

SHAREHOLDERS' RIGHTS IN EUROPE-WORK IN PROCESS

THE U. S. RESPONSE

OUTLINE AND SUMMARY OF ISSUES¹

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I. Background Of Corporate Governance And Shareholders' Rights In The United States.

Originally, corporate charters were granted by governmental authorities for the specific purpose of serving the public interest. Corporate charters contained a statement of the specific public purpose of the corporation. It was not until the twentieth century that the primary goal of corporations became the maximization of the financial value for shareholders.

Under the federal system of jurisprudence in the United States, the substantive law relating to the governance of corporations was developed on a state- by- state basis. Thus, the laws, rules and regulations involving the framework of where and how corporations are incorporated and operate - the relationships among the shareholders, directors, officers and managers of corporations - have by and large been developed and do vary on a state-by-state basis.

Federal or national laws and the regulations and rules developed thereunder provide primarily for the full public disclosure of information relating to, and the reporting of, financial results to the shareholders of public companies on a timely basis. Thus, the Securities Act of 1933 tries to assure that purchasers and potential purchasers of securities of corporations making offers of securities have sufficient and accurate information to allow them to evaluate the potential investment and tries to protect against sales of securities to "unsophisticated" purchasers who do not have sufficient

¹ This is a brief outline and summary of some general corporate governance principles. It is not intending to be a complete or thorough presentation or analysis of these issues.

financial information or resources to evaluate the proposed purchase or who may be unable to make such an evaluation. The Securities Exchange Act of 1934 relates to the trading of public securities and regulates the information that must be given to shareholders when corporations seek the votes of shareholders. The Williams Act (1968) is designed to provide full disclosure and equal treatment to shareholders in connection with proposed takeovers and other actions, so that shareholders have adequate time and information to evaluate whether to vote in favor of, or against, and participate in, or refuse to participate in, a proposed takeover bid. These federal laws are not designed to provide or regulate substantive corporate governance issues. The listing rules of the New York Stock Exchange, the American Stock Exchange and NASDAQ do have certain minimum requirements relating to corporate governance issues that need to be met, but state laws provide the basis of most corporate governance regulations.

II. Substantive Corporate Governance Laws In The United States

Generally, state laws tend to favor the interests of management and the directors over the interests of shareholders. The founders and managers of businesses are the ones who choose the state that will issue the corporate charter and the state whose corporate laws will regulate the governance of the corporation. Commentators who favor providing more power to shareholders to participate in the governance of corporations have called the selection of the choice of the state of incorporation as a “race to the bottom,” because managers choose to incorporate in states with laws that favor management rights and the rights of incumbent directors over the rights of shareholders and potential hostile bidders for the for the corporation.

Individual states recognizing the financial and local or state community benefits of attracting new corporations to their states adopt corporate statutes that are favorable to managers and incumbent directors, and that are designed to protect local jobs and services. That is why the tiny state of Delaware has become the leading state for incorporation of public companies in the United States. Delaware has reaped substantial financial benefits for its citizens and especially for its legal community.

III. Benefits of Incorporation in Delaware

A substantial portion of U.S. publicly-traded companies are incorporated in Delaware. The legislature and legal community in many states keep very close tabs on the corporate laws of Delaware and the decisions of its courts, and from time to time revise their corporate statutes to keep up with the latest changes in the Delaware.

There are thought to be several benefits to incorporate in Delaware; some of these benefits are:

- You only need one person who can serve as the sole officer, director, and shareholder.
- There are extensive rights to provide comprehensive indemnification to officers and directors, thereby limiting their personal liability.
- No minimum amount of capital is required.
- Directors do not need to be shareholders.

- Delaware corporate law has well-established legal precedents, and Delaware courts are respected nationwide for their expertise in corporate matters.
- Shareholders, directors and committee members may act by unanimous written consent in place of formal meetings.
- Corporations may fix the number of directors needed for a quorum of board of directors within certain parameters.
- Corporations are not limited as to the kinds of business they may conduct, and they can merge or combine easily with other types of domestic and foreign business entities.
- Directors may be given the power to make and alter by-laws. Corporations may hold stocks, bonds or securities of other corporations, real and personal property, within or outside the state, with no limitation as to amount.
- Classes of stock may be issued in series.

IV. Some Governance Principles of Delaware Corporate Law

A. Fiduciary Duties of Directors.

Under Delaware law, the corporation's board of directors is responsible for the management of, and obligated to manage, the business and affairs of the corporation. Delaware statutes do not set forth specific standards for how the directors must manage the business of the corporation. The law of fiduciary duties of directors in Delaware has evolved through judicial decisions.

The courts of Delaware have consistently ruled that directors of Delaware corporations have a triad of primary fiduciary duties: the duty of due care, the duty of loyalty and the duty of good faith. In exercising their fiduciary duties, and making business decisions, directors are presumed to have acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company and its shareholders. This "business judgment" is a presumptive rule of evidence that places the burden of proof on any party seeking to challenge the actions of the directors. To rebut the presumption, any shareholder seeking to reverse the action of the directors has the burden of proving that the board violated any one of its triad of fiduciary duties. If the challenging shareholder fails to meet the evidentiary burden, the "business judgment" rule operates to provide substantive protection for directors and their decisions. If the presumption is rebutted, the burden shifts to the directors to prove that the transaction in question was "entirely fair" to the shareholders.

The duty of loyalty requires that directors act in the best interests of stockholders and generally requires that stockholders be treated equally. Delaware courts have stated that there is no safe harbor in Delaware for divided loyalties of directors.

In many states, the board is specifically authorized by statute in exercising its fiduciary duties and maximizing values for shareholders to take into consideration the impact of its actions on constituencies other than just shareholders - i.e. creditors, customers, employers, suppliers and even the community in general.

B. Rights and Obligations of Majority Shareholders and Minority Shareholders.

Shareholders have the right to and must approve certain fundamental corporate transactions, such as mergers, sales of substantially all of a corporation's assets and corporate dissolutions. Notwithstanding these rights of shareholders, the directors of a Delaware corporation are not necessarily obligated to follow the wishes of a majority of shareholders. They must act in accordance with the best interests of the corporation in carrying out their fiduciary duties.

As a general rule, controlling shareholders of a Delaware corporation have no obligation to minority shareholders and under certain circumstances there can be selective treatment of shareholders where the best interests of the corporation is the goal. Directors may be prohibited from selective dealing, however, to fend off a hostile takeover, especially after it has been determined that the corporation will be sold.

There is no general law that protects minority shareholders other than providing for general rights of minority shareholders to vote their shares. In some circumstances minority shareholders have appraisal rights.

C. Takeover Issues in Delaware

The most controversial cases in Delaware have involved the duties of directors in maximizing the economic value for shareholders in the context of hostile takeover battles. In response to the hostile takeover battles, various states have adopted "fair price" statutes, "disclosure" statutes, "share plan endorsement" statutes, "anti-greenmail" statutes, "cashout/redemption rights" statutes, "business combination" statutes and "control share acquisition" statutes.

The Delaware Business Combination Statute provides that an acquirer who obtains 15% of the ownership of a Delaware corporation is prohibited from engaging in a business combination, such as a merger for a period of 3 years, unless it obtains the approval from the target's board of directors before the acquisition, with two exceptions- if the acquirer obtains 85% of the target's voting stock or if the combination is approved by the target's board and by two-thirds of the shares not owned by the acquirer any time after the acquirer passes the 15% threshold.

Delaware courts in scrutinizing the use of defensive tactics in hostile takeover situations have ruled that directors can only make proportionate responses to legally recognizable threats to the acquisition target arising from a hostile tender offer. Nevertheless, Delaware courts have allowed directors to take strong steps to impede hostile bids. As long as directors can be defeated for election in a proxy contest, directors have succeeded in taking steps to impede takeover bid. Some protective measures include adopting by-laws that prevent shareholders from calling meetings or acting by consent, the classification of boards with the election of only a proportion of directors each year, establishing classes of non-voting or restricted voting stock, and the use of "White Knights."

Although these defensive tactics have aided directors in resisting hostile takeovers, it has been the rise and judicial approval of “poison pill” plans that have provided incumbent directors with the power in many cases to just say “no” to hostile takeover bids as long as directors follow the business judgment rule. Even though shareholders under Delaware must approve fundamental corporate transactions such as mergers, sales of substantially all of a corporation’s assets and dissolutions, directors can adopt and act on poison pill plans without shareholder approval. There have been few, if any, cases in which a bidder proceeded to purchase a target with an unredeemed poison pill in place.

A board has been able to just say “no” where it claims a hostile offer is coercive, inadequate, or impaired; if the board requires time sufficient to consider other alternatives to promote shareholder value; where an offeror insists that the target take decisive action upon target’s receiving a bare offer or upon merely negotiate with one bidder; where resisting an offer continues to serve a valid purpose such as fulfilling the target’s pre-conceived business plan and promoting long term shareholder value; where the risk of non-consummation is substantial or the quality of the securities offered in the exchange is unsatisfactory. The poison pill in combination with a classified board has proven to be very effective in allowing boards to entrench themselves without necessarily increasing long term shareholder value.

V. Trends In Shareholder Governance

The ability of management to entrench themselves, the increased focus on short-term gains over long-term shareholder value, the staggering increase in executive compensation and stock option plans, and the increased benefits provided to directors, etc. have caused many shareholder activists to take a new look at management issues in the governing of corporations.

A. Aftermath of Enron, etc.

The shareholders of Enron, Global Crossing and a host of other companies have suffered as a result of questionable accounting and financial reporting practices. There has been intense pressure for management and the board to continue to report improved financial results on a quarter-to-quarter basis. As Enron and other cases make clear, directors in many cases did not act independently and did not provide the oversight necessary to protect shareholders from financial disasters. There may be a movement to create more professional and independent directors who will provide serious oversight over management and internal directors.

There may also be changes in auditing and accounting rules. Europeans are calling for a change in rigid U.S.GAAP rules that may hide the fact that the assets stated on balance sheets may not be as solid as stated. In addition, US accounting rules for stock options are causing controversy. Currently, corporations are not charged with expenses when options are issued whereas European accounting rules generally require this. Stock options are treated one way for tax purposes and another for financial reporting purposes. Off-balance sheet reporting and revenue recognition issues will be subject to more scrutiny by directors and auditing firms.

B. Role of Institutional Investors

Institutional investors, such as mutual funds and pension funds, have increased their percentage of shareholder ownership substantially over the last ten years. There is increasing evidence that such institutions actively will exercise voting power to effect the decisions of management on fundamental issues relating to shareholder value. The Hewlett Packard/Compaq battle is the most recently visible battle for support of the institutional investors. There are numerous examples of such institutions participating in proxy contests.

The U.S. Department of Labor under the ERISA statute requires that managers of pension funds exercise their fiduciary duties to their beneficiaries by voting the securities they hold for the best interest of the beneficiaries. The Securities Exchange Commission has changed its rules to permit large shareholders to communicate with each other more easily without having to file extensive proxy materials. There is great concern that management and the boards of directors have not followed their obligations to increase long-term shareholder value, but rather have opted through greed to increase their own personal wealth over the short term. Institutional investors are taking a much closer look at executive compensation packages, change of control protections and other benefits given to company executives and directors.

C. Movement for Corporate Social Responsibility.

The movement for corporate social responsibility also may make more inroads in the governance of corporations. There has been increased pressure for so called triple bottom line reporting of earnings, social factors and environmental issues. Although the U.S. started the corporate social responsibility movement for companies over such issues as apartheid, bribery of foreign officials and some environmental issues in the third world, European companies have moved beyond U.S. companies in this area. Culturally, the U.S. has relied more on capitalism and the private sector to boost overall living standards, whereas Europeans have looked to their governments to play a more active role in providing social services and a security net for its citizens. Accordingly, European companies seem more willing to accede to government regulation in corporate social responsibility issues. U.S.-based companies may be dragged along in addressing corporate social responsibility issues to remain competitive.