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SHAREHOLDER RIGHTS, EQUITABLE TREATMENT AND THE ROLE OF THE STATE

Shareholders' rights in cases of related parties transactions

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§ 1. Overview of some self-dealing hypotheses

1. According to the traditional concept of company law, the shareholders, as the owners of the company, entrust the management of the company to its directors, who are expected to manage the business in the exclusive interest of the shareholders. Accordingly, directors will be held accountable to the shareholders if they do not perform their duties and do not act with sufficient care. But more dangerous is the case of directors acting in their own interest, in the interest of third parties, or in the interest of some of the shareholders. Here the duty of loyalty comes into play.

The basic paradigm of the company is often described in terms of "agency". In small companies, the owners can manage the company by themselves: controllers and controlled are the

same. Once the company gets larger, there will be separation of ownership and management: the owners will have to entrust the management to the directors, with the consequence that the principal, i.e. the shareholder, is less able to control the business, while the agent, i.e. the director, will have a tendency to act in his own interest, rather than in the interest of his principal. Owners will have to take measures to discipline the management: there will be a conflicting relationship, leading to additional costs ("agency costs"), born by the shareholders. A complex series of instruments have been developed to curb management's tendency to be distracted from the shareholders' interest: appointment of auditors, rules on conflicts of interest, corporate governance measures, aligning the interest of the management with that of the shareholders ("incentive plans") but also rules on dismissal of managers (e.g. the widespread rule that a manager can be dismissed without notice, often even without indemnification).

2. In the present contribution, we will focus on a specific type of risk born by the shareholders, i.e. the risk of the management attempting to harm the company by entering into transactions with the company from which the manager will benefit himself. This type of abuse seems a relatively simple one: one should avoid directors contracting with their company, or at least certain safeguards should be imposed to avoid transactions taking placing at too unfavourable terms.

3. In reality the problem is more complex, and the ways to deal with it present a great variety of solutions, or at least answers.

The simplest case is that of the director himself contracting with the company. There is a suspicion that he will promote his own interest, not that of the company. Hence he will be forbidden to conclude the deal himself (no self-dealing) but also safeguards will be introduced to ensure that the decision is not biased in favour of the director.

4. But conflicts arise not only with directors, but also with one or some of the shareholders. Shareholders often have divergent interests, some of which may be contrary to those of the company. Theoretically, one could state that the directors should manage the company in the interest of all shareholders. The law deals with this issue by requiring "equal treatment of shareholders", an important but elusive concept.

If a director acts in the interest of one of the shareholders, he will most of the time violate the interest of the others. Therefore, shareholders will also be interested to see that they all have identical, at least parallel interests, as this protects them against the management giving a preference to one of them. If one of the shareholders has a divergent interest, and is able to influence the management so that decisions will be more favourable to that shareholder than to another, there will be a negative feeling among all other shareholders.

This explains why investors usually shun companies in which the state has a significant interest: the state stands for a multiplicity of interests, and may prefer to influence the management to give priority to one of these rather than to the proper interest of the company. To give an example: state enterprises often prefer employment over return, which runs contrary to the profit maximisation objective of private investors. In some state enterprises, it was therefore stipulated that the public authorities would - and should - refrain from any intervention in the management of the company[1]. As a consequence partial privatisations lead to fragile situations, as shareholders remain under the threat of government intervention.

5. A similar reasoning could be applied to the case in which a company is partially owned by a dominant shareholder, a holding company, or a large group, while the remainder of the shares belongs to the investing public. The minority shareholders will often fear that the group management will act with no due regard to the investing public. Three cases can be distinguished, depending on whether the dominant shareholder is a physical person[2], a group of companies or the state.

If the dominating shareholder has no clear conflicting interest, e.g. if it is a physical person, the conflict will be less acute: although there may be decisions in which the dominant shareholder prefers his own interest to that of the company (e.g. remuneration, perks), or in which he will restrict the company's policies in its own interest (e.g. by not allowing a public share issue for fear of seeing his controlling block being diluted, hence burdening the company's financing), the risk of siphoning off assets is more limited. Hence markets will evaluate these shares more favourably than in the two other cases.

If the dominant partner is a group of companies, there might be different types of transactions with the group, ("intra-group transactions"), or investment or management decisions

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1 This was e.g. the case in BP, before privatisation.

2 Including families, or holding companies belonging to a family.

that do not necessarily benefit the minority shareholders. Also, there usually will be a different time horizon: individuals have a limited time horizon, groups usually a much longer, often indefinite one. Moreover there is a danger of the group diverting part of the business, or imposing restrictions of the business expansion of the subsidiary. These cases are usually referred to as the diversion of "business opportunities" and raise particularly difficult issues. Hence the discount on the market against regular market value will increase, and sometimes teaches 50% or more of the value of the underlying assets.

6. There is however, a major difference between the last mentioned case and the one in which the state has a dominant stake: while the state has a wide range of interests for which it may intervene (different policies motives, usually a low degree of profit maximisation), the private majority shareholder exclusively strives for profit maximisation. The conflicting interests of the state are moreover particularly difficult to curb: invoking the public interest, the private shareholders will have to admit that their claim has a lower rank.

7. Some attention should be drawn to other, somewhat more remote conflicting interests that show up in company decision-making, especially the interest of the creditors and of the employees. The presence of creditors incites the company to act more prudently, and hence to reduce risky investment. Employee claims reduce the shareholders' return: the management is under pressure to keep wages under control, lest it be held accountable to shareholders.

Other interests can only be mentioned shortly: the product markets, or the suppliers and, today more strikingly, environmental or ethical interests will also influence the company's behaviour.

However, as opposed to the shareholders' interests, in many legal systems these interests are not structurally involved in the decision-making. The creditors have no say, except in case of insolvency, in which, according to numerous legal systems, the leading role is taken over by a state-appointed receiver. Employees have a certain influence on decision-making (especially through the works council), but their direct impact on company decision-making remains limited, at least in most legal systems. The German co-determination and the Scandinavian co-decision systems are notable exceptions. As to the other interests, they are - or should be - integrated in the firm's overall decision-making.

§ 2. Comparative overview

8. Against the background of the foregoing analysis, one can now proceed to give an overview of the different solutions that legislative systems have given to the issue of conflicts of interest in companies. Only the limitation of my knowledge explains why most examples will be drawn from the Western European legal systems.

Four series of cases can be distinguished:

a) The conflict between a director and his company.
b) Conflicts between majority and minority shareholders.
c) Conflicts in groups of companies
d) Conflicts in state-owned firms.

a) Traditional conflict issues

9. Traditionally, at least in the European jurisdictions, conflicts of interests have mainly been analysed in terms of conflicts between individual members of the board and the company itself.

This analysis dates back to the times that directors themselves were managing the company, thus being entitled to engage the company. This pattern still prevails in many a small company, while in the larger ones decisions are taken by the board, which is not involved in the actual implementation of the decisions, as this is left to the managing directors. Therefore the conflicts issue may come up in different terms.

When there is a suspicion that directors will be unfaithful, and act in their own interest, the legal system offers a range of solutions to this problem. These solutions range from explicit prohibitions, to the imposition of procedures, over disclosure, to finally a broad standard of conduct.

10. Prohibitions of specific types of transactions are found in English law, where the UK Companies' act prohibits directors to enter into certain transactions that are deemed to be

detrimental for the company[3]. The advantage of this approach is clear: all practitioners know where the boundaries are. There will be no fine analysis as to the possibilities to circumvent the prohibition. The disadvantages are the lack of flexibility of the rule: even economically useful transactions may not come into being if the law contains a flat prohibition. Also parties will make great efforts to circumvent the rule. From a more philosophical point of view, if the law contains an outright prohibition, this feature will point to a concept whereby the company is not viewed as being a body functioning exclusively in the interest of its owners, the shareholders, but also has to take account of external interests, such as those of the creditors[4].

11. Other companies Acts contain no prohibition but prescribe certain procedures, allowing for conflict transactions to be decided by the board, but only under conditions of fairness and full disclosure.

Here one finds a whole range of solutions:

a) Adapted decision-making: the member of the board with a conflicting interest should inform his fellow directors of the existence of the conflict of interest and further abstain form taking part in the decision[5].

   This rule is followed in Belgium, but no such abstention is necessary, except for stock exchange listed companies[6].

b) Full disclosure

   Normally the members of the board should be fully informed about the potential impact of the decision on the assets or on the results of the company. Disclosure should be supervised by the statutory auditor.

c) Information to the general meeting

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3 S. 330 (2), Companies Act; there is an exception for small short term loans.
4 The prohibition does however only apply to public companies limited.
5 Art. 2391, Codice civile of Italy.
6 Art. 523, Codes des sociétés, Belgium.

The shareholders should at least be informed about transactions that create conflicting interests. This is found in Belgium, and in France[7] where the contracts are disclosed in full to the general meeting.

But the general meeting would normally not be called upon to approve these contracts, as this would on the one hand undermine the managing powers of the board, while on the other hand reduce the level of liability board members may be faced with vis à vis shareholders.

12. Other schemes may depend on the existence of a two-tier board. If such a board has been instituted, it would be a sensible solution to submit transactions in which directors have a conflicting interest to the supervisory board. In almost all cases the conflicts will disappear, as there is little chance that the members of the supervisory board will equally have a similar personal conflict[8].

The foregoing analysis makes it clear that it offers but limited protection to the shareholders: directors will not always disclose their conflicting interest, and even if they do, the information will not always be reliable. Also directors and shareholders often are the same, or have similar interests. Creditors or other parties, such as minority shareholders will not be protected by these procedures.

13. In some jurisdictions there have been calls to change the approach and foster more substantive criteria of fairness: transitions with conflicting interests should always be open to challenge on the basis of unfairness, at least gross unfairness. This approach is frequently found in US law, and with less insistence in the UK as well[9].

The use of fairness, or of a fiduciary standard has the advantage of extreme flexibility: no economically useful transactions will be forbidden, while the vagueness of the standard will normally incite parties to greater prudence, and hence incite them to voluntarily adhere to stricter standards. There, especially from the US side, the superiority of a general fairness standard, in terms of fiduciary duties, is often argued. However, the use of a fairness standard also has some drawbacks. Most of the time it only works ex post, parties taking the risk that the transaction will

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7 Art. 101, L 225-38 Code du Commerce.

8 See § 89, Aktiengesetz, comp. § 114 for members of the Supervisory Board.

9 See in the UK, The Law Commission, Company directors: Regulating conflicts of interest and formulating a statement of duty, September 1999, 282 p., document Law Com no. 261.

escape judicial scrutiny. Also the system functions in a highly litigious US legal system, where the plaintiff bar is eager to take up any case that will procure benefits to the plaintiff, and to his lawyers. Finally the existence of ample case law offers sufficient guidelines to highly experienced judges to assess later cases. The US approach has undoubtedly led to a greater awareness of conflict of interest issues, and to aspects (such as corporate opportunities) that remain largely undiscussed on the European continent. The final outcome, i.e. whether there is less unfair dealing, is another issue. Here the impact of other factors, such as the presence of a vigilant tax inspectorate, or the influence of the financial markets should be mentioned.

b) Conflicts between majority and minority shareholders

14. Conflicts between majority and minority shareholders are frequently found, especially in closely held companies. These conflicts may lead to a paralysis of the firm and even to its perdition. Therefore the legal systems have an interest in having these conflicts solved.

In listed companies, conflicts can be solved by selling the shares. Exiting a closely held company is much more difficult. The legal systems have offered different types of solutions, some more efficient than others.

The winding up of the company is a remedy that is often worse than the desease: most of the time the dissolution results in the destruction of the firm, and triggers considerable tax and other liabilities that will destroy the remaining enterprise value. Although winding up usually is the last instrument, it is found is several legal systems.[10]

15. The case law in France, and in Belgium as well, allows the disgruntled shareholder to sue the majority for "abusive exercise of his majority rights" ("abus de majorité"), in practice resulting in a decision of the board, or of the general meeting, being annulled. Some interesting cases have been rendered in which the majority tried to seriously damage the rights of the minority. So e.g. - and the case is noteworthy because a similar case is found in Germany[11] - has the decision of the general meeting been annulled because it consisted of transferring the entire business of the company to a subsidiary. As the minority shareholders would have had no

[10] See e.g. in Belgium (art. 183 ff. Companies Code) in France (art. L 225-246 Commercial Code), in the UK, s.459 e.s. Companies Act.

[11] This is the so-called Holzmüller case, Bundesgerichtshof, Decision, 25 February 1982, II ZR 174/80 (Hamburg).

influence in the subsidiary, the court found that the majority had made an illicit use of its voting power[12].

There is a discussion in legal writing whether the same remedy would also apply to the minority abusing its position, e.g. in blocking supermajority decisions at the general meeting that necessarily require the minority's co-operation. The prevailing opinion seems to be to the negative[13].

16. Another useful remedy is to allow a shareholder to take-over the shares of the other shareholders. Dutch law, copied by Belgian law, allows a significant (e.g. 30%) shareholder to apply to court and obtain a decree whereby the shares of the minority shareholders will be attributed to the applicant, at the price fixed by the court. The technique can only be applied if the applicant has "serious reasons" to complain about the other shareholders' behaviour. In that sense the provision can be analysed as a further remedy based on a case of abusive exercise of majority power.

The Dutch rule is framed in the following wording:
" One or several shareholders, who own, individually or jointly, at least one third of the issued capital, have the legal right to demand that a shareholder transfer his shares, if this shareholder by his conduct harms the interest of the company in such a way that one could not reasonably tolerate the continuation of his shareholdership"[14]. Belgian law contains a similar provision: here the rule applies upon a showing " just or well founded reasons"[15].

These remedies have proved in both countries to be effective instruments against dominant shareholders exercising their control to the detriment of the minority. In larger companies, especially the listed ones, other techniques have to be put into place.

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12 Cass. com. 24 January 1995, Rev. Sociétés, 1995, 46, nt. Jeantin.

13 See for France: Cass. Com. July 15 1992, RJDA 8-9/92; cf. Cass. Com. March 9 1993 RJDA 4/93 n° 323; Cass. com. 5 May 1998, n° 987P, Sté Arti Moul « SAAM » v. Couvaud, Bulletin Rapide du Droit des Affaires, 98-10 p. 3; Cass. com. 27 May 1997, Bulletin Rapide du Droit des Affaires, 1997/11 p.4; CA Paris, 3ème ch. , 24 January 1997, Sté Viel et compagnie finance c/Sté Concept, BRDA 97-5 p. 6; M. BOIZARD, L'abus de minorité, Revue des sociétés, 1988, p. 365, 1990, p. 613; D. TRICOT, "Les abus de droits dans les sociétés (abus de majorité et abus de minorité)": Revue Trimestrielle de Droit Commercial, 1994, p. 617; and for Belgium: T., TILQUIN, "Les opérations d'assainissement du capital des sociétés en difficulté et l'abus de droit des actionnaires", *T.B.H.* 1991, 6, 2.

14 See art. 335 NBW, applicable to the closely held company of the BV type and of the NV type provided in the latter case certain conditions are met.

15 See for Belgium art. 334, applicable to the closely held company; art. 635, for the SA the securities of which are not listed.

17. Minority shareholders may in some jurisdictions also have the right to be bought out by the majority. This technique exists in the Netherlands and in Belgium, in similar conditions as applicable in the previous case[16].

Finally in several European states the legislation also provides for a so-called squeeze-out remedy, whereby the owners of a 95% stake in the company can apply to court to have the rights of the minority transferred to them, paying an indemnification. This "going private" transaction effectively puts an end to the potential conflicts of interest that might have existed between the 95% shareholders and the remaining minority. The technique is frequently used, especially for listed companies.

c) Conflicts in groups of companies

1. Group law in general

18. In many respects, the case in which a minority shareholder, or an investor confronts a large shareholder, even a majority shareholder, is different from the one in which the company is part of a group of companies. In the group context, the conflict is continuous and may concern the entire business activity, which often is fully embedded in the group's business. It further is a continuous and reciprocal relationship, to the benefit of both parties. Finally it is a very complex one, involving all aspects of the subsidiaries activities, not just its economic ones.

Legal systems all over the world are confronted with issues of groups of companies. Some have developed formal rules; others have left developments to case law. Formal regulation has mainly been developed in Germany, in Portugal, and in some Eastern European states. Brazil and Senegal are examples where group law has formally been introduced in the companies act, although it is not clear how the law is actually applied.

Other jurisdictions have more or less extensive group law, developed by the courts. Officially the United States has no group law, but the extensive series of books published by professor Blumberg[17] has revealed that thisdoes not correspond with the reality. Also, in the

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[16] Art. 343 Dutch Companies Code; art. 642 Belgian Companies Code. The rules are applicable to the same types of companies as the previous one.

[17] See Philip Blumberg, The law of corporate groups : problems of parent and subsidiary corporations under statutory law of general applications, Boston, 1989; The law of corporate groups : problems in the bankruptcy or

European states other than Germany the group approach is being practised in all fields of the legal system.

Australia has recently announced reports outlining the main fields in which a law of company groups would be introduced.

19. Group law pervades the entire legal system. Although in the following developments the relationship between shareholders will be highlighted, while the field of creditor protection will remain largely unmentioned, it goes without saying that for most practical purposes the creditor side is more important and has witnessed more innovative developments than the shareholder protection aspects. Sometimes both are interrelated.

But many other aspects also deserve attention: the most developed rules on group law can probably be found in the field of accounting, where the obligation to draw up consolidated accounts has been imposed by the Seventh EU Directive on harmonization of consolidated accounts[18]. In tax law, state sovereignty and the need for the tax authorities to be able to raise the required amount of taxes has prevented major developments, at least at the level of cross border taxation. Case law illustrates that there may be specific issues of contract law that can be raised in the group context, while labour law contains numerous applications of group issues. Also competition law, intellectual property law, prudential supervisory rules and so many other fields of the legal system are touched by the group phenomenon. All this to say that to practice law without taking into account the group dimension would be highly unsatisfactory.

20. What are the issues in group law?

To state it bluntly: if a company dominates another, there is a serious risk that it will utilise the latter for its own business objectives. Hence, both the creditors and the shareholders of the subsidiary may be put at risk. The risk is greater for the creditors than for the shareholders: the subsidiary's insolvency would greatly damage the surviving parent.

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reorganisation of parent and subsidiary corporations, including the law of corporate guaranties : 1987 supplement, Boston, 1987; The law of corporate groups : tort, contract, and other common law problems in the substantive law of parent and subsidiary corporations, Boston, 1987; The law of corporate groups : problems in the bankruptcy or reorganization of parent and subsidiary corporations, including the law of corporate guaranties, Boston, 1985; The law of corporate groups : procedural problems in the law of parent and subsidiary corporations, Boston, 1983.

[18] Directive 83/349/EEC of 13 June 1993.

The position of the shareholders is weaker. On the one hand they benefit from being part of the parent's business, on the other hand they may have to contribute to the parent's welfare. Therefore the question arises to what extent the directors of the subsidiary can accept instructions given by the parent, and where are the limits of the subsidiary's independent interest. These issues can be synthesised under two headings. Most questions will arise under the heading of the intra-group transactions, whereby financial substance may be shifted from one group company to another as a consequence of transactions between group companies. More difficult is the question of the attribution of opportunities arising within the group: which of the group-entities is entitled to these opportunities, and what are the instruments for allocating these benefits over the group as a whole?

2. The main approaches to group law

One finds different solutions in national regulations or case law.

21. At present one can identify two main philosophies underlying the rules on groups of companies. According to the philosophy on which German statutory provisions on groups are based, group law mainly serves to avoid parents robbing their subsidiaries. Group influence should be avoided, and neutralised, and, if that is not feasible, the parties should enter into a group contract, whereby the interests of the minority shareholder will be protected.

In "de facto" groups, which occur most frequently, the subsidiary should each year establish the list of advantages and charges it has received from the group management. These items should then be valued, and will give rise to the duty to compensate any damage the parent has inflicted on the subsidiary. Directors of the subsidiary will be liable if they have not adequately pursued indemnification. Minority shareholders will be able to sue the directors for neglecting the company's interest[19].

22. The other system, which is most clearly formulated in the French legal order, is based on the acceptance of the usefulness of group influence. Therefore subsidiaries are entitled to take the group interest into account in their own decisions, and should not request an indemnity from

[19] This short description does not attempt to outline the complex rules of German Group Law: see § 311 e.s. and the numerous comments.

the group for every item. However, there are two minimum limits to the group interest: the first one is that the subsidiary may not enter into transactions with other group entities that would jeopardise its solvency, e.g. by granting loans that at the moment of granting would probably have been irrecoverable. The other limit is based on a certain "quid pro quo" between parent and subsidiary: there should be a just balance between the burden imposed on the subsidiary and the advantages it gets from its participation in a wider group. The cases do not give further details as to how this balance is to be struck, in what time frame, which items have to be taken into account - both monetary and non monetary - , and who would establish the balance. As to the last point, in the leading French case, which is a criminal case, it was held sufficient that there be no gross imbalance[20]. A similar reasoning can be found i.a. in Belgian case law.

The French cases further underline that transfers between members of a group of companies should not take place in a haphazard way. These transfers will only be justified if they are based on an overall scheme ("a common policy") for which adequate justification of economic, social and financial nature can be produced.

23. The main differences between the two systems seem to be that while the German system is much stricter and calls for an annual set off of the mutual benefits or charges of group formation, implying that these benefits should better not exist, the French system is much more lax, and will only sanction excessive transfers between group entities. After several unsuccessful attempts had been made in the EU to introduce a system of group law that was more or less inspired by the German system, one can state that the strict approach - based on the concept that the mutual benefits of group formation should be offset and therefore should not be taken into account - has no great future as the standard for a future European rule for company groups.

24. Europe-wide, the French approach would probably be favoured, provided it is flanked by a series of measures that would ensure its effective enforcement. It has been advocated as the common denominator by the Forum Europaeum on Groups of Companies[21]. It has as a major drawback that it leaves a very large leeway to group management and may not sufficiently discipline management to take due account of the shareholders' interest. Also, both in terms of guidance for group managers and for safe decision-making, especially in stock exchange listed

[20] Cass. fr., February 4 1985, *Rev. Sociétés*, 1985, 648, comm. BOULOC (Rozenblum e.a.).

groups, it probably leaves too much leeway to group policy and does not sufficiently protect minority shareholders, or creditors. Therefore, alternative techniques have been devised to better flag the limits of group behaviour.

3. Alternative techniques

25. Preventive techniques to avoid group decisions to be challenged have been developed in some EU states, while these can also be found in the self-regulatory instruments imposed by some of the securities market regulators.

Three instruments require special attention: the mandatory bid, rules on decision-making within groups, and stock exchange regulations.

3.1. Mandatory bids

26. In the regulation of the securities markets of a considerable number of EU states, the rule is formulated according to which the party that acquires a controlling block in a listed company - usually defined at a 1/3rd level - will be bound to make a bid for all remaining shares, often at the price at which he has acquired the controlling block, or at another price fixed in an objective way. This rule is first and foremost a rule related to the correct functioning of the securities markets. But in effect it directly affects the formation of groups. The sale of a controlling stake in a listed company - whether an independent one or a subsidiary of another group - to another group will lead to the acquirer being obliged to offer an exit to the minority investors, thereby avoiding any further conflict to arise. Normally, after the bid, and possibly after a squeeze-out, all investors will have left the subsidiary, resulting in a 100% affiliation relationship, so that group issues, at least with shareholders, disappear. The rule was planned to be introduced in the EU directive on take-over bids, which was refused by the EU Parliament in its final stage. However, today, most member states have a similar rule.

Moreover, one sees that with the present restructuring of EU industry going on, many groups voluntarily reorganise themselves and bid for the remaining shares of their listed subsidiaries. Often these bids are share for share exchange bids, whereby the parent offers its

[21] See Corporate Group law for Europe, published by Corporate Governance Forum, JURE, Stockholm; originally

shares in exchange for the shares of the subsidiary owned by the public investors. The overall outcome is clarity and efficiency: rather than being a shareholder in a small subsidiary, the investors end up owning a share in a larger listed entity, often with a better risk profile, and a deeper liquidity. The parent gets rid of the cumbersome procedures and requirements flowing from the subsidiary's status as a listed entity. Investors will not be misled by the low valuation of the subsidiary shares, due to their limited liquidity, a valuation that reverberates on the parent. Finally, if the parent intends to sell the subsidiary, it better masters the transaction, and will not have to take account of the minority**.**

3.2. Corporate Governance techniques

27. The issues raised by the - perceived - abusive exercise of majority power may, to a certain extent at least, also be tackled from the "corporate governance" side. As "corporate governance" rules aim at improving the quality of management and insure an optimum equilibrium among the principal interests involved, being mainly the shareholders, the directors and the management, it is not surprising that the solution for conflicts of interest has also been sought in the use of techniques that are normally situated in the governance debate.

In at least one EU jurisdiction, where issues involving the behaviour of company groups, especially conglomerate holdings, have received wide attention for several decades, the legislator adopted a provision in 1995, obliging the board of directors of listed subsidiaries[22] who are called upon to enter into a contract with one of its shareholders with a dominant influence - often the holding company controlling the listed company - to appoint three of its members as being independent. [23] This committee will give an opinion on the proposed transaction, and with the assistance of an independent expert, will report to the full board as to whether the transaction, having been duly described and valued, is in the interest of the company and all its shareholders, and whether there is no privileged advantage, direct or indirect, flowing from the transaction in

in ZGR, "Konzernrecht für Europa" ZGR 1999, 672-772 1999.

22 See Art. 524 Belgian Companies Code. These are referred to as "subsidiaries" but in fact the definition of the law is broader and includes "listed companies".

23 Under the present definition, this independence is a relative one, being restricted to independence towards the planned decision/transaction.

favour of one of the shareholders. On the basis of this report, the board will decide. The annual report will contain a summary of these reports, and the conclusion they have reached.

The sanctions are important: the law provides for nullity of the transaction if the procedure has not been followed, and personal liability of the directors. These sanctions would be reinforced under the future legislation: the directors will equally be liable, if the procedure was followed, provided the parent has received an "unjustified advantage from the transactions". The remedy, mainly a detenent, would come close to applying a general fiduciary duty.

The rule has been in operation for about five years. In general, the companies involved have followed it. It probably has refrained some companies from entering into transactions that would otherwise have been open to challenge under the "abus de majorité" rule. Generally the rule has contributed to a greater awareness of fairness in intra-group transactions.

3.3. Stock exchange regulations

28. Attention should be drawn to the case of at least one stock exchange, in this case the London Stock Exchange, who imposes, in its listing agreement, provisions dealing with groups of companies issues, especially in case of the presence of a dominant shareholder.

Under these rules companies have to commit themselves to guarantee independence of management: if one of the shareholders has a dominant position - defined as holding 30% or more of the shares - the board should not contain more than one third of the members as being proposed by that shareholder. In general the company should be "capable at all times of operating and making decisions independently of any controlling shareholder and all transactions and relationships in the future between the applicant and any controlling shareholder must be at arms' length, and on a normal commercial basis".

Further restrictions concern the issue of additional shares whether against cash, or against a consideration in kind, in order to avoid dilution of the participation; rules relating to intra-group service contracts, rules on corporate opportunities, or on the use of intellectual property within the group.

The English approach is clearly based on the philosophy that there should not be a controlling shareholder in listed companies. In line with that philosophy, it is compulsory in the UK to bring a mandatory bid for any shareholder that has acquired shares as a consequence of which his holding has exceeded 30%.

The English philosophy therefore appears to be different from the continental, Germany excepted.

3.4. Criminal law techniques

29. Some words should be said about provisions in certain national laws that could be applied in case transactions between companies take place and cause considerable damage to the company. In most jurisdictions the general rules on embezzlement, fraud, or other definitions of criminal conduct will be invoked to institute criminal proceedings for unjustified intra-group transactions.

However in some jurisdictions specific provisions have been enacted that may more directly involve some types of intra-group dealings. These are the well-known French rules on " abus de biens sociaux", in art.437 French Criminal Code. A weaker version has been enacted in Belgium[24]. The French rule is particularly interesting and powerful as it allows initiating criminal proceedings

> … "against the directors and managers of the company who in bad faith have made use of the assets, the credit, the powers within the company in a way that they knew would be contrary to the interest of the company and this in their personal interest or in the interest of other companies in which they have a direct or indirect interest[25] "

The provision has been applied in numerous cases in France, also vis à vis the most important business leaders, most of the time on the basis of personal enrichment. In a company group context, the requirement of a personal interest of the director was met in the

[24] Art. 492 bis, Criminal Code.

[25] Art. L 242 – 6 French Commercial Code: " (les dirigeants) qui de mauvaise foi, auront fait, des biens ou du crédit de la société, un usage qu'ils savaient contraire à l'intérêt de celle-ci, à des fins personnelles, ou pour favoriser une autre société ou entreprise dans laquelle ils étaient intéressés directement ou indirectement". Shareholder approval does not prevent the prohibition from applying.

abovementioned Rozenblum case[26], where the intra-group transactions took place among several companies in which the defendant Rozenblum was a significant shareholder. In that and in later cases, the courts have accepted that the group interest may be taken into account provided that a group strategy has been put into place. [27]

A case that has been submitted to the courts or commented on in legal writing in several jurisdictions is that of the pooling of cash within a group of companies.

d) Conflicts of interest in state owned firms

30. In principle the governance rules applicable to state-owned companies, at least those that belong to the competitive sector, should not be different from the ones that are applicable to any other company. One could even draw a further comparison: one could identify and compare the position of the state to that of a dominant shareholder, who has to abstain from certain types of intervention, unless offering a just indemnification. In fact the situation of the state vis-à-vis a company in which it holds a significant interest, is much more complex than that of a dominant private shareholder, as it acts, not on the basis of self-interest - which is the driving force behind the action of the dominant shareholder- and moreover by way of command - where the dominant shareholder still has to follow the quasi-contractual mechanism of the corporate decision making. Therefore it seems useful to draw up a list of items where the presence of the state as an important shareholder would constitute a difference, and often a handicap, v.à.v. the functioning of regular private business firms.

A - Specific issues of corporate governance

31. Government owned companies have a certain tendency to develop specific governance characteristics. These can be described as follows:

a) - The board of directors is composed on the basis of political criteria:

[26] See note 20.

[27] Among the more recent cases see: Cass. crim., 4 September 1996, Rev Sociétés, 1997, 365, nt. Bouloc.

Sometimes clients, suppliers, or even competitors from other state-owned businesses take part in the board. There is considered to be no conflict of interest between these firms, which is often doubtful.

b) -Allegiance to public political interest is stronger than allegiance to the company's interest:

- Decision-making may reflect political appreciation, or the power position of the government department represented on the board, but is not based on business motives
- Material decisions are made outside the boardroom, on the basis of political motives or power: the board merely serves to register the positions taken by the political actors
- The political opposition may be reflected at the company level: it then plays the role of the company's minority
- Conflicts of interest issues - also relating to the wider public interests - are decided on political grounds; usually there are no effective procedures for dealing with these conflict cases, as the state's interest is considered paramount.

c) - Absence of a clear business purpose: whose "interests" are to be served?

- Investors: accountability to the markets?
- Consumers: product innovation is slow; sub-cost pricing
- Clients: poor service
- Public interest: accountability to the public opinion? To the parliament?
  Politicking will result.
- Directors' interests: lower remuneration might result in side benefits.

As a consequence: weak accountability, with higher propensity for exposure to "public scandals".

Deep pocket: lack of profits will be balanced by more subsidies.

d) -Board functioning

Board functioning is generally rather weak: large unbalance between internal directors and external members who have little information about the business.

Few formal procedures: audit committees are rarely found, ethics committees, nomination and remuneration committees are usually absent.

Secrecy is difficult to maintain especially v.à.v. the body politic: is there a duty to communicate, or should the opposite be true?

e) - External control and auditing.

Accounting: sometimes still on a cash basis.

Often very strong controls: government control (cour des comptes), state inspection (inspecteurs des finances) and private auditors, with overlaps.

Internal accounting and control procedures often quite weak.

Unclear procedures: to whom is there to be accounted for? See e.g. amortisation: if short duration is adopted, new funds will be needed from the government. Therefore: a low amortisation rate is applied, leading to a substandard investment policy.

B - Miscellaneous weaknesses in the functioning of state owned business firms

32. One could draw up a list of weaknesses of state controlled firms v. private firms. The following items can easily be observed:

a) - Financing: the state has no money, but blocks expansion if private shareholders are associated for fear of dilution;

b) - State aid: if the state increases its contribution, this may be qualified state aid, and hence forbidden;

c) - Procurement policy: mandatory under EU directives. But in whose interest this is this: often doubtful. See the directive on “Telecom, Electrical supply, water, etc”. where alternative procedures have been provided for in the directive

d) - Price setting: often determined by the state, on non-economic criteria

— Sometimes part of inflation policy

— Sometimes on the basis of social policies: “primary needs” e.g. Postal services, telecom. But who pays for the public service?

e) - Financial: no proper rating, but annex of State’s rating Bank financing usually’s expensive, while subsidies are paid late.

f) - Social: state as a shareholder wants no trouble: hiring policy is politically driven.

State owned firms often cannot freely hire, and even less fire employees. Hence excessive employment with low motivation and productivity.

g) - Foreign expansion: often frowned upon - formation of subsidiaries is often forbidden, for fear of delocalisation of business, and loss of control.

h) - Numerous external controls: external audit, in addition public controls on the basis of administrative criteria

i) - Sale of business:there is no listing, no valuation, and therefore no easy merger possible.

j) - Industrial relations: powerful unions, as employers are not accountable for profits of the firm.

To sum up: all these problems are a consequence of the state having an inherent conflict of interest in running a business firm. Privatisation might be a solution, but politically often is not feasible.

33. However, one should further distinguish between firms that have in whole or in part a public function, and those that are merely government-owned firms, acting in the competitive sector. In order to avoid these difficulties and weaknesses, the latter firms should better be privatised, as e.g. the UK, Italian, French and other governments have clearly decided, obviously in the interest of the firms themselves many of which have since prospered.

As to the former, one should try to identify which part of the function belongs to public service, and which is private.

The dividing line between the two "sectors" is a flowing one, both geographically and in time. The banking sector, once regarded in many states as closely related to the public interest, is today dealt with as any other private business, although additional prudential safeguards are to be applied. Public transportation is in part evolving in the same direction: air transport, and related activities, as airports and airport services are now adays generally considered private sector activities and are being privatised. But in rail transportation, the evolution obviously is subject to much more controversy. The supply of water, of electrical power, of telephone or postal services is increasingly perceived as activities that are only partly a public service. And even state prisons are being privatised!

C - Some practical ideas

34. What are the practical consequences to which these general developments could lead? What measures could be taken to enhance state-owned firms to become more efficient, more sensitive to people's needs?

One should distinguish between firms that have an exclusively economic role in the competitive sector, and firms that are, in whole or mostly in part, also in charge of offering public goods.

With respect to the first group of firms, although the most radical approach would be to fully privatise the firm, this often will not be feasible, especially if the firm is functioning in financially immature markets. By way of intermediate solution, therefore, the state will be obliged to keep its controlling holding. On the other hand, it should be avoided that the firm be run according to political imperatives. Here the rules on corporate governance might offer a useful perspective, if not a solution.

35. The political power should define the firm's objective. It is essential that the government decides what it considers to be the role of the firm in the given economic system, especially when the firm is acting in the competitive sector and whether its role is other than

maximising its profit. In most economies in transition, the role of the firm will be broader than mere profit maximisation.

The government decides what public interest activities the firm has to engage in, what charges it has to support and how these charges will be financed. Technically, the state should offer indemnification for the charges the firm is sustaining for subsidising public interest activities, in a way comparable to the dominating German parent companies indemnifying their subsidiaries for the charges imposed on the subsidiary. In practice however, the firm will have to subsidise the charges cause by its public interest duties from the profits realised on its other economic functions.

36. If the firms want to be successful in the competitive sector, and hence successfully subsidise the "public interest" part of its mission, it should be enabled to manage its business in the most effective way. Therefore usual techniques of good businesslike management should be called upon. A few of these techniques can be listed here:

— The government should explicitly state that the board acts independently, in the interest of the firm, under the charge of meeting the public interest obligations that it has formulated;
— It is a question of general policy whether business firms, of whatever legal nature, should be headed by a one or by a two tier board; the latter formula has the advantage of offering more efficient solutions to the functioning of the board as a supervisory organ for the management, while introducing more adequate formulas for dealing with conflicts of interest with the shareholder;
— The day-to-day running of the company should be the task of the managers, or of the management board in the two-tier structure; the board should essentially act as a supervisory body, without intervention in the management's operational decisions;
— The unitary board of directors should be composed of a limited number - not more than 12- competent directors, a minority of which would be insiders, belonging to the firm's staff; several of the other directors should be independent, not merely outside directors;
— The state should at least decide what the role of its appointee directors will be: in some statutes, it has been mentioned they may be entitled to suspend any decision they would consider contrary to the "public interest", or may require a second deliberation of any

measure considered incompatible with government policies. Less evident is the rule that a casting vote may be attributed to these directors, in case of a tie. One sees however that the role of these directors comes quite close to that of a government commissar, an institution which some states have introduced to supervise and monitor independent public bodies (e.g. universities). If this type of supervision is deemed necessary, the commissar is the better solution, being more transparent as to the interests involved, over the appointment of state directors;

— Directors should be selected on the basis of their capabilities; a formal selection procedure is to be introduced at the firm level;

— Directors should be appointed without regard to political allegiance; therefore it might be useful to call on an external adviser, who proposes nominees to the board, or to its nomination committees; the government as shareholder should not appoint directors except on the proposal of the board;

— The board should constitute within itself specialised committees, and at least an audit committee; the task of which not only consists of dealing with accounting and auditing issues, an essential element in the firm's management, but also in more detailed supervision of the way the firm is run. It might be part of this committee's brief to determine whether business decisions are effectively taken in the interests of the firm only, without any outside interference;

— Special rules should be devised for dealing with conflicts of interest, in this case conflicts between the proper interest of the firm and that of the state; the principles should be laid down in a memorandum of understanding dealing i.a. with disclosure procedures, decision-making rules; resulting in the obligation for the state to indemnify charges beyond the statutory limits. Therefore, a special committee, composed of independent directors might be instituted, in charge of supervision the implementation of the rules governing the relations between the state and the company;

— Special accounting rules would be applicable to separately identify the public services activities of the firm, creating transparency as to the firms' obligations and right of indemnification for public charges;

— Apart from the internal auditing procedures, the state should be entitled to exercise supervision on the way the firm is accounting for the means it has received from the state.

But this supervision should not result in intervention in the running of the firm, nor in the policies it develops within the limits of its statutory mission.

It is important for management, customers, creditors and employees but also for suppliers, especially international suppliers and banks to have a precise view about the perspective in which the firm should be placed. This will increase its creditworthiness. Therefore independence and professionalism of management and transparent accountability as to the firm's outside appearance are key concepts on the way of success of state owned business firms.