period of study. There is ample evidence of UK policymakers targeting dividends for various reasons. For example, in 1951 the Labour government announced a plan, which was subsequently abandoned, to introduce legally binding dividend controls.[31] The rationale behind these dividend controls was to give something back to the trade unions and the labour force in turn for a restraint on wage demands. At the time, this move was characterised as a "politico-economic compromise".[32]

In order to test Mark Roe's thesis, they based themselves on the classic dividend model which was developed by John Lintner.[33] In the 1950s, Lintner

[30] S Bank, B Cheffins and M Goergen, "Dividends and Politics", (2006) *European Corporate Governance Institute Law Working Paper no* 24/2004 (revised).
[31] "Six Disastrous Years", *Times*, 3 October 1951, 7.
[32] E Collins, "Profits in Politics", *New York Times*, 6 August 1951, 30.
[33] J Lintner, "Distribution of Incomes of Corporations Among Dividends, Retained Earnings and Taxes" (1956) 46 *American Economic Review* 97-113.

interviewed the chief financial officers of large US companies and found the following patterns:

- Managers have some kind of long-term target in mind when they decide on dividend payouts
- Managers tend to focus on dividend changes rather than on dividend levels

and

- They are reluctant to change dividends unless this is justified by a permanent change in the earnings of their firm. For example, they will only increase dividends if profits are up on a permanent basis

Bank, Cheffins and Goergen augment Lintner's model by a politics index. In detail, they regress annual aggregate dividends in the UK over the period of 1950 to 2003 on the politics index – compiled by John Cusack – which attributes a score to each government on the scale of –100 (extreme left-wing) to +100 (extreme right-wing). Strikingly, they do not find a link between politics and dividend policy. As an alternative measure of politics, they use a series of variables that are likely to be influenced by the government in power such as tax and trade-union power. Indeed, the link between politics and dividends may be an indirect one. There are several examples where the UK government introduced new tax rules intended to dictate a certain dividend policy. For example, in 1947, Hugh Dalton, the Labour Chancellor of the Exchequer, justified an increase in tax on dividends by stating that the recovery from World War II had been hindered because '*[t]oo much … ha[d] been distributed, and too little ploughed back into the business*'.[34] Fifty years later, Gordon Brown, another Labour chancellor, justified the termination of major tax exemptions on

[34] 436 PARL. DEB., H.C. (5th ser.) (1947) 84 (statement of Mr. Hugh Dalton).

dividends enjoyed by pension funds and other institutional investors on the basis that existing rules "encourage[d] companies to pay out dividends rather than reinvest their profits".[35] However, even by replacing the politics index by these "secondary-politics" variables, they still do not find a link between politics and dividends. So, if dividend policy is a valid measure for corporate governance, there is no support for Mark Roe's thesis of a link between politics and corporate governance.

Jana Fidrmuc, Marc Goergen and Luc Renneboog analyse the market reaction to directors' trades in UK companies over the period of 1992 to 1998.[36] They test whether the market reaction to these trades is influenced by a firm's ownership structure. They hypothesise that firms with shareholders who monitor the firm's management experience less substantial market reactions to directors' trades. Indeed, such firms are less likely to suffer from asymmetric information between the managers and the shareholders and the directors' trades are therefore expected to contain less information that is not yet known by the market. Based on previous empirical evidence on the UK,[37] they argue that institutional investors are mostly passive and do not engage in monitoring. Conversely, they expect families or individuals and other companies to be active investors. They find evidence that monitoring shareholders do indeed mitigate asymmetries of information as the share price reaction to directors' trades in firms with such shareholders is much less pronounced. On the contrary, the market reaction to directors' transactions in companies with passive shareholders is amplified. This confirms that different types of shareholders provide different levels of monitoring.

[35] Chancellor of the Exchequer (Mr. Gordon Brown). "1997 Budget Speech", para. 72. http://archive.treasury.gov.uk/pub/html/budget97/chxstat2.html, accessed on 5 February 2003).
[36] J Fidrmuc, M Goergen and L Renneboog, "Insider Trading, News Releases, and Ownership Concentration" (2006) 61 *Journal of Finance* 2931-2973.
[37] See e.g. J Franks, C Mayer and L Renneboog, "Who Disciplines Management in Poorly Performing Companies?" (2001) 10 *Journal of Financial Intermediation* 209-248.

To summarize, it is still not clear what the benefits and shortcomings of each corporate governance system are. Further, there is still uncertainty as to the role of individual corporate governance devices in each system and the interaction between the different devices. However, this has not prevented policy makers from moving ahead.

For example, the European Union adopted its Directive on Takeover Bids in April 2004.[38] The aim of the Takeover Directive is to provide a level-playing ground for cross-border mergers and acquisitions in the European Union. Although the rationale of the Directive is to increase investor protection and facilitate takeovers across the EU, it is unlikely that the Member States will eventually move towards an Anglo-American system of corporate governance. Indeed, Marc Goergen, Marina Martynova, and Luc Renneboog find that the new Directive's effects on corporate control and investor protection are likely to depend on the existing corporate governance system of each Member State and the effects are therefore expected to be very different from country to country.[39]

So, what is the role of takeover regulation in terms of corporate governance? First, takeover regulation can facilitate corporate restructuring and is therefore crucial in order to ensure that the factors of production are used by the most efficient firms within the economy. Second, takeover regulation can also play an important role in terms of mitigating conflicts of interests between the different types of corporate stakeholders.

At first sight, some of the provisions contained in the EU Takeover Directive might seem likely to align the corporate governance of Continental Europe with that

[38] Directive 25/2004 EC [2004] OJ L12/142.

[39] M Goergen, M Martynova and L Renneboog, "Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe" (2005) 21 *Oxford Review of Economic Policy* 243-268.

of the UK. However, the same provisions may have very different outcomes in each corporate governance environment.

First, there are provisions in the new directive which clearly push Continental Europe towards a more market-oriented system. For example, the principle of equal treatment ensures that minority shareholders are given the opportunity to exit their firm in the wake of a takeover bid on the same terms as the large shareholder. The introduction of this principle will not only increase shareholder protection across Europe, but also reduce the incentives to hold large blocks in the first place. Hence, this principle is likely to decrease ownership concentration in Continental Europe.

Second, for other provisions the effect on ownership and investor protection is ambiguous at best. An example is the one-share-one-vote principle. This principle prohibits any restrictions on voting rights. Such restrictions are, for example, voting caps which limit the percentage of votes any shareholder can cast, and dual-class shares, whereby shares of one class carry more votes than those of the other. There are two discernable impacts from preventing violations of the one-share-one-vote principle. First, there will be a liberalisation of the takeover market, making it now possible to acquire firms that would previously have been protected from unwelcome acquisitions. As a result, managerial discretion may now be limited. Second, getting rid of voting caps, one of the deviations from the one-share-one-vote rule, may result in a decrease in minority-shareholder protection as it makes it now easier for an investor to obtain uncontested control over a firm. This uncontested control may very well be misused to expropriate the minority shareholders. Hence, the overall effect from introducing this principle is ambiguous.

Third, at least one of the provisions contained in the new directive is likely to reduce investor protection. This is the case of the controversial break-through rule

which faced opposition from Germany and Sweden and was only adopted in a watered-down form. The break-through rule enables a bidder to circumvent voting restrictions contained in a company's articles of association. As these voting restrictions had to be approved by the shareholders in the first place, the break-through rule violates the principle of shareholder decision-making. It may also make inefficient bids possible that would otherwise have failed. Finally, it may increase the use of pyramids of ownership which are not covered by the rule. To summarise, the impact of the new Takeover Directive on investor protection and ownership concentration is ambiguous. On one side, a provision may have very different outcomes in each corporate governance environment. One the other side, although the Takeover Directive contains a majority of provisions which are likely to bring about some degree of convergence of Continental Europe towards the shareholder-oriented system, it also contains provisions that may further strengthen the existing differences between the systems.

We have seen that cross-national regulation can have dubious effects and may even reinforce rather than reduce the differences between corporate governance systems. If, contrary to intentions, regulation does not necessarily align the different systems, what tools are policy markers left with? Susanne Espenlaub, Marc Goergen and Arif Khurshed's empirical results suggest that similar types of firms, in this case high-tech firms, behave in similar ways.[40] They found that, although there is no such requirement, most UK firms use so called lock-in agreements when they go public. A lock-in agreement is a contract whereby the firm's initial shareholders engage themselves not to sell all or part of the stake they hold immediately after the flotation for a certain period.

Exhibit 1 reproduces the lock-in contract of Carpetright plc which went public in June 1993. The agreement states that all the directors consented not to sell any of their shares until the publication of the preliminary results for the year following the year of the IPO. Further, Sir Philip Harris, the main shareholder, chairman and CEO, agreed to lock in part of his shares for an additional period of 2 years.

During the late 1990s, Belgium, France, Germany, Italy and the Netherlands set up new stock markets to give high-tech firms, which do not satisfy the entry requirements of the main stock market segments, the opportunity to raise external capital.[41]

The success of these markets has been mixed.[42] Between 1997 and the bursting of the internet bubble, the German *Neuer Markt* managed to attract as many as 268 IPOs, which is about half of the number of the firms listed on the main market segments. The *Neuer Markt* was eventually closed down in January 2003. There are various reasons for the demise of this market. One of the reasons for the market's closure is a series of scandals, such as the scandal surrounding Kermit the Frog, or at least the firm, EM.TV which owned the rights to the Muppet Show.

Contrary to the UK, the new European stock exchanges have imposed minimum lock-in periods. For example, the German *Neuer Markt* required that 100 percent of the shares the initial shareholders held immediately after the IPO could not be sold for at least 6 months after the flotation. The French *Nouveau Marché*, the Italian *Nuovo Mercato*, and their Belgian and Dutch equivalents, had similar requirements in place.

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[40] S Espenlaub, M Goergen and A Khurshed, "'IPO Lock-in Agreements in the UK", (2001) 28 *Journal of Business Finance and Accounting* 1235-1278.
[41] M Goergen, J McCahery and L Renneboog, "The Impact of Stock Exchange Regulation on Corporate Performance of the European New Markets" (2003) 3 *Journal of Corporate Law Studies* 379-399.

Marc Goergen, Arif Khurshed and Luc Renneboog, analyse the patterns of lock-in agreements on the French and German markets.[43] They find that a majority of firms on both markets lock in their shareholders beyond what the regulators require. Similar to the example of Carpetright for the UK, most French and German firms have more than one lock-in contract in place. For example, executive directors are often subject to more stringent contracts than the other initial shareholders. Further, the length of the lock-in and the percentage of shares locked in depend on the firm's characteristics such as its age and its size which can be considered as proxies for the level of uncertainty about the firm's prospects. All this suggests that firms, or at least some firms, have strong incentives to go beyond any existing regulation to obtain investor confidence.

D. Conclusion

To conclude, our knowledge to date about the different corporate governance devices and different systems of corporate governance is still fairly limited. There is some evidence that suggests that individual corporate governance devices – such as dividend policy and control – act together and should therefore not be studied in isolation. Our knowledge about the advantages and the shortcomings of the different systems of corporate governance is as yet relatively limited. However, the limited empirical evidence that is available suggests that both of the two main systems of corporate governance have clear advantages as well as major shortcomings. Given the limited amount of research available, policy makers reforming national systems face an ambitious task.

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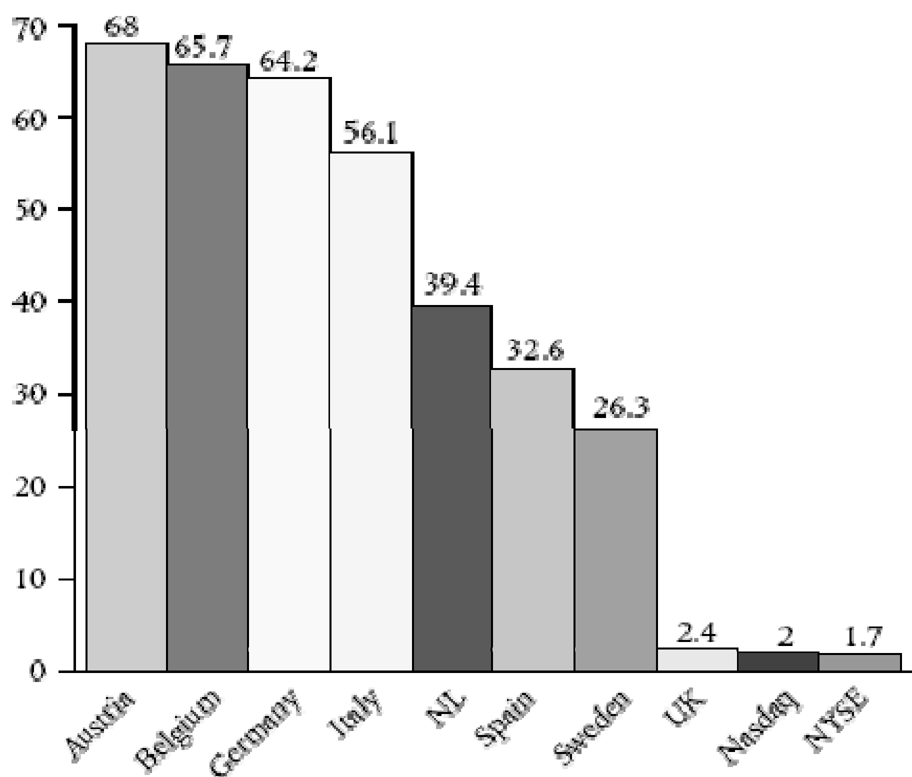
[42] M Goergen, L Renneboog and A Khurshed, "Explaining the Diversity in Shareholder Lockup Agreements" (2006) 15 *Journal of Financial Intermediation* 254-280.
[43] *Ibid.*



Source: Barca and M. Becht, *The Control of Corporate Europe* (Oxford, Oxford University Press, 2001).

Figure 1 – Percentage of Listed Firms with a Majority Shareholder

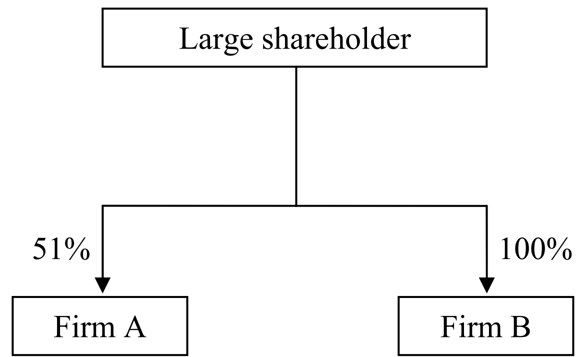


Figure 2 – Minority shareholder expropriation

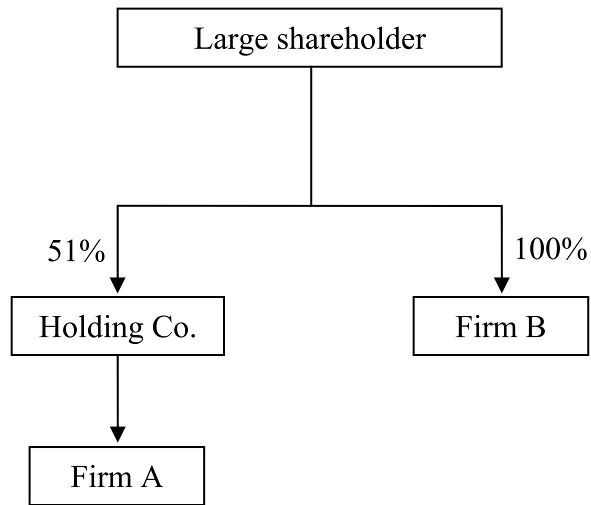


Figure 3 – Minority shareholder expropriation

Each of the Directors has undertaken not to sell further shares until the publication of Carpetright's preliminary results for the year ending 30 April 1994, other than with the consent of County NatWest. Sir Philip Harris and Harris Ventures Limited have undertaken that they will not, together, other than with the consent of County NatWest, sell more than two and a half per cent of the ordinary share capital of the Company in the first year following this period or more than five per cent of the ordinary share capital in total in the two years following this period."

Source: Carpetright's IPO prospectus, p.24

Exhibit 1 – Carpetright plc's lock-in agreement

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