A Winter's tale

The European Commission's attempts to harmonise company law in the EU have been criticised before for being more concerned with political dogma than business needs, writes **Stephen Copp**. But recent developments – particularly the report of its legal expert group – suggest that harmonisation might be a positive force for reform

A prominent legal academic called Len Shaw, writing in his 1984 book *Company Law and Commercial Reality*, recalled a conversation he'd once held with a politician who'd had considerable experience of European affairs.

"You don't understand that negotiations in Europe are a question of give and take," he was told, rather patronisingly. "You have to be prepared to make concessions on something unimportant and technical, such as a company directive, so that you can keep something in reserve. You need to save the big guns for topics that really matter: sheep-meat or UHT milk."

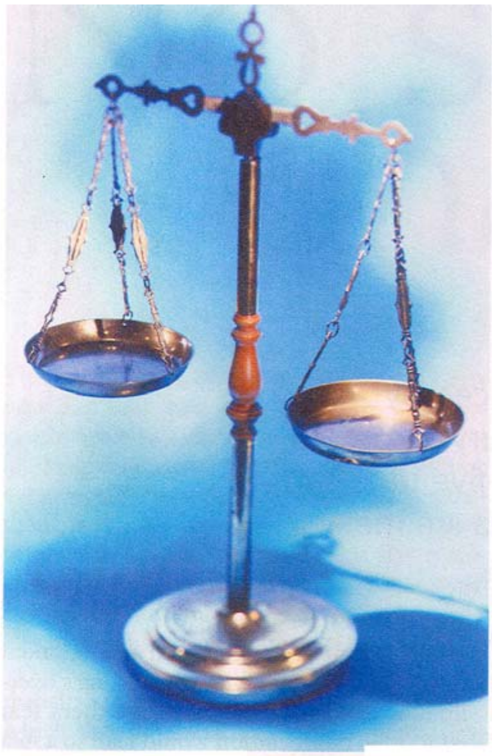
Nearly two decades later, it's clear that the tide has turned: now company law and corporate governance are seen as the topics that really matter in Europe, especially in the light of the Enron and WorldCom scandals in the US. There is growing evidence of a new approach to company law harmonisation that bodes well for businesses in the EU.

The origins of this new approach can be traced to the July 2001 defeat in the European Parliament of proposals for a thirteenth directive on takeovers, which had already undergone 12 years of drafting and redrafting. Two months later the European Commission established the High-Level Group of Company Law Experts. This body's immediate task was to prepare a new proposal for the directive. But, significantly, its wider remit was "to define new priorities for the broader future development of company law in the EU". It was also to "provide recommendations for a modern regulatory European company law framework designed to be sufficiently flexible and up to date to meet companies' needs, taking into account fully the impact of information technology".

The language used here was similar to that of the company law review launched by the UK government in 1998, which has enjoyed widespread support. It may be a coincidence, but it's interesting to note that the British representative on the group is Jonathan Rickford, a key figure in the company law review.

Later, in the light of the EC's initial analysis of the Enron scandal, the mandate of the group was extended further in April 2002 to cover additional corporate governance and auditing issues, such as the role of non-executive directors. (This development paralleled the creation of the Higgs committee in the UK in the same month.) The group's report – named after its chairman, Jaap Winter – was published in November 2002.

The Winter report covers not only companies but also co-operatives and other forms of enterprise. It extends to corporate governance, groups and pyramids, as well as restructuring and mobility. The corporate governance issues it identifies begin with disclosure, which is described as having "a pivotal role in company



law". The section on shareholders covers both widely debated issues such as the responsibilities of institutional investors, as well as some that have attracted less attention, such as minority shareholder rights and cross-border voting. Similarly, the section on the board of directors covers well-trodden issues, such as the role of non-executive directors and remuneration policy, and also wrongful trading and disqualification. This is welcome, because the role of insolvency law in creating appropriate board incentives has been largely omitted from the governance debate.

Unsurprisingly, in the light of Enron, there is a section on auditing practices, but the approach taken by the Winter report is perhaps more important than its scope. Early on it boldly sets out the new way: "The EU approach to company law harmonisation has focused on the protection of members and third parties. Company law should primarily concentrate on the efficiency and competitiveness of business:'

Winter concludes that there should be a move <}way from fixing rules in directives towards alternative forms of regulation, perhaps including model 'laws. It says that disclosure is to be preferred and that efficient company law structures should not be hindered by anti-abuse provisions.

Central to the report's recommendations on corporate governance is the belief that listed companies should be required to include a corporate governance statement in their annual report and accounts. This should be a coherent and descriptive statement of the governance rules that are being applied - for example, which national code is being used - but the key input for corporate governance codes should continue to come from the markets and their participants. Coordination across the EU should be encouraged, it says, but not made mandatory.

There's little doubt that this attitude is sensible given the dange?s inherent in any move to harmonise corporate governance codes across Europe, where negotiations might be protracted and lead to a system that could be inflexible, stifling innovation.

The use of electronic communications to help shareholders make decisions is another key theme of the Winter report. Proposals include a requirement for listed companies to maintain a specific section on their websites with all the information necessary for shareholders along with the opportunity for them to vote electronically. Listed firms would also be required to post annual corporate governance statements on the internet. They would be permitted - but not required - to allow shareholders to participate in general meetings via internet or satellite links.

In terms of cross-border voting, Winter observes that "it is often very difficult and cumbersome, or practically impossible, for shareholders in one member state or outside the EU" to vote in a listed company in another country. Accordingly, it proposes that the EC prioritise the recommendations of the separately established Cross- Border Voting Group with a view to building a regulatory framework to remedy the situation.

The controversial and divisive issue of onetier and two-tier boards is nicely handled by a proposal that listed companies across the EU should be allowed to choose whichever system best suits their particular governance needs. This seemingly innocuous recommendation may turn out to the most far-reaching of them all. There could well be potential demand in continental Europe for such a choice and, if companies are given the option, it's possible that two-tier boards will become a thing of the past. By facilitating takeover bids of continental European companies that might decide to change such structures, this measure could do much to encourage a genuine single market.

The Winter report sees nomination, remuneration and audit as issues that require disinterested monitoring by independent non-executive directors. It specifically links the lack of such monitoring to the recent corporate scandals and encourages the EC to make a (non-binding) recommendation to member states that they should put measures in place to achieve this, enforceable on a "comply or explain" basis. It proposes detailed rules about the meaning of independence, together with a requirement that the annual corporate governance statement divulges which directors are considered independent and why. The statement will also be required to include information on why each nonexecutive director has been appointed and on which other board positions they hold.

Winter makes detailed proposals for the disclosure of policies on directors' remuneration, as well the reward packages of individual board members. Reflecting concerns that existing practices might encourage directors to produce accounts that overstate results, the expert group went as far as considering the complete prohibition of remuneration in shares and options, but eventually rejected this measure.

Despite its general reliance on disclosure in place of direct regulation, in some areas the Winter report seeks to increase the number of sanctions available against directors. Accordingly, it proposes that all board members should be made legally responsible for the "probity" of financial statements (and some non-financial documents, such as the annual corporate governance statement); that a Europe-wide rule imposing liability on directors for wrongful trading should be introduced; and that a Europe-wide directors' disqualification regime should be considered.

While the proposal to increase the responsibility of board members for statements represents a worrying potential increase in liability, the governance recommendations in Winter aren't much of a threat to UK companies or their directors. In fact, the recommendations might present potential opportunities, especially if one-tier board structures become the norm throughout continental Europe.

If you see it as the EC's response to the Enron and WorldCom scandals, the Winter report is relatively mature and sensible. In contrast, America's Sarbanes-Oxley Act 2002 has been roundly criticised both at home and abroad for being an overreaction. Porsche, for example, has claimed that the legislation was the key factor behind its move to cancel its proposed listing on the New York Stock Exchange. At a time when economies in both Europe and the US are slowing down, it would be ironic if Europe were to gain a competitive advantage over the US by taking what is, in essence, a ttee- market approach. FM

Stephen Copp is senior lecturer at Bournemouth University's School of Finance and Law