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Agenda

Advancing economics in business

One share, one vote? Golden shares in privatised companies

Shareholder rights are a matter for corporate governance, providing checks and balances so that company management is subject to proper oversight. Among the impediments to shareholders playing an effective role as owners are special control rights, or 'golden shares', retained by governments in privatised companies. What are these impediments, and how important are they?

The rights of shareholders and their relationship with companies are fundamental aspects of corporate governance. Shareholders should be able to play an effective role as the owners of the companies in which they invest. The European Commission Action Plan on modernising company law and enhancing corporate governance in the EU, adopted in May 2003, recognised that improving shareholder rights was a priority.

Numerous barriers exist across Member States for shareholders to exercise their rights as owners effectively, and the European Commission has taken various actions to empower shareholders. In his speech to a corporate governance conference organised by the EU presidency in Luxembourg on June 28th 2005, The Commissioner for Internal Markets, Charlie McCreevy focused on actions in two areas.[1]

– *Cross-border voting rights*—in 2004, the European Commission started a consultation process on facilitating the exercise of basic shareholder rights in company general meetings and solving problems in the cross-border exercise of such rights. The second public consultation in this area was closed on July 15th 2005, and the results are yet to be published. In addition, the Commission is undertaking an economic impact assessment of the current obstacles to cross-border voting in the EU.

– *Special rights in privatised companies*—governments often retain control in privatised companies by granting themselves 'special rights'—also known as 'golden shares'—which go beyond the rights associated with normal shareholding. Special rights constitute deviations from the 'one share, one vote' principle and enable governments to limit voting rights in privatised companies, to block takeovers and to veto management decisions.

This article focuses on the second area, and examines the recent Commission staff report on the current status of special rights in privatised EU companies.[2] It also

Types of special rights

Rights to influence the decision-making process	***Rights to control changes in ownership***
Requirements for approval of, or rights to veto, certain strategic management decisions by the government **eg, Copenhagen Airport, Telecom Italia**	**Caps restricting substantial blockholdings** **eg, Petrogal, BAA, Telefónica**
Rights to approve or appoint members of the company board **eg, KPN, TNT**	**Requirements for approval of, or rights to veto, changes in ownership by the government** **eg, Elf Aquitaine, ENI, Endesa**
Limitations of other shareholders' voting rights **eg, Volkswagen, Repsol**	

Note: Examples of affected companies include special rights that have now been redeemed.
Source: Oxera presentation at Second European Corporate Governance Conference, June 28th 2005.

refers to the panel presentations on special rights at the June conference in Luxembourg, in particular Oxera's presentation of the ongoing research for the Commission into the economic impact of special rights.[3]

Special rights in privatised EU companies

A common feature of almost every privatisation in Europe during the privatisation wave of the 1980s and 1990s was the retention of special control rights by governments in the privatised companies. The rights preserve the influence of governments over the companies they sold off, and grant them powers that are otherwise only available to, or go beyond that of, a majority shareholder.

The rights are often granted in connection with a share—ie, 'golden share' in the UK, 'action spécifique' in France, or 'Spezialaktie' in Germany. The nominal value of the share is not important since the rights it confers are not related to value, and may even take the form of an absolute veto right. Indeed, special rights can be stipulated without the requirement for a government to hold a single share.

Special rights grant the government exclusive rights to control changes in ownership of the company or influence management decisions (see box above).

Based on a 2004 survey of Member States, the Commission identified special rights in 141 EU companies, covering significant sectors of the economy from enterprises providing public services in telecommunications, electricity, gas and postal services to banking, insurance and other industries outside the public utilities sector.[4] In some countries, this includes regional companies; in others, the scope of the companies is national. However, the count follows a period of considerable scaling-down and abolition of special rights, either resulting from the voluntary initiative of governments or fostered by rulings of the European Court of Justice (ECJ).

The compatibility of special rights with the EC Treaty has long been contested by the Commission.[5] The ECJ has reached several judgments confirming that in most cases the measures are infringements of the Treaty freedom of capital movement. In the first judgment, *Commission v Republic of Italy* in 2000,[6] the ECJ found that, by adopting the 1994 Law on Privatisation and Decree Laws on ENI and Telecom Italia, Italy had failed to fulfil its Treaty obligations. On June 4th 2002, the ECJ made a second wave of judgments relating to three landmark cases involving similar types of restriction, including, for example, caps restricting foreign investments in Portugal, caps restricting substantial shareholdings in Portugal and France, rights to appoint management in Belgium, and exclusive veto rights in France and Belgium.[7] In 2003, the ECJ ruled against legal arrangements in Spain that required prior authorisation for certain decisions of the board of directors, including merger or break-up of the privatised companies.[8] It also ruled against provisions in the UK that limited the possibility of acquiring voting shares in airports operator, BAA, as well as requiring state consent for disposal of the company's assets.[9]

The Commission started proceedings against further cases of public investment restrictions in other EU Member States, and decisions on these cases are pending. For example, in the Netherlands, the case concerns special powers in KPN (telecommunications) and TNT (postal services), which grant the state the right to nominate members of the supervisory board and veto strategic business decisions. In Germany, the case concerns the Volkswagen law, which prevents shareholders from acquiring more than 20% of the voting rights, and grants a special blocking minority to any shareholder who has 20% of voting rights. The law also confers mandatory state representation on Volkswagen's supervisory board.[10]

The precedents established by the court rulings accelerated the scaling-down and abolition of special rights in some cases. For example, in Denmark, ownership limits in Copenhagen Airport were abolished in 2004. After redeeming its golden share in BAA in October 2003, in May 2004, the UK government also redeemed its shares in, among other companies, National Grid (now National Grid Transco), ScottishPower, and Scottish Hydro-Electric (now a subsidiary of Scottish & Southern Energy). In many of the new Member States, the process of scaling down special rights started in the course of accession negotiations, although many rights remain.

The likely economic impact of golden shares?

Empirical evidence on the economic impact of golden shares in EU companies is relatively limited, and the final results of the impact assessment will only be available later in 2005. Nevertheless, there are indications that golden shares have negative impacts, at shareholder level, for individual companies, and for EU capital market integration more generally.

– *Impact on investment and shareholders*—golden shares present public restrictions on investment in privatised companies. They may be restricting investment directly (eg, through caps on substantial blockholdings), or indirectly through the government's influence on the management and operation of the company, which may deter strategic investors seeking

an active role in the decision-making process. In other words, the markets in which transactions are being restricted are, in the first instance, the European markets for corporate control.

Where golden shares deter a bidder from gaining control of a company, they almost invariably have an additional impact on the market for portfolio investment—the potential target's shareholders are deprived of an opportunity to dispose of their investments in the company. Usually, a takeover bid provides an exceptionally attractive opportunity for selling shares. Goergen and Renneboog (2003) report share price announcement effects of 9% for target firms in a sample of European takeovers, with price increases over the two-month period prior to announcement amounting to 23%.[11]

As an example, consider the golden shares held by the UK government in the water and electricity sectors, which effectively prevented anyone from controlling more than 15% of voting shareholdings. The redemption of the golden shares in 1995 triggered a surge in takeover activity in both sectors. Within two years of redemption all but one of the 12 regional electricity companies had been merged or acquired, in most cases by foreign companies. In water, the first takeover bid for a water and sewerage company occurred just two months after the golden share redemption. The events were associated with significant share price reactions.[12]

– *Impact on company performance*—at the level of individual companies, special rights that provide a shield from takeovers may adversely affect the performance of the protected companies. They may thwart cross-border restructuring of industries and shelter management from market pressures. Any reduced fear of hostile takeovers may mean that the disciplining device that the market for corporate control would otherwise create has become less effective, and that overall corporate governance has been reduced. Poorer corporate governance may in turn result in managerial slack and a deterioration in economic performance. Gompers et al (2003) and Bertrand and Mullainathan (2003) are among the many academics who have established a relationship between the performance of companies and the likelihood of takeover.[13]

– In addition to reducing market discipline, any direct interference of governments in *the management of the privatised companies may have a negative impact on the performance of the firms*. This view is supported by academic research establishing performance improvements of companies following privatisation.

One of the studies has explicitly tested for the impact of golden shares. Examining the share price performance of 99 international companies following privatisation, Boardman and Laurin (2000) find evidence that

> failure to transfer complete control to the private sector, combined with uncertainty surrounding the exercise of the golden share, has a detrimental effect on long-run share price performance.[14]

– *Impact on market integration*—by restricting investment in privatised companies, golden shares present barriers to the full integration of the EU capital markets. In particular, they may distort market-driven direct investment activity, preventing firms from realising economies of scale and synergies that may result from cross-border mergers and acquisitions. More generally, they may hinder the efficient allocation of savings and capital. At the EU level, golden shares also raise concerns about the level playing field in the EU market for corporate control, since the companies they protect are removed from the class of potential takeover targets, while the companies themselves may still act as bidders.

Even if golden shares have a negative impact on performance and/or restrict direct and portfolio investment in the privatised companies, they may be justified in some circumstances. In particular, governments may deem it necessary to impose golden shares following privatisation, given concerns about a divergence between social objectives and the private goals of unconstrained private companies. This applies in particular to enterprises providing public services, where there may be concerns about security of supply, universal access to a service, and distributional implications of pricing policy.

This would suggest that any negative implications would have to be set against the social benefits that may result from the retention of golden shares. At the same time, however, it is important to appreciate the existence of alternative mechanisms to retain control in privatised companies that provide a potentially less restrictive, or indeed more effective, means of achieving a given public policy objective. In particular, regulation, often carried out by an arm's-length regulatory authority, is now an essential part of the way in which most governments approach privatised companies, at least in the public utility sectors. This is consistent with the Commission's view on special rights:[15]

> All the alternative public measures to regulate the provision of services by companies operating in specific sectors normally do not discriminate in

terms of nationality of investors. They are more transparent and interfere, to a predictable degree, in the direct management and strategic decisions of the companies and only with regard to public policy objectives agreed at EU level. Special rights, on the other hand, introduce investor uncertainty about government intentions and can act as a deterrent of direct investment in practice. […] Therefore, it is in the public interest to apply special rights only under narrowly specified conditions, where it can be shown that their justifications are in line with the EC Treaty and ECJ rulings.

Special rights in context

Special rights provide governments with a mechanism to privatise companies without relinquishing control. An alternative would be not to relinquish ownership in the first place. Indeed, governments might be less likely to sell their ownership stakes and fully privatise a company if they do not have the possibility of retaining special control rights. This is important since, despite the significant privatisation wave in the last two decades, many EU governments still retain large stakes in companies and, as major shareholders, can use that ownership power to block acquisitions or influence management decisions. Although they present a deviation from the 'one share, one vote' principle, golden shares may be considered preferable to continued state ownership.

It is also necessary to appreciate that golden shares present only one very special type of deviation from 'one share, one vote'. There are many others, and these do not only apply to privatised companies. The list of specific national measures which provide a deviation from the proportionate allocation of control in EU companies encompasses, for example, restrictions on the transferability of shares, shares with multiple voting rights, shares with limited or non-existent voting rights, and participation rights that carry no votes.[16] A recent study by Deminor Rating (2005) presents a comparative analysis of the capital structure of European companies aimed at identifying how many follow the 'one share, one vote' principle.[17] Covering all constituents of the FTSE Eurofirst 300 index, the study reports that the principle did not hold in 35% of the companies analysed, with considerable variations across countries.

Even if shareholders have proportionate rights in principle, they may not be able to exercise their rights effectively—for example, because they have late access to often incomplete information; because they have insufficient time to cast a vote; or because of administrative constraints. There may be particular problems for cross-border voting, which, as mentioned above, is currently being addressed by the Commission.

The issue of shareholder rights is likely to remain high on the European policy agenda. It will form part of specific debates on progress towards an integrated market for corporate control. Given the emphasis on 'comply or explain', it will also be a key component of wider discussions on corporate governance in Europe.

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[1] 'The European Corporate Governance Action Plan: Setting Priorities', speech by Commissioner McCreevy at the Second European Corporate Governance Conference, Luxembourg, June 28th 2005.
[2] European Commission (2005), 'Special Rights in Privatised Companies in the Enlarged Union: A Decade Full of Developments', Commission Staff Working Document, July 22nd. The study's findings were also presented at the Luxembourg conference.
[3] 'Golden Shares: The Microeconomic Cost', presentation by Oxera at the Second European Corporate Governance Conference, June 28th 2005. Oxera's final research report is due for submission in November 2005.
[4] European Commission (2005), op. cit.
[5] See 'Communication of the Commission on certain legal aspects concerning intra EU-investments', OJ C 220, 19.07.1997, p. 15.
[6] Case C-58/99.
[7] Cases C-367/98, C-483/99, and C-503/99.
[8] Case C-436/00.
[9] Case C-98/01.
[10] European Commission (2005), op. cit.
[11] Goergen, M. and Renneboog, L. (2003), 'Shareholder Wealth Effects of European Domestic and Cross-border Takeover Bids', European Corporate Governance Institute, Working Paper 08/2003, January.
[12] Oxera presentation at Second European Corporate Governance Conference.
[13] Gompers, P., Ishi, J. and Metrick, A. (2003), 'Corporate Governance and Equity Prices', *Quarterly Journal of Economics*, **118**, 107–55, and Bertrand, M. and Mullainathan, S. (2003), 'Enjoying a Quiet Life? Corporate Governance and Managerial Preferences', *Journal of Political Economy*, **111**, 1043–75.
[14] Boardman, A. E. and Laurin, C. (2000), 'Factors Affecting Stock Price Performance of Share-issued Privatisations', *Applied Economics*, **32**, 1451–64.
[15] European Commission (2005), op. cit., p. 9.
[16] See the report of the High Level Group of Company Law Experts (2002), 'Report on Issues Related to Takeovers', January 10th, Brussels.
[17] Deminor Rating (2005), 'Application of the One Share One Vote Principle in Europe', report commissioned by the Association of British Insurers.

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