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Boards in Europe - Accountability and Convergence

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Abstract

Corporate boards play a central role in corporate governance and therefore are regulated in the corporate law and corporate governance codes of all industrialized countries. Yet while there is a common core of rules on the boards, considerable differences remain, not only in detail, but sometimes also as to main issues. These differences depend partly on shareholder structure (dispersed or blockholding), partly on path dependent historical, political and social developments, especially employee representation on the board. More recently, in particular with the rise of the international corporate governance code movement there is a clear tendency towards convergence, at least in terms of the formal provisions of the codes. This article analyses the corporate boards, their regulation in law and codes and their actual functioning in nine European countries (Belgium, France, Germany, Italy, the Netherlands, Poland, Sweden, Switzerland and the United Kingdom) in a functional and comparative method. Issues dealt with are inter alia board structure, composition and functioning (one tier v. two tier, independent directors, expertise and diversity, separating the chair and the CEO functions, information streams, committees, voting and employee representation) and enforcement by liability rules (in particular conflicts of interest), incentive structures (remuneration) and shareholder activism. The article finds convergence in these European countries due to the pressures of competition, a pro-shareholder change supported by government and institutional investors and, to a certain degree, the impact of the EU. This convergence shows more in the codes and the ensuing practice than in the statutes. On the other side considerable differences remain, in particular as a result of the failure to adopt a mandatory „no frustration" rule for takeovers at EU level and diverging systems of labor codetermination. The result is an unstable balance between convergence and divergence, shareholder and stakeholder influence and European v. national rulemaking.

Keywords: Corporate law, corporate boards in Europe, accountability, convergence, two-tier boards, independent directors, diversity, board committees, cumulative voting, labor codetermination, conflicts of interest, enforcement, remuneration, shareholder activism, decision-making.

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Boards in Europe
– Accountability and Convergence –

P. L. Davies and K. J. Hopt[##]

Abstract

Corporate boards play a central role in corporate governance and therefore are regulated in the corporate law and corporate governance codes of all industrialized countries. Yet while there is a common core of rules on the boards, considerable differences remain, not only in detail, but sometimes also as to main issues. These differences depend partly on shareholder structure (dispersed or blockholding), partly on path dependent historical, political and social developments, especially employee representation on the board. More recently, in particular with the rise of the international corporate governance code movement there is a clear tendency towards convergence, at least in terms of the formal provisions of the codes. This article analyses the corporate boards, their regulation in law and codes and their actual functioning in nine European countries (Belgium, France, Germany, Italy, the Netherlands, Poland, Sweden, Switzerland and the United Kingdom) in a functional and comparative method. Issues dealt with are inter alia board structure, composition and functioning (one tier v. two tier, independent directors, expertise and diversity, separating the chair and the CEO functions, information streams, committees, voting and employee representation) and enforcement by liability rules (in particular conflicts of interest), incentive structures (remuneration) and shareholder activism. The article finds convergence in these European countries due to the pressures of competition, a pro-shareholder change supported by government and institutional investors and, to a certain degree, the impact of the EU. This convergence shows more in the codes and the ensuing practice than in the statutes. On the other side considerable differences remain, in particular as a result of the failure to adopt a mandatory „no frustration" rule for takeovers at EU level and diverging systems of labor codetermination. The result is an unstable balance between convergence and divergence, shareholder and stakeholder influence and European v. national rulemaking.

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Survey

1. The Role of the Board

1.1 Introduction

The board sits at the interface between the investors in the company and its senior management. That it therefore plays an important role in the taking of significant corporate decisions may seem obvious. Nevertheless, identifying the role that the board does in fact discharge in the governance of the large public company[1] and determining to whom it is accountable for the exercise of its powers is in fact far from easy. The role and functioning of the board are matters of continuing debate among policy makers, academics and others; and the rules relating to these matters are never stable.[2]

At first sight, this uncertainty about the role of the board in public companies is surprising. These companies typically have too many shareholders for those shareholders as a whole to be a feasible body for setting and implementing corporate strategy.[3] The shareholder body may be able to exercise periodic review of how well others have fulfilled those tasks but can hardly discharge them themselves. Consequently, an opportunity apparently opens up for a smaller, more committed and more expert body, such as the board of directors, to perform these functions. However, we observe across jurisdictions considerable variation in the legal provisions which purport to specify the role of the board and its relationship to the shareholders, on the one hand, and the full-time executive management of the company, on the other. At one extreme lies UK law, which does not specify any significant mandatory rules on either relationship, and at the other lies German corporate law, especially in its 1937 version, which sought to reduce the scope for either the (supervisory) board or the shareholders to intervene in the strategic choices of executive management.

These differences in the formal rules have survived to a considerable extent the international spread since the early 1990s of corporate governance codes. The Corporate Governance Code has two crucial and symbiotic features from our point of view. On the one hand, it is more intrusive in relation to the functioning of the board than are provisions in the law; on the other those more intrusive rules are usually framed at best on a 'comply or explain' basis, i.e. the only 'hard' rule underpinning the Code is that the board must either comply with the Code recommendations or give a public explanation of the non-compliance. As we shall see, however, the borderline between legal and code provisions is by no means theoretically

[1] We focus in this article on companies whose shares are publicly traded (i.e. are public in the securities law sense of the term) but we also make reference to companies which are public in the corporate law sense of the term and are economically large but whose securities are not publicly traded.

[2] As to the state of theoretical and empirical research, see R. B. Adams/B. E. Hermalin/M. S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey,* 48:1 JOURNAL OF ECONOMIC LITERATURE 58-107 (2010); L. A. Bebchuk/M. S. Weisbach, *The State of Corporate Governance Research,* 23(3) REVIEW OF FINANCIAL STUDIES 939 (2010); K. J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation,* AMERICAN JOURNAL OF COMPARATIVE LAW (AJCL) 59 (2011) 1; A. M. Fleckner/K. J. Hopt, eds., COMPARATIVE CORPORATE GOVERNANCE, A FUNCTIONAL AND INTERNATIONAL ANALYSIS, Cambridge University Press, forthcoming 2013. Cf. also O. E. Williamson, *Corporate Boards of Directors: In Principle and in Practice,* JOURNAL OF LAW, ECONOMICS, & ORGANIZATION 24:2 (2007) 247.

[3] J. Armour/H. Hansmann/R. Kraakman in R. Kraakman et al., THE ANATOMY OF CORPORATE LAW, 2d ed., Oxford 2009, p. 12 et s. (cited: ANATOMY).

obvious and is contested in policy terms.[4] Furthermore, the Code movement has re-focussed attention on what boards actually do (within the framework of the rules established by the law) and that research, as we have already noted, remains inconclusive.

At a very general level, there are two factors which heavily influence the role of the board in public companies. The first is the dispersed or concentrated nature of the shareholder body.[5] The second is the extent to which corporate law in any particular jurisdiction seeks to address the agency problems of stakeholders other than shareholders, in particular of the employees. The dispersed or concentrated nature of the shareholder body may affect both what the board does and to whom it is accountable. With a dispersed shareholding body, there are strong and obvious efficiency reasons for conferring extensive powers on the board rather than allocating them to the shareholders. However, those same reasons, notably the shareholders' coordination costs, may make the accountability of the board to the shareholders tenuous. By contrast, in a concentrated shareholding structure, the large shareholders can more plausibly claim to be able to take effective decisions themselves. Even if they leave management decisions to the board, for example, in order to be able to incorporate professional management in the decision-making, large shareholders are in a much better position to hold the board accountable for the decisions taken. In this situation, the central question is whether large shareholders exercise their governance rights to promote only their own interests or the interests of the shareholders as a whole.

In other words, in dispersed shareholding companies the most pressing agency problem exists between management and shareholders as a class; in concentrated shareholding companies the agency relationship between majority and minority shareholders is the most pressing one.[6] In both cases, however, the board's role in the agency relationship is central, but one cannot predict a priori what that role will be. At one end of the spectrum the board may simply reflect the dominance of the agent, as where the board is dominated by the management (in a dispersed shareholding context) or by the large shareholders (in a concentrated shareholding context). At the other end of the spectrum, the board, depending on how it is chosen and composed, may act as a mechanism for protecting the principal (the shareholders as a class or the minority shareholders, as the case may be).

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[4] C. Jordan, *Cadbury 20 Years On,* (2012), available at < http://ssrn.com/abstract=2099820 >.

[5] As to the patterns of corporate ownership, see R. La Porta et al., *Corporate Ownership Around the World,* 54 JOURNAL OF FINANCE 471 (1999); M. Faccio/L. H.P. Lang, *The Ultimate Ownership of Western European Corporations,* 65 JOURNAL OF FINANCIAL ECONOMICS 365 (2001); F. Barca/M. Becht, eds. THE CONTROL OF CORPORATE EUROPE, Oxford 2001; J. Armour/H. Hansmann/R. Kraakman in ANATOMY, *supra* note 3, p. 29 et s., 305 et s.

[6] We use the term 'agency problem' in the sense adopted in law and economics scholarship. In this usage an 'agent' is someone who has the factual power to take decisions or undertake actions which affect, positively or negatively, the welfare of another person, the 'principal'. It is not a requirement of an agency relationship in this sense that the principal should have authorised the agent to act on the principal's behalf. Such authorisation, which is the core of the doctrinal lawyer's concept of an agency relationship, may exist but need not. Clearly, the minority shareholders (the 'principal' in law and economics terms) do not normally authorise the majority shareholders to act on their behalf. See R. Kraakman et al., *supra* note 3, p. 35-37.

A linked but distinct developed is the rise of institutional shareholdings[7], primarily insurance companies, pension funds and collective investment schemes but also hedge funds. They may constitute the mechanism whereby concentration of shareholdings is reduced, but, even if that is not the case, they may provide an effective lobby group to advance the protections for minority shareholders in concentrated shareholder jurisdictions. Equally, in dispersed shareholding jurisdictions, institutional shareholders may provide a possible mechanism for reducing the collective action problems of dispersed shareholders, certainly at the level of formulating board rules and perhaps also at investee company level.[8]

Whilst the board contributes to the assurance provided by company law to investors that their interests will be protected in the running of the company, it does not follow that the sole function of the board is to reduce the agency costs of shareholders. In half the Member States of the European Union representation of the employees on the board is mandatory in the private sector of the economy. In these jurisdictions, therefore, the board has a role in facilitating the company's acquisition of labour inputs as well as inputs of capital.[9] The potential impact of mandatory employee representation[10] on the accountability of the board is clear enough, but it may also have an impact on the authority of the board. For example, it is conceivable that board level representation for employees is associated with boards that have less authority. Sometimes, it is argued that that this hypothesis explains why mandatory employee representation is confined to supervisory boards in a two-tier board structure.[11] However that may be, a board whose function includes the reduction of the agency costs of employees is likely to function differently from one whose function is confined to reducing the agency costs of the shareholders.

We make only passing references to the role of boards in financial institutions, especially banks. In the light of the recent financial crisis the corporate governance of banks has become a very live issue,[12] the aspects of board composition (independence versus expertise), board

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[7] See *infra* part 5.

[8] It is less costly for the institutions to combine at industry level to lobby for changes which benefit them, whether in legislation, corporate governance codes or stock exchange rules, than to intervene to change the policies of particular companies. Industry level lobbying via associations of institutions also generates fewer 'free rider' costs. See G. Stapledon, INSTITUTIONAL SHAREHOLDERS AND CORPORATE GOVERNANCE, Oxford 1996, ch 4.

[9] See G. Jackson/M. Höpner/A. Kurdelbusch, *Corporate Governance and Employees in Germany: Changing Linkages, Complementarities and Tensions,* in H. Gospel and A. Pendleton, eds., CORPORATE GOVERNANCE AND LABOUR MANAGEMENT, Oxford 2005, ch. 11, also available at < http://ssrn.com/abstract=503962 >.

[10] See *infra* part 2.8.

[11] However, in some countries, mandatory board representation occurs in a one-tier structure (for example, Sweden) and in others a two-tier structure is available, even though employee representation is not mandatory (for example, Italy). Thus, mandatory board representation for employees is not congruent with the distinction between one-tier and two-tier boards.

[12] Cf. Basel Committee on Banking Supervision, PRINCIPLES FOR ENHANCING CORPORATE GOVERNANCE, October 2010; European Commission, GREEN PAPER ON CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS AND REMUNERATION POLICIES, 2 June 2010, COM (2010) 284 final; OECD, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: KEY FINDINGS AND MAIN MESSAGES, Paris, June 2009; K. J. Hopt/G. Wohlmannstetter, eds., HANDBUCH CORPORATE GOVERNANCE VON BANKEN, Munich 2011; K. J. Hopt, *Corporate Governance of Banks after the Financial Crisis,* in: E. Wymeersch/K. J. Hopt/G. Ferrarini, eds., FINANCIAL REGULATION AND SUPERVISION: A POST-CRISIS ANALYSIS, Oxford 2012, p.

function (especially risk management) and executive director remuneration being particularly contentious. We make only passing reference to this debate because the central question is whether the high and unique leverage of banks suggests that accountability to shareholders is the wrong model and that greater sensitivity on the part of boards to the interests of creditors (and the taxpayers who stand behind the depositors) is what is required. To the extent that corporate governance of banks is becoming separate from corporate governance in non-bank or non-financial companies, we do not deal with it in full. However, to the extent that corporate governance innovations for banks have spilled over to companies generally (for example, in the United Kingdom, with the notion of 'shareholder stewardship'), we consider them fully.

1.2 Convergence of board function

Whilst it is possible to identify grounds for divergence in board rules and practice across jurisdictions, viewing those matters in cross-section, it can also be asked whether in recent years board rules[13] and practices have been converging. In all jurisdictions it is possible to identify changes in recent years in the applicable board rules, sometimes substantial ones. In order to establish whether these changes have increased the degree of convergence in board rules in European jurisdictions, we need to identify and evaluate the drivers of change in this area of corporate law and practice. There have been substantial developments in legal scholarship on the causes of change in corporate law. A particularly important, but controversial, theory predicts that market forces will produce significant change in corporate laws and that the direction of those changes will be towards the convergence of company laws onto a common model.[14] The market forces pointed to in this theory are the pressures of competition released by globalisation, i.e. the reduction in the barriers to trade in both good and services. Globalisation has clearly had profound effects on economies around the world, but its specific effect on corporate law is hypothesised to be that jurisdictions with company laws which do not provide for the combination of productive inputs in the most cost effective way will come under pressure to change their company laws so as to accord with a model which minimises the costs of production. Entrepreneurs in jurisdictions with 'inefficient' company laws will lobby their governments to reform those laws so that the costs of production are minimised. Governments will have an incentive to respond to such lobbying since more efficient laws may encourage inward investment or otherwise increase the tax

337 and idem, *Better Governance of Financial Institutions,* Cambridge University, November 30, 2012 (forthcoming Journal of Corporate Law Studies, autumn 2013).

[13] We use the term 'board rules' to refer to all rules relating to the board, whether taking the form of statutory rules, rules laid down by courts or the 'comply or explain' recommendations of corporate governance codes. On boards cf. P. Davies/S. Worthington in Gower and Davies, PRINCIPLES OF MODERN COMPANY LAW, 9th ed., London 2012, §§ 14-18 (p. 383-686); P. C. Leyens, *Corporate Governance in Europe: Foundations, Developments and Perspectives,* in: T. Eger/H.-B. Schäfer, eds., RESEARCH HANDBOOK ON THE ECONOMICS OF EUROPEAN UNION LAW, Cheltenham (Elgar) 2012, p. 183, available at < http://ssrn.com/abstract=2176987 >.

[14] The literature on this issue is now extensive, but the original argument is best put in H. Hansmann/R. Kraakman, *The End of History for Corporate Law*, (2001) 89 GEORGETOWN LAW JOURNAL 439. See also H. Hansmann, *How Close is the End of History?* (2006) 31 JOURNAL OF CORPORATE LAW 745 and H. Hansmann/R. Kraakman in A. Rasheed/T. Yoshikawa, CONVERGENCE OF CORPORATE GOVERNANCE: PROMISE AND PROSPECTS, London 2012.

revenue and employment opportunities within the jurisdiction.[15] Since the corporate constituency which benefits most from cost-reducing corporate laws are the shareholders, as residual claimants, this theory suggests that company laws in general, and board rules in particular, will move in a shareholder-friendly direction.[16]

There are a number of qualifications which must be made to the above (somewhat crude) presentation of the theory of market-driven convergence. First, as its authors themselves point out, their theory does not specify clearly a timescale over which convergence on the cost-reducing form of company law will be achieved. It is a theory which proposes a direction of travel in corporate law reform rather than a time-table for that reform. Second, the traditional comparative lawyer's qualification must be made: the theory supports view that company laws will converge on functionally efficient models, not necessarily that they will converge doctrinally, though some, perhaps a high, degree of doctrinal convergence is to be expected as well.[17] Thus, in one jurisdiction court-enforced standards may be more important in securing board sensitivity to shareholder desires than in another where strong governance rights for shareholders are deployed to that end. This difference may reflect effective procedures for the enforcement of legal standards in the one jurisdiction and low collective action costs for shareholders in relation to their governance rights in the other. But both techniques may be equally effective in securing board responsiveness to shareholder interests.

However, further questions raised about the convergence theory are more far-reaching. Political forces are important even under the market theory, because lobbying by firms suffering from inefficient company law is seen as a crucial mechanism whereby legal change is brought about. However, and this is the third qualification, the political process may as easily throw up obstacles to the reform of company law as provide a channel for its implementation. Incumbents may lobby against reform if their current benefits from an unreformed system are greater than they can expect from a reformed one.[18] Managers may not welcome changes which make them more accountable to shareholders, for that may threaten

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[15] "Company law can help business or it can hinder it. Company law can encourage entrepreneurship, promote growth, enhance international competitiveness and create conditions for investment and commitment of resources, whether of savings or employment. Or it can frustrate entrepreneurs, inhibit growth, restrict competitiveness and undermine the conditions for investment." Company Law Review Steering Group, MODERN COMPANY LAW: FINAL REPORT, 2001, para 1 (UK) – putting forward extensive proposals for the reform of UK company law.

[16] Since shareholders will be the beneficiaries of market-driven change, they have the strongest incentive to lobby for it. Indeed, shareholders may lobby more strongly than bodies representing managers, who may wish to oppose certain pro-shareholder reforms if these will increase the chances of managers losing their jobs. So, managers may appear, at least on some reform issues, as incumbents opposing change rather than lobbyists for it. However, managers may support pro-shareholder reforms if those reforms enable the company to compete more effectively in international markets. See the case of France as analysed by P. Culpepper, QUIET POLITICS AND BUSINESS POWER, Cambridge 2011, ch. 3.

[17] R. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function,* AMERICAN JOURNAL OF COMPARATIVE LAW 49 (2001) 329, arguing that the adaptivity or otherwise of a corporate governance system will determine the extent to which the convergence which occurs is functional or formal.

[18] In other words, the incumbents do better from having a larger slice of a smaller pie than a smaller slice of a larger one. Whether this is so, or is perceived to be so, in any particular case is, of course, an empirical matter.

their job tenure. Equally, controlling shareholders benefitting from high private benefits of control may resist reform aimed at encouraging institutional investment. Moreover, incumbents, because they are already entrenched, may have some natural advantages in the lobbying process, so that it is not obvious that the reformers will always win. The balance of power as between reformers and incumbents will naturally vary from jurisdiction to jurisdiction and from time to time.

We may imagine that, for most voters most of the time, company law rules are a matter of indifference, so that their reform is, indeed, a matter of lobbying and counter-lobbying by those interest groups to whom the rules do matter. However, in times of crisis, such as the collapse of Enron and other companies at the beginning of the century or the more recent financial crisis, company laws (or at least certain parts of them) may become salient for elected politicians, because voters do perceive that these rules matter. At such times, the balance in the corporate law debate may shift in favour of the reformers,[19] but the political pressures may also move the reforms in a populist direction, so that the question of the efficiency of company law in cost reduction terms becomes submerged in other issues.

However, the strongest challenge to the theory of convergence of company laws via the pressures of competition comes for the 'varieties of capitalism' literature.[20] At the heart of this literature lies the concept of complementarities, ie that a feature of a corporate governance system may have greater impact in lowering the costs of production in the presence of some other element of the environment (its 'complement') than if the complement is not present. To take a simple example, a rule permitting the shareholders by ordinary resolution at any time and for any reason to remove the members of the board will have a different impact if the shareholdings in the company are concentrated than if they are completely atomised. This argument gives rise to the possibility that differently constructed company law systems may be equally efficient because they are constructed around different complements. In the example, company law needs to address the agency problems of the minority shareholders, where shareholdings are concentrated, and the agency problems of shareholders as a class where shareholdings are dispersed. The resulting company law rules are likely to look very different, but they may represent equally efficient equilibria. One might try to find convergence here on the basis that both systems of company law seek to make the board responsive to the needs of non-controlling shareholders (who are the shareholders as a whole in the one case or only the minority shareholders in the other). However, the fact remains that the provisions of the company laws in the two systems will be different, functionally as well as formally, and any attempt to impose the rules of the one system on the other would be likely to increase the costs of production so long as the latter's shareholder structure remained unchanged.

A more challenging example are company law rules which reduce the responsiveness of the board to shareholder influence but can be regarded as complementary to rules and institutions which encourage firm-specific human capital investments by employees. It is conceivable that such rules raise the company's cost of capital (because of the reduced shareholder influence over management) but reduce the company's costs of production overall, because the company's labour costs are reduced to a greater extent than its capital costs are increased. Whether this is empirically the case in any particular jurisdiction may be difficult to demonstrate. For example, the empirical literature on the German institutions of employee

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[19] P. Davies, *Enron and Corporate Governance Reform in the UK and the European Community,* in J. Armour/J. A. McCahery, eds., AFTER ENRON, Oxford/Portland 2006, p. 415.
[20] P. Hall/D. Soskice, eds., VARIETIES OF CAPITALISM, Oxford 2001.

voice suggests that strong works councils are not inconsistent with an overall reduction in companies' costs of production, whilst even mandatory board level representation, if structured in a particular way, can have positive efficiency effects.[21]

The 'varieties of capitalism' literature thus suggests that differences in corporate law are likely to persist, even under the competitive pressures of globalisation, where the corporate law rules are complements to other differences in the productive arrangements in a particular jurisdiction. In fact, to change the corporate law rule in such a case might lead to a less efficient outcome. Thus, if corporate law rules in jurisdiction A, diluting the responsiveness of the board to shareholder interests, are a complement to institutions giving employees a strong voice in the governance of the enterprise, then changes increasing the influence of the shareholders on the board might both increase the levels of conflict within the board and render employees less likely to make human capital investment in the company. So, the equilibrium position within jurisdiction A is one where the shareholders' influence is diluted in order to maintain high levels of human capital investment.

However, it does not follow that this equilibrium (within jurisdiction A) is as successful in reducing the overall costs of production as the equilibrium which obtains in jurisdiction B, where the corporate law rules give shareholders a strong influence over the board and the employees have only limited governance rights. Let us suppose that the institutions overall in jurisdiction B do in fact produce lower costs of production than those in jurisdiction A. In this situation, a convergence theorist might argue that, under the pressures of competition, jurisdiction A will change its rules so as both to increase the board's responsiveness to shareholders and to reduce employees' governance rights. However, the costs of making both changes in jurisdiction A are likely to be greater than the single change needed in jurisdiction B, where employee governance rights are not entrenched, to increase shareholder influence on the board. This is because there is likely to be greater opposition in jurisdiction A by incumbents (ie the employees) to the change and because of the transitional costs of moving from a production system based on cooperative employee relations to one based on arm's length employee relations. Thus, one might predict that jurisdiction A will increase the responsiveness of the board to shareholders only where the gains from such a move will be much higher than in jurisdiction B, where more modest gains will induce this move because the costs of reform (both political and financial) are less.[22]

Overall, the above theories suggest that over relatively short periods of time it will be difficult to predict the pace of change and perhaps even its direction. The purpose of this article is to

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[21] J. Addison/C. Schnabel/J. Wagner, *Works Councils in Germany: their effects on establishment performance,* (2001) 53 OXFORD ECONOMIC PAPERS 659, suggesting that the distributional effects of works councils in favour of employees and away from shareholders are not inconsistent with an overall reduction in the costs of production. L. Fauver/M. Fuerst, *Does good corporate governance include employee representation? Evidence from German corporate boards,* (2006) 82 JOURNAL OF FINANCIAL ECONOMICS 673, suggesting that the efficiency gains are more likely if the representation is set at a less than parity level and if the employee representatives are not union appointees.

[22] For an analysis along these lines of the impact of globalisation on German corporate governance see A. Börsch, GLOBAL PRESSURE, NATIONAL SYSTEM, Cornell University Press 2007. This is not to say that fundamental reform will never occur, especially if the institutions of employee governance are themselves starting to malfunction. For an analysis of the UK reforms of employee governance in the 1980s along these lines see C. Crouch, CAPITALIST DIVERSITY AND CHANGE, Oxford University Press, 2005, p. 143 et s.

consider what conclusions about the convergence theory can be drawn from an analysis of recent changes in the board rules in a number of important European jurisdictions.[23] Some of these jurisdictions (for example, Germany, the Netherlands) have traditionally used corporate law to reduce the agency costs of employees as well as of shareholders; most have highly concentrated shareholdings but the UK is a dispersed shareholding jurisdiction one, Poland, had relatively recently adopted a capitalist system; Switzerland is outside the EU but the rest are Member States.

2. Board structure and composition

2.1 One-tier and two-tier boards

The two board systems, one-tier and two-tier, look completely different at first sight as far as division and delegation of powers is concerned, so that the fact that some European jurisdictions (for example, UK, Sweden, Italy, France) have traditionally used the one-tier system, whilst others (for example, Germany, the Netherlands) a two-tier system appears to be a significant dividing line. In the *two-tier systems*,[24] a strict division of powers between the management board and the supervisory board is mandatory. This functional division is bolstered by the incompatibility principle that a person cannot be a member of both boards at the same time,[25] and there is usually a prohibition against the supervisory board giving instructions to the management board.[26] The delegation of tasks is generally only possible to a certain extent within the respective board, and key decisions and certain matters – such as the remuneration of managing directors in Germany recently– are reserved to the whole board.

In traditional *one-tier systems*, there is no formal division between management and supervision. However, because one size does not fit all types of company, the board typically has far-reaching discretion to delegate powers to managers below the board level, in which case the task of the board is restricted to monitoring the management. The most liberal and flexible approach is to leave the distribution of powers, apart from appointment and dismissal rights, entirely to the board itself. The prototype is the UK, where the default rule is that the board of directors exercises all the company's powers but may delegate its powers to managers below the board level.[27] In one-tier systems, boards can thus be seen to outsource

[23] They are identified in the note at the beginning of this article.

[24] For example, Germany, Poland, as well as France, Italy and the Netherlands in their two tier-models.

[25] But the Belgian legislator, when introducing a two-tier model, provided that members of the management board may at the same time be members of the supervisory board. This provision was taken from the rules for credit institutions, where a two-tier board with such a "personal union" is mandatory. And Italy allows members of the supervisory board to be members of the management board under its two-tier option.

[26] For Germany there were other models for saving banks and state-owned banks (*Landesbanken*) until the Stock Corporation Act of 1937; Poland follows the German model, but is much less clear in practice. In the Netherlands giving instructions is allowed by law, but it does not occur in listed companies and it is debated in legal literature. Italy has different models.

[27] In Sweden the responsibility for the day-to-day management of the company lies with the CEO, who is recognized by law as a separate corporate body; major decisions, however, stay within the competence of the board. In Switzerland the management function can be and usually is delegated to a management board. Similarly, in Belgium, Italy, and France, boards of listed companies delegate management powers to an informal executive committee.

most of their tasks and powers to a separate formal or informal executive body below the board level. Another question is whether executives are or even must be members of the one-tier board.[28] If the board has only non-executive members (so-called NEDs or outside directors) and its task is limited to monitoring the outsourced management, its function approximates that of a supervisory board,[29] with the difference, however, that the board can always revoke the delegation. The extent to which boards in one-tier systems can delegate their powers may vary from country to country, but some common characteristics can be distinguished: certain powers cannot be delegated; the board has the right to give instructions to the body exercising the delegated powers; delegation is non-privative and revocable; and the board is obliged to monitor the exercise of the delegated powers.

Convergence

The two different models that at first sight look completely different are functionally much less different; indeed, one could say that there is considerable convergence. For Switzerland, an ostensibly one-tier system, for example, it has been stated that "no genuine one tier board has survived in Swiss public companies." (P. Böckli) Four observations back this convergence statement: First, the one-tier board makes use of delegation to the management to a large degree, and monitoring the exercise of the delegated powers becomes its main task. Second, not only the supervisory boards but also the one-tier boards are dependent on management for information and advice, sometimes to the extent that management takes over. Third, in the one-tier board itself there has been, de facto and de iure, a certain separation, not only between executives and non-executives, but between non-independent and independent directors. And fourth, there is also a convergence in the exercise of certain functions such as strategy, risk management, and internal control.

As to the first: taking or participating in key decisions – and in particular monitoring and control – are matters for the (single) board. These matters are sometimes mandatorily reserved to the board for decision, a technique that resembles the catalogue of matters reserved for approval by the supervisory board in the two-tier system.[30] A prototype is Switzerland. Swiss company law contains a "seven-point" catalogue of powers that cannot be delegated by the one-tier board, the most important of which are the determination of strategy, the appointment

[28] In some one-tier systems the board has to consist of executives and non-executives, and all senior executives are board members (UK, the Netherlands), whereas in others executives do not have to be board members (Switzerland, Sweden, Belgium and Italy). Swiss boards are even exclusively populated by non-executives. Cf. also W. J. L. Calkoen, THE ONE-TIER BOARD IN THE CHANGING AND CONVERGING WORLD OF CORPORATE GOVERNANCE, doctoral dissertation, Erasmus Universiteit Rotterdam, 2011, comparing boards in the UK, the US and the Netherlands.

[29] The Swiss model is sometimes referred to as "supervisory board plus".

[30] See K. J. Hopt/P. Leyens, *Board Models in Europe ...,* EUROPEAN COMPANY AND FINANCIAL LAW REVIEW (ECFR) 2004, 135 at 150. German corporate law in its 1937 version, which was carried over into the post-war laws, limited the powers of the supervisory board to approve strategic issues or to remove managing board members without cause. However, under reforms of 2002, at least in the majority view, the supervisory board is now required to establish ex ante a catalogue of management decisions which require its prior consent, which catalogue includes the main elements of corporate strategy. In this case, therefore, a two-tier system moved in the direction of the de facto operation of the one-tier system, but the 1937 German law was always an outlier among two-tier systems by reason of its restrictive approach to the role of the supervisory board.

and removal of management, the ultimate supervision of management, the preparation of the annual accounts, and the structuring of the accounting system and financial controls.[31] In Belgian practice, many companies with a one-tier board have an informal executive committee, to which the board has given a general delegation of powers that goes beyond the day-to-day management, but which does not include the determination of strategy and supervision.[32] In other countries, apart from the determination of strategy and the supervision of management, the range of delegated powers is not limited, but the board may not be deprived of all of its powers. This is also the bottom line in the UK, the most liberal country in this respect, where boards may delegate all powers to managers below the board level. Yet even there the board cannot divest itself of overall responsibility for management by delegating particular functions.[33]

Second, it is a general practice that proposals to the board (whether one-tier or two-tier) to exercise powers that are not delegated are usually prepared at the executive level (management or management board), sometimes even in the form of draft resolutions. In many listed companies, supervisory or non-executive board members do not have the expertise or the time to carefully study and seriously challenge management proposals. The management thus not only exercises de iure those powers that have been delegated to it, but also de facto the powers that have formally remained with the (supervisory) board. More generally speaking, the formal differences between the board making a decision and the board approving a decision are not as important as the way these powers are exercised in practice. It is less relevant whether the law concentrates powers in a one-tier board if that board has extensive authority, and uses it, to delegate those powers to management below the board level. The same is true if the law divides the powers between two boards, but the supervisory board exerts a significant ex ante influence by the mere fact that it has extensive approval rights.

Third, there are strong tendencies to divide functions between executives and non-executives in the one-tier systems, too. In the one-tier board there is de facto and de iure separation not only between executives and non-executives but between non-independent and independent non-executive directors, the latter being responsible for certain functions – in particular, control functions – which in the two-tier systems are the task of the supervisory board (see further §2.5 below in relation to board committees)). The separation between the management board and the supervisory board is also mirrored in those one-tier board countries in which separation between the CEO and the chairman of the board has become good corporate governance (see *infra* 2.4).

Finally, convergence can also be observed in the identification of the functions which are regarded as central to the role of the (supervisory) board and which must thus be retained by it, at least formally, and not delegated to management. In both one-tier and two-tier systems strategy, risk management, and internal control are in this category.[34]

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[31] In Italy there is a similar catalogue, but it does not contain the determination of strategy, Art. 2382 CC.
[32] For delegation to board committees, see *infra* part 2.6.
[33] This is the effect of the company law; the UK Corporate Governance Code § A.1.1 recommends that a list of matters which require board approval be drawn up.
[34] P. Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?* 2 INTERNATIONAL AND COMPARATIVE CORPORATE LAW JOURNAL 435 (2000); J. N. Gordon/M. J. Roe, eds., CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE, Cambridge 2004; J. A. McCahery et al., CORPORATE GOVERNANCE REGIMES, CONVERGENCE

Strategy

The power to determine the company's strategy and to monitor its implementation is one of the most important powers of the board. In most one-tier systems this power cannot be delegated to the sub-board level and has to be exercised by the entire board. But in practice, strategy proposals are usually prepared by senior management together with executive directors (if they are on the board at all), whereas the board reviews the proposal. Non-executive directors of listed companies, because of information asymmetry, may find it difficult to fully challenge the plans of the executives or even to maintain a contrary view.[35]

In two-tier systems, the management board determines the strategy, but this decision is usually subject to approval by the supervisory board, either mandatorily or in practice. This approval requirement enhances prior coordination and consultation between the two boards. Supervisory boards in two-tier models are increasingly seen to participate in determining the company's strategy. So again there is a functional convergence here with the one-tier board model.

Risk Management and Internal Control Systems

There is also no clear-cut division between the one-tier and two-tier systems as to risk management and internal control, not in law and even less so in practice. In some one-tier systems, the (entire) board is responsible for setting up the risk management and internal control systems, whereas the task of management is limited to implementing these systems.[36] This is also the view of the European Commission in its Green Paper of April 2011.[37] In other one-tier systems, the management is primarily responsible for setting up the systems, whereas the task of the board is limited to approving the basic guidelines as well as to monitoring the setting, implementation and functioning of the systems.[38] This division comes near to the two-tier systems, where the management board sets and implements the strategy and the supervisory board monitors the setting up and implementation,[39] though there mere monitoring is usually mandatory. In the Italian traditional model, the situation is more complicated, as the monitoring of the effectiveness of the company's internal control and risk management systems is also exercised by the board of (internal) auditors. It should, however,

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AND DIVERSITY, Oxford 2002.

[35] In Switzerland there is a tendency of strong top managers to preempt many decisions that belong to the Board's reserved turf by indirect and informal exertion of power in the preparatory stage of decision-making (P. Böckli).

[36] Italy, Sweden, Switzerland.

[37] EU Commission, Green Paper, THE EU CORPORATE GOVERNANCE FRAMEWORK, 5.4.2011, COM(2011) 164, p. 10: "To be effective and consistent any risk policy needs to be clearly 'set from the top' i.e. decided by the board of directors for the whole organisation. It is generally recognised (note 43: From Commission interviews) that the board of directors bears primary responsibility for defining the risk profile (..)." However, the EU Commission Recommendation of 15.2.2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, O.J.E.U. L 52/51 of 25.2.2005, mentions as a key responsibility of the board "to monitor the procedures established for the evaluation and management of risks," Preamble no. 14.

[38] France, Switzerland.

[39] Poland, Germany, the Netherlands.

be noted that the right of management to make a decision and the right of the board to approve a decision often mean co-decision in practice.

Monitoring of the internal control and risk management systems entails ensuring that a state-of-the-art risk management system is in place, checking whether the risk profile corresponds with the business profile and strategy, and reviewing how the system worked in the past period. Where the setting up and implementing of internal control systems is primarily a task of management, either by law or in practice, the board must be aware that managers often underestimate risks. Yet whether the board is in a position to effectively carry out such a check is questionable, since it is very difficult to identify unlikely risks ex ante. The bottom line is that detailed questions about risk can only be asked by the management. Therefore, additional checks and risk-assessment procedures are often built in: within the board by a separate audit committee where particular financial expertise is required by law, sometimes by a specific risk committee,[40] and ultimately by internal as well as external auditors.[41]

Choice of board structure

In three jurisdictions, France, Italy and very recently the Netherlands, the legislature has implemented reforms which formally make available to companies the choice between the two tier and the one tier forms.[42] The choice is also available to companies which choose the EU-provided form of incorporation as a 'European Company'. A choice between the two forms might be thought to be evidence against the convergence thesis, since that thesis suggests the one/two-tier distinction is relatively unimportant and thus undeserving of legislative attention. In France the initial reform of 1966, introducing a choice between one-tier and two-tier forms, seems to have been driven by a particular rigidity of the one-tier board system instituted in that country under legislation dating from 1940, namely, the mandatory combination of the roles of chief executive and chair of the board in a single person (the *président directeur générale* (PDG)). In reforms of 2001,[43] however, a further choice was made available, this time within the one-tier system: management and supervisory functions could now be split between the chief executive and the chair of the board or remain concentrated in the hands of the PDG. The underlying issue in France thus seems to have been about the division of powers at the top of the company, rather than about board structure as such, though about 13% of the CAC 40 companies (the top listed companies) have adopted a two-tier structure.

The 2003 reforms in Italy also introduced, in place of the previous one-tier system, three choices for companies: besides a two-tier system fashioned after the German model, the single tier arrangement was offered either with the traditional board of internal auditors or without it but with a mandatory audit committee of the board. It is less clear what policy considerations were driving the Italian reforms and it is perhaps significant that the traditional model remains the default choice and that 96% of listed companies have remained with the traditional model. It is also the case that the Italian two-tier model permits both executive and non-executive directors to be members of the management board, which suggests that a strict division of function between management and supervision was not an objective of the reforms. By contrast, Dutch legislation, traditionally based on a two-tier system, was amended

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[40] See *infra* part 2.6.
[41] Italy and France.
[42] In France the choice has been available since 1966; in Italy it was introduced in 2003.
[43] Nouvelles Régulations Économiques, no. 2001-420, 15.05.2001, JOURNAL OFFICIEL (J.O.), 16.05.2001, 7776 ff.

in 2012 so as to provide the option for a one-tier board. This reform was motivated by a desire to make available a governance form which was familiar to foreign investors, especially Anglo-American ones. This suggests that no incumbent domestic interests were significantly threatened by the move to a one-tier board.[44]

Overall

There has been a very significant degree of convergence in practice in the operation of the one-tier and two-tier systems, mainly as a result of the delegation of management powers within the one-tier system, whilst strategy-setting remains with the board, and partly as a result of the practice of members of the management board in the two-tier system attending meetings of the supervisory board, whilst not being members of it. Formally, the difference remains that delegated powers can be normally be withdrawn at short notice within the one-tier system, so that the board can readily instruct the management what to do. However, it is doubtful whether this is a difference of practical importance. In non-crisis times the (supervisory) board is largely dependent upon management expertise for the formulation of policy; in times of crisis the company's strategy is likely to be implicated so that the issue is, even formally, one for the (supervisory) board. However, it is doubtful whether this example of functional convergence provides strong support for the more general convergence thesis outlined in section 1 above. If anything, convergence on the two-tier model shows the inherent difficulty of establishing a high level of accountability of management to the shareholders by making the board the management organ of the company. The arguments based on expertise and commitment which make the board rather than the shareholders the appropriate body for setting corporate strategy also support sub-delegation by the board to management so that the board discharges, at best, a monitoring function. It is worth recalling that the shift in board function, associated with the corporate governance code movement and its emphasis on independent directors (see infra 2.2), was not from a managing board to a monitoring board but from an advisory board to a monitoring board. In large public companies the board's function, as it used to be described in the model articles for public companies in the UK, ie that 'the affairs of the company shall be managed by the board' had long ceased to be a realistic prescription, if anything other than a limited meaning was attached to the word 'managed'.[45]

2.2. Non-executive and independent directors

The *composition* of the board in the various countries also differs, but this is more controversial than structure. The main controversy relates, of course, to the constituencies to be represented, namely shareholders alone or shareholders plus employees or labour co-determination.[46] Within shareholder representation, however, a dominant question over the past quarter century has been the mix of executive and non-executive directors and the proportion of independent directors on the board. The latter question is linked to the former

[44] In particular, a company does not escape the mandatory worker representation requirements by moving to a one-tier structure. Mandatory worker representation may be perceived as a good reason for not adopting the one-tier structure. As of January 2012 only two of the 80-odd companies listed on the Amsterdam stock exchange had opted for the one-tier structure, one of which, Unilever, which is not subject to mandatory employee representation, had been able to use it even before the reforms.

[45] The current version of the model articles states, rather more realistically, that the directors 'are responsible for the management of the company's business'

[46] See *infra* part 2.8.

but is more critical. Recently, the discussion has focused less on the concept of non-executive directors and more on the (non-executive) independent director. It is even reported that in France there is no concept of executive/non-executive director. In the UK, unlike earlier versions of the Corporate Governance Code, the current code makes recommendations entirely in terms of independent non-executive directors; other non-executive directors are no longer mentioned. The same is true in Switzerland. The issue of independence is normally treated in corporate governance codes, i.e. it is a matter of 'comply or explain' recommendations, though there are some mandatory (if minimal) requirements, such as the EU requirement that at least one member of the audit committee be independent.[47]

In the two-tier systems – at least in the German and Dutch versions – there is a mandatory neat division between the executives (only) in the management board and the *non-executives* (only) in the supervisory board, though, as mentioned, the Italian two-tier system permits the management board to consist of executives and non-executives.[48] In the UK there is a Corporate Governance Code rule that at least half of the members of the board should be (independent) non-executives, but also a requirement that the board contain an appropriate combination of executive and non-executive directors,[49] while in others there should be at least (Netherlands and Italy) or at most (Sweden) one member who is an executive director. In other countries without such requirements the practice varies: in Belgium, the CEO is usually on the board; this is also true rather often for France and Sweden (in 40 to 50 per cent of the cases); but in Switzerland it occurs more and more rarely. The EU Recommendation is satisfied if there is "an appropriate balance."[50]

As to the requirement, either mandatory or by code, of having *independent directors*[51] on the board, there is as much variety and even more controversy. The lead has been taken by the USA with 81 per cent independent directors in listed companies and their "super-majority independent boards."[52] It should be clear in the two-tier systems - though in Germany it was first disputed - that the members of the supervisory board, who cannot simultaneously be members of the management board, are non-executive by definition but certainly not per se independent; in fact, independence is usually completely contrary in the practice of Rhenish capitalism. In Germany with its traditional reluctance to accept independent directors, the corporate governance code only recommends that the number of independent directors be adequate as seen by the supervisory board itself and that the chairman of the audit committee should be independent and not have been member of the management board for the last two years. In the Italian two-tier model, if the management board consists of more than four members, at least one has to be independent. Among the one-tier systems, the UK had 80 per cent of independent directors as of 2011.[53] But there are usually only code provisions with

[47] Directive 2006/43/EC of 17 May 2006 on statutory audits, OJEC L157/87, art. 41.1.
[48] The Italian corporate governance code, however, envisages a management board with only executives.
[49] There should be an "appropriate combination of executive and non-executive directors," UK Corporate Governance Code 2012, B.1 (Supporting Principles), but at the same time the board should be composed of at least 50 per cent independent non-executive directors (B.1.2).
[50] EU Recommendation of 15.2.2005, *supra* note 38, no. 3.1.
[51] M. Roth, *Unabhängige Aufsichtsratsmitglieder,* ZEITSCHRIFT FÜR DAS GESAMTE HANDELSRECHT UND WIRTSCHAFTSRECHT (ZHR) 175 (2011) 605; K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 25 et s., 35 et s.
[52] L. Enriques/H. Hansmann/R. Kraakman in: ANATOMY, *supra* note 3, p. 70.
[53] UK Financial Reporting Council, Developments in Corporate Governance 2011, December 2011, p. 11.

recommendations that vary from at least two, at the one extreme (Poland), to all but one as independent directors, at the other (Netherlands).[54] Switzerland has no legal rules at all, but Swiss boards are almost exclusively composed of non-executive persons.[55] The EU Recommendation again looks for a compromise by recommending a “sufficient number” of independent directors.[56]

The concept of independence is difficult and controversial. In formal terms, independence can be defined by a general clause or by a catalogue that may be finite[57] or just contain major examples of independence. It is also possible to combine both approaches. This is what the European Commission has done in its Recommendation. It defines independent as being “free 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.”[58] But the Recommendation has an annex in which a long list of far-reaching – though non-binding – criteria concerning possible threats to directors’ independence is laid down.[59] Most national corporate governance codes have incorporated all or most of the Recommendation’s catalogue.[60] Only in Germany and Switzerland[61] are the situations not sketched out in such a level of detail.

A critical point that is often overlooked is how to deal with companies with a controlling shareholder. The European Recommendation confines itself to treating a representative of a controlling shareholder[62] as not independent. Even this recommendation has up to now not been followed in all member states, in particular in countries where controlling shareholder and family enterprises are typical. The prototype for this negative reaction was Germany[63], though with the understandable argument that half the board of the relevant companies is

[54] In Belgium three, in Italy one-third, in most countries one-half (UK, Sweden, France).
[55] With certain exceptions.
[56] EU Recommendation of 15.2.2005, *supra* note 37, no. 4.
[57] The Belgian and Dutch corporate governance codes do not have a catch-all provision and present the list of criteria as exhaustive, i.e., if one of the listed criteria is met, the director concerned is considered non-independent, and if none of the criteria is met, the director is considered independent.
[58] EU Recommendation of 15.2.2005, *supra* note 37, no. 13.1.
[59] Annex II of the EU Recommendation of 15.2.2005, *supra* note 37, no. 1. The wording is rather unspecific: “a number of situations are frequently recognised as relevant in helping the (supervisory) board to determine whether a non-executive or supervisory director may be regarded as independent (..). (A) number of criteria (..) should be adopted at national level. Such criteria, which should be tailored to the national context, should be based on due consideration of at least the following situations: (a) – (i)).”
[60] The Polish corporate governance code simply refers to the independence criteria in the Recommendation.
[61] However, the Swiss corporate governance code, para 22, contains a specific definition of independence of members of board committees: members who never were or were more than three years ago a member of the executive management and who have no or comparatively minor business relations with the company.
[62] EU Recommendation of 15.2.2005, *supra* note 37, Annex II, no. 1 (d), control as defined in Council Directive 83/349/EEC, O.J.E.C. L 193/1 of 18.7.1983. As to employee representatives and the independence requirement see *infra* 2.8.
[63] German Corporate Governance Code (2010 version), no. 5.4.2: „A Supervisory Board member is considered independent if he/she has no business or personal relations with the company or its Management Board which cause a conflict of interests.“

filled by labor.[64] For controlled companies,[65] the French corporate governance code lowers the recommended percentages of independent directors from one-half to one-third. Other countries go further than the European Recommendation and treat shareholder representatives as not independent if the shareholder is "significant" according to the UK, or "major."[66] In the latter case, the Swedish corporate governance code recommends that at least two of the directors who are independent of the company and its management (this should be the majority) have to be independent of the major shareholders. The French corporate governance code states that a board representative of a "major shareholder" may be considered independent if the major shareholder does not "take part in the control" of the company. Representatives of holders of at least 10 per cent of the shares are considered non-independent in Belgium (in the law) and in the Netherlands and Sweden (in the corporate governance code). This 10 per cent threshold has also been suggested by the German Corporate Governance Code Commission for the 2012 code revision, but it received harsh critique for this in both practice and academia. In the end this threshold has been adopted, but only for transparency and not for the actual definition of independence.

If the independence criteria are set up in the listing conditions – as, for example, in the USA[67] – the decision on independence lies with the stock exchange or, as the case may be, the stock exchange supervisory body. In many European countries, the final determination of what constitutes independence remains fundamentally an issue for the (supervisory) board itself to determine. In the United Kingdom as well as under the European Recommendation,[68] it is up to the board to determine whether each director is independent in character and judgment. The aforementioned criteria are then only non-binding guidelines for the board when there are circumstances that may threaten the independence of a particular director. While the rationale of this rule in the UK is the flexibility for the board to deal with a particular case, the European Commission may have chosen this rule because it was well aware that the list of criteria in the annex to its Recommendation went far beyond what was the practice in the different member states and left them an easy way out, in particular with respect to independence of a director from a controlling shareholder. The recommendation that there should be an annual review of whether a person may still be regarded as independent is tightening the rule just a bit.

More recently there has been much discussion on the merits of a senior independent director (lead independent director) who has the task of coordinating the work and the views of the independent directors. Pursuant to the UK Corporate Governance Code, the senior independent director should provide a sounding board for the chairman to serve as intermediary for other directors and to be available to shareholders if the contact through the

[64] M. Roth, *supra* note 51, ZHR 175 (2011) 605 at 629 et s. The 2012 revision of the German Code has extended the definition of the independent director by treating a director who has a personal or business relationship with a controlling shareholder as not independent, provided there is a substantial and not only temporary conflict of interest. The definition of „controlling shareholder" is not fully clear (actual control as under German group law or majority of votes as in German group annual accounts law or 30 per cent as in German takeover law).

[65] French company law defines a controlling shareholder as a person who holds the majority of the voting rights, or has the power to appoint and dismiss the directors, or effectively determines the decisions of the shareholders meeting.

[66] Italian company law further contains independence rules in case of related party transactions and takeover bids.

[67] To this and the following, K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 36.

[68] European Recommendation of 15.2.2005, *supra* note 37, no 13.2.

chairman or CEO is inappropriate or has failed to resolve the issue concerned.[69] Other countries – for example, Italy and Switzerland – are following this concept of "lead director." In Italy, the presence of a lead director is recommended if the chairman is the CEO or a representative of the controlling shareholder. There the lead director cannot be a representative of a major shareholder because the director would not be considered independent. In Italy a lead director may be the representative of a major shareholder, similarly in France, but there only if he does not take part in the control of the corporation. A lead director is more relevant in one-tier systems than in two-tier systems or if the CEO and the chairman are separate, but he may also be useful in two-tier system countries like Germany.[70] To a certain degree, a lead director could function as a substitute for these separations.

One of the key problems has shown to be independence v. competence. The high expectations of independent directors[71] have been only partially fulfilled.[72] The economic studies do not provide clear positive data.[73] Independent directors seem to have had an impact on replacing executive directors, but this was often mainly due to pressures from institutional investors. Undeniably, independent directors have not been able to prevent huge scandals.[74] One reason for this is that they are usually nominated or selected by the CEO or executive directors who have professional or personal relationships with them. Unless they are professional non-executive directors, they are working part time and, while being independent, may not have the necessary know-how, either of the business sector or the actual corporation. Furthermore, the flow of information to them is often suboptimal, particularly in the case of supervisory boards[75], but also quasi two-tier boards as in Switzerland. They are also paid less than the

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[69] UK Corporate Governance Code 2012, A.4.1. See the significant shareholder vote against the senior independent director of Redrow plc who was thought to have been insufficiently robust in resisting an undervalue bid for the company in which the company's CEO and chairman were both involved (FINANCIAL TIMES, November 11, 2012).

[70] M. Roth, *Information und Organisation des Aufsichtsrats,* ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 2012, 343 at 364.

[71] Cf. J. N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices,* 59 STANFORD L. REV. 1465 (2007).

[72] P. Davies/S. Worthington, *supra* note 13, § 14-76. As to the following, see K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 36. See also L. Enriques/H. Hansmann/R. Kraakman in: ANATOMY, *supra* note 3, p. 66: independent directors are "a wide-spectrum prophylactic," "potentially valuable for treating all agency problems, but not exclusively dedicated to treating any." See also L. Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence,* 90 NW. U. L REV. 898 (1996); A. B. Gillette et al., *Board Structures around the World. An Experimental Investigation,* 12(1) REVIEW OF FINANCE 93 (2008); R. Duchin et al., *When are Outside Directors Effective?* 96 JOURNAL OF FINANCIAL ECONOMICS 195 (2010); R. Fahlenbrach et al., *Why do Firms Appoint CEOs as Outside Directors?* 97 JOURNAL OF FINANCIAL ECONOMICS 12 (2010).

[73] Cf. L. A. Bebchuk/M. S. Weisbach, *supra* note 2, at 943 et s.; cf. also R. B. Adams/B. E. Hermalin/M. S. Weisbach, *supra* note 2 at 80 et s;. L. Guo/R. Masulis, *Board Structure and Monitoring: New Evidence from CEO Turnover*, 2012, available at < http://ssrn.com/abstract=2021468 >.

[74] E.g., Enron, where the board was composed of a majority of qualified independent directors. As to Enron see C. J. Milhaupt/K. Pistor, LAW & CAPITALISM, Chicago/London 2008, p. 47 et s.; J. C. Coffee, GATEKEEPERS: THE ROLE OF THE PROFESSIONS IN CORPORATE GOVERNANCE, Oxford 2006.

[75] P. Leyens, INFORMATION DES AUFSICHTSRATS, Tübingen 2006, p. 156 et s.

executive directors, in particular if they are supervisory board members, and therefore may also be less motived to devote much of their time and energy to their task.[76] Therefore, in the past years, in particular after the financial crisis, the emphasis has shifted to competence.[77] The EU Green Paper of April 2011 does not touch upon independence as a discussion theme and mentions it just once as one of the "broad set of criteria" for the selection of non-executive board members.[78] This tendency can be seen in various countries. There is also a growing interest in other governance mechanisms such as pay-performance sensitivity and the market for corporate control.[79]

Assessment

The introduction of independent directors was associated in the UK and the US with a change in the function of the board, ie from advising to monitoring (or, better, from advising only to monitoring and advising). Before the change, in a dispersed shareholding model the board was chosen, normally, by the management. Being beholden to the management for their places, the non-executive members of the board are valuable because of the advice which they may provide from a perspective not well represented in the management or because of networking contacts they have which management does not have, but they are not well placed to monitor management. By contrast, the code movement proposed the injection of independent non-executive directors into the board in order to strengthen its monitoring function (as well as to provide advice). The board, afforced by the independent directors, should both participate in the setting of corporate strategy and review its implementation. The spread of independent director requirements across Europe, notably via corporate governance codes, can thus be seen as evidence of the convergence of board rules and of convergence in a direction which favours the interests of shareholders. In the UK context independence requirements constituted a pro-shareholder reform because they lessened the managerial agency costs of the then dominant shareholder group, the long-only institutional shareholders, who were not block-holders but did have sufficiently large shareholdings across the market as a whole to have a strong interest in the promotion of shareholder interests through corporate governance reforms.

The adoption by the other European jurisdictions of the independent director model is more surprising, since in those other jurisdictions the dominant form of shareholding is block-holding or concentrated shareholding. The presence of independent directors on boards is hardly needed to make directors responsive to controlling shareholders, who can use appointment and removal rights effectively for this purpose. On the contrary, rules requiring

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[76] As a quid pro quo, their risk to be sued is much smaller.

[77] Cf. H. Hau/M. P. Thum, *Subprime Crisis and Board (In-)Competence: Private v. Public Banks in Germany,* ECGI Working Paper in Finance No. 247/2009, available at < http://ssrn.com/abstract=1627921 >. See also already *supra* ch. 2.1.

[78] EU Commission, GREEN PAPER, *supra* note 37, p. 5. The following criteria are mentioned there (in this sequence): "merit, professional qualifications, experience, the personal qualities of the candidate, independence and diversity." Cf. also EU Commission, FEEDBACK STATEMENT ON THE GREEN PAPER ON THE EUROPEAN CORPORATE GOVERNANCE FRAMEWORK, 15.11.2011, http://ec.europa.eu/internal_market/company/modern/corporate-governance-framework_en.htm

[79] D. Ferreira/M. A. Ferreira/C. C. Raposo, *Board structure and price informativeness,* JOURNAL OF FINANCIAL ECONOMICS 99 (2011) 523 at 543: negative relation between price informativeness and board independence; stock market monitoring as a substitute for board monitoring.

independent directors on the board are likely to dilute the influence of block-holders, especially if the board must contain employee representatives in whose appointment the block-holder plays no role. Independent directors might operate in this context as protectors of non-controlling shareholders, but this is again to underline their dilution of the influence of block-holders.

It is significant that, in all but one of our jurisdictions, the UK recommendation for a majority of independent directors was softened in one way or another in other jurisdictions' codes.[80] In particular, no code other than the UK one recommends parity of independent directors with the non-independents.[81] In Germany, at least until recently, the recommendation is simply that "the Supervisory Board shall include what it considers an adequate number of independent members",[82] without specifying a specific number of independent directors.[83] As we have noted, the European Recommendation approaches the problem by treating as non-independent only a representative of a *controlling shareholder*,[84] thus permitting large (but non-controlling) shareholders to make appointments to the board of 'independent' directors, Another way of proceeding is to specify composition rules in terms of non-executive, rather than independent non-executive, directors. As is expressly noted in some of the national analyses, the recommendations on board composition do not in fact prevent a controlling shareholder from appointing a majority of the board who are linked to that controlling shareholder.[85] The Polish experience is particularly instructive. The Polish Corporate Governance Code of 2002 recommended a majority of independent directors on the supervisory board, but by 2010 that recommendation had been reduced to a reference to two independent members. This was a response to complaints by controlling shareholders.

[80] The exception is the Netherlands whose Corporate Governance Code recommends that all but one of the members of the supervisory board be independent. However, in most of the Dutch companies listed on Euronext Amsterdam there is no controlling shareholder, so that the problem discussed in the text does not arise or does not arise in an acute form. . It is also notable that the independence principle applies also to the employee representatives who in the Netherlands are not permitted to be employees of the company or employees of the union with representation rights within the company.

[81] France is a partial exception to this statement. The AFEP/MEDEF code recommends that half the directors should be independent in a widely held company, but only one third in a closely held one.

[82] German Corporate Governance Code 5.4.2. It has been recommended by Government Commission for the German Corporate Governance Code that the provision should be amended as from 2012 so as to suggest a "reasonable number of independent members" This is a significant strengthening but it still falls short of recommending a particular proportion of independent directors.

[83] Since the supervisory board has to state and publish concrete aims for its composition and, since the 2012 revision, has to do this inter alia taking into consideration the number of independent supervisory board members, there is an expectation that also the actual number is published, no. 5.2.1 sections 2 and 3 of the Code. But it remains to be seen how this section will be construed in practice.

[84] EU Recommendation of 15.2.2005, *supra* note 37, Annex II, no. 1 (d), control as defined in Council Directive 83/349/EEC, O.J.E.C. L 193/1 of 18.7.1983.

[85] In Sweden the nomination committee and plurality voting requirements tend in the same direction. In Belgium, if there is a controlling shareholder, non-independent non-executives are always in the majority.

This adaptation of the UK Code when adopted in continental jurisdictions could be explained as reflecting the ability of incumbents, powerful block-holding shareholders, to resist developments which threaten their position. Alternatively, it could be seen as functional. If the goal is the sensitivity of management to the interests of the shareholders, it would be contradictory to weaken the influence of large shareholders over boards.[86] In principle, minority protection can be addressed in other ways. Or the continental codes might reflect some scepticism about the ability of independent directors to exercise effective control over the management of companies.

However, this account does raise the question of why corporate governance codes spread to continental Europe at all if the UK model was designed to address a managerial agency problem for shareholders which is not typical in continental Europe. One possible answer is that the effect of globalization was to increase successful companies' demand for risk capital and to promote the relaxation of obstacles to cross-border investment. Consequently, a code may have been seen as a necessary element in a policy of attracting foreign, especially US, portfolio investment. Codes drawn up from this perspective might then be as much concerned with explaining the domestic arrangements to foreign investors as with changing those arrangements. There seems to have been a strong element of this function when codes were adopted initially.[87] However, over time the parts of the Code containing actual recommendations have grown considerably, whilst the explanations have been criticised as being sometimes too imprecise or even wrong and more generally as unnecessary today.[88] Of course, codes in continental jurisdictions never were simply information-giving mechanisms. They were concerned as well, today perhaps primarily, to provide assurance to foreign investors that the local corporate governance arrangements were credible. An enhanced role for independent directors was important in providing this assurance, even if the recommendation did not extend to the level of half the board.

2.3 Expertise and diversity

The focus of corporate governance codes on directorial independence has been challenged from two directions as a result of the financial crisis. Policy debates on board composition now focus today as much on the elements of expertise and diversity as on independence. The formulation of the principle underlying board composition in latest version of the UK Corporate Governance Code has changed from avoiding dominance by a small group of executive directors to emphasising the characteristics (of which independences is only one) for the effective discharge of the responsibilities of the board.[89] Whilst the recommendation

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[86] In France a distinction is made between the more demanding independence requirements for widely held companies and the less demanding ones for closely held companies can be seen as functional.

[87] In its introduction the German Code says that „The Code aims at making the German Corporate Governance system transparent and understandable. Its purpose is to promote the trust of the international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations."

[88] K. J. Hopt, *Der Deutsche Corporate Governance Kodex: Grundlagen und Praxisfragen,* in: FESTSCHRIFT FÜR HOFFMANN-BECKING, Cologne 2013, p. 561. But in a lecture for the 2012 German Corporate Governance Code Conference in Berlin H.-C. Hirt from the UK pension fund Hermes remarked that this function may still be useful at least for US and other non-EU member states investors.

[89] Main Principle B1 refers to 'the appropriate balance of skills, experience, independence and knowledge of the company.'

for at least half the directors to be independent remains, the Walker Review[90] recommended that a financial company should not feel inhibited from departing from the 50% recommendation if it needs to increase the number of non-independent directors in order to obtain the required level of board expertise.[91] In other words, if the need for expertise causes a financial company to have to choose between an unwieldy large board and departure from the 50% recommendation, it should take the latter course. The EU Green Paper of April 2011 does not touch upon independence as a discussion theme and mentions it just once as one of the "broad set of criteria" for the selection of non-executive board members.[92].

Diversity can consist of very different aspects, including background, gender, age, nationality, and residency. The policy focus in Europe is almost entirely on gender diversity, with some nods in the direction of other aspects of the topic, especially background and national diversity.[93] As to *gender diversity*, the situation in Europe is indeed unsatisfactory. According to the Heidrick & Struggles 2011 Report, the average percentage of women on boards in Europe is 12 percent. The lowest percentage of women on boards is in Italy (6%), while Sweden, where the issue is left to self-regulation, has a very high percentage of women on boards (29%).[94] The empirical evidence on whether companies perform better when they have women on their boards is mixed,[95] but there are other arguments even apart from fairness and equality, such as the waste of talent, the increasing need to broaden the pool of candidates in aging societies, changes in the discussion culture of boards, and a different outlook on

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[90] The Walker Review, A REVIEW OF CORPORATE GOVERNANCE IN UK BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES, FINAL RECOMMENDATIONS, London, 26.11.2009.

[91] See also Financial Services Authority, EFFECTIVE CORPORATE GOVERNANCE (SIGNIFICANT INFLUENCE CONTROLLED FUNCTIONS AND THE WALKER REVIEW), London, January 2010.

[92] EU Commission, Green paper, *supra* note 37, p. 5. The following criteria are mentioned there (in this sequence): "merit, professional qualifications, experience, the personal qualities of the candidate, independence and diversity." Diversity, rather than independence, is referred to as the "key to efficient board work". Cf. also EU Commission, FEEDBACK STATEMENT ON THE GREEN PAPER ON THE EUROPEAN CORPORATE GOVERNANCE FRAMEWORK, 15.11.2011, *supra* note 78.

[93] EU Green Paper, *supra* note 37, 1.1.

[94] Poland and Belgium are also on the lower end of the scale with 8 per cent, followed by France and Switzerland (11%), Germany (13%) and the Netherlands (15%). Heidrick & Struggles, EUROPEAN CORPORATE GOVERNANCE REPORT 2011, CHALLENGING BOARD PERFORMANCE, p. 39. For France the latest figure is 21% according to the AMF 2011 report on Corporate Governance and Executive Compensation. For the UK the figure was 12.5% in 2010 (5.5% of executives, 15.5% of non-executives), Lord Davies, WOMEN ON BOARDS, 2011, URN 11/745.

[95] R. B. Adams/D. Ferreira, *Women in the Boardroom and their Impact on Governance and Performance,* JOURNAL OF FINANCIAL ECONOMICS 94 (2009) 291; K. R. Ahren/A. K. Dittmar, *The Changing of the Boards: The Impact on Firm Valuation of Mandated Female Board Representation,* THE QUARTERLY JOURNAL OF ECONOMICS, (2012) 127, the authors analyze the impact of the 2003 Norwegian law which was the forerunner of the quota regimes in Europe. Cf. also D. A. Carter et al., *Corporate Governance, Board Diversity, and Firm Value,* 38(1) FINANCIAL REVIEW 33 (2003); K. A. Farrell/P. L. Hersch, *Additions to Corporate Boards: The Effect of Gender,* 11(1-2) JOURNAL OF CORPORATE FINANCE 85 (2005); L. Rodríguez-Domínguez/J.-M. García-Sánchez*, Explanatory factors of the relationship between gender diversity and corporate performance,* EUROPEAN JOURNAL OF LAW & ECONOMICS 33 (2012) 603.

decision-making, including the attitude to risk-taking.[96] The latter arguments have some psychological backing, though there is still controversy. In any case, it is not yet clear what this means in terms of company performance.

Whatever the merit of these arguments may be, there is a clear trend of juridification. The diversity debate thus challenges not only the conventional emphasis on director independence but also the role of the 'comply or explain' mechanism in setting board composition rules. The importance of gender diversity is stressed in most countries, but in a number of them – such as Sweden and Poland – no targets or quotas are yet recommended or imposed. In others – such as the Netherlands, Germany and the UK – code provisions recommend targets to be set by the companies themselves and enforce them on a comply-or-explain basis. But in the meantime, many countries have recently enacted laws to reach more gender diversity, or initiatives are pending, as in the Netherlands and Switzerland.[97] The minimum percentages to be reached in the next five to seven years are 30 percent in Belgium and the Netherlands, 40 percent in France, and most recently one-third in Italy. The EU Commission followed the trend[98] in its Green Paper of April 2011. While it recognizes there that companies should decide whether they want to introduce such a diversity policy, the companies should be required to consider the matter and disclose the decisions made.[99] Most recently, the Commissioner in charge has threatened the companies with a mandatory quota if no clear progress is reached by 2013, but has failed to get agreement within the European Commission. It remains to be seen how the problems with mandatory quotas will be dealt with, not so much in the context of subsidiarity and constitutionality as in the (still) insufficient pool of qualified women and the danger of "golden skirts" as reported from Norway.

Another issue, though not directly involving qualifications but very important for effective board decisions, is directors' availability for board meetings and time fully to prepare for them, especially since non-executive and supervisory board members, unlike managers. usually work part-time for the company. Many corporate governance codes, including the UK and German Corporate Governance Codes, expressly state that the directors should be in a position to devote sufficient time for the directorship. The practical demands on directors' time had already increased sharply already under normal circumstances, but this intensified greatly during the financial crises of the company and the economy.[100] Though it is very difficult to spell out more concrete time requirements in law or codes, one possibility would be to limit the number of board memberships. A number of countries still leave this to the shareholders to decide, but with proper disclosure.[101] The UK Corporate Governance Code recommends a limitation only for executive directors (who should not accept more than one non-executive directorship of a FTSE-100 company and not be the chair of such a company).

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[96] R. B. Adams/P. Funk, *Beyond the Glass Ceiling: Does Gender Matter?* MANAGEMENT SCIENCE 58 (2012) 219. See more generally as to diversity A. N. Berger/T. Kick/K. Schaeck, *Executive board composition and bank risk taking,* Discussion Paper Deutsche Bundesbank No 03/2012.

[97] In the UK a government-endorsed commission recommends that FTSE-100 companies strive for 25 percent of women in 2015. See *supra* n 95.

[98] Communication from the Commission "Strategy for equality between women and men 2010-2015," COM(2010) 491 final, September 2010; and its follow-up Commission Staff Working Paper "The Gender Balance in Business Leadership," SEC(2011) 246 final.

[99] EU Commission Green Paper, *supra* note 37, p. 7.

[100] An average time estimate for Swiss board members is 200 hours a year.

[101] Sweden, Switzerland, Italy.

In other countries the regulators have chosen a more interventionist approach, either by law or by code provision.[102] The limits set for multiple board memberships vary: in Germany, for example, a maximum of 10 supervisory seats (by law) viz. a maximum of three in listed companies (by code, not counting supervisory seats within the same group); in French listed companies, no more than one position as CEO and no more than five (in future possibly only three) positions as non-executive director.[103] The numbers are arbitrarily chosen and neglect the fact that companies and directors are very different. What is too much for some may be no problem for others. If limits are considered, there should be enough flexibility, such as a code comply-and-explain mechanism. A special limit to interlocking directorates was recently introduced in Italy by a law forbidding board members (and key managers) of national banks, insurance companies and investment firms to hold similar positions in competing financial institutions or groups, but this reform was probably driven by concerns other than the availability of time to do a good job.

In the end, it remains an open question what makes a person a good board member. Diversity, special qualifications, and enough time are prerequisites. But what counts ultimately – though the boards tend to dislike this kind of director, and top management of course even more so – is the director's personality, willingness to call into question what management proposes, a feeling for the right balance between opportunities and risks, and a readiness to speak up in the group and confess that one did not understand or is not convinced of something presented by management or considered by the majority of the board as self-evident. Standing up against "group think" seems to be the essential quality, and it is doubtful whether this can be learned or that it is correlated with any of the characteristics which are discussed under the heading of diversity. Moreover, as we discuss in section 2.5, even a person with the desired personal characteristics for an effective director may struggle to perform effectively if the relevant information for decision-making is controlled by corporate management.

The current policy emphasis on expertise and diversity is likely to reduce overall the priority given to independence. Although neither expertise nor diversity is necessarily inconsistent with independence, the regulatory pressure to meet the former two requirements is likely in practice to lower the priority attached to the latter. This is particularly likely to occur if, as is currently proposed in relation to women directors, significant legal sanctions are attached to the gender characteristic of directors but not to independence.[104] Whether this is a positive or a negative development from the shareholders' point of view is difficult to judge. Although both reforms are advocated on the basis that they will promote the economic success of the company, it is not clear whether this will turn out to be the case and it is even less clear whether economic success from the perspective of the shareholders is the objective of the reforms. On the other hand, the high expectations of independent directors[105] have been only

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[102] The technique – law or codes – may have consequences for the sanctions in case of violation.
[103] The Dutch corporate governance code, finally, has a similar provision for members of the supervisory board in listed companies, but in addition thereto also limits for management board members the number of supervisory board memberships to two positions (not as the CEO) in listed companies. Furthermore, a law is to be enacted in the near future containing the same (but mandatory) rules for large and medium-sized listed companies.
[104] Current proposals envisage administrative penalties and exclusion from public sector contracts as sanctions for failing to meet the quota targets for women on the board (FINANCIAL TIMES, November 13, 2012).
[105] Cf. J. N. Gordon, *supra* note 71, 59 STANFORD L. REV. 1465 (2007).

partially fulfilled.[106] Consequently, the efficiency case against downgrading the independence requirement is difficult to make convincingly. Given the difficulty of ensuring the efficient functioning of the board through rules which address only its composition, there is a case for boards individually engaging in critical assessment of their own functioning. There is a clear trend towards periodic evaluation of the board as a whole and its individual members. The EU Recommendation follows the recommendations of codes in the member states and states that boards should evaluate their performance annually. Still open to discussion is whether external evaluation is to be considered a requirement of good corporate governance. The UK Corporate Governance Code (for the first time in 2010) and also the French and Belgian corporate governance codes recommend external facilitation of the annual review at least once every three years. In Germany this is seen with reluctance; the Code just recommends that the supervisory board examine the efficiency of its activities on a regular basis.[107] The Green Paper of the EU Commission, based on OECD research,[108] goes further and suggests board evaluation by an external service provider, e.g., every third year.

2.4 Separation of the Functions of Chair of the Board and CEO

We have seen that there is considerable convergence between the seemingly divergent one-tier and two-tier boards. This is confirmed when one looks at the increasing corporate governance trend toward separation of the function of the chairman and the CEO. It is said: "The chairman makes or breaks the board." This is true for one-tier and two-tier systems alike. The chairman is responsible for an effective interaction and information flow between the executives and non-executives viz. between the two boards in the two-tier systems. Where the chairman is not the CEO, he also maintains regular contact with the CEO and consults with the CEO on strategy.

Separation of roles in one-tier models started in the UK, where it was proposed in 2003 and is recommended in the current corporate governance code. As stated for the UK: "Separation is a crucial expression of the notion of the board's role as a monitor of the management of the company." (Paul Davies) As of 2011, 96 per cent of the FTSE-350 companies had a separate chairman and CEO.[109] A number of other countries have incorporated separation in their corporate governance codes.[110] In Switzerland, the combination of chairman and CEO is not prohibited, but it occurs very rarely as it is considered politically incorrect. The only country with widespread combined functions is France,[111] where, during the Second World War, the combination of the two functions was made compulsory. In 2009 more than 50 per cent of the CAC-40 companies with a one-tier board had combined functions, though this concentration of power is somewhat counterbalanced by the appointment of a senior independent director, a concept that was borrowed from the UK. Yet the combined structure is decreasing in French listed companies, probably because a clearer distinction between management and supervision is sought as a feature of good corporate governance.

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[106] See the literature cited *supra* 2.2 in note 72.
[107] German Corporate Governance Code, no. 5.6.
[108] OECD, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: CONCLUSIONS AND EMERGING GOOD PRACTICES TO ENHANCE IMPLEMENTATION OF THE PRINCIPLES, 24.2.2010, p. 20.
[109] Financial Reporting Council, *supra* note 53, p. 11.
[110] UK, Sweden, Italy, Belgium, the Netherlands.
[111] 1st AFEP/MEDEF's annual report relating to the implementation of its corporate governance code by companies listed on SBF 120 and CAC 40, Nov. 2010, p. 4.

In the meantime, the separation movement is developing further, both in one-tier and two-tier board countries. While continuity may be good for the company, effective monitoring may be impaired if the *retiring CEO* can change over directly to be chair of the board, and in this new capacity can monitor his or her own former management decisions. This practice, which in countries such as Germany was widely used, is now viewed with increasing scepticism. It is objectionable on two grounds. If the new CEO sticks to the existing strategy, the monitoring may be lax; on the other hand, he may be inhibited from implementing a new one, i.e. the monitoring may be too close. The UK Corporate Governance Code holds this move to be incompatible with good corporate governance, though this recommendation is sometimes departed from.[112] In a very controversial German company law amendment of 2009, there is even a mandatory two-year waiting period for members of the management board to move onto the supervisory board unless the general assembly of shareholders, upon a motion of shareholders with more than 25 per cent of the voting rights, permits this.[113] The corporate governance codes of most other countries, however, are still more lenient, allowing a retiring CEO to become the chair with or without an explanation.[114]

Given the importance of the role of the chair of the board, it is natural to enquire what support the chair has. The company secretary (or board secretary) may act in that role. That person may be – but usually is not – a member of the board. The company secretary assists the board and its committees in ensuring compliance with corporate governance and internal rules and takes care of the information streams within the board and between the boards. The company secretary is mandatory in the UK and Switzerland and recommended by the Dutch and Belgian codes. The UK Corporate Governance Code states: "Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior management and non-executive directors, as well as facilitating induction and assisting with professional development as required. The company secretary should be responsible for advising the board through the chairman on all governance matters." In Swiss public companies the company secretary acts as a "corporate memory." In German practice the chairman of the supervisory board often has a small bureau staff, though the staffing of this department is done by the management board. Some claim that the chairman should have a full chairman bureau of his or her own in order to make the chairman independent of the management board.[115] This department and sometimes the company's general counsel fulfil the function of a company secretary.

2.5 Information Streams

Information is a key problem for the board in exercising its functions, in particular for monitoring. Getting sufficient and unbiased information on what is happening in the company is more crucial and difficult for independent directors in one-tier systems, and even more for supervisory board members in the two-tier systems. Apart from information gained from the CEO and, of course, the external auditors, two main additional sources of information for the board can be distinguished: on the one side, access to the management information systems of

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[112] The Dutch corporate governance code, which does not consider a former executive non-independent nor requires the chair to be independent, recommends that a retiring CEO should not become a chairman (except in exceptional circumstances), both for the one-tier model and for the two-tier model.

[113] Section 100 subsection 2 as amended by law of 31.7.2009.

[114] Sweden, Belgium, Italy, Switzerland, Poland.

[115] M. Roth, *supra* note 70, ZGR 2012, 343 at 371.

the company and directly to the non-board member executives and employees; and on the other side, information from outside experts.

Although the laws of most countries give the members of (supervisory) boards the right to access all information necessary for the performance of their tasks and, less often, to pose questions to executives (also outside the board meetings), in practice when a (supervisory) board member needs information from the executive level, the request is usually made by the chairman to the CEO. For example, this is the case in the UK where the corporate governance code makes the chairman of the board responsible for obtaining all relevant information. Also in France, the boards of directors obtain information almost exclusively from the CEO. Only the CEO has the right to request information directly from employees. In Sweden, the board's access to information is de facto often indirect and filtered by the CEO. Sometimes audit committees are seen to make these requests, as in Poland. Direct contact of non-executive board members with executives (who are not board members) is often not allowed or regarded as an unfriendly act by the executive board members.

Yet the problem with this practice is that almost all information of the board is filtered by the management. The board tends to get good information fast, but bad information late and asymmetrically. The only independent sources of information are the external and internal auditors, with whom in most cases only board members serving on the audit committee have direct and regular contact. Therefore, in some countries there are tendencies to allow a more direct access to company information by the board. According to the Dutch corporate governance code, if the supervisory board considers it necessary, it may obtain information directly from (and speak to) officers and external advisers of the company, though in practice it is usually the chairman of the supervisory board who contacts the president of the management board (CEO) if specific information is needed. Swiss law provides that board members may, upon approval of the chairman, request information directly from employees; each director may, with the consent of the chairman, inspect the company's documents. In Switzerland access of outside directors to the management information system is rare, in any event directors usually do not ask for it, except in crises. Italian law states that each director is entitled to ask executive directors to provide information in a board meeting, and in legal literature it is assumed that the same may be done outside board meetings.[116] In Germany it is controversial whether supervisory board members may put questions to employees without prior consent of the management board. In recent years this has become more accepted by academia, but it would still be considered as an expression of distrust. Some chairpersons of the supervisory board have access to the management information system, especially if they were CEO of the company previously. In German practice, it is said that about half of the supervisory board members insist on gaining management-independent information as well. In the Netherlands board members usually do not have direct access to the management information systems, but there is usually a direct communication line from the head of compliance to the chairman of the supervisory board. Furthermore, the heads of compliance often report directly to the audit committee and the chairman has a seat in that committee. Heads of compliance probably could be summoned, on the basis of the Dutch Corporate Governance Code, to appear before the board without permission of the CEO, but it is not known whether this happens given the direct line between the head of compliance and the

[116] An important role is entrusted to the senior independent director (if appointed), who has to ensure appropriate information streams.

chairman of the board. In other countries, for example Poland, the supervisory board must request information from the management board.[117]

It is a controversial issue whether the supervisory board has access to external advice. Asking for external advice is a direct challenge to the management, though it might be acceptable in the context of related-party transactions. It may also be a defensive step because it allows the board to rebut the charge of mismanagement. The practice appears to be that corporate governance codes give the right to get external advice, but this right is not generally used because it is seen as unfriendly, in the quasi two-tier model of Switzerland it would even be seen as hostile. However, if there is a possibility of incurring liability, the supervisory board will seek external advice. In general, the likelihood of being seen as hostile is probably lower in a two-tier model, since the role of the supervisory board is to monitor.

2.6 Board committees

The corporate governance codes aimed to increase not only the proportion of independent directors on the board, but also their role in deciding matters where management's conflicts of interest were likely to be at their most acute. To this end, the committee structure of the board, which had generally developed without any intervention by the rule-maker, was deployed: matters of acute conflict were assigned to board committees where the independent directors exercised greater influence than they did on the board as a whole, perhaps to the extent of constituting the whole of the committee's membership.

There are many *kinds of committees* in practice,[118] but three key committees for the most important tasks are recommended by nearly all the national corporate governance codes as well as by the EU Recommendation:[119] the nomination, the remuneration, and the audit committees. The most important is the audit committee, which will be treated separately infra. The nomination committee has the task of selecting suitable candidates, a task that is hardly relevant in companies with a controlling shareholder, and of periodically assessing the balance of skills, independence and experience on the board. The remuneration committee normally makes proposals for the company's remuneration policy and the remuneration of the individual directors.[120] In most countries, a separate risk committee is mandatory for financial institutions, and in some countries – such as France and Switzerland – it is also used for other companies. The corporate governance codes of most countries contain separate sets of provisions for each of the three committees but allow companies to combine the nomination and remuneration committees, in which case the more stringent independence requirements

[117] But in Poland and other countries audit companies have direct access to the information in banks and other financial institutions.
[118] For example, risk committee, strategic committee, financial committee, corporate governance committee, and other ad hoc committees; this is the case for Switzerland.
[119] The EU Recommendation of 15.2.2005, *supra* note 37, no 5, states that boards should be organized in principle in three board committees with the aim that "a sufficient number of independent non-executive or supervisory directors play an effective role in key areas where the potential for conflict of interest is particularly high."
[120] In some cases, for example in the UK, the remuneration committee actually decides this issue for the executive directors (UK Corporate Governance Code § D 2.2). By contrast, the German law reform of 31.7.2009, Federal Gazette I 2509, has provided that decisions on the remuneration of managing directors be taken by the whole supervisory board (which, of course, does not contain executives); increasing the influence of the employee representatives may have been a side motive.

for the remuneration committee apply. Whereas the German and Swiss corporate governance codes are brief on committees, the French, Belgian, Italian and UK corporate governance codes elaborate extensively on their tasks.

Committees should normally be *composed* of at least three members,[121] but companies with small boards may assign the function of the committee to the board as a whole. The codes of most countries recommend that the committees should consist only of board members, but "the use of other structures – external to the (supervisory) board – or procedures" are allowed under the EU Recommendation, provided that they are "functionally equivalent and equally effective."[122] Under the German co-determination scheme, employee representatives are elected by the workforce, so the nomination committee is exclusively composed of shareholder representatives. In Sweden the shareholders have the exclusive right to nominate board members, but they delegate it to the committee. Unusally, the Swedish corporate governance code provides that the committee's members be appointed by the shareholders and that only a minority of board members may be members of the committee.

The usual rule under the national codes as well as under the EU Recommendation is that the nomination and the remuneration committees should consist of at least a majority[123] of independent directors; the latter must contain only non-executives. The UK Corporate Governance Code used to recommend that all the members of the remuneration committee be independent directors, but since a change in 2006 the chairman of the board may also be a member of the committee (but routinely not the chair) if he or she was considered independent on appointment as chair.[124] The Dutch corporate governance code goes further and provides that, in each committee, all but one board member should be independent.[125]

<u>*The Audit Committee in Particular*</u>

A separate audit committee is considered indispensable today and is now a general feature of listed companies.[126] Not only is this committee recommended in corporate governance codes, but such a committee is required by EU law for 'public interest' companies, which term includes those whose shares are traded on a regulated market.[127] The *task* of the audit

[121] EU Recommendation of 15.2.2005, *supra* note 37, Annex 1, No. 1.1; in companies with small (supervisory) boards exceptionally only two members.
[122] EU Recommendation of 15.2.2005, *supra* note 37, Art. 1.3.2.
[123] The composition rules for audit committees are stricter.
[124] The UK Corporate Governance Code does not treat the chair of the board as independent on a continuing basis (because of the closeness of the chair's interactions with the management of the company), even though it is recommended that the chair be independent on appointment. In companies with a controlling shareholder, the most critical task is certainly with the audit committee, while the controlling shareholder has its own interest in keeping the remuneration of management in line.
[125] The Dutch corporate governance code allows the chairman of the board and former executives to be a member of the remuneration committee but not the chair. The Belgian corporate governance code, on the contrary, recommends that the chairman of the board be the chair of the committee.
[126] In the traditional model in Italy, there is an overlap between the tasks of the audit committee (which is called "internal control and risk management control committee" in that model) and those of the board of auditors (which mainly performs an ex post control function), requiring a certain level of coordination between the two bodies
[127] EU Audit Directive of 17 May 2006, *supra* note 47, Art. 2.13 (Definitions).

committee is to monitor the integrity of the company's financial information, reviewing at least annually the internal control and risk management systems, ensuring the effectiveness of the internal audit function, making recommendations as to the selection of the external auditor, and monitoring the external auditor's independence and objectivity. The audit committee has direct access to information that other board members do not have: it is entitled to meet any person in the company outside the presence of executive directors, it is the principal contact point for the internal and external auditors, it receives internal and external audit reports, and it should obtain timely information about any issues arising from the audit. As the head of internal control, the audit committee has a strong position against the CEO, as it will or should have the same information.

The rules on the *composition* of the audit committee take this specific task into consideration and are sometimes more demanding than for the other committees. Thus, the UK Corporate Governance Code recommends that all the members of the audit committee in the largest listed companies be independent directors. The French and Belgian corporate governance codes are satisfied with two-thirds of the committee members, viz. a majority of them, being independent.[128] While the Audit Directive only requires that at least one member of the audit committee of public interest entities should be independent,[129] the EU Recommendation recommends that the audit committee be composed exclusively of non-executive directors, a majority of whom (including, in some countries, the chairman) should be independent.[130]

The EU Audit Directive[131] provides that at least one (independent) member of the audit committee should be a *financial expert.* As of 2011 in the UK, recent and relevant financial experience is present in 92 percent of the FTSE-350 companies.[132] The Swiss corporate governance code is more demanding and provides that a majority of its members, including the chairman, should be financially literate, but does not require a "financial expert" to sit on this committee while in reality this is often the case.

2.7 Cumulative and slate voting

The main agency problem for shareholders in concentrated shareholder jurisdictions exists between controlling and non-controlling shareholders. The recommendations in corporate governance codes for a minority of independent directors may go some way to protect

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[128] Both the Dutch and the Belgian corporate governance codes allow the chairman of the board to be a member of the committee (but not the chair), as does the UK code for smaller listed companies, and the Dutch corporate governance code provides the same with respect to former executives. The German Corporate Governance Code, conversely, allows the chairman of the supervisory board but not a former executive to be chair of the committee.

[129] The EU Audit Directive, *supra* note 47, Art. 41. It allows member states to provide that a company may refrain from instituting a separate audit committee if its functions are vested in a corporate body, such as the (entire) supervisory board. But almost all listed companies have a separate audit committee.

[130] In most countries, this discrepancy between EU Recommendation of 15.2.2005, *supra* note 37, and EU Audit Directive, *supra* note 47 is maintained in the sense that the less stringent (but mandatory) requirement of the Directive has been implemented in the law and the stricter (but not mandatory) provision of the Recommendation in the corporate governance code. Technically, it suffices if the company follows the law and explains why it has not followed the corporate governance code.

[131] EU Audit Directive of 17 May 2006, *supra* note 47, Art. 41.

[132] Financial Reporting Council, *supra* note 53, p. 11.

minorities (at least where directors appointed by large or controlling shareholders are not treated as independent) because independent directors may be more sensitive to minority interests than those directors chosen de facto by management or controlling shareholders. In some countries – especially in countries with a two-tier board – *minorities* are protected by having special legal appointment rights to the board.[133] Two forms must be distinguished: *cumulative voting* as in Poland and Austria,[134] and *slate voting* as in Italy.[135] In Poland, shareholders representing at least 20 per cent of the share capital can opt for "group" voting, which produces a result similar to cumulative voting. This permits the requisite number of shareholders to form a group which is entitled to elect, on a one share/one vote basis, one member of the board (though at the cost of having no role in the election of the other board members).[136] This leads to a proportional representation of the shareholder groups and is considered a powerful right of the minority shareholders. In Italy, cumulative voting is allowed for companies in general. In listed companies there is mandatory slate voting, which is a sort of cumulative voting, but it does not necessarily lead to a proportional representation of shareholders on the board. Under the slate voting system, shareholders may propose lists of candidates. At least one director is appointed by the minority side that gets the highest number of votes and at least one director (or two, if the board members are more than seven) has to be independent according to the board of (internal) auditors' independence requirements. Thereby the majority side always gets a majority, while the minority directors get an average of one and a half seats. The Italian system is considered less effective in practice than originally thought because one or two representatives on the board have no real impact.

Overall, cumulative voting and similar arrangements have not proceeded very far in Europe. This may be functional, since minority representation may lead to high levels of intra-board conflict. Employee codetermination constitutes another reason against mandatory representation of minority shareholders on the board, since it would split up the shareholder side of the board even further.[137]

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[133] In most countries – for example, Germany – this is not possible. Sometimes it is not forbidden but very rare, as in Switzerland and in the United Kingdom, or in Belgium for listed companies. Switzerland has a mandatory legal representation of one board member for common stockholders when there is a separate class of multiple voting rights or preferred stock.

[134] K. J. Hopt/M. Roth, GROßKOMMENTAR ZUM AKTIENGESETZ, 4th ed., Berlin 2006, § 101 comment 57.

[135] Cf. also assonime, AN ANALYSIS OF THE COMPLIANCE WITH THE ITALIAN CORPORATE GOVERNANCE CODE (YEAR 2010), April 2011, Part 2: An analysis of slate voting in Italy, p. 76 et s.

[136] The relevant group size is determined as follows. "Persons, who in general meeting represent that portion of shares which is a resultant of dividing the total number of represented shares by the number of supervisory board members, may form a separate group for electing one board member, but they shall not take part in electing the remaining members." (Art 385(5) of the Code on Commercial Partnerships and Companies). The World Bank gives the following example of the process. "For example: assume a company with 5 board seats. Before the AGM, a 20% block of shareholders requests group voting. At the AGM, two 20 % blocks opt for group voting, and appoint one board member each. The remaining 3 board seats are elected by standard majority AGM resolution, by the remaining 60% of capital" (World Bank, CORPORATE GOVERNANCE COUNTRY ASSESSMENT: POLAND, Washington 2005, p 14, fn 12.).

[137] Cf. the modern requirements for representatives with special knowledge in financial matters and for diversity, in particular a mandatory gender quota; cf. K. J. Hopt, *supra* note 2,

2.8 Employee representation on the board

We have considered above ways in which board composition rules might be reformed so as to make the board more responsive to the interests of the shareholders, either as a class or as minority shareholders. As we have seen, the principal technique which has been deployed to this end of the past twenty-five years is to enhance the number and role of independent directors on the board and on board committees. A further way to increase board responsiveness to shareholder interests is to downgrade composition rules which stand in the way of board responsiveness to shareholder interests. The clear candidate for such attention is the rules which require employee representation on the board.[138] Mandatory rules on board representation are not uniform across EU jurisdictions: about half the member states have such requirements for private sector companies. Mandatory employee representation presupposes that conflicts between capital and labour can be solved within the board by information, discussion, and compromise. If there is a tradition of confrontation between the employers and the trade unions as in Italy,[139] or if there is a strong tradition of collective bargaining as in the UK,[140] or if there are other path-dependent reasons as in Belgium and Switzerland, co-determination at the board level does not exist. In some other countries, in particular formerly socialist countries such as Poland, it is to be found only in state enterprises and companies with state participation, i.e. partially privatized companies.

Employee representatives and the independence requirement

There is an initial issue of how rules requiring employee representation on the board are aligned with the rules on independent directors. The European Recommendation provides in its Annex that *employees* and persons who were employees for the previous three years cannot be considered independent unless they have been elected to the board in the context of a workers' representation system recognized by law and provided that they do not belong to senior management.[141] As regards national rules for companies without labour co-determination, the Recommendation is generally followed. The UK, French, and Dutch corporate governance codes are more severe by taking into account five previous years.

The situation in *countries with labour co-determination* at the board level is more problematic and sometimes strongly politicized. The reactions are quite different in the various countries. In the *Netherlands*, the Recommendation's carve-out for employee representatives is not followed because Dutch labour co-determination rules provide that employees of the company (or of another company in the group) as well as representatives of a union that

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A.J.C.L. 59 (2011) 1 at 27 et s. A. Pacces (*Controlling the Corporate Controller's Misbehaviour* (2011) 11 JOURNAL OF CORPORATE LAW STUDIES 177) argues for reliance on independent directors as a solution to this problem rather than effective enforcement of self-dealing rules (see *infra* 3.2).

[138] All jurisdictions promote some mechanism for the collective representation of the employees' interests to the company, for example through collective bargaining or works councils. Our concern here is only with the technique of board representation. However, the economic impact of board level rules often turns on how they interrelate with other elements in the system of representation of employee interests. See G. Jackson/M. Höpner/A. Kurdelbusch, *supra* note 9.

[139] In Italy board level employee representation has not even been put on the political agenda.

[140] But in the UK this tradition has been declining.

[141] EU Recommendation of 15.2.2005, *supra* note 37, Annex II no. 1 (b).

conducts collective bargaining with the company cannot be members of the supervisory board at all.[142] The works council usually nominates outside persons with a labour background. These directors are not excluded from being classified as independent because of their selection process.. For example, a former Dutch trade union chairman (and former prime minister) was appointed as a supervisory board member of ING. In *Germany*, the unions claim that there is a clear case for the co-determination carve-out of the Recommendation, and the Corporate Governance Code shies away from addressing the question at all, dealing with independence on the shareholder side only. But a growing opinion criticizes the carve-out and points out the disruption of the carefully balanced constitution of the boards that are co-determined at parity. According to academia, there is a subjective standard of independence, and the trend seems to be that if it is not clear whether a person is independent, that person should be considered not independent.[143] In *Sweden*, two – or in large companies (more than 1,000 employees) three – employee representatives may be appointed by the labour union if a collective bargaining agreement is concluded between the company and that union. In general, employee representatives are not considered independent from the company, but the independence provisions in the corporate governance code apply only to directors appointed by the shareholders' meeting, and the employee representatives under the co-determination rules are appointed by the works council.

The approach of the EU Recommendation – treating employee representatives as putatively independent – has little to commend it, especially as a director appointed by a controlling shareholder is not treated as independent under that Recommendation.[144] If one looks at both issues – controlling shareholder and labour representation – it seems that it is hardly justified to treat each of these issues separately, as was done for political reasons in the EU Recommendation. It is hardly understandable that independence from a controlling shareholder and independence of employees or union representatives should be treated differently, even more so as this splits the shareholder side, which in practice is already much less homogeneous in attitude and voting than the labour side. The balance would be easier to maintain if labour also had to elect a proportion of directors who are independent, at least in a co-determination system with parity.[145]

<u>*The selection of employee representatives*</u>

The appointment of labour representatives can be set up in different ways. The actual appointment may be up to the shareholders, but on the nomination of the works council as in the Netherlands. This nomination may be rejected by the general assembly under certain conditions, but then the works council may make new nominations. More usually the labour representatives are elected by the workforce of the company. The voting system for such an election is complicated and costly because of the sheer number of the electors and can be either by direct selection or by selection of voting delegates. The selection process is even more difficult and costly if not only the domestic workforce is entitled to vote. Reserving the labor seats on the board only to the German worker constituency is the rule in Germany, but this rule is rightly criticized and may even violate European law.[146]

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[142] Art. 2: 160 BW.
[143] Cf. M. Roth, *supra* note 51, ZHR 175 (2011) 605 at 620, 630 et s.
[144] See the discussion *supra* at 2.2.
[145] M. Roth, *supra* note 51, ZHR 175 (2011) 605 at 640 et s.
[146] See also Reflection Group, REPORT OF THE ON THE FUTURE OF EU COMPANY LAW, Brussels, 5.4.2011, p. 53.

Sometimes trade unions have their own seats on the board. This leads to representatives with a broader outlook beyond the company, but on the other hand this may bring in more ideological arguments depending on the history and status of the trade union movement in that country. Accordingly, one cannot generalize whether the representation of trade unions on the board adds good diversity or has negative effects on the coherent work of the board. Sometimes the "leading employees" (senior white-collar workers) have the right to select their own representatives. This gives credit to the particular interest of this group. This interest may lie closer to the interest of the shareholders and the board and therefore weakens the influence of the labour side in general.

Proportion of employee representatives

The extent of co-determination at the board level varies considerably. Most often the co-determination laws provide for one-third of the board to be elected by labour. This is the case for many EU member states.[147] In some countries such as Sweden, under certain circumstances labour gets up to two or three seats on the board.[148] A parity form of boardroom co-determination exists only in Germany and existed, in a co-optative form, until 2004 in the Netherlands. The German co-determination regime, although best known outside Europe, is in fact an outlier since, for large companies, it is at parity, more exactly at quasi-parity since the shareholder-elected chairman has a casting vote. Yet this casting vote is hardly ever used because of its very negative consequences for the working climate in the company and possible clashes with the unions. This far-reaching co-determination system is path-dependent and has its origins in the post-World War I (1922) and post-World War II (1950/1952/1976) eras when the forces of capital and labour had to jointly rebuild Germany's industry after the two wars. The extent of the co-determination depends on the legal form of the company and its size (below 500 employees: no mandatory employee representation; from 500 to 2000 employees: one-third representation – applying to about 3,000 companies; more than 2000 employees: parity, applying to with about 40 companies). The employee representatives are elected by the workforce either directly or indirectly. Some board seats are reserved for representatives of the trade unions. This far-reaching co-determination regime and its accompanying vested interests are so deeply rooted in the country that Germany has held up EU efforts to harmonize national company laws on board composition or to provide EU forms of incorporation – for fear on the part of trade unions that German companies would avoid the national codetermination rules by re-incorporating in other member states or as EU companies. To date, all the many efforts of reform within Germany have failed.

Impact of mandatory employee representation

The most challenging, controversial, and least empirically confirmed question is what impact mandatory employee representation at the board level has.[149] Apart from a problematic impact

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[147] T. Baums/P. Ulmer, eds., UNTERNEHMENS-MITBESTIMMUNG DER ARBEITNEHMER IM RECHT DER EU-MITGLIEDSTAATEN/EMPLOYEES' CO-DETERMINATION IN THE MEMBER STATES OF THE EUROPEAN UNION, Heidelberg 2004. For the beginnings, cf. K. J. Hopt, *Labor Codetermination in Europe,* JOURNAL OF COMPARATIVE BUSINESS AND CAPITAL MARKET LAW 6 (1984) 216.

[148] In France, one or more directors shall be elected among the employee-shareholders when the shares held by a listed company's staff and by the staff of affiliated companies represent more than 3% of the company's share capital.

[149] See K. Pistor, *Corporate Governance durch Mitbestimmung und Arbeitsmärkte,* in: P. Hommelhoff/K. J. Hopt/A. v. Werder, eds., HANDBUCH CORPORATE GOVERNANCE, 2d ed.,

on the size of the board, felt most under parity co-determination in Germany, and of the costs and the slowing down of the decision-making process, much of the information from companies and trade unions remains anecdotal and is very often contradictory.

As to possible impacts on the company and its corporate governance, the impact on the information streams is most probable. The presence of employee representatives on the board may improve the information available to the board because the information the (supervisory) board receives from the company is filtered by the management. The employee representatives are usually members of the works council, and as such they have thorough information about what is going on at the grassroots level of the company. But information goes both ways. Some seats of the labour side, at least in Germany, are filled directly by trade unions, and most of the other employee representatives are trade union members. The labor constituency and the trade unions expect to be informed by their representatives. While there is a mandatory rule on boardroom secrecy, in practice this is often not respected. Even inside information slips out to employees and trade unions, though the European Court of Justice has clearly stated that co-determination cannot justify such a leak.[150] The danger of such leaks may make the management reluctant to inform the (supervisory) board of inside information. Whether an increased flow of (non-inside) information about corporate strategy to trade unions reduces the likelihood of management and union misunderstanding their respective positions in collective bargaining is rather speculative.

Another impact on decision-making is probable insofar as labour issues are more likely to be brought to the board from the workforce in the company as well as from the trade unions. This may be helpful because critical labour issues may be discussed and solved at the board level instead of looming unsolved or coming up only during collective bargaining. But there is also a quid pro quo: the management and the board may omit or delay decisions that would be useful for the company, such as more investment in foreign countries that would have consequences for the workforce at home.[151] On the other hand, if measures, even drastic ones, need to be taken in the interest of the company, this may even be facilitated by co-determination, as the experience of rescues, layoffs, and close-downs of companies after the German reunification has shown. Some expect that co-determination will enable better board control over management risk-taking and management remuneration. But experiences from the financial crisis and cases like the Mannesmann case[152] cast doubt on this. Nevertheless, recent decisions in Germany about the compensation of directors have been taken away from the remuneration committees and mandatorily assigned to the board as a whole.[153]

Cologne 2009, p. 231 at 236 et s. on economic and sociological theories and at 246 et s. on empirical studies (and, in English, K. Pistor, *Co-Determination in Germany: A Socio-Political Model with Governance Externalities*, in M. Blair/M. Roe, eds., EMPLOYEES AND CORPORATE GOVERNANCE, Washington 1999, p. 163. See also K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 54. See further Fauver/Fuerst, supra note 21, suggesting that the strongest evidence for an efficiency impact of employee representation on corporate performance exists in relation to less than parity codetermination.

150 European Court of Justice, Grøngaard and Bang, decision of 22.11.2005 – C-384/02, European Court Reports 2005, I-09939; see K. J. Hopt, *Insider- und Ad-hoc-Publizitätsprobleme*, in H. Schimansky/H.-J. Bunte/H.-J. Lwowski, eds., BANKRECHTS-HANDBUCH, vol. II, 4th ed., Munich 2011, § 107 comment 58 et s.

151 Anecdotal evidence on Volkswagen and Brazilian subsidiaries.

152 C. Milhaupt/K. Pistor, supra note 74, p. 69 et s.

153 K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 34 and 54. This has led to an increased influence of trade unions, though this has not been emphasized in the reform discussion. The

Co-determination may have a distorting impact on the general corporate governance function of the board. Co-determination, at least co-determination at parity, leads to a division between two camps ("benches"). The employee members regularly meet previously in a caucus and tend to discuss and vote as a single body, unless there is a special representative for leading employees. This has been different for the shareholder side, though the German Corporate Governance Code recommended that they also have separate pre-meetings.[154] The distorting effect may be even stronger if the unions have their own representatives on the board. While the unions tend to have a broader view that may be useful for the board in some cases, they may bring in labour interests from outside the company that may not be in the interest of the company and the shareholders. On the whole, this polarization by cementing "benches" is rather negative. Whether this distorting effect can be avoided by having independent directors is doubtful, even if the employee side were to have independent directors as well.

Co-determination may also have an effect on external corporate governance, i.e., on the takeover market. Indeed, co-determination is sometimes considered to be one of the many structural obstacles to the development of a lively takeover market. This is because both management and labour have an incentive to fight off (hostile) takeovers that may result in installing new management and cutting down labour costs and jobs at home.

Evidence about the consequences of co-determination beyond the company are even more anecdotal and speculative. Co-determination in Germany is said to have contributed to a more peaceful climate between capital and labour, to fewer strikes, and to better cooperation of both sides in the interest of the economy as a whole. Some have called co-determination an early social monitoring system.[155]

<u>*Recent changes*</u>

From the point of view of the hypothesis of convergence on a shareholder friendly model of corporate governance, the outstanding fact about employee representation systems in recent years is the absence of formal changes. Contrary to what the convergence thesis might predict, there has been no significant downgrading of the representation requirements in the European jurisdictions. The changes made in the Netherlands in 2004 constitute an apparent exception to this statement. Here, the previous regime, in which the board was in effect a self-perpetuating body, but the shareholders and employees had equal (if limited) rights to object to appointment proposals put forward by the board, was replaced by the more standard European system of the works council having the right to select one third of the board. In theory the former regime might have led to parity of representation but in practice the level of employee representation was much lower. The appointment rights over one third of the board under the new regime are normally exercised by the works council, so in practice the reform may have led to an increase in the board influence of the employees.

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trade unions obviously were in favour of this reform since it gives them more bargaining power on the board for other issues.

[154] The German Code Commission has been criticized for this and in its May 2012 changes has abolished this recommendation and merely states that this can be done.

[155] K. J. Hopt, *Labor Representation on Corporate Boards: Impacts and Problems for Corporate Governance and Economic Integration in Europe,* INTERNATIONAL REVIEW OF LAW AND ECONOMICS 14 (1994) 203 at 212.

However, the formal resilience of existing systems of board level representation may be misleading in the light of the exit opportunities from national systems offered, probably unintentionally, by the Community legislature through the European Company (SE) form of incorporation. Companies, already subject to national employee representation rules, which transform into SEs achieve certain flexibilities often not available under national law, such as the ability to negotiate with employee representatives to remove or amend the board level representation rules or to reduce the size of the board, even if the proportion of representatives remains the same. A transforming company, not subject to mandatory representation or not to the highest proportion of representation because it has not yet reached the relevant employee threshold, is able to 'freeze' that situation, even if it later exceeds the threshold as an SE.[156] Empirical evidence shows that companies subject to mandatory employee representation at national level exhibit more SE formations.[157] For some, this is an example of 'regulatory dualism' whereby existing companies remain subject to the established regulatory regime, whilst new companies are offered a way around it.[158] It remains to be seen how big an incentive exit from national employee systems via the SE will turn out to be. A natural experiment to determine whether shareholders view national representation rules as facilitating rent-seeking by employees or human capital investment, to the benefit of shareholders, may be in the offing,

3. Liability rules

Liability rules traditionally perform a role in making directors sensitive to the interests of the shareholders. Prescriptive duties, ie requirements that directors act in the best interests of the company or, in some jurisdictions, the shareholders, are ideologically important but of little practical use in litigation because they are usually defined in subjective terms. The board must act in what it considers the best interests of the company or shareholders. However, duties of care or loyalty may constrain the board from acting negligently or from promoting the interests of the management or a controlling shareholder (proscriptive duties), and thus indirectly induce it to promote the interests of the shareholders as a class.

3.1 Duty of Care

The standard of care is an *objective* one nearly everywhere (in contrast to the prescriptive duty). A director cannot excuse herself by pointing to a personal lack of knowledge or

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[156] EU Commission, STUDY ON THE OPERATION AND THE IMPACTS OF THE STATUTE FOR A EUROPEAN COMPANY (SE) of 9. 12.2009 (Ernst & Young), and EU Commission Report of 19.11.2010, http://ec.europa.eu/internal_market/company/se/index_en.htm.

[157] H. Eidenmüller/A. Engert/L. Hornuf, *Incorporating under European Law: the Societas Europaea as a Vehicle for Legal Arbitrage,* (2009) 10 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW 1 and H. Eidenmüller/L. Hornuf/M. Reps, *Contracting Employee Involvement: an Analysis of Bargaining over Employee Involvement Rules for a Societas Europaea* (2012) 12 JOURNAL OF CORPORATE LAW STUDIES 201. For a more positive assessment W. Njoya, *Employee Ownership in the European Company: Reflexive Law, Reincorporation and Escaping Co-determination,* (2011) 11 JOURNAL OF CORPORATE LAW STUDIES 267. See also B. Keller/F. Werner, *The Establishment of the European Company: The First Cases from an Industrial Relations Perspective*, (2008) 14 EUROPEAN JOURNAL OF INDUSTRIAL RELATIONS 153.

[158] R. Gilson/H. Hansmann/R. Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S. and the E.U.*, ECGI Working Paper 149/2010, available available at < http://ssrn.com/abstract=1541226 >.

experience. This is also the standard under general civil law with its concepts of *pater familias* or reasonable person. Up to 2006 there was an exception in the United Kingdom,[159] but this has been changed into an objective standard by the Companies Act 2006 that requires the director to achieve the level of competence that a reasonable person in the director's position would adhere to.

The general duty of care is concretized by case law and legal commentaries in each of the jurisdictions. This could lead to the impression that liability of directors for violating their duty of care in one of their many concrete forms is a great risk and would lead to many court cases. Yet in practice the number of cases in which directors are actually held liable for violation of their duty of care is limited. A major factor explaining this result is *de iure* or *de facto* the *business judgment rule*, which exists in many countries. It is sometimes laid down expressly in the company statute, as in Germany, while in other countries – such as Italy or the United Kingdom – the courts decide accordingly. The legal definition of the business judgment rule, if there is one, varies considerably from one jurisdiction to another. The German definition goes as follows: There is no violation of the duty of care if the director who makes a business decision may reasonably believe that he or she acts, on the basis of adequate information, in the interest of the company.[160] While this and other definitions of the business judgment rule lead to many difficult interpretation problems,[161] the heart of the rule is that (managing) directors cannot but make business decisions with uncertain consequences since business by definition implies incomplete knowledge and risk-taking. If directors were liable in cases where their predictions proved to be wrong or the risk materialized, they could no longer perform their profession. The business judgment rule gives them a safe haven. This necessity to avoid judicial hindsight is acknowledged by company law judges in all countries, regardless of whether a formal legal business judgment rule exists. It is clearly in the shareholders' interests that courts should assess the duty of care in this way, for otherwise the directors would act in a more risk-averse way than diversified shareholders would desire.

Yet this safe haven has important limits. The most important are the rather strict informational duties. To ensure that they receive adequate information, directors must meet increasingly severe organizational standards, including setting up an internal control system or more recently, as a spillover from the law of financial institutions, installing some sort of a risk management system.[162] In a liability suit, the question of who has the burden of proof may be decisive. Some company laws, such as the German one, lay the burden of proof on the director. Furthermore, far-reaching documentation duties may come into play, as in Germany and even in Switzerland,[163] where judgments are less fond of the "business judgment rule" idea than legal writings.

Finally, the requirements of the duty of care rise dramatically if the company runs into difficulties and financial distress. Not only must the board become more active to solve the

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[159] The idea was probably shareholder supremacy. If the shareholders want to entrust their affairs to an "amiable lunatic," they should be free to do so without holding him liable if things go wrong.
[160] Section 93 subsection 1 sentence 2 of the German Stock Corporation Act.
[161] There are intense debate and controversies in Italy and Germany. See K. J. Hopt/M. Roth, *supra* note 134, comments on § 93 Abs 1 Satz 2, 4 nF.
[162] Cf. M. T. Moore, *The evolving contours of the board's risk management function in UK corporate governance,* 10 JOURNAL OF CORPORATE LAW STUDIES 2010, 279.
[163] P. Böckli, *Die Schweizer Verwaltungsräte zwischen Hammer und Amboss*, SCHWEIZERISCHE JURISTEN-ZEITUNG 106 (2010) No. 1, p. 1, No. 2, p. 25.

difficulties or to negotiate a workout before outright insolvency,[164] but the board must also inform the shareholders. For the EU member states this is specified expressly as a legal duty if more than half the capital of the company is lost.[165] The board must also carefully consider whether it may go on with its business. Otherwise, in many countries the directors run the risk of becoming liable to the creditors in respect of debts contracted after the critical moment. When this moment is reached, how the board should weigh the positive and negative prospects of the company and the amount of time it has to look for a rescuer who might bring in fresh money is generally controversial.[166] In addition, the doctrines concerning this liability and their relevance in practice vary considerably, such as wrongful trading in the UK[167] and similar actions in France, Belgium, Germany, and other countries.[168] Once the company is insolvent and the insolvency procedure has begun, things change completely. An insolvency practitioner takes over and usually the board no longer has any say. In some states and under special circumstances, the debtor may remain in possession and the board can go on under the supervision of the creditors or, as in Switzerland, a court-appointed trustee.

3.2 Conflicts of Interest

While the duty of care circumscribes the general professional behavior of the directors, there are special situations in which the directors may be tempted by particular circumstances not to act in the interest of the shareholders. There the *duty of loyalty* comes in. The directors are dealing with other people's money. They are trustees of these other people, expressly as in the United Kingdom and in the USA, or *de facto* as they are held to similar standards as trustees in many other countries. The temptation not to act in the interest of the shareholders is particularly strong if there is a *conflict of interest*[169] between the interest of the shareholders and of the directors themselves, or third parties with whom the directors have close relations or owe conflicting duties. This temptation is even more acute and the interests of the shareholders are even more endangered if, as is often the case, the conflict of interest situation is not apparent to the shareholders, or if it is known only theoretically but not for the concrete case.

[164] In Switzerland, the entire leadership functions may quickly concentrate in one person: the Chairman/CEO. In the Netherlands, the notion of intensified supervision by the board in financial distress has been developed by the courts.
[165] Art. 19 of the Second Council Directive, so-called capital directive (Directive 2012/30/EU).
[166] See J. Armour/H. Hansmann/R. Kraakman in ANATOMY, *supra* note 3, at 134 et s.
[167] F. Steffek, *Wrongful Trading – Grundlagen und Spruchpraxis,* NEUE ZEITSCHRIFT FÜR DAS RECHT DER INSOLVENZ UND SANIERUNG 2010, 589; idem, GLÄUBIGERSCHUTZ IN DER KAPITALGESELLSCHAFT, KRISE UND INSOLVENZ IM ENGLISCHEN UND DEUTSCHEN GESELLSCHAFTS- UND KAPITALMARKTRECHT, Tübingen 2011, ch. 4, p. 259 et s.
[168] K. J. Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 43 et s.; Forum Europaeum Group Law, *Corporate Group Law for Europe,* EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (EBOR) 1 (2000) 165 at 245 et s. for the UK, France, Belgium, and Germany.
[169] P. Davies/S. Worthington, *supra* note 13, §§ 1693 et s.; K. J. Hopt, *Conflict of Interest, Secrecy, and Insider Information of Directors, A Comparative Analysis,* available at < http://ssrn.com/abstract=2178152 >; J. Farrar/S. Watson, *Self-dealing, Fair Dealing and Related Party Transactions – History, Policy and Reform* (2011) 11 JOURNAL OF CORPORATE LAW STUDIES 495. The question whether the duty of loyalty encompasses the duty of care can be left aside in this context.

This strong principal-agent conflict between the shareholders and the board[170] is addressed in all jurisdictions, but what they consider a conflict of interest varies considerably. Some jurisdictions, such as the United Kingdom and the USA, go very far, while most European continental countries circumscribe a conflict of interest more narrowly. Some are content with a general clause, while others enumerate a whole catalog of situations that may lead to a conflict of interest for the directors.

The *techniques* for dealing with conflicts of interest differ considerably. The old rule is to avoid the conflict of interest at all, such as by a *substantive* prohibition rule. For example, self-dealing, a special conflict situation treated in more detail infra, would be forbidden irrespective of possible good reasons for it. Such a strict prohibition or exclusion of conflict of interest is not practicable, since the director may be the best supplier of the good or service the company requires, most obviously where the director contracts with the company about the provision of his or her services to the company as a full-time manager. Therefore, *procedural* techniques have been developed. As a minimum, conflicts of interest have to be disclosed. Disclosure is usually to the board or, as a more strict solution, to the shareholders, either in the general assembly and/or in the annual report. Yet mere disclosure is usually considered insufficient. Authorization may be required. Here again the solutions differ: normally authorization by the board (as a whole or only by the independent directors, as in the United Kingdom) and sometimes authorization by the general assembly (ex ante or, as in the United Kingdom, ex post; "whitewash" in Italy). The requirement of calling in outsiders is more severe (for example, the statutory auditor as in Belgium[171]), as is asking for the fairness opinion of an independent expert (as in Switzerland and Italy).[172]

Particular problems arise as to whether the conflicted directors may *continue to make decisions* in the company. There are various degrees of incapacitation. The interested director may not participate in the decision of the board on the approval of the conflicted transaction. This seems clear-cut, but is not required by law in the UK in the case of self-dealing transactions which are regarded as low risk.[173] According to some views, the director also may not participate in the discussion on this matter. In more severe cases of conflict of interest, the interested director must abstain from the conflicted activity more broadly; for example, the director cannot serve on the board of a competitor of the company. If the conflict is serious and permanent, there is no other way for the director than stepping down or being ousted.[174]

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170 For the two other principal-agent conflicts (minority shareholder/controlling shareholder, shareholders/other stakeholders), see J. Armour/H. Hansmann/R. Kraakman in: ANATOMY, *supra* note 3, p. 35 et s.

171 In Belgium related party transactions between a controlling shareholder and its listed company are dealt with by a committee of three independent directors and an independent expert. This is not necessary for conflicts of interest of directors.

172 On fairness opinions more generally, see H. Fleischer, *Die Fairness Opinion bei M&A-Transaktionen zwischen Markt und Recht,* in: S. Grundmann et al., FESTSCHRIFT FÜR KLAUS J. HOPT ZUM 70. GEBURTSTAG, vol. 2, Berlin 2008, p. 2753.

173 The company's articles often impose such a disqualification.

174 Cf. the Swiss Corporate Governance Code para 16 subpara. 2 (second sentence); similarly for Germany K. J. Hopt, *Interessenwahrung und Interessenkonflikte im Aktien-, Bank- und Berufsrecht, Zur Dogmatik des modernen Geschäftsbesorgungsrecht,* ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT (ZGR) 2004, 1 at 31 et s.; idem, *Prävention und Repression von Interessenkonflikten im Aktien-, Bank- und Berufsrecht,* in: FESTSCHRIFT FÜR PETER DORALT, Wien 2004, p. 213 et s.

These general definitions, rules, and techniques are applied differently to different *categories of conflict*. Three of these are covered below: related-party transactions, corporate opportunities, and inside information. Even then, some specific conflicted transactions may be singled out for special treatment. An example is *loans* to a director, which in many jurisdictions are prohibited or need special authorization by the whole board. Another example is *directors' jobs* outside the company, which may require special authorisation, either because directors should give their full capacity for work to the company or because strong conflicts of interest may arise. The latter is particularly true if the other employing company is a competitor; in that case, working for it may be prohibited. The rules we discuss are those laid down in the law or corporate governance codes. In the case of executive directors especially, these general restrictions may be supplemented by provisions in the contract of the director, for example, by a no-competition clause which applies even after the director has resigned.

The whole area of regulation of conflicts of interest is *in flux*. Traditionally, the civil law countries concentrated more on the duty of care, while the United Kingdom, the United States, and other common law countries have always been more rigid regarding conflicts of interest of directors.[175] More recently the attitude has also been changing in the continental European countries, partly because of more case law and partly because of new legislation. The European Commission is aware of and is proposing to regulate the conflict of interest of directors.[176] In 2011 the German Corporate Governance Commission declared that one of its main focuses for 2012 will be conflicts of interest. This raises the question why this was different to begin with and why this has only now begun to change and converge. One hypothesis is again the different shareholder structure. In a system with dispersed ownership, the basic principal-agent conflict is between the shareholders and the board. The former trust the latter only if conflicts of interest are dealt with satisfactorily. If there are controlling shareholders, detailed conflicts of interest rules for the board arguably protect the minority and outside shareholders less effectively than direct protection against the majority. For this protection, special rules restraining controlling shareholders or an outright law of groups are needed. With increasingly dispersed ownership and the rise of institutional investors in continental European countries, the attention devoted to directors' conflicts of interest is also increasing. Additional factors play a role, including the dominance of Anglo-American legal practice in the process of internationalization.[177]

3.2.1 Related Party Transactions and Self-Dealing

Related-party transactions constitute a specific group of conflicts of interest. In a broad sense, related-party transactions comprise the appropriation of corporate opportunities by a director

[175] But in the limited liability company, the conflict of interest rule for the manager (whose equivalent in the stock corporation is the management board) was always more apparent and regulated more strictly.
[176] Cf. European Commission, Green Paper, Corporate governance in financial institutions and remuneration policies, Brussels 2.6.2010, COM (2010) 284 final sub 3.1: The question of conflicts of interest. Cf. also Report of the Reflection Group, *supra* note 146, ch. 4: Groups of companies.
[177] J. von Hein, DIE REZEPTION US-AMERIKANISCHEN GESELLSCHAFTSRECHTS IN DEUTSCHLAND, Tübingen 2008; P. Böckli, *Osmosis of Anglo-Saxon Concepts in Swiss Business Law,* in: FESTSCHRIFT FÜR THOMAS BÄR UND ROBERT KARRER, Zurich 1997, p. 9 et s.

as well as securities transactions by a director on the basis of inside information obtained from the company.[178] In economic terms this is indeed so, but corporate opportunities present special problems, and insider dealing is not confined to directors. Accordingly, both shall be treated here separately from related-party transactions. The prototype of related-party transactions by directors is *self-dealing,* i.e., transactions between the director and the director's company. These transactions may be direct, i.e. the director is the counterparty, or indirect, either via a business in which the director is interested or in the context of a group of companies. The principal-agent conflict in such transactions is particularly striking because the director acts on both sides, thereby putting the director in a position in which he has an incentive to shape the price and the contractual conditions in his own interest to the detriment of the shareholders.

The *techniques* used are very different. In some countries such as the Netherlands[179] the need for special rules is denied completely, the general conflict of interest rules are considered to be sufficient. In other countries there are supplementary rules in the Corporate Governance Code or in the listing rules. In virtually all jurisdictions there must be full disclosure to the whole board. This is easy and low-cost but open to mutual back scratching. Therefore, in the United Kingdom, approval by the shareholders is required in four cases: for substantial property transactions, for loans to directors, and for two cases relating to the remuneration of directors. However, the Listing Rules go further and require shareholder approval for all related-party transactions above a de minimis level. In some countries such as Belgium and Italy the fairness rules, both procedural and substantive, are so much stricter and detailed that it may be appropriate to give a flavor of this even in a general analysis. In Italy there must be full transparency, not only to the board but also to the shareholders. The board that authorizes the transaction must follow a strict procedure; in particular, it must act on the advice of a committee consisting of a majority of independent directors. For transactions of greater importance, all members must be independent. The committee has the right (in Belgium it is required) to be assisted at company expense by outside independent experts; it must motivate its decision by pointing out the interest of the company in the relevant transaction and the substantive fairness of the deal. In Italy, in transactions of greater importance the opinion of the committee is binding on the board. In Belgium, the statutory auditors must certify the correctness of the factual information on which the advice of the committee and the decision of the board are based. The result of so many procedural obstacles may finally be the same as a substantive prohibition.

As the practice in various countries shows, regulating the self-dealing of directors is particularly relevant in two cases. First, self-dealing between directors and the company seems to happen more frequently *in smaller companies,* such as the limited liability company (GmbH) in Germany, probably because of the more personalized relations there. At least case law is clearly less rare for such companies. Second, self-dealing is frequent but less transparent *in groups of companies*, not only between the different companies belonging to the group, but also as far as contracts with directors in the group are concerned. The self-dealing rules can constitute a way of addressing abuses by controlling shareholders, usually but not always a company, either because the controlling shareholder is a director of the company or because the controller is treated as associated with the director or as being a de facto or 'shadow' director of the company. In countries with a more developed law of groups, such as Germany, related-party transactions – both by member companies and by members of

[178] See, for example, L. Enriques/G. Hertig/H. Kanda in: ANATOMY, *supra* note 3, p. 154.
[179] This is the position of the Dutch government in response to the Green Paper of the European Commission on corporate governance.

the organs of the various group members – are covered by special group law provisions. For example, the transaction must be at arms' length and must be disclosed in the group dependence report. Yet enforcement and effectiveness, of both group law and the standard self-dealing rules, are not beyond doubt.[180]

Overall, there seems to be a *tendency toward more strictness* vis-à-vis related-party transactions and self-dealing. In some countries, specific rules have been set up by the supervisory agency; in some other countries, company law reform has produced stricter rules. It is to be noted that the reforms have been of an essentially procedural character rather than focused on court review of the fairness of the transaction. If fairness review plays a part in the procedure, it is provided by outside professionals, for example, investment banks. Although effective courts or other bodies are required to enforce the strengthened procedures, that role is less demanding for them than substantive review of fairness. The procedural bias of the European reforms, even in the UK, may reflect a traditional reluctance to give such open-ended tasks to courts and thus the failure of courts to emerge which have an expertise in this activity.[181]

3.2.2 Corporate Opportunities

Corporate opportunity is a different conflict of interest. While in self-dealing the director enters into a transaction with the director's company, in a corporate opportunity situation the director takes away from the company and for the director a business opportunity that "belongs" to the company. The conflict of interest thus arises out of the prior analytical step of characterizing the business opportunity as a corporate one, i.e. as one over which the company has a claim which is prior to that of the director. Among the conflict of interest situations, it is the clearest case of misappropriation or even outright "theft" by the director. Of course, it is not theft in the technical sense of criminal law, and its contours are controversial, particularly as to when a business opportunity becomes a corporate one.

A corporate opportunity is usually *not defined* by written law, even in the UK where statute now embodies the long-standing common law rule against the taking of corporate opportunities.[182] In many countries, such as Belgium, Sweden, or Poland, there is no rule against the use of corporate opportunities, though there are transparency rules, as in Belgium, and sometimes there is recent doctrine and occasional case law. Also, in continental European countries where the corporate opportunity doctrine is established, such as Germany and the Netherlands, this has been developed only relatively late and by case law. The reasons for this may be similar to those mentioned above for the duty of loyalty and conflicts of interest in general. But an additional reason may be that here the fact patterns are manifold, and more factual inquiry and flexible reactions by the courts may be needed.

The *technique* used for dealing with corporate opportunities for once is clear-cut. Disclosure alone is not enough. Approval by the board is necessary and usually sufficient; consent by the shareholders is an exception. In the United Kingdom board approval is the rule for public companies, provided the articles stipulate it. If the rules are more sophisticated, interested directors may not vote. The *sanction* is also clear. If a corporate opportunity has been appropriated by the director for himself or herself, the company has a damage claim. In

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[180] For example Italy and, more generally, infra 3.2.1.
[181] *Cf.* R. Gilson/A. Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review,* ECGI – Law Working Paper 194/2012.
[182] Companies Act 2006, s. 175.

addition, the company may have the right to require the director to hand over the product of his or her disloyal action to the company, as, at least in theory, in Switzerland, or even suffer outright disgorgement of all personal profit, as in Germany and the UK. The latter sanction gives to the company more than it would have had if it had made use of the opportunity itself, and even more than if it had decided not to make use of it at all. But this overreaching sanction is intended to work as a deterrent. Without it, the director would have an incentive to take a corporate opportunity knowing that, even if detected, he might retain some of the gain made.

As seen for self-dealing, the practical relevance of the corporate opportunity rule appears foremost in two cases: in *smaller companies* as the German GmbH, and in *groups of companies*, even though in the latter the problems are less the appropriation of a corporate opportunity by directors to themselves than the attribution of corporate opportunities by the parent among the companies in the group. In some countries[183] there are special group law provisions designed to identify the right balance between the interests and expectations of the outside shareholders in subsidiaries and the need for a consistent group policy by the parent, inter alia for tax reasons, cheaper production possibilities, and similar considerations.

Also in the case of corporate opportunities, a *certain tendency toward more strictness* is perceptible. It is reported that United Kingdom case law is even stricter than in the United States.[184] Yet this tendency is not so clear as in the other cases of conflict of interest; it is perceptible only in certain countries, and in particular by courts that may have to face hard cases. It is true that hard cases make bad law, but sometimes one has the impression that the court may not have fully evaluated the economic consequences of a strict decision. In Germany, for example, the *Bundesgerichtshof* had to decide a case in which the manager of a GmbH was an expert in a particular area and worked as a director in this business for a company. He got an offer to open his own business in the field together with a partner who promised to bring in the capital. The manager terminated his contract correctly and started the new company. The *Bundesgerichtshof* overturned the decision of the court of appeals and held that this was a corporate opportunity of the company and that the ex-director had to disgorge his profit.[185] Whether or not this case was decided correctly, extending the doctrine of corporate opportunities too far may have undesired economic consequences, such as tying the director too much to the company, hampering new start-ups, and stifling competition and innovation.

3.2.3 Inside Information

Insider law is an important and broad part of capital market law today that goes far beyond the prohibition of insider dealing by board members, though originally the latter was at the

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[183] Germany, France.

[184] Cf. the case Bhullar v. Bhullar, [2003] 2 BCLC 2241, CA. In particular, there is no equivalent in the UK to § 122(17) Delaware General Corporation Law permitting a company through its articles to renounce in advance its interest in certain or all categories of corporate opportunity; cf Companies Act 2006 (UK) s. 232.

[185] German Bundesgerichtshof, decision of 23.9.1985, NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 1986, 585 as to Court of Appeals of Stuttgart. It must be disclosed that at that time Hopt was a part-time judge at the lower court and referee of this case. Cf the extensive UK law on this topic permitting directors to take preliminary steps towards setting up a competing business whilst in office but not to initiate it. See P. Davies/S. Worthington, *supra* note 13, § 16-170.

heart of the insider dealing problem. This was the case in the United States, where insider law started before spreading all over Europe and beyond. When the European Union started to introduce insider dealing provisions, it first started with a proposal for the European Company to prohibit insider dealing by the directors of such a company. But today board members – like many other persons inside and outside the company – are prohibited from using inside information by acquiring or disposing of, for their own account or for the account of a third party, financial instruments to which that information relates.[186] Therefore, this specific conflict of interest will not be covered here in more detail.

The real problems of inside information of board members relate not so much the use of inside information by the directors themselves or persons close to them, this prohibition being generally accepted; instead, they are, first, the requirement by law and stock exchange rules to disclose inside information as soon as possible, and second, certain restrictions on passing on inside information even to major shareholders and third parties. The requirement to disclose inside information as soon as possible has continuously been extended, even to situations where the transaction is still pending and the supervisory board has not yet given its consent.[187] This is of course very difficult for companies to handle. On the other hand, early and comprehensive disclosure of information to the market helps accurate price formation for companies' shares, and signals from the share price assist independent directors to judge the effectiveness of management policies.

3.3 Enforcement

Overall, liability rules have become stronger in Europe over the recent period, especially in relation to self-dealing and corporate opportunities. However, liability rules are only as good as their enforcement, and in all European jurisdictions levels of private enforcement of liability rules are low, except perhaps when the company is in liquidation.[188] In the case of going concern companies the crucial issue concerns the barriers to and incentives for litigation on the part of non-controlling shareholders. The board is unlikely to initiate litigation, though, if it is a new board installed after the sale of the company, it may do so. A controlling shareholder may be implicit in the breach of duty or, if it is not, have other remedies at its disposal, so that it will not be interested in securing a decision to sue the directors from the general meeting. So, where there is a controlling shareholder, initiation of suit by a minority shareholder against the directors constitutes a form of minority shareholder

[186] Taken from the proposal for a European Regulation on insider dealing and market manipulation (market abuse) of 20.10.2011, Art. 7 para 1. This proposal is still very controversial and up to change.

[187] European Court of Justice, Geltl (Daimler case), decision of 28.6.2012 – C-19/11, on referral by the German Bundesgerichtshof in 2011. The problem is mitigated by the fact that under the present law the company is allowed under certain narrow circumstances and under its own responsibility to postpone the disclosure if the transaction is still pending. The actual relevance and meaning of the ECJ's decision is highly controversial, cf. for example M. Nelemans/M. Schouten, Taekover Bids and Insider Trading, August 2012, available at < http://ssrn.com/abstract=21473960 >; L. Klöhn, *Das deutsche und europäische Insiderrecht nach dem Geltl-Urteil des EuGH,* ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT (ZIP) 2012, 1885; G. Bachmann, *Ad-hoc-Publizität nach "Geltl",* DER BETRIEB 2012, 2206.

[188] For an overview see M. Gelter, *Why Do Shareholder Derivative Suits Remain Rare in Continental Europe?*37 BROOKLYN JOURNAL OF INTERNATIONAL LAW 843 (2012). On enforcement by private and by administrative remedies see P. Davies/S. Worthington, *supra* note 13, §§ 17-18.

protection. Where shareholdings are dispersed, the collective action problems of the shareholders may prevent the general meeting from taking action. Here, enforcement of directors' duties by a minority shareholder may operate so as to protect the shareholders as a class against management. Thus, in both types of shareholding structure, it is highly significant whether a minority shareholder, in law and in practice, is in a position either to act on behalf of the company to enforce its rights (the 'derivative' action) or cause the company itself to act to enforce its rights. We will use the term 'minority shareholder action' to refer to both types of suit.

In all jurisdictions there are still considerable obstacles to minority shareholder actions. In the past, law-makers have been suspicious of the motives of minority shareholders, with only limited stakes in the company, who wish to see the company's rights enforced. They have therefore set high standing rules, usually expressed in terms of a percentage of the company's equity, for access to the minority suit. In the past a standing requirement of 10% was common and it still remains at that level in Sweden. Generally, however, standing requirements have been reduced in recent reforms, often to the 1% level.[189] Even in these jurisdictions, however, the level of minority shareholder actions is reported to be low. There are two possible explanations for the lack of impact of the reduction of the standing requirements. One is that even 1% of the capital of a large publicly traded company is a large amount.[190] The alternative is that there are other barriers to minority shareholders' actions even if the standing criteria are met. The fact that levels of litigation are low even in countries where a single shareholder may sue[191] suggest that the non-standing barriers are significant.

In some jurisdictions, the costs rules are a big disincentive to suit. If the suing shareholder bears the costs of the litigation but recovery is by the company, this creates a strong disincentive to litigation, especially if the costs rule in question is that the loser pays the winner's costs. However, the costs disincentive is not there in all jurisdictions. If the minority shareholders' action takes the form of the company being forced to litigate, the costs will fall on the company. Even in a derivative action it is possible to make the company liable for the costs of the action, including cases where the action is unsuccessful.[192] The final point is that, even if standing and costs considerations are put on one side, the financial incentives for a minority shareholders' suit are limited: the effort falls on the minority shareholder but the recovery goes to the company so that the shareholder benefits only to the extent of his or her (ex hypothesi) limited interest in the capital of the company.[193] Contrary to the traditional

[189] This the requirement in Germany – subject to restrictions (see AktG §148 - for extensive discussion of the reform process see H. Hirt, *The Enforcement of Directors' Duties in Britain and Germany*, Bern 2004, ch. 6.3 to 6.5) and in Belgium. Italy has a 2.5% rule, whilst Poland allows any shareholder to sue if the company has not acted within a year of the injury.

[190] In some cases there is an alternative monetary qualification threshold which may be easier to meet e.g. holding shares of a nominal value of at least €1.25m in Belgium, though this is still a stiff hurdle. More easy to meet is the German alternative monetary threshold of €100,000.

[191] This is the case in Switzerland and Poland. In the UK the reforms of 2006 permit a single shareholder to sue, provided a court approves the litigation. The operation of this judicial filter is still being tested in litigation.

[192] As in the UK.

[193] It may also act as a disincentive to minority shareholders' litigation that, outside the UK, liability for breaches of the loyalty duties is often confined to damages for the harm caused to the company and that disgorgement of the profit made by director, where the company has suffered no harm, is not clearly available as a remedy.

view, therefore, the problem may not be that minority shareholders are over-incentivised to sue but that they are under-incentivised. However, positive encouragement of minority shareholder suits, for example, by facilitating the funding of litigation by lawyers through contingent fees or by non-lawyer third-party funders, is underdeveloped in Europe. Despite recent reforms it can be said that the traditional suspicion that liability suits brought by minority shareholders are likely not to be in the interests of the company as a whole still sets limits to policy makers' willingness to encourage such suits.[194] The US notion of the individual shareholder as the company's 'private attorney-general' has not taken root.

In a two-tier board system there is the additional possibility that litigation against the management could be brought by the supervisory board as well as by the shareholders, collectively or individually. However, there is a disincentive for the supervisory board to bring litigation against the management board in that it may implicitly reveal its own failures in supervising that body. Hence the decision of the Bundesgerichtshof in the *ARAG/Garmenbeck* case is significant because it in effect deprived the supervisory board's decision not to sue of the protection of the business judgement rule and exposed it to a more rigorous level of judicial scrutiny. Even so, the supervisory board retains some discretion in weighing up the corporate interest in litigation. Greater litigation by supervisory boards against management boards has followed the *ARAG/Garmenbeck* decision, and in particular since the financial crisis, but, though it is hard to get empirical data beyond the financial press and anecdotal evidence, supervisory board litigation has not yet fundamentally altered the overall picture of low levels of litigation to enforce liability against directors.

D&O insurance (ie insurance paid for by the company but protecting the director against liability to the company for breach of duty) is generally permitted, though often with some restrictions, either in law or in practice, on its cover against criminal liability or civil liability for intentional wrongdoing.[195] In principle, one would expect D&O insurance to increase the incidence of litigation and also the rate of settlement of litigation. The presence of a defendant who is assured of being able to meet the damages claim is an incentive to litigation, but both claimant and defendant director have an incentive to settle within the limits of the insurance coverage, with regard to both its financial and its substantive limits.[196] Nevertheless, D&O insurance appears not to have been effective to overcome the barriers to litigation to enforce

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[194] E. P. M. Vermeulen/D. A. Zetzsche, *The Use and Abuse of Investor Suits – An Inquiry into the Dark Side of Shareholder Activism,* EUROPEAN COMPANY AND FINANCIAL LAW REVIEW (ECFR) 1 (2010) comparing Germany and the Netherlands; C. A. Paul, *Derivative Suits under English and German Corporate Law,* ECFR 81 (2010) comparing Germany and the UK. This approach may explain why in some countries – France, Italy – shareholders can 'piggyback' a civil claim on a criminal prosecution e g for abuse of the corporate assets. Control of the criminal process by the public authorities reduces the risk of 'gold-digging' suits – though it creates other problems.

[195] Germany introduced in 2009 a mandatory deductible for D&O insurance, which seems likely to be ineffective.

[196] Thus, if the insurance excludes wilful misconduct, the settlement of a claim based on intentional wrongdoing may still be covered by the insurance if intentional wrongdoing is not admitted in the settlement. To some extent, this analysis depends upon the defendant's insurer regarding it as more important to retain the company's D&O insurance business than to minimise its losses in a particular case. If the company is not very sensitive to the premium levels, settling rather than fighting the case may be the financially more attractive course for the insurer, because it will be able to recover its payout through future premium increases.

directors' duties noted above, suggesting that the standing and funding restrictions operating on the claimant are still substantial.

In some jurisdictions public enforcement partly makes up for weaknesses in private enforcement, but, as with the provisions on the disqualification of directors in the UK through action taken by the Insolvency Service, an agency of the UK government, these provisions are applicable only to insolvent companies and are thus aimed mainly at the protection of creditors, though shareholders may benefit indirectly.

3.4 The board and non-employee and non-shareholder stakeholders

Stakeholders other than employees and creditors are usually not protected by board rules and company law but by other laws, in particular disclosure and social accounting rules. But in some countries that provide for a stakeholder-oriented approach for the board, the board has to consider as a matter of law not only employees' and creditors' interests, but more broadly the interests of other stakeholders and the "public interest." In the UK, for example, the core duty of loyalty requires directors to have regard, when promoting the success of the company for the benefits of its members, also to the impact of the company's operations on the community and the environment. However, this formulation does not require a balancing of shareholder and non-shareholder interests: non-shareholder interests are relevant only in so far as they promote the success of the company for the benefit of its shareholders. Going somewhat further, in Germany, since 1937, the board has been required to take the public interest into account, balancing it with the interest of the shareholders and employees. Since 2009 in listed companies, German boards have to look for a sustainable creation of value and take a long-term perspective in setting the remuneration of directors. The balancing of interests by the board reaches its limits when substantial money is diverted from the business., Limits of charitable gifts (a general practice), art collections (a not unusual practice, for example the famous art collection of the Deutsche Bank), and contributions to political parties are generally not clearly set, though the latter do require shareholder approval in the UK. In many countries, corporate social responsibility has gained attention in business practice, though often only as far as this promotes business interests.

Since stakeholders do not have rights to enforce restrictions against the board, the actual impact of these rules is limited. But the trend is to put more teeth into these requirements. This applies especially to sustainability information[197] if it is part of the annual report and as such has to be audited. The European Commission is becoming more active in the field of social responsibility[198] and, as in corporate governance, is considering coming up with more legal duties, though this is widely criticized.

4. Incentive strategies

Instead of trying to correct management's potential conflicts of interest through liability rules, the law or the company itself may seek to align the incentives of the managers with those of the shareholders.

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[197] For the UK: The annual report of quoted companies in the UK must contain in its business review part information about environmental matters and social and community matters; similarly for France.

[198] O. de Schutter, *Corporate Social Responsibility European Style,* EUROPEAN LAW JOURNAL 14 (2008) 203.

4.1 Remuneration

Remuneration of directors and officers is a hot topic in many continental European countries, though the excesses known from the United States and the United Kingdom have not yet spilled over into many of them. Following a public outcry in many countries over excessive remuneration, in particular over exorbitant exit pay, recent reforms of corporate law and codes have been enacted. The pros, cons, and ways of directors' remuneration have been discussed at length in economic and legal literature.[199] Many of these remuneration reforms have had a strong populist bent – but also a distributional and societal side (societal cohesion and trust in the economic system) – that goes beyond board and company law concerns. For all these reasons, the board remuneration problem shall be treated here only succinctly under the aspect of remuneration as an incentive for directors. Remuneration as a positive incentive – traditionally stock options to align the interests of the directors with the shareholders' interests in performance and higher stock prices– supplements the measures already discussed for holding directors accountable, most of which work with negative incentives. For financial institutions it is less obvious that directors' interests should be aligned with the shareholders rather than the creditors, at least in part. This was shown in the financial crisis where remuneration rules and practices for directors and officers of financial institutions contributed to the crisis. Therefore, remuneration rules for financial institutions have been considerably tightened and subjected to certain supervisory and enforcement competences of the supervisory agencies. This latter field is excluded from this study, though some spill-overs are already recognizable.

Generally, there is no obligation under the law for companies to use incentivized remuneration. However, corporate governance codes often recommend that listed companies do so.[200] The codes and the law then adopt various techniques designed to ensure that incentivized remuneration aligns directors' interests with those of the shareholders rather than the managers' own interests. There are *two basic techniques:* moving the competence for deciding on managers' remuneration out of the hands of the executives themselves;[201] and rules for the structure, content, or limits of remuneration. Corporate governance codes now uniformly recommend that remuneration be set or recommended by remuneration committees dominated by independent directors, though in two-tier Germany greater objectivity in executive remuneration was thought by the legislature to be achieved by insisting that remuneration is a task for the (codetermined) supervisory board as a whole. More contentious have been proposals to give shareholders a role in executive pay setting. Traditionally, this

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[199] G. Ferrarini/N. Moloney/M. C. Ungureanu, *Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis,* ECGI Law Working Paper No. 126/2009; G. Ferrarini et al., *Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe,* 10 JOURNAL OF CORPORATE LAW STUDIES 73 (2010); Y. Hausmann/E. Bechtold-Orth, *Changing Remuneration Systems in Europe and the United States – A Legal Analysis of Recent Developments in the Wake of the Financial Crisis,* 11 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW (EBOR) 195 (2010); R. Thomas/J. Hill, eds., RESEARCH HANDBOOK ON EXECUTIVE PAY, Elgar 2012; L. Enriques/H. Hansmann/R. Kraakman in ANATOMY, *supra* note 3, p. 75 et s. For figures, see Heidrick & Struggles, supra note 94, p. 45 et s.

[200] For example, UK Corporate Governance Code, § D.1: "A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance."

[201] This is really an issue only in the absence of controlling shareholders. Where such exist, they will indirectly set executive pay, not the executives themselves.

has been the case only for stock options and the like because of the danger of dilution of the shareholders.[202]

Since self-regulation does not work well in the field of 'say on pay' – not even in the United Kingdom, the stronghold of self-regulation – the legislature has stepped in. An annual advisory vote was introduced in the UK in 2002 on both overall executive pay policy and the remuneration of individual directors, and recently proposals have been made for a three-yearly binding vote on pay policy.[203] Even the existing advisory system has produced adverse shareholder votes, especially, but not only, in financial companies where shareholders fear intrusive regulation if shareholder activism is not seen to work.[204] More recently, various countries such as Germany, Italy, and Sweden have followed the British example and give the general assembly a say on pay,[205] but this is only consultative and relates only to the remuneration system and structures without a real competence to get down to the remuneration provisions of individual service contracts. In some other countries, such as France, say on pay is discussed but is not on the reform agenda. Interestingly enough, some minority shareholders associations are not in favour for fear that compensation approved by the general assembly might be more difficult to challenge. In other countries, such as Switzerland, there is pressure, as in the UK, to have the general meeting fix the remuneration instead of a mere advisory vote. Termination payments are seen with particular scepticism in Germany and France, for example. Clawback provisions exist or are discussed in many countries (not just for financial companies), including Germany, the Netherlands, and Poland. These rules are also extended to pension payments.

In most countries, there are also *substantive rules* as to directors' remuneration and the structure of the compensation packages concerning a link to performance and sometimes to sustainability. The requirements concern the following in particular: an adequate relationship between the remuneration and the tasks and performances of the director and the financial situation of the company; sometimes particular reasons for a remuneration beyond the normal level of comparable companies or in the business sector; the orientation of the remuneration toward the long-term development of the company (for variable remuneration parts more than a one- or two-year basis); the possibility for the board to reduce unilaterally the remuneration in case of extraordinary developments; and more generally, the reduction of the remuneration to an adequate level if the company gets into difficulties.[206]

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[202] In the United Kingdom, two additional special cases are reserved to shareholder decision: compensation for loss of office in connection with a takeover, or transfer of a business and long-term service contracts. The Listing Rules provide shareholder approval also for long-term incentive plans (ltips).

[203] Department of Business, Innovation and Skills (UK), EXECUTIVE REMUNERATION: DISCUSSION PAPER, 2011; ibid, CONSULTATION ON ENHANCED SHAREHOLDER VOTING RIGHTS, 2012.

[204] FINANCIAL TIMES, Boards wake up to a shareholder spring, May 4, 2012.

[205] In Germany, in 2010, 27 of the DAX 30 companies practised 'say on pay' at the general meeting. In Germany as well as in many other countries equity based remuneration plans need to be approved by the general assembly. See further J. Lieder/P. Fischer, *The Say-on-Pay Movement – Evidence from a Comparative Perspective* (2011) 8 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 376.

[206] All this can be found, for example, in Art. 87 of the German Stock Corporation Act as of 31.7.2009. See also the list of the French AFEP/MEDEF corporate governance code. Cf. L. A. Bebchuk, J. M. Fried, *Paying for Long-Term Performance,* 158 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 1915 (2010).

The results of these reforms, in terms of driving down the overall level of executive remuneration, were disappointing.[207] Simple disclosure requirements,[208] probably the earliest reaction of law and codes, proved to have some effect, not the least of which was raising public envy. Sometimes it even had the perverse effect of driving up the overall payment level, as no company wished to locate its directors' pay in the lowest quartile. Say on pay also had fewer effects in than expected apart from some spectacular cases in the United Kingdom. This is because of the natural propensity of shareholders to more risk-taking, in contrast to the risk-averseness of creditors, which is the main reason why corporate governance and debt governance for financial institutions are fundamentally different. Shareholders were not against high levels of pay provided the company's results justified them. The role of employees in countries with labour codetermination was weak, too, as in the famous German Mannesmann case. Not only the chairman of the board Ackermann, but also the trade union boss waved through the high bonuses even though the takeover had already been successfully completed.[209] In sum, the problem is still unsolved, in part because it is not well defined, as between levels of pay which are perceived as too high in absolute terms and executive rewards which are not aligned with shareholder interest.[210] To date, actual legislation has formulated the problem in the latter way but it remains to be seen whether more radical reforms propagated by popular envy will succeed.

4.2 The market for corporate control

Similar to insider dealing law, the regulation of takeovers has become a very important part of capital market law.[211] Even though there are many duties of the board – both of the bidder company and much more so of the target company, and not only during the takeover but also before and afterwards[212] – these duties do not need to be described in an article on the convergence of board rules Only two observations concerning the board under the heading of accountability should be made. One concerns board neutrality, or more precisely the prohibition on the board of the target to frustrate a bid; the other relates to the mandatory opinion of the board of the target company for its shareholders.

As a frequent consequence of a takeover, in particular a hostile takeover, the management of the target is replaced by a new team. This threat is a powerful incentive for directors to avoid this, either by good performance that would drive up the stock price and make takeovers more costly and less probable, or by defensive actions either before or at least during the takeover bid period. Accountability to shareholders is arguably promoted by the former, but diluted by the latter, response. Takeovers are therefore an important instrument of accountability of the

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[207] B. Cheffins/R. Thompson, *Should Shareholders Have a Greater Say over Executive Pay? Learning from US Experience* (2001) 1 JOURNAL OF CORPORATE LAW STUDIES 277.
[208] See, for example, the Directors' Remuneration Report as of 2006 in the United Kingdom..
[209] C. J. Milhaupt/K. Pistor, *supra* note 74, ch. 4: The Mannesmann Executive Compensation Trial in Germany, p. 69 et s.
[210] In the latter analysis, high pay is not in itself objectionable. See J Gordon, *Executive Compensation: If There's a Probem, What's the Remedy?* COLUMBIA LAW SCHOOL WORKING PAPER 273, 2006.
[211] P. Davies/K. J. Hopt in ANATOMY, *supra* note 3, ch. 8 on Control Transactions.
[212] For example, K. J. Hopt, *The Duties of the Directors of the Target Company in Hostile Takeovers – German and European Perspectives,* in: G. Ferrarini, K. J. Hopt, E. Wymeersch, eds., CAPITAL MARKETS IN THE AGE OF THE EURO – CROSS-BORDER TRANSACTIONS, LISTED COMPANIES AND REGULATION, The Hague et al. 2002, p. 391.

board. This instrument may be more important than the possibility of removal under the ordinary corporate law provisions because of the collective action problems of dispersed shareholders[213] and more effective than the duties of care and loyalty that may be enforced finally only by lengthy lawsuits with an insecure outcome. It is therefore hardly surprising that the question of what defenses are allowed against takeovers is most controversial in all countries. Usually the board can arrange defensive actions relatively freely before the takeover. But frustrating an announced or anticipated bid is forbidden by the 'no frustration' rule in the United Kingdom and some other countries, including Switzerland and, with the exception of reciprocity,[214] France. This rule requires mandatory shareholder approval for frustrating actions after the bid is made or is imminent. The European Commission was not able to introduce a similar rule in the 13th Directive on a mandatory basis, but had to allow the member states to opt out of the board neutrality rule as well as of the encompassing breakthrough rule and to introduce a reciprocity exception. This is what many member states chose. As a consequence, the boards in Germany, the Netherlands, Belgium, Poland, and other countries have wide possibilities for shielding themselves from being held accountable by means of unfriendly takeovers.[215] In takeover situations, the target board will often form a coalition with labor because the interest of the directors to stay in office and the interest of labor not to be subject to restructuring lay-offs that often run in parallel. This effect is reinforced if there is labor codetermination in the board. Looking out for a white knight always remains possible, but often the board of the target retains broad discretion to pass on relevant information only to the white knight while holding it back from the bidder. The Dutch Code provides that if a competitive bidder requests the management to give information on the company, it has to discuss this request with the supervisory board immediately. In Switzerland and the UK competitive bidders have to be treated alike. This has the effect of strengthening the accountability of the board.

In case of a takeover bid, the target board has the right and duty to give its opinion on the bid and the reasons for it, including its views on the effects of the bid on all the company's interests, specifically employment.[216] This is perfectly legitimate under the accountability perspective as well, because as mentioned initially, the board is the trustee of the shareholders, and possibly labor and other stakeholders. This opinion may be tilted by self-interest, but this must be taken into account; it is mitigated by the fact that reasons must be given. It is up to the shareholders and their intermediaries to judge the conflicting views of the target and the bidder boards. In some jurisdictions, for example the UK, the board must also commission an opinion from an independent source and make it available to the shareholders. This is particularly valuable where the incumbent management supports the offer, as in a management buy out.

One of the reasons for the fundamentally different policies described above is again the shareholder constituency. In the United Kingdom with its dispersed shareholdings, the institutional investors played a primary role in the development and satisfactory practice of

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[213] Again, this is an issue only in the absence of controlling shareholders. The latter can replace management themselves without relying on an acquirer to do so.

[214] The reciprocity exempts a target from the 'no frustration' rule in the case of an offer from a bidder which is not subject to that rule.

[215] P. Davies et al., *The Takeover Directive as a Protectionist Tool?* in: U. Bernitz/W.-G. Ringe, eds., COMPANY LAW AND ECONOMIC PROTECTIONISM, Oxford 2010, p. 105.

[216] Art. 9 para 5 of the 13th Directive. Particular problems arise for two-tier boards and regarding dissenting views of individual board members.

the 'no frustration' rule.[217] In countries where families and controlling shareholders in groups of companies prevail, institutional shareholders have a much lesser role, although it is increasing. It is true that controlling shareholders and blockholders are much less threatened by unfriendly takeovers, which may explain why the 'no frustration' rule exists without much ado even in some continental European countries. But still they have an interest in keeping the directors they have chosen, directly or indirectly, in office. So in many continental European countries, the British rule is not very much in vogue. This is particularly so in the wake of the financial crisis, which has led to a wave of protectionism, as shown by the example of Italy with its three successive different versions of this rule. The actual situation of takeovers as an instrument of accountability of the board is therefore the result of difficult tensions between industry, labour, government, regulators, and the financial press. Under these circumstances, the pending reform of the 13th Directive cannot be expected to take up this problem, and even less so to replace the present option and reciprocity system by the British 'no frustration' rule.[218]

5. Shareholder activism

Although the topic of this article is board rules, some central techniques of board control depend on shareholders being active to enforce or respond to the information generated by those controls. This is clearly true of the 'comply or explain' technique (since the explanation is directed at the shareholders) or private enforcement of liability rules. As well, independent directors will be able to operate more effectively if they have channels of communication to and support from the shareholders. While the controlling shareholder and also the blockholders have their own incentive to monitor the board, in companies with dispersed shareholding the only shareholders to be called on are the institutional investors, since rational apathy prevails for retail investors.[219] In some countries like the United Kingdom, institutional shareholders make up a clear majority of the shareholders of listed companies, while since the 1960s individual share ownership has dropped from 50 per cent to under 20 per cent.[220] Institutional shareholding is also prevalent in some other European countries, such as Sweden with 85 per cent of the total shareholding in listed companies, in France with 40 per cent of the CAC 40 companies, and similarly for the top-tier Swiss listed companies. In other European countries, institutional investment is still lagging behind because of special factors: in Italy because of prevailing blockholder control and in Germany in particular because of labour's dependence on the state old age retirement and pension system rather than on their own saving and investing. Yet in many DAX 30 companies, foreign shareholding, and in

[217] J.Armour/D.Skeel, *Who Writes the Rules for Hostile Takeovers and Why* (2007) 95 GEORGETOWN LAW JOURNAL 1727.

[218] K. J. Hopt, *Stand der Harmonisierung der europäischen Übernahmerechte,* in P. O. Mülbert et al., eds., 10 JAHRE WERTPAPIERERWERBS- UND ÜBERNAHMEGESETZ (WPÜG), Frankfurt 2011, p. 42; idem, EUROPÄISCHES ÜBERNAHMERECHT, Tübingen, forthcoming 2013.

[219] On institutional shareholders, see the introductory remarks in: ANATOMY, *supra* note 3, p. 83, 92,106, 108, 181 et s.

[220] See the tables in D. Prentice, *The United Kingdom,* in: S. Bruno/E. Ruggiero, eds., PUBLIC COMPANIES AND THE ROLE OF SHAREHOLDERS, Alphen aan den Rijn 2011, p. 197 at 206 et s.: B. Cheffins, OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED, Oxford 2008; R. Crespi-Cladera/L. Renneboog, *Corporate Monitoring by Shareholder Coalitions in the UK,* ECGI Finance Working Paper No. 12/2003. In the US, institutional shareholders already held 61.2 per cent of the whole share capital in 2005, The Conference Board, U.S. Institutional Investors Continue to Boost Ownership of U.S. Corporations, Jan. 22, 2007.

particular foreign institutional shareholding, is very considerable – for example, in the Deutsche Börse AG, where the large private German banks sold out their shareholdings some years ago under a changed tax system. More generally, the Rhineland capitalism model with its close intertwining of German industry and banks has been disappearing over the years.

However, these figures and statistics should be read with caution because they group together the different kinds of institutional investors that may have very different short-term or long-term investment policies. The traditional institutional investors may be pension funds such as CalPERS, insurance companies, mutual funds (UCITs), sovereign wealth funds, and banks. Typical institutional investors hardly ever hold large blocks. Usually they stay with only up to 5 per cent, but they may cooperate in order to influence the companies they are invested in. Their investment horizon is traditionally not short term, though more recently there has also been a trend for institutional investors to have shorter time horizons in their investment policies. This is different on the one side from private equity, which is clearly longer term with an exit policy of between three to five years and which usually seeks complete control of a target, and on the other side activist hedge funds,[221] with a special business model that is clearly short term, based on a small shareholding and looking for a quick rise of the stock prize and immediate exit afterward.

Whilst institutional shareholders in the UK have long exercised influence over corporate governance rule-making and, to a lesser extent, the policies of particular portfolio companies, that country was the first to put regulatory pressure on institutional shareholders to take up a role in the internal corporate governance of companies.[222] There is a complex double relationship here. On the one hand, shareholders who have pushed for policies which make the board more sensitive to their interests may come under pressure from government to use that influence to improve the management of the company. On the other, governments which want shareholders to improve the governance of companies, so that they can reap the financial benefits (taxes, jobs) arising from more competitive companies, do not want shareholder to engage in activities which will cause them political problems. The UK Stewardship Code, which stems from the Financial Reporting Council, recommends on a comply-or-explain basis that institutional investors (or fund managers acting on their behalf) take an active role by having a clear policy on voting and disclosure of voting activity, by developing a policy on intervention (beyond reactive voting) in portfolio companies, and reporting periodically on their stewardship. Other countries such as France and the Netherlands have followed or are considering following this path and are putting pressure on the institutional investors, though up to now legislators have not yet enacted mandatory legal rules. They have only threatened to do so if disclosure and self-regulation do not work.[223] As to the practice of many institutional investors to rely for their own voting decisions on the advice of proxy advising

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[221] Cf. J. Armour/B. Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds,* ECGI Law Working Paper No. 136/2009.

[222] The Stewardship Code is available at < http://www.frc.org.uk/corporate/investorgovernance.cfm >. Cf. P. Davies/S. Worthington, note 13, §§ 15-25 et s., 15-30; B. Cheffins, *The Stewardship Code's Achilles' Heel,* MODERN LAW REVIEW 73 (2010) 1004; D. Arsalidou, *Shareholders and Corporate Scrutiny: the Role of the UK Stewardship Code* (2012) 9 EUROPEAN COMPANY AND FINANCIAL LAW REVIEW 342.

[223] For example, in the United Kingdom, the Companies Act 2006 contains a reserve power for the government. Cf. also European Commission, Green Paper, supra note 37, at 164 sub 2.3 and 2.4 as to institutional investors.

firms, legislative intervention is on the way in the European Union and several European countries, also others, like Switzerland, have begun to try self-regulation.

Whether the hopes placed in institutional investors to play an important role in holding directors accountable as active shareholders will materialize is still open to doubt. Traditionally there have been special rules only for controlling or major shareholders, especially in group law. But as institutional investors hold only small blocks of shares, these rules are not applicable; worse, other rules work as an obstacle for more activism, such as the concerted actions rule under the disclosure and takeover regime of the European Union as well as in Switzerland. In addition, the prudential rules for insurance companies and investment funds to behave as prudent investors, to pay a minimum interest and, in the case of open funds, to take back the shares at any time set an incentive to these institutions to follow the market and not to do worse than the market rather than being criticized if activism does not pay out. The most relevant point is the lack of incentive for institutional investors to become active because this implies costs. They lack manpower, and if they have a large portfolio – sometimes many hundreds of investments – it may economically just not make sense for them to become active in all these companies. It is doubtful whether the incentives that are discussed would make a substantial change, such as double voting rights for more long-term shareholders as they exist in France and are considered by the European Commission, or similar measures such as bonuses for attending the general assembly or loyalty dividends. Therefore, while there is clearly a rise of activism of institutional investors in many countries, high expectations to solve their accountability problem by better self-regulation, or even by turning self-regulation into hard law of disclosure and similar duties, may turn out not to be well-founded.[224]

A further question is whether governments favour all forms of activism. When governments propose deeper shareholder engagement with companies, for example as the UK and the Netherland as well as the European Union[225], they are thinking probably about engagement by long-only institutional shareholders, whose interests in the long-term success of the company coincide broadly with those of other stakeholders. However, shareholder engagement could also be attractive to more short-term shareholders, notably activist hedge funds. There is a strong argument that such funds, which take only minority stakes in companies, can be successful only if they attract the support of long-only shareholders, so that the dichotomy between activist and institutional shareholder engagement is a false one. Activist shareholders, it can be argued, provide the mechanism whereby long-only investors overcome their collective action problems. Nevertheless, whilst long-only shareholders typically engage with investee company management in a reactive way, in order to preserve the value of investments made for non-activist reasons, activist hedge funds are pro-active, ie they invest in order to reap benefits from changing the policies of the incumbent management. They tend to concentrate on proposing immediate and fairly radical changes to existing corporate strategy in order to increase the value of the company, with aim of exiting it after the changes have borne fruit. Interventions by activist shareholders can thus be seen a qualitatively

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[224] For a rounded discussion of the problems associated with promoting long-term engagement see KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING, FINAL REPORT, July 2012,URN 12/917 and the UK government's response (Department for Business, Innovation and Skills), ENSURING EQUITY MARKETS SUPPORT LONG-TERM GROWTH, NOVEMBER 2012, URN 12/1188.

[225] European Commission, Green Paper, *supra* note 37, states at p. 11 that "engagement is generally understood as an activity which improves long-term returns to shareholders"; cf. also Report of the Reflection Group, *supra* note 146, ch. 3.

different from interventions undertaken by long-only shareholders, even if the former type of intervention is dependent upon the support of the institutions. Activists' interventions are more likely to be resisted not only by incumbent management but also by other stakeholders, especially employees. Governments tend not to welcome such forms of engagement, because they are politically unpopular, but it is difficult to craft laws which facilitate long-term but not short-term engagement.[226] The tensions in this area are well illustrated by Dutch experience, where reforms of 2004 making it easier for minority shareholders to influence management are currently proposed not only to be reversed but also to be replaced by more constraining rules than existed before 2004, in the light of only limited, but politically unpopular, use of such rights by activist shareholders.[227] Thus, governmental support for increased governance rights for non-controlling shareholders is not without limits.

6. Conclusion

The supporters of the convergence thesis can derive some comfort from the above analysis. Their hypothesis that the pressures of global competition would drive board rules in a shareholder-friendly direction is supported in particular by the recent reforms to the rules on board composition (emphasising the role of independent directors and board committees and the separation of the roles of the chair of the board and the CEO) and the strengthening of the controls on related party transactions. However, as we have noted, this has not meant the general adoption of the UK Corporate Governance Code recommendation that at least half the board should be independent directors or, even in the UK, the uniform practice of a retiring CEO not moving on to take up the board chair. Furthermore, there are some indications that the policy commitment to independence as the dominant characteristic for non-executive board members is waning, in the face of the very different pressures for more expert and more gender-diversified boards.

The location of board composition rules in corporate governance codes also currently receives less whole-hearted endorsement, at least at EU level, than had previously been the case. The 'comply or explain' principle puts the shareholders at the centre of enforcement of the recommendations of the codes. They will find the explanations for non-compliance convincing or not, and, if not, either exercise their governance rights to try and change the directors' behaviour or dispose of the stock in the market, actions which in either case will put pressure on the management to comply with the substantive provisions of the code or to provide more convincing explanations of their non-compliance. The rationale for self-regulation, rather than court or regulator enforcement in this area, is that corporate governance codes enter into very sensitive and detailed areas of board operation and it is unlikely that in these areas the rule-maker is capable of producing a single solution which is the best for all companies. On efficiency grounds, some degree of flexibility for companies is required.[228]

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226 Incentives to long-termism are an alternative approach which has been adopted in France and in the Netherlands. See for a general proposal P. Bolton and F. Samama, *L-Shares: Rewarding Long-term Investors,* available at < http://cgt.columbia.edu/papers/Bolton_Samama_L-Shares-Rewarding_Long-Term_Investors/ >.

227 A similar but less extreme story can be told about France where reforms of 2001promoting shareholder activism were supplemented by reforms in 2010 prohibiting opaque 'empty voting' and restricting activism by hedge funds.

228 S. Arcot/V. Bruno, *One Size Does Not Fit All, After All: Evidence from Corporate Governance* (2007), available at < http://ssrn.com/abstract=887947 >.

In all the jurisdictions there is a high level of compliance with the substantive recommendations of the code. This may indicate that the drafters of the code have done a good job identifying practices which suit the majority of companies or at least that the companies see no merit in fighting the recommendations.[229] However, the quality of the explanations for non-compliance, which is crucial to the self-regulatory process, is sometimes criticised. If the explanation of non-compliance is inadequate, this constitutes in principle a breach of the 'comply or explain' obligation. Those responsible for policing this rule seem disinclined to enforce the rule by imposing sanctions against particular companies, perhaps fearing that the line between judging the completeness of the explanation and judging its persuasiveness will be difficult to draw. However, in some jurisdictions there is an annual survey of the quality of the explanations, which may help to improve the usefulness of the explanations to shareholders.[230] The European Commission has expressed the view that 'in the majority of cases' the explanations given for non-compliance are 'not satisfactory'[231] and has expressed scepticism in principle about the operation of the mechanism where there is a controlling shareholder. Further, whilst stating that the first problem should be addressed in a way which does undermine the 'comply or explain' approach, the Commission seems open to the notion of stronger regulatory policing of the adequacy of the explanations given.

Furthermore, the line between matters which substantively are to be dealt with in hard law and those which are to be dealt with in codes is necessarily contestable. There is some evidence that, as issues become politically more salient, there is likely to be a shift of provisions from codes to legislation,[232] as witness the current debate over quotas for women directors. The movement from code to legislation is particularly noticeable in relation to code provisions on remuneration. Strict criteria for performance-related pay, taken from codes and inserted in legislation, are not necessarily contrary to the interests of shareholders, though they risk constraining the company's freedom to structure pay in an optimal way. Outright limits on payments are more questionable from a shareholder's point of view, even when they are expressed in general terms.[233]

The technique of 'comply or explain' may be at a cross-roads, both because it begins to lose substantive ground to the law and because of stronger regulatory policing of its operation, These changes, if appropriately carried out, are not necessarily inimical to the interests of

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[229] In so far as companies comply with a provision of the code for fear that something worse will be enshrined in legislation, we are not talking about self-enforcement, but compliance 'in the shadow of the law', where the adverse reaction is anticipated to come from government rather than shareholders or other stakeholders in the company.

[230] In the UK the Financial Reporting Council, which is responsible for the substance of the Code, was recently moved to issue a paper designed to increase companies' understanding of what a good explanation is: Financial Reporting Council, *What constitutes an explanation under comply-or-explain?* (February 2012). It followed this move up with a short book celebrating the principle: Financial Reporting Council, COMPLY OR EXPLAIN: 20th ANNIVERSARY OF THE UK CORPORATE GOVERNANCE CODE, 2012.

[231] European Commission, Green Paper, supra note 37, COM (2011) 164 p. 3. The Financial Reporting Council documents, referred to in the previous note, were in part a response to this scepticism.

[232] See, for example, Hopt, *supra* note 2, A.J.C.L. 59 (2011) 1 at 16, n. 66, giving three examples two in the remuneration area.

[233] For example the requirement that remuneration be based on the 'sustainability' of the company.

shareholders, but the risk to shareholders is that the reforms are driven by political goals which do not reflect the policy of promoting shareholder primacy. The same set of issues arises in relation to the increasing pressure, from both national governments and the EU,[234] that long-only shareholders engage more actively with their portfolio companies. On the one hand, activism is an inherent expression of shareholder primacy, but activism is not its only expression and may not be the most efficient method of promoting shareholders' interest in particular situations, for example, as against disposing of the shareholding. Voice is not always the better choice than exit, even if it sometimes is. Reforms aimed at reducing shareholders' coordination costs or the agency costs within the long chain of institutional investment would be consistent with promoting the interests of shareholders, whilst pressure on institutional investors to pursue government-favoured goals at portfolio level would not be.

We have noted two areas where shareholder interests have failed to make headway: the failure to adopt a mandatory 'no frustration' rule at EU level in relation to takeover bids and the lack of reform of mandatory employee representation rules. Even in these two areas, however, the picture needs qualification. As to the first, in the period up to 2000, when the first attempt to adopt a Takeover Directive surprisingly failed, a number of member states did in fact adopt a 'no frustration' rule in anticipation of the proposed directive's requirements[235] Even where a member state does not have a domestic ban on frustrating action, there are likely to be some controls in place in relation to defensive measures, though these controls are likely to be significantly less effect than a comprehensive requirement for post-bid shareholder consent.
The 'stickiness' of the rules on hostile takeovers again admits of an efficiency and a 'political' explanation. Making hostile takeovers difficult permits companies to commit to rewarding firm-specific human capital investments by employees, and thus can be argued to be a complement to rules requiring mandatory representation of employees at board level. Even in jurisdictions without mandatory board representation for employees, management will be in a better position to commit to employees if it is not subject to the threat of a hostile bid. The political explanation suggests that the view of incumbents, especially incumbent managers, were crucial determining the rate and direction of change in the rules on hostile takeovers. In general, managers might be expected to oppose more liberal rules on hostile takeovers, though in some jurisdictions they might support them if they expected more often to be bidders than targets.[236]

The potential downsides of excluding hostile bids are clear: less managerial discipline and a lesser possibility of synergistic changes of control occurring. However, if, in jurisdictions where the hostile bid is not facilitated, shareholdings are concentrated, both these potential downsides are reduced. Concentrated shareholders are well placed to remove underperforming management themselves through the exercise of their governance rights (rather than relying on a bidder to do so). Further, where shareholdings are concentrated, a synergistic bid will turn on the decision of the shareholders, since the board, appointed by

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[234] Shareholder activism is one of three main topics raised in the EU Green Paper, *supra* note 37.

[235] M.Goergen/M.Martynova/L.Renneboog, *Corporate Governance Convergence: Evidence from takeover regulation*, ECGI Law Working Paper 33/2005, Figure 10. Their data, however, do not clearly distinguish whether shareholder approval for defensive measures is required post-bid or may be given in advance of the offer.

[236] P. C. Culpepper, *supra* note 16, arguing that the interests of incumbent managers were predominant in determining the stance of takeover rules in France, Germany and the Netherlands, but explaining the more liberal stance of French takeover law by reference to the internationalist ambitions of French managers.

those shareholders, is not likely to operate contrary to their interests. In other words, the rules on hostile takeovers are irrelevant if the shareholders and the directors are, in effect, the same people. However, even in jurisdictions with predominantly concentrated shareholdings, there will be some companies with sufficiently dispersed shareholdings that a decision by the shareholders cannot be expected always to be the same as a decision by the board, so that in these cases the rules on hostile takeovers do matter. In the jurisdictions studied there is evidence of some decrease in the levels of concentration amongst the largest publicly traded companies.[237] Consequently, the question of whether post-bid defensive action is permitted without shareholder approval is likely to become more, not less, important in the future.

As to the second, in none of our jurisdictions were the board representation rights of employees significantly reduced over the past two decades. On the other hand, none of the existing regimes for employee representation at board level was significantly strengthened in this period.[238] Equally, there is no example of the introduction of board level representation in jurisdictions previously without it. It is difficult to know whether the better explanation for the 'stickiness' of the rules on board level representation is to be found in the opposition of politically important incumbents (notably organised labour) or in a complementarities story under which greater protection for employee interests in strategic decision-making facilities firm-specific human capital investments by employees.

The qualification to this picture of the 'freezing' of mandatory employee representation rights is the possibility of the use of the European Company (SE) for new and expanding companies to avoid codetermination obligations.[239] So far, relatively little use has been made of this possibility, since relatively little use has been made of the SE form for any purpose. Escape from codetermination for newly created and expanding companies was probably not the intention of the European legislature, and it remains to be seen whether steps will be taken to close off this evasion technique, if it is significantly take up.[240]

The above account suggests that the role of politics in mediating the pro-shareholder impact of globalisation is important. Pro-shareholder change was supported by government, partly because it encouraged the inward flow of equity capital, but also because boards were seen as insufficiently accountable and prone to error. But pro-shareholder change might meet effective opposition from non-shareholder groups, notably managers and employees, and that would set limits to its development. For the future, it is not clear that the same level of political support for pro-shareholder change will be forthcoming. The recent financial crisis is perceived in some quarters to have shown that shareholders are not capable of controlling boards or even that the shareholders played an unacceptable role in urging boards to pursue reckless courses of action. Whether this will prove to be a passing phase of analysis or

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[237] For example in Germany and France.

[238] For a discussion of the reform of the Dutch 'structure regime', which may be an exception, i.e. the position of the employees was strengthened in practice, see supra 2.8.

[239] Supra 2.8.

[240] The SE Regulation required a review of its operation after 5 years. In the staff paper, commenting on the results of the survey of its use, there is a discussion of the issue of the operation of employee involvement provisions in shelf companies, a careful reading of which suggests an awareness of this issue outside the precise area of shelf incorporations: Commission Staff Working Document accompanying the Report from the Commission . . . on the Operation of the Statute for a European Company (SE), SEC(2010) 1391final, § 3.2.1.

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whether the pressures for pro-shareholder change will permanently weaken remains to be seen.

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