Corporate Board Elections and Internal Controls

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Briefing: Board elections in Europe by Professor Guido Ferrarini, Professor of Law, University of Genoa; Vice Chairman of the ECGI and ECGI Fellow

Moderator: Roberta C. Ramo, Shareholder, Modrall, Sperling, Roehl, Harris & Sisk P.A and 1st Vice President, The American Law Institute
Professor Guido Ferrarini, who is the Professor of Law, from the University of Genoa, will give us a European perspective, on this same topic.

Based on a paper by Francesco Chiappetta (Telecom Italia), Guido Ferrarini (University of Genoa and ECGI) and Gerard Hertig (ETH Zurich and ECGI)

Professor Guido Ferrarini:

I. Introduction

Shareholders' powers to elect directors are as key to corporate governance as citizens' powers to elect members of parliament are to democracy. It thus comes as no surprise that legislators, courts and commentators on both sides of the Atlantic are giving considerable weight to board elections issues.

However, the scope and effectiveness of shareholder board election rights differ across jurisdictions. In the U.S., shareholders of public companies interested in having a voice in director choice face multiple barriers (L. Bebchuk, 'The Case for Increasing Shareholder Power' (2005) 118 Harvard Law Review 833). Incumbent management has the advantage when it comes to access to the corporate ballot and proxy apparatus (L. Bebchuk 'The Case for Shareholder Access to the Ballot' (2003) 59 Business Lawyer 43). In addition, a majority of public companies has a staggered board, a structure that increases the cost of attempting to replace directors (L. Bebchuk and A. Cohen, 'The Costs of Entrenched Boards' (2005) Journal of Financial Economics (forthcoming)). As a result, board-nominated candidates usually face no competition and can be certain that they will be elected, as even opposition by a majority of shareholders does not prevent them from becoming directors. Moreover, most public companies are incorporated in Delaware, where shareholders cannot initiate charter amendments (or reincorporation in a more shareholder friendly jurisdiction) to reduce board electoral dominance.

Shareholders in European listed firms have more of a say about board appointment. Obviously, regulatory impediments matter less when there are controlling shareholders, as is still often the case in continental Europe (see F. Barca and M. Becht, The Control of Corporate Europe, Oxford University Press 2001). But even in the UK, where public companies have dispersed owners, shareholders face lower election barriers, in particular when it comes to proxy solicitations (R. Kraakman et al., The Anatomy of Corporate Law, Oxford University Press 2004).

This does not mean that there are no board election issues in Europe. First, managerial entrenchment remains a problem, especially in jurisdictions where employees participate in board elections. Second, minority shareholders often fail to benefit from the freedom of choice advantages recognized to European shareholders as a class. Third, a combination of remaining barriers to cross-border voting and increasing institutional ownership create election issues that are comparable to those existing in the U.S.

Evidence of the non-trivial nature of these issues is provided by current EU reform efforts. Like past and current U.S. regulatory developments, these efforts reveal the growing role of institutional investors. For example, the requirement that shares must be blocked for several days prior to board elections is a significant regulatory issue because of institutional investors alleging that resulting liquidity costs deter them from voting. But EU reform efforts also reflect differences between U.S. and European ownership and market structures. In the U.S., current proposals aim at reducing board dominance by modifying the "plurality voting" rule and by facilitating shareholder access to corporate proxy material. In Europe, reformers focus on reducing controlling shareholder dominance and financial market fragmentation by facilitating minority voting in general and improving cross-border communications.

It would be misleading, however, to assume that current EU reform proposals are dealing with all or even the major European board elections issues. First, the significant pan-European diversity in the board election role of employees or the State often prevents reaching the level of political consensus required to regulate at the EU level. Employee board participation and golden shares in previously State-owned companies are prototypical examples.

Second, globalization and European integration create new board election issues at a pace faster than EU reformers can cope with. In particular, the gradual replacement of families and governments by institutional investors as major shareholders of listed firms results in boards starting to adopt pre-emptive strategies that remain below the EU regulatory radar. Hence, depending on the Member State, one can observe that some directors are progressively nominated by the board itself (for example in France) while in other countries (such as Italy) board election procedures are in place that allow for institutional investor representation on boards or audit committees

Against this background, in a paper still in progress we analyze board elections in major European jurisdictions (France, Germany, Italy, Spain, Switzerland and the UK) taking into account both the regulatory frameworks and the articles of association (charters) of the relevant FTSE Eurofirst 300 companies. In this paper, which summarizes some aspects of our work in progress, we focus on issues that are relevant for Europe-U.S comparisons or are important from an EU internal market perspective.

II. Current Issues in the U.S. and Europe

Reform proposals in both the U.S. and Europe reflect the increasingly global role of institutional investors. In the U.S., board election reformers are attempting to provide institutional investors with a more direct say in board elections by modifying the "plurality voting" role and by facilitating shareholder access to corporate proxy material. At the EU level, where the scope of reform is broader (it deals with shareholder rights in general), institutional investors could get more of a board election voice following the adoption of proposals on share blocking and proxy voting. However, EU harmonization efforts also address small investor protection issues such as information and communication deficiencies. Moreover, a review of statutes and charters in our select European jurisdictions reveals significant board elections issues (such as one share/one vote or stakeholder representation) that are not being dealt with by the EU law-makers.

A. The U.S. Debate

The current US discussion on corporate elections focuses on two main issues. The first is "plurality voting" for the election of directors (see ABA Committee on Corporate Laws, Draft Discussion Paper on Voting by Shareholders for the Election of Directors, June 22, 2005, at 2). Plurality vote is the default rule included in the Revised Model Business Corporation Act (RMBCA) and followed by the majority of the states (including Delaware). Directors are elected upon receipt of the most votes (i.e. a plurality of votes) without regard to the number of votes against them or not cast. The rationale for the plurality voting system reflects long-established concerns about the risk that not all open board positions may be filled under a majority voting system when there are more nominees than open board positions. The plurality system, however, has a down-side. It generally results in de facto director cooptation when shareholders are not in a position to put nominees on the ballot to compete with the board's own nominees – a result that, as noted above, is frequent under the current U.S. regulatory regime.

Cooptation having become widespread in U.S. public companies, there is an on-going debate on whether the plurality system should be amended to enhance the accountability of corporate boards by giving greater effect, in a non-contested directors' election, to votes cast against or withheld from one or more directors (ABA Committee on Corporate Laws, Draft Discussion Paper on Voting by Shareholders for the Election of Directors, June 22, 2005, at 4 – 10). Amongst the specific alternatives being considered are either changing to a majority vote default rule (which would require a change in federal securities regulation, for proxy cards today do not provide for a vote "against" a directors' nominee) or requiring a "minimum" plurality vote, such as one-third of the total of the "for" and "withheld" votes (ibidem, 12 ff.).

The second issue for discussion concerns the SEC's proposal to provide a limited right of access to corporate proxy material under a new Rule 14a-11. Under this proposed rule, it would be easier for qualified shareholders to cause an annual election of directors to become contested. In fact, the corporation would be required to bear the expense of including in its proxy statement information on up to three shareholder nominees (depending on the size of the board) and of distributing to shareholders proxy cards that allow for voting for the shareholders' nominees (see Task Force on Shareholder Proposals of the ABA Committee on Federal Regulation of Securities, August 15, 2005, at 9). However, the proposed rule has up to now failed to receive the necessary support and, for the time being, its partisans have given priority to lobbying for the adoption of alternatives to the plurality voting system.

B. The European Debate

In Europe, there is no similar discussion on plurality voting or access to proxy material. On the one hand, majority voting is generally the default rule for corporate elections (see T. Baums, 'General Meetings in Listed Companies – New Challenges and Opportunities', paper presented at the Conference 'Company Law Reform in OECD Countries', Stockholm, 7 - 8 December 2000, downloadable at http://www.oecd.org, stating (at 9) that 'absolute majority' is the predominant rule, equating voting abstention to negative voting; however, the 'simple majority' rule is applied in several countries including Austria, Belgium, Germany and the U.K.). On the other hand, proxy solicitations with respect to corporate elections are not as heavily regulated in Europe as in the US, so that the problems dealt with by the SEC's proposal do not arise in the same terms.

At the EU level, the debate touches upon four other topics, as shown by the European Commission's recent consultation document (see European Commission, Fostering an Appropriate Regime for Shareholders' Rights, Second Consultation

Document, May 13, 2005). The first relates to voting being contingent to blocking the shares for a few days prior to the board election meeting. Apparently, institutional shareholders consider the requirement one of the greatest obstacles to voting and many seem to prefer abstention to being prevented from trading their shares for a couple of days. However, as pointed out by the European Commission, few Member States still impose share blocking and it is unclear why a proposition to move to a default U.S. style record date system would significantly facilitate shareholder voting.

Second, the European Commission is considering reducing uncertainties in the stock lending and depositary receipt areas by improving lenders' information about their voting rights and requiring depositaries to get express receipt holder authorization before exercising voting rights attached to the shares they hold. It appears that these reforms target unsophisticated shareholders and are unlikely to have a major practical effect.

Third, EU law-makers are enquiring about the need for improved communication prior to the general meeting, in particular regarding the availability of all information necessary for an informed vote. Timely and adequate information may be crucial for board elections, especially when it comes to voting for independent directors. However, while many listed firms are not very forthcoming about the background of nominees, their identity is generally posted well in advance on the company's web-site. This should provide a sufficient basis for an educated vote by most institutional investors, due the availability of sophisticated data banks. To be sure, improved pre-general meeting communication would reduce transaction costs and facilitate the task of less sophisticated shareholders. Nevertheless, one can doubt that it would have a major practical effect.

Fourth, the European Commission is addressing two crucial voting procedure issues, the right to add items on the agenda and proxy voting. In several European jurisdictions, the statutes or articles of associations limit the right to put nominees on the ballot to shareholders owning a substantial share percentage or even give nomination exclusivity to the board. While this may not have been a major issue when controlling shareholder dominated most European listed firms, the increasing importance of institutional investors is changing the equation. Thus, the European Commission's consultation about giving agenda setting rights to at least those shareholders owning either 5% of the firm's capital or shares valued in excess of € 10 million is worth discussing.

As to proxy requirements, the European landscape is quite diverse. While the Transparency Directive states that shareholders must not be prevented from exercising their rights by proxy, proxy rights remain subject to the law of the Member State in which the issuer is incorporated (Article 17 Transparency Directive [2004] O.J. L 390/38). Member States have used their regulatory power to impose or allow various constraints, including restrictions on who may be appointed as a proxy and the number of proxies a person may hold. Here again, the European Commission's consultation about giving any shareholder the right to appoint any person as a proxy and the prohibition to limit the proxies any such person may hold is worth discussing.

The European debate, however, is not limited to issues currently addressed at the EU level. Obviously, the implementation of recently adopted EU rules, such as the recommendation on director independence, is generating board eligibility debates. More importantly, however, the significant diversity in the board election role of employees or in state interventionism across jurisdictions prevents reaching the level of political consensus required for European harmonization. In addition, globalization and European integration create board election issues at a pace faster than EU reformers can cope with, in particular when it comes to issues related to changes in ownership structures due to the gradual replacement of controlling families and governments by global institutional investors.

It follows that, at the Member State level, additional board election issues are debated due to concerns related to institutional investor activism, small shareholder protection, employee participation, managerial opportunism and/or State intervention. Clearly, not all debates are of pan-European interest, nor do they necessarily address the most fundamental issues. This is why our work in progress is not limited to those board election issues that are openly debated, but does also address significant issues revealed by an examination of FTSE Eurolist 300 charters and their practical implementation.

As far as public discussion in the Member States is concerned, there are two center stage issues: one share / one vote and employee board representation. The one share / one vote debate deals with the discrepancy between the voting power and the equity investments of controlling shareholders in many Member States. This discrepancy has become a hot issue due to major increases in the equity stakes of institutional investors in continental European listed firms (see also Deminor, 'Application of the One Share – One Vote Principle in Europe, March 2005, downloadable at www.deminaor-rating.com). As a result, regulatory and market change is in the making.

Employee board representation is subject to recurrent debate in Germany, where co-determination is decried by many managers as hampering their firms' competitiveness. However, employee board representation is also an important albeit less controversial topic in other European jurisdictions. In France, for example, corporate law fosters employee board representation, especially when employees are equity holders or in firms that have been recently privatized.

Both issues are worth discussing more in detail not only because they are at the heart of public debate, but also because FTSE 300 charters indicate that firms have implemented and continue to implement corporate law provisions in these areas. The analysis of said charters, however, shows that the public debate should be extended to three sets of additional issues.

First, attention should be given to whether the growing role of institutional investors should be dealt with through mechanisms other than those envisaged by the EU or corporate governance activists. Hence, the Italian experience shows that the list voting system for board or audit "committee" elections should be taken into account when attempting to devise mechanisms to facilitate the co-existence of controlling shareholders and institutional investors.

Second, one must not overlook that the transition from controlling shareholders to institutional investor dominance provides room for managerial opportunism. Thus, the French experience seems to indicate a trend towards the nomination of non-voting directors by the board himself, which may be a first step towards U.S. style cooptation.

Third, it is interesting to note the lack of mechanisms facilitating board election participation by small investors. To be sure, these investors' active participation would not be without costs. However, their participation in corporate life is presently close to non-existent, as shown by the data relative to the attendance to shareholder meetings in listed companies in Europe.

C. Comparing the U.S. and EU Debates

Greater attention is devoted in Europe, for structural and political reasons, to the roles of controlling shareholders and employees, with significant enrichment of the board election debate. Hence issues such as minority and employee board representation, are both important and European specific.

From a quantitative perspective, the European board election debate thus seems richer than the U.S. one. However, this is partly misleading, as the discussion in Europe tackles problems (such as share blocking and pre-general meeting disclosure) that have been already solved in the US. On the other hand, from a qualitative perspective, the current U.S. debate is potentially more important than its European equivalent, as it could lead to alter boardroom composition and activity.

That being said, the two critical issues of proxy voting and board entrenchment are common and unresolved on both sides of the Atlantic. However, the relevant questions need to receive, to some extent at least, different answers reflecting differences in regulatory frameworks and ownership structures between Europe and the US.