A Scandinavian Approach to Corporate Governance

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1 **The Intimate Relationship of Law and Language** …………………..... 126

2 **The Approach to Corporate Governance** …………………………… 128

3 **Nordic Corporate Governance** ……………………………………… 130

4 **Challenges to the Scandinavian System** …………………………… 133

5 **An 'Independent' Board?** ……………………………………………... 135

6 **Different Voting Rights on Shares** …………………………………….. 137

7 **Conclusion** ……………………………………………………………… 142

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The question of what is Scandinavian law seems to presuppose that Scandinavian law is inherently different from other legal systems. It is a bold proposition, but in my opinion a well founded one. At least as a company law scholar, I have no problem of identifying Scandinavian law as a body of law distinct from other contemporary legal systems even in countries that are closely related to Scandinavia both geographically and culturally. In fact, when looking at the subject of corporate governance that forms part of company law it is possible to point out at least three different approaches, which may crudely be labelled Anglo-Saxon, German and Scandinavian, respectively, and there may well be others that my lack of proficiency in foreign languages prevents me from recognising. Before I proceed to describe this distinct Scandinavian approach to company law, I would like to broaden the subject somewhat more by addressing the overarching question raised by this conference, namely is there such a thing as distinct legal systems.

1 The Intimate Relationship of Law and Language

The human being is a social creature, born and raised in groups. Evolution seems to have rewarded the human capacity of coordinating the activities of ever larger groups of individuals. This is done mainly by language and, we may add with pride, in large part by the subset of language that is made out of norms on proper behaviour, that is, by law.

Thus, there is an inherent relationship between law and language. When debating whether there are separate legal systems, we may just as well debate whether there are different languages. This is not as obvious as it may appear at first. It is still debated among experts whether language is hard-wired in our brain by evolution or is a soft skill acquired by training. Apparently, there is evidence to support both propositions. Furthermore, it is debateable whether languages really are different, because many languages have proven to be part of larger families with ancient common roots, such as the Indo-European language that lies behind the language that most of us would use here at this conference.

One may argue that albeit languages differ they still describe the same reality. *A table*, *une table* and perhaps even *ein Tisch* may all be readily understood by the English, French and Germans, but even though *et bord* may sound more different to a non-Scandinavian, the object itself will still be a table even if you are not a Dane, a Swede or a Norwegian. Even non-physical ideas may be the same when expressed in different languages and are easy to translate. In the cold North we say that it is only the tip of the iceberg that is visible when we want to caution that there is more than meets the eye. In central-Africa, dire short of icebergs but with plenty of wildlife, the saying goes that it is only the tip of the hippopotamus that is visible. The dangers of submerged threats are the same irrespectively of language and culture, because basically humans and the societies they create and inhabit are identical.

Yet, another may counter and point out that it is seldom possible to translate directly from one language to another. This has been the scourge of automated translation systems and it remains a source of entertainment to many to take a

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text and have it first translated into a foreign language and then back again only to find that the 43rd President of the United States is a Mr Leaves. Great literature should be read in the original language, because reading a translation is like kissing through a handkerchief as the saying goes. The centuries old ban on translating the holly Koran reflects an understanding of the risk of diluting the original meaning of a text. The fact that all the many languages of the European Union are equally authentic when construing its legal texts is a source of great pride to many especially small communities and a welcomed supply of jobs for their youth but also a reason of uncertainty as to the effective meaning of these texts to many business professionals and lawyers.

Most would agree that it is possible to communicate in a language different from one's one and that it is often very helpful to do so, but would also agree that it is difficult to convey the exact meaning, which requires an intimate knowledge of the foreign language and an appreciation of the subtleties of specific words and their inter-dependence as phrases of that language to avoid misunderstandings. Whether we should strive for a unified language, a *lingua franca* such as (pidgin) English or the artificial Esperanto is a much more contested issue. Normally, the enforcement of one language to the exclusion of others is the hallmark of conquering oppressors, not the activity of friendly tradesmen seeking to do business.

We may at this point leave language and look at its minor sibling, the law, because what we have found so far is true of law as well. We may translate national law, but we do it at our peril because legal concepts often have a unique meaning within that legal system that may be difficult to appreciate in another legal system. If one fails to appreciate the inter-relatedness of a legal concept with other concepts of that legal system and replaces it with an imported one, the delicate fabric of law may soon unravel.

It may be true that many business professionals would wish that the law was the same all over the European Union and the greater European Economic Area and this has for some time been a powerful motor behind the efforts of harmonisation, but as already the Greeks observed, the gods may punish us by fulfilling our dreams.

First of all, it does appear somewhat naïve to think that any lack of integration that may still persist in Europe today is due to differences in law and not in the much more important differences of language and culture that cuts across our Continent and makes it look like a patchwork blanket.

Second, these differences may make it difficult to reap economies of scale by standardisation which in turn may hamper the further growth of large companies, but is does provide a feeding ground for a variety of smaller companies ready to cater to the different tastes. To put it in another way, the lack of growth potential for industrial behemoths does not preclude a thriving industry at the long tail and even if we did have just one law and only one language, people's preoccupation with keeping up with the Joneses in being different from the rest may prevent any such growth potential just the same. When captains of industry fantasises of the revenue a more harmonised Europe could bring, they might as well dream that all people shared the same shoe size.

Third and perhaps most important, it should by now be generally accepted that humans are fallible and although good intentions may be abundant the

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capacity to fully foresee the consequences of regulation in the dynamic and chaotic system that makes up our society is as difficult as it is to make predictions about another well known dynamic system, the weather. Thus, we must expect that even with the best intentions, any regulation enacted by man may prove wrong and produce a bad outcome. The only way we can sensibly correct this is by allowing competing systems to work at the same time, thus making it possible to evaluate their different outcomes and judge which worked the better. Is it better to have a system of high taxation that offers an abundance of welfare goods or is it better to have low taxation and let people decide on their own how to use their income? No one can tell, but allow both systems to operate and we will see in a few years which system is thriving and which is crumbling under the weight of bad policy decisions. This could hardly be called unfair if the systems were chosen freely by their own citizens, no more than you could call a footrace unfair simply because one person actually won. If we instead opt for total harmonisation, we put all our eggs in one basket and can only hope that we got it right first time around with no way of learning whether things could have been done better.

To sum up this excursion into law and language; law is intimately related to the country of its origin and the people who live there, with their language, their culture and history. This is not a bad thing and should not in itself be a course for alarm. History teaches us, that when people of different cultures interact, their language often changes to accommodate the interaction and we may expect the same of law. This is a bottom-up development that may take time, though not necessarily as long as it used to; hardly anything does that any more. Harmonisation as carried out by the institutions of the European Union is on the other hand a top-down approach, which may be somewhat quicker, but also carries the great risk of petrifying the development by preventing alternatives. Consequently, European harmonisation of law may bring about further cross-border activity to mutual gain for the peoples of Europe, but it should not be an end in itself, nor should we strive for total or near total harmonisation. It should rather remove obstacles for free movement and enterprise and leave the positive regulation to the Member States for them to chose and compete in finding the best regulation available. Where harmonisation is deemed necessary, it should be done by directives leaving some discretion of implementation to the Member States to ensure that the new European norms can dovetail with the old national law in that area.

2 The Approach to Corporate Governance

There are many definitions of corporate governance. Some tend to incorporate a normative view of how to enhance the governance of a company, also known as good corporate governance, but strictly speaking it suffice to say that the subject of corporate governance at least in a legal sense is to describe the legal norms on who is competent to govern the company and make decisions on its behalf. This is something different, and to some extent less difficult, than the normative question of what constitutes good corporate governance as opposed to bad. The two different approaches overlap somewhat, because the existing corporate

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governance systems are often the result of political decisions of what would produce the best corporate governance, but it is important to note that it does not necessarily have to be that way. A system of corporate governance may simply have evolved from proprietary rights reflecting bargaining powers and the attempts to justify the resulting system as producing good governance may be an after the fact rationalisation unhinged by empirical evidence. This should be taken into account, not to prevent the normative exercise of determining what is good corporate governance, if that is at all possible, but because we should respect property rights wherever we meet them, remembering that the ownership of property is one of the most fundamental human rights as it serves as the best protection of the individual from the risk of abuse by the State or any other majority. Thus, when we embark on the daunting task of finding the holly grail of company law, the illusive best practises of corporate governance, we must not set aside property rights simply because we believe they are in the way of a greater good, nor should we ignore that the holders of property rights may be at least as qualified to determine what is best for them.

Another caveat is in place here, although it is not particularly about corporate governance but pertains to all regulation of human behaviour. There are basically two ways of dealing with problematic behaviour: an *ex ante* approach and an *ex post* approach. The former will try to prevent the unwanted behaviour before any problem arises, the latter will try to address the problem when it has happened. The merit of the former is the fact that the problem will never arise; the disadvantage is the need to make the regulation so broad and general that it serves its preventive purpose. If the unwanted behaviour is easily defined, this may not pose a problem, but if, as is the case with the governance of a company, unwanted behaviour is indistinguishable from acceptable behaviour, the *ex ante* approach risk preventing that as well and may serve effectively as a hindrance for reasonable business behaviour. In these cases the *ex post* approach may be more relevant as it will single out the unwanted behaviour and seek to either punish or repair the damage done. Consequently, where a problem is related to behaviour that is easily recognised as bad or where the damage done may be difficult to repair, the *ex ante* approach may be the better regulatory choice. In the case of corporate governance, however, where behaviour is extremely difficult to categorise because it must be judged in the context of the facts surrounding it and where damage is usually pecuniary, the *ex post* approach should be the regulatory tool of choice. Indeed, within business organisation law of which corporate governance is also a subset, the best discipline against wrongful behaviour, e.g. an unfortunate business decision that causes losses, is not to try and prevent such a decision being made, which is often near impossible, but to let the shareholders vote out the incumbent management and replace it with another and, depending on the malfeasance of the case, possibly sue the old managers for damages.

Our approach to corporate governance should thus be first to note what the system looks like and then we may examine whether the system could be expected to produce good corporate governance. In making the latter argument we should not only respect the right of property holders to decide what is best for them, we should also use the *ex post* approach, which means that it is not enough to identify the risk of unwanted behaviour to justify regulation to ban or

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otherwise prevent it, if the parties involved have the necessary means to address the problem afterwards.

Then we may proceed to the next big question of corporate governance, namely what is it exactly we refer to as good corporate governance as opposed to bad? Is it good corporate governance to ensure that the company provides the biggest possible profits to its shareholders? Yes, it may be argued, because that ensures the most efficient use of the society's resources. Although a powerful argument, it is not universally endorsed. Some would argue that good corporate governance is to seek an evenly distribution of the proceeds of the company, e.g. by paying good wages and remedying any externalities that the company may produce. And even if that proposition is not acceptable, it remains difficult to argue that it should be the obligation of the talented manager to hand over as much as possible of the profits that the manager has provided by his hard toil and late hours to the inactive minority shareholder who simply invested his small inheritance some years ago. Many other opinions are locked in battle here with only a few camps flying the flags of *shareholder value* or *stakeholder interest*. Basically, it should be recognised that this is inherently a political argument and as jurists we may either state our preferences as clearly as possible before proceeding to label an outcome good or bad, or, which I believe is the better option, we may leave it to the parties involved and only interfere in so far as we believe that the setting prevents the parties from making an informed choice.

3 Scandinavian Corporate Governance

The legislation of the five Nordic countries of Denmark, Finland, Iceland, Norway and Sweden on the Public Limited Company (PLC), are to a high degree identical, which I have explored in my 2003 book on *Nordic Company Law* (DJØF Publishing, Copenhagen). The recent reforms in Finland and Sweden and to some extent in Norway and the ongoing reform in Denmark may warrant a new edition of said book, but it has so far not changed the common structure of law in this area.

This is especially so in respect of governance. The original governance structure in place at the beginning of the 20th Century was a one-tier structure similar to that of the Anglo-Saxon system. The PLC was governed by a board of directors. In larger companies day-to-day management was the responsibility of the CEO and he could serve on the board as well. In the Danish reform that ended with the 1930 PLC Act, it was pointed out that in very big companies it was unsound that responsibility for the governance of the company was vested only with the board of directors and did not include the CEO, who would have a major say in the governance of the company. Liability should follow capability and consequently, the management should be liable for their day-to-day management. For that reason, the 1930 Act introduced the management as another company organ below the board of directors and with liability for day-to-day management. As the management in Danish company law was regarded as a collective body of executive officers headed by the CEO, it was referred to as the board of managers (direktion). This was mandatory for companies with a

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share capital of 100,000 DKK, a considerable sum at the time. Other companies of the PLC type covered by the Act were free to continue with the one-tier structure, but could opt to introduce a similar arrangement in their articles. In the late 1930'es, company law reform was again debated among the Nordic countries. The outbreak of World War II stopped the reform, except for Sweden, which remained neutral and in 1944 introduced a reformed PLC Act that included, *inter alia*, the new governance structure known from Danish company law. However, as the management in Swedish company law was understood to be solely the CEO, the new company organ of management became a one-person entity comprised of the CEO (värkställande direktör, VD) After the war company law reform was continued and the new governance system spread to the other Nordic countries, with Iceland joining Denmark in regarding the management as a collective body, whereas Finland and Norway joined Sweden in regarding it as comprising the CEO alone.

Irrespectively of whether the new company organ of management was considered a one person entity or a collective body of executives, the governance structure was identical in all five countries. It is very important to note that in effect the one-tier structure was maintained. The new company organ of management was inserted *below* the board of directors and subject to their instructions. A member of management may serve on the board of directors, but to strengthen the capacity of the board to control management, a manager cannot chair the board and where management is a collective body, the legislation further states that they must form a minority of directors. The liability of management is the day-to-day business that is their job and if confronted with unusual situations or far reaching decisions, they must put the case before the board to decide. The board of directors enjoys executive powers beside their power to supervise the management. In fact, as management is confined to day-to-day management, the board enjoys the overall and residual executive powers, including the power to sign on behalf of the company. For this reason, the Scandinavian governance system may be described as a *dual executive system*, because it has two executive organs: the board of directors and the management. To secure the position of the board of directors as the upper-level executive organ *vis-à-vis* the management, managers are hired and fire by the board at their discretion.

This is very different from a two-tier structure of governance as the one known in German company law. In German law, the executive powers of a PLC are vested solely with the management, which is then working under the supervision of a distinct supervisory board, hence the description as a two-tier system. A manager cannot simultaneously serve on the supervisory board and *vice versa*. The supervisory board may not usurp executive powers although it may to a limited extent have a right to veto certain far reaching decisions if mandated by the articles and even in that case, the management may circumvent it by putting the matter before the general meeting of shareholders. To safeguard management from undue influence from the supervisory board, managers are appointed for a fixed, though renewable, term and may only be dismissed if a material reason is proven.

Another and even more important difference is the position of the shareholders. Here it is clear that the Scandinavian governance system is

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basically a one-tier system but with an internal arrangement of managerial powers divided between a lower- and upper-level executive organ. Perhaps it is better described as a one-string system, because it is strictly hierarchical with the shareholders on top with almost *omni potent* powers, the board of directors below and the management below that. The hierarchical nature of this system assures that the level above may instruct the level below and remove any member of it at its discretion. Thus, the general meeting of shareholders may make any decision short of a decision on how to retrieve money from the company either as dividends or a reduction of capital as this would require consent from the board of directors, who are personally liable for the affairs of the company. The decision of the general meeting must be implemented by the board of directors, who holds the executive powers to act and sign on behalf of the company. If a majority of the general meeting is not pleased with one or more directors, it may replace that director irrespectively of the term he was appointed for, thus eliminating the possibility of staggered boards. The decision may in turn be forwarded by the board of directors to the management to be implemented and again any manager not behaving as required may be fired by the board.

This strict hierarchical structure with the shareholders firmly on top stands in stark contrast to the two-tier structure of German law, or as it may be viewed its system of check-and-balances. In German law, the management is entrenched not only against the supervisory board but also against the shareholders in general meeting. In fact, the general meeting has a limited competence exhaustively set out in law and mainly consisting of issues related to the issuance of new shares and the control of the management by reviewing their financial accounts. The shareholders in general meeting have no direct say over management, but management may voluntarily put issues before the general meeting to decide. The boot is obviously on the other foot compared to Scandinavian law. This preoccupation with limiting shareholder influence is also seen within the field of company groups. Where one company is a major shareholder in another company, German law sets up a comprehensive system to ensure that the dominant company either does not interfere with the management of the controlled company or takes over the management of it but offers certain protective measures to any minority shareholders. This special regulation of company groups is symptomatic to the general attempt in German company law to reduce the influence of shareholders on management. To some this elaborate regulation of company groups serve as model; others would point to the fact that few German companies actually organise themselves according to these rules and conclude that it is an unnecessary *ex ante* approach to preventing shareholders' abuse of power.

The one-tier or rather one-string governance structure of Scandinavian company law is thus different from German law and its two-tier system but has much in common with the Anglo-Saxon one-tier system. Here as well, the shareholders are considered to represent the superior interest of the company and the directors are viewed as their agents giving the system a hierarchical character similar to that of Scandinavian law. However, this does not quite hold up in respect of listed companies. Market financing in much greater in the UK than on the Continent and at least since the World War II this would appear to have

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created a dispersed shareholding in listed companies. In the Scandinavian countries as in many other places around the Globe there is a persistent tradition of dominant ownership of shares even in listed companies. As it has been observed, power abhors a vacuum, and with dispersed ownership of shares, the power afforded to the general meeting of shareholders by English company law is in the absence of any major shareholders usually picked up by the directors of these companies. This has been the case for so long, that English exchange regulation contrary to the position in company law is quite sceptical of dominant shareholders and thus requires the boards of listed companies to remain detached from them.

Consequently, when we look at listed companies, it is German and English law that is most alike, each displaying a distaste for dominant shareholders, albeit for different reasons. This leaves the Scandinavian corporate governance system in opposition, and handicapped by their minor size and odd languages the Scandinavian countries often find it difficult to explain the merits of their system to the powers that be in Brussels who contemplate harmonisation.

4 Challenges to the Scandinavian System

In Scandinavia, the hierarchical system of the one-string structure places the shareholders on top with wide powers to run the company and to place the people they trust as directors to ensure that their wish is the company's command. So great is this notion of shareholder superiority that company legislation mandates that the majority of the board of directors must at all time be appointed by shareholders in general meeting. And at the general meeting, whoever controls the majority may pick up all the seats on the board as there is no requirement of accumulative voting. This is a system devised to ensure that a dominant shareholder can govern the company.

But are the inhabitants of the Scandinavia really that blond and blue-eyed that they do not see the risk of abuse from majority shareholders? Of course they do and their law has through generations been keenly developed to match these problems. The problem of excessive risk taking by a management coerced by a dominant shareholder is solved by making not only management but also the dominant shareholder liable if he is responsible for any reckless behaviour. The problem of abuse of powers are solved by a general clause that enables the courts to strike down any decision made to unfairly advantage one shareholder at the expense of the company or other shareholders. The problem of private benefits has further been solved by a system of always diligent and assertive tax authorities who make it impossible to siphon funds out of the company without being taxed heavily at the higher rate put on wages. Not only are these solutions in place and have stood the test of time, they are also *ex post* measures that does not prevent the company from functioning efficiently which the high living standards enjoyed in Scandinavia are a direct result of.

Yet, this system is being threatened by EU harmonisation. Not out of ill will but from a sheer lack of understanding of the system's special features. The centrepiece of the Scandinavian system is the proposition that a company is run

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best when shareholders are the ultimate decision makers. Shareholders only receive a return on their investment when all other duties of the company have been paid and the company still turns a profit. For that reason, the shareholders have an incentive to make the company profitable. This is not to overlook that shareholders have a perverse incentive structure. Due to limited liability their downside is limited but their upside is unlimited, which may give the shareholders a preference for reckless risk taking. This particular problem is mitigated by vesting the executive powers with the board of directors and making the directors personally liable for excessive risk taking in that way ensuring that the shareholders cannot run the company without the assistance of the directors who are personally liable for the company's welfare and if necessary by making dominant shareholders liable along side them if they have taken part in reckless decision making. But overall the system is designed to ensure that shareholders hold ultimate power over the company. Appreciating that the PLC is made to cater for free riding investors, which is facilitated by the limited liability that enables an investor to make his investment without having to monitor it to avoid liability, it is understood in Scandinavian law that the power vested with shareholders must often be in the hands of a single shareholder if not to be so dispersed as to leave the power effectively with management.

In Scandinavian law, the explanation of why a single shareholder may invest to become a dominant shareholder and spend his resources monitoring the company is not the prospect of taking private benefits but is explained by the fact that the dominant shareholder finds it worthwhile to carry these costs to increase the return on his major investment within one company rather than distributing his investment on several companies with a higher risk due to his lack of effective monitoring. The fact that the effort of the dominant shareholder produces an increase in the profitability of the company that the dominant shareholder has to share with the other free riding shareholders is no more mysterious to Scandinavian company law scholars than all the other benefits bestowed on society by the invisible hand of the market described so vividly by Adam Smith more than 330 years ago.

Consequently, the gist of the Scandinavian system is that we want shareholders to have direct influence on the affairs of a company, be it listed or not, and that the presence of dominant shareholders are welcomed because they may be able to monitor and discipline management on behalf of all shareholders that minority shareholders on their own are unable to.

This system is being challenged by the new initiatives of harmonisation from the European Union, which would seem more to reflect the sentiment of Anglo-Saxon and German company law than the Scandinavian approach. Two examples are to be offered here, one is the quest for 'independent' directors, the other the campaign against different voting rights for shares.

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5 An 'Independent' Board?

One challenge that is at present benign but has the potential to significantly damage the Scandinavian approach to corporate governance is the attempt to make the board of directors more 'independent'.

The Commission has issued a recommendation (2005/162/EC) on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board. The recommendation correctly observes the differences on corporate governance systems within Europe and that most Member States appear to distinguish between directors engaged in daily management and those who are not in order to secure a supervision of the former by the latter. This is well known in Scandinavian company law, where the dual executive system from its conception in the Danish 1930 Act has been subject to the requirement that members of the daily management must occupy below half of the seats on the board of directors and cannot perform the task of chairing the board. But when the recommendation then goes on to state as it main principle in point 3.1 that the board of directors should be composed in order that 'no individual or small group of individuals can dominate decision-making on the part of these bodies', this is in direct opposition to the very foundation of Scandinavian law that dominant shareholders should have decisive influence on the decision-making process.

Somewhere between the very sensible observation at the outset of the recommendation's preamble that there should be a difference between executives and non-executives to enhance supervision of daily management and the proposition in Section II of the recommendation that no one should dominate decision-making at board level, something has gone wrong at least when viewed from a Scandinavian viewpoint. The first problem with this line of reasoning is probably the lack of clearly distinguishing between regulation *ex ante* and *ex post*, that is, regulation to prevent a problem or to solve a problem. The problem of a possible conflict of interest may be solved *ex ante* by ensuring that only persons with absolutely no conflicting interests with anybody may serve on the board or it may be solved *ex post* by requiring that if a conflict of interest arises, then the conflicted director may not participate in the decision. The latter approach is more flexible and makes it possible to rely on a much broader base of business professionals from which to recruit, while at the same time preserving the possibility of a dominant shareholder to discipline the board by removing unqualified or self-serving directors. The interest of minority shareholders is not only safeguarded by making it illegal for directors to participate in decisions where their interests conflict, but also by expressly prohibiting the directors from making decisions that benefit one shareholder at the expense of the company or other shareholders, that is, a ban on private benefits. The approach chosen by the recommendation, however, is an *ex ante* approach that directly defines 'independence' in point 13.1 as the absence of 'any business, family or other relationship, with the company, its controlling shareholder or the management of either, that creates a conflict of interest such as to impair his judgement.' Thus, the question of conflict of interest is to be determined in advance of any specific occasion which means that any ties with a dominant shareholder may disqualify a person from serving as a director.

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The approach of the recommendation is undoubtedly at odds with the gist of the Scandinavian system of corporate governance, although it is at present only a modest challenge. The recommendation does not interfere with the appointment of directors, which in the Scandinavian system is left to the majority of the general meeting of shareholders and thus effectively to any dominant shareholder who may hold a majority of the votes. The consequence would appear only to be a narrowing of the talent pool from which the dominant shareholder may draw new directors as they cannot have any specific ties such as a previous commitment on the board of another company. In small countries the talent pool is small even without unnecessary limitations like this, but still big enough for the system to overcome it. Dominant shareholder will no doubt manage to get their people on the board anyway.

It is much more worrisome that the recommendation seems to fail to understand the underpinnings of the Scandinavian approach to corporate governance. According to the Scandinavian approach, the task of disciplining management and ensuring that they are working in the interest of the shareholders, a task recognised by the recommendation in consideration 7 of the preamble, is guaranteed by ensuring that the board is subservient to the general meeting of the shareholders and if one shareholder is dominant among them, that shareholder is expected to discipline management in the interest of the other shareholders. Provisions on conflict of interest and a ban on taking private benefits ensure that any dominant shareholder does not transgress on his powers to the detriment of the minority. This is a system that works and has worked well for years. Yet, the recommendation appears to go directly against this. Rather than leaving the job of supervising the board to a shareholder who has the economic incentive to do it well because every *krona* spend by the directors is a *krona* less in dividends, the job is placed with an individual who is supposed immediately to take up a seat next to the persons he is to supervise. It is strangely naïve to believe that a director without any special incentive other than an urge to do good should be better at monitoring than a shareholder for whom it has some actual economic consequences. This becomes almost absurd in the case of remuneration of directors, where the recommendation calls for a majority of 'independent' directors to monitor their fellow directors; so in the case where the risk of collusion among directors is the greatest, that of putting the company's money into their own pockets, the very person who may be hurt the most by this, the dominant shareholder, is obliged to retain a minority influence on that decision.

The questionable logic behind this whole approach to supervision would appear to point at the Commission's much earlier commitment to German corporate governance as evidenced by the now defunct proposal for a 5th Company Law Directive. In German law, supervision is a clear cut task, it is done by the Supervisory Board (Aufsichtsrat) in respect of the Management Board (Vorstand) and each of the two company organs have their separate task either to supervise or to manage, but never the twine shall meet. But in the Anglo-Saxon system, as in the Scandinavian system, well practically every where else, supervision is a part time affair done by executives on their lower ranking fellow-executives. In the English one-tier system, supervision of executives is done by non-executive directors serving on the same board and all

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of them, executive and non-executive, help run the company, because the board of directors is the executive organ, or as EC parlance would have it: the administrative organ. Equally, in the Scandinavian dual executive system, the non-executive directors supervise the executive directors who may either be members of the board or serve on the lower executive body of daily management. But in either case, the board itself may take executive action. So who monitors the non-executives when they act as executives in making decisions on the board level? The answer is, of course, the shareholders and experience tells us that if shareholders are to perform the powers that company legislation have bestowed upon them, it often requires a dominant shareholder who can afford the time and resources to do so. It is only in a German setting that monitoring by shareholders is deemed unnecessary and can be left to (supervisory) directors.

The problem of understanding the Scandinavian approach is ominous, because the recommendation may become a stepping-stone for something worse to come. That this is not entirely impossible, is evident from the last consideration of the recommendation's preamble that '[i]n view of the importance attaching to the role of nonexecutive or supervisory directors with respect to the restoration of confidence, and more generally to the development of sound corporate governance practices, the steps taken for the implementation of this Recommendation in Member States should be monitored closely.' This would appear to be an only thinly veiled threat of Community action should the recommendation not be followed widely. But the notion of implementation is inconsistent with a recommendation that is by its very nature intended to be non-binding on the Member States as laid out in Article 249 EC. That is why, after all, the Commission has the power to issue recommendations on its own in the first place, because the EC Treaty expressly reserves the power to issue binding legal instruments to the Council and, when Article 251 is applicable, to the European Parliament. If something is important enough to monitor closely, it should be left for these institutions who alone share a democratic legitimacy to decide on which measures to implement. And should the issue of corporate governance ever progress that far, it must be hoped that the European legislators will be more acutely aware of the differences and merits of the various Member States. That would probably grant them the wisdom not to force the straightjacket on company law that harmonisation in this area would be.

6 Different Voting Rights on Shares

Another challenge to the Scandinavian approach to corporate governance is the continuing attempt to elevate the principle of one share, one vote (OSOV) to be the only lawful solution. Again, this commitment can be traced back to the German inspired proposal for a 5th Company Law Directive, which originally was unacceptable to the English as well, albeit within other areas such as co-determination, and for that reason was abandoned although never really given up. It was not surprising therefore that elements of it would reappear in the proposal for a directive on takeovers.

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In Scandinavian company law, reliant on the *ex post* approach of regulation as it is, the attitude to voting rights for shares has been relaxed and permissive. It is best decided by the company and its investors. Experience has shown that the possibility of issuing shares with different voting rights serves as a control enhancing mechanism (CEM) and the prevalence of dominant shareholders in Scandinavia is to a large part explained by the possibility of issuing shares with a lower voting right per share, say one vote for each 100 kronar, than the shares already hold by the shareholders controlling the company, say ten or more votes for the same share. As dominant shareholders are viewed favourably in Scandinavian company law, the possibility of issuing shares with different voting rights is considered an important feature of law worth preserving. This approach is, however, not based on the acceptable outcome it produces. It is born out of a respect for the autonomy of the participants in the company. If the existing shareholders want to preserve control when issuing new shares, thereby issuing shares with lower votes, and if investors want to buy these shares, so be it. As long as there is full transparency, which is provided by the publicity of the company's articles of association mandated by the 1st Company Law Directive and the 2nd Company Law Directive in respect of shares issued by companies of the PLC type, then the decision is better left with the parties themselves irrespectively of the desirability of the outcome.

This respect of party autonomy and its offspring, the freedom of contract, is important to note and should in principle preclude any need to discuss the desirability of the outcome it produces. However, it is not uncommon that the outcome of party autonomy may be so damaging either to the parties or to society that regulation may be warranted. This may be true, but the onus of proof must be on those arguing for a restriction of the freedom of contract once we have established that the parties already enjoy the necessary transparency when making their decisions.

The first question is whether shares with different voting rights, which analytically must include vote-less shares as well, are a bad investment that unsophisticated investors should be protected from. The answer must be no, not only because of the high degree of transparency and the easily understood differences between the various classes of shares which are hardly as complicated as some pension schemes or derivative instruments offered to the public at large, but also when such shares are viewed in a strictly financial sense. A share issued with a lower voting right per share than other shares issued by the same company is an alternative to a debt investment in the company, e.g. a bond. In the case of a bond, the investor usually has no influence on the company, receives fixed instalments and is paid before shareholders in case of bankruptcy. If the investor buys a share with inferior voting rights, he receives some influence on the company, albeit less than other shareholders, he has a greater risk because shares are repaid only after all other obligations of the company, and, what is probably most important, the investors is entitled to a dividend in proportion to the financial success of the company. To the lay investor, influence is probably of minor importance, because even if the shares observed the OSOV principle, as a small investor he would still not have any influence at the general meeting. The real choice would therefore be either to receive a fixed return on investment with less risk by buying bonds or the possibility to receive a higher

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return at somewhat higher risk by buying shares. It is difficult to state in beforehand that the lay investor should always choose the former investment rather than the latter; that would depend on the investment opportunity and is thus best left with the investor.

Another related argument against regulation is the voluntary character of the arrangement. If shares with inferior votes are a bad investment, they would soon be shunned by the market and even lay investors would learn to stay away. In fact, they don't. Most of the complaints about vote differentiation appear to come from institutional investors. They suffer the burden of having to invest trillions of euros which means that their acceptance of shares with inferior votes may not be quite voluntary. Or to put it another way: they appear to be frustrated that they have to invest in whatever is offered. If vote differentiation was banned, they would get more influence for their money. Nonetheless, in spite of the understandable frustration of not getting exactly what they want, it must be maintained that even institutional investors are free to choose and if they really think vote inferior shares are a bad deal, they could boycott them. So far, they have not, and although the number of new issues not applying the OSOV principle is down, it can hardly be argued that they have gone out of favour. As it is, one of the largest IPO's seen recently in Europe, that of Google, applied shares with different voting rights. But even if it where correct that new share issues were overwhelmingly applying the OSOV principle, it would still not amount to an argument in favour of regulation to ban vote differentiation, rather, it would be a perfect argument not to regulate at all, as the market would appear to solve the problem by itself.

Yet another related argument could be that even if investors are not hurt by the issuance of shares with different votes, the company itself is damaged, because it does not attract as much funds as it would have had it issued shares according to the OSOV principle. There can be little doubt that shares issued with inferior voting rights compared to other shares issued by the same company must be trading at a lower price than the price of shares with superior voting rights. If I go to a bar, I expect to pay less for half a pint of beer than I pay for a full pint. This, however, does not tell me anything about how the bar is doing, because that depends on the total amount of beer they are selling. Shares with inferior voting rights are often offered for sale in order to preserve control with the existing shareholders and are regarded as an alternative to debt financing, e.g. the issuance of bonds or taking on bank loans. As the Modigliani & Miller Theorem teaches us, it should not matter to a company whether it is financed by debt or equity. As Merton Miller explained it is almost like deciding whether to cut your pizza in four or eight pieces, the amount of pizza you end up with is the same. So what is important here is not the fact that that the company issued shares with inferior voting rights in lieu of debt, but that the existing shareholders decided not to depart with control completely. By not offering control in parity with the amount of equity wanted to finance the company, the existing control holders do not raise as much money as they could. But again it is impossible to argue that this is a bad decision that would hurt anyone. If you decide to sell your furniture to raise cash but decide to keep the comfy chair, you will raise less cash than if you had sold it all, but if you actually value your old chair that much no economist could argue that you made a bad decision. On the

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contrary, noting that shares and debt are interchangeable should warn us against limiting the flexibility of issuing shares, because if the possibility of issuing shares with inferior voting rights does not exist, the control holders may opt for debt financing. As debt financing does not provide the up-side available to holders of shares who can participate in the future earnings of the company, which may serve to mitigate the risk associated with any investment in the company, debt may be considerably more expensive for the company. So not only could such a move to ban shares with different voting rights prevent companies from going public, thus reducing further the companies available for public investment, it may actually provide the financial harm that was the problem this argument started out with.

Another more independent argument against vote differentiation has turned up in the debate accompanying the directive (2004/25/EC) on takeover bids and concerns whether shares with multiple voting rights are detrimental to the takeover process. It would appear that this argument first appeared in the debate as a move by the Germans to counter what they believed was a full frontal attack on their corporate governance system, and rightly so. As mentioned above, the German corporate governance system seeks to entrench management and protect it from shareholder influence in order for management to take into account not only the interests of shareholders but of all stakeholders in the company, *inter alia*, the employees and society in general. The gist of the proposed directive was, on the other hand, that a takeover was to be decided by the shareholders alone and that any intervention from the incumbent management was probably an attempt by them to prevent getting ousted once the takeover was completed. For that reason the proposal carried an anti-frustration clause that would require management to remain passive in face of a takeover bid. This, to the Germans, was unacceptable as it would violate the management's obligation to decide what is best for the company and not just for the shareholders. As part of the opposition to the proposal, they argued that if such an anti-frustration rule should be enacted it was necessary to make all companies as open for takeovers as German companies are. If German companies may not strike you as particularly open to takeovers, it is in fact not due to different classes of shares; it has more to do with the cross-holding and heavy involvement of banks that used to be ubiquitous and to the involvement of unions due to co-determination. In respect of shares, German company law is quite strict and bans most forms of CEM except for vote-less shares, that have to carry a preference in respect of dividends which make them resemble bonds. It may be argued that German company law has no need for CEM, because the shareholders have no control to enhance anyway.

The predictable consequence of this argument on the debate was to alienate the Scandinavians, who could not accept that shares with multiple voting rights should be an obstacle to takeovers. If a company has dominating shareholders, it is their privileged to decide on the takeover bid irrespectively of the shares they hold. Nor would the existence of multiple voting shares affect the takeover price as that is determined by the price the bidder wants to pay for enough votes to control the company divided by the number of shares required to carry this amount of votes. The prize of a company with only one class of shares is the

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same as that of a company with two or more classes; it's the story of the pizza slices all over again.

The result of the German argument is well known. The anti-frustration rule that should have been left for the individual company to decide has been enacted as Article 9, and the break-through rule that obliges a company to introduce the OSOV principle in the aftermath of a bid that has been accepted by 75 per cent of the capital and thus confiscates the superior voting rights paid for by some shareholders is now Article 11. But both provisions have due to the combined opposition by Germany and Scandinavia been made optional for the Member States to use and a recent survey found that most Member States have chosen not to implement them. This ought to be proof that the two provisions are unwanted, but it may not be the way the Commission sees it when the directive is up for revision a few years from now.

Besides the argument made in respect of takeovers, it was argued that the presence of CEM, including vote differentiation, would damage the performance of companies. A survey was commissioned and on 4 June 2007 a comprehensive report of more than 700 pages was published by the Commission. It did not, however, find a causal link between CEM and performance. It is hardly surprising that the success of a company depends more on the persons running it and the products and services it offers than on the capital structure it has chosen. But it is deeply disturbing that the argument has been given such prominence lately. What if is was found that companies where the existing control holders use CEM to safeguard the control over their company did in fact do poorly compared to companies without CEM, should their property then be taken to promote growth? Since when has it become European policy that property rights are dependent on their efficient use? After all, a public company is not owned by the public; it is owned by its shareholders.

A more technical problem with this unappealing line of thinking is how to measure efficiency. A company with dispersed ownership can be taken over almost by surprise by anyone ready to pay more than the market price. If the managers want to keep their job, they have every incentive to keep the price of the company's shares as high as possible, which in some unhappy cases have even involved cooking the books. A company with a dominant owner on the other hand has no incentive to keep its share price high, in fact, it may chose to belittle its wealth not necessarily out of modesty but also not to arouse unnecessary attention from tax authorities. It is not possible to compare these two companies financially simply by looking at their financial reports or the market price of their shares.

To sum of this argument on the possibility of issuing different classes of shares: The most important argument would appear to be that since full transparency is provided, the question of which shares to issue is best left with the existing shareholders, whose prerogative it is to decide on the issuance, and to the investors who alone will decide whether to take up the shares offered. Shares of different classes will be issued if they are deemed useful and they will be subscribed if the investors find them acceptable. There would appear to be no risk to the company, the existing shareholders or the investors that could justify a ban on certain forms of shares. The presence of different classes of shares cannot serve as an obstacle to takeovers, nor do they appear to reduce

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profitability insofar as we can measure it at all. In short, there is no valid argument for European regulation within this area. That different classes of shares also serve as a means for consolidating control and thereby provide dominant shareholders is considered a beneficial consequence by Scandinavian company law, though not a justification on its own.

7 Conclusion

The Scandinavian approach to corporate governance is not widely known, but appears to have worked well in countries that have produced great wealth and provided a fair society with painfully high taxes and no corruption. Despite its quiet appearance, it is as sophisticated as any of the major legal systems in the world today. It has developed gradually and solved most of the problems that many other systems still grabble with, including how to ensure deference of management to the interest of the shareholders and how to avoid the abuse of power from a dominant shareholder. It is flexible and relies on an *ex post* approach to regulation that seems to work well. Although corporate scandals do occur, they are few and far between.

A major reason why this system of corporate governance is so little known outside its countries of origin is probably due to the strange languages spoken there. Until recently, only little had been written in one of the major languages on Scandinavian corporate governance. Considering the intimate relationship between language and law, it is slightly ironic that it may help to avoid the challenges being posed by European harmonisation within this area and thereby preserve the special features of Scandinavian corporate governance if we translate our system from our native Scandinavian tongue into different but more broadly understood languages. Perhaps we can save the uniqueness of this part of Scandinavian law by giving up at least to some extent our preference for Scandinavian languages in the law literature that we produce. Scandinavian Studies in Law is one such possibility and regardless of the anniversary that we celebrate in this volume the Journal has never been more vitally necessary for the future of Scandinavian law.

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