

European Trends in Corporate Governance

by

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### I. Introduction

For the purposes of this speech, I have taken "corporate governance" to mean the institutions and procedures established by law concerning the decision making of companies. In common law jurisdictions, this implies an examination primarily of the board of directors, managing or non-executive, and their relation to the shareholders, normally acting through their general assembly. In civil law countries, dual (or two tier) board structures incorporating management and supervisory boards and, though somewhat less important, the role of commissioners ("commissaires" in French, the "sindaci" in Italian) must also be included. An overview of current European developments and trends in this field at both national and Community levels falls conveniently, like ancient Gaul, into three parts: those concerned with supervision of management on behalf of shareholders, those concerned with such supervision on behalf of employees, and finally those concerned with such supervision on behalf of some other interest or interests. I propose to speak of each of these in turn. To simplify, I shall also concentrate my remarks on the "public" as opposed to "private" or "closed" companies. By "public company" I mean those companies which can raise capital from a large number of sources, the public, not companies which are publicly owned.

### II. Supervision of management on behalf of shareholders

The earliest European conception of supervision of management on behalf of shareholders was relatively simple: shareholders, astute in the defence of their own interests, would act on their own behalf through the general meeting to appoint, supervise and if necessary remove those charged with the legal responsibility for managing a company's affairs, the directors. However, this simple conception had to be accommodated to the realities of life relatively quickly. On the one hand, management decisions could not always be taken by the entire board of directors. Delegation of decision making powers to committees and subsequently to individual "managing" or executive directors was necessary if companies were to be able to act effectively and quickly. On the other hand, it also became clear that not all shareholders were ready, or indeed able to supervise for themselves the conduct of those managing the business. Other commitments, limitations on their knowledge and expertise, their external position,

these and other factors might limit their real ability to protect their nevertheless legitimate interest in a particular company. The question therefore arose of who might act effectively in their interest if they themselves could not.

One idea which developed early on, as far back probably as the rise of the great Dutch trading companies such as the Dutch East Indies Company, was the appointment of "commissioners" by shareholders to supervise the directors' conduct on their behalf. Highly developed in the Netherlands, the idea was also given expression in Belgium, France, Italy and Luxembourg. In these countries, while the law has required the appointment of commissioners, their functions have been limited to controlling the accuracy of company accounts and the legality of their activities. The basic conception behind the "audit committee", as you have come to know it, thus has a long, even distinguished European ancestry.

In Germany, which began its industrialisation relatively late, the need to encourage investment through adequate protection of the small investor led to a more radical application of the idea with the creation of mandatory dualist or two tier board structures for certain kinds of company. Since 1870 German public companies have had two decision-making bodies in addition to the general meeting: a supervisory council ("Aufsichtsrat") and a management board ("Vorstand"). The supervisory council appoints, supervises and, when necessary, can replace members of the management board. The members of the supervisory council, with the exception of those who are appointed by the company's employees, are normally appointed by the shareholders and can be removed by them. Even under the "quasi parity" system of worker participation in large companies introduced by the Co-determination Act of 1976, the shareholders have a decisive influence as to the appointment of the chairman of the supervisory council who in turn has a casting vote in situations in which the council is equally divided. The role of the supervisory council as guardian of the shareholders' interests in relation to management thus remains of central importance. The situation in the coal and steel sector is somewhat different from that in the rest of the economy due to special historical reasons. Time does not permit a full explanation of this system here.

In the Netherlands, the "commissioners" have been developed into a similar dualist system, since 1971 obligatory for large companies. In France, a similar system was made available on an optional basis in 1966, but the supervisory council is a notably weaker body, which cannot itself replace the management board but must secure the agreement of the general meeting. This weakness seems to have resulted in a number of situations arising where disagreements between the management board and the supervisory council could not be readily resolved. For this reason, the French dualist structure has not yet proved as popular as some had expected. In Denmark, the law of 1973 imposes on larger stock companies a similar structure although the management board has been given a less autonomous role and the upper board has management functions.

Moreover, in Member States which have not introduced formal dualist systems for all public companies, namely Belgium, France, Ireland, Italy, Luxembourg and the United Kingdom, nevertheless, the division of directors on a single board into executive and non-executive groups frequently operates to produce in practice a similar separation of function. Such information as is available suggests that the non-executive director, or "outside director" as you know him, is achieving ever widening recognition as a watch dog of management on the shareholders' behalf. However, it is important to stress that at present non-executive directors in single board systems are often not in reality the equivalent of members of a separate supervisory institution appointed by and answerable to the shareholders. Much will depend on the precise facts of the particular case, but suffice it to say that non-executive directors are frequently in a minority. They are not necessarily objective outsiders but possibly well known to the executive directors, even shall we say their business associates. And on many occasions, they are present not to act so much as guardians or supervisors, but to provide special expertise on legal matters, accounting or something else. An interesting study in this connection is *The Board of Directors* published by the British Institute of Management in 1972, Management Survey Report No. 10, containing much objective information as to the role of the non-executive director in the UK.

At the level of the European Community, the Commission has sought to further the general adoption of mandatory dualist board structures for public companies. Both the proposal for a European Companies' Statute and

the proposal for a fifth directive on the structure of public companies provide for a supervisory board which nominates, supervises and if necessary replaces members of the management board which in turn has the legal responsibility for managing the company. One of the major considerations which have motivated the Commission to make such proposals is the guarantee which dualist systems provide for shareholders who cannot supervise management effectively for themselves. The trend of developments in the national legal systems is clearly towards the general adoption of such structures at least for large companies. Proposals for legislation have been made in Belgium and Luxembourg which may well be enacted in the foreseeable future. Any such reform will probably have an effect as an example in countries which have yet to take the plunge. As we shall see, employee participation at company level is likely to act as another incentive for the adoption of dualist structures. Of course, the Commission will not be taking a formalist position. It is perfectly possible while retaining the idea of a single board to arrive at a dualist system through a distinction between its executive and non-executive members. Provided that the distinction between the non-executive and executive functions is clear and the non-executive members are given adequate powers and independence, the Commission will almost certainly consider its goal achieved.

As for the use of "commissioners" or "audit committees" and the like there is no doubt that these institutions can also perform useful functions, though as Italian experience in particular shows, limitations on their powers and scope of operation can severely limit their real utility. As a transitional means of developing and strengthening the role of the non-executive director, they could conceivably play a useful role. But in our view, they are not in themselves a substitute for a supervisory board with power to supervise effectively the whole of the management function.

Incidentally, this is perhaps an appropriate place to make a remark about the development of Community company law in general, and the harmonization programme in particular: considerable periods of time are inevitably required to effect important changes. You may have been astonished, even alarmed, by my references to the Dutch seventeenth century trading companies and to nineteenth century German history. I make no apology for them, because they show how deeply rooted are our legal institutions. Added to that is the fact that these institutions have not all developed in

precisely the same way for reasons some of which are valid to this day. Finally, the Community legislative machine works by consensus, so any change has to be agreeable to all concerned. Taken together these factors, and others which I have not the time to discuss, explain why a Community directive on an important commercial law matter takes on average ten years from conception to adoption. On the other hand, when the direction in which institutions are developing can be seen to form part of a pattern stretching back for many years, one is able to decide with greater confidence on the appropriate action at Community level. For this reason, I am convinced that the requirement for a separate, non-executive supervisory function to safeguard shareholder interests in public companies will indeed become a general feature of the legal systems of the Member States.

### III. Supervision of management on behalf of employees

As I know you are aware, recent years have seen the continued development in Europe of another important aspect of corporate governance, namely the participation of employees in the supervision of management. Commissioner Etienne Davignon has already explained briefly to you the political and economic considerations surrounding this development. I would like to begin by observing that, whatever one's private political views, as a matter of fact the spread of this idea has in recent years been undeniable, not only inside the Community, but in other European countries, notably in Scandinavia. When the Commission made its first proposal in this area in 1970 (proposal for a European Companies Statute) only one Member State (Germany) had a generally applicable requirement that in large public companies employees should participate in the nomination of the boards of public companies. At this moment, three other Member States have already introduced such systems, namely Denmark, Luxembourg and the Netherlands. I do not include France since employee representatives are admitted to board meetings only in a consultative capacity and not as full members. The Republic of Ireland has begun to experiment by introducing the system for five large State owned enterprises, the most familiar of which is Aer Lingus. In the other four Member States, serious political debate and discussion has begun and given the right conjunction of economic and political circumstance, reform seems quite likely in the medium to long term.

The Commission does not however underestimate the difficulty of the task in those countries which have a social system and legal institutions which stress the conflict of interest between labour and capital

to the point where common interests have almost been lost from sight. For this reason, it is in favour of a flexible approach at Community level which will permit the Member States to adopt systems which are adapted to the greatest degree possible to their particular circumstances and traditions. In addition, time is clearly required to enable certain Member States to alter their systems progressively.

The Commission has suggested that as a first step during a transitional period Member States should introduce dualist board structures as an option where such structures are not presently available. A clear distinction between the management and supervisory functions will in our view favour the introduction of employee participation at corporate level, since it will make it possible to confine participation to the supervisory function. In general, neither management nor labour seems to favour participation in the general management function itself.

Second, the Commission has suggested that Member States which do not at present feel able to require employee participation in the appointment of the supervisory board should legislate again as a transitional measure for the creation at corporate level but outside the board of an institution representing company employees. Such an institution should have the right to be informed and consulted about the general development of the company's business, and in advance about major specific decisions concerning the company's future, for example, significant new investment or disinvestment. In the Commission's view, external representative institutions of this kind can provide the practical experience which will enable those concerned to move on to participation within the board itself at a later date.

At present, the proposed fifth directive on the structure of public companies and employee participation has not completed the consultative stage of the Community's legislative machine. It will thus still be some years before the Council can arrive at a decision on the matter, certainly not before the end of 1981. The final form of the directive will depend to a great extent on the pace of developments in the Member States between now and the date of adoption. However, the flexible, progressive approach of the Commission has received a considerable amount of support, in the European Parliament, in the Economic and Social

Committee and in interested circles. The major controversial questions at present appear to be the following ones.

First, as to the transitional period itself, will it prove possible to agree on a finite period at the end of which all national laws will have to choose between a limited number of options defined in the directive by which employees will participate in the appointment of the members of the supervisory boards of public companies? For the time being, the Commission considers that such a finite period should remain the objective. The speed of development in the Member States in the last ten years has been such that there is good reason to believe that by the time a directive is adopted it will be possible to fix such a period. The experience of these years does not lead one to the conclusion that the next ten will see little change in those countries which have not yet taken the plunge.

Second, as to the specific issue of dual board structures, the value of an institutional distinction between the management and supervisory functions has yet to be universally accepted. In the Commission's view, the merits of the distinction are such that it will be given increasing, if gradual, application. From the shareholder's point of view, it provides a control which he often cannot exercise himself. From the employee's point of view, it provides a means of being informed about and influencing the corporation's strategic decision making without the representatives crossing that line, rather difficult to define, where they find themselves ceasing to be employee representatives in a real sense and becoming part of the management hierarchy. The allegation that dualist structures may unduly limit employee influence because decision making can be shifted to lower levels may or may not be justified depending on the circumstances of particular cases. But any such limitation is not inherent in the institutional distinction and can be avoided or cured by an appropriate allocation of powers either to all persons exercising the supervisory function, or possibly, to a certain proportion of them.

Accordingly, the Commission will continue to argue for the general adoption of dualist structures with supervisory and management boards, though of course it is the substance and not the form or the labels which counts.



Finally, how should Community legislation deal with the question of the methods by which employees participate in the appointment of board members? The Commission has never considered that a directive could regulate these methods in detail. The original proposal certainly does not. There are those, however, including the European Trade Union Confederation (1), who would like to see the matter left entirely to national law. At this stage, the Commission's view is that while not regulating the methods in detail, the directive should seek to include a number of principles with which all systems should comply. As indicated previously, the green paper suggested that these might be that all employees should be able to participate in the system, according to methods guaranteeing a free expression of opinion and reasonable protection for minorities. The Commission's reasons for taking this position are multiple.

First, as a matter of principle, the Commission considers that any reform of the decision making structures of companies in the name of democracy must embody the essential features of democratic institutions as these have been slowly and painfully developed in western Europe. If a system does not embody such basic principles, it is a sham. Second, for practical reasons, the Commission considers it important that the machinery should be responsive to the real needs and views of the employees. Systems which do not embody democratic safeguards are unlikely to perform this task very well. There is then a risk of pressures building up which have to find expression outside the system, perhaps in a destructive fashion. Finally, a formally democratic character is probably a necessary part of any compromise capable of achieving a broad enough political consensus to enable legislation to be adopted which will work and be respected in practice. If this consensus is absent, even if legislation is adopted, it may well prove to have disappointing results.

The democratic principles proposed by the Commission would not prevent provision being made to guarantee that where unions are organized, they play an appropriate role in the system. Techniques exist in several Member States which have precisely that purpose. Other techniques can no doubt be developed more appropriate to other situations. But the Commission will seek to convince the Member States that we must avoid the adoption of systems which create enfranchised and disenfranchised workers inside the same company, and which can lead to unrepresentative machinery of doubtful utility or acceptability.

In concluding this part, let me remark that although European developments as regards employee participation may seem alien from a United States point of view, they may well not be without significance for the USA in the long term. The economic and social backgrounds are very different, but probably convergent in the long run. The Bill recently introduced into Congress by Representative William D. Ford of Michigan on plant closures seems to have been much influenced by European co-determination law and practice. Should the economic climate remain difficult with lower growth rates and less expansion, it would perhaps not be surprising if organized labour in the U.S. sought to defend its members interests by insisting on having a greater say on matters traditionally left to management prerogative.

IV. Supervision of management on behalf of interests other than those of companies' shareholders and employees

I am aware that in recent years in the United States, it has become fairly common, indeed fashionable, to seek to include on the boards of large companies "outside directors" representative of interests other than those of the companies' shareholders and employees. Members of minority racial groups, women, persons associated with environmental or consumer protection or a locality where the company is particularly active have been invited to join the board in large part as a representative of the constituency from which they come. Of course, such appointments have been made in Europe too, but there is little evidence of a general trend though from time to time a particular interest group such as a consumer protection organisation will call for progress to be made in this direction.

In my view, dramatic developments of this kind in Europe are unlikely, and indeed one can even doubt their desirability. The economic motive force which can make employee participation in the supervisory board work is clearly identifiable. Employees, shareholders and management have a common interest in increasing or at least maintaining the added value generated by their company. Conflicts of interest as to the division of that added value there certainly are, and appropriate methods need to be developed to resolve them. But there can be little doubt about the reality and strength of the common interest in added value. If one turns to other interest groups, however, it is difficult to identify a common interest of

sufficient strength to make their participation in joint supervision of management by employee and shareholder representatives a workable proposition. Indeed, there seem to be powerful potential conflicts of interest as to the company's generation of added value. Added value to the company may be a price rise to the consumer. On the other hand, environmental protection entailing increased costs may well reduce the company's surplus. While other interests such as those of consumers may need protection, there is therefore good reason to doubt that representation on corporate boards is the best method of going about it.

As a two-way channel for information such representatives may perhaps perform a limited function, but in my view it would be wrong to expect more of them in the European context, save perhaps as a means of resolving deadlock when it is desired to give equal representation to capital and labour. However, even then the representation of the "general interest" is not without its difficulties, and it is perhaps significant that while proposals have been made, no European country has so far sought to implement such a system.

#### V. Conclusion

In a brief introduction, it is not possible to say all that one would wish on a topic as complex as corporate governance. I hope that my remarks will at least have brought out the main lines of European developments and can therefore serve as a useful basis for the discussion which follows.