INSTITUTE FOR LAW AND FINANCE

GUIDO FERRARINI

ONE SHARE – ONE VOTE: A EUROPEAN RULE?

INSTITUTE FOR LAW AND FINANCE
JOHANN WOLFGANG GOETHE-UNIVERSITÄT FRANKFURT

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PROF. DR. THEODOR BAUMS
PROF. DR. ANDREAS CAHN

INSTITUTE FOR LAW AND FINANCE

JOHANN WOLFGANG GOETHE-UNIVERSITÄT

SENCKENBERGANLAGE 31

D-60054 FRANKFURT AM MAIN

TEL: +49 (0)69 / 798-28941

FAX: +49 (0)69 / 798-29018

(INTERNET: HTTP://WWW.ILF-FRANKFURT.DE)

Guido A. Ferrarini

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Abstract

In this paper, I tackle the question whether "one share – one vote" should become a European law rule. I examine, first of all, the economic theory concerning one share – one vote and its optimality, and the law and economics literature on dual class recapitalizations and other deviations from one share – one vote. I also consider the agency costs of deviations from one share-one vote and examine whether they justify regulation. I subsequently analyze the rules implementing the one share – one vote standard in the US and Europe. In particular, I analyze the self-regulatory rules of US exchanges, the relevant provisions of the European Takeover Directive (including the well known "break-through rule"), and the European Court of Justice's position as to "golden shares" (which also are deviations from the one share-one vote standard). I conclude that one share – one vote is not justified by economic efficiency, as also confirmed by comparative law. Also the European breakthrough rule, which ultimately strikes down all deviations from one share – one vote, does not appear to be well grounded. Only transparency rules appear to be justified at EU level as disclosure of ownership and voting structures serves a pricing and governance function, while harmonisation of the relevant rules reduces transaction costs in integrated markets.

Keywords: one share-one vote, corporate voting, non-voting shares, multiple-voting shares, golden shares, European Takeover Directive, break-through rule.

JEL Classifications: G32, G38, K22

Guido Ferrarini
University of Genoa - Law School
Via Balbi, 22
16126 Genova,
Italy
phone: +39 010 209 9894; fax:+39 010 209 9890
e-mail: guido.ferrarini@giuri.unige.it

I. INTRODUCTION

1. *Paper's Scope*

In this paper, I tackle the question whether "one share – one vote" should become a European law rule. In order ultimately to provide an answer, I proceed as follows. In this section, I briefly consider the recommendations by the High Level Group of Company Law Experts on the regulation of pre-bid defences and criticisms raised by the same. In section II, I examine the economic theory concerning one share – one vote and its optimality, and the law and economics literature on dual class recapitalizations and other deviations from one share – one vote. Moreover, I consider the agency costs of deviations from one share-one vote and examine whether they justify regulation. In section III, I analyze the rules implementing the one share – one vote standard in the US and Europe. In particular, I analyze the self-regulatory rules of US exchanges, the relevant provisions of the European Takeover Directive (including the well known "break-through rule"), and the European Court of Justice's position as to "golden shares" (which also are deviations from the one share-one vote standard). In section IV, I draw some conclusions from the analysis of the economic and legal issues considered in the preceding sections, and try to answer the main question of this paper.

2. *The High Level Group and the Breakthrough Rule*

Interest in the study of one share – one vote was renewed in Europe by the first Report of the High Level Group of Company Law Experts (Winter Report)[1] and by discussions on the new proposal for a Takeover Directive presented by a Commission Communication of 2 October 2002. The previous proposal had been rejected by the European Parliament on 4 July 2001, despite agreement having been reached on a compromise text within the Conciliation Committee. The European Parliament, in particular, rejected the principle whereby, in order to take defensive measures in the face of a bid, the board of the offeree company must first obtain the approval of shareholders[2]. The rejection was motivated by the absence of a level playing field between European Companies facing a takeover bid also with respect to US corporations[3].

2.1 The Winter Group's Recommendations

The Winter Group explored ways to level the playing field for corporate takeovers in Europe, while keeping the principle of shareholders' approval of post-bid defences. As a result, the Group

[1] Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, Brussels, 10 January 2002.
[2] On this principle and its rationale, P. Davies and K. Hopt, 'Control Transactions', in R. Kraakman et al., *The Anatomy of Corporate Law.* **A Comparative and Functional Approach (Oxford 2004) p. 157 et seq.**
[3] See the Explanatory Memorandum to the 2002 Proposal for a Directive on Takeover Bids.

proposed, in its first Report, a "break-through rule" based on two "guiding principles": one requiring that, in takeover bids, the ultimate decision is always with shareholders; the other positing proportionality between risk bearing and control, i.e. the share capital which has an unlimited right to participate in the profits or residue on liquidation should normally carry control rights[4]. These principles were to be applied also to "company law mechanisms and structures which may frustrate a bid and which may already be in place prior to the bid"[5]; briefly stated, to pre-bid defences. To achieve a similar purpose, the Report recommended introducing a rule that allowed the offeror to "break-through" such mechanisms and structures in the case of a takeover bid. In particular, a successful bidder "should have the ability to break-through any mechanisms which frustrate the exercise of proportionate control"[6].

As to the proposed rule's scope, the same should have applied to all provisions in the articles of association and related constitutional documents of the company which deviated from the principles of shareholder decision-making and proportionality[7]. In particular, the following provisions should have been overridden: (i) voting caps, multiple or double voting rights, non-voting shares, voting rights attributed to nonrisk bearing capital; (ii) provisions preventing the exercise of core control rights, including the right to appoint board members and to amend the articles of association and other constitutional documents.

As a result, under the recommended approach, the bidder acquiring 75 per cent or more of the risk bearing capital should have been able to control the affairs of the company and the operation of its business[8]. For instance, the bidder who acquired 80 per cent of the share capital, including non-voting shares representing 40 per cent of the total, could have voted for 80 per cent of the capital thanks to the rule in question.

2.2 Main Criticisms

The break-through rule was criticised on various grounds[9]. First of all, those losing superior voting power upon application of the rule would not be compensated by those gaining voting power (an objection that was overcome by the break-through rule included in the Takeover Directive, which requires compensation: see section III, para. 2). In addition, it was not clear why the proposed rule should be applicable in the case of a takeover and not at an earlier stage. These objections were explained by L. Bebchuk and O.Hart with an example referred to the Swedish Company,

[4] See Report, note 1, p. 20 et seq.
[5] *Ibidem*, p. 29.
[6] *Ibidem*.
[7] *Ibidem*, p. 30.
[8] *Ibidem*, p. 32 et seq.
[9] See E. Berglöf and M. Burkart, 'European Takeover Regulation' (2003) 36 Economic Policy 173.

Ericsson[10]. The company had two classes of shares: A shares, which had the majority of votes but less than 10 per cent of the cash flow rights, and B shares which were entitled to the remaining votes and rights. Under the Winter Group's proposal, a bidder acquiring all the B shares would be able to gain control; in other words, "the B shares would take the superior voting power away from the A shares"[11]. However, A shares traded at a premium over B shares, reflecting their superior voting power. If the proposed break-through rule were adopted, A shareholders would lose their control premium without compensation[12]. As a result, dual-class structures would be easily undone[13].

Moreover, companies making recourse to the capital markets would no longer use dual-class structures (consisting of either multiple voting shares or non-voting shares). They would rather employ mechanisms not subject to the proposed break-through rule, such as pyramidal groups[14]. Pyramids also separate ownership from control, allowing the controllers to own a lower share of cash flow rights than would otherwise be necessary. However, it is more difficult for regulators to fight pyramids, as corporate groups should generally be permitted, whilst it may be hard to define pyramids and limit their use by listed companies[15].

Further criticism was advanced by J. Coates expressing doubts about the break-through rule on grounds of empirical research[16]. He suggested that companies with dual-class structures are relatively rare in the EU. As shown by M. Bennedsen and K. Nielsen, out of 5,162 public companies in the EU , only 20 percent had dual-class structures at the time of their analysis[17]. According to their

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[10] L. Bebchuk and O. Hart, 'A Threat to Dual-Class Shares', FT May 31, 2002, 11.

[11] Bebchuk and Hart, note 10, 11.

[12] See Report, note 1, p. 35, admitting, however, that in exceptional cases compensation for loss of control rights would be appropriate.

[13] Bebchuk and Hart suggest that the following mechanism could be used. A shell company (BH) is set up, with the same total number of shares as Ericsson. BH would then make a takeover bid for all of Ericsson's A and B shares, offering each shareholder of Ericsson shares in BH on a one-for-one basis. This offer would succeed since BH would obtain most of the cash flow rights of Ericsson and, according to the break-through rule, would have control. The dual class structure would be undone and the A shareholders would lose their control premium.

[14] *Ibidem*; **E. Berglöf and M. Burkart, note 9, at 202.**

[15] See, for this argument, G. Ferrarini, 'Share Ownership, Takeover Law and the Contestability of Corporate Control', in *Company Law Reform in OECD Countries. A Comparative Outlook of Current Trends*, **at http://ssrn.com/abstract=265429.**

[16] J. Coates, 'Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?', in G. Ferrarini, K. Hopt, J. Winter and E. Wymeersch (Eds.), *Reforming Company and Takeover Law in Europe* **(Oxford 2004) p. 682 et seq. See also P. Mülbert, 'Make It or Break It: The Break-Through Rule as a Break-Through for the European Takeover Directive',** *ibidem*, **p. 711, arguing that the rationale for a strict 'one share – one vote' regime is difficult to defend given the mandatory bid rule which, in his opinion, should cover also non-voting shares. A different solution was, however, adopted in the European Takeover Directive: see Article 5(1) on mandatory bids referring to 'securities' and Article 1(1)(e) defining the latter as 'transferable securities carrying voting rights in a company'.**

[17] M. Bennedsen and K. Nielsen, 'The Impact of a Break-Through Rule on European Firms', Working Paper (2003), at http://ssrn.com/abstract=328020. These authors mainly refer to data from M. Faccio and L. Lang, 'The Ultimate Ownership of Western European Corporations' (2002) Journal of Financial Economics, 65.

estimates, in 3-5 percent of these companies the controlling owners would have incurred a direct loss of control under the break-through rule, whereas in an additional 11-17 percent of the same the controlling owners would be likely to incur a control loss[18]. Coates concluded that, in all, only 4 per cent of all public firms would have been put at-risk of takeover by the proposed rule and that this figure in any case overstates the potential value of the rule[19]. In fact, companies would "dynamically respond" to the adoption of the break-through rule. For instance, large shareholders of vulnerable companies would increase their holdings of cash-flow rights above the 25 percent threshold, so that no bidder could acquire sufficient cash flow rights to trigger the break-through rule[20]. An alternative could be switching to a pyramid or cross-holding structure which produces a similar result[21].

Coates further argued that the break-through rule would not create a level playing field in Europe. First of all, the fact that dual-class structures are equivalent to pyramids and cross-holdings "means that disproportionality can make takeover defences cheaper at a range of public companies, some of which will, and most of which will not, be affected by the BTR [break-through rule]"[22]. He suggests that no more than 12.5 per cent of EU public firms with disproportional capital structures would be affected by the rule[23]. Moreover, the bulk of the concentration of voting control among public firms in the EU does not result from disproportionality, but from the fact that controlling shareholders retain a control block in an ordinary one share – one vote capital structure[24].

3. *Further Developments*

As a result of similar critiques and, above all, of the pressure exercised by powerful interest groups, including some prominent families of European capitalism, the Winter Group's recommendations had limited influence on the European Takeover Directive[25]. The break-through rule included in this Directive is a default rule, as I better explain in sec. III, para. 2: Member States can opt-out of it, while listed companies will be allowed to opt-in. As a result, the rule's impact will be negligible. Yet, the discussion on one share – one vote is bound to continue in Europe, for several reasons. Firstly, institutional investors welcome adherence to this standard by listed companies. Also the corporate governance codes tend to support the one share – one vote principle, although

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[18] 17, 10 et seq.
[19] Coates, note 16, p. 683-684.
[20] *Ibidem*.
[21] *Ibidem*.
[22] *Ibidem*, 686.
[23] *Ibidem*.
[24] *Ibidem*.
[25] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids, (2004) OJ L142/12. For a comment, see V. Edwards, 'The Directive on Takeover Bids – Not Worth the Paper It's Written On?' (2004) ECFR 416.

many favour some flexibility in this respect[26]. Secondly, the Commission, in defining its Company Law Action Plan, declared that it intends to undertake a study on the consequences that further implementation of the principle of proportionality between capital and control, advocated by the Winter Group, would entail[27]. Thirdly, recent developments in Member States show some convergence towards Anglo-American standards, including one share – one vote, as I briefly explain in sec. III, para. 4. Fourthly, significant deviations from one share – one vote persist in some Member States, such as Sweden and France where listed companies make extensive recourse to multiple-voting[28] and double-voting shares respectively[29].

II. ECONOMIC ANALYSIS AND POLICY DISCUSSION

1. *Should Deviations from One Share – One Vote Be Forbidden?*

In this paragraph, I examine the US debate on whether one share – one vote should be mandated by regulation. This debate took place about twenty years ago when the NYSE listing rules, which included a rigid one share - one vote standard, were reviewed and common standards were adopted for the US stock exchanges and Nasdaq (on these standards see section III below).

1.1 Is "One Share – One Vote" always Optimal?

Economists dealt with this question in a series of theoretical papers the most frequently cited of which is probably one by S. Grossman and O. Hart[30]. The main argument advanced by Grossman - Hart is that the ease with which a take-over can occur depends on a variety of factors (such as the range of defensive measures available to management, the attitude of courts, etc.) in-

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[26] See Comparative Study of the Corporate Governance Codes relevant to the European Union and its Member States, http://europa.eu.int/comm/internal_market/en/company/company/news/corp-gov-codes-rpt_en.htm.

[27] See Communication from the Commission to the Council and the European Parliament, Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward, Brussels, 21.5.2003 COM (2003) 284 final, at 14.

[28] See, for an illustration and defence of Swedish dual class structures, R. Skog, 'the European Union's proposed takeover directive, the "breakthrough" rule and the Swedish system of dual class common stock' (2003) Riv. Soc. 1141.

[29] See, for an overview of European practices, Deminor Rating, Application of the One Share – One Vote Principle in Europe, March 2005 (Report commissioned by ABI – Association of British Insurers).

[30] S. Grossman and O. Hart, 'One Share – One Vote and the Market for Corporate Control' (1988) 20 J. Fin. Econ. 175. This paper's ideas were subsequently incorporated in O. Hart, *Firms, Contracts and Financial Structure* **(Oxford 1995) p. 186 et seq., which connects the same with other aspects of financial contracting theory. Other important contributions were made by M. Harris and A. Raviv, 'Corporate Governance: Voting Rights and Majority Rules' (1988) 20 J. Fin. Econ. 203; G. Jarrel and A. Poulsen, 'Dual-Class Recapitalizations as Antitakeover Mechanisms. The Recent Evidence (1988) ibid. 129; R. Ruback, 'Coercive Dual-Class Exchange Offers' (1988) ibid. 153.**

cluding a company's security voting structure, i.e. how the company's votes are allocated across securities. They show, in particular, that under a given set of circumstances one share - one vote is the optimal security-voting structure. In a more recent work, Hart [31] makes a distinction between the company's "public value" (i.e. the present value of the future dividend stream to shareholders) and its "private value", i.e. the private benefits enjoyed by the company's managers. He also assumes that a company has two classes of shares each entitled to 50 per cent of the dividends: Class A shares have no vote; class B shares have all the votes. He further supposes that the company's public value under the incumbent managers is 200, each class being worth 100, and that there is a less efficient management team wanting to take over the company. Under this rival team, the public value of the company is 180 (instead of 200). However, the rival has private benefits of 15, whereas the incumbent's private benefits are negligible. Therefore, if the rival gets control, the value of the company is reduced by 20 (as the new management team is less efficient). Yet, the rival could make a tender offer for all Class B shares at a premium of 1, for example. In the absence of a counter-offer and assuming that shareholders are disperse, they would face the well known prisoner's dilemma: either keeping their shares (which are now worth 100 but would be worth 90 if the rival wins) or tendering the same for 101. Given that co-ordination amongst small shareholders is lacking, all shareholders would tender and the rival wins. Clearly, the rival pays 101 for shares which are worth 90 under its management; however, his loss of 11 is more than offset by his private benefit of 15. Shareholders as a whole lose, since class B shareholders are bought out for 101, while class A shareholders end up owning shares worth 90 (for a total value of 191)[32].

Assuming that the same company had a one share - one vote structure, the rival would not get control. In fact, he should offer more than 200 to get all shareholders to tender to him, but this would imply a capital loss of 20 (200-180) against a private benefit of 15. If the private benefit were more than 20, then the rival would offer and win; however, shareholders would not lose as all of them could be bought out at a premium (say, for a total of 202, against a total value of 191 in the previous case of a dual class structure)[33].

The same example is modified to show that a superior rival (rather than an inefficient one) would be prevented from obtaining control by a dual-class structure[34]. The public value under the incumbent is still 200, but under the rival it is now 220 and the incumbent's private benefit is 15, while the rival's private benefit is negligible. In a similar situation and assuming a dual class structure such as the one referred to above, the maximum that the rival could offer for Class B shares is

[31] See Hart, note 30, p. 187 et seq.
[32] *Ibidem*, p. 190.
[33] *Ibidem*.
[34] *Ibidem*, p. 191.

110 (220 : 2, in the absence of significant private benefits). However, the incumbent could counter-offer a higher price (for example, 111), given that her capital loss (of 11) would be offset by her private benefit of 15. Assuming, on the contrary, a one share - one vote structure, the rival would win as he could offer up to 220 and the incumbent would tender as the shares are worth only 215 to her.

Therefore, Grossman - Hart conclude that, if only one of the management teams has a significant private benefit, one share - one vote is optimal. However, they also argue that, if both teams have a significant private benefit, a departure from one share - one vote may increase the total value of the company[35]. The simple intuition behind this conclusion is that "shareholders benefit when the rival and incumbent compete over products for which they have a similar willingness to pay"[36]. In other words, competition between rivals and incumbents is higher if they derive substantial benefits from control and need to focus on one class of shares only (class B in the examples made). Therefore, if we consider the initial owner before his company goes public, he will prefer a one share - one vote structure whenever it is unlikely that both the incumbent and the rival have substantial private benefits. Otherwise, he will choose a security-voting structure which departs form one share - one vote so as to allow the company's value to be maximized in a contest for control. Grossman - Hart believe that there is a higher probability of cases in which only one party (either the incumbent or the rival) has substantial private benefits. Yet, they concede that the level of minority protection may vary from country to country influencing the measure and distribution of private benefits of control[37]. If we consider countries where private benefits are generally substantial because of weak investor protection, we might expect, in these countries, frequent departures from one share - one vote[38].

Grossman - Hart also draw some conclusions with respect to the policy debate on whether a company should be required to adopt a one share - one vote structure as a condition for listing on a stock exchange[39]. To this end, they make a distinction between the deviations from one share - one vote occurring before the company goes public and those taking place at a later stage when the company's shareholders are dispersed. With respect to the former type of deviations, it is argued that "an initial owner has an incentive to choose a value-maximizing security-voting structure since he bears the full consequences of his actions through the effect on the prices of the company's securities"[40]. As we have seen already, in some cases the initial owner may find it wealth-maximizing to

[35] See Grossman and Hart, note 30, at 180.
[36] Hart, note 30, p. 201.
[37] *Ibidem*.
[38] See para. 2.2 of this section.
[39] Grossman and Hart, note 30, 200 et seq.
[40] Hart, note 30, at 208.

depart from one share - one vote. The second type of deviations is, on the contrary, suspect as the managers of a dispersed ownership company have not the same incentives as an initial owner, since the consequences of their actions are borne by the company's shareholders[41]. Therefore, the managers could seek changes in the security-voting structure simply to entrench themselves, while reducing the company's value. However, Grossman - Hart recognize that this observation is less forceful with respect to a corporation in which the managers are already controlling shareholders and want to change the voting structure. They make the example of a family – controlled company wishing to raise capital for other projects. The family does not want to lose voting control, so that the company creates a class of shares with lower dividend claims, but more votes than the common shares to allow the family to keep control. Grossman - Hart's comment is that, if the initial shareholders expected the family to maintain voting control, the change in security structure should not be interfered with[42].

1.2 Dual Class Recapitalizations as a Problem

At the time when the economic theory just examined was developed, lawyer-economists examined dual class structures on a more specific ground. The interest for these structures was raised by the New York Stock Exchange's proposal to end its prohibition on listing the securities of companies with dual class of common stock. Attention was focussed on dual class recapitalizations, particularly on transactions by which a publicly held company changed its capital structure to replace a single class of voting stock with two classes, one of which had multiple votes per share and usually carried dividend rights lower than the pre-existing class of common stock. The multiple voting shares were assigned to management or an existing shareholder group, the official justification being that centralizing control in those receiving the class with superior voting rights would increase the value of the company and, as a result, that of the shares with limited voting rights[43].

As noted by R. Gilson, in complete capital markets (assuming, in other words, no transaction costs) the dual class transaction just described would have a familiar substitute: a leveraged buyout (LBO), which also serves to shift control to managers or an existing shareholder group[44]. In perfect capital markets, non-controlling shareholders would get the same portion of gain from either an LBO or a dual class recapitalization and, therefore, would be indifferent as to the choice of transac-

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[41] *Ibidem*.

[42] **Grossman and Hart, note 30, at 201.**

[43] **See D. Fischel, 'Organized Exchanges and the Regulation of Dual Class Common Stock' (1987) 54 U. Chicago L. Rev. 119; J. Seligman, 'Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy' (1986) 54 Geo. Wash. L. Rev. 687.**

[44] **See R. Gilson, 'Evaluating Dual Class Common Stock: The Relevance of Substitutes' (1987) 73 Virginia L. Rev. 807, at 808.**

tion. However, in the real world, transaction and information costs "may result in the systematic selection of other than the least-cost transaction form"[45]. Otherwise stated, public shareholders may be disadvantaged by the choice of a transaction form that is more beneficial to the managers or a given shareholder group. In this respect, Gilson reviews the empirical studies concerning dual class recapitalizations and LBOs and concludes that two interesting patterns appear in the data. First, shareholder wealth is largely increased as a result of LBOs, while it is, at best, unaffected by dual class transactions. Second, pre-existing dominant shareholder groups are present in companies subject to dual class proposals and not in companies subject to LBO proposals. Gilson finds two possible explanations for these patterns. One is "more benign" and looks at the two types of companies potentially subject wither to LBOs ("cash cows") or to dual class transactions ("question marks"). Companies of the second type suffer from a capital shortage, are in an earlier stage of development and operate in markets that are growing quickly[46]. The second explanation looks at the "dark side" of the data and finds "coercion" of public shareholders, in the sense that dominant shareholders impose a wealth transfer from disperse shareholders to themselves[47]. This dark side story has been developed most thoroughly by J. Gordon and R. Ruback who argue that, even where the dominant shareholder group has not absolute voting control, strategic considerations will result in disperse shareholders approving the transaction, even if it is not in their best interests[48].

Gilson also tries to draw regulatory implications from the observed empirical patterns. He argues that a successful regulatory effort would have to eliminate dual class transactions intended to coerce public shareholders, without foreclosing those efficient transactions which may be required by competitive product markets[49]. He suggests that the key to efficient transactions should be that a firm is able to raise equity for positive net present value investments without diluting the dominant shareholders or increasing their unsystematic risk disproportionately. In contrast, the key to inefficient transactions would be the ability of a dominant shareholder to coerce other shareholders into further strengthening its control[50]. Therefore, Gilson concludes that a rule should be adopted to "prohibit the conversion of existing stock into dual classes, but not the public offering of a *new* class of limited voting or non-voting common stock", as this "would allow new capital to be raised

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[45] *Ibidem,* at 810.
[46] *Ibidem*, at 824 et seq.
[47] *Ibidem*, at 832 et seq.
[48] See J. Gordon, 'Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice' (1988) 76 Cal. L. Rev. 3, at 43 et seq., who analyzes the collective action problems affecting shareholder voting in dual class recapitalizations; Ruback, note 30, who shows that dual-class exchange offers can induce outside shareholders to exchange their shares for limited voting shares though the same shareholders, in the same circumstances but acting collectively, would choose not to exchange.
[49] Gilson, note 44, at 841
[50] *Ibidem*.

without diluting the control of the dominant group"[51]. As we shall see, a similar rule was subsequently adopted by NYSE and Nasdaq.

1.3 Summary

Both the theoretical and the law and economics studies examined above are directly relevant to the present discussion. First of all, they show that deviations from one share - one vote should be admitted and that, at least in one case, such deviations are not problematic: this is the case of an initial public offering by a company with a dual class capital structure. The limited voting rights are reflected in a reduced price of the relevant class, so that the company's initial owners, and not the purchasers of the shares, bear the cost[52]. Moreover, although the company, in a similar case, could be sheltered from the corporate control market, this is not a change of status and has been clear since the offer of the company's shares to the public. The case of a company changing its capital structure from one class of shares to two classes is more problematic, as the transaction could be intended mainly to entrench the company's managers. However, the criteria suggested by R. Gilson to discriminate between efficient and inefficient transactions should help to devise a rule allowing, with some limits, the adoption of a dual class structure. In particular, the issuance of non-voting (or limited voting) shares to raise new capital does not appear problematic, while the transformation of ordinary shares into non-voting shares is at least suspect, as it could result from a coercion of public shareholders by the dominant shareholder group.

2. *The Agency Costs of Deviations from One Share – One Vote*

2.1 Theory and Evidence

Another strand of research on this paper's topics is that concerning the agency costs created by dual class structures and similar arrangements separating control from cash flow rights. The notion of controlling-minority is used to identify similar structures, which include dual class schemes, stock pyramids (or pyramidal groups), and cross-ownership ties (or cross-holdings). A theoretical study by L. Bebchuk, R. Kraakman and G. Triantis analyses the agency costs associated with the controlling-minority structure in several contexts[53]. They start form the general comment that this structure lacks the principal mechanisms limiting agency costs in other ownership structures. First of all, controlling-minorities are not exposed to hostile takeovers and proxy contests which contrib-

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[51] *Ibidem*.
[52] *Ibidem*, at 809.
[53] L. Bebchuk, R. Kraakman and G. Triantis, 'Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control From Cash-Flow Rights, in R. Morck (ed.), *Concentrated Corporate Ownership* (Chicago 2000), p. 445.

ute to discipline management in diffuse-ownership companies. Moreover, controlling minorities (unlike controlling majorities) do not internalize most of the value effects of their decisions through shareholdings, which may represent only a small fraction of the cash-flow rights in their firms. Bebchuk, Kraakman and Triantis demonstrate that, as the relevant fraction of cash-flow rights (which they denominate α) declines, controlling minorities can externalize progressively more of the costs of their misbehaviour and that the agency costs of the interested firms can rise at a sharply increasing rate as a result [54]. For instance, in the choice of investment projects, the controller might choose, depending on α, the projects with the lower value but the larger private benefits of control. Moreover, as α declines, the difference in value between two projects will become less important to the controllers relative to the difference in private benefits of control[55]. As the same authors acknowledge, however, there are, at least, two factors limiting the agency costs of controlling-minority structures. The first is reputation: controllers who intend to return to the equity market must establish a reputation for sound management. The second is legal protection of minority shareholders: agency costs of dual class and similar structures "tend to be comparatively larger in countries in which legal rules are lax and private benefits of control are consequently large"[56].

Empirical studies support this theory. For instance, research conducted on a sample of 1301 publicly traded corporations from eight East Asian economies tried to disentangle the incentive and entrenchment effects of large ownership[57]. In addition to being controlled by a single shareholder in two-thirds of the cases[58], East Asian firms show a sharp divergence between cash-flow rights and control rights, i.e. the largest shareholder is often able to control a public corporation with a relatively small direct stake in its cash-flow rights[59]. This is done through pyramid structures, cross-holdings among firms, and sometimes through dual-class shares. The study in question finds that relative firm value (as measured by the market-to-book ratio of assets) increases with the share of cash-flow rights in the hands of the largest shareholder[60]. This confirms the incentive effects of large ownership[61]. The same study, however, shows that the difference between control rights and cash-flow rights of the largest shareholder is associated with a value discount and "that the discount generally increases with the size of the wedge between control rights and cash-flow rights"[62]. This

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[54] ***Ibidem*, p. 447 et seq.**
[55] ***Ibidem*, p. 451 et seq.**
[56] ***Ibidem*, p. 452 et seq.**
[57] **See S. Claessens, S. Djankov, J. Fan, and L. Lang, 'Disentangling the Incentive and Entrenchment Effects of Large Shareholdings' (2002) 57 J. Fin. 2741.**
[58] **See S. Claessens, S, Djankov, and L. Lang, 'The Separation of Ownership and Control in East Asian Corporations' (2000) 58 J. Fin. Econ. 81.**
[59] **See S. Claessens, S. Djankov, J. Fan, and L. Lang, note 57, 2742.**
[60] **Ibidem, 2743.**
[61] **Ibidem.**
[62] **Ibidem, 2744.**

is a negative entrenchment effect of large ownership: increases in control rights are accompanied by declines in firm value[63].

A study on US dual-class companies reached similar results[64]. The authors find that that firm value (as measured by Tobin's *Q*) is "increasing in cash-flow ownership and decreasing in voting ownership"[65] and offer the following explanation: "some firms adopt dual-class structures when their original owners are reluctant to cede control; later, these firms are less likely to tap capital markets (so as to avoid diluting control) and thus invest less, grow slower, and are valued lower"[66]. A more recent study on a sample of 675 European public companies from 11 countries shows similar results as to the relation between firm value and the wedge between the voting and the cash-flow rights of the largest shareholder[67]. The authors find their evidence consistent with the international one showing a negative association between corporate valuation and the control-enhancing devices used by the largest shareholder[68].

2.2 Policy Implications

Given that deviations from one share – one vote increase agency costs, it might appear desirable to limit the recourse to similar structures[69]. As I indicate below, some EU Member States restrict the use of dual-class structures, while the US tax laws discourage recourse to pyramidal groups. However, as shown by L. Bebchuk, this is not necessarily a desirable policy approach. If controlling-minority structures were prohibited or discouraged, this would not imply that companies would choose to go public with a dispersed ownership structure: "They might instead choose to remain closely held and avoid going public altogether"[70]. Indeed, if going public were only possible through non-controlling shareholder structures and if private benefits of control were high, the firm's owners might not want to "leave control up for grabs"[71]. An alternative policy approach to deviations from one share – one vote would be to reduce private benefits of control through corporate law reform. However, the introduction of new rules and enforcement of the same could be

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[63] Ibidem, 2770.
[64] P. Gompers, J. Ishii, and A. Metrick, 'Incentives vs. Control: An Analysis of U.S. Dual-Class Companies', NBER Working Paper No. 10240, January 2004.
[65] Ibidem, 4.
[66] Ibidem, 20.
[67] R. Barontini and L. Caprio, 'The Effect of Family Control on Firm Value and Performance. Evidence from Continental Europe, ECGI Finance Working Paper No. 88/2005, June 2005.
[68] Ibidem, at 16 et seq.
[69] See L. Bebchuk, 'A Rent Protection Theory of Corporate Ownership and Control' NBER Working Paper no. 7203, June 1999.
[70] Ibidem, 30.
[71] Bebchuk, Kraakman and Trinatis, note 54, 22.

costly and the relevant costs should be compared with the benefits of eliminating controlling-minority structures[72].

III. COMPARING US AND EU APPROACHES

In this section, I briefly analyse how and to what extent the one share – one vote standard was implemented in the US and in the EU and its Member States. I consider, in particular, the listing requirements introduced by US stock exchanges and Nasdaq (after repeal of the strict one share – one vote standard enforced for more than 50 years by the New York Stock Exchange) and the way in which pyramidal groups were discouraged in the US through tax reform. I further examine the European Takeover Directive, its rules on transparency of ownership structures and the break-through rule included in the same as a default rule. I also consider the cases decided by the European Court of Justice concerning golden shares, their relevance from the one share – one vote standard's perspective and the partial convergence of national company laws in this area.

1. *US Approach*

1.1 Listing Requirements

According to the main treatise on US securities regulation, the one share – one vote controversy began in 1925[73]. By the end of the 19th century, common and preferred stock had equal voting rights. However, in the first quarter of the following century corporate stock issues showed "an increasing tendency to restrict the voting rights of certain classes of shareholders"[74]. As noted by A. Berle and G. Means, a number of legal devices developed to form controlling minorities, such as pyramiding, non-voting preferred stock and the voting trust[75]. In 1925, some leading corporations (including Dodge Brothers and Industrial Rayon Corporation) issued non-voting common stock[76].

This caused public outcry, initially inspired by Harvard economist William Ripley, who invoked regulation of the subject arguing that banks were assuming control of business corporations[77]. In 1926, the NYSE first disapproved an issue of non-voting common stock, a policy which was subsequently hardened and specified[78]. The rationale for such a policy was explained by the NYSE Listed Company Manual making reference to a "long-standing commitment to encourage

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[72] **Bebchuk, note 69, 31.**
[73] **L. Loss and J. Seligman,** *Securities Regulation* **(New York 3rd ed. 2003) p. 1833.**
[74] *Ibidem***, p. 1834.**
[75] **A. Berle and G. Means,** *The Modern Corporation and Private Property* **(New Brunswick rev. ed. 1968) p. 69 et seq.**
[76] **Loss and Seligman, note 74, p. 1834.**
[77] *Ibidem***, p. 1835.**
[78] *Ibidem***, p. 1836.**

high standards of corporate democracy" as reflected by individual standards of "corporate responsibility, integrity and accountability to shareholders"[79]. However, a similar policy was not followed by NASDAQ and AMEX, which therefore competed against NYSE by attracting companies with dual class shares structures. This caused concern to NYSE particularly when, in the eighties, listed companies enhanced their search for effective takeover defences including the issuance of either non-voting or multiple voting stock[80]. Under pressure from key political figures threatening enactment of a federal rule, the two exchanges and NASD held discussions to find a common approach to one share – on vote. However, these discussions failed and NYSE adopted a proposal permitting dual class structures for its listed companies.

As a result, the SEC held a public hearing to examine whether the Commission could, by its own initiative, insert a one share – one vote rule in the self-regulatory rules of the exchanges and NASD. In the end, a similar rule was enacted by the SEC (Rule 19c-4) prohibiting the listing on an exchange or the inclusion in NASDAQ of the equity securities of an issuer that issued securities or took other corporate action "that would have the effect of nullifying, restricting or disparately reducing the per share voting rights" of one or more classes of outstanding common stock of the issuer[81]. The Rule, however, permitted initial public offerings of stock with disparate voting rights or subsequent public offerings of lesser voting stock, and the issuance of stock with lesser voting rights in an acquisition. Yet, dual class recapitalizations were prohibited. In this respect, the SEC commented: " … there may be valid business or economic reasons for issuing disparate voting rights stock, the effect of which is not disenfranchising existing shareholders. The Commission believes, however, that disparate voting rights plans that disenfranchise existing shareholders are inconsistent with the requirements of the [Williams] Act"[82]. Several cases of disparate voting rights were included in the prohibition, such as restrictions based on the length of time a shareholder has held stock (exemplified in the Europe by the French model of double voting shares) and voting caps (popular in some European countries: see para. 2.3). Rule 19c-4 was subsequently vacated by the District of Columbia Court of Appeals as having been issued in excess of the Commission's mandate[83]. Nonetheless, the exchanges and NASDAQ voluntarily adopted an equivalent to former Rule 19c-4 as part of their own rules[84].

[79] *Ibidem*.
[80] *Ibidem*, p. 1837.
[81] *Ibidem*, p. 1846.
[82] *Ibidem*, p. 1849.
[83] See J. Seligman, *The Transformation of Wall Street*. A History of the Securities and Exchange Commission and Modern Corporate Finance (New York, 3rd ed. 2003) p. 588.
[84] *Ibidem*.

1.2 Double Taxation

Another way to implement the one share - one vote principle in the US was introducing, in the 1930s, the double taxation of inter-corporate dividends[85]. An explicit purpose of this reform by President Roosevelt was to force the dismantling of pyramidal groups. These are corporate groups in which a wealthy family or individual typically controls a family firm, which controls a majority voting block in a publicly traded company that, in turn, holds majority voting blocks of other publicly traded companies: "Pyramidal corporate groups allow wealthy individuals or families to control corporate assets worth vastly more than their corporate wealth"[86]. In other terms, pyramidal groups are means to separate ownership from control and to deviate from one share – one vote standards[87]. Roosevelt's objectives were summarized by contemporary scholars as follows: "There can be no denying that the President's message was an attack upon wealth; he and his followers would say, not upon innocent wealth, but upon concentrated, monopolistic, tax-evading, unsocial wealth, and particularly upon that taken from the masses by the vicious, pyramided, consciousless holding companies"[88]. Roosevelt's reform was successful, for pyramidal groups are currently unknown in the US[89].

2. *EU Approaches*

2.1 The European Takeover Directive

The European Takeover Directive does not include a clear policy in favour of one share – one vote. Deviations from this principle are admitted and may substantially limit the contestability of corporate control. Yet, similar deviations must be disclosed by listed companies publishing detailed information as to "the structure of their capital … with an indication of the different classes of shares and, for each class of shares, the rights and obligations attaching to it and the percentage of total shares capital that it represents" (Article 10(1)(a)). Information should also be published as to "the holders of any securities with special control rights" (e.g. golden shares) and to "any restrictions on voting rights, such as limitations of the voting rights of holders of a given percentage or number of votes, deadlines for exercising voting rights, or systems whereby, with the company's

[85] R. Morck, 'Why Some Double Taxation Might Make Sense: The Special Case of Inter-corporate Dividends' (March 20, 2003), University of Alberta Centre for Financial Research Working Paper No. 03-01, http://ssrn.com/abstract=369220.
[86] Ibidem, at 18.
[87] See M. Bianchi, M. Bianco, and L. Enriques, 'Pyramidal Groups and the Separation Between Ownership and Control in Italy', F. Barca and M. Becht (eds.), *The Control of Corporate Europe* (Oxford 2001), p. 154 et seq.
[88] See R. Blakey and G. Blakey, 'The Revenue Act of 1935' (1935) 25 American Economic Review 673-690, cited by Morck, note 85, at 12.
[89] Morck, note 85, at 2.

cooperation, the financial rights attaching to securities are separated from the holding of securities" (Article 10(1)(d) and (f)). Clearly this provision makes reference to voting caps and to the use (which was common in the Netherlands until recently) of depositary receipts for shares as an anti-takeover device (see para. 2.3).

As commented by H. Hirte, "Article 10 of the Takeover Directive goes far beyond the regulation and/or harmonization of takeovers; it is, in fact, a "Mini-Directive" on the structure of the Corporation which takes up many of the issues that the draft Fifth Directive failed to harmonize"[90]. Yet, the provision includes transparency requirements, rather than harmonizing substantive law, and is therefore less intrusive, even if these requirements "are in no way 'neutral', for they are implicitly based on the 'one share – one vote' system, insofar as deviations from this line ought to be disclosed"[91]. Hirte concludes that Article 10 has a greater impact on the harmonization of European company laws than most other articles of the Takeover Directive, and establishes "one share – one vote" as a European standard[92]. This conclusion, however, should not be overstretched: arguing that one share – one vote is the background model for disclosure requirements is still far from showing that it is already a principle of European law.

Indeed, the "breakthrough rule" story highlights that one share – one vote is an aspirational principle more than an effective one. A rule similar to that suggested by the Winter Group is, in fact, included in Article 11 of the Directive with reference to pre-bid defences in general; however, Member States are allowed to opt-out of this rule. For what concerns voting rights, in particular, Article 11(3) states that restrictions on those rights provided for in the articles of association of the offeree company (as well as restrictions on voting rights provided for in contractual agreements between the offeree company and holders of its securities, or in contractual agreements between holders of the offeree company's securities entered into after the adoption of the Directive) shall not have effect at the general meeting of shareholders which decides on any defensive measures in accordance with Article 9. Therefore, if the articles of association include a voting cap, this will not be applicable in the shareholders' meeting which decides on post-bid defences. Similarly, if the company has issued non-voting shares, their holders will be entitled to vote in that meeting. As to multiple-vote securities, Article 11(3) last sentence states that they shall carry only one vote at the above mentioned meeting. In essence, the one share –one vote principle will govern resolutions as to post-bid defences, reducing the scope for entrenchment of the company's managers and blockholders.

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[90] H. Hirte, 'The Takeover Directive – a Mini-Directive on the Structure of the Corporation: Is it a Trojen Horse?' (2004) ECFR 1, at 10.
[91] *Ibidem*.
[92] *Ibidem*, 18.

Moreover, under Article 11(4), the same principle applies whenever, following a bid, the offeror holds 75% or more of the capital carrying voting rights, with reference to "the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members". In this meeting, therefore, voting caps will not apply; non-voting shares will vote, while multiple-voting shares will carry only one vote; furthermore, "extraordinary rights of shareholders concerning the appointment or removal of board members provided for in the articles of association of the offeree company" shall not apply.

The directive also takes care of the objections raised with respect to the breakthrough rule as recommended by the Winter Report, which excluded, save for exceptional cases, any compensation to the holders of rights affected by the rule[93]. Art. 11(5), in fact, provides that "equitable compensation shall be provided for any loss suffered by the holders of those rights" under the terms set by the Member States. Moreover, paragraphs 3 and 4 do not apply to those securities for which "the restrictions on voting rights are compensated for by specific pecuniary advantages" (Article 11(6)), the assumption being that, where non-voting shares carry a preference, their holders do not deserve special protection under the breakthrough rule, as they have been compensated in advance for the loss of the voting rights. However, this argument is rather simplistic, as it also assumes that the preferential rights' value is always equal to that of the excluded voting rights, which is not necessarily the case. In fact, the value of voting rights depends on that of private benefits of control which can be extracted, in a given company, by those managing the same[94]. Furthermore, if the preferential rights are not a sufficient compensation for the loss of the voting rights, the non-voting shares will be treated at a discount with respect to common shares to reflect the lower value of the former.

However, Member States may opt-out of the breakthrough rule under Article 12(1) allowing them to "reserve the right not to require companies … which have their registered offices within their territories to apply Article 9(2) and (3) [on shareholder approval of post-bid defences] and/or Article 11". Yet, where Member States make use of this option, "they shall nevertheless grant companies which have their registered offices within their territories the option, which shall be reversible, of applying Article 9(2) and (3) and/or Article 11" (Article 12(2)). Listed companies, therefore, shall be granted an opt-in right with respect to the breakthrough rule by those Member States opting-out of the same. What is the incentive for companies to opt-in, when they would not otherwise be bound by the breakthrough rule? The answer is "reciprocity"[95]: Member States may, under the conditions determined by national law, exempt companies subject to the "breakthrough rule" from applying the same (as well as Article 9(2) and (3) on defensive measures) when they become the

[93] See Report, note 1, p. 35.
[94] See L. Zingales, 'What Determines the Value of Corporate Votes' (1995) 110 Quarterly J. of Econ. 1047.
[95] See M. Becht, 'Reciprocity in Takeovers', in Ferrarini, Hopt, Winter and Wymeersch, note 16, p. 647.

target of "an offer launched by a company which does not apply the same Articles as they do, or by a company controlled, directly or indirectly by the latter …" (Article 12(3)).

It is difficult to forecast how many Member States will adopt the breakthrough rule when implementing the Takeover Directive. It is easy to predict, however, that most of them will opt-out of the rule, the reason being that many Member States see at least one or more of the relevant takeover defences (including the departures from one share – one vote) widely used in their corporate practice, so that strong opposition to the breakthrough rule will emerge from interest groups. As a result, a large number of European listed companies will be entitled to opt-in, a faculty which will presumably be exercised only be those companies which are less likely to be affected by the breakthrough rule. These could be either companies with diffuse shareholdings or controlled companies which already fully comply, in both cases, with the one share – one vote principle (i.e. have no dual class shares nor voting caps; do not belong to pyramidal groups; and are not governed by shareholder agreements). All this shows that the impact of the Directive's breakthrough rule will be minimal.

2.2 Golden Shares and the EC Treaty

The breakthrough rule does not apply to golden shares and similar rights. Article 11(7) specifies it, firstly, with regard to "securities in the offeree company which confer special rights on the Member States …"; secondly, with respect to "special rights provided for in national law …". The first concept refers to golden shares as originally adopted in the UK, where the articles of association of privatised companies used to provide for the issuance of special shares to the State. The second concept refers to the practice of privatisations in countries like France and Italy, where the law foresees that special rights (similar to those deriving from golden shares) may be attributed to the State with respect to privatised companies[96]. In both cases, a problem arises of compatibility of the Member State's special rights with the EC Treaty. To the extent that a Member State is entitled, for instance, to authorize either transfers of control in the relevant company or mergers of the same with another company, the fundamental freedoms of the Treaty may be restricted as a result.

This has been recognised by the European Court of Justice in a series of cases concerning golden shares and the privatisation laws of several Member States[97]. The Court focussed attention on Article 56 of the EC Treaty stating that "all restrictions on the movement of capital between

[96] See S. Grundmann and F. Möslein, 'Golden Shares – State Control in Privatised Companies: Comparative Law, European Law and Policy Aspects' (2001-2002) Euredia 623, at 630 et seq.

[97] ECJ 13.5.2003 – Case C-98/01 *Commission v. United Kingdom*, ECR 2003, I-4641; 13.5.2003 – Case C-463/00 *Commission v. Spain*; 4.6.2002 – Case C-503/99 *Commission v. Belgium*, ECR 2002, I-4809; 4.6.2002 – Case C-483/99 *Commission v. France*, ECR 2002, I-4781; 4.6.2002 – Case 367/98 *Commission v. Portugal*, ECR 2002, I-4731; 23.5.2000 – Case C-58/99 *Commission v. Italy*, ECR 2000, I-3811.

Member States and between Member States and third countries shall be prohibited". In the case of *Commission v. France*[98]**, for instance, the Court examined, from the perspective of free movement of capital, the golden share in** *Société Nationale Elf-Acquitaine***, whereby any holding of shares or voting rights which exceeded certain limits had to be authorized in advance by the French government and a decision to transfer or use as security the majority of the capital of four subsidiaries could be opposed in advance by the same government. The Court specified that "Article 73b [now 56 EC] lays down a general prohibition on restrictions on the movement of capital between Member States. That prohibition goes beyond the mere elimination of unequal treatment, on grounds of nationality, as between operators on the financial markets"[99]. On the basis of it, the Court held: "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 concerned and to dissuade investors in other Member States from investing in the capital of those undertakings. They are therefore liable, as a result, to render the free movement of capital illusory …"[100]. Once ascertained that the rules at issue had to be regarded as a restriction on the movement of capital, the Court also considered whether this restriction could be justified by reasons referred to in Article 73d(1) of the Treaty [now Article 58(1)(b) EC] or by overriding requirements of the general interest, and concluded that it could not[101].**

Are the ECJ judgements on golden shares relevant to the general discussion on one share – one vote? No doubt, golden shares represent a departure from this principle and one that is prohibited under the Treaty, unless justified by the reasons cited above. However, the issue has been analysed from a more general perspective by S. Grundmann and F. Möslein[102], who argued that the ECJ judgements on golden shares could have an impact on company law in general. The thesis advanced by these scholars is fascinating. According to them, in terms of European law doctrine "it is universally accepted that at least some form of obligation for private law subjects arises from the fundamental freedoms"[103]. No doubt, private autonomy could be unduly restricted by a general application of the Treaty rules to private law subjects: "In fact, the ECJ does not review national rules with respect to fundamental freedoms, if these rules are subject to party autonomy and party choice"[104]. Yet, a similar argument "is no longer valid where the (private law) legislator grants powers to private law entities that allow a restriction of fundamental freedoms without the consent

[98] **ECJ 4.6.2002 – Case C-483/99, note 98.**
[99] *Ibidem*, **para. 40.**
[100] *Ibidem*, **para 41.**
[101] *Ibidem*, **para. 45 et seq.**
[102] **Note 97, at 671 et seq.**
[103] *Ibidem*, **655.**
[104] *Ibidem*.

of the affected party being required"[105]. Therefore, techniques such as voting caps and multiple voting rights should be questioned from the perspective of the free movement of capital, along lines similar to those followed by the ECJ even if neither golden shares nor special rights of a Member State are involved[106].

Nonetheless, it is unlikely that similar conclusions would be shared by the ECJ, particularly in light of the judgement issued in the case of *Commission v. United Kingdom*[107] **(after publication of the paper by Grundmann and Möslein). In this case, the UK Government argued that the special share foreseen by the articles of association of British Airports Authority plc was governed by national company law. If the special share at issue was open to challenge, so would be in general every class of shares with more extensive voting rights than another class of shares issued by the same company. In rejecting this argument, the Court did not assert that private company law mechanisms could** *per se* **restrict fundamental freedoms. Rather the Court relied on the fact that a public authority had approved the BAA's special share under the relevant statute[108]. Emphasis was put on the involvement of a public authority implicitly showing that, in the Court's opinion, mere recourse to company law mechanisms could not (as also argued by the UK government) represent a restriction of fundamental freedoms.**

The solution could be different when a deviation from the one share – one vote standard is foreseen by mandatory provisions of company law[109]. Reference can be made to "one member – one vote" rules provided for by national laws on cooperatives. Indeed, the breakthrough rule does not apply to cooperatives (see Article 11(7) of the Takeover Directive). This exemption is justified by the particular nature of cooperatives, as reflected in their ownership structure[110]. Similar reasons justify the restriction of free movement of capital brought about by one member – one vote rules. Yet, in individual cases, these rules do not appear to be justified from the Treaty perspective . In the case, for instance, of the Italian *banche popolari* **it is often argued that they have in fact lost their cooperative nature and operate similarly to for-profit banks. This argument can be used to object to the one member – one vote standard foreseen by Italian Banking Law for** *banche popolari***, which practically operates as a powerful antitakeover device limiting the freedom of establishment and the free circulation of capital.**

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[105] *Ibidem*.
[106] *Ibidem*, **656.**
[107] **ECJ 13.5.2003 – Case C-98/01, note 98.**
[108] *Ibidem*, **para. 48 and 49.**
[109] **See Grundmann and Möslein, note 97, at 673.**
[110] **See, from a general perspective, H. Hansmann,** *The Ownership of Enterprise* **(Cambridge, Mass., and London) p. 66 et seq.**

2.3 Convergence in the Member States

As shown by recent research, the law and practice in European countries is slowly converging towards Anglo-American corporate governance standards, including one share – one vote[111]. Firstly, there is convergence towards the abolishment of voting caps[112]. This is notably the case of German Law which specifies that voting restrictions can only be adopted by non-listed companies[113]. A similar provision was recently adopted by Italian Law[114]. On the whole, the use of voting caps has been decreasing in the last five years in countries of German and French legal origin[115]. Secondly, the use of multiple voting shares is forbidden in Germany and Italy. Moreover, it is declining at European level: by 2004 only one third of the European countries allowed shares with multiple voting rights, down from more than one half in the early 1990s[116]. Scandinavian countries make large use of this type of shares; however, Sweden in 2004 introduced a maximum ratio of 10 : 1 for the votes that can be attributed to multiple voting shares (clearly not a radical reform, but a significant step towards more proportionate governance structures)[117]. Thirdly, non-voting shares are still allowed in most countries, mainly in the form of preference shares. However, the law generally restricts the issue of non-voting shares to a maximum percentage of the equity (varying between 25 and 100 per cent, with 50 per cent in the majority of countries)[118].

It is also interesting to note, from the perspective of convergence towards one share – one vote, that the Dutch Corporate Governance Code of 2003 includes new provisions with respect to depositary receipts for shares. After acknowledging that "depositary receipts for shares are a means of preventing minority shareholders from controlling the decision-making process … ", the Code provides that these receipts shall not be used as an antitakeover measure and requires the trust office's management to issue proxies "in all circumstances and without limitation to the holders of depositary receipts who so request" (see Principle IV.2).

3. *A Brief Comparison*

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[111] See M. Goergen, M. Martynova and L. Renneboog, 'Corporate Governance Convergence: Evidence from Takeover Regulation Reforms in Europe', ECGI Law Working Paper No. 33/2005, April 2005. See also Deminor Rating, note 29.

[112] Ibidem, 26.

[113] See Para. 134 (1) of the German Law on Joint-Stock Companies.

[114] See G. Ferrarini, P. Giudici and M. Stella-Richter, 'Company Law Reform in Italy: Real Progress?' (2005) 69 RabelsZ 658.

[115] M. Goergen, M. Martynova and L. Renneboog, note 111, 25, figure 6.

[116] Ibidem, 27.

[117] See R. Skog, 'A Remarkable Decade: The Awakening of Swedish Institutional Investors', in M. Isaksson and R. Skog (Eds.), *The Future of Corporate Governance*. The Stockholm Symposium 2004 (Stockholm 2004) p. 141, at p. 147.

[118] Goergen, Martynova and Renneboog, note 111, 26.

The US and Europe clearly followed different paths. In the US, the one share – one vote story dates back to the 1920s reflecting a widespread opposition to any form of concentration of economic power, which led the NYSE to adopt one share – one vote as a listing condition and President Roosevelt to fight pyramidal groups through taxation. This approach presumably contributed to the formation of diffuse ownership companies and was relaxed only in the 1980s when more flexible standards were adopted by the US exchanges and Nasdaq substantially to allow the adoption of pre-bid defences by listed companies. Deviations from one share – one vote were therefore admitted, but only in circumstances (such as the public offering of a new class of non-voting stock) where the relevant costs would not be born by public shareholders. Other transactions, such as the introduction of a voting cap by a company already listed, were precluded as they would cause a wealth transfer from one shareholder group to another.

In Europe, one share – one vote attracted public attention only recently as a result of capital market development and the growing influence of institutional investors. This led some Member States (like Germany and Italy) to forbid multiple-voting shares and voting caps in listed companies and to limit the issuance of non-voting shares, while deference to one share – one vote is sometimes paid by corporate governance codes (like the recent Dutch Code). These national developments have had repercussions at EU level, where some Member States and interest groups denounced a level playing field problem originated by the different treatment of pre-bid defences under national laws. The case of multiple voting shares is striking: while German and Italian law forbid their issuance, they are a typical feature of Swedish capitalism and are also diffuse in France where companies can issue double voting shares. The Takeover Directive will presumably have no impact in this respect (as Member States are allowed to opt-out of the breakthrough rule), save for improving the transparency of ownership structures including departures from one share – one vote.

IV. ENHANCING HARMONISATION THE EU?

In order to answer the main question of this paper, it is necessary to establish, first of all, whether the issue of one share – one vote should be regulated at national level. Only if a positive answer were offered in this respect, would the issue of regulatory harmonisation have to be considered[119]. In this section, I summarize this paper's outcomes and argue that harmonization at EU level is not needed (except for the transparency of ownership structures which is already regulated by the Takeover Directive).

[119] For a similar approach, see K. Hopt, 'European Takeover Regulation: Barriers to and problems of Harmonizing Takeover Law in the European Community', in K. Hopt and E. Wymeersch (Eds.), *European Takeovers* – Law and Practice (London 1992) p. 172 et seq.

1. *Lessons from Economic Analysis*

The study by Grossman – Hart examined above concludes that one share – one vote is frequently, but not always optimal. The two economists consider a company at the IPO stage and ask what voting structure should be chosen in order to maximize the total value of the company. They assume that the company has a diffuse ownership structure after the offer and that two management teams (the incumbent managers and a rival team) consider taking over the company. They argue that the optimal voting structure depends on the likely distribution of private benefits between the two competing teams: if only one team has private benefits with respect to the target company, one share - one vote is optimal; if both teams have private benefits, a dual-class structure is preferable. In countries where private benefits of control are high, one might expect frequent deviations from one share - one vote. Grossman – Hart conclude that one share - one vote should not be mandated as a legal standard at least with respect to the IPO stage. Their conclusions are different with reference to deviations taking place at a later stage when the company's shareholders are dispersed, if these deviations are effected by the managers to entrench themselves and the relative costs are borne by the public shareholders. However, if the managers are already in the company's control, a change in the voting structure should not be interfered with.

The policy recommendations made by law and economics scholars are similar. The case of IPOs is always non-problematic, as the initial shareholders bear the cost of limited voting structures. Dual-class recapitalizations, on the contrary, create problems if they are used to entrench the managers at the expense of public shareholders who see their shares' value reduced. The consent given by public shareholders to similar transactions could be the result of coercion by the managers. On the contrary, if a new class of non-voting shares is issued to allow new capital to be raised without diluting the dominant group, the transaction should not be interfered with.

However, dual-class structures generate agency costs which increase with the size of the wedge between control rights and cash-flow rights, as shown by both theoretical and empirical studies. These agency costs are higher in countries where investor protection is weaker. Moreover, dual-class structures are more common in these countries for the controllers can obtain higher benefits of control. Not infrequently, in similar countries, the initial owners of a company adopt a dual-class structure before offering the company's securities to the public, as they do not want to leave control up for grabs in situations where the amount of private benefits could attract unfriendly takeover-bids. On a policy level, the relevant agency costs could be dealt with either by forbidding dual-class structures or by increasing investor protection. However, if separating control rights from cash-flow rights were not possible, the initial owners could rather choose not to go public, possibly generating

social costs higher than those caused by dual-class structures. Also increasing investor protection could have a chilling effect if the costs of going public became relatively high.

2. *Lessons from Comparative Analysis*

The US approach to one share – one vote is consistent with the comments just made from an economic perspective. While the traditional NYSE rule forbidding all deviations from one share – one vote overshot the target, the new rule adopted by the US exchanges and Nasdaq discriminates between types of transactions along lines similar to those suggested by scholars in the discussions leading to self-regulatory reform. Initial public offerings of securities with disparate voting rights and subsequent public offerings of lesser voting stock are permitted, while other types of transactions "disenfranchising" existing shareholders, like the adoption of voting caps by listed companies, are forbidden.

The European approach is diversified. Rules forbidding deviations from one share – one vote were only recently adopted in some Member States, but offer partial solutions to the problems at issue. For instance, in Italy multiple voting shares were forbidden a long time ago and voting caps were excluded for listed companies by the recent company law reform, while a breakthrough rule applies to voting pacts under the Draghi law in the case of a takeover; yet, pyramidal groups are still present in Italy and non-voting shares can be issued by joint-stock companies[120]. The situation is similar in other Member States, where deviations from one share – one vote are relatively common[121]. This may depend on weak investor protection, even though departures from one share – one vote do not always correlate to private benefits of control, as shown by the use of multiple voting shares in Sweden which is generally considered as a "good law" country[122]. The situation is no doubt evolving as a reflection of corporate governance practices and legal reforms introducing Anglo-American standards; however, path dependence and the rigidity of corporate ownership structures slow down the transition to one share – one vote as a general standard.

The European approach is partially consistent with the policy recommendations formulated by economists (and received by American law). Deviations from one share – one vote are permitted even in countries that forbid some of them. However, no distinction is made in Europe concerning the ways in which similar deviations occur. Voting caps, where permitted, can be introduced either at the IPO stage or afterwards. Otherwise, they are generally forbidden to listed companies (as is the case in Germany and Italy). Similarly, non-voting shares can be issued either through a capital in-

[120] See Bianchi, Bianco and Enriques, note 87.
[121] See Goergen, Martynova and Renneboog, note 111.
[122] See R. Gilson, 'Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy', ECGI Law Working Papers No. 49/2005 (August 2005).

crease or by way of conversion of voting stock. Yet, dual-class recapitalizations do not seem to be an issue in Europe, possibly as a result of higher corporate ownership concentration. On the contrary, the breakthrough rule suggested by the High Level Group and included in the Takeover Directive do not conform to the policy recommendations considered above. To be sure, this rule does not mandate one share – one vote, so that deviations are still possible. Moreover, Member States can opt-out of this rule. However, where applicable, the breakthrough rule will have an impact similar to an outright prohibition on voting structures. In fact, controlling shareholders will rather choose those structures, such as pyramidal groups and cross-shareholdings, which are not at risk of a breakthrough in the case of a takeover.

3. *A European Rule?*

In light of the comments made in the preceding two paragraphs, the need for European harmonisation is in principle excluded. Mandating one share – one vote is not justified by economic efficiency, as also confirmed by comparative law. If there is no need for regulation at the national level, also the European breakthrough rule, which ultimately strikes down all deviations from one share – one vote, does not appear to be well grounded. Only transparency rules appear to be justified also at EU level as disclosure of ownership and voting structures serves a pricing and governance function[123], while harmonisation of the relevant rules reduces transaction costs in integrated markets.

Some scholars have tried to find a rationale for the breakthrough rule in the European commitment to economic and political integration. According to J. Gordon[124], this rule is aimed to foster the development of diffusely-held public firms on the assumption that these companies better serve the EU integration project. In fact, cross-border takeovers would become easier if corporate ownership evolved towards Anglo-American standards, while economic nationalisms would be curbed if companies were more easily contestable. Similarly, J. Coates[125] suggested that the best rationale for the breakthrough rule is that many companies with dual-class structures were established long ago when they had already achieved a self-sufficient scale. Now that the EU has liberalised markets, "scale economies are not being achieved in the most efficient manner (through M&A transactions) because controllers are unwilling or in some cases legally unable to sell or share con-

[123] See R. Kraakman, "Disclosure and Corporate Governance: An Overview Essay", in Ferrarini, Hopt, Winter and Wymeersch (Eds.), note 16, p. 95.

[124] 'An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the Euroepean Union, 1990 – 2000' ECGI Law Working Paper No. 06 (February 2003).

[125] Note 16.

trol"[126]. Coates concludes, however, that the breakthrough rule is not necessarily the best remedy for such companies and that a better balance could be achieved with a periodic 'reopening' of control, as recommended by American scholars suggesting that takeover defences be revisited every ten or twenty years at a general meeting of shareholders[127].

These two scholars try to justify the breakthrough rule on grounds different from those usually referred to for legal harmonisation. If the Member States did not consider anything like this rule for their own laws, the reasons traditionally given for harmonisation, such as reduction of transaction costs caused by divergent national rules and protectionism inherent in national regulations[128], cannot be invoked for the breakthrough rule. Nonetheless, the Treaty's freedoms do not seem to support such a drastic regulatory move. As argued above with respect to "golden shares", the conclusions reached by the ECJ in the relevant cases could not be extended to all sorts of deviations from one share – one vote, as they concern deviations specifically provided for by the law. Similarly, the Treaty freedoms could not be invoked to strike down all deviations from one share - one vote under the breakthrough rule, as this would unduly restrict private autonomy, while it is not at all clear whether structures like dual-class shares are substantial impediments to economic integration in Europe[129].

[126] Ibidem, p. 705.
[127] Ibidem.
[128] See G. Ferrarini, 'Pan-European Securities Markets: Policy Issues and Regulatory Responses' (2002) 3 EBOR 249.
[129] See section I, para. 2.2, above.

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