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Chapter Four

Corporations and Shareholder Eugenics: How Corporate Law Sustains the Great Reversal in Shareholdership

Chapter Three constructed an index that quantified corporate rules with regard to their shareholder value-friendliness and was thus able to produce a trend line for the post-Bretton Woods development of corporate law (Figure 31) that mirrors the trend line for the post-Bretton Woods development of business capital accumulation (Figure 13). Thus, it was shown that it is plausible to expand the causality chain of the First Hypothesis by adding corporate law as a contributing factor to the Great Reversal in Corporate Governance (Figure 29).

The question, to which we turn in this Chapter, is whether to the array of legal and extra-legal institutions of Figure 10 that brought about the Great Reversal in Shareholdership corporate law should be added. In other words, is corporate law one of the determinant factors of the movement of shareholders’ towards shorter holding periods?

Ideally, following the example of Chapter Three the current Chapter should design an index quantifying the impact that corporate rules have on shareholders’ myopia. Nevertheless, such a venture would require an estimate of the exact time, by which shareholdership’s horizons are shortened, as a result of the introduction, abolishment or amendment of a certain corporate law provision; this estimate is practically impossible and would be entirely arbitrary.

In absence of such an index it would be too risky from a scientific point of view to name corporate law as one of the initiating factors of equity’s short-termism; there just wouldn’t be a great deal of convincing indications, so as to contend that corporate law has been one of the initiators of the Great Reversal in Shareholdership. This is why the Third Hypothesis that this Chapter seeks to buttress is more conservative compared to the two first Hypotheses. As mentioned in Section 3.4. of the Introduction, the Third Hypothesis claims that corporate law reforms in the post-Bretton Woods era that were intended to merely help this legal niche adjust to the era of ‘financialization’ have escalated the divestment of structurally long-termist institutional investors from equity positions and have preserved the trend towards shareholder short-termism that other institutions have directly caused. In other words, the Third Hypothesis presented here does not contend that corporate law has caused equity’s short-termism, but that it has made the latter more acute and has prevented a ‘reversal’ in the shareholder composition of listed firms that would bring more long-termist investors in the corporate governance game.

The attempt to back the Third Hypothesis in this Chapter is done by ‘cherry picking’ legal developments generating bias in favor of short-termism in the five jurisdictions (France, Germany, The Netherlands, UK, US), whose capital accumulation rates and movement towards shareholder value were
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studied in Chapters One and Three respectively. As far as the four EU jurisdictions of the sample are concerned, this time instead of studying corporate law developments that took place at the national level, reforms that took place at the EU level are studied. The focus on developments at the EU level also helps illustrate better the point that was made in Section 4.2. of Chapter One that the European Court of Justice in interpreting the Treaty rules on the free movement of capital developed over time a case law that may be construed as preventing the engagement by firms in shareholder eugenics that would help them craft their shareholder base, so as to include more long-term shareholders.

The conservative character of the Third Hypothesis that does not acknowledge an initiating role for corporate law in the Great Reversal in Shareholdership, but only an ancillary one, makes one wonder whether shareholders’ myopia is eventually a trend that emerged mainly from extra-legal institutions or developments outside the sphere of private law. Indeed, a quick look at Figure 10 shows that apart from the abolishment of fixed commission rates for stock exchange transactions, there weren’t any serious (private) legal developments in the post-Bretton Woods era at least in Europe that can be viewed independently as contributory factors to the Great Reversal in Shareholdership. Was there really an impatience gene in investors waiting to be unlocked through the mere liberalization of capital movements and the deregulation in securities transactions costs? Developments in business law have nothing to do with that?

For the case of the US an answer to this question has already been given in Section 5.5. of Chapter One, where changes in banking regulation during the 1980s and the 1990s that indirectly promoted the Great Reversal in Shareholdership are described. But, for the case of Europe the issue is still wanting. Therefore, in Chapter Four before embarking on the effort to back the Third Hypothesis and complete this thesis’s triad of arguments some developments in non-corporate niches of EU business law are presented that have contributed significantly to equity’s increasing short-termism during the post-Bretton Woods era. In fact, a discussion of the non-corporate law legal constraints to long-term investing may push things faster towards a reform, as changes in corporate law traditionally move slower compared to other niches of business law, such as financial regulation. Thus, Section 1 below aspires to contribute towards this direction.

1. Non-corporate law legal constraints to long-term investing: infusing pension funds and insurance firms with myopia through financial regulation and accounting standards

For the purposes of our analysis we classify institutional investors into those, whose liability profile requires them to frequently liquidate a considerable percentage of their assets in order to service short-term obligations towards their beneficiaries and into those, whose liability structure allows them to defer the
distribution of a greater proportion of their current assets for the distant future. The former category of investors entails institutions that are structurally short-termists (mutual funds, private equity funds), while the latter entails those that have at least the inner potential of becoming long-termists (sovereign wealth funds, university endowments, insurance firms, pension funds)\textsuperscript{988}.

From the potentially long-termist institutional investors, life insurance firms and pension funds stand out, as the systemically most important investors with total assets under management close to $11 trillion and $30 trillion respectively, as per August 2008, i.e. a month before the financial meltdown that led to the ongoing crisis started\textsuperscript{989}. Sovereign wealth funds (‘SWFs’) are sizeable only in countries with substantial fiscal surpluses (e.g. Norway)\textsuperscript{990} and financial endowments in countries with big private universities and foundations (e.g. US)\textsuperscript{991}; together these two types of institutions have in total around $5 trillion under management\textsuperscript{992}.

The influence that pension funds and life insurance companies can have as shareholders on corporate governance is substantial, since a great proportion of their assets are directed towards equity ownership in listed corporations. For instance, before the race to safer assets and the ‘\textit{evaporation\textquoteright} of equity value occurred in the post-2008 crisis domestic pension funds and insurance companies in the US held together close to 30\% of the stock in listed corporations\textsuperscript{993}, around 26\% in the UK\textsuperscript{994} and around 28\% in Japan\textsuperscript{995}\textsuperscript{996}. If there were adequate data concerning the identity of foreign investors in the stock exchanges\textsuperscript{997}, then we would certainly find that the total percentage of stock held by pension funds and insurance companies globally would be greater than the aforementioned.

\textsuperscript{988} In this I largely follow the classification of the World Economic Forum; see supra note 137
\textsuperscript{990} SWFs can be further classified into multigenerational, whose purpose is to save the state’s surpluses for future generations, and stabilization funds that seek to reduce the volatility in the state’s revenues. It is the multigenerational SWFs that have the potential of becoming long-term investors and particularly long-term equity investors, as they invest about 50\% of their assets in shares, while the stabilization funds invest exclusively in cash and fixed-income assets, as they fulfill a different role; see WEF, supra note 137, 29. For instance, the Norwegian Government Pension Fund – Global (\textit{Statens pensjonsfond utland}) managed by Norway’s central bank invests the surplus generated by the Norwegian petroleum sector in 8,300 listed companies worldwide; see Het Financieele Dagblad, 8 November 2010.
\textsuperscript{991} Endowments of non-profit organizations have a mandate to exist in perpetuity and to provide a steady income for their beneficiaries; two of the largest are the Harvard and the Yale University endowments.
\textsuperscript{992} See supra note 653
\textsuperscript{993} Data source: US Flow of Funds (2006)
\textsuperscript{994} Data source: Office for National Statistics (2008)
\textsuperscript{995} Fact Book of the Tokyo Stock Exchange (2006)
\textsuperscript{996} Percentages include equity holdings of all insurance companies, not only life insurers.
\textsuperscript{997} The percentage of foreign investors in EU stock exchanges was 37\% at the end of 2007; see Federation of European Securities Exchanges, \textit{Share Ownership Structure in Europe} (2008), 8. Available at http://www.bourse.lu/contenu/docs/commun/societe/Actualites/2008/FESE_SHARE_OWNERSHIP_SURVEY_2007.pdf
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Given the liability structure of pension funds and life insurance companies these two types of institutions could use their equity positions to generate accumulation-friendly long-termist influence on corporations. Currently though, they are not given the proper incentives by international accounting standards and financial regulation to extend their average holding period of stock and exert this positive influence. In fact, as it will be shown below, new rules have forced institutions to increase their buffers of liquid investments and move away from equity investments and towards liquid debt investments.

1.1. Mark-to-market accounting and pension funds

As far as pension funds are concerned, the forces of short-termism have been released by the relevant international accounting standards. A fundamental issue in pension finance is whether the pension plan’s assets and liabilities have to be reported on the financial statements of the company (employer) sponsoring the plan or not. If accounting rules require this reporting on behalf of the sponsor company (employer), then the financial interests of the pension fund, to which the plan’s assets legally belong, and the interests of the sponsor company become interwoven, since the fund’s performance will affect the financial position of the company. The interweave becomes more acute in defined benefit plans. Pension plans are classified into defined contribution and defined benefit plans. Under a defined contribution (‘DC’) plan, the employer promises to pay specified contributions to the pension fund without having any further obligation to put more in case the fund cannot eventually cover the employee’s entitlements upon retirement. Under a defined benefit (‘DB’) plan, the employer promises to pay a specified level of pension to the employee, calculated on the basis of a formula, whose constituents include the employee’s salary while in service and the length of the service; this promise brings with it a constructive obligation on behalf of the employer to make further payments if the fund does not have sufficient assets to pay the promised pension.

Until recently in many OECD countries it was not necessary to report the net balance of the pension fund’s assets and liabilities on the sponsor company’s financial statements; at best, disclosure was required to be made only in the notes to the corporate accounts. Nevertheless, things changed during the past decade. The EU issued Regulation No. 1606/2002, by which it required the EU listed corporations’ financial statements from 2005 onwards to be prepared according to the reporting standards of the International Accounting Standards Board (‘IASB’). The IASB had issued since 1985 IAS 19 pertaining to the appropriate method of reporting the cost of providing post-employment benefits.

996 DAVID BLAKE, PENSION FINANCE (2006), 79
997 Pensioenmonitor, Pensioen & Verzekeringskamer (PVK) (2003), 16
1000 JUAN YERMO & FIONA STEWART, PROTECTING PENSIONS: POLICY ANALYSIS AND EXAMPLES FROM OECD COUNTRIES (2006), 45
benefits on the company’s (employer’s) financial statements. The European Commission issued Regulation No. 1725/2003\textsuperscript{1002}, by which it made the adoption of the accounting rules set out in IAS 19 compulsory for listed corporations. IAS 19 required the employer in the case of a DB plan to recognize in its financial statements the present value of expected future payments required to settle the defined benefit obligation, as adjusted for unrecognized actuarial gains and losses and as reduced by the fair value of the pension plan’s assets (IAS 19.54). Actuarial gain or loss is the one arising from the difference between estimates and actual experience in a company’s pension plan; actuarial gains and losses are in essence experience adjustments, as they show on the corporate financial statements the effects of differences between the previous assumptions about the fund’s performance and what has actually occurred\textsuperscript{1003}.

The way actuarial surplus or shortfall is calculated and recognized is determinative as to whether the sponsor company will have to unleash short-termist forces upon the governance of the pension fund. The accounting convention that used to prevail was that due to the volatility that exists in financial markets, where the pension fund’s assets are invested, the long-term actuarial gains and losses may offset one another and therefore the sponsor company would not have to recognize these shortfalls or surpluses immediately. Accounting conventions used to introduce some temporal smoothing for these pension funds’ deficits or surpluses. This approach though has changed recently and the accounting convention worldwide has moved towards a more ‘mark-to-market’ approach\textsuperscript{1004}.

In the UK the national accounting standards body introduced in November 2001 standard FRS17, under which actuarial gains and losses are immediately recognized in a Statement of Recognised Gains and Losses that is attached to the company’s (employer) P&L account. As a result of this approach, the investment results of the pension fund may have a major impact on the financial results of the company, whose pension scheme the fund is implementing; a shortfall in the pension fund’s results will be reflected immediately in the company’s financial statements, indirectly affecting the firm’s share price. Thus, the company has a stake in the performance of the pension fund’s portfolio and it will thus seek to influence the investment policy of the fund, so that the latter does not jeopardize the short-term financial position of the firm. As a result, the pension fund will receive pressure to apply a short-time investment horizon to minimize the risk of a negative impact of its activities on the company running the pension scheme; the long-term policy that a pension fund structurally requires, in order to fulfill its objectives, is thus watered down by the imminent interests of the employer, as a result of FRS17.


\textsuperscript{1004} Jaap Winter, Aandeelhouder Engagement en Stewardship, in SAMENWERKEN IN HET ONDERNEMINGSRECHT (2011), 47
The same short-termist pressure is now applied by sponsor companies in the governance of US pension funds, as in September 2006 the Financial Accounting Standards Board (‘FASB’) reformed the pension accounting standard of FAS 87 and required immediate recognition of actuarial gains and losses in defined benefit plans.\textsuperscript{1005}

The IAS 19 currently adopts the so-called ‘corridor approach’ with regard to the recognition of actuarial gains and losses allowing companies not to recognize gains or losses that do not exceed 10\% of the greater of the defined benefit obligation or the fair value of plan assets (IAS 19.92-93). Nevertheless, the immediate recognition of gains and losses on the employer’s financial statements became an option as a result of an amendment to IAS 19 that was effectuated in December 2004. That means that companies that have succumbed to market pressures to report immediately on their financial statements the actuarial gains and losses of the pension funds they are sponsoring are already exerting short-termist influence on the governance of EU pension funds even under the current regime of IAS 19\textsuperscript{1006}. But, the immediate recognition of pension fund’s surpluses and deficits might become the norm for everyone in the EU shortly under the contemplated IAS 19 reform that seeks to abandon the corridor approach altogether; as a result, I would expect pension funds to be induced by sponsor companies to de-risk their portfolio and divest from long-term positions\textsuperscript{1007} that bring with them the possibility of having to ride out periods of short-term volatility.\textsuperscript{1008} All in all, the new accounting standards promote the integration of the sponsor’s pension-funding decisions with corporate-finance decisions.

1.2. The ‘Prudent Investor Rule’ in pension fund management

As briefly mentioned in Section 3.3. of Chapter One the rise of the institutional ownership of stock from the 1970s and onwards was accompanied by the rise to dominance of the Modern Portfolio Theory (‘MPT’) in the field of asset management. The financial economists that developed the MPT sought ways, by which an asset manager can obtain an optimum balance between risk and return. The hallmark of the MPT is the ‘total portfolio approach’, which means that the manager should not be worried so much for the return on an individual investment, but for the return that will be achieved on the whole portfolio. Corollary to MPT’s ‘total portfolio approach’ is the principle of diversification; managers should invest their funds in a wide array of securities and financial products, so as to minimize downside correlation and contagion risks among the portfolio’s assets and to guarantee the portfolio’s liquidity.

\textsuperscript{1005} See \textsc{Yermo & Stewart, supra} note 1000, 49
\textsuperscript{1006} \textsc{René Maatman, Dutch Pension Funds – Fiduciary Duties and Investing} (2004), 36
The development of computer technology since the 1970s facilitated this diversification effort. The manager sets the annual return that must be achieved on the invested capital and a computer-generated mathematical formula indicates the optimum asset allocation to obtain this result; to minimize the risk the formula indicates how to best allocate the assets to different investment categories and different securities, i.e. how to best diversify the portfolio’s assets 1009. Essentially, this means that very little human energy goes to selecting a particular security; pension funds increasingly become shareholders by virtue of a mechanical process based on algorithms rather than on the basis of a flesh-and-bone individual’s hand-selection. As a result, the MPT tenets coupled with advanced computer technology and financial valuation have disfavored relationship/long-term investing by institutional investors, including pension funds.

To be sure, diversification diverts the investor’s attention away from the choice of individual securities and directs it towards the balancing of the portfolio as a whole1010. In the case of an investment in shares this approach reduces the investor’s commitment to the specific firm, whose equity she is holding and requires the fund manager to sell the stock, as soon as an investment opportunity in another firm appears, which helps to better balance the portfolio. This leads to high frequency trading, which is also essential for the sake of liquidity, a favorable portfolio characteristic under MPT. But, liquidity does not go hand in hand with long-term investing, since a long-term position in a firm by definition means that the institution is willing to sacrifice liquidity1011.

In essence, MPT reduces equity ownership into a commodity with only two dimensions: risk and return1012; this ‘commodification’ of equity is not helping funds to become long-termist shareholders, since this would require them to view shares as titles of ownership. But, MPT is now well-embedded in the way institutional investors and particularly pension funds make their investment decisions not only because of its rise to dominance in practice, but also because of its institutionalization in the legal sphere through the ‘prudent investor (or person) rule’ that governs on both sides of the Atlantic the discharge of the fund trustees’ fiduciary duty to the their beneficiaries. To show how MPT has entered the legal sphere globally through the regulation of financial institutions I am going here to examine the legal regime of pension fund investment management in the US, whose pension funds represent 34% of the global pension assets and the respective regime in The Netherlands, whose pension funds represent 6% of the global pension assets making Holland the most important EU jurisdiction, when it comes to pension law and finance1013.

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1009 MAATMAN, supra note 1006, 230-232
1010 Winter, supra note 1004, 42
1011 John Coffee, Liquidity versus Control: The Institutional Investor as Corporate Monitor, 91 COLUMBIA LAW REVIEW 1277
1013 Dutch pension funds currently have a total of EUR 567bn under management rendering The Netherlands third in the global distribution of pension assets after the US and Japan and ahead of the UK.
The Netherlands amended recently its pension fund regime in order to align the relevant national rules with the EU Pensions Directive, the Pensions Act of 2007 (Pensioenwet – ‘PW’) replaced the Pension and Savings Fund Act of 1952 (Pension-en Spaarfondsenwet – ‘PSW’). The PSW required in Art. 9b that the monies of a pension fund be invested ‘in a sound manner’ (‘op solide wijze’). The meaning of the soundness requirement was not clear and it was left so on purpose by the legislative bodies, as a formal abstract definition could prove to be an unnecessary restriction for the investment freedom of the fund; the ratio legis was that the soundness criterion would be given content on a case-by-case basis against the background of the specific obligations of the in casu pension fund. In addition to this, it was expected that the (no longer existing) Pensions and Insurance Supervisory Authority (Pensioen- & Verzekeringskamer), would come to further specify the ‘soundness’ criterion within the scope of the exercise of its supervision tasks upon pension funds. While the issue of pension fund managers’ fiduciary duties was rarely litigated, thus not giving the competent courts the opportunity to shape the criterion’s content, a good part of Dutch literature was in favor of a more restrictive interpretation of ‘soundness’ pointing to a more defensive investment approach. However, the dominant view –perhaps more in line with the legislative intent- seemed to be that the criterion gave pension fund managers a good deal of investment freedom.

In 2007 Art. 135(1) of the PW in line with Art. 18 of the EU Pensions Directive replaced the ‘soundness’ requirement of the PSW with a well-known standard deriving from Anglo-American trust law, i.e. the ‘prudent person’ rule. The ‘prudent person’ standard is globally understood as giving broad authority to invest the pension assets and as requiring the fund’s governing body to fulfill the investment management function with the skills and knowledge that an expert in the asset management industry would bring to the required tasks.

To be sure, in legal methodology the ‘prudent person’ rule would qualify as an undefined normative legal concept. When a legal rule that contains such a concept is applied in a particular case, its meaning ought to be shaped

and all other EU jurisdictions; see P&I/TW Top 300 Pension Funds – Analysis at 2010 year end (prepared by Towers Watson). Available at: http://www.towerswatson.com/assets/pdf/5351/TW-PI-300.pdf


Kamerstukken II (Dutch Parliamentary Documents of the Second Chamber), 1971-1972, 11529, no.5, pg. 3

Supra note 1006, 211 on the decision of Amsterdam’s Enterprise Chamber of 31 October 1991 (NJ 1992, 88).

See MAATMAN, supra note 1006, 216 fn. 23 with references to literature supporting this viewpoint.


W. Brugman, Pensioenwet, in PENSIOENRECHT – TEKST & COMMENTAAR (M. DOMMERHOLT & J. WIRSCHELL, EDS.) (2010), 273

with reference to the relevant evaluations of this broader group of people, whose
behavior is regulated by this rule\textsuperscript{1022}. So, in applying the ‘prudent person’ rule
the court ought to have recourse to the beliefs and assessments of fund
managers, as to what prudence means in managing assets on behalf of your
beneficiaries. Furthermore, the ‘prudent person’ rule should be seen as
embodying \textit{jus aequum}, in the sense that its content is not strict and fixed to a
crystallized set of asset managers’ beliefs, but it evolves over time, so that it can
be dynamically signified by what managers believe in the era that the rule is
called to application\textsuperscript{1023}. Therefore, in the era of the dominance of the MPT the
manager in question will be deemed to have abided by the ‘prudent person’ rule,
when she has followed the processes and the principles that the MPT dictates.
Consequently, the ideology of modern financial economics, which, as explained
above, favors short-termism and reduced commitment to issuers, has entered as
a Trojan horse inside the EU system of pension fund regulation by means of an
undefined legal concept.

In light of this character of the ‘prudent person’ rule, whenever the
practices of an EU pension fund manager are called into question, it suffices for
her to show that she has followed a reasonable and accepted investment
process\textsuperscript{1024}; the test of whether the fiduciary duty to the beneficiaries is
discharged properly favors process over results\textsuperscript{1025}. Prudently managing the
pension assets means avoiding undue risk and according to the MPT this is
procedurally done by diversifying well your portfolio\textsuperscript{1026}, as long as the fund
manager has followed the principle of diversification she won’t be held liable
even if the total return on the investments is poor\textsuperscript{1027}. After all, diversification is
explicitly mentioned as one of the investment rules in Art. 18 of the EU
Pensions Directive transposed into Dutch law through Art.135(c) PW and Art.13
of the Decree on the Financial Assessment of Pension Funds\textsuperscript{1028}. Diversification
with all its consequences is thus a legal institution of the pension world in The
Netherlands and the EU.

The situation is exactly the same in the US both for public and for
private pension funds. The only difference is that the name of the undefined
legal concept is ‘prudent investor’ rule. With regard to private US pension
funds, ERISA’s (see Section 4.3.1. of Chapter One) ‘prudent investor’ rule

\begin{footnotesize}
\textsuperscript{1023} HERMANN SOELL, \textit{VERWALTUNGSRECHT}, 9. AUFL., 173ff.
\textsuperscript{1024} MAATMAN, \textit{supra} note 1006, 220
\textsuperscript{1025} Teresa Ghiarducci, \textit{US Pension Investment Policy and Perfect Capital Market Theory}, 37 CHALLENGE 4, 7
\textsuperscript{1026} Note by the OECD Secretariat, ‘Prudent Person Rule’ Standard for the Investment of Pension Fund Assets, n. 18
\textsuperscript{1027} Diversification is Principle No.11 in the OECD Basic Principles of Regulation of Private Occupational Funds.
\textsuperscript{1028} Besluit van 18 december 2006, Stb. 710, houdende regels met betrekking tot het financiële
toetsingskader op grond van de Pensioenwet en de Wet verplichte beroepspensioenregeling, zoals dit
besluit is gewijzigd bij het Besluit van 20 december 2007, Stb. 572
\end{footnotesize}
requires managers to discharge their duties ‘with the care, skill, prudence, and diligence under the circumstances’ prevailing in the managers’ peer group\textsuperscript{1029}. Moreover, private pension fund managers are expected to diversify ‘the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so\textsuperscript{1030}. The management of public US pension funds is governed by the law of the state, wherein the pension fund is located. The vast majority of US states have now adopted the Uniform Prudent Investor Act of 1995 (‘UPIA’), which is applicable to all trusts (not only pension funds) and requires a trustee, who invests and manages trust assets to comply with the ‘prudent investor’ rule [§1(a)]. Just like the EU Pensions Directive puts forward some more specific investment principles in an attempt to shape the undefined normative legal concept, so does the UPIA state the trustee’s investment decisions with respect to individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole [§2(b)] and that a trustee shall diversify the investments of the trust (§3). The application of the MPT tenets is, therefore, unequivocally required in the management of US pension funds and what is mentioned above within the scope of Dutch pension funds applies here mutatis mutandis. US pension fund regulation institutionalizes the MPT and thus hampers pension fund’s structural potential of becoming long-term investors.

1.3. ‘Solvency II’ and life insurers

One of the implicit goals of Chapter Four is to show that legal institutions have a structural bias in favor of equity’s short-termism. To demonstrate this, it is necessary not only to point to pre-2008 legal developments that shortened the time-horizons of equityholders, but also to explain how the lawmaking path that is followed in the post-2008 world is set to produce the same consequences for shareholders’ time-preferences.

In late 2012 the EU ‘Solvency II’ Directive\textsuperscript{1031} will enter into force and will apply to insurance companies (including life insurers) and possibly pension funds as well. This Directive has so far been criticized as doing two things that are relevant to our discussion: (i) it introduces solvency constraints for life insurers that bias their time-horizons towards short-termism\textsuperscript{1032}; and (ii) it forces life insurers to rebalance their portfolio towards safer assets by migrating from equity positions to fixed-income securities\textsuperscript{1033}.

As it was mentioned above, life insurers have a liability structure that requires them to make investments in securities that provide long-term cash flows, so that the asset side of their balance sheets can match the liability

\textsuperscript{1029} ERISA, 29 USC § 1104(a)(B)
\textsuperscript{1030} ERISA, 29 USC § 1104(a)(C)
\textsuperscript{1031} Directive 2009/138/EC of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)
\textsuperscript{1033} Winter, supra note 1004, 47
Nevertheless, the Solvency Capital Requirement (‘SCR’) introduced by ‘Solvency II’ will measure life insurers’ solvency on the basis of short-term values, as risks will be controlled with a one-year horizon\textsuperscript{1034} their measurement, thus, becoming much more sensitive to market volatility\textsuperscript{1035}. In addition to this, life insurers will be penalized for holding assets with greater volatility, such as equity, as they will have to hold greater capital reserves in response. The SCR, i.e. the capital that an insurer will need to survive potential losses, is given by the combination of the Basic Solvency Capital Requirement (‘BSCR’) and the operational risk\textsuperscript{1037}. In measuring the BSCR market risk plays a central role; the market risk is the one that derives from the volatility of securities’ prices. A component of market risk is naturally equity risk, i.e. the risk that shares held by insurers will go down in value. ‘Solvency II’ introduces a shock scenario, where the solvency of the insurer is called into question, when the market value of the shares it holds plunges by 30% to 40% (depending on the country of origin of the issuer) [Art. 105(5)(b) & Annex IV]. This causes greater sensitivity on behalf of life insurers to volatility in share prices discouraging them from investing in the long-term, as that would require them to be prepared to ride out short-term volatility; more generally, this prudential regulation is likely to discourage them from investing in equity altogether. As a consequence, after the entry into force of ‘Solvency II’ the equity markets will most likely see structurally long-termists shareholders reducing their exposure to shares, thus leaving behind those that are structurally short-termists to influence corporate governance with a negative implication for accumulation dynamics.

2. Long-term investors and risk appetite: The lost opportunity of US corporate law to introduce effective corporate risk management

2.1. The relationship between corporate risk management and long-term investing

What financial regulation and accounting rules that were described in the previous section essentially do is that they affect a long-term institutional investors’ risk appetite. It is generally acknowledged that it is not only an institution’s liability profile that is crucial for its ability to be a long-term investor, but also its investment beliefs, i.e. whether the institution believes long-term investing can produce superior returns, its risk appetite, i.e. the ability and willingness of the institution to accept potentially sizeable losses, and its decision-making structure, i.e. the ability of the investment manager to employ a

\textsuperscript{1034} Bassanini & Reviglio, supra 1007, 37
\textsuperscript{1035} René Ricol, Report on the Financial Crisis (to the President of the French Republic), (Sept. 2008), 68. Available at http://www.norea.nl/Sites/Files/0000023746_080900_Ricol_Final_Report.pdf
\textsuperscript{1037} David Howden, Institutions in Crisis: European Perspectives on the Recession (2011), 92-93
long-term investment strategy. Putting an institution’s risk appetite at the heart of its ability to hold on to its investments for the long-term makes sense, because an institution that is not willing to accept moderate levels of risk, short-term volatility or potential permanent capital loss will not be able to employ a long-term investing strategy. When an investor considers making a long-term investment, it must have the patience to ride out periods, during which the portfolio securities will be producing unrealized capital losses; greater volatility must be tolerated and the temptation to divest in order to avoid further short-term plunges in value must be resisted by the investor.

The institution’s ability to invest for the long-term may be affected not only by rules shaping the risk management framework at the institution’s level, but also by the rules shaping the risk management at the level of the issuer of the security that is part or that may be part of the institution’s portfolio. That means that effective corporate risk management rules may reduce the uncertainties associated with certain equity securities and thus induce more institutions to invest in them for the long term. In the presence of stricter prudential regulation for pension funds and insurance firms the latter can tolerate less risk and the period, for which they can ride out volatility in connection with a security without divesting from it has shortened; good risk management on behalf of the issuer though can decrease the security’s volatility and shorten the potential periods, for which its performance brings an unrealized short-term loss to these investors. In other words, the assumption here is that good corporate risk management can make the issuer’s shares a safer investment and thus make them more conducive for long-term investing.

The assumption that good corporate risk management may extend the average holding period of stock is backed by evidence that shows that long-termist shareholders tend to invest more in acquiring information about the effectiveness of risk management in a corporation, whose shares they consider investing in or have already invested in, and by case studies that show that when corporations reduce particularly the risks that are associated with earnings management (e.g. by effectively giving up their ability to ‘cook the books’), their share’s volatility drops dramatically indicating that a greater number of patient investors with low portfolio turnover pick the firm’s stock. When long-term investors try to assess risk, what matters is not the next quarter’s earnings, as is the case for short-termists, but the corporate strategy and the policies designed to carry it out, including risk management.

1038 See WORLD ECONOMIC FORUM, supra note 137, 10
1039 Id., at 21
1041 Drexel University Center for Corporate Governance Roundtable on Risk Management, Corporate Governance and the Search for Long-Term Investors, 22 JOURNAL OF APPLIED CORPORATE FINANCE 58, 68
1042 Id., at 69
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It follows that if corporate law succeeds in introducing an effective system of risk management for issuers, then stock, even if it is not blue chip\textsuperscript{1043}, may be seen by long-termist institutions as a less risky and volatile asset to invest in.

Corporate law had the opportunity particularly in the aftermath of corporate scandals to institutionalize a system of corporate risk management that could reverse the trend among long-termist institutions to divest from equity and thus relieve firms from the pressure that they were receiving by short-termists to downsize and distribute in a way detrimental to the overall business accumulation dynamics. The question then is: did corporate law succeed in doing so?

2.2. Corporate law as a risk-seeking legal field

The notion of risk is central in corporate law, which in fact is a risk-seeking field of the law. The mere privilege of limited liability, the ‘bedrock’ of corporate law\textsuperscript{1044}, is designed to encourage risk-taking by guaranteeing to shareholders the upside benefit of a venture while insulating them from downside exposure. The business judgment rule, a standard of review of managerial actions that has lately spread from the US to the corporate laws of various other jurisdictions (see Section 2.4.2. of Chapter Three), as well as other liability standards that grant managers wide business discretion are also designed so as to ensure that directors and officers feel free to take risks without fearing that their risk-taking actions are likely to cause their personal liability\textsuperscript{1045}. Even private ordering corporate governance arrangements, which are made possible by enabling corporate law provisions, are focused on inducing managers to take more risks. Shareholders, being the residual claimants of the corporation want managers to increase the firm’s profitability and since there is a positive correlation between risk and return shareholders want to induce

\begin{center}
\textbf{Corporate Risk Management and Equity’s Time-horizons}
\end{center}

Effective corporate risk management on behalf of the issuer has the potential to attract more long-termist shareholders.

\textsuperscript{1043}Empirical studies have shown that when it comes to equity long-termist investors, such as SWFs, prefer blue chip stocks rather than growth stocks; see Christopher Balding, \textit{A Portfolio Analysis of Sovereign Wealth Funds}, (2008). Available at SSRN: \url{http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1141531}.

\textsuperscript{1044}Simon Deakin, \textit{The Coming Transformation of Shareholder Value}, 13 \textit{CORPORATE GOVERNANCE} 11, 11

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managers to take more risks by tolerating executive compensation schemes that promote risk taking.

In light of the above, one can easily understand that a certain risk culture is inescapably developed within corporations. Insufficient risk-taking on behalf of the management would mean low returns for the firm and its investors. But, risk is not always beneficial; there is a difference between optimal risk-taking and excessive risk-taking (see Figure 32). To get higher returns one needs to bear higher risks, but higher risks are also associated with a higher probability of loss, which is a painful experience for firms and investors alike. Profitability can thus be a destructive measure of performance without risk control\(^{1046}\); excessive risk taking may result in reduced firm earnings or even bankruptcy\(^{1047}\). This is why under modern corporate law firms are supposed to be required to install risk management systems, in order ‘to strike an optimal balance between growth and return goals and related risks’\(^{1048}\). But, what lengths does corporate law really go to in order to ensure that a sound risk management is actually installed in firms?

\[\text{Relative Risk and Return}\]

\[\text{Figure 31 - Relative Risk and Return}\]

Source: JAMES LAM, ENTERPRISE RISK MANAGEMENT (2003), 5

\(^{1046}\) MICHEL CROUSHY, DAN-GALAI & ROBERT MARX, THE ESSENTIALS OF RISK MANAGEMENT (2006), vii

\(^{1047}\) JAMES LAM, ENTERPRISE RISK MANAGEMENT: FROM INCENTIVES TO CONTROLS (2003), 4

\(^{1048}\) The Committee of Sponsoring Organizations of the Treadway Commission (COSO), ENTERPRISE RISK MANAGEMENT – INTEGRATED FRAMEWORK, EXECUTIVE SUMMARY, (Sept. 2004), 1. Available at http://www.coso.org/Publications/ERM/COSO_ERM_FacultySummary.pdf

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2.3. Risk management and legislative response to corporate scandals

Risk-taking might have been in the center of corporate functioning and in the ratio legis of several corporate law rules for decades, but it was not until recently that the notion of risk management as a distinct corporate governance device emerged. Shareholders were always thought to constitute a more efficient layer of risk management, as they could hedge against risk at a lower cost than the issuer by diversifying their portfolio. This viewpoint started changing in the 1990s, when some severe cases of risk mismanagement shook the corporate world in the US, the UK, Germany and Japan with venerable institutions, such as Barings Bank, Metalgesellschaft AG and Sumitomo, experiencing billions of losses because of inadequate oversight of traders and inadequate understanding of trading strategies by firms’ board and senior management. Then came the corporate scandals of the early 2000s (Enron, WorldCom, Adelphia) that revealed that corporations were failing to manage those risks that were specifically associated with related-party transactions and earnings management.

In response, many firms adopted an enhanced risk management system, best practices guides for risk management and credit rating agencies announced that they would rate companies’ by also taking under account their risk management arrangements. Risk management systems were emerging as another agency cost control mechanism.

Corporate law and securities regulation, traditional devices for providing alleviation to the problems of agency costs and concomitant informational asymmetries, followed with a failed attempt to institutionalize risk management in listed corporations. The reforms mostly focused on imposing a strict environment for managing the operational risks pertaining to self-dealing and accounting fraud, i.e. the issues that caught media attention as a result of the Enron and WorldCom scandals. A deeper realignment of the way public corporations are managing risks was not attempted apparently out of fear of creating the impression to managers that risky decisions would be penalized. The introduction of specific rules on risk management was believed that it would hamper risk-taking altogether. Thus, the legal provisions pertaining to

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1049 Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982)
1051 Harner, supra note 14, 6
1052 See COSO, supra note 1048
1054 Bainbridge, supra note 14, 981
1055 The idea that it is difficult to disentangle risk management from risk-taking was also expressed in a different manner in the recent post-crisis Delaware Chancery Court adjudication on the losses incurred by Citigroup In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 123 (Del. Ch. 2009)
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risk management were more of a scarecrow turned to a perch\textsuperscript{1056} for management rather than a meaningful limitation on excessive risk-taking. The love for risk in corporate law prevailed over the misgivings that negative externalities would continue ensuing from the traditional deferential approach to the risk culture of the corporate world. The side effect was that corporate law missed the opportunity to create a corporate environment that would attract long-termist investors after years of steady divestment by the latter from equity securities.

To illustrate the above statement, I focus below on the effect of the efforts undertaken in the early 2000s in the framework of US \textit{lato sensu} corporate law (see Section 1.3.2.1. of Chapter Three for the term) with regard to the issue of corporate risk management.

2.4. The unfulfilled promise of the Sarbanes-Oxley Act

The enactment of the Sarbanes-Oxley Act (\textit{\textbf{SOX}})\textsuperscript{1057} in the US in the aftermath of the Enron and WorldCom scandals marked another act in that play that started with the New Deal where in every small or large-scale Wall Street crisis Main Street, i.e. the federal government, attempts to make inroads to the corporate governance of public corporations, an area that traditionally is a responsibility of the states\textsuperscript{1058}. SOX aspired mainly to tackle the specific risks associated with self-dealing, accounting irregularities and inadequate or fraudulent financial reporting, but also attempted to \textit{indirectly} introduce a broader system of risk management in public corporations.

First of all, SOX directed the SEC, the national securities exchanges (e.g. NYSE) and securities associations (NASDAQ) to establish standards relating to the independence of audit committees in order to ensure the impartiality of the monitoring of the auditing process\textsuperscript{1059}. In response, the aforementioned self-regulatory organizations (\textit{\textbf{SROs}}) submitted, as they were required by law\textsuperscript{1060}, their new set of revised listing standards applicable to corporations listed on their indexes, which the SEC later approved.

The NYSE introduced an \textquoteleft Audit Committee Charter Provision\textquoteright\textsuperscript{1061}, pursuant to which the audit committee of a corporation has the duty \textit{inter alia} to discuss guidelines and policies with respect to risk assessment and risk

\textsuperscript{1056} The metaphor of the ‘scarecrow of the law’, taken by William Shakespeare’s play \textit{Measure for Measure} (Act 2, Scene 1, Line 1), is ingeniously used by Robert Monks in order to illustrate how corporate management manages to co-opt and neutralize all mechanisms of accountability that law tries to introduce from time to time; \textit{see} ROBERT MONKS & NELL MINOW, POWER AND ACCOUNTABILITY (1992), Ch. 4

\textsuperscript{1057} \textit{Pub.L. 107-204}, 116 Stat. 745, enacted July 30, 2002

\textsuperscript{1058} Under the Commerce Clause of the US Constitution the Congress does have the authority to legislate in the area of corporate law. However, many argue that federalism in corporate law should be constrained as it is inefficient for corporate America; \textit{see} Stephen Bainbridge, \textit{The Creeping Federalization of Corporate Law}, 26 \textbf{REGULATION} 32

\textsuperscript{1059} SOX Act § 301, 116 Stat. at 775

\textsuperscript{1060} Section 19(b)(1) of the Securities Exchange Act of 1934 and Rule 19b-4 thereunder

\textsuperscript{1061} Section 303A of the NYSE’s Listed Company Manual
management. However, according to the official commentary to this provision the audit committee is not meant to be the sole body responsible for risk management, as this is an area that remains within the responsibility of the firm’s senior management. The audit committee within the scope of the support that it provides to the board in the latter’s discharge of its monitoring function (‘a monitor within a monitor’) should discuss the major financial risk exposures and the steps management has taken to control such exposures. In its new risk management responsibilities the audit committee should be assisted by an internal audit function, which will provide the committee with ongoing assessments of the firm’s risk management processes. Thus, the NYSE rules created in response to SOX a three-layer system of risk management system in listed corporations. The board has the ultimate risk authority through its specialist arm, the audit committee that, apart from ensuring the integrity of the accounting information, becomes a risk watchdog; the senior management is responsible for the installment, operation and maintenance of an enterprise-wide risk management system that will ensure the flow of risk-related information bottom-up; and, finally, the internal auditors are assigned the task of scouring and scanning the risk management system in order to report to the audit committee.

The NYSE institutionalized risk management as a function of the audit committee in response to SOX, although it did not provide any guidelines as to how this function should be discharged. But, in SOX itself and the thereunder promulgated SEC rules the term ‘risk management’ is nowhere to be found. The SOX and the SEC rules introduce a series of burdensome obligations on senior management—especially the CEO and CFO—but none of them seems to relate to the evaluation of risk. Nonetheless, boardroom lawyers stressed that a risk management obligation of the senior management is implied by the new provisions and thus compliance with SOX obligations should also take into account risk management issues. Thus, while through the NYSE listing standards risk management was institutionalized at the board layer, SOX and the SEC rules—albeit indirectly—seem to have institutionalized risk management at the senior management level as well.

In an attempt to increase corporate responsibility within the scope of periodical reports that are filed with the SEC, a firm’s CEO and CFO are under SOX required inter alia to certify in each annual report that they have designed internal controls to ensure that material information relating to the business is made known to them and that they have disclosed to the audit committee any material weaknesses in the internal controls. Under SOX rules and the

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1063 Commentary to Section 303A(7)(d), id. at 13
1065 SOX Act § 302, 116 Stat at. 777
amendments that the SEC made to the reporting requirements the annual reports of the listed corporations should be accompanied by a certified CEO and CFO internal control report stating the responsibility of management for establishing and maintaining an adequate internal control structure, containing an assessment of the effectiveness of this structure and identifying the framework used to conduct the required evaluation of the effectiveness of the internal control.

The breadth of the putative risk management requirement that is thought to be indirectly introduced by SOX and SEC rule amendments depends on the definition of the term ‘internal control’. Is this supposed to mean a process leading to the preparation of a financial report that also entails risk considerations?

In the codified Statements on Auditing Standards (‘SASs’) of the American Institute of Certified Public Accountants (‘AICPA’), which provide guidance to external auditors regarding the auditing of an entity, internal control is defined as ‘a process […] designed to provide reasonable assurance regarding the […] (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations’ and consisting of five interrelated components: control environment, risk assessment, control activities, information and communication systems and monitoring. Although the definition of internal control that the SEC provided in the rules that were promulgated pursuant to SOX is based on the aforementioned SAS, it consciously omits the part that refers to the five components of the process. Therefore, at first sight risk assessment seems to be intentionally left out of the internal control process that the SEC requires from public corporations to implement and refer to in their annual reports. After all, the SEC admits to have refused to follow the suggestion of some of the commenters that took part in the rulemaking process to construct a broader definition of internal control that would incorporate risk management.

In light of the above, one would suggest that boardroom lawyers were wrong and that risk management was ruled out of the financial reporting procedure that was established by the SOX reforms. But, risk management actually managed to enter to the new corporate governance mechanisms through the back door.

The SEC, despite the exhortation of some of the commenters, did not provide explicit guidelines regarding the evaluation of the effectiveness of the firm’s internal control. In the promulgated rules the SEC merely stressed that ‘the framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control

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1067 See Item 307 of the SEC Regulations S-K and S-B
1068 SOX Section § 404, 116 Stat. at 789; SEC Rule 13a-15
1069 See text accompanying fn.149
1070 SASs AU § 319
1071 SEC Rule 15d-15
1072 See SEC Final Rule Release No. 33-8238
1073 Id.
framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. In its Final Rule Release Note the SEC expressly mentioned that although it does not mandate any specific such framework, the internal control framework established by the Committee of Sponsoring Organizations of the Treadway Commission (‘COSO’) -a private sector organization that publishes guidelines on several aspects of corporate governance- satisfies its criteria. Since the COSO internal control framework is the one, on which the aforementioned SAS definition was based, it follows that the SEC in the bottom line encourages the adoption of a framework that entails risk assessment as one of its inextricable components. Thus, companies, whose senior management has to abide by SOX, are urged –although not mandated- to adopt an internal control framework with a risk management aspect in order to play it safe and be sure that they comply.

Still though, I need to justify why I have characterized the SOX as a legislative attempt that failed to introduce an effective system of risk management into corporate governance. My critical approach to the direct or implied risk management provisions of SOX and its regulatory or self-regulatory progeny is based on the fact that they are in reality either misapplied or underenforced.

First of all, the business community in the US has since the enactment of SOX been complaining about the high costs of compliance with the certification requirements that outweigh the benefits that were supposed to accrue to investors from more accurate financial reporting. It is true that management has to expend considerable time in making sure it is compliant with the certification requirements of SOX, thus being distracted from its duty to focus on operating the business (a.k.a. opportunity costs). At the same time the corporation has to pay higher D&O insurance fees, as chances of management liability are in the post-SOX deemed to be higher. This has led management in most US public firms to follow a ‘compliance-by-checklist approach’ to SOX that actually results in corporations emphasizing form over substance, thus missing the underlying point of the SOX regulation, which was to introduce the concept of responsibility into financial reporting and corporate governance in general. This ‘compliance-by-checklist approach’ cannot be expected to form the basis for meaningful risk management within the internal control process since, as it was described above, risk management is encouraged but not required by the reporting firms. With the compliance costs being so high the

1074 SEC Rule 13a-15
1075 SEC Release, supra note 1072
1076 See COSO Internal Control – Integrated Framework (1992)
1079 Cheryl Wade, Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?, 39 LOYOLA UNIVERSITY OF CHICAGO LAW JOURNAL 595, 597
CEOs and CFOs have an interest in doing just the minimum they are required to do in order to comply. Performing ‘superfluous’ risk assessment within the internal control process, as the COSO framework would suggest, is just not economically rational for a large number of firms. Therefore, despite what the law says or implies, *ex ante private control of the risk management function* on behalf of the managers is ineffective. In other words, the US corporate governance regime provides managers with poor incentives to engage in meaningful risk management, effectively driving away long-termist shareholders from listed corporations.

However, corporate law is privately enforced not only by the managers, but also by the shareholders who are equipped with three default powers: the right to vote, the right to sell and the right to sue. I will resist the temptation to analyze how the right to vote and the right to sell might help in enforcing the risk management requirement upon the firm and I will instead focus on the last right to make my case: the right to sue. The right to sue has been very successful in functioning as a private enforcement mechanism of corporate law in the US. Thus, I am inquiring into whether it can also work as an *ex post private control of the risk management function* within corporations.

The first theoretical option for shareholders to *ex post* enforce risk management upon the firm would be to initiate litigation against the directors by using the NYSE rules that introduce the risk management responsibilities of the audit committee as a legal basis. However, US courts have repeatedly adjudicated that the listing standards of a securities exchange constitute part of a contract between the listed corporation and the exchange, so that rights and obligations flow *inter partes*. Therefore, the listing standard is from the shareholder viewpoint a ‘*res inter alios acta*’ and thus the shareholder has no right to enforce it by initiating civil litigation\(^\text{1080}\).

The second theoretical option for shareholders to *ex post* privately enforce the risk management requirements upon the firm would be to file a direct claim against the firm’s officers in the federal courts by using the relevant SOX provisions as a legal basis. Shareholders have in the past been successful in bringing either individually or in groups (a.k.a. class actions) direct suits against the management based on federal securities laws for injuries they have suffered\(^\text{1081}\). The permissibility of such a suit presupposes either an express right of action or an implied right of action in the federal securities laws. SOX does not grant an express right of action to shareholders against the officers, so that the former can hold the latter accountable in connection with their certification and internal control report obligations. Thus, the question is whether an implied private cause of action can at least be drawn by the relevant sections of SOX, i.e. §§ 302 and 404.


\(^{1081}\) Mark Jickling, Barriers to Corporate Fraud: How They Work, Why They Fail, CRS Report for Congress (Dec. 27, 2004), CRS-47. Available at www.policyarchive.org/handle/10207/bitstreams/18578.pdf

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One could suggest that the doctrine of implied private right of action is prominent in federal securities law since the one rule that has been the engine of the private securities litigation industry in the US in the last sixty years is SEC Rule 10b-5, which does not contain any express cause of action, but was judicially diagnosed to confer an implied private right of action upon individual investors. However, the doctrine of implied private right of action has entered an era of contraction mainly as a result of the jurisprudence of the US Supreme Court, which has tried to reduce the number of frivolous lawsuits in the federal courts that aspire to make a case by invoking a putative implied right of action. The US Supreme Court in an attempt to narrow the circumstances, under which an implied private right of action is diagnosed in a statute, has established as sole criterion the congressional intent, i.e. whether Congress intended to provide beneficiaries of the statute with the possibility or privately enforcing their rights. In other words, the technique of statutory interpretation that the US Supreme Court promotes with respect to the ascertainment of whether an implied private cause of action is contained in a provision is the legislative historical approach.

Indeed, shareholders did attempt to hold officers accountable for breach of their obligations under SOX § 302, one of the two provisions that relate to the certification requirements and the internal control system, which –as discussed above- could be construed as indirectly encouraging the adoption of a risk management system by a public firm. Unfortunately though, the federal courts in two cases denied to acknowledge the existence of an implied private cause of action under this provision by arguing that if Congress wanted a right of action to exist under § 302, it would provide for it explicitly, as it did in other sections of SOX, e.g. in § 306. This judicial precedent has effectively extinguished any hope there was for holding in the future officers accountable for irregularities regarding the risk assessment part of an internal control report by means of a direct claim brought under SOX.

Since SOX does not provide any built-in enforcement mechanisms to shareholders regarding corporate risk management, the final option for shareholders to *ex post* privately enforce the SOX putative risk management requirements would be to initiate corporate litigation at the state level, so as to propose a revised fiduciary duty analysis influenced by the SOX corporate

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1082 The implied right of action was institutionalized in 1946 in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946). It was upheld by the US Supreme Court in 1964 in I. Case Co. v. Borak, 377 U.S. 426 (1964)

1083 Louis Ebiner, *Sarbanes-Oxley Section 501(a): No Implied Private Right of Action and a Call to Congress for an Express Private Right of Action to Enhance Analyst Disclosure*, 93 IOWA LAW REVIEW 1919, 1925


1086 Lyman Johnson & Mark Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WILLIAM MITCHELL LAW REVIEW 101, 140
governance provisions. At first sight, such an attempt may seem as non-feasible from a legal point of view. But a closer look will prove otherwise.

I am not saying that SOX federalized the corporate law fiduciary duties of the senior officers. The latter remained an area regulated by state corporate law. However, in the political climate, in which SOX was passed, its corporate governance provisions pertaining to the new responsibilities of senior management were conducive to influence the state corporate law fiduciary duty analysis. At least, Delaware judges were willing to be influenced according to the statements they made in the post-Enron era. This is because Delaware, the state where the vast majority of US public corporations is chartered, could not afford to show incompetence in regulating corporate America. With SOX the federal authorities showed their teeth to Delaware by making inroads into corporate law and they were threatening to do it again if they felt that state corporate law was keeping on supplying insufficient safeguards for the investor community. Given that federal provisions preempt state law, Delaware was running the risk of being entirely wiped out by Washington if it continued being so deferential to its major interest group, the managers.

The only option for Delaware judges would be to be tougher on management. They could do so by being more willing to interpret the fiduciary duty doctrines in light of the heightened responsibility for officers that the SOX introduced. This would be the chance for shareholders to litigate for a broadened duty of care for corporate officers, under which the latter could be held liable for not installing an adequate internal control system in the spirit of SOX. Especially the installment of a rudimentary internal control system designed to ensure just mere formal compliance with the SOX requirements (see ‘compliance-by-checklist approach’), which would omit the risk assessment component that the COSO framework requires could be attacked as a breach of the officers’ duty of care. On the other hand, directors by virtue of their role as monitors of everything that senior management does or should do could also be held liable for not demanding a risk assessment component in the internal control report that is submitted to them according to the SOX requirements.

But did the politics of US corporate law finally helped shareholders in recouping some of their losses by holding management accountable for risk management failures? Unfortunately, the Citigroup case proved that lax risk

1087 However, this argument has also been presented in academic theory. See Robert Thompson & Hillary Sale, Securities Fraud As Corporate Governance: Reflections Upon Federalism, 56 VANDERBILT LAW REVIEW 859
1088See Vice Chancellor Strine’s paper Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUSINESS LAWYER 1371, 1373 (stating that the Enron case will exert pressure on courts to look more carefully at whether fiduciaries make good faith efforts to accomplish their duties)
1089Mark Roe, Delaware’s Shrinking Half-life, 62 STANFORD LAW REVIEW 125, 149
1090Mark Roe, Regulatory Competition in Making Corporate Law in the United States – And its Limits, 21 OXFORD REVIEW OF ECONOMIC POLICY 232, 233
1092Johnson & Sides, supra note 1086, 163
1093In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009)
management still has a long distance to cover in order to become part of those irregularities that according to courts of equity constitute breach of a fiduciary duty.

Citigroup was one of those corporations, whose shareholders suffered immense losses from its risk exposure to the subprime mortgage market. A derivative suit was thus filed in the Delaware Chancery Court attempting to hold the directors accountable for a breach of the duty of good faith, as they allegedly did not ‘make a good faith attempt to follow the procedures put in place [...] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup’s risk to the subprime mortgage market’\textsuperscript{1094}.

But Delaware judges, despite the pressure that they were supposed to feel in light of the circumstances surrounding the crisis and the new threat of Washington to take over corporate law, employed an old-fashioned argumentation that reconfirmed the deification of risk within the corporate law edifice: ‘[W]hat is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company.’\textsuperscript{1095}

Thus, to the 2006 question of three prominent US law scholars on whether SOX will bring any changes to the fact that state law imposes little risk on directorial liability\textsuperscript{1096}, the answer is: it didn’t. At the same time, to the question that was posed in Section 2.1. above on whether corporate law has succeeded in introducing an effective risk management system capable of making equity investments more attractive to long-termist institutional investors the answer, as far as the US is concerned, is again: it didn’t.

\textsuperscript{1094} Id., at 123
\textsuperscript{1095} Id., at 124
\textsuperscript{1096} William Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organizations (2006), 288
3. More food for short-termist shareholders: The facilitation of share repurchases

After examining the failure of corporate law in the US to introduce an institution that would reverse the trend of divestment of long-termist investors from equity securities, I now turn to an institution of EU corporate law that has the effect of attracting short-termist investors to corporations' shareholder base. This is the institution of stock repurchases, which has lately been facilitated by national corporate laws and EU corporate law alike. By presenting stock buybacks' effect on shareholder eugenics in this section and by showing how...
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corporate law has promoted stock buybacks’ use I back the Third Hypothesis and expose corporate law’s silent bias in favor of short-term shareholdership.

3.1. Share repurchases mechanics and the incentives they create

There are three main share buyback methods: (i) the open market repurchase program; (ii) the fixed-price self-tender offer; and (iii) the Dutch auction self-tender offer.

In the open market repurchase program a company buys its own shares on the exchange by keeping substantial flexibility over the timing, size and number of shares it buys. Of course the details of the program must be disclosed to the public prior to its start, but given that the firm must disclose the maximum consideration, the maximum number of shares to be acquired and the duration of the buyback period nothing prevents it from buying less than the maximum shares, for a smaller consideration or stop the repurchases before the program’s stated duration. Both in Europe and in the US open market repurchases are by far the preferred method of conducting a stock buyback.

Within the scope of a fixed-price self-tender offer the firm offers a single price to all shareholders for a specific number of shares. The self-tender offer often involves a significant premium to the traded share price and is valid for a specified period of time, during which shareholders may subscribe to the offer. A fixed-price self-tender offer may be very alluring even for non-momentum investors, as the premium offered might represent a value well above any increase in the share price that the shareholder was expecting in the mid-term. A fixed-price self-tender offer is thus a device at the management’s toolbox, by which it may offer to the shareholder a premium to divest from the firm; it’s a mechanism that reinforces ‘exit’ over ‘voice’ in shareholder governance.

The Dutch auction self-tender offer is to a certain extent coercive to shareholders and thus may result in them divesting from the firm before the planned time; although not such a popular method, it still has the potential of inducing shareholders to shorten their holding period. In a Dutch auction self-tender offer the firm establishes the maximum number of shares that will be repurchased and a price range. Then shareholders may tender at any price within the established range. Once the tendering period is over, the firm counts the tendered shares starting from those that were tendered at the lowest price and moves upwards until the maximum number of shares is reached. The last price observed in the counting process is the clearing price and all shares tendered at

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1097 See Paul Stonham, A Game Plan for Share Repurchases, 20 EUROPEAN MANAGEMENT JOURNAL 37
1100 Gustavo Grullon & David Ikenberry, What Do We Know About Stock Repurchases?, 13 JOURNAL OF APPLIED CORPORATE FINANCE 31, 31
that price or below that are eventually those repurchased by the firm. If the maximum price in the price range that the firm sets is well above any increase in the share price that the shareholder would expect in the near-term, then she has the incentive to tender at a price below the maximum, so as not run the danger to liquidate her investment at a lower price later. The Dutch auction self-tender offer has the potential of shortening the average holding period of stock in the firm’s shareholder base.

In Section 7.4.2. of Chapter One I pointed to the increasing number of share repurchases during the post-Bretton Woods era. I explained this rise by stating that stock buybacks are compared to dividends a preferred vehicle of distribution for firms, because they serve better both the interests of shareholders, as well as the interests of managers.

In a nutshell, I stated that by initiating a stock buyback the firm is signaling to the market that the share price is lower than a valuation of the firm’s fundamentals would suggest and is boosting earnings per share. Thus, share buybacks are used as signaling devices that help pump the share price up, managers benefit because the ensuing higher share price functions as a ‘natural’ takeover defense and because it allows them to realize higher capital gains by cashing in their stock options, while shareholders benefit by being able to realize higher capital gains by selling their stock.

The above statements are reiterated to show, why firms would prefer to distribute free cash flow by engaging in stock buybacks rather than by paying dividends. The assumption that share repurchases and dividends are substitutable vehicles of distribution is backed by empirical evidence that shows that firms buying back shares do it with funds that would have otherwise been used to increase the dividend level. This assumption coupled with the fore stated advantages of equity repurchases suggest that all things being equal firms have the tendency to pay out profits to shareholders by buying back stock from them, rather than by paying dividends. It follows that the more a legal regime facilitates share repurchases, the greater the number of share repurchases will be; the more the law facilitates the distribution mechanism that firms prefer, the more the latter are going to use it.

Prima facie, as long as share repurchases stay within the boundaries set by securities regulation, and they do not result in an unacceptable manipulation of the market, there seems to be nothing wrong with them or with a legal regime that encourages them. Nevertheless, apart from the remarks made right above regarding the divestment incentives stock buybacks create to shareholders, in this part I claim further that equity repurchases is food for short-termist shareholders, so that the more a firm uses them as a vehicle for distributions, the greater the number of short-termists gathering in its shareholder base is. Thus, if corporate law in the post-Bretton Woods era is

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1101 See Ofer & Thakor, supra note 548
1102 See Gustavo Grullon & Roni Michaely, Dividends, Share Repurchases and the Substitution Hypothesis, 57 JOURNAL OF FINANCE 1649
1103 e.g. Regulation (EC) No 2273/2003, supra note 1098
found to be contributing to the greater use of equity repurchases, then it is indirectly contributing to the proliferation of short-termism in corporate governance and the increasing abandonment of equity investments by long-termist investors. In other words, if corporate law is found to be increasingly facilitating stock repurchases, then the Third Hypothesis makes a valid point.

3.2. Why short-termists prefer firms that pay with stock buybacks

Momentum investors seek to profit from small differentials in the price of the stock. When the share price guarantees a profit to the short-termist institutional investor the investment manager puts a sell order. This order is often broken into several trades. This sequence of trades (‘sell package’) is executed over several days, since not all of the shares that the trading desk has received an order to dispose of have found a buyer the very first day of the trading sequence. However, this unavoidable delay in the actual execution of trades comes at a cost for the selling institution, because as a result of the sell order the supply of that specific stock increases with demand for it not necessarily changing instantly; therefore, a lower price equilibrium is created for the stock. This price impact of multi-day sell packages is documented in empirical studies, which identify that the price of the stock declines by several basis points between the first and the last day of the execution.1104

In quantitative finance the actual loss in value caused by the market impact of the selling pressure that the institution creates is measured in the framework of execution costs. ‘Execution cost’ is the difference between the final average trade price, including commissions, fees and all other costs and a suitable benchmark price representing a hypothetical perfectly executed trade.1105 Of course commission, taxes and exchange fees are excluded from the quantitative analysis of execution costs because they are predictable; what counts to see whether there was loss of value in the sell package is the price discrepancy between the benchmark price and the actual price, at which the stock was sold. The standard benchmark price in equity trading is the arrival price, i.e. the quoted market price in effect at the time the order was released to the trading desk.1106 Empirical studies have shown that when measured relative to this benchmark the principal-weighted average of the market impact cost is fairly large for institutions that seek to make a short-term profit by taking advantage of small price differentials.1107

1104 See Louis Chan & Josef Lakonishok, The Behavior of Stock Prices Around Institutional Trades, 4 THE JOURNAL OF FINANCE 1147 (22bp for the trades of 37 large investment managers in the US between 1986 and 1988)
1105 Robert Almgren, Execution Costs, in ENCYCLOPEDIA OF QUANTITATIVE FINANCE (2009)
1106 Id.
1107 Chan & Lakonishok, supra note 1104, 1161 (35bp for the trades of 37 large investment managers in the US between 1986 and 1988); Jacob Bikker et al., Market Impact Costs of Institutional Equity Trades, 26 JOURNAL OF INTERNATIONAL MONEY AND FINANCE 974 (33bp for the trades of the largest Dutch pension fund in the first quarter of 2002); Donald Keim & Ananth Madhavan, Transaction Costs and Investment Style: An Inter-Exchange Analysis of Institutional Equity Trades, 46 JOURNAL OF FINANCIAL ECONOMICS 265 (between 55bp and 143bp for the trades of 21 US institutions in the period between
It follows from the above analysis that short-termists fight with execution costs and will be tempted to buy stock from an issuer that is likely to help them have a smaller loss by the market impact that their selling pressure creates when they want to divest from the issuer’s securities. Issuers conducting stock buybacks purchase their shares *en masse* with the result being that the orders of their buy package buffer the market impact of the selling pressure of shareholders and allow the latter to incur smaller execution costs. Therefore, short-termists seeking to make a profit by taking advantage of small price differentials will rationally prefer to invest in firms that conduct stock buybacks regularly; their profit can thus be several basis points higher, if their sell order is matched by the firm’s buy order in the framework of a stock buyback.

In fact, the connection between stock buybacks and short-termist shareholders is so strong that it has led to the construction of the ‘monitoring hypothesis’ that suggests that one of the determinants of share repurchases decisions is the willingness of the management of the issuer to attract short-termist shareholders that engage in less active monitoring than long-term investors.

### 3.3. Why long-termist shareholders prefer dividend-paying stock

Unlike short-termists, long-termist shareholders prefer investing in dividend-paying stock instead of stock issued by firms, whose payout policy relies heavily on equity repurchases. The reason for that preference is found in tax law. In several jurisdictions a short-term capital gain is taxed unfavorably compared to the capital gain realized on stock that was held by the investor for a considerable amount of time. As a result, investors, who do not seek to make

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1991 and 1993); Ian Domowitz et al., *Liquidity, Volatility and Equity Trading Costs across Countries and over Time*, 4 INTERNATIONAL FINANCE 221 (executions costs for 42 countries in the period between 1996 and 1998; from 30bp average execution costs in France to 138bp average execution costs in Korea); Carole Comerton Forde et al., *Transaction Costs and Institutional Trading in Small-Cap Equity Funds*, 35 AUSTRALIAN JOURNAL OF MANAGEMENT 313 (32bp for trades of 12 small-cap equity funds active in the Australian Stock Exchange in the period 1996 to 2004);


1109 Id.

1110 Jurisdictions with favorable long-term capital gains tax include: Australia (shares held for more than a year means capital gains are calculated as discounted (50%) in the assessable income), Austria (capital gains realized on shares held for more than a year are tax-exempt), Czech Republic (capital gains realized on shares held for more than six months are tax-exempt), France (capital gains realized on shares held for more than 3 years in innovative new companies are tax-exempt), Germany (capital gains on shares held for more than a year and representing less than 1% of the firm’s nominal capital are tax-exempt), Greece (no capital gains tax if shares are held for more than one year), Korea (capital gains on shares representing more than 3% of the firm’s share capital and held for more than one year are taxed 10% less), Luxembourg (capital gains on shares held more than six months are tax-exempt), US (capital gains on shares held less than a year are taxed at the marginal ordinary PIT rate, while the capital gains for shares held for more than one year are taxed at a 15% rate); see OECD TAX
a quick profit by taking advantage of small differentials in the stock price, effectively defer/‘lock in’ their unrealized capital gains, because they expect the present value of their after-tax gains from selling in the future to exceed the after-tax gains from selling today. This is called a ‘capital gains overhang’ and its occurrence among those who seek something more than a mere profit from a small price differential is well-documented in empirical literature\textsuperscript{1112}.

Shareholders deferring the sale of their holdings may well be structurally long-termists and as such prepared to make illiquid investments, but a long-term equity investment is not supposed to be totally illiquid given the possibility of periodical distribution of dividends by the issuer. Therefore, a non-momentum investor that due to the capital gains overhang defers the divestment from the stock she invests in for a certain point in the future will prefer a dividend-paying stock because that will allow her to enjoy some liquidity until the time of divestment comes. An issuer who distributes a greater part of its free cash flow through stock buybacks is making to the non-momentum investor an offer that she cannot accept because of the ‘lock-in’ effect; therefore, stock of issuers that conduct more share repurchases and thus necessarily distribute lower dividends will be avoided by non-momentum investors that with the help of tax law become long-term shareholders.

3.4. The corporate law-propelled increase of equity repurchases

Traditionally, the corporate law of co-ordinated market economies (‘CMEs’) (see Section 4.1. of the Introduction) views equity repurchases with suspicion. At the heart of the capital maintenance system of CMEs’ corporate law lies the limitation of the distribution of net assets to shareholders for the benefit of creditors\textsuperscript{1111}; a stock repurchase represents a distribution of net assets and thus if the capital maintenance system is to function properly, buybacks should be controlled. Especially, if the price offered by the firm to repurchase the stock is higher than the actual value of the share, then the premium


\textsuperscript{1112} See Second Council Directive (77/91/EEC) of 13 December 1976 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent.
distributed to the shareholder could result in the net assets of the firm becoming lower than the amount of the subscribed capital plus the undistributable reserves. In other words, the avoidance of the watering down of the legal capital as a result of the stock buyback is the main reason why the CME approach to equity repurchases is traditionally so rigid compared e.g. to the US where share repurchases were always welcome because of capital maintenance being effected through the balance sheet and the equity insolvency tests.\textsuperscript{1113}

As a result, the general principle in CMEs was the prohibition of share repurchases with exceptions permissible under very strict conditions. As far as the EU jurisdictions that this study deals with are concerned, the Second Directive left them free to decide whether they would allow stock buybacks or not; if eventually allowed, the Directive required the Member States to subject the buyback to strict conditions that \textit{inter alia} required the buyback’s authorization by the shareholders’ meeting every 18 months and the value of the redeemed shares not to exceed 10\% of the subscribed capital.\textsuperscript{1114}

However, the increasing acknowledgment of the benefits of stock buybacks prompted EU jurisdictions to follow the example of other CMEs, such as Japan,\textsuperscript{1115} and relax their approach towards this vehicle of distribution.

Following the so-called ‘Esambert report’ that advocated for the facilitation of share repurchases on the basis of shareholder value creation,\textsuperscript{1116} France implemented in 1998 a new legal regime\textsuperscript{1117} applicable to share buybacks that essentially lifted the general principle of prohibition of share buybacks that existed under French corporate law previously. Under the pre-1998 regime French firms could buy back their own shares to annul them and reduce their capital, to distribute them to their employees within the scope of a stock option scheme and to stabilize their share price in the stock exchange.\textsuperscript{1118} Following the liberalization of the French legal regime the shareholders’ meeting could authorize –along the lines of the Second Directive- the board to conduct a stock buyback in pursuit of several other objectives. Therefore, distributions of free cash flow to shareholders through stock buybacks became legal in France. After the liberalization of the regime the total value of share repurchases in France skyrocketed (Figure 33); this implies according to the analysis in Sections 3.2. and 3.3. above that a greater number of short-termist

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{1113} See CLARK, supra note 912, 610ff.
\item\textsuperscript{1114} Art. 19 of the Second Directive, supra note 1112, as it was before its amendment through Directive 2006/68/EC.
\item\textsuperscript{1116} Bernard Esambert, Rapport sur le rachat par les sociétés de leurs propres actions (January 1998). Available at: http://www.amf-france.org/documents/general/3269_1.pdf
\item\textsuperscript{1117} Art. 41, Loi 98-536 du 2 juillet 1998
\item\textsuperscript{1118} Art. 217 & 217-2 of Loi no 55-637 du 24 juillet 1966
\end{itemize}
\end{footnotesize}
shareholders gathered around French firms from 1998 onwards and a greater number of long-termists divested from French equity.

In 1998 a similar reform facilitating considerably equity repurchases was made in Germany. Before 1998 German corporate law allowed share repurchases under exceptional circumstances, such as to prevent an imminent damage to the company, to award shares to the employees, to compensate shareholders in specific circumstances and to execute a reduction of capital. From 1994 onwards only financial institutions had the discretion on the basis of an authorization by the shareholders’ meeting to execute stock buybacks for purposes of securities trading. In 1998 the KonTraG liberalized – along the lines of the Second Directive – the legal regime of stock buybacks also for non-financial corporations adding another permissible objective for the execution of share repurchases. As a result, after 1998 the total value of share repurchases in Germany skyrocketed (Figure 33); this implies according to the analysis in Sections 3.2. and 3.3. above that a greater number of short-termist shareholders gathered around German firms from 1998 onwards and a greater number of long-termists divested from German equity.

Soon after these reforms though the entire legal capital regime of the Second Directive came under attack because of its rigidity and the European Commission initiated a consultation process to modernize it. A working group made recommendations on the Simplification of the Legislation on the Internal Market (‘SLIM’) and advocated for the further facilitation of equity repurchases. The recommendations were partially adopted by the European Parliament in March 2006 and thus the amending Directive 2006/68/EC was enacted that brought two significant changes to the Second Directive’s legal regime governing share repurchases in the Member States. First, national corporate laws may provide that the authorization by the shareholders’ meeting to the board to execute stock buybacks is valid for a period up to five years, rather than 18 months that it was previously. Secondly – and most important – national corporate laws are free to provide that the redeemed treasury shares may represent more than 10% of the subscribed capital, while previously 10% was the maximum limit.

Following the transposition of the amended Directive into their national laws France and Germany chose not to raise the maximum limit that treasury

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1120 AktG 71(1)
1121 Gesetz über den Wertpapierhandel und zur Änderung börsenrechtlicher und Wertpapierechtlicher Vorschriften (Zweites Finanzmarktförderungsgesetz) vom 26.07.1994
1122 AktG 71(1) no.7
1123 See supra note 887; AktG 71(1) no.8
1124 ADRIAAN DORRESTEIJN ET AL., EUROPEAN CORPORATE LAW (2ND ED.) (2009), 54
1126 IP/06/312, Brussels 14 March 2006
1127 Art. 19(1)(a) Second Directive
1128 Art. 19(1)(i) Second Directive
shares may represent above 10%\textsuperscript{1129}. The Netherlands though dropped the maximum entirely and left it up to the general meeting to decide whether there are going to be any limits in the authorized stock buybacks\textsuperscript{1130}. As a result the total value of share repurchases increased considerably in The Netherlands following the transposition of the amendment in May 2007 (Figure 34); even before that date the AMF, i.e. the Dutch financial markets supervision authority, had approved share repurchases over the 10% limit, when it became clear that the new regime would be more enabling. The increase implies according to the analysis in Sections 3.2. and 3.3. above that a greater number of short-termist shareholders gathered around Dutch firms from 2007 onwards and a greater number of long-termists divested from Dutch equity.

\textsuperscript{1129}Art. L.225-210 Code de Commerce; AktG 71(8)

\textsuperscript{1130}2:98(4) BW
**Stock Buybacks and the Great Reversal in Shareholdership**

The price impact of multi-day sell packages drives up the execution costs for short-termist traders who want to take advantage of small price differentials. Issuers conducting stock buybacks purchase their shares *en masse* with the result being that the orders of their buy package buffer the market impact of the selling pressure of short-termist shareholders and allow the latter to incur smaller execution costs. It follows that short-termist shareholders will prefer to invest in firms that distribute their profits by conducting share buybacks. On the contrary, long-termist shareholders who want to sell their equity holdings at a later stage in order to have a greater after-tax capital gain will prefer dividend-paying stock, since that provides them with liquidity during the prolonged holding period. It follows that long-termist shareholders will prefer to invest in firms that distribute their profits through dividends.

But, managers in the age of financialization have the natural tendency to distribute profits through stock buybacks rather than through dividends because of repurchases’ signaling and EPS boosting effects. Therefore, the more corporate law facilitates stock buybacks the more firms will naturally take advantage of the opportunity to repurchase their stock.

In the EU stock buybacks were facilitated in two waves. First, through a reform in national corporate laws in the late 1990s that effectively lifted the legal prohibition on distributing profits through stock buybacks and second through the amendment of the Second Directive that allowed Member States to drop the maximum limit in the percentage of shares that can be repurchased. As a result, stock buybacks in the EU skyrocketed after these reforms effectively attracting more short-termist shareholders into EU corporations’ shareholder base and driving away long-termist investors from EU equity investments. Consequently, corporate law in the EU has shown its silent bias towards short-termism, thus sustaining the Great Reversal in Shareholdership and proving that the Third Hypothesis makes a valid point.
Figure 32 - Total Value of Share Repurchases, EUR real millions (2000 prices), France & Germany, 1989 - 2005

4. Corporate law as an impediment to the introduction of loyalty structures in corporate governance

As mentioned in the introductory part to Chapter Four the Third Hypothesis claims that corporate law reforms in the post-Bretton Woods era have had two consequences, when it comes to the issue of shareholders' time horizons: (i) they escalated the divestment of structurally long-termist institutional investors from equity positions; and (ii) they have preserved the trend towards shareholder short-termism that other institutions have directly caused. While the corporate law developments regarding risk management and equity repurchases presented under Sections 2 and 3 above relate to the former ramification, this section deals with corporate legal provisions that relate to the latter ramification. To be more precise, the goal of this part is to show that certain corporate rules applicable in the four EU jurisdictions scrutinized in this study may be functioning as a repellent for loyalty structures, which could foster long-term shareholdership. Rules deriving from primary and secondary EU law that enjoy primacy over national corporate laws appear to have such a far-reaching effect, so as to effectively deprive corporations from the tools, which they could use to craft their shareholder base in a way that would allow them to
have more long-term shareholders. In other words, EU law indirectly does not allow firms to engage in shareholder eugenics and employ ‘shaping’ or ‘socialization’ strategies, by which their short-termist shareholders would be transformed into long-termist shareholders\(^{1131}\). Firms introducing loyalty structures risk to be found defendants in lawsuits brought by shareholders, who might think they have been treated unfairly compared to the ‘loyalists’.

The EU rules, whose influence on potential loyalty structures is studied in this part, are of two kinds. Firstly, there are the rules deriving from primary EU law, i.e. the Treaty provisions, as interpreted by the ECJ, that deal with the free movement of capital (Art. 63 TFEU). Secondly, there are the rules deriving from secondary EU law; the principle of equal treatment of shareholders with regard to distributions (Art. 42 Second Directive) and the rules of the Takeover Directive. The Treaty provision on the free movement of capital and the principle of equal treatment of shareholders with regard to distributions share something in common: they are both ambiguous and susceptible to dynamic interpretation\(^{1132}\). These attributes render the issue of whether they impede or not shareholder eugenics and the introduction of loyalty structures in corporate governance mainly an issue of legal interpretation. This legal interpretation is unavoidably affected by the dominant conceptual approaches to European integration and to corporate governance. In other words, the structural (legal) difficulties that the introduction of loyalty structures into European corporations incurs may be nothing more than a mere spillover effect of the way the Member States are integrating into an Internal Market with the help of supranational agents like the ECJ, as well as of the institutional logics of corporate governance and capital markets.

In the following sub-sections I attempt to make my case by presenting the two most popular loyalty structures that authors and policymakers allege they can steer long-term shareholdership, i.e. time-phased voting rights and loyalty dividends, and then show how primary and secondary EU law may actually be preventing their introduction. The ‘anti-loyalty’ direction that the interpretation of the rule on the free movement of capital and the principle of equal treatment of shareholders may take coupled with the outright effect of the Takeover Directive make firms shun using security design (i.e. awarding extra voting rights or bonus dividends to loyalists) to craft their shareholder base in a way, so as it can feature more long-termists.

To be sure, I do not agree with the ‘anti-loyalty’ direction that the legal interpretation of EU rules might be taking, as I believe that the relevant debate must be informed by the First Hypothesis that exposes the damage that short-termism can do to growth. The purpose of this part though is merely to reveal


\(^{1132}\) See Giulio Itzovich, *The Interpretation of Community Law by the European Court of Justice*, 10 GERMAN LAW JOURNAL 537, 555ff.
the problem that might exist with the current rules as a positive rather than as a normative issue.

4.1. Time-phased voting rights: How they might stumble upon the free movement of capital and the Takeover Directive

Time-phased voting rights, more commonly known as ‘loyalty shares’\(^{1133}\), are extra voting rights awarded to shareholders who have registered their shares and have held their stock for a specific amount of time determined in the corporation’s articles of association\(^{1134}\). This loyalty structure is of course out of the question in jurisdictions that have institutionalized the 1S/1V rule or that prohibit multiple voting rights. In the US (coercively imposed) time-phased voting rights programs are effectively prohibited under SEC Rule 19c-4\(^{1135}\), while from the EU jurisdictions under scrutiny in this study Germany prohibits multiple voting rights and thus German corporations cannot benefit from the loyalty benefits that would flow from the introduction of time-phased voting rights into corporate governance\(^{1136}\). The other European jurisdictions studied here do not have a blanket ban on disproportionate voting, but certain (corporate) legal institutions of EU origin that regulate the corporate governance of their firms might cumulatively be generating a structural bias against the adoption of time-phased voting rights. That is to say that none of the EU legal institutions that are presented below may alone have a decisive disincentivizing effect on the adoption of this loyalty structure. Nevertheless, these institutions taken together might actually be doing the damage and not encouraging firms to move towards long-termism through the designing of time-phased voting rights.

4.1.1. How does the mechanism of time-phased voting rights work: The example of French double voting rights

The paradigm type of loyalty shares is the one issued by French firms pursuant to an enabling provision of French corporate law\(^{1137}\). According to this provision a shareholder may receive in connection to her share a double voting right, if she has held this share continuously for a period of at least two years. The shareholder must have previously registered her shares in the firm’s share


\(^{1134}\) Piet Duflues, Geen Loyaliteitsdividend voor Langetermijnandeelhouders, 84 MAANDBLAD VOOR ACCOUNTANCY EN BEDRIJSECONOMIE 303, 312; Mathijs de Jongh, Reactie: Loyal en Duurzame Waardevoordeel, 17 ONDERNEMINGSHOOG 706, 707

\(^{1135}\) See John Elofson, Lie Back and Think of Europe: American Reflections on the EU Takeover Directive, 22 WISCONSIN INTERNATIONAL LAW JOURNAL 523, 554 (fn. 111)

\(^{1136}\) AktG §12(2). Apart from Germany a strict prohibition of multiple voting rights is found in the laws of Belgium (Art. 541 Code des sociétés), Spain (Art. 50.2 Ley de 1989), Portugal (Art. 384 of the Portuguese company law of 1.11.1986) and Italy (Art. 2351, comma 4 Codice Civile). In none of these jurisdictions would the introduction of time-phased voting rights be possible.

\(^{1137}\) Code de Commerce L. 225-123
registry. Once awarded, the double voting right cannot be transferred with the share, since it is not attached to the latter, but it is awarded to the person holding it by virtue of her loyalty. That means that contrary to what happens in Scandinavian jurisdictions, where multiple-voting stock belongs to one class of shares and common 1S/1V shares to another class\textsuperscript{138}, in France the loyalty shares belong to the same class with the firm’s 1S/1V shares\textsuperscript{139}. Because of the fact that the extra voting right disappears upon the transfer, the French loyalty shares are not traded at a premium to the common share, as the Scandinavian multiple-voting stock does.

The mechanism of time-phased voting rights allows long-term shareholders to keep control of the firm, even when their shareholdings are diluted; it is obviously a control-enhancing mechanism that brings about a deviation from the 1S/1V principle in the firm’s shareholder structure. Despite the criticism exercised to loyalty shares by the shareholder activists’ community\textsuperscript{140}, the majority of French corporations do make use of time-phased voting rights\textsuperscript{141}, since they view the support that long-termist shareholders offer as beneficial to the firm’s value and the increased control that accrues to the long-termists as a counterbalancing force to the pressure that is exerted upon the firm by speculators, whose short-term objectives may not always be aligned to the corporate interest\textsuperscript{142}.

Indeed the loyalty share has the potential of inducing shareholders to hold on their stock for a greater amount of time in order to acquire more influence over the corporate affairs. Moreover, once the extra voting right is awarded to a shareholder the increased influence the latter has gained generates a kind of ‘lock-in’ effect, given that the double-voter shareholder knows that she has over the fate of her investment in that particular firm a far greater degree of control than she would have been able to secure on any other equivalent investment. As a result, the firm will have got rid of some impatient capital that is poorly equipped to finance investment and fixed capital formation. The induced long-termist shareholders are more likely to allow the funds they

\textsuperscript{138} Jesper Lau Hansen, \textit{A Scandinavian Approach to Corporate Governance}, 50 SCANDINAVIAN STUDIES IN LAW 125, 137ff.

\textsuperscript{139} Nevertheless, it has been asserted that loyalty shares may effectively constitute a separate class of stock; see Michel Storck & Thibault de Ravel d’ Esclapon, \textit{Faut-il supprimer les actions à droit de vote double en droit français?}, BULLETIN JOLY SOCIÉTÉS (Janvier 2009) 90

\textsuperscript{140} See Pierre Henry Leroy, \textit{En réponse à Claude Bébéar: Contre le droit de vote double!}, LES ÉCHOS No 20129 du 12.03.2008, 15: ‘Au nom d’ une fidélisation hypothétique, l’ introduction du droit de vote double […] fondé sur le nominatif prive malheureusement tous les actionnaires étrangers qui ne peuvent ou ne souhaitent être au nominatif de ce droit…Allons donc! Quel investisseur autre celui qui contrôle minoritairement l’ assemblée déciderait de conserver ses actions parce qu’ il a des droits de vote double?’

\textsuperscript{141} A study conducted among 190 firms included in the SBF 250 (the market index representing the French firms with the greatest market capitalization) both in 2005 and in 2008 revealed that 68.4% of them make use of time-phased voting rights; see Nicolas Chene, \textit{Le droit de vote double en France – Panorama de son utilisation et impact en termes de valorisation des sociétés}, Mémoire de Recherche à HEC Paris (2008), 27. Available at http://www.vernimmen.net/hp/Nchene_Memoire_DDVdoubles.pdf

provide the firm with to be recycled into long-term capital-intensive projects before the latter come to fruition and the funds return to them in the form of dividends or other transitory distributions.

The loyalty share has the potential of strengthening tremendously the voting power of long-termists. The French case of loyalty shares may allow the doubling of the voting right of the loyalists, but in other jurisdictions, where the issue of loyalty shares is not regulated, private ordering may in principle create time-phased voting rights, in the framework of which the long-term shareholders’ voting power would be multiplied by more than two. In the mid-1990s a Delaware firm had initiated a time-phased voting rights plan, pursuant to which shareholders having held the stock for three consecutive years received ten votes per share, rather than two.¹¹⁴³

So far, French firms, required by law not to multiply long-termists’ voting power by more than two, have not been dragged to court by non-loyalist shareholders because of the issuance of loyalty shares. This is most likely because the doubling of voting rights of the loyalists has not caused a major degree of decoupling between cash flow and control rights in the shareholder structure of French firms, so as to be viewed in all cases as an outright control-enhancing mechanism. Empirical data have shown that only in one out of ten French firms has the institution of loyalty shares allowed the effective ownership regime to move from dispersed to concentrated and in only one out of five cases has the loyalty structure helped dominant shareholders secure the absolute majority of votes.¹¹⁴⁴ Indeed, in French firms of concentrated ownership that are using loyalty shares the ratio of the dominant shareholders’ voting rights to the dominant shareholders’ share capital is on average 1.21, which implies that loyalty shares do not cause a provocative degree of disconnection between control and cash flow rights.¹¹⁴⁵

But, what happens if private ordering in an EU jurisdiction wants to dilute the influence of short-termists over corporate governance by quadrupling or sextupling the voting power of long-termists? To this question, the following sub-sections will attempt to provide an answer.

4.1.2. The free movement of capital as a potential repellent to the introduction of time-phased voting rights

In the case of European integration Ernst Haas, the father of the theory of international relations, turned out to be wrong about renouncing the conceptual framework of neofunctionalism, which he had previously created to explain the processes of regional integration in the post-War world.¹¹⁴⁶ The neofunctionalist analysis of regional integration posits that in a regional

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¹¹⁴³ See Williams v. Geier, 671 A.2d 1368 (Del. 1996)
¹¹⁴⁴ Chene, supra note 1141, 38
¹¹⁴⁵ Id., at 37
¹¹⁴⁷ See Ernst Haas, The Obsolescence of Regional Integration Theory (1975)
organization, such as the EU, the members on the one hand set the initial agreement and on the other hand try to restrict its overreaching effects. Gradually though the promotor members are faced with a situation, where the supranational agents that they had established as guardians of the agreement (in the case of the EU: the Commission and the ECJ) seek to address the unintended consequences that the application of the agreement eventually had on policy areas resting outside its initially planned scope. The result is that promotor members cannot de facto control the supranational agents’ authority, which unavoidably starts expanding into different policy areas. Consequently, according to the neofunctionalist spirit integration in one policy area inevitably leads to integration in another because of a spillover effect. In the case of the European integration neofunctionalists noticed that

‘…once fixed in a given domain, European rules –such as relevant treaty provisions, secondary legislation, and the European Court of Justice’s (ECJ’s) case law- generate a self-sustaining dynamic that leads to the gradual deepening of integration in that sector and, not uncommonly, to spillovers into other sectors […] these processes gradually, but inevitably, reduce the capacity of the member states to control outcomes.’\(^\text{1149}\)

Indeed, the Commission and the ECJ evolved into the engines of European integration\(^\text{1150}\) and contributed in leaving behind the vision for the creation of a Ricardian free trade zone, where Member States would get to capitalize on their comparative advantages and preserve their different institutional settings\(^\text{1151}\).

At the early phase of European economic integration, which started in the 1970s and was consummated in the early 1990s, the ECJ sought through its case law to complete product market integration\(^\text{1152}\). In this phase the ECJ’s rulings did not yet put transformative pressure on supply-side institutions, but sought to foster competition between the Member States’ different institutional settings; this had in principle the potential of reinforcing differences between countries, as each one of them would seek to build on its respective strengths

\(^{1148}\) John Gerard Ruggie et al., Transformations in World Politics: The Intellectual Contributions of Ernst B. Haas, 8 ANNUAL REVIEW OF POLITICAL SCIENCE 271, 279

\(^{1149}\) Alec Stone Sweet & Wayne Sandholtz, European Integration and Supranational Governance, 4 JOURNAL OF EUROPEAN PUBLIC POLICY 297, 299-300


\(^{1151}\) Robert Franzese, Comparative Institutional and Policy Advantage: The Scope for Divergence within European Economic Integration, 3 EUROPEAN UNION POLITICS 177, 184ff.

and capitalize on its comparative advantage, so as to survive the competition in the free trade zone.\textsuperscript{1153}

The forces exerted on the supply-side institutions of the Member States appeared, as the European economic integration was entering its next phase. In Section 4.2.1. of Chapter One it was explained how the effort to promote the EMU gathered steam in the late 1980s with the Single European Act that pushed towards complete harmonization pertaining to the issue of free movement of capital. The Maastricht Treaty of 1992 unequivocally prohibited the restrictions on the free movement of capital both between Member States and between the latter and third countries (Art. 73b(1) EC Treaty; now Art. 63 TFEU). Following the enactment of this provision the ECJ undertook the task of turning it to the vehicle, by which European economic integration would enter in its post-Ricardian phase. The Treaty provisions on the free movement of capital would become the force behind the strive towards the creation of a level playing field between Member States, where institutional differences would be seen as an element of distortion of competition and would thus have to be eliminated.\textsuperscript{1154}

In 2002 the ECJ delivered three rulings on the issue of golden shares, through which it provided an authoritative interpretation of the Treaty provisions on the free movement of capital and paved the way for the elimination of institutional differences in corporate governance between Member States.\textsuperscript{1155} ‘Golden shares’ is an umbrella-term for various forms and ways, by which the State may be granted special rights to intervene in the share structure and the management of privatized firms.\textsuperscript{1156} In these joined cases the Court viewed the French and Portuguese legislation subjecting the acquisition of substantial shareholdings in privatized firms to the requirement of prior approval as a clear and direct access restriction. This was an unsurprising ruling given the ordoliberal approach that the Court had adopted over the years vis-à-vis public intervention in the economy.\textsuperscript{1157} Nevertheless, in this line of cases the Court was faced in respect with the free movement of capital with the fundamental question that had previously arisen with regard to all the other fundamental freedoms of the Internal Market: only measures, which discriminate against the foreign should be caught or any measure restricting cross-border movement regardless of whether it has an equivalent domestic effect or not? The Court’s view expectedly tilted towards the latter opinion:

‘Even though the rules in issue may not give rise to unequal treatment they are liable to impede the acquisition of shares in the undertaking

\textsuperscript{1153} Martin Höpner & Armin Schäfer, \textit{A New Phase of European Integration – Organized Capitalisms in Post-Ricardian Europe}, MPIfG Discussion Paper 07/4, 8

\textsuperscript{1154} See Miguel Maduro, Reforming the Market or the State? Article 30 and the European Constitution: Economic Freedom and Political Rights, \textit{3 European Law Journal} 55, 61


\textsuperscript{1156} Holger Fleischer, Comments on Cases C-367/98, C-483/99 and C-503/99, 40 \textit{Common Market Law Review} 493, 493

\textsuperscript{1157} See Maduro, supra note 1154, 61-62
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created and to dissuade investors in other Member States from investing in the capital of those undertakings.\textsuperscript{1158}

Therefore, the ECJ adhered to the view that the fact that a Member State imposes similar restrictions on domestic transactions is simply irrelevant\textsuperscript{1159}, a view, which essentially turns the Treaty provisions on free movement into a general proportionality review of national law affecting economic activity\textsuperscript{1160}. The implications of this approach can be far-reaching, as it paves the way for a broader ‘quality control’ review of national corporate law by the ECJ\textsuperscript{1161}. Thus, already since the three golden share cases of 2002 there were commentators that shared the view that Art. 63 TFEU ran the same danger of overreach as the other freedoms\textsuperscript{1162}.

This view was further reinforced after the issuance of the 2006 Volkswagen ruling\textsuperscript{1163} that consummated a second wave of golden share cases, in the framework of which structures that limited one’s control over the investment were acknowledged as non-permissible under the Treaty provisions on the free movement of capital\textsuperscript{1164}. Following the Volkswagen case commentators noted that ‘the Court is in fact creating a set of EU-based values on regulating companies, rather than purely safeguarding the interests of market integration’\textsuperscript{1165}. This is because in the Volkswagen case the Court moved one step further and sought to put under the test corporate law rules, given that the voting cap and the supermajority requirement under scrutiny were provided for by a special statute regulating Volkswagen AG and did not directly favor the state authorities, as in previous golden share cases\textsuperscript{1166}.

The Court’s approach in Volkswagen has made commentators wonder whether, in the aftermath of the failed effort by the Commission to harmonize corporate law with regard to the issue of the 1S/1V principle through measures of secondary EU law\textsuperscript{1167}, the Court is flirting with the idea of turning primary EU law into the vehicle of institutionalization of the 1S/1V principle at the EU

\textsuperscript{1158} Case C-367/98, supra note 1175, paras. 44-45; Case C-483/99, supra note 1175, paras. 40-41.
\textsuperscript{1160} Eleanor Spaventa, From Gebhard to Carpenter – Towards a (Non)economic European Constitution, 41 CMLR 743
\textsuperscript{1161} Wolf-Georg Ringe, Company Law and Free Movement of Capital, 69 CAMBRIDGE LAW JOURNAL 378, 379
\textsuperscript{1162} Leo Flynn, Coming of Age: The Free Movement of Capital Case Law 1993-2002, 39 COMMON MARKET LAW REVIEW 773, 783-4
\textsuperscript{1163} Case C-112/05, Commission v. Germany, [2007] ECR I-8995
\textsuperscript{1165} Ringe, supra note 1161, 379
\textsuperscript{1166} Jonathan Rickford, Free Movement of Capital and Protectionism after Volkswagen and Viking Line, in PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION (M. Tison et al., eds.) (2009), 61
\textsuperscript{1167} See Commissioner McCreevy, Speech at the European Parliament’s Legal Affairs Committee, 3 October 2007, Sppech/07/592
level\textsuperscript{1168}. In such a case structures that disentangle ownership and control, such as time-phased voting rights, would be running the risk of being found incompatible with Art. 63 TFEU. But, this would require the Court to recognize that the Treaty provision on the free movement of capital has horizontal direct effect, so that control-enhancing mechanisms will be problematic not only if they favor the State, but also if they favor private shareholders\textsuperscript{1169}. Only then could Art. 63 TFEU be interpreted as creating individual rights, which national courts must protect\textsuperscript{1170} and only then could time-phased voting rights, provided that they are recognized as falling within the ambit of the prohibition of Art. 63 TFEU, be challenged in court by non-loyalist shareholders.

While there is no doubt that Art. 63 TFEU generates a vertical direct effect, it seems that the golden shares line of cases carries in it the seed of a future recognition of horizontal direct effect, since in these cases the Court did not distinguish between statutory law and provisions that are featured in the firm’s articles of association\textsuperscript{1171}. Therefore, one cannot exclude that the Court might employ a similar analysis even when the benefit from the deviation from the 1S/1V principle flows to private parties\textsuperscript{1172}. Indeed, it has indeed been suggested that

‘one cannot easily justify scrutinizing rules which only restrict specific investment possibilities under the fundamental freedoms, just because they favour public entities and, on the other hand, not scrutinizing rules that have the same effect, but affect the market as a whole (i.e. rules with structural effect) only because they favour private law entities as founders or majority shareholders.’\textsuperscript{1173}

In light of the above, the scheme of time-phased voting rights, introduced into a firm’s corporate governance structure on the basis of an enabling provision in the state’s corporate law, might be seen on the basis of the reasoning of the Court as a governance arrangement impeding the free movement of capital, since as a potential control-enhancing mechanism it might be disincentivizing investors from other Member States to buy shares in the firm that has adopted the time-phased voting rights program\textsuperscript{1174}. It is possible then that in the future private firms will be thought of on the basis of Art. 63 TFEU

\textsuperscript{1168} Wolf-Georg Ringe, Deviations from Ownership-Control Proportionality – Economic Protectionism Revisited, in \textit{COMPANY LAW AND ECONOMIC PROTECTIONISM} (Ü. Bernitz & WG Ringe, eds.) (2010), 213
\textsuperscript{1169} Ringe, \textit{supra} note 1178, 389
\textsuperscript{1170} Case 26/62 \textit{Van Gend en Loos v Nederlandse Administratie der Belastingen} [1963] ECR 1
\textsuperscript{1171} Ringe, \textit{supra} note 1161, 215
\textsuperscript{1172} Wolf-Georg Ringe, \textit{Case C-112/05, Commission v. Germany (‘VW law’), Judgment of the Grand Chamber of 23 October 2007, 45 CMLR 537}
\textsuperscript{1174} Walter Bayer, \textit{Zulässige und unzulässige Einschränkungen der europäischen Grundfreiheiten im Gesellschaftsrecht, BETRIEBS-BERATER} (2002), 2289, 2290

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as having the obligation to approximate the 1S/1V structure and if they violate it they might be held liable in national courts\footnote{CHALMERS, supra note 346, 274; Case 36/74 Walrave, [1974] ECR, 1405, 1419ff; Case 13-76 Doná, [1976] ECR, 1333, 1340ff; Case C-415/93 Bosman, [1995] ECR I-4921, 5065-5067; Case 58/80 Dansk Supermarked, [1981] ECR, 181, 195}.

The possibility of recognizing Art. 63 TFEU as having a horizontal direct effect, particularly when this effect would help to capture deviations from the 1S/1V, becomes even greater, when considering that among the Treaty provisions that have in the past been acknowledged as horizontally directly effective were those that mandated the abstention on behalf of individuals from discriminatory behavior vis-à-vis their counterparties\footnote{See Case 43/75 Defrenne v. Sabena (No. 2) [1976] ECR 455 that recognized that to regulate the issue of equal pay for men and women Art. 157(1) TFEU should be generating a horizontal direct effect; Case C-281/98 Roman Angonese v. Cassa di Risparmio di Bolzano SpA, [2000] ECR I-4139 recognizing a horizontal effect to the discrimination ban in Art. 45 TFEU} . Accordingly, the Court may be tempted to apply Art. 63 TFEU horizontally in a way that prohibits time-phased voting rights by asserting that through this loyalty structure a firm exhibits a discriminatory behavior against the short-termist shareholders without an objective justification\footnote{See Ringe, supra note 1161, 393}.

In light of the above, the dynamic interpretation of Art. 63 TFEU by the ECJ might, particularly in this post-Ricardian phase of European integration, be generating a structural bias against time-phased voting rights that coupled with the provisions of the Takeover Directive that are examined below jointly act in a disincentivizing way for the adoption of this loyalty structure that has the potential of stimulating long-term shareholdership.

4.1.3. The mandatory bid rule as a potential repellent to the introduction of time-phased voting rights

Many might not perceive the Treaty provisions on the free movement of capital as a potent threat for a firm adopting a time-phased voting rights program, but there can be little doubt regarding the impact that the mandatory bid rule of the Takeover Directive\footnote{Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.} will have on the proper functioning of this loyalty device in the EU jurisdictions that are studied here.

Commentators have indeed noted that time-phased voting rights may lead to unpleasant surprises for loyal shareholders because of the mandatory bid rule (Art. 5 Takeover Directive)\footnote{Geens & Clottens, supra note 1133, 176}. The completion of a loyalty period on behalf of the shareholder, which according to the time-phased voting rights program brings automatically the doubling (or greater multiplication) of the loyalist’s voting rights, may result in the loyalist crossing the mandatory bid threshold and thus be obliged to make a bid to the minority shareholders. Negative implications for the shareholders in connection with the mandatory bid rule derive not only from the award of extra voting rights to a shareholder, but
also from the fact that the extra voting right disappears, when the stock is transferred. Thus, a shareholder with a substantial shareholding in a firm can be suddenly found to have crossed the mandatory bid threshold, when another loyalist shareholder, who had previously been awarded multiple voting rights, transfers her shares with the result being that the voting power of the former shareholder concentrates again and is automatically recalculated at a greater percentage. The effects that the mandatory bid rule can have for potentially loyalist shareholders, but also for shareholders with potentially substantial shareholdings in a firm that has adopted a time-phased voting rights plan is by itself an adequate disincentive for the adoption of such schemes by corporations.

Therefore, the fact that loyalty shares, contrary to other types of multiple-voting shares that are classified into a separate class, would continue according to the Takeover Directive to carry their extra voting rights in the general meeting deciding on the adoption of takeover defenses, as well as in the first post-bid general meeting, is eventually of little significance given the impediments that the mandatory bid rule is posing.

4.2. Loyalty dividends: How they might stumble upon the principle of equal treatment of shareholders

4.2.1. The mechanics of a loyalty dividend plan: The example of Koninklijke DSM N.V.

The loyalty dividend has been described as the most interesting proposal for redressing the balance between short-termism and long-run value. It is a mechanism, by which the firm can engage in shareholder eugenics and craft its shareholder base, so as to induce more of its shareholders to stay committed in the firm. The loyalty dividend gives shareholders, who have registered their shares in the firm’s registry and hold on to them for a specified amount of time, a dividend premium, a bonus dividend. This

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1180 According to Art. 11(3) & (4) of the Takeover Directive multiple-voting securities carry only one vote at the general meeting deciding the adoption of post-bid defensive measures and at the first post-bid meeting. But, in Art. 1(1)gg) “multiple-voting securities” are only those that belong to a separate class of shares, so that loyalty shares that belong to the same class with common shares are excluded from this definition.

1181 Nevertheless, it has been suggested that the breakthrough rule would disable the enhanced voting rights that long-term shareholders enjoy under a time-phased voting rights plan, but in this suggestion probably lies the implicit assumption that once awarded extra voting rights the loyalists’ shares enter into a separate class. See Elofson, supra note 1135, 533 (fn. 32)

1182 Peter Butler, Address to the ICGN Annual Conference in Washington, (July 2006). Available at http://www.governanceforowners.com/images/upload/pdf/12_comment_44_0.pdf

1183 However, in the 4th Conference of the Centre of European Company Law in September 2011, where I had the opportunity to present the mechanism of the loyalty dividend, Prof. Jaap Winter expressed the
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dividend premium is a reward for the fact that the shareholder is willing to temporarily sacrifice the liquidity of the share and to deal with the additional costs that the ‘voice’ route has over the ‘exit’ one. In addition to this, because of the fact that the shareholder will have to register its share in the share registry, in order to be eligible to receive the loyalty dividend upon the completion of the loyalty period, the bonus dividend that she receives is also viewed as compensation for the depreciation of the share, since it is commonly believed that—in jurisdictions where bearer shares are allowed—a registered share has reduced tradability compared to a bearer share, because the former’s transfer is subject to additional delays.

Apart from the incentive a dividend premium provides to shareholders to extend their time-horizons with regard to their equity investment, the loyalty dividend is also seen as a tool that can improve investor relations, since the shareholder is induced in the framework of this loyalty mechanism to register her share and thus a channel of direct communication between her and the firm’s management is created.

The loyalty dividend is allowed under French corporate law, which thus emerges as the champion jurisdiction for the application of loyalty structures, while its introduction was recently considered by the German legislator as well. Nevertheless, to understand how the loyalty dividend works in practice I choose here the case of a Dutch listed firm, Koninklijke DSM N.V., which sought to introduce the loyalty dividend back in 2006-7, despite the absence of any enabling provision in Dutch corporate law. The choice to illustrate the loyalty dividend mechanism through the DSM example is not arbitrary, since it was in the DSM case, where the loyalty dividend structure was challenged by non-loyalist shareholders as infringing the principle of equal treatment of shareholders.

In September 2006 DSM’s board announced that shareholders, who according to the register, will have kept their DSM shares for a period of at least three years will be entitled, on top of the regular dividend, to a non-recurring loyalty dividend amounting to 30% of the average annual dividend paid on

opinion that the loyalty dividend would be a poor incentive for shareholders to extend the time-horizon of their equity investment (see also Duffhues, supra note 1134, 31). Instead, he suggested that it would be more effective if the firm would place shares privately with investors, agree with them that they won’t dispose of the stock before a specified amount of time and in return for their commitment pay them upfront the sum that would constitute the bonus dividend.

1184 Duffhues, supra note 1134, 312
1186 Duffhues, supra note 1134, 312
1188 Art. L. 232-14 Code de Commerce
1189 Bundesministerium der Justiz, Bericht über die Entwicklung der Stimmenrechtsausübung in börsennotierten Aktiengesellschaften in Deutschland seit Inkrafttreten des Namensaktiengesetzes, 24, available at http://www.bdi-online.de/de/fachabteilungen/7469.htm

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common shares in the three previous financial years. For each subsequent consecutive year that the shareholder will keep on holding her share, she will be receiving an extra loyalty dividend of 10% per year\textsuperscript{1190} (Figure 35).

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{dsms_loyalty_dividend_structure.png}
\caption{DSM’s Loyalty Dividend Structure}
\textit{Source: Jos Op Heij, Loyalty Dividend – A Boost for Investor Relations, (14 Nov. 2006)}
\end{figure}

Technically, DSM planned to introduce the loyalty dividend plan in the fore stated way by amending its articles of association, so that they would provide that the amount of dividend paid on a common share would no longer be determined by the class of the share, but by circumstances concerning the owner of the share\textsuperscript{1191}. Just like the time-phased voting rights mechanism, the loyalty dividend device would thus become a route towards the ‘personification’ of the share. The circumstances though, according to which the dividend paid to the shareholder would be calculated, were not to be provided for in DSM’s articles of association, but in an ‘extra-charter’ private agreement between the firm and those shareholders, who would opt to register their shares in the firm’s share registry\textsuperscript{1192}. In other words, the articles of association would be amended – after a shareholder vote- to include limited provisions, referring to a separate regulation that would in essence be the one containing the loyalty dividend scheme. According to this regulation the directors would have the power to deny

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\textsuperscript{1191} Marie-Louise Lemarts & Monique Suzanne Koppert-Van Beek, Loyalty Dividend and the EC Principle of Equal Treatment of Shareholders, 5 EUROPEAN COMPANY LAW 173, 174
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\textsuperscript{1192} This agreement was named ‘Rules for register I of holders of ordinary shares Koninklijke DSM N.V.’.
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the loyalty dividend to the shareholder on discretionary grounds listed in that separate regulation.\textsuperscript{1193}

4.2.2. The loyalty dividend and its potential clash with the principle of equal treatment of shareholders

After a recommendation by the proxy voting agent Institutional Shareholders Services (ISS) to DSM shareholders to vote against the management’s proposal to amend the articles of association, so as to (indirectly) introduce a loyalty dividend plan, the investment management firm, Franklin Mutual Advisors, that was managing several funds, which appeared formally as shareholders of DSM, communicated an objection to DSM’s management regarding the introduction of the loyalty dividend and urged the board to withdraw the request for approval of this new loyalty structure from the shareholders’ meeting agenda.\textsuperscript{1194} DSM’s management refused to comply with Franklin’s request and therefore the latter initiated inquiry proceedings before Amsterdam’s Enterprise Chamber (see Section 2.4.1. of Chapter Three for the Dutch legal remedy of ‘enquêterecht’) and sought the suspension of the introduction of the mechanism of the loyalty dividend by the firm.

Franklin’s complaint was substantiated on the alleged clash of the loyalty dividend plan with the Dutch principle of equal treatment of shareholders, according to which ‘save as is otherwise provided in the articles, all shares shall rank pari passu in proportion to their amount’.\textsuperscript{1195} Franklin’s plea was that DSM by not creating a separate class of shares for loyal shareholders was proposing the ‘personification’ of the equity security by choosing to award more cash flow rights to some shareholders compared to other shareholders of the same class.

The Enterprise Chamber agreed with the insurgent shareholder’s arguments and ordered –as a provisional measure- the suspension of the relevant amendment of the articles of association, as there were valid reasons to doubt the correctness of DSM’s policy.\textsuperscript{1196} The Chamber ruled that the Dutch rule on the equal treatment of shareholders prohibits a diversification of rights on the basis of the identity or other qualifications of a shareholder.\textsuperscript{1197} It follows that the only way, by which a Dutch firm would be able to legitimately differentiate the rights awarded to shareholders would be by amending the articles of association, so as to introduce separate classes of shares.\textsuperscript{1198}

In response DSM withdrew the plan to introduce a loyalty dividend altogether and decided not to file a cassation against the Enterprise Chamber’s

\textsuperscript{1193} Art. 17.3.2 of the ‘Rules for register I of holders of ordinary shares Koninklijke DSM N.V.’; See Ferdinand Mason & Tim Carapiet, Loyalty Dividends: DSM and the Legal Debate over Shareholder Incentives, The IN-HOUSE LAWYER (May 2008) 80, 80
\textsuperscript{1194} Id., at 173
\textsuperscript{1195} BW 2:92(1)
\textsuperscript{1196} Lennarts & Kopper-Van Beek, supra note 1191, 174
\textsuperscript{1197} No. 3.12, OK 28.03.2007, JOR 2007/118 (DSM)
\textsuperscript{1198} Mason & Carapiet, supra note 1192, 80
Nevertheless, the Dutch Supreme Court’s Advocate General decided that the case merited an appeal in cassation in the interest of the law and therefore the legal debate on the loyalty dividend under Dutch law continued. The Advocate General substantiated his cassation on the argument that Dutch corporate law (BW 2:92 lid 1) does not imply that a differentiation in cash flow rights is legitimate only if the shares are classified into separate classes. Pursuant to his argumentation the law (BW 2:92 lid 3) requires explicitly the creation of a separate class of shares only if the differentiation concerns the control rights attached to the share; a contrario the creation of a separate class is not necessary in case there is a differentiation in cash flow rights, as in the case of a loyalty dividend. The Dutch Supreme Court agreed with the Advocate General’s arguments and issued a ruling, pursuant to which a loyalty dividend plan in The Netherlands is legitimate, as long as it is set out clearly in the articles of association, and does not constitute a breach of the principle of equal treatment of shareholders, which has been transposed into Dutch corporate law (BW 2:92 lid 2) from Art. 42 of the Second Directive.

The DSM ruling indicates that the issue of whether a loyalty dividend plan, as a tool that a firm may use to engage in shareholder eugenics and craft its shareholder base, is permissible in EU jurisdictions or not depends on whether it is in conformity with the principle of equal treatment of shareholders with regard to distributions. At this point it must be noted that conformity with the principle of equal treatment of shareholders with regard to distributions is a precondition for the legality of a loyalty dividend plan not only in jurisdictions, such as The Netherlands, where there is no provision in the national corporate law enabling this mechanism, but also in jurisdictions, such as France, where the loyalty dividend is allowed explicitly by law. This is because the principle of equal treatment of shareholders with regard to distributions derives from (secondary) EU law, and as such enjoys primacy over any conflicting provision found in national law. Therefore, if eventually a loyalty dividend plan is found to be by its nature incompatible with the principle of equal treatment of shareholders, then any national rule allowing its introduction is inapplicable and any future adoption of such a rule would be invalid. The fact that the amendment to the articles of association introducing the loyalty dividend plan will necessarily have been voted by the shareholders’ meeting might not be enough to bring the security design in conformity with the principle of equal treatment of shareholders, because –at least under the

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1199 No. 3.28, Conclusie, LJJN BB3523, Hoge Raad, 07/11510 (CW 2516). On the fact that the law of most EU Member States tends to be more flexible as to differentiation in relation to dividend rights compared to voting rights see Geens & Clottens, supra note 1133, 176.

1200 Mason & Carapiet, supra note 1192, 81.

1201 To be sure, the discussion is about the principle of equal treatment of shareholders with regard to distributions found in Art. 42 of the Second Directive; the principle of equal treatment of shareholders is not a general principle of EU law, see Case C-101/08, Audiolux S.A e.a. v Groupe Bruxelles Lambert S.A (GBL) and Others and Bertelsmann AG and Others, [2009] ECR I-9823.


As mentioned in the introductory part to the current section, the principle of equal treatment of shareholders is an ambiguous concept and whether it will be interpreted as allowing a loyalty dividend plan or not depends on the dominant institutional logics of corporate governance. The ambiguity of the principle and the fact that different presuppositions vis-à-vis corporate governance can lead to different outcomes as to the legality of loyalty dividends were apparent in the framework of the debate that the Advocate General’s opinion in the DSM case triggered in Dutch literature.

The Advocate General recognized that he was dealing with a principle of EU origin and thus had recourse to ECJ’s case law. Since there is no ECJ ruling, in which the interpretation of Art. 42 of the Second Directive is called into question, the Advocate General tried to distill from the line of ECJ cases that dealt with the equal pay of men and women (Art. 157 TFEU) how the provision on the equal treatment of shareholders should be interpreted. This body of case law indicates that whenever there is a scheme that features the unequal treatment of persons that should normally be treated equally, there must be a reasonable and objective justification for this unequal treatment. This reasonable and objective justification exists when the measure at hand survives the tests of proportionality and subsidiarity. Therefore, the bottom line is that whether the loyalty dividend is permissible under EU law depends on the interpretation of these vague notions, whose shaping may be influenced strongly --in the case of a loyalty dividend plan-- by the dominant institutional logics of corporate governance.

The Advocate General viewed the loyalty dividend proportional and objectively justified in the light of the envisaged aim of promoting long-term shareholdership. But, the majority of Dutch commentators disagreed with this view following a consequentialist approach largely influenced by the fundamental tenets of the agency theory (see Section 6.2.2. of Chapter One). The common line in the dissenters’ argumentation was that shareholder eugenics through mechanisms, such as the loyalty dividend, result in higher agency costs and in compromising the disciplining function of the market for corporate control.

The dissenters to the Advocate General’s opinion start from the assumption that the probability that the voicing of discontent by a shareholder will lead to improvement in the board’s performance is directly proportional to the credibility of the shareholders’ threat that she will subsequently ‘vote with her feet’ by selling her stock. The existence of a loyalty dividend ‘carrot’ in

1204 See UWE HÜFFER, AKTIENGESETZ (2002), §179 Rn 21
1205 See Art. 267 TFEU
1206 Lennarts & Kopper-Van Beek, supra note 1191, 175
1207 See Case C-170/84, Bilka-Kaufhaus GmbH v Karin Weber von Hartz, [1986] ECR 1607
1208 Michael Schouten, Loyaal aan het eigen belang, 14 ONDERNEMINGSRECHT 579, 579
the firm’s corporate governance structure reduces the credibility of this threat, because the directors know that if the shareholder sells her stock—as she implicitly threatens to do when expressing dissatisfaction—she will lose the opportunity to receive a bonus dividend. In essence, the argument is that, when the board ‘poisons’ the shareholders with the temptation of receiving a bonus dividend if they remain loyal to the firm, the board is effectively stripping shareholdernesship from its monitoring power and its ability to reduce residual loss by influencing the management’s decision-making. In Hirschman’s words, whose seminal work on corporate governance in the 1970s the dissenters invoke to make their case: ‘Loyalty-promoting institutions and devices are not only uninterested in stimulating voice at the expense of exit: indeed they are often meant to repress voice alongside exit’ 1209. All in all, this viewpoint sees the loyalty dividend as an entrenchment device for management and therefore the unequal treatment that it introduces between short- and long-term shareholders cannot be objectively justified.

In addition to this, the opponents to the Advocate General’s opinion introduce the argument that there cannot be a quality difference between a long-term shareholder and a short-term one that would justify their unequal treatment 1210. In their view it is highly questionable whether it is correct to view an investment as of high quality, just because the investor is loyal to the board, since there is no empirical evidence that shows why it is in the interest of firms to have loyal long-term shareholders. In fact, the dissenters posit that if one group of shareholders is of lower quality, it is the loyalists because their loyalty does not allow them to act as a counterbalancing force to the board’s erroneous decisions 1211. In other words, the agency institutional logics of corporate governance would suggest that loyal shareholders are bad monitors for management and therefore their favorable treatment through mechanisms, such as loyalty dividends, cannot be objectively justified and thus permissible under Art. 42 of the Second Directive.

All in all, it seems that—despite the DSM ruling in The Netherlands—the agency theory’s institutional logics of corporate governance are strong enough to result in the loyalty dividend device not necessarily qualifying as a permissible exception to the principle of equal treatment of shareholders in other EU jurisdictions. As an agency cost-increasing device, the loyalty dividend might be seen by national courts in the EU as missing the characteristics of subsidiarity and proportionality that would render it objectively justified and thus legitimate under secondary EU law.

1209 ALBERT HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970), 92
1210 Duffhues, supra note 1152, 307; HR 14 Dec. 2007, JOR 2008/11 annotated by Doorman (DSM)
1211 Id., at 308
Corporate governance structures that would allow firms to engage in shareholder eugenics and to attract more long-termist investors to their shareholder base might stumble upon rules of primary and secondary EU law.

Time-phased voting rights, designed to allow the increase in the voting power of loyal shareholders, might be found in the future by the ECJ to be violating the Treaty provisions on the free movement of capital. *Obiter dicta* in the ECJ’s rulings on golden shares, particularly in the *Volkswagen* case, indicate that ECJ is on its way to acknowledge to the free movement of capital the effect of horizontally prohibiting structures that introduce deviations from the 1S/1V principle. Indeed, the post-Ricardian phase, into which European integration has entered, and the pressure on behalf of EU’s supranational agents on supply-side national institutions are capable of inspiring the ECJ to render invalid loyalty structures, such as time-phased voting rights. Apart from this, the mandatory bid rule of the Takeover Directive may also be functioning as an impediment for the adoption of time-phased voting rights.

The mechanism of loyalty dividends might be running afoul to the principle of equal treatment of shareholders with regard to distributions, particularly if interpreted in light of the agency theory’s institutional logics of corporate governance. The recent *DSM* case discussed before the Dutch Supreme Court and the discussion ensued on the loyalty dividend device in literature show that loyalty dividends may constitute an impermissible exception to the principle of equal treatment of