Corporate Governance Reforms in Continental Europe

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Corporate governance in the United States is about alleviating the conflict of interest between dispersed small shareowners and powerful controlling managers. Classic works like Berle and Means (1932) and Jensen and Meckling (1976) discussed this separation of ownership and control and its consequences. Although some companies in the United States are controlled by large blockholders (for instance, Microsoft, Ford, and Wal-Mart), they are relatively few and have thus drawn less attention in the corporate governance debate (Anderson and Reeb, 2003).

Corporate governance in continental Europe and in most of the rest of the world is fundamentally different. There, few listed companies are widely held. Instead, the typical firm in stock exchanges around the world has a dominant shareholder, usually an individual or a family, who controls the majority of the votes. Often, the controlling shareholder exercises control without owning a large fraction of the cash flow rights by using pyramidal ownership, shareholder agreements and dual classes of shares (La Porta, Lopez-de-Silanes and Shleifer, 1999).

These differences in ownership structure have two obvious consequences for corporate governance, as surveyed in Morck, Wolfenzon, and Yeung (2005). On the one hand, dominant shareholders have both the incentive and the power to discipline management. On the other hand, concentrated ownership can create conditions for a new agency problem, because the interests of controlling and minority shareholders are not aligned**.**

In this essay, we begin by describing the differences in the ownership structure of companies in continental Europe (Germany, France and Italy) and in the United Kingdom and the United States. We next summarize the corporate governance issues that arise in firms with a dominant shareholder. Then, we take a look at the major European corporate scandal, Parmalat, as an extreme example of investor expropriation in a family-controlled corporation. We outline in general the legal tools that can be used to tackle abuses by controlling shareholders. Finally, we describe the reforms enacted by France, Germany and Italy between 1991 and 2005 and assess the way in which investor protection in the three countries has changed.

Concentrated Ownership across Countries

A common measure of ownership concentration is whether one shareholder owns at least 20 percent of a company’s voting rights. The first column of Table 1 shows how many of the 20 largest listed companies in France, Germany, Italy, the United Kingdom and the

United States qualify as concentrated by this standard. The numbers show that dispersed ownership is common in the US and UK and very rare in Italy, with Germany and France falling in the middle. The second column shows that, with the exception of Britain, family control is quite common even among the largest corporations. Third, pyramidal ownership is a common way of holding control in continental Europe. A pyramid is defined as an ownership structure in which the controlling shareholder exercises control of one company through ownership of at least one other listed company. As we can see in column 3, pyramidal ownership is absent in Britain and America, but found even among the top 20 corporations in France, Germany and Italy.

[Insert Table 1 approx. here]

One may wonder why there are no pyramids in the US or the UK. The answer probably lies in historical differences in regulation: Morck and Yeung (2005) suggest that the taxation of inter-company dividends introduced in 1935 could explain the disappearance of pyramids in the US. According to Franks, Mayer and Rossi (2005), the introduction of the mandatory takeover bid in 1968 may explain the disappearance of pyramids in the UK.

The difference between US and UK on the one hand and continental Europe on the other is not restricted to the largest corporations. Going by the median fraction of votes owned by the largest shareholder in all listed companies (column 4), ownership is highly concentrated in Germany and Italy, and diffused in Britain and America, with France in an intermediate position. Remarkably, in half of German and Italian listed companies, one blockholder owns at least 57 percent or 55 percent, respectively, of the votes. A final measure of ownership concentration is the share of a country's total stock market capitalization held by the 10 richest families. By this measure, shown in column 5, company ownership in continental Europe is concentrated in the hands of a small number of wealthy individuals.

To understand how pyramids, shareholder agreements and dual classes of shares work, let us consider three prominent examples. Louis Vuitton Moët Hennessy (LVMH) is the world leader in luxury goods and one of the largest companies listed on the Paris Bourse, with a market capitalization of about $45 billion. The firm has an ultimate owner, Bernard Arnault, who is also the chief executive officer and chairman of the board. The firm is controlled via a pyramidal group that includes several non-listed and one listed company (Christian Dior). Figure 1 plots this control chain. The number above each company to the right of the arrow shows the fraction of the shareholder votes owned by the entity listed above it. The numbers on the left of the figure show for each company the fraction of its cash flow rights that are owned either directly or indirectly by the controlling shareholder. For example, Arnault owns 98.7 percent of the cash rights in Semyrhamis, and this company owns 70 percent of Christian Dior SA, so Arnault owns 69.1 percent of the cash flows in Dior (that is, 98.7 percent multiplied by 70 percent). As a consequence of this control structure, he controls 47 percent of the voting rights in LVMH with a direct and indirect ownership of 34 percent of the cash flow rights.

[Insert Figure 1 approx. here]

The separation of ownership from control is more dramatic in Telecom Italia, one of the world's largest telecom companies with a market capitalization of about $40 billion. The pyramidal group includes three listed companies and two non-listed companies (Figure 2). Telecom Italia's Chairman of the Board, Marco Tronchetti Provera controls 18 percent of the votes in Telecom Italia (and is by far its largest shareholder), although he holds only 0.7 percent of the cash flow rights. Notice that the control over one of the companies in the pyramid (Pirelli Spa) is strengthened via an agreement with other large shareholders on how to vote shares (known as *voting syndicate*). Because of this agreement, Tronchetti Provera controls 46.1 percent of the votes in Pirelli Spa: 25 percent being directly owned by his holding company Camfin and 21.1 percent being provided by other friendly blockholders.

[Insert Figure 2 approx. here]

As a third example, consider the ownership structure of Volkswagen AG, which has a market capitalization of about $25 billion. The largest shareholder in this company is another listed company, Porsche AG. Because Volkswagen AG also has non-voting preferred shares, Porsche AG owns 25.1 percent of the common shares but only 18.9 percent of the equity. Notice that the 1960 Volkswagen Law caps the voting power of any shareholder at 20 percent. Hence, Porsche AG does not technically control Volkswagen AG but, as its largest shareholder, holds a blocking minority. Porsche AG in turn is controlled by the family of the company's founder, Ferdinand Porsche. The Porsche family owns 100 percent of the common (voting) shares but only 50 percent of Porsche's equity, half of which consists of preferred (non-voting) shares. Because of the combined effect of the dual classes of shares and the pyramidal structure, the Porsche family controls 25.1 percent of the votes in

Volkswagen AG but owns only 9.44 percent of its cash flow rights.

[Insert Figure 3 approx. here]

Corporate Governance in Family-Controlled Companies

On average family-controlled firms are better managed than widely held ones. In a sample of large US companies, Anderson and Reeb (2003) find a significantly higher Tobin's q for family-controlled firms (a third of their sample) than for widely held companies. Barontini and Caprio (2005) find a similar result for European companies. Tobin's q is the ratio of the market value of a firm to the replacement value of its assets (typically measured as the book value of the firm's assets). A higher (industry-adjusted) Tobin's q suggests that the assets are used efficiently – that is, they are worth more within the firm than in alternative uses.

These findings do not imply that family-controlled firms are always better governed than widely held ones. Family control does help to protect shareholders' interest against managerial abuses, since the controlling owner and the manager are often the same person. Moreover, the controlling family is likely to commit more human capital to the firm and care more about its long-run value (see Bertrand and Schoar, 2006). But families can abuse their power and use corporate resources to their own private advantage. The point is that family-controlled companies usually have less separation of ownership and control, but the controllers (the families) are much more powerful than managers in a widely held company, because they cannot be ousted by a hostile takeover or replaced by the board of directors or by the shareholders' meeting.

Self-dealing or *tunnelling* (Johnson et al., 2000) is the transfer of value from firms where the controlling shareholder owns a small fraction of the cash-flow rights (lower down in the pyramid) to firms where the controlling shareholder owns a large fraction of cash-flow rights (higher up in the pyramid). Value can be transferred in many ways: related-party transactions (i.e., transactions with the dominant shareholder, a director or parties associated with them) at other than arm's-length terms, the biased allocation of intangible assets and liabilities, excessive director compensation, and so on.

A hypothetical example may help to clarify how tunnelling works. In the pyramidal group described in Figure 2, Marco Tronchetti Provera may force Telecom Italia to buy inputs from Camfin at above market prices. This related-party transaction neither creates nor destroys value, because the loss for Telecom Italia is equal to the gain for Camfin. But Tronchetti Provera is better off, because he pockets 29.1 percent of the Camfin's gain and suffers only 0.7 percent of Telecom Italia's loss.

Controllers' power to use corporate resources to their private advantage is likely to create a wedge between the value of a company for the controlling shareholder and for the other (minority) shareholders. This difference in value is known as the private benefits of control. One empirical measure of these benefits is the "block premium," which is the difference between the price per share paid in a block transaction and the market price after the transaction. The first column of Table 2 shows that block premiums are somewhat larger in Germany and much larger in Italy than in the United States, the United Kingdom, or France. Another measure is the "voting premium," which is the difference between the market prices of voting and non-voting shares. The second column of Table 2 shows that the voting premium is much higher in France and Italy, moderate in Germany and the United Kingdom, and low in the United States. These results suggest that the value of control is larger in continental Europe than in the US and the UK.

[Insert Table 2 approx. here]

The Parmalat Collapse

Parmalat is the most glaring example to date of corporate governance abuses in insider-dominated countries. Our account here draws on Ferrarini and Giudici (2005). The story begins when Calisto Tanzi inherited a small family business in the 1960s and the firm started a pattern of ever-accelerating growth. When it listed on the Milan stock exchange in 1989, Parmalat Finanziaria was the holding company of a group comprising 58 companies (33 based outside Italy) with aggregate sales of $720 million. The Tanzi family was the controlling shareholder via a non-listed company. The acquisition drive became even more intense in the 1990s, with aggregate sales reaching $3.6 billion in 1996 and almost $10 billion in 2002.

Most of the group's expansion was in milk and dairy products, especially in South America. But the Tanzis also diversified outside the food industry, mainly into soccer, the pet project of Calisto Tanzi's son Stefano, and tourism, the pet project of Tanzi's daughter Francesca. Most of the acquisitions were financed with debt. The peculiar characteristic of Parmalat's balance sheet was the simultaneous presence of high levels of debt and cash. In

2002, the annual report indicated $4.3 billion in cash and equivalent against $9.3 billion of debt. The reality was that most of the cash reported in the balance sheet no longer existed: it had already been consumed.

Tanzi's empire collapsed in December 2003. After several unsuccessful attempts to refinance its debt, on December 8 Parmalat informed the market that it could not repay a bond that was maturing. Following the bonds' downgrade to junk level, the share price collapsed. Meanwhile, Consob (the Italian securities and exchange commission) required confirmation of the existence of a bank account with Bank of America where all $4.3 billion of Parmalat's cash was supposedly deposited (via a Cayman Islands company called Bonlat). Bank of America soon replied that there was no such account, Parmalat Finanziaria was declared insolvent, and Calisto Tanzi was jailed.

According to an estimation of the sources and uses of funds reported in Table 3, from 1990 to December 2003 the Parmalat group used a total of $18.2 billion of financial resources, including $16.9 billion raised from debt. Over that period of time the family siphoned off (in "unknown" uses) about $3 billion. This is a lower bound of the expropriation, because overpayment for the acquisition of assets would be classified as acquisitions or other capital expenditures. Most of these resources were transferred to the other businesses directly owned by the Tanzis. The techniques used to conceal the fraud were rudimentary. Parmalat hid losses, overstated assets (and recorded non-existent ones), understated debt, forged bank documents and diverted cash to the Tanzi family.

[Insert Table 3 approx. here]

As in any large financial scandal, the designated watchdogs (auditors, investment banks and regulators) are partly to blame for not detecting the patterns of negligence, fraud and corruption. However, Parmalat is mainly an example of outright expropriation of both shareholders and creditors by a family that treated company resources as their own. Although it represents an extreme case (given the scale of the expropriation), the evidence on private benefits of control reported in Table 2 indicates that minor forms of expropriation are systemic in continental Europe.

There is an important difference between financial scandals in companies with concentrated ownership (like Parmalat) and in those with diffused ownership (like Enron and Worldcom). In Enron and Worldcom (as well as in Vivendi and Royal Ahold, two European widely held companies) corporate managers engaged in earnings manipulation and accounting irregularities, in order to inflate the stock price and gain from their equity and options holdings. In Parmalat (as well as in Adelphia, a US company with concentrated ownership), the controlling shareholders expropriated investors of corporate resources via self-dealing. As Coffee (2005) argues, these differences must lead to different regulatory responses in different countries.

Four Legal Tools

Dominant shareholders (and insiders more generally) have good opportunities to expropriate investors. Can this problem be solved without regulation, namely via private contracting and social norms? From the available evidence, the answer is no. For instance, we know that countries with weaker investor protection have less developed financial markets (La Porta et al., 1997 and 2006) and that weaker insider trading legislation and enforcement is associated with higher cost of capital (Bhattacharya and Daouk, 2001). Because finance matters for growth (Rajan and Zingales, 1998), financial regulation matters. In this section, we briefly describe four legal tools that are commonly used to protect investors. In the following section, we discuss the evolution of these tools in the three major economies of continental Europe – France, Germany and Italy – and compare it with the US.

Strengthening Internal Governance Mechanisms

The board of directors is the primary institution of corporate governance. Its main task is to hire and monitor top management on behalf of shareholders, and it is best placed to screen related-party transactions. Whether firms are widely held or family-controlled, the danger is that, rather than represent the interests of faceless shareholders, boards will bond with management, whom they interact with regularly, or the family, who has the ultimate power to select and remove them.

Regulations mandating greater independence for directors and defining the board's functions, powers and internal workings – including matters like auditing, setting executive compensation, screening related-party transactions, and disclosure of information flows – may give the board of directors some power to challenge the dominant shareholder. So far, though, there is little evidence that these reforms have curbed controlling shareholders' abuses (Denis and McConnell, 2003).[1]

Empowering Shareholders

The law traditionally protects shareholders by enhancing their rights to sell, sue and vote. First, in widely held companies, the shareholders' right to sell their shares allows for a market for corporate control to emerge as a mechanism to limit insider abuses (Manne, 1965). Where ownership is highly concentrated, as in continental Europe, this market only disciplines the insiders of the relatively few companies that are widely held (Rossi and Volpin, 2004).

Second, regulators may empower shareholders by granting them the right to sue the company and its directors. The effect of such suits will depend on how easy or costly it is to bring them and how efficient the court system is.

Third, regulation can empower shareholders by giving them a say over key corporate governance issues. For this purpose, regulators can extend the subject matters to be decided by the shareholder meeting, mandate super-majority requirements, lower the cost of voting, limit deviations from one-share-one-vote, and mandate minority shareholders' representation on the board. The evidence in Djankov et al. (2006) indicates that shareholders' right to vote on self-dealing transactions is particularly important.

Control transactions may also provide the occasion for self-dealing (see Kirchmaier and Grant, 2005). Controlling shareholders may reject value-maximizing takeovers (if they are not fully compensated for the foregone private benefits of control), and accept value-destroying ones that let them appropriate the control premium (see Bebchuk, 1994, also for an extensive discussion of the trade-off between investor protection via equal treatment clauses and efficiency of the market for corporate control). The law can protect minority shareholders by allowing them to share the control premium with majority shareholders (so as to align controlling and minority shareholders' incentives).

Enhancing Disclosure Requirements

Whether shareholders effectively exercise their rights to sell, vote and sue effectively depends on their access to information. An extensive regime of disclosure may help alleviate agency problems in listed corporations: as Louis Brandeis (1914, p. 62) once famously wrote,

[1] A similar sceptical view applies to compensation schemes for executives, which are unlikely to solve the problem of controlling shareholders' abuses, if – as it seems – they are not immune from managerial abuses

sunshine is "the best of disinfectants." For example, mandatory disclosure of related-party transactions and of directors' compensation can be an effective tool to limit self-dealing by those in control. Disclosure of price-sensitive information helps prevent insider trading. Well-designed accounting standards and independent and skilful audits can detect Parmalat-style frauds early on.

Tougher Public Enforcement

Another type of regulatory intervention is enforcement of corporate and securities laws through supervisory agencies and criminal sanctions. There is not much evidence that public enforcement matters (Djankov et al., 2006). Yet it may be the most effective tool to prevent specific forms of expropriation, like insider trading, which are otherwise hard to detect. It may also be needed to impose sufficiently severe sanctions, like prison terms, in extreme cases.

Corporate Governance Reforms in France, Germany and Italy

In the last fifteen years reforms have been enacted in France, Germany and Italy to improve internal governance mechanisms, empower shareholders, enhance disclosure and strengthen public enforcement. To understand the impact of these reforms, it is helpful to start by describing the status quo in comparison with the US.

In the United States the directors make all the decisions (or have an exclusive power to initiate them if a shareholder vote is mandated). In Europe shareholders have a final say on a larger number of issues, such as share buy-backs, dividend payments and new issues. European shareholders also have much greater power to set the shareholder meeting agenda (Cools, 2005). This allocation of power backs up the prevailing ownership structures: in both cases, the law grants the controllers (management in the US, dominant shareholders in Europe) the right to exercise and retain control.

The US central government has long played a much more important role in regulating corporate governance than the European Community on the other side of the Ocean: US securities regulation has developed since the thirties and now deals with many crucial corporate governance issues, such as shareholder meetings and voting, insider trading, takeovers, securities fraud, and now, with the Sarbanes Oxley Act (SOX), even board

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in widely held corporations (Bebchuk and Fried, 2004).

composition and functioning (Roe, 2003). By contrast, the European Community, despite its power to enact binding laws (called regulations and directives) in corporate law matters, has traditionally had a much lower impact on European companies' corporate governance (Enriques, 2006).

Furthermore, US securities regulation provides for a system of mandatory disclosure that is traditionally far more comprehensive than Europe's. Its effectiveness is ensured by an aggressive set of enforcement institutions, such as the securities plaintiff bar (i.e. lawyers who bring class action suits on behalf of large numbers of investors), the Securities and Exchange Commission (SEC) and the Department of Justice. In Europe, enforcement is in the hands of Member States, which have traditionally been far from aggressive in tackling violations of corporate and securities laws via public enforcement. With no plaintiff bar and long-standing legal hurdles to shareholder litigation, private enforcement of directors' duties was almost unheard of. This is in sharp contrast with the US, where corporate directors face a high risk of being sued if they engage in self-dealing. When this happens, the courts, especially in Delaware, are very strict in judging a director's loyalty to the corporation.

While there are features common to the various continental European corporate governance systems, especially compared with the US, each also has its own distinctive traits.

German law mandates a two-tier board structure, made up of a "supervisory board" and a "managerial board." In companies with more than 2,000 employees, the supervisory board must be composed of equal numbers of shareholder-elected and employee-chosen members (so-called co-determination). Banks have traditionally played a central role in listed companies' supervisory boards, as a result of their shareholdings and of their acting as their clients' proxies in shareholder meetings (Fohlin, 2005). Unsurprisingly, supervisory boards, packed with employees and bank representatives, have been quite ineffective in monitoring management (and dominant shareholders) on behalf of outside investors (Theisen, 1998).

In France, managerial power has historically been concentrated in the hands of the chief executive officer, who, by law, also acted as chairman of the board. At least on paper, corporate law has traditionally been friendlier to minority shareholders in France than in Germany or Italy. Two mention but two instances, individual shareholders of French companies have since long been able to sue directors derivatively and a special regime has always applied to related-party transactions involving board members: these transactions need to be approved by the board and ratified by the shareholder meeting, unless they are deemed to be routine transactions (i.e., "current transactions entered into at normal conditions"). In general, however, judges and practitioners have traditionally provided a mild interpretation of this regime, e.g. by qualifying most transactions with companies of a same group as routine ones (Enriques, 2004).

In Italy, a separate board of auditors, i.e. an internal body composed exclusively of formally independent members, has traditionally performed the internal audit functions. Neither the board of directors nor the board of auditors have ever been able to exercise effective control over managers (and hence over the dominant shareholders who appoint them), as the Parmalat scandal vividly illustrated. More generally, Italian corporate law has historically provided poor protection for investors, while enforcement institutions, like courts or the Italian securities and exchange commission (Consob), have been unable to make up for the deficiencies of the law (Aganin and Volpin, 2005).

There have been three main drivers of continental European corporate governance reforms over the last two decades. First, reforms aimed to make national capital markets more attractive at a time when international competition for equity capital was increasing due to deregulation and globalization and States were engaging in privatizations (Kamar, 2006). Second, especially on disclosure issues, changes were spurred as part of the European Community's efforts to institute a common regulatory framework for European financial markets (Ferran, 2004). Last but not least, many of the corporate law reforms recently enacted in Europe have come as a response to corporate scandals. This is the case not only of the reforms recently enacted in the wake of US and European scandals,[2] but also of the 1998 German corporate governance reform, which was enacted after Metallgesellschaft and other corporate scandals exposed German corporations' defective internal control mechanisms (Cioffi, 2002).

The discussion that follows highlights the corporate governance reforms that may help protect minority shareholders of listed corporations. Our focus is on lawmakers' effort to improve European companies' corporate governance provisions. Case law, including in the core area of fiduciary duties, is out of the scope of this paper.[3] Tables 4 to 7 summarize the relevant reforms. For general overviews of European corporate law reforms see Nowak (2004) and Noack and Zetzsche (2005) (Germany), Conac (2006) (France), and Bianchi and Enriques (2005) and Ferrarini, Giudici and Stella Richter (2005) (Italy). Enriques and Gatti (2006) provide an overview of recent reforms at the European Community level.

[2] Albeit smaller than Parmalat, France and Germany have also experienced their share of financial frauds at the beginning of the century: see e.g. Enriques (2003).

[3] Fleischer (2005) discusses the "transplant" of Anglo-American fiduciary duty doctrines in continental Europe.

Strengthening Internal Governance Mechanisms

In the wake of US scandals, reforms enacted by Congress and the main stock exchanges (NYSE and NASDAQ) have required that a majority of directors be independent, that audit committees be entirely composed of independent directors and that companies have adequate internal control mechanisms. Further, independence requirements have been tightened and audit committees' powers and responsibilities have been extended. Finally, attempts to curb self-dealing have been made by requiring that companies have a compensation committee entirely composed of independent directors and by banning corporate loans to directors. None of the European countries considered here have gone as far as the US in their attempts to strengthen internal governance mechanisms, whether by improving *board effectiveness* or by tightening rules on *related-party transactions.*

In Germany, the 1998 reform was geared to improve internal corporate governance by redefining the functioning of both the management board and the supervisory board. The management board now has to ensure that adequate risk management and internal audit systems are in place and must report to the supervisory board over risk management issues, budget and business plans. Supervisory boards have to meet at least four times a year and have an increased role in the choice of, and relationship with, the auditor.

French law has done little to empower the board of directors, other than to *allow* companies to separate the roles of chairman of the board and chief executive officer. Some attempts were made to give more information to directors from outside the firm. In 2001, a new law stated that "each director should receive all information needed to fulfill his duties" and that "each director can obtain any and all documents that he sees fit to request" (Menjucq, 2005, p. 702). But two years later, French lawmakers scrapped the latter provision, preventing individual board members from accessing the company's documents directly.

In Italy, the 1998 reforms have strengthened the board of directors by requiring that executive directors regularly inform the board of directors and the board of auditors of business developments and related-party transactions, and, most importantly, that at least one director and one board of auditors member be elected by minority shareholders. The reforms also entrusted the board of auditors with greater powers and somewhat tightened their members' independence requirements.

France and Italy have strengthened their rules on self-dealing transactions by dominant shareholders. France did so in 2001, when it made its special regime on directors' related-party transactions also applicable to transactions involving the parent company or any shareholder holding more than 10 percent of the voting rights. In 2005, the same regime was extended to executive compensation packages granting a lump-sum bonus at the time of appointment or dismissal.

In its 2003 corporate law reform, Italy revised its previously lax regime on self-dealing transactions to "strengthen its prophylactic character" (Ferrarini, Giudici and Stella Richter, 2005, p. 680). Directors now have to disclose to the whole board and to the board of auditors any direct or indirect interest they might have in a transaction. Prior board-of-directors approval is required for transactions in which the chief executive officer has an interest. While interested directors need not abstain from voting, the board resolution must "adequately explain the reasons for the transaction and the benefits deriving to the company" (p. 681). This mandatory justification of the transaction's fairness has to be more detailed and analytical when the corporation decides for it under the influence of its parent company.

By contrast, no new rules for related-party transactions have been enacted in Germany over the past 15 years.

[Insert Table 4 approx. here]

Empowering Shareholders

In the US, pressure from shareholder activists has led to more powerful shareholders' voice. The two main exchanges amended their listing rules in 2003 to require shareholder approval of stock-based compensation plans, and also prohibited brokers from voting their clients' shares to approve such plans, unless the clients instruct them on how to vote. Restrictions on brokers' discretionary voting (they usually back management's proposals) are now being discussed with reference to board elections, an issue where recent developments at the state and federal level have strengthened shareholders' power (Klingsberg, 2006; for the policy debate see Bebchuk, 2005, and Bainbridge, 2006).

Lawmakers in continental Europe have taken various steps to increase minority shareholders' powers vis-à-vis managers and dominant shareholders. First, they have *strengthened shareholders' voice* in corporate governance. Shareholders now have the power to authorize or ratify some transactions and resolutions in potential conflict of interest. As noted, in France the general meeting has to ratify any non-routine transactions with a major shareholder and some forms of executive compensation. In Italy, a specific provision now requires the meeting's approval of any form of stock-based compensation.

In each of the three countries, shareholders now have lower costs for voting. Companies can allow remote voting via Internet and telecommunications technology. France and Germany have also introduced rules to reduce technical barriers to voting by shareholders residing abroad and to facilitate the circulation of documents, including shareholder proposals, prior to the meeting.

Italian companies' shareholders formerly had to deposit their shares with a bank five days prior to the meeting, which prevented them from selling their shares during those five days and hence severely discouraged voting, especially by institutional investors. In 2003 this provision was repealed; the default rule is now no deposit obligation, although company bylaws may require an up to two-day deposit obligation. No such requirement exists in Germany, where a new law has clarified this point. In France, corporate bylaws can require the deposit of shares for up to five days prior to the meeting, but a 2002 decree provides that shareholders remain free to sell their shares up until the day before the meeting.

To limit the power of controlling shareholders, special majorities for "non-routine" shareholder resolutions have traditionally been in place in France and Germany. In Italy, since 1998, a two-thirds majority of the shares represented at the meeting has been required for various kinds of resolution, including new issues, mergers, and amendments to the bylaws. The purpose is to allocate some power to large minority shareholders, in hopes that they monitor the controlling shareholder.

France and Italy also lowered the ownership thresholds for some minority shareholder rights, such as the right to call a meeting (from 10 to 5 percent and from 20 to 10 percent, respectively) or to ask a court to appoint an expert for the review of transactions (from 10 to 5 percent in both countries).[4]

Of these three countries, Germany has done the most to *limit deviations from the one-share-one-vote principle*, but Italy has also taken steps in this direction. Germany banned multiple-voting shares in 1998, and also prohibited banks from acting as clients' proxy if they own more than 5 percent of the shares. More generally, the rules on banks' voting of clients' shares were revised to discourage the clients' tendency to let banks decide freely on how to vote and hence, as a rule, support management. Finally, in 2002 Germany revised its tax code to exempt capital gains from sales of shareholdings held by corporations. The aim was to encourage firms and financial institutions to disentangle their cross-shareholdings. Italy did the same in 2003. In both countries the exemption also applies to newly acquired holdings, so

[4] French law provides that shareholders may petition the court for the appointment of such an expert in order to gather information about suspicious transactions. Italian law grants minority shareholders a similar right, but where serious irregularities in the company's management are found, the court may take further measures, such as convening the general meeting or even removing the directors.

that it is not obvious that it should lead to a lower number of corporate shareholdings. In fact, while in Germany firms did disentangle their cross-shareholdings, a process that was already under way when the tax-break was enacted (Fohlin, 2005), in Italy the tax-break was followed by an increase in the number of corporate block-holdings (Bianchi and Bianco, 2006).

Italy also reformed its corporate law to counter various forms of deviation from one-share-one-vote. In 1998 the so-called "Draghi Law" tackled shareholder agreements – that is, pacts among blockholders to set a common voting policy and/or restrict their freedom to sell shares. These agreements, which are very common in Italy's large listed companies, stabilize control in the hands of the blockholders, who are often linked by a web of cross-holdings (Ferrarini, 2001). The 1998 law introduced a three-year time limit for these agreements, so that parties are free to back off from them every three years. The law also provides that in the event of a takeover bid the parties are free to tender their shares, no matter what restrictions the agreements would impose on their sale.

Another mechanism by which shareholders can have more say is *private enforcement by shareholder lawsuits.* Germany and Italy have enacted reforms favoring derivative suits, i.e. shareholder actions for damages against directors on behalf of the corporation.

In Italy, derivative suits were first permitted in 1998, but standing to sue was restricted to shareholders holding at least 5 percent of the shares. No derivative action has yet been brought, probably because of this high threshold and to other hurdles, such as the fact that the losing party in a suit has to pay the winner's lawyer fees and that it is almost impossible for shareholder plaintiffs to obtain the evidence they need to substantiate their claim, in the absence of US-style rules providing for pre-trial discovery (Enriques, 2004). However, Italy has made some changes. Contingency fees (lawyers' fees that are owed only if the client wins or settles) were made legal in 2006, and the threshold for a shareholder suit was reduced to 2.5 percent in 2005.[5] Further, minority shareholders have been granted the right to sue the parent company for damages, if it has abused its control powers.

Of the three countries, Germany has enacted the most extensive revisions to encourage US-style shareholder litigation. For example, rules introduced in 2005 make it possible for shareholders representing at least 1 percent of shares or shares worth at least €100,000 (approximately $125,000) to bring a derivative suit against directors. Settlement agreements have to be disclosed to the public, and a special regime on lawyers' fees more favorable to plaintiff shareholders has been introduced.

Germany also enacted rules to facilitate shareholder suits for damages stemming from violations of issuers' duty to disclose material information. Such suits were first allowed in 2003. Two years later, procedural rules were introduced to facilitate securities class action lawsuits. No such procedural rules exist in Italy or in France.

European lawmakers have also been active in the field of *control transactions.* All three countries have introduced a "mandatory bid rule": that is, the acquirer of a control block must offer to acquire all the remaining shares at a price usually above market.

[Insert Table 5 approx. here]

Enhancing Disclosure Requirements

The regulatory framework for disclosure has improved on both sides of the Atlantic. After the scandals, the US imposed additional disclosure obligations and enhanced the role of auditors (Coates, 2007). In continental Europe in the last 15 years major disclosure reforms have been enacted, that mainly cover four spheres: 1) corporate governance; 2) self-dealing and insider trading; 3) compensation; 4) financial reporting.

In France, companies are required to disclose *corporate governance arrangements* in a detailed report, which must also state whether they comply with the relevant Corporate Governance Code. In Italy companies must declare whether they comply with the stock exchange corporate governance code, in Germany with the official code.

Disclosure of self-dealing has also improved. Following a 2002 European Community Regulation, starting in 2006 the annual accounts of listed companies must be drawn according to the International Financial Reporting Standards (IFRS), whose Standard 24 requires detailed and specific disclosure of related-party transactions. Annual disclosure of related-party transactions was already the rule in France, although in practice shareholder meetings had traditionally been given little specific information about them (Enriques, 2004). Italy, at least on paper, went further. In 2002, Consob issued new rules requiring prompt, on-going disclosure of *material* related-party transactions. However, companies rarely disclose

[5] The ban on contingency fees and the procedural hurdles also exist in France and may explain why derivative suits have always been extremely rare there, despite the absence of any ownership threshold (Enriques, 2004).

such transactions (Consob, 2005), taking advantage of the vagueness of the criteria used to identify materiality.

A 2003 European Commission directive on "market abuse" – the short name for insider trading and securities fraud – contains disclosure provisions aimed to prevent it (Ferrarini, 2004). The directive extends the definition of inside price-sensitive information requiring immediate disclosure. It also requires disclosure of trading activity on a company's shares by its directors and persons closely connected with them. Between 2003 and 2005, all three countries have changed their laws to incorporate these provisions. Only Italy followed the US example and extended the disclosure requirement to trading activity by controlling shareholders.

Until recently, compensation received by European companies' directors was a well-guarded secret. Reforms have now mandated complete disclosure of individual board members' compensation, including stock options: Italy has required annual disclosure since 1999, France since 2001 and Germany since 2006. However, German companies, upon a vote of shareholders representing at least 75 percent of the shares, may opt out of the new disclosure requirement until 2011.

Companies from continental European countries used to accumulate hidden reserves due to conservative accounting policies. Under the new IFRS rules on *financial reporting*, the principle of "fair value accounting" forces companies to disclose such reserves. As a consequence, investors should be better able to understand whether companies retain excessive cash in the effort to maximize the size of the firm and the private benefits that size can bring.

Finally, continental European jurisdictions have also taken steps to strengthen auditors' independence and effectiveness, similar to the U.S. rules imposed under SOX (see Table 6 for details).

[Insert Table 6 approx. here]

Tougher Public Enforcement

By international standards, the United States has very strict public enforcement of corporate governance rules, which the post-scandal reforms have made even tougher: the US congress granted, by raising SEC resources, increasing criminal sanctions for fraud and setting up a public body to supervise auditors, the Public Company Accounting Oversight

Board (PCAOB) (Coates, 2007).

France, Germany and Italy have all reshaped and strengthened their *public enforcement structures* in the past 15 years. Germany has done the most in this area, for the remarkable reason that prior to 1994 it had no authority for supervising securities markets. Germany has thus had to build it up from scratch. Italy has granted Consob greater powers. France, which already had a powerful public enforcement agency in place, merged (like Germany) all its financial supervision into one authority, the AMF (BaFin in Germany).

France, Germany, and Italy all now provide for criminal sanctions in cases of *market abuse*. France has done so since 1970; since 1996, fines for insider trading violations can also be imposed on corporations. Italy prohibited insider trading in 1991 and market manipulation in 1998, Germany in 1994 and 2002. With the adoption of the Market Abuse Directive in 2003, all three countries had to tighten their regime with various measures to facilitate the punishment of insider trading and market manipulation. For example, Italy increased the maximum prison term and the fines for the two crimes, coupled the criminal sanction with an administrative one that Consob can impose directly (as a remedy to the frequent inertia of public prosecutors), and strengthened Consob's investigative powers.

All three countries have strengthened their public enforcement apparatus on *financial reporting and auditing*. Germany and Italy have introduced rules providing for the supervisory agency's review of companies' financial reports. All three countries have introduced or strengthened the public oversight on auditors. France in 2003 and Germany in 2004 instituted an equivalent of the PCAOB. Italy's Consob supervisory powers over audit firms were greatly extended in 2005 (after they had been reduced by the 1998 reform).

[Insert Table 7 approx. here]

Conclusion

Corporate governance in continental Europe traditionally differs from that in the US in two important ways. First, most European companies have controlling shareholders, while most American corporations are widely held; second, the regulations on self-dealing have traditionally been stricter in the US.

In the last 15 years the three largest continental European countries (France, Germany and Italy) have enacted significant corporate law reforms to strengthen the mechanisms of internal governance, empower shareholders, enhance disclosure requirements and toughen public enforcement. Special emphasis was placed on empowering minority shareholders and on disclosure, which are the most effective tools for countering abuses by dominant shareholders.

However, there are two caveats to the conclusion that as a consequence of the reforms investors are actually better off. First of all, far too little has been done to resolve the problem of related-party transactions, which is the most common form of self-dealing for dominant shareholders in Europe. Germany has done nothing to improve its law on this matter. France and Italy have introduced stricter rules on such transactions but have not done enough to strengthen private enforcement, which is an absolute necessity for giving these rules "teeth," making them effective in the real world, not just in the statute books. In other words, there is a serious risk that these rules will be better only on paper.

Second, a good part of the European reforms have been patterned after US corporate and securities law. This is only natural, in light of America's well-developed legal framework for corporate governance, which has been further improved by the post-scandal reforms, and the success of the US economy over the last two decades. However, the fundamental differences in ownership structure between Europe and the US mean that emulating laws whose focus is on curbing managerial opportunism may not be an appropriate way to prevent self-dealing by controlling shareholders. Indeed, to be cynical one might observe that politically it may be a kind of "path of least resistance" for European policymakers to adopt US-style solutions designed to tackle managerial agency problems. This way, they can appear to be doing something to reform corporate governance while actually leaving the rents of dominant shareholders perfectly intact.

In view of its recent evolution, corporate governance law in Europe is often described as being in a "state of permanent reform" (Noack and Zetzsche, 2005). The reform effort needs to continue if continental Europe is to address in an effective manner the basic problems of corporate governance that are posed by the power of dominant shareholders.

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Table 1. Ownership concentration

	Widely held	Family control	Pyramid control	Median largest block	Family wealth
France	60%	20%	15%	20%	29%
Germany	50%	10%	20%	57%	21%
Italy	20%	15%	20%	55%	20%
United Kingdom	100%	0%	0%	10%	6%
United States	80%	20%	0%	5% (NYSE) 9% (Nasdaq)	N.A.

Notes: Widely held is the fraction of firms with no controlling shareholder among the 20 largest companies by stock market capitalization at the end of 1995. A company has a controlling shareholder if the sum of a shareholder's direct and indirect voting rights exceeds 20 percent. Family control is the fraction of the 20 largest companies where the controlling shareholder is an individual. Source: La Porta, Lopez-de-Silanes and Shleifer (1999, Table 2). Pyramid control is the fraction of the 20 largest companies, where the controlling shareholder exercises control through at least one publicly traded company. Source: La Porta, Lopez-de-Silanes and Shleifer (1999, Table 4). Median largest block is the median size of the largest ultimate voting block for listed industrial companies. Source: Barca and Becht (2001). Family wealth is the percentage of total stock market capitalization controlled by the 10 richest families. Source: Faccio and Lang (2002, Table 10).

Table 2
Private benefits of control

	Block premium	Voting premium
France	2%	28%
Germany	10%	10%
Italy	37%	29%
United Kingdom	2%	10%
United States	2%	2%

Notes: Block premium is the country average of the difference between the price per share paid for the control block and the trading price two days after the announcement of a control transaction. See Dyck and Zingales (2004, Table 2) for details. Voting premium is the country average of the estimated value of a vote as a percent of firm value. See Nenova (2003, Table 5) for details.

Table 3
Parmalat Group: Uses and sources of funds
(*aggregate estimates for the 1990-2003 period in billions of US dollars)*

Sources		Uses	
Internal funds	1.3	Interests & fees	6.8
Debt	16.9	Acquisitions	4.8
		Other capital expenditures	3.6
		Unknown (diverted)	3.0
Total sources	18.2	Total uses	18.2

Source: Ferrarini and Giudici (2005).

Table 4
Internal governance reforms in France, Germany and Italy.

France	Germany	Italy
Board Effectiveness		
Separation of Chairman and CEO allowed (2001). New rules on board's information (2001 and 2003).	Greater role for supervisory board (1998). Specific duties on risk management and internal controls (1998).	New rules on board's information (2003). Minorities represented in board of directors (2005) and in board of auditors (1998). Greater role and powers for board of auditors. Stricter independence requirements for its members (1998 and 2005).
Internal Governance and Self-Dealing		
Board approval of non-routine transactions with significant shareholders and of some forms of executive compensation; board disclosure of non-trivial routine self-dealing transactions mandated (2001, 2003 and 2005).		Increased board disclosure and procedural requirements on related-party transactions (2003).

Table 5
Shareholder empowerment reforms in France, Germany and Italy.

France	Germany	Italy
Greater Voice for Shareholders		
Annual ratification by shareholder meeting of non-routine transactions with significant shareholders and of some forms of executive compensation (2001, 2003 and 2005). Exercise of voting rights made easier (2001). Lower thresholds for minority shareholder rights (2002).	Exercise of voting rights made easier (2001). Communication among shareholders facilitated (2005).	Shareholder approval of stock-based compensation (2005). Exercise of voting rights made easier (2003). Qualified majority for major resolutions (1998). Lower thresholds for minority shareholder rights (1998 and 2005).
One-share, one-vote rules		
	Multiple voting shares banned and banks' influence over shareholder meetings curbed (1998). Sale of corporate shareholdings tax-exempt (2002).	Voting caps banned (2003). Limits on validity of shareholder agreements (1998). Sale of corporate shareholdings tax-exempt (2003).
Private enforcement		
(Individual shareholders were already allowed to bring derivative suits.)	Derivative suits made easier (2005). Civil actions for securities fraud made easier (2003).	Derivative suits for minorities representing at least 2.5 percent of shares allowed (1998 and 2005). Contingency fees allowed (2006). Direct shareholder suit against parent company for damages stemming from abuse of corporate control introduced (2003).
Control Transactions		
Mandatory bid rule (1992).	Mandatory bid rule (2002).	Mandatory bid rule (1998).

Table 6
Disclosure reforms in France, Germany and Italy (European Community reforms in italics).

France	Germany	Italy
Corporate governance		
Corporate governance report mandated; corporate governance code mandated on a comply-or-explain basis (2003).	Corporate governance code mandated on a comply-or-explain basis (2002).	Corporate governance code mandated on a comply-or-explain basis (2005).
Self-dealing		
IAS/IFRS 24 (2002, effective 2006). Annual disclosure of non-routine transactions with significant shareholders and of some forms of executive compensation (2001, 2003 and 2005). *Price sensitive information to be immediately disclosed* (pre-existing; revised in 2005). *Disclosure of directors' and officers' trading* (2005). Annual disclosure of individual directors' compensation (2001).	*IAS/IFRS 24* (2002, effective 2006). *Price sensitive information to be immediately disclosed* (1994 and 2004). *Disclosure of directors' and officers' trading* (2002 and 2004). Annual disclosure of individual directors' compensation (2006).	*IAS/IFRS 24* (2002, effective 2006). Immediate disclosure of material related-party transactions (2002). *Price sensitive information to be immediately disclosed* (1991 and 2005). *Disclosure of directors' and officers' trading* (2005). Disclosure of major shareholders' trading (2005). Annual disclosure of individual directors' compensation (1999).
Financial reporting and audit		
IFRS reporting mandated (2002, effective 2006). CEO abstains from proposal of auditors (2003). Audit partner rotation (6 yrs) (2003). Prohibition on non-audit services to audit clients (2003).	*IFRS reporting mandated* (2002, effective 2006). Increased cooperation between supervisory board and auditor (1998). Audit partner rotation (7 yrs) (1998). Prohibition on non-audit services to audit clients (2004).	*IFRS reporting mandated* (2002, effective 2006). Increased cooperation between supervisory board and auditor (1998). General manager's and CFO's statement on truth of financial reports and adequacy of accounting procedures (2005). Audit partner rotation (6 yrs) and audit firm rotation (12 yrs) (2005). Prohibition on non-audit services to audit clients (2005).

Table 7
Public enforcement reforms in France, Germany and Italy (European Community reforms in italics).

France	Germany	Italy
Powers of supervisory authority		
Merger of securities and banking authorities (2003).	Securities regulator set up (1994) and granted extensive investigative and sanctioning powers (various years). Merger of securities and banking authorities (2002).	Increased regulator's investigative and sanctioning powers (1998 and 2005).
Sanctions against market abuse		
Market abuse regime tightened (2005).	Criminal sanctions for *insider trading* (1994) and market manipulation (2002). *Market abuse regime tightened* (2002 and 2004).	Criminal sanctions for *insider trading* (1991) and market manipulation (1998). *Market abuse regime tightened* (2005).
Enforcing rules concerning financial reporting and auditing		
French "PCAOB" (2003)	Securities' agency review of financial reports (2004). German "PCAOB" (2004)	Securities agency's review of financial reports (2005). Securities agency's powers on audit firms strengthened (2005).

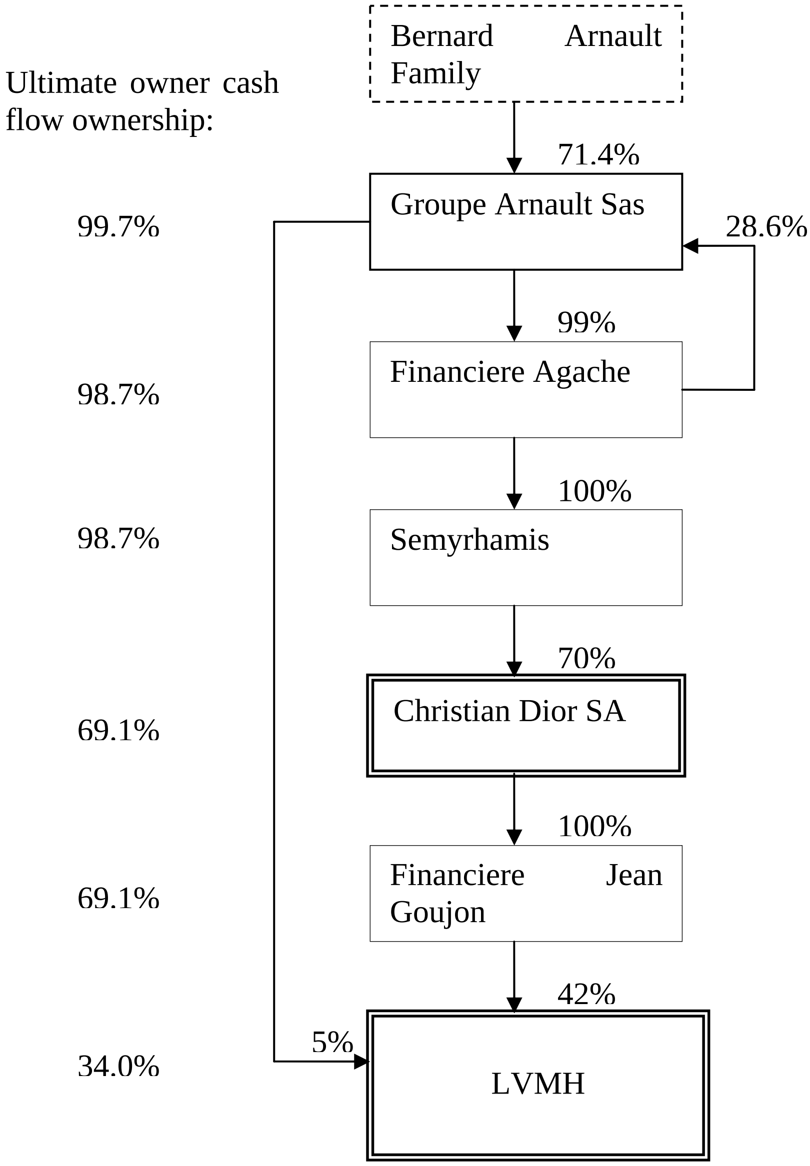

Figure 1. Ownership structure of LVMH in 2005.
The ultimate owner is indicated in a dash-line bordered box at the top. Single-bordered boxes represent non-listed companies. Double-bordered boxes represent listed companies. The arrows indicate the direction of control. The numbers next to the arrows indicate the fraction of votes owned. The numbers on the left represent the fraction of cash-flow rights owned directly and indirectly by the controlling shareholder in each of the companies in the pyramid. Source: Amadeus and Factiva.

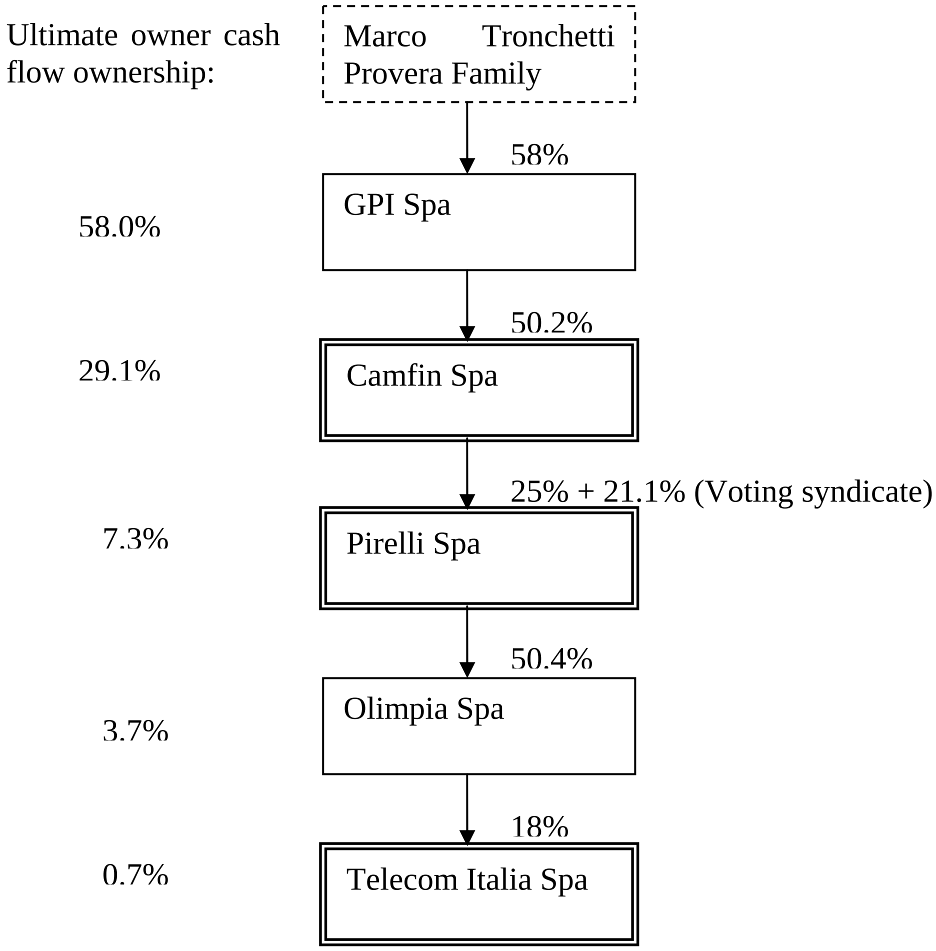

Figure 2. Ownership structure of Telecom Italia in 2005.
See Figure 1 for details. Source: Consob.

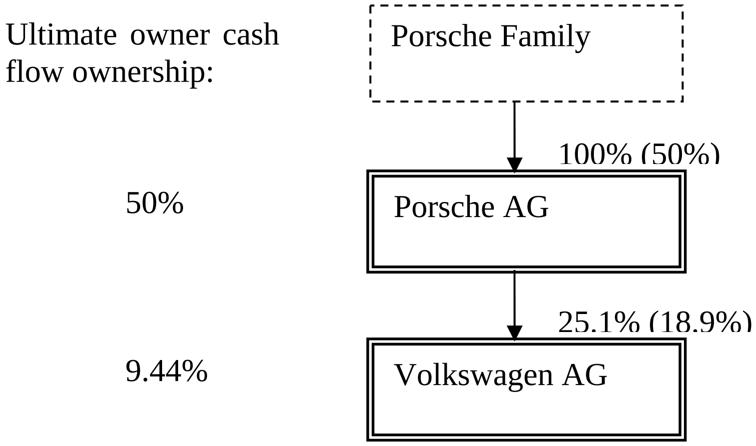

Figure 3. Ownership structure of Volkswagen AG in June 2006.
See Figure 1 for details. In parentheses, we report the fraction of equity owned by the direct controlling shareholder. The latter differs from the fraction of votes owned in this case because companies have both common (voting) shares and preferred (non-voting) shares. Source: Porsche AG and Volkswagen AG websites.