Financial Law Institute

Working Paper Series

Economic Analysis of Corporate Law in Europe: an introduction

Christoph Van der Elst

WP 2002-01

January 2002

UNIVERSITEIT GENT

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Firms are a crucial part of the explanatory set-up of the economy. They are the dominant organisation of the modern world. Only since the nineteen twenties, economists felt the need to go beyond the market approach and develop a theory to address the reasons for the existence of the institution known as a corporation, its boundaries and its internal organization. As companies are one of the most important social and economic powers in an advanced economy, an efficient corporate legal framework is of considerable importance. This paper describes the subject 'corporation' and corporate law from a European perspective. The most important characteristics of a corporation and its economic (dis)advantages, legal personality, limited liability, centralized management and free transferability of shares, will be discussed. Also issues of the internal structure of the corporation will be analysed. Ownership structures of European companies, conflicting interests, separation of ownership and control and mechanisms mitigating the agency costs due to this separation are briefly described. The last section summarizes the agency relationship between creditors, managers and shareholders.

Comments to the Author:

christoph.vanderelst@rug.ac.be

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Christoph Van der Elst
Financial Law Institute
Ghent University, Belgium

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Firms are a crucial part of the explanatory set-up of the economy. They are the dominant organisation of the modern world. Only since the nineteen twenties, economists felt the need to go beyond the market approach and develop a theory to address the reasons for the existence of the institution known as a corporation, its boundaries and its internal organization. As companies are one of the most important social and economic powers in an advanced economy, an efficient corporate legal framework is of considerable importance. This paper describes the subject 'corporation' and corporate law from a European perspective. The most important characteristics of a corporation and its economic (dis)advantages, legal personality, limited liability, centralized management and free transferability of shares, will be discussed. Also issues of the internal structure of the corporation will be analysed. Ownership structures of European companies, conflicting interests, separation of ownership and control and mechanisms mitigating the agency costs due to this separation are briefly described. The last section summarizes the agency relationship between creditors, managers and shareholders.

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Table of contents

1. Introduction
2. The corporation and corporate law
3. Basic characteristics of the company in a European context
    3.1. Legal personality and perpetual life
    3.2. Limited liability
        3.2.1. Description, advantages and risks
        3.2.2. Solutions mitigating the risks and implementation in European member states
    3.3. Free transferability of shares
    3.4. Centralized management
4. Organisation of the corporation
    4.1. Ownership structures and the separation of ownership and control
    4.2. Mitigating the costs of the separation of ownership and control
        4.2.1. Market for corporate control
        4.2.2. Managerial financial incentives
        4.2.3. Disclosure of information
        4.2.4. Corporate governance
        4.2.5. Shareholder empowerment
5. Corporate finance
6. Conclusion

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1. Introduction

Firms are a crucial part of the explanatory set-up of the economy. They are the dominant organisation of the modern world. However, for a long period of time firms, like households, were not as such examined in any detail. The theory of the firm was actually a theory of the market. The basic economic model describes how markets can produce an efficient outcome. The economic theory approached a firm or a company as a 'black box': a production function run by a selfless owner-manager who chooses the input and output levels that maximize profits and minimize costs. In this theory firm behaviour was considered constant to institutional organisation and therefore questions on incentives and coordination did not emerge. Economic theory simply did not explain why firms existed.

In practice, generally speaking two methods of production organizing coexist. In the first method an entrepreneur contracts with different parties to supply parts, to assemble them and to sell the finished products. In this method, the traditional domain of contract law is based on the price system and is explained by the theory of the market. The entrepreneur can also hire employees to perform the different tasks under his direction. The entrepreneur pays the employees wages for the right to direct their performance (Posner, 1977, p. 289).

The second method internalises several transactions and the question emerges why these transactions had been removed from the price system.

Only since the nineteen twenties, economists felt the need to go beyond the market approach and develop a theory to address the reasons for the existence of the institution known as a corporation, its boundaries and its internal organization.

In 1937 Coase reasoned that the cost of using the price mechanism explains the existence of firms (Coase, 1937, p.390). Although not explicitly mentioned by Coase in his seminal article, the idea of transaction costs was born. Markets will be used to produce when the costs of direct authority exceeds the costs of the market. Factors of the costs of the market include the solvability of the contracting party, the political risks, time limits, the flexibility to revise contractual terms and so on.

To illustrate the difference, Hart uses the example of the merger of General Motors and Fisher Body (Hart, 1995, p. 7). Fisher Body delivered car bodies to General Motors . In the nineteen twenties the demand for car bodies soared. General Motors urged to revise the formula for determining the price in the long term delivery contract. The management of Fisher Body refused to revise the formula so General Motors bought Fisher out. General Motors was now in a stronger position to force the reduction of the price since it could dismiss the managers of Fisher if they refused to accede General Motors' request.

However General Motors did not only get benefits from the deal. Before the managers had strong incentives to reduce the costs of producing the car bodies as to gain more profit. When General Motors had full control it could reduce the transfer price and reduce the return to Fisher's management but the latter no longer had strong incentives to reduce the costs and to increase benefits.
The introduction of the notion of transaction costs enables to elaborate a general theory of economic organization. In fact, it should be mentioned that this new approach not only explains the existence of corporations but also of other organisational forms like partnerships, franchising arrangements, joint ventures and so on. Posner points out that the clue to distinguish corporations and the other organizations is that the former allows to raise substantial amounts of capital (Posner, 1977, p. 290). If the input consists primarily of labour other organisational forms are used. This distinction does not explain all differences but the theory on other organisational patterns will not be developed in this chapter.

This chapter is organised as follows. The next section describes the subject 'corporation' and corporate law. The third section discusses the most important characteristics of a corporation and its economic (dis)advantages: legal personality, limited liability, centralized management and free transferability of shares. Some issues of the internal structure of the corporation will be analysed in the fourth section. Ownership structures of European companies, conflicting interests, separation of ownership and control and mechanisms mitigating the agency costs due to this separation are briefly described. Section five summarizes the agency relationship between creditors, managers and shareholders. Section six concludes.

2. The corporation and corporate law

In their pioneering work 'theory of the firm' Jensen and Meckling describe a corporation as a 'legal fiction that serves as a nexus for contracting relationships and that is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization, which can generally be sold without permission of the other contracting individuals' (Jensen and Meckling, 1976, p. 309) This definition links up with the civil law approach of a company being a contract between two or more people to bring together some assets with the intent to procure a benefit to the former parties.[1] The twelfth European Directive enlarged the application of companies formed by a sole member or companies of which all shares 'come to be held by a single person'[2].

Companies can only exist and perform within a legal framework. Corporate law governs the internal affairs of a company and more specifically the relationship between the shareholders, bondholders, the directors and the managers. The ties between the shareholders as residual claimants to the firm's assets and the agents that manage those assets are subject to study in corporate law (Ramseyer, 1998, p. 503). 'The system by which organisations are directed and controlled', the definition of 'corporate governance'[3] by the Cadbury Report (Report, 1992, p. 15) is a core element of company law.
As companies are one of the most important social and economic powers in an advanced economy, an efficient corporate legal framework is of considerable importance.
Company law is related to banking law and commercial law, which govern inter alia the relations between companies and its creditors.[4] It is also linked with labour law, which governs the relationships between the company and its (lower-level) employees.[5] Further, as a company is an incomplete contract, company law is related to contract law. Even tort law and criminal law sometimes govern companies daily life.[6]
Within Europe, large companies more and more tap the capital market. Therefore companies must act in accordance with capital market law which sometimes directly intervenes in companies internal structure.[7]

Company law should provide a set of contract terms to which participants agree, and provide default rules to govern everything else. While in Anglo Saxon countries like the UK it is generally thought that the basic goal of these rules should be the maximization of the return for the shareholders, other countries like Germany and the Netherlands focus on a broader goal. Not only shareholders' interests but other interests, for example of employees, creditors and to a certain extent general welfare, should be taken into account (Wymeersch, 1998, p. 1084). The different attitude towards the functions of company law intervenes in the European competition of company law regimes. Where Cary argued that in the US Delaware company law, consisting largely of waivable rules, leads to a 'race for the bottom' approach (Cary, 1974, p. 673)[8], most European countries and the European Union established mandatory corporate rules that limit company law competition (Wymeersch, 2001, p. 119). Some state that these EU rules were adopted precisely to avoid the effects of jurisdictional competition (Ramseyer, 1998, p. 507). However, some scholars argue that in the 1999 Centros case the European Court of Justice[9] introduced a new era of company law competition between the member states.[10]

3. Basic characteristics of the company in a European context.

According to the law and economics literature four characteristics distinguish the corporation from the other forms of economic organizations like the proprietorship or partnership:

- legal personality and perpetual life
- limited liability
- centralized management
- free transferability of shares

Only the second characteristic has been thoroughly examined in the law and economic literature.

3.1. Legal personality and perpetual life

A corporation enjoys 'legal personality'. It means that the corporation has rights and obligations on its own behalf and in its own name. Corporations invest in assets to carry on a business. The corporation is treated as if it were an individual.[11] Recognizing companies as separate legal personalities, the law permits teams to cooperate in firms and to yield superior productivity.
As corporations have a life on their own, separate from the constituent shareholders and the directors, they exceed the life span of the latter and are thus said to enjoy perpetual existence. In most legal systems, partnerships and other types of firms will come to an end if one or more of the partners die. Corporations continue to exist and the shares will be transferred to third parties, probably the heirs.
However, it should be noted that legal systems provide the possibility for the shareholders to dissolve a corporation voluntarily and in some jurisdictions if certain conditions are met, corporations can be dissolved involuntarily.

3.2. Limited liability

3.2.1. Description, advantages and risks

A principal feature of modern corporations, limited liability, has been known in Europe since at least the twelfth century (Carney, 1999, p. 659) and was already used in the 17th century. The Dutch Vereenigde Oost-Indische Compagnie was founded in 1602 by members whose obligations were limited to the promised amounts. Their membership was represented by tradable shares, 'actie ende gerechticheit', each having a different nominal value (Van der Heijden and Van der Grinten, 1976, pp. 1-5). In 1807 the French Commercial Code provided limited liability for joint stock corporations known as 'sociétés

anonymes'. In the UK limited liability was introduced under the Limited Liability Act of 1855.[12]
Limited liability and the general idea of a corporation means that the members of the corporation are not responsible for the obligations arising therein nor are they entitled to the benefits. The members' rights and obligations are confined to receiving their share of the profits and paying the amounts due. The investors in the corporation are not liable for more than the amount they invest. We should note that the limited liability rule is not applicable to all members in all the different kinds of firms that exist in the European Union. Different member states allow the foundation of a corporation in which some members enjoy limited and others unlimited liability.[13]

This basic feature creates major advantages for the development of a business. First it decreases the need to monitor the agents of the company.[14] The risk the investors bear is limited to a fixed amount and therefore beyond a certain point, more monitoring will not be worth the cost. It fosters economic growth by enabling and encouraging investors to take risks. In the eighteenth and the beginning of the nineteenth century both limited and unlimited liability banks coexisted in Scotland. In the beginning of the nineteenth century the average size of the limited liability bank was ten times that of the unlimited liability bank. However, and consistent with risk theory, the latter generated higher returns for the shareholders (Carney, 1999, p. 671). This does not imply that rational members do not understand the risk that the managers' acts might cause some loss.[15]
Second, the limited liability rule reduces the costs of monitoring other shareholders. Additional liability forces members to monitor whether other shareholders transfer assets to third parties. If those shareholders reduce their wealth, the assets of the monitoring shareholder is at stake. Limited liability reduces the likelihood of hiding shareholders' assets and therefore reduces administrative costs. It avoids enormous litigation costs.
Third limited liability enables portfolio diversification. If an unlimited liability firm goes bankrupt, the member can loose his entire wealth. Investors in limited liability corporations can minimize risk by diversifying their portfolio of assets.[16] Also managers of those companies can engage in risky project with a net present value which investors in unlimited liability firms would reject due to their risk-oriented behaviour.
Fourth, limited liability generates shares as homogeneous commodities that investors can easily trade. This trade determines a price that optimally reflects all available information without expending additional resources to prospect the firm's strategic decisions. Further, the determined price signals the managerial performance.

Notwithstanding the major advantages, limited liability does not eliminate the risk of business failure. It simply shifts the risk from the shareholders to the creditors. The equity owners will capture all the benefits while the downward risks are shared with the creditors. The former will support the managers to select risky projects because the owners can externalise part of the social costs of their choice. However, for most creditors this moral hazard problem is acceptable as they demand a compensation determined by the risks they face. Trade creditors, banks, even employees and consumers can set the terms of the transaction and as voluntary creditors they will receive compensation in advance for the risk that the company will not meet its obligations.
However, it is not generally accepted that managers will always select risky projects. Most managers of corporations hold large undiversified stakes in firm-specific human capital and therefore they will be concerned about business failure, which will cost them their jobs. Further the decreased incentive of the shareholders to monitor will be offset by the increased incentive of the creditors to monitor. For other, involuntary creditors, like for the liabilities in tort, limited liability is major disadvantage – a specific externality problem - and some countries have legally implemented systems to protect these creditors. In Europe tort creditors have not been granted any priority rights. To the contrary: like in the US, secured creditors have priority over tort creditors.

3.2.2. Solutions mitigating the risks and implementation in European member states

A number of solutions to mitigate the risks of limited liability have been developed. We will briefly discuss the minimum capital requirements, mandatory insurance, the prohibition to distribute dividends, piercing the corporate veil, the extension of liability and the liability of the board.

* In the European Union the Second Company Directive protects (involuntary) creditors by obliging shareholders of public limited companies and equivalent forms to subscribe a minimum capital of not less than 25.000 euro. This capital may consist only of assets capable of economic assessment and may not include an undertaking to perform work or supply services.[17] Also the capital must be maintained. First, there is a positive obligation to consider certain measures, like the winding up of the company, in the event of a serious loss of capital. Second, it is prohibited to distribute dividends when the company's last annual account shows that its net assets are or would become less than its subscribed capital. Third, the Second Company Law Directive prevents companies from buying their own shares, whether directly or through an intermediary or by means of a controlled company.[18] However,

the European Community was aware that acquisitions of own shares may sometimes be useful, for instance as a price stabilization mechanism (Denecker, 1977, p. 672). Under certain conditions it is allowed to acquire up to 10% of the own shares.[19] Fourth companies are prohibited to financially assist third parties to acquire its own shares.[20] Finally the reduction in capital – as long as it exceeds the minimal capital requirement – will only be allowed if the creditors whose claims antedate the publication of the decision to reduce capital are entitled at least to obtain security for claims that are not due by the date of that publication.[21]

By obliging public companies to have and maintain a minimum capital, the European Union has judged the advantages of the maintenance of minimum capital higher than the disadvantages. In fact a minimum capital requirement creates an important cost of error. When the minimum level is set too high, not enough corporations will start production. Monopolies will arise and projects with a net present value might not be executed. The European Union was aware of these risks and set a figure that is rather low. It is questionable whether the minimum capital amount is a genuine guarantee for third parties in general and involuntary creditors in particular. Nevertheless, the Directive allowed the member states to set higher minimum levels. Table 1 stipulates the minimum capital to form a limited liability company in a number of European countries. Some countries have changed or will change the amount with the introduction of the euro.

Second, the minimum capital requirement creates a lot of administrative costs. The limited amount required to set up a public limited company did not prevent companies from failing. Companies have to set up an internal policy to assess the capital and its maintenance and countries need a specific control system. Third, only public limited companies are subject to the minimum capital requirements and therefore this rule can be easily evaded.
The requirement for a legal capital has become the subject of criticism. Creditors can be better protected by using other tools. Some of the provisions were revised by a working group and are now reconsidered in different member states (Wymeersch, 2001, p. 128-129).

Table 1: Minimum capital for a public limited company in seven European member states

	Minimum capital	Companies Act	in euro*
Belgium	2.500.000 BEF	Article 439 W. Venn.	61.973
Germany	100.000 DEM	§ 7 Aktiengesetz	51.129
France	250.000/1.500.000 FFR**	Article 224-2 Comm. Code	38.112/228.673
Italy	200.000.000 ITL	Article 2327 Codice civile	103.291

The Netherlands	100.000 NLG	Article 67, §2 Boek 2 B.W.	45.378
Spain	10.000.000 ESP	Article 4 L.S.A.***	60.101
U.K.	50.000 GBP	Section 117-118 CA 1985	74.195****

*: some countries will slightly change the amount due to the introduction of the euro (for example under Belgian law it will be 61.500 euro from 1/1/2002 on);**: 1.500.000 FFR if the company has publicly raised capital; ***: Ley de Sociedades Anonimas; ****:exchange rate of March 15 1999.

* Mandatory insurance is another feature to protect shareholders if under certain conditions limited liability will not be restrained. Economic theory rejects this possibility as inefficient. New corporations will have higher risks than well-established ones. Therefore the insurance premium will be higher, which will increase production costs. Monopolies might arise.[22]

* The prohibition to distribute dividends and other distributions of assets to shareholders not only ensures capital maintenance, in general it also increases the guarantees for the creditors.

* Further, courts can pierce the corporate veil and hold the members liable for the corporate debts. It is stated that piercing the veil is far more likely in closely-held corporations and parent-subsidiaries situations because the ability to monitor is readily available (Carney, 1999, p. 668). However in most countries it is well established that courts do not have a discretionary power to lift the veil in the interest of justice in general. The cases in which the European courts generally lift the veil are those where the corporate form was used as a 'façade' to evade an existing legal obligation or other deception. Under Belgian law the concept of the "shadow" director has been developed to impose the same liability rules to persons directing the company from behind the scenes. Article 530 of the Belgian Companies code states that persons who have real decision making power may be held liable for the company's debt under certain conditions. Further if the company goes bankrupt within three year of its formation the promoters will be held liable if it appears that the initial capital was manifestly insufficient for the operational business for a period of two years.[23] Under German Law the dominant company must compensate the creditors if a company of the group has deficits.

* The latter exception can be seen as a specific element of the possibility to extent liability. In the US the laws of California imposed pro rata shareholder liability between 1849 and 1931 and the federal law imposed double liability for shareholders of banks between 1865 and 1932 (Carney, 1999, p. 664). This possibility is generally seen as a burdensome solution to the disadvantages of limited liability. Many difficulties might arise: to what amount will the shareholders be held liable? What if some of the shareholders are unable to meet the liability requirements? And so on.

* Another solution used in a number of civil law countries in Europe is to make the board of directors personally liable for corporate obligations. The board of directors has a duty to file for bankruptcy under Belgian law. If they do not file in due time the board will be held liable for the damage caused by the failure to file. In France (Carney, 1999, p. 684) and Belgium the board is liable to the company and third parties when the members violate the company's constitution or the companies Act. In general one should note that the board is an inefficient risk-bearer and therefore imposing liability on directors will lead to more risk aversion.

3.3. Free transferability of shares

Limited liability facilitates the possibilities to raise equity capital and to divide the capital into transferable shares. Shares represents a part of the equity capital put up by investors to finance the corporate investment opportunities. The shareholders as owners of the shares are entitled to the profits of the shares and the increases in the market value of the corporation. Further in most cases the shares carry a right to vote. At general meetings shareholders can influence the risk to which they are or will be exposed.[24] The monitoring function of these principals – the shareholders - will be proportionate. The transferability of shares enables the shareholder who disagrees with the monitoring of the other shareholders to transfer his shares without the permission of the latter. It allows the monitoring function to be optimised as the shares will flow to those residual claimants having the abilities to monitor efficiently.
Limited liability creates incentives for managers to act efficiently due to the free transferability of shares. Rational shareholders understand the risks that managers might act in their own interest. They will sell the shares when firms are run poorly and/or in the interest of the managers. The price will reflect those risks. If votes are attached to shares, investors who assemble a large number of shares at a discount will have the ability to dismiss and replace the management. Therefore managers will operate efficiently to keep the share price high and reduce the risk of being replaced.

3.4. Centralized management

In the majority of the European countries the companies Act provides for a single governance body, the board of directors. In theory, the management

function is vested in this body, while economically, the board of directors monitors the managers to ensure that they maximize equity share prices. The executive officers actually run the corporation as full-time managers under the supervision of the board. Fama and Jensen have analysed these differences in the decision making process. 'An effective system of decision control implies, almost by definition, that the control (ratification and monitoring) of decisions is to some extent separate from the management (initiation and implementation) of decisions' (Fama and Jensen, 1983, p. 304).
Like in the US, in most European countries the board of directors may include both executive officers – managers – and non-executive directors who have a supervisory role. Dutch and German law have officially institutionalised a two-tier board structure consisting of a management board – 'Vorstand' or 'Raad van Bestuur' – and a supervisory board – 'Aufsichtsrat' or 'Raad van Commissarissen'. The management board is obliged to properly perform the tasks and responsibilities assigned to it.[25] It has executive powers monitored by the supervisory board. It must be noted that these two different approaches have significant consequences. Legally the one-tier board structure acts as the agent of the corporation. Economically the supervisory board acts as a monitoring agent of the principals, the board of directors as an agent of the monitoring agents.

4. Organisation of the corporation

4.1. Ownership structures and the separation of ownership and control

In wholly owned firms the owners will probably make all operating decisions in order to maximize their utility. They will be the owners and the managers of the company and they can claim all the profits of the firm. In this kind of proprietorship the ownership of the residual claims is held by the decision agent. For several reasons, like the necessity to raise substantial amounts of capital, other organisational forms like the public limited company are founded. Large companies mostly have a large number of shareholders. For efficiency reasons it is not possible to govern these companies if each decision must be taken by all individual shareholders. Therefore other persons –managers- govern the company. These persons will at the most have a fraction of the equity. As a result 'the position of the ownership has changed from that of an active to that of a passive agent. In place of actual physical properties over which the owner could exercise direction and for which he was responsible, the owner now holds a piece of paper representing a set of rights and expectations with respect to an enterprise' (Berle and Means, 1932, p. 64). The claim to the profits of the company by the managers diminishes and this will encourage the managers to appropriate a larger

amount of the profits in the form of perquisites. This divergence of the interest of the managers and the interest of the shareholders is responsible for the agency costs. The managers might not always act in the best interests of the principals, the shareholders, and costs arise from this possibility. Back in 1776 Adam Smith already pointed out that 'the directors of such companies... being in charge rather of others people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in private copartnery frequently watch over their own' (Smith 1776 1937, p. 70) Jensen and Meckling define the agency costs as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss (Jensen and Meckling, 1976, p. 308).

It should be noted that there is an important difference in the concept of agency between law and economics. Theoretically for the concept of agency to be met it is essential that the principal has the authority to control the activities of the agent. The corporation as a separate legal entity is the principal, and not the shareholders. At least theoretically the corporation controls the activities of the agent. The shareholders do not have the right to determine or to command specific management actions. In economic theory an agency relationship exists 'whenever one individual depends on the action of another... The individual taking the action is called the agent. The affected party is the principal' (Pratt and Zeckhauser, 1985, p. 2).

The agency conflicts between the shareholders and the managers consist of different elements. First, managers do not have the incentives to exert as much effort as shareholders expect them to have. Second, managers typically have a different and shorter time horizon for achieving results as a corporation has perpetual life. Third the managers' wealth is tied to the viability of the company and therefore the former tend to be more risk averse. Finally, managers might have incentives to abuse corporate assets to their own benefits because they do not bear the full costs of their actions (Byrd, Parrino and Pritch, 1998, p. 15).

The first important study to highlight the separation of ownership and control dates from 1932. Berle and Means empirically found that in most of the 200 large American corporations shareholders are no longer able to direct policy nor to control the 'affairs of the company... occasionally a measure of control is exercised not through the selection of directors, but through the dictation of management' (Berle and Means, 1932, p. 66). Notwithstanding the ability to elect the directors, due to inter alia the existence of collective action problems and the control of the voting proxy machinery, managers effectively control corporations characterized by a widely diffused ownership structure.

Before turning to the mechanisms to mitigate the costs of this separation of ownership and control and the specific European solutions, it is necessary to point out the benefits of the system. Hierarchical decision-making may be

more efficient than market transactions (Marks, 2000, p. 694). The in-house development and production process of idiosyncratic products and services may be less time-consuming and the negotiation, communication and dispute resolution costs may be lower. Second, investors can not only diversify and optimally allocate their investments but also reduce or avoid time-consuming management duties. Third, it enables profiting from the economies of scale in the production and decision making process.

The question must be raised whether the widely diffused ownership pattern and the separation of ownership and control exist throughout Europe like in the US. Until the beginning of the nineteen nineties no reliable information on ownership structures was available. The 1988 European Directive on the information to be published when a major holding in a listed company is acquired or disposed of allows a detailed analysis of the stakes and the identity of the largest shareholders of stock listed companies as the former must notify if a voting block reaches, exceeds or falls below one of the thresholds of 10%, 20%, 1/3, 50% or 2/3. Since the implementation of this Directive several studies show a significant difference between the ownership pattern of UK/US companies and the continental European listed companies. In Germany, Italy, France and Belgium approximately 50% to 60% of the listed companies have one shareholder controlling more than 50% of the votes (table 2). In other continental European countries the figure is somewhat lower but significantly higher than in the UK or the US. There is also some evidence that in non-listed companies the ownership concentration is even higher (Köke, 1999, 11). Less than 10% of the companies listed in the former countries have a widely diffused ownership structure in which no shareholder owns a voting block of more than 10% of the voting rights.

Table 2: Voting concentration in Europe and the U.S. – Per cent of companies

Voting stake of the Largest shareholder	Bel.** 1999	It. 1999	Fr. 1999	Germ. 1999	Sp. 1999	Neth.* 1998	U.K.*** 1994	U.S. 1996
Over 50%	62,1%	62,0%	57,5%	48,5%	27,3%	19,5%	12,5%	10,3%
25% to 50%	25,7%	17,9%	21,9%	26,6%	28,9%	22,6%	20,1%	20,7%
10% to 25%	6,4%	14,5%	13,1%	17,7%	33,1%	34,0%	42,5%	39,1%
less than 10%	5,7%	5,6%	7,5%	7,2%	10,7%	23,9%	25,0%	29,9%

Note:
*: It is not clear whether the figures are capital or voting blocks;
**: Stake of the parties acting in concert;
***: The figures include the summed stakes of the board of directors.
Source: C. Van der Elst, 2002a, table 17.

In 1999 the voting block of the largest shareholder can be situated in five continental European countries between 37.9% in Spain and 52.0% in France (Van der Elst, 2002a, figure 6). For the UK this figure is 18.3% in 2001 (Van der Elst, 2002a, table 5) and in the US it was only approximately 3.5% (Gugler, 2001, p. 13).
In companies with a controlling shareholder agency costs are less likely to be as substantial as they are in the other companies because the largest shareholder has incentives to monitor the agents. However empirical studies on the profitability enhancing role of owner controlled firms are ambiguous (Gugler, 2001, pp. 14-23). So far, the number of continental European studies on the performance differences between owner-controlled and manager-controlled firms are almost non-existent.
Some refinements must be made. In owner controlled companies the risks of shirking by the managers shift towards the risk of shirking by the controlling shareholder. It might be that a company controlling another company forces the latter into less interesting deals. Several European countries have taken measures to protect the interests of minority shareholders. In Germany the Companies Act of 1965 contains a detailed framework on the relationships of and within groups of companies. The Italian civil code prohibits shareholders to vote on matters in which they have a conflicting interest either for themselves or for third parties.[26] Under Belgian law transactions between a large shareholder and a listed company is submitted to a specific procedure in which independent directors must assess the transaction conditions.[27] In France the highest court has decided that the parent company can impose certain burdens on its subsidiary if in the longer term the burdens are offset

by benefits for the subsidiary and the burden does not exceed the subsidiary's capacities to support it.[28]

In all countries companies can be found in which control is separated from ownership. In the US several mechanisms are explored as incentives to conform managers behaviour to act in the best interest of the (current) shareholders. Corporate law already offers instruments to limit the agency costs between managers and shareholders. The market for corporate control, managerial financial incentives, disclosure of financial and other information, corporate governance and shareholder empowerment are frequently mentioned mechanisms.

4.2. Mitigating the costs of the separation of ownership and control

4.2.1. Market for corporate control

One of the most radical measures to align the interests of shareholders and managers is the (hostile) takeover bid. When managers do not maximize the shareholders' value, stock prices will decline. This enables other market participants to acquire large stakes or make a successful unfriendly bid and remove the incumbent management. This mechanism is regularly criticized as too burdensome. Other criticize the efficient market hypothesis on which the mechanism is based (Marks, 2000, p. 700). Except for the UK, hostile takeover bids are almost unknown in Europe. Even in the UK the number of hostile bids is rather limited (Wymeersch, 1998, p. 1191). This is partly due to the different ownership structure of continental European countries. Transactions of large or even majority share blocks are frequently found (Wymeersch, 1998, pp. 1189-1197). In a number of European countries protective measures prevent the development of a hostile takeover market. Also, in a large number of countries it is mandatory to make an offer for all shares if control has been acquired. In the Netherlands, due to the specific company structure no hostile bid has ever occurred. However there are some recent takeovers that signal a new era has started: the hostile takeover of Mannesmann by Vodafone in Germany, of Telecom Italia by Olivetti in Italy and Paribas and Société Générale by BNP illustrate this new trend.

4.2.2. Managerial financial incentives

An important device to align the interests of shareholders and the management board is the use of performance-related remuneration packages. Stock options, warrants, phantom stock and other performance related or long

term incentive mechanisms are frequently used by American corporations. It has resulted in some very high and contested remuneration packages. However it is quite puzzling that most studies on different remuneration schemes found that company size and changes in size are much more significant determinants of executive pay than performance measures (Gugler, 2001, p. 44). The studies certainly indicate the managerial interest in perquisites: size and changes in size are directly visible to the outside world.
In Europe, only the UK has developed a transparent regime with detailed information on the remuneration packages of each board member. The remuneration is only due if it has been provided for. The bylaws will usually call for a shareholder vote.
In France, Italy, the Netherlands and Belgium the general meeting fixes the total remuneration of the board of directors. The board itself divides this remuneration package. This system allows the shareholders to determine the emoluments.
In Switzerland and Belgium 'tantièmes', paid out of taxed profits and a kind of performance related pay are frequently found but they are forbidden under French law.
Granting stock options is not yet a usual practice in continental Europe and stock options are of negligible importance (Prigge, 1998, p. 967). Only recently it is allowed in some European countries to issue stock options and it might be expected that this kind or remuneration package will be frequently used in the near future.

In European continental states reliable information on the remuneration of the board of directors and executive pay packages is not yet disclosed. The fourth and seventh European company law directive only obliges companies to disclose the aggregate board remuneration: 'emoluments ... granted to the members of the administration, managerial and supervising bodies ... and any commitments arising or entered into in respect of retirement pensions for former members of those bodies, with an indication of the total for each category'[29]. Most other continental European countries have no other disclosure regimes installed but in several countries parliaments recently enacted or discussed the introduction of a more transparent regime.[30]
Managers are often employees of the company and their remuneration packages are the subject of a contractual arrangement. No reliable information on these packages is publicly disclosed. So far, it remains unknown whether European companies use these financial incentive mechanisms to reduce agency costs.

4.2.3. Disclosure of information

Shareholders need detailed and reliable information to evaluate the actions of management. It is said that the distinctive feature of American business law is 'the stringent requirements it imposes on the issuers of publicly traded securities to produce ongoing disclosure' (Fox, 1998, p. 702). Without this information it will be impossible for shareholders to know about a breach of the management duties.
In continental European countries there is an expectation gap between the disclosed information and the requested information. At the European level the Commission was aware of the shortcomings of the different systems and has that decided at the latest from 2005 onwards, all companies listed in a regulated market must prepare their consolidated financial statements in accordance with the international accounting standards.[31] This is a more sophisticated financial reporting system enabling the international comparison of the financial statements, the financial position and performance of European (listed) companies. These norms focus inter alia on fair value, segmental information, ... largely unknown in different European member states in 2001. It can be seen as a major step towards more supervision by the shareholders.

4.2.4. Corporate governance

Policies to structure the internal organisation and procedures to organize the decision making process in a corporation can limit agency costs. The board of directors plays a key role in this corporate governance process. To optimize the agency relationships a number of important questions arise: How should the board be selected? Who should be on the board of directors? Who should the board represent? ...
In US corporations the board is elected by shareholders and composed of insider and outsider directors. The latter provide oversight while the former manage the day-to-day business. Directors are selected by nomination committees. These committees consist of a majority of outsider directors. The fiduciary duty law system offers a response for directors' acts of negligence or undue self-interest. Internal audit investigations is the taks of another committee, the audit committee. In the majority of corporations the same person undertakes both the roles of chief executive officer and chairman of the board. As an advantage of this duality understanding and knowledge of the company's operating environment is mentioned.
The evidence of all these governance measures relating to their impact on performance tends to be inconclusive. It is even found that they harm performance (Romano, 1996, pp.284-290). However, it should be noted that noise disturbs the measurement of the relationship. Second, it has been

proven that shareholders, especially institutional investors are willing to pay a premium for well-governed corporations (McKinsey, 2000, 8).
In Europe different systems coexist. In the UK the board structure can be compared with the American organisation structure. However, in a large majority of UK listed corporations the practice of duality of chairman and CEO is regarded undesirable as it concentrates too much power and this inside director is difficult to control.
In Germany the executive directors are not elected by the shareholders, but by the supervisory board. The latter is composed of representatives of the shareholders and, in large companies up to 50% of employee representatives. It can be doubted whether these representatives are independent (Schilling, 2001, p. 149). Second, this codetermination system is seen as an excuse to keep members uninformed and uninvolved. Third, few committees have been formed. Some say that demands of labor unions to sit on these subcommittees delay committees to be set up. (Schilling, 2001, p. 150).
In the Netherlands the members of the board of directors of corporations satisfying certain requirements - over 60% of the listed companies (Cortenraad, 2000, p. 190) - are appointed by the independent supervisory board, the latter selecting their own members. This is called the cooptation system. The shareholders only have a non-binding recommendation right. The number of subcommittees is rather limited.
In France two systems coexist. The two-tier board structure is a voluntary system but contrary to the German and Dutch organisational structure, the influence of the shareholders has been maintained. In the one-tier board structure, until a new law was voted in 2001, it was mandatory to be at the same time chief executive officer and chairman of the board, thus empowering one person with all management tasks. This "président-directeur-général" selects the board members and submits his choice to the shareholders (Wymeersch, 1998, p. 1114). Recently corporate governance codes encouraged the introduction of subcommittees and the election of independent directors. These directors must be independent of the controlling stakeholders which can be the majority shareholder or the management. A large number of companies created subcommittees and nominated independent board members. It is still to early to evaluate the result of these new developments on corporate performance.
In Belgium, Spain and Italy the same developments as in France occur.[32] Italy already had installed a specific kind of audit committee, the 'collegio sindacale'.

4.2.5. Shareholder empowerment

In the US and Europe scholars recently have made different proposals to increase the power of shareholders over management. These measures must reduce the agency costs of the separation of ownership and control and give shareholders more say in management.
Shareholder empowerment is linked to corporate governance. It consists of at least two major topics:

- enhancing shareholders' interest to vote and reorganize the voting procedures;
- give shareholders more rights

A corporation is known as an incomplete contract. It is impossible to specify fully all the duties of and limitations on each actor. It would also be inefficient. Company law can be seen as a standard form contract for a number of issues of corporate structure (Easterbrook and Fischel, 1983, p. 401). However the legal rules are not sufficiently detailed. The details must be filled out (some of) the actors. Voting serves this function. In the US and Europe the right to vote follows the residual claim. As the shareholders are the residual claimants of the corporation's income, they possess this right. In a number of European countries a debate is being held on a number of aspects concerning the voting rights: one of the most important is the question of the necessity to have the one share one vote-system. Disproportionate voting will shift power to some shareholders who will not necessarily take optimal decisions. This economic analysis does not prevent that in Germany, Belgium, France, the Netherlands, Sweden and so on, different types of shares or shares with different voting rights exist. Some do not possess voting rights where other have double or multiple voting rights. Further, it should be mentioned that not all countries allow the shareholders to vote on the details of the corporate contract. As an example the Netherlands could be mentioned. The supervisory board of a large Dutch corporation elects and nominates the board of directors and co-opts its own members. Shareholders in those corporations have voting rights but most of the time they are useless.
It is well known that general meetings have lost their economic importance. In the nineteen seventies and eighties even with proxies the total votes cast in the UK was no more than 12 to 13 per cent. Some sat the same situation can be found in Sweden (Meidner, 1978, p. 38-39) and in corporations with a widely diffused ownership structure in other countries.
In the UK a number of attempts have been made to raise this average per cent of voting. The Cadbury Report (1992) urged institutional investors owning the majority of the shares of UK listed companies, to "make positive use of their voting rights and disclose their policies on voting." The National Association of Pension Funds and the Association of British Insurers recommends to vote wherever possible. The Hampel Report (1998) refers explicitly to the responsability of institutional investors to make "considered

use of their votes". As a consequence the average level of voting increased to more than 40% in the second half of the nineteen nineties (Mallin, 2001, p. 124). Second the Department of Trade and Industry circulated different proposals in its document 'Electronic Communciation: Change to the Companies Act 1985' to enhance shareholders involvement in companies business by enabling electronic delivery of company communications, electronic voting and the appointment of proxies. These new proposals imply the necessity to identify the interest holders in shares: are they the custodians, the fund managers, the trustees or the beneficiaries of the trust (Stapledon and Bates, 1999, 22)?

In Germany the attendance of shareholders is significantly higher due to a specific system of proxies. It is common practice to mandate the bank which holds the shares in custody to vote the shares. For the largest companies on average between 55% and 64% of the votes were cast between 1995 and 2000 (Prigge, 1998, 967 and DSW, 2000, 9). The companies act explicitly mentions that in these circumstances banks have to act in the interest of the shareholder, but nevertheless they usually vote for the proposals made by management. A government commission is reconsidering the system and inter alia supports more accountability of all participants.

In the Netherlands a system has been set up by a number of large listed companies and in cooperation with the custodian banks to encourage shareholders to vote electronically. To that extend, the Dutch Civil Code has been changed to fix the date at which the shareholder must prove to possess the shares to which the votes are attached.

A new French law has abolished the regime that allows the bylaws of a corporation to stipulate that a shareholder may only physically attend a general meeting if he possesses a minimum number of shares. Second, videoconferences are explicitly allowed and the threshold for the right to call for an extraordinary general meeting has been lowered to 5% of the capital.

In Belgium a proposal has been made to oblige companies to publish the agenda of the general meeting 30 days prior to the meeting. This longer time-frame allows shareholders to reconsider their voting behaviour and support a more considered manner of voting.

It is important to note that these examples only give an incomplete overview of all the measures that have been taken throughout Europe to empower the shareholders. Second, it is still too early to study whether these measures effectively reduce the agency costs.

5. Corporate finance

Companies can use two mechanisms to raise capital: issuing equity or issuing debt. The use of debt in the capital structure generates specific agency

problems. The management and the shareholders can transfer wealth from the debtors to themselves. Limited liability shifts the risks of failure to the debtholders. Generally speaking company law does not protect creditors. Bond covenants are used to mitigate the agency bondholder-stockholder conflict.
However, the European directives protect creditors in a number of ways. The Second Company Law Directive protects creditors if a company reduces its capital. Article 32 stipulates that creditors whose claims antedate the publication of the decision to reduce capital are entitled to obtain security for claims which have not fallen due by the date of that publication. National law must prescribe the conditions for the exercise of these rights and eventually grant further rights.
Second, in case of mergers the Third Company Law Directive requires the European member states to provide for an adequate system of protection of the interests of creditors of the merging companies whose claim antedate the merger but have not fallen due. The member states might opt for different protection for the creditors of the acquiring company and for those of the company being acquired.[33] An analogous protection system exists for creditors of companies being divided.[34]
Third, distributions to shareholders are prohibited if the net assets are or will become less than the subscribed capital and undistributable reserves. This regime is also applicable for the payment of interim dividends.

6. Conclusion

Only recently economic theory has developed models to explain the existence of corporations. Corporations are more than a simple production function.
Corporations differ from other principal forms of organization by four characteristics: legal personality, limited liability, centralized management and free transferability of shares. Each of these characteristics has been briefly discussed. Special attention is devoted to the specific context in which European companies have to operate. The characteristics also offer explanations as to why individuals organize their activities in corporations.
A second part of this chapter analyses the key feature of the public corporation concerning the separation of ownership and control. The corporate form provides the means for an efficient mobilization of large amounts of capital, an important benefit. The separation also creates a number of agency problems, the potential costs. Corporate law is directed at mitigating agency problems. However this study shows that in a European

context ownership and control is only separated in a limited number of corporations thus creating other agency conflicts. As a consequence corporate law in continental Europe is less well developed to reduce the manager-shareholder agency conflicts. In some European countries, like the Netherlands and Germany, corporate governance structures seem to increase these agency conflicts. A market for corporate control does not exist in some European countries. Aligning the interests of the managers and shareholders with performance-related remuneration packages has only recently gained attention. Parliaments all over Europe are busy studying the implementation of new shareholder empowerment mechanisms. Notwithstanding these organisational differences the existing empirical studies have not (yet?) established a clear link of performance disadvantages of European companies.

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[1] Compare with article 1 of the Belgian Company Law.

[2] Article 2 (1) of the Twelfth Council Company Law Directive EEC/89/667 on single-member private limited-liability companies, Official Journal L 395, p. 40.

[3] However there exist many definitions of corporate governance.

[4] Section 135 of the German company code (Aktiengesetz,) lays down the proxy rules of banks. Section 613 Belgian company Code protects creditors against companies that reduce their capital.

[5] See the representation of "labour" in the supervisory boards of German Aktiengesellschaften (public limited companies).

[6] In France and Belgium abuse of company property is a criminal offence.

[7] See for an example the corporate governance rules for companies listed at Nasdaq Europe (Ministerial Decree of May 29, 2001, Belgian Official Gazette, June 8 2001, p. 19048).

[8] This view is highly contested (see R. Winter (1977), 'State law, shareholder protection and the theory of the corporation', Journal of Legal Studies, 6, 251-292.

[9] Danish citizens set up a private company limited in the UK with a minimum capital of 100 £ and wanted to start doing business in Denmark.

[10] For a discussion see De Wulf, H. (1999), 'Centros: vrijheid van vestiging zonder race to the bottom', Ondernemingsrecht, 321-324.

[11] See for an example the Dutch Civil Code section 2:5.

[12] In the United States limited liability was adopted between 1816 and 1847 (Carney, 1999, 664).

[13] Like a "commanditiare vennootschap op aandelen" in Belgium or a Kommanditgesellschaft in Germany and Austria. Those organizational forms of companies allow more flexibility in their internal governance structure. Further, the unlimited liability feature can be evaded if the members themselves are limited liability companies.

[14] See further on the centralized management.

[15] See further on agency theory.

[16] See the general theory of the capital assets pricing model.

[17] See article 7 of the Second Company Law Directive.

[18] Article 18 of the Second Company Law Directive.

[19] Article 19 of the Second Company Law Directive.

[20] Article 23 of the Second Company Law Directive.

[21] Article 32 of the Second Company Law Directive leaves it to the national law to prescribe the conditions for the exercise of the rights of the creditors.

[22] An important distinction between mandatory insurance and minimum capital requirement can be found in the appreciation of risks. If a corporation has a minimum capital it will not invest in excessively risky activities due to the monitoring of the shareholders. Insurance companies will probably not have the same direct monitoring capabilities and therefore the risk taking of insured companies will increase.

[23] Article 456, 4° Companies Law Code.

[24] Although not directly as in general the law does not allow the shareholders to govern the corporation. The board of directors has this mandatory duty. However, in most countries shareholders can dismiss the directors. This incentive enables the shareholders to influence corporate investment decisions.

[25] See article 2:9 of the Dutch Civil Code.

[26] Article 2373 Italian Civil Code.

[27] Article 524 Company Law.

[28] Cass. Crim. Fr. (Rozenblum) February 4, 1985, Dalloz 1985, 478, note Ohl; Revue des Sociétés 1985, 648, note Bouloc. In Belgian case law an analogous decision can be found, Brussels, September 15, 1992, Journal des Tribunaux 1993, 312.

[29] Article 43 (1) (12) of the Fourth company law directive, July 25, 1978, Official Journal August 14, 1978, L 222/11.

[30] Like in France where the total remuneration of each director, his stock options and "jetons de presence" must be disclosed (article 116, 117 and 132 Loi n° 2001-420 du 15 mai 2001 relative aux nouvelles regulations économiques (Official Journal May 16, 2001, nr. 113, p. 7776), ad also in Germany, the Netherlands and Belgium.

[31] For an overview of the decision making process, see Dendauw, C. and J.-P. Servais (2001), 'Articulation en droit belge des rapports entre le droit fiscal et le droit comptable: état de la question et perspectives d'évolution à l'aune de l'utilisation des normes IAS', Comptabilité et Fiscalité Pratiques, (365), 378-394.

[32] For Belgium see Van der Elst, 2002b, to be published; for Spain see Garrido, 2000, 24 p. and for Italy see Ruggiero, 1999, 79-110.

[33] See article 13 (3) the the Third Company Law Directive.

[34] Article 12 of the Sixth Company Law Directive.

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