



**The Board of Directors:
Composition, Structure, Duties and Powers**

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I. Introduction

Core company law is concerned with addressing three main sets of principal/agent problems. These arise out of the relationships between, first, the management and the shareholders as a class; second, between majority shareholders and minority shareholders; and, third, between the controllers of the company (whether managers or majority shareholders) and non-shareholder stakeholders.¹ This paper advances the following three propositions. First, the rules relating to board composition, structure, duties and powers ('board rules') are capable of being utilised to address any one or more of these sets of agency problems. Second, however, there is a trade-off between breadth and depth, that is, if board rules address more than one set of the agency problems, their effectiveness in relation to any one set is reduced. Third, the focus of the recent corporate governance movement has been on enhancing the board's effectiveness in addressing the first agency problem (management and shareholders as a class) and in consequence the burden of addressing the other two agency problems (and especially the third, that between controllers and non-shareholder stakeholders) has been thrown onto other parts of company law or onto bodies of law other than company law.

II. Core Company Law and Principal/Agent Problems

Core company law addresses three sets of principal/agent problems which are inherent in the structure of large companies: those arising between management and the shareholders as a class; between majority shareholders and minority shareholders; and between the controllers of the company (whether managers or majority shareholders) and non-shareholder stakeholders. Within a particular company the first two sets of problem are mutually exclusive (at least at any one point in time) and which predominates depends upon the structure of shareholdings. Where shareholdings are dispersed, the principal/agent problem which emerges is that between shareholders as a class and the management of the company. No matter what the formal governance rights of the shareholders may be, their collective action problems may make it in practice impossible or very difficult for the shareholders to exercise effective control over the management of the company. In consequence, management may give priority to non-shareholder interests, including the interests of the managers themselves. The question for company law, therefore, is what contribution it can make to reducing the costs of diversified ownership and the principal/agent problem generated by such diversification.

On the other hand, where a single or small number of shareholders hold a substantial block of shares in the company (say, in excess of 25% of the voting rights), securing managerial accountability to the shareholders (or at least to the controlling shareholders) through the traditional governance mechanisms of company law will not usually be difficult. What, however, emerges in such a situation is the principal/agent problem between the controlling shareholders and the non-controlling (or ‘minority’²) shareholders. What contribution can company law make to protecting minority shareholders from diversion by block holders to themselves of a disproportionate share of the company’s economic surplus?

What is true of a single company tends also to be true of company law systems, according to the typical pattern of shareholdings in large companies in the jurisdiction. Where the typical pattern is one of dispersed shareholding (as in the UK), legislative and policy attention tends to focus, as the provisions of the Combined Code³ demonstrate, on the first agency problem. Where, on the other hand, large block-holders typify the pattern of shareholdings in large companies, policy-makers are likely to take the view that the second set of agency problems presents more pressing demands on their resources.⁴

Whatever the orientation of a legal system as between the first two principal/agent problems, it will have to go on and address the third set of principal/agent issues. These arise out of the relationships between the controllers of the company (whether managers or shareholders) and non-shareholder stakeholders.⁵ All company law systems address one type of such stakeholder relations, namely those between the company and its creditors. This is because company/creditor relations are

¹ I am grateful for discussion of these issues in recent years with my colleagues from the International Faculty for Company and Capital Markets Law: Henry Hansmann, Reinier Kraakman, Klaus Hopt, Gérard Hertig, Hideki Kanda and Ed Rock.

² In fact, the ‘non-controlling’ shareholders may collectively hold more voting shares than the ‘controlling’ shareholders. However, if the non-controlling shares are widely dispersed, effective control of the company will lie in the hands of the block-holder, even if that block consists of less than 50% of the voting shares. In this paper the terms ‘non-controlling’ and ‘minority’ shareholders are used interchangeably, with some preference for the latter term because it is shorter!

³ The Combined Code may be found at the end of Financial Services Authority, *The Listing Rules* (London, 2000). It is discussed further below in section VI.

⁴ See Brian C Cheffins, ‘Current Trends in Corporate Governance: Going from London to Milan via Toronto’ (2000) 10 *Duke Journal of Comparative and International Law* 5. Of course, minority shareholder protection may demand legislative attention even in jurisdictions where shareholdings in large companies are dispersed, if one broadens the focus from large companies to the population of companies as a whole. Within a particular jurisdiction, even if shareholdings in large companies are dispersed, that is unlikely to be true of small companies. In such a case, the first two principal/agent problems end up sorting themselves by size of company. This is true of the UK where legislative protection for minority shareholders is discussed almost entirely in relation to small companies.

⁵ For the purpose of this paper ‘stakeholders’ may be taken to be any group of people who have a potentially long-term relation with the company, the terms of whose contracts cannot be specified in full ex ante and the quality of whose relationship with the company is vital to the company’s business success.

crucially affected by one universal feature of core company laws across jurisdictions, namely, the principle of limited liability for the company's shareholders, at least as the default rule. In addition to providing for limited liability, company laws seek to control the incentives to opportunistic behaviour on the part of company controllers which limited liability generates.⁶

Many company law systems do not deal with stakeholder relations beyond those with creditors. Where systems do go further, the driving force is a policy of using company law to regulate company/employee relations. This policy is particularly strongly embedded in the company laws of Germany and the Netherlands, but is found less strongly in about half the countries which are members of the European Economic Area. Beyond creditors and employees company laws do not seem to pay significant attention to any other category of stakeholder relation.

The above is an attempt to analyse the role of company law as a whole in the regulation of principal/agent relations. This paper, however, is not concerned with such a large topic. It deals only with the role of 'board rules' in addressing the three principal/agent problems identified above. Therefore, this paper will not consider in any detail company law techniques for addressing principal/agent problems which do not involve the board, for example, a rule requiring distributions by companies to be made pro rata to the proportion of the equity held by each shareholder. Sections III to V analyse the range of options in principle available to policy-makers for the use of board rules to address the three principal/agent problems; section VI says something about current trends in policy making; and section VII concludes.

III. Board rules and the principal/agent relationship between managers and the shareholders as a class.

(a) The division of functions between shareholders and the board

One could say that the principal/agent problems between the managers and the shareholders as a class are most effectively met by shifting decision-making out of the hands of the agent (the managers) and into the hands of the principal (the shareholders). However, although this would solve these principal/agent problems at a stroke, the costs of such a strategy in a large company are normally far too high for the shareholders to bear. This strategy would deprive the shareholders of

⁶ Because company law's interest in creditor relations is driven by the principle of limited liability, company law does not usually provide a complete code of rules for company/creditor relations, but only for those aspect of the relationship upon which limited liability impinges. Other aspects of the relationship are governed by rules pertaining to

all the benefits to be gained from allocating decision-making to a small number of expert and committed managers. If in large companies centralised management is a *sine qua non* for effective conduct of the company's business, this first class of principal/agent problem cannot be so easily eliminated. For this reason, all company laws are very cautious about allocating decision-making to the shareholders' meeting on a mandatory basis. Company laws commonly take this step only in one of three situations: changes to the company's constitution; decisions which are as close to investment decisions as they are to management decisions (for example, the decision whether to merge the company with another one); and decisions on matters where the directors are conflicted.⁷ The current controversies revolve around the scope of the second category: should any board decision which has sufficiently large impact upon the company's business be treated as analogous to an investment decision and so require shareholder approval.⁸ Even in these cases, shareholders in some cases acquire a decision-making role only if the management has proposed the decision in question. In such cases the shareholders have a veto right over certain classes of decision but no power to take the initiative. Such an arrangement is more protective of centralised management than rules giving shareholders the power of initiative.

Thus, for good functional reasons the boards of large companies operate in all systems under a broad mandate of powers: the division of functions between shareholders' meeting and the board is one where the board takes the lion's share. This result may be required by company law (as in Germany and the US) or it may result from practice, as in the UK, where the shareholders, even in large companies, could keep nearly all decision-making for themselves, but in fact choose the opposite policy. Only one further thing needs to be said about the division of functions between shareholders and the board. A particularly effective technique for ensuring accountability of the board to the shareholders as a class is to facilitate an exit right for dissatisfied shareholders via a hostile take-over bid. The hostile bid depends crucially on the ability of the bidder to make an offer to the target shareholders over the heads of the incumbent management of the target. A central issue for take-over regulation, therefore, is whether it seeks to side-line management in the bid procedure (ie allocates decision-making solely to the shareholders) or whether it aims to preserve a role for centralised management even where the target board is potentially in a position of severe conflict of

creditor/debtors in general (ie whether the debtor is a company or not). See, for example, the personal property rules on reservation of title or the insolvency rules on putting assets out of the reach of creditors.

⁷ In this latter case, the costs of shareholder decision-making may still be regarded as so high that alternative techniques are used, such as decision-making by non-conflicted directors or by an outside body such as a court.

⁸ See the *Holz Müller* decision of 1982 in Germany (83 BGHZ 122). This decision suggests the addition to the list of instances where shareholder approval is required that of 'fundamental business decisions'. This idea can be found, though expressed in very different language, in the UK Listing Rules' requirement for shareholder approval of 'Class One' transactions: above n 3, para 10.37. An alternative technique is to give the shareholders an exit right in such a situation (see, for example, art 5.6.6 of the *règlement général* of the *Conseil des Marchés Financiers* in France) but, of course, this technique takes us beyond board rules, as defined for the purposes of this paper.

interest as between their personal interests and those of the target shareholders. As is well known, the British City Code on Take-overs and Mergers adopts the first approach,⁹ as indeed do the recently adopted stock exchange laws dealing with takeovers which have been adopted in continental Europe. By contrast, US state laws tend to preserve an important role for the management of the target through their freedom to adopt, and to refuse to redeem, poison pills.¹⁰ Even in Europe, however, the matter remains one of controversy in the drafting of the proposed EU Directive on takeovers.¹¹ Thus, although centralised decision-making is in general in the shareholders' interest, the effectiveness of the market in corporate control rests upon the takeover bid decision being kept wholly in the hands of the shareholders.

Leaving aside the issue of take-over bids, a substantial allocation of decision-making power to the board, either by law or in practice, seems uncontroversial. In consequence, therefore, the first set of principal/agent problems need to be addressed by board rules. There are three main techniques available within company law. These are: giving shareholders appointment and/or removal rights in respect of the directors; subjecting directors to legal duties which require them to exercise their discretion in the interests of the shareholders as a class; and structuring the incentives of the members of the board so as to induce them to promote the interests of the shareholders as a class.

We shall now say a little about these techniques. However, there is one preliminary point which is worth making. Although the first principal/agent problem has been described above in terms of management/shareholder relationships, the company law strategies described in the previous paragraph all focus on the board, not 'management'. This illustrates the ambiguous position of the board in large companies. In nineteenth century literature the board is often conceptualised as the body which supervises the management on behalf of the shareholders. If, however, the accountability of the board to the shareholders is weak, the board will be 'captured' by management and become an expression of the unaccountability of the management rather than an instrument for the control of management by shareholders. Legal strategies, however, focus on the board and its members, either because they seek to restore the board to its nineteenth century ideal or because they take the members of the board to constitute the apex of the managerial structure of the company and proceed on the basis that legal regulation of the board amounts to regulating the top

⁹ At least once a bid is in the offing. Pre-bid, the Code does not apply and general company law is more favourable to the adoption of takeover defences by boards, provided such defences can plausibly be argued to promote a commercial interest of the company.

¹⁰ See M Kahan 'Jurisprudential and Transactional Developments in Takeovers' in Hopt et al (eds) *Comparative Corporate Governance* (Clarendon Press, Oxford, 1998) 683.

¹¹ Contrast the final version of the proposed Directive adopted by the Commission (OJ C 378/10, 13.23.97) art 8(b); the common position adopted by the Council (OJ C 23/1, 24.1.2001) art 9; and the recommendations of the Committee on Legal Affairs and the Internal Market of the European Parliament (A5-0368/2000, final) art 9.

management of the company. Either way, whilst business schools talk about the senior management of companies, the law schools talk about the role of the board of directors and of individual directors.

(b) Appointment and removal of board members

The most obvious way to make the board accountable to the shareholders as a class is to make it easy for the shareholders to remove directors of whom they disapprove. Thus, removal rights for shareholders, exercisable by ordinary majority, which can be exercised at any time and for any reason to remove all or any of the directors would appear to be a powerful tool to make the board accountable. At least, this should be so where the removal rights are coupled with easily exercisable powers for shareholders to convene meetings to consider the removal of directors and where there is a good disclosure regime in place so that the shareholders can accurately evaluate the board's performance. By contrast, rules which secure the board against removal except at certain intervals (for example, only at the annual general meeting or at the expiry of a term of office) or which do not give the shareholders direct powers of removal (as in two-tier board systems where the managing board is not removable by the shareholders but only by the supervisory board) or which deny shareholders removal rights altogether (as in the Dutch 'structure' regime, where the board is a self-appointing body) all operate so as to dilute the power of shareholders to remove directors.

However, even where the shareholders formally have strong appointment or removal rights over the board, these rights may in practice prove difficult for the shareholders to operate effectively in jurisdictions with dispersed shareholding structures, because of their collective action or other problems. These problems may exist even at relatively low levels of dispersal of shareholdings. Thus, in the UK there has occurred over the past 40 years a relative *re*-concentration of shareholdings in listed companies into the hands of pension funds and insurance companies (and their fund-managers), so that institutional shareholdings in the 3 – 5% range are common. Nevertheless, for reasons related to competition among the institutions and conflicts of interest between the fund management and other arms of financial conglomerates and insurance companies,¹² co-operation among institutional shareholders to exercise their removal rights (which in the UK are strong) has often proved difficult. As ever, the 'law in the books' is one thing, its operation in practice may be quite another, and assessment of its impact needs to take account of the incentive-structure which applies to those who are apparently intended to make use of the rights which company law confers. Further, the law may itself put obstacles in the way of collective

¹² See Company Law Review, *Completing the Structure*, Consultation Document 8 (DTI, London, November 2000) paras 4.49 – 4.62.

shareholder actions, for example, if it contains rules which make communication among shareholders difficult.¹³

(c) Setting the incentives of members of the board

The practical difficulties surrounding the exercise of removal rights explains in large part the interest in jurisdictions such as the UK in reform of the rules concerning the *composition and functioning* of the board. After the Cadbury Code of 1992 and now the Combined Code there is considerable pressure on listed companies¹⁴ to increase the number and role of non-executive directors (NEDs) and especially of *independent* NEDs on the boards. In particular, their role in the areas of audit, executive remuneration and board appointment is to be increased. In the US similar pressures have led to a position where the majority of members of the boards of large companies are NEDs.

The theory behind the NED-movement seems to be based on the supposed value of introducing onto the board a group of directors whose incentive structure is different from that of the executive directors and who, therefore, will be better positioned to discharge the traditional function of the board of monitoring the management on behalf of the shareholders. Thus, whereas shareholder removal rights are consistent with a structure in which the shareholders monitor the board and the board leads the company, the injection of a strong element of independent non-executive directors onto the board supposes that the board will perform a monitoring role as against the company's management as well as a role of setting the company's strategy. In this schema a continuous element of monitoring of management is provided by the non-executive directors which supplements the necessarily episodic monitoring which is provided by the shareholders collectively.

However, why should NEDs be thought to be effective monitors? There seem to be two arguments. The negative argument is that NEDs are not subject to the potentially high-powered conflicts of interest to which executive directors are subject. The scope which executive directors have to advance their own interests at the expense of the shareholders is not replicated in the case of non-executive directors. By itself, however, this argument might lead one to expect supine NEDs rather than ones who actively protect the shareholders' interests. The positive argument is that NEDs are subject to incentives, albeit low-powered ones, to do a good job on behalf of the shareholders,

¹³ For example, how easy is it for a shareholder to find out who the other shareholders in the company are and to communicate with them? This may depend in part upon whether shares are issued in registered form, but even if they are, a shareholder may not have free access to the register of shareholders.

¹⁴ For a discussion of the scope of application of the Combined Code see section VI below.

because in that way they will enhance their reputations and promote their careers. It has to be said that the jury is still out on how far, or in what circumstances, NEDs are capable of operating as effective corporate monitors. It is not clear that the reputational incentives are strong enough to induce NEDs to overcome strong opposition to board monitoring from dominant CEOs, at least without some degree of accountability of the NEDs to the shareholders.¹⁵ Equally, in some areas the NEDs may share, albeit at one remove, the same conflicts of interest to which executive directors are subject. For example, if NEDs are typically executives of other companies and/or are responsible to executives of fund management companies, they may share the same ‘high compensation’ culture as the executive directors and thus perform poorly as monitors of executives’ remuneration packages.

A strategy alternative or additional to the mandatory introduction onto the board of NEDs with different incentive structures to those of the executive directors is re-structuring the incentives of the latter.¹⁶ The aim now is to align the personal incentives of the management with those of the shareholders, normally by making a substantial element in the financial rewards granted to senior management dependent upon proof of achievement of shareholder-oriented goals. Instead of trying to constrain, through either shareholder or NED monitoring, the tendency of management to pursue personal goals, this strategy makes use of the personal goals of the management to advance the shareholders’ interests. As far as I am aware, no legal system requires this strategy to be adopted,¹⁷ but systems do vary in the extent to which they facilitate such alignment of executive and shareholder interests through share-option schemes or other forms of long-term incentive plans. Particularly important here are company law rules relating to non-standard share issues and share re-purchases and, of course, tax rules about the profits made on such schemes.

The risk involved in the adoption of incentive schemes for aligning management’s interests with those of the shareholders is that the process of setting the scheme will be captured by the executive directors. The resulting incentive schemes will thus be more an expression of the executives’ conflict of interest than a way of overcoming that conflict. Attempts to address this problem have focussed on three main elements: full disclosure of the detail of individual directors’ remuneration

¹⁵ For an instructive example see the recent debate in the UK about the failure of the non-executive directors of Tomkins plc to act with sufficient vigour to control waste of corporate assets by a strong CEO: *Financial Times*, October 31, 2000.

¹⁶ Anglo-American law has long facilitated this technique. Recently, Prof Ferrarini has remarked that, now, ‘these mechanisms have been subject to sweeping changes in Continental Europe’: ‘Shareholder Value and the Modernisation of European Corporate Law’, paper delivered at a conference on Company Law and Capital Market Law held at the University of Siena, March 2000, p 20.

¹⁷ Except, in some jurisdictions, in the weak form of requiring directors to have a minimum shareholding in the company.

packages; reducing the role of executives in setting their remuneration packages (remuneration committees to consist wholly of NEDs; shareholder approval of remuneration policies or packages); and requiring demanding performance criteria for the awarding of the incentives. However, the area of executive remuneration continues to be problematic. Governments are unwilling to set substantive pay levels or even to control rates of increase in remuneration in the private sector of market economies. On the other hand, there is good evidence of market failure in the setting of executive remuneration. Neither of the strategies discussed above (shareholder monitoring and monitoring by non-executive directors) seems to have been wholly successful in addressing such market failures. Consequently, even in countries in which ‘corporate governance’ reform has been taken a long way, the setting of executive remuneration remains an area of controversy.¹⁸

(d) Legal liability

Despite the fact that imposing liability upon directors who act incompetently or disloyally would seem to be an obvious legal strategy to deal with the principal/agent problem between management and shareholders as a class, this approach has been left until last, because it plays a relatively small role in constraining the activities of boards of directors. We are principally concerned here with a court reviewing managerial conduct *ex post* by reference to some fairly broad standard. All systems in principle have provisions which could be invoked to impose liability on directors who act incompetently. In practice, however, such provisions are invoked only in egregious cases: qualifications such as the business judgement rule, a subjective formulation of the duty of care or the requirement that directors need only avoid ‘gross’ negligence mean that such liability is not a routine way of monitoring the performance of boards. In principle, this seems correct. Litigation is an expensive and uncertain way of monitoring boards and judges are not necessarily expert in discharging the monitoring role. Nevertheless, competency standards do perform a necessary background role, by setting minimum standards, and the modern tendency has been to increase their rigour.

Turning to duties of loyalty, an obvious background rule to have in order to protect the interests of the shareholders as a class is one which requires the board to exercise its necessary discretion in the interests of the shareholders. In many legal systems, there is some doubt about the scope of this background rule, because the duty is said to be to further the interests of the ‘company’ and it is not clearly specified whose interests are the company’s interests. Even where, as in the reforms

¹⁸ See Pensions and Investment Research Consultants, *Corporate Governance 2000* (London, 2000), laying the blame in part on the freedom the Combined Code gives companies not to implement its recommendations fully, provided reasons are given for non-implementation (see section VI below); Department of Trade and Industry, *Directors’ Remuneration: A Consultative Document* (London, July 1999).

proposed by the Company Law Review in the UK,¹⁹ it is made clear that the company's interests are the interests of the shareholders as a class, the practical impact of this background rule is rather limited because of its subjective formulation, at least where there is a plausible commercial explanation for the directors' decision. For the same reason that it is undesirable to have the courts monitor the competence of directors, it is also undesirable to have them assess whether another decision than the one the directors actually took would have advanced the shareholders' interests more effectively. Both the competence and the basic loyalty rules are designed to catch only egregious cases.

Where the directors' lack of loyalty takes the more obvious form of self-dealing, courts are probably better at identifying the proscribed conduct, and legal systems tend to have stronger rules on self-dealing than other forms of lack of loyalty to the shareholders as a class. The issue which concerns all systems, whether common law or civil law, is how widely to distribute the power to initiate legal action against self-dealing on the part of the directors. Directors, even those not involved in the alleged illegality, may not have a strong incentive to begin legal action; whilst shareholders as a body in large companies may experience collective action problems in relation to the litigation decision just as they do in relation to any other class of decision they are allocated. Pushing the power to initiate litigation further down within the shareholder body, to either minority groups of shareholders or even to individual shareholders, creates the risk that litigation will not be brought in the interests of the shareholders as a class, but in order to promote the particularist interests of small groups of shareholders. Both the UK and Germany are currently wrestling with law reform in this area.²⁰

IV. Board rules and principal/agent problems between majority and minority shareholders

The importance of good legal protection for minority shareholders is now well recognised as an important policy issue if it is thought desirable to encourage outside investment in companies and the development of stock markets.²¹ Such protection is clearly a major task for core company law, but how far is it a task for board rules? The answer is that in principle the legal strategies identified above to deal with the management/shareholders as a class relationship can also be deployed to address the majority/minority shareholder relationship, but that in practice less use is made of board

¹⁹ See section VII below.

²⁰ For the UK see Law Commission, *Shareholders' Remedies* (Cm 3769, London, 1997); for Germany see Baums, *Gutachten F zum 63. Deutschen Juristentag*.

²¹ Bernard S Black "The Core Institutions that Support Strong Securities Markets" (2000) 55 *Business Lawyer* 1565.

rules to address the latter conflict than the former. We shall return to why this might be after we have analysed in the majority/minority context the legal strategies identified in the previous section.

(a) Allocation of functions to the board

The allocation of decision-making to the board, and thus away from the shareholders in general meeting, has the potential to protect minority shareholders against majority shareholders. This potential certainly exists in jurisdictions where the shareholders do not have strong removal rights as against the directors, and may even be true in jurisdictions where shareholders have strong removal rights in law but find it difficult to exercise them in practice. The point is that a board which is not directly responsive to the shareholders has less incentive to promote policies which advance the interests of the majority against the minority of the shareholders. In other words, whilst centralised management may be in the interests of both shareholders as a class and of minority shareholders, their interests may diverge over legal rules which facilitate the removal of directors by the shareholders (ie the majority). However, there is a clear trade off here, because boards which are not made responsive to the shareholders may pursue policies which are in the interests of neither majority nor minority shareholders. Protection of the minority as against the majority may thus be bought at the cost of relegating shareholders' interests within the company across the board.

Even where decision-making has been allocated to the shareholders in general meeting, the influence of the board (and, thus, possibly the interests of the minority shareholders) may be preserved to some degree by giving the shareholders only a veto right over the decision in question. In this situation, unless the board proposes a certain decision, the shareholders are unable to consider it; on the other hand, without the shareholders' consent the decision may not be adopted by the company. By contrast, in full shareholder decision-making the shareholders may both propose and approve the decision. Of course, minority interests can be directly protected, at least to some extent, by setting supermajorities for the passing of certain types of resolution or allowing minority shareholders to obtain a court review of the majority's reasons for adopting a particular resolution, but such techniques lie outside the scope of this paper since they do not involve to board rules.

(b) Appointment and removal rights

As we have seen, centralised management under a board relatively unresponsive to the shareholders creates only the potential of protection for minority shareholders. It does not guarantee that the board will protect the minority from either the majority's or management's self-interested decisions. A more effective technique of minority protection may be to secure representation of minority interests on the board. This may enable them to influence the board's decisions in their favour and,

at least, will put them in a position where they are better informed about the board's activities. Minority shareholders may be able to bargain for board representation, but mandatory rules on the matter are rare. The most obvious technique to promote minority representation on the board is cumulative voting, but that has never been a popular mandatory requirement except in the United States and even there it is now a requirement only in a small minority of states.²² The reason for this may be that where there is no strong conflict between majority and minority shareholders, cumulative voting is unnecessary; where such conflict does exist, cumulative voting simply shifts that conflict to the board and reduces the effectiveness of centralised management.

A lesser form of protection for minority shareholders which does not have the same potential to transfer conflict to the board room is to limit the voting rights of large shareholders through voting caps. Here, however, there is a clear conflict between the solutions to the two main principal/agent conflicts considered so far. A voting cap may hinder an overbearing majority from inflicting its will on the minority; it may also protect inefficient or self-seeking management against removal. In particular, a voting cap is likely to have the effect of making the removal of management by a successful take-over bidder much more difficult. It will chill take-overs and help to entrench management against such bidders, thus rendering less effective one of the primary tools for security management responsiveness to shareholders as a class.

(c) Legal Liability

For the reasons given in the previous section, it is doubtful whether judges are better arbiters of majority/minority conflicts than they are of management/shareholders as a class conflicts. However, in this area too legal rules perform an important background function, setting minimum standards, and so there is a case for using liability rules to provide a basic level of protection for minorities. There seem to be two basic approaches. One is to extend the competence and loyalty duties currently owed by directors. They may be extended in terms of the beneficiaries of the duties, so that they are owed not only to 'the company' (shareholders as a class) but also to individual shareholders. They may also be extended in terms of who is subject to the duties, ie beyond the directors of the company. Since the controllers may exercise their powers as shareholders as well as directors, it would be necessary, on this approach, to impose such duties on controlling shareholders as against non-controlling ones, at least in some cases. This latter extension may be particularly useful within groups of companies when it can be used to impose liability in appropriate cases on the parent company vis-à-vis the outside shareholders of a subsidiary company. However, within

²² See Jeffrey N Gordon, 'Institutions as Relational Investors: A New Look at Cumulative Voting' (1994) 94 *Columbia Law Review* 124, especially at pp 142-160. Note, however, the recent use of cumulative voting as a 'self-enforcing'

individual companies there seem to be strong arguments against replicating in favour of individual shareholders the duties owed by directors to shareholders as a class. The main argument against is that it amounts to a subversion of the collective nature of the company.²³

An alternative approach is to fashion distinct legal duties owed to minority shareholders. These duties, too, should be placed on the ‘controllers’ of the company, so that it does not matter whether the majority express their influence via decisions of the board or of the shareholders’ meeting. The main problem in fashioning such duties is to determine the standard(s) by which the conduct of the controllers is to be judged. Giving the courts a free reign to determine the balance of advantage between controllers and non-controllers is likely to be welcomed by neither business people nor the judges. A minimalist form of intervention, which has been adopted by the courts in the UK, is to use such ‘unfair prejudice’ laws to enforce informal agreements and arrangements upon which minority shareholders came into the company, whether or not these understandings were embodied in the company’s formal constitution. Such an approach confines the courts to enforcing the shareholders’ own bargain, albeit an informal one.²⁴

(d) Conclusion

It is clear from the above that board rules can make a contribution to the principal/agent problem as between majority and minority shareholders, but that contribution is a modest one. There are two reasons for this. First, this task is better allocated to other parts of core company law. For example, minorities may be protected by the rules relating to voting at shareholder meetings (to be discussed at another session of the conference) or by the rule found in most jurisdictions that distributions by companies to shareholders must be pro rata to the equity holdings of those shareholders. Second, as we have noted, adjusting board rules as to address the majority/minority conflict may well make the board rules less effective at dealing with the first agency problem (management and shareholders as a class). There may thus be a trade-off between rules addressing the two sets of problems and legislators may have chosen to give greater prominence to first agency conflict. Alternatively, there may be thought to be a comparative advantage in using board rules to address the first agency conflict whilst using other parts of company law to address majority/minority conflicts. The board is institutionally the body which mediates between shareholders and management and it thus provides a natural focus for legal rules addressing the first agency conflict. Majority/minority conflict is not necessarily focussed on the board and thus is open to regulation by non-board rules.

mechanism for the protection of minorities in the new Russian corporate law.

²³ This issue is different from the issue discussed in section III(d), which was whether the individual shareholder should have the right to enforce *on behalf of the company* breaches of duties owed by directors to the company.

²⁴ See P.L.Davies, *Gower’s Principles of Modern Company Law* (Sweet & Maxwell, 6th ed, London, 1997) pp 742-745.

V. *Board rules and controller/stakeholder agency problems*

The third use to which board rules may be put is for the protection of non-shareholder stakeholder interests. As already indicated, the only stakeholder interests which are in fact significantly protected in this way are those of the creditors and the employees. However, whilst creditor protection is an important function of all company laws, the use of board rules to protect creditors is not well developed in any system, at least whilst the company is a going concern. This seems to be because, at a general level and short of insolvency, the creditors' interests are well protected by the duty upon the board to advance the interests of the 'company' (however that may be interpreted); whilst specific types of company opportunism as against creditors can be controlled by rules other than board rules. Thus, the risk of controllers shifting assets out of the corporate 'box' to the detriment of creditors can be met by rules on capital maintenance or restricting the financial circumstances in which distributions may be made to shareholders, which rules apply whether the decision which would contravene them is one proposed to be taken by the directors or the shareholders.

By contrast, employee protection through company law is not a feature which all jurisdictions display, but where company law is used in this way, it does tend heavily to involve board rules. In fact, control of the company/employee agency problem through company law is almost synonymous with employee representation on the board, ie the use of board rules to implement the policy. As with the use of board rules to control majority/minority shareholders agency problems, however, there is often a trade off between use of board rules to control the management/shareholders-as-a-class agency problem and that arising between companies and non-shareholder stakeholders.

(a) Appointment and removal rights

Creditors can bargain for board representation, but company laws seem not to require such representation. This is true, at any rate, up until insolvency intervenes, when the right to appoint the controllers of the company usually passes to the creditors or some sub-group of them or to a court acting in the interests of the creditors, and the board is displaced. However, it is controversial how early in the insolvency process the board should be displaced by representatives of the creditors. Debtor-friendly jurisdictions will allow the unsuccessful board to remain in place much further into

the insolvency process than creditor-friendly jurisdictions.²⁵ Postponing creditor access to control of the company may be a policy adopted to ‘encourage entrepreneurs’ (ie the incumbent management and/or the shareholders) and/or to protect stakeholder interests other than the creditors. For example, a ‘work out’ may be thought to benefit employees, customers and suppliers as well as the incumbent management of the company. It is a matter of judgement whether work outs are helped or hindered by postponing creditor control of the company.

As already indicated, use of company law to regulate the company/employee agency problem invariably involves board rules if jurisdictions use company law in this way at all. Appointment rights for employees to one third or less of the board are quite widespread in Europe. In Germany large companies (more than 2000 employees) are subject to quasi-parity representation on the board (ie the employees appoint half the members of the supervisory board, though the shareholders through the chair of the board usually retain the balance of power). The appointment rights may be vested in the employees as a whole or in representative trade unions or some mixture of the two. Evidence from Germany, where the matter has been extensively researched,²⁶ suggests that employee representation at board level acts both to reduce the principal/agent problem as between company and employees and to reduce the effectiveness of the board in regulating the management/shareholders-as-a-class agency problem. For example, shareholders acquiesce in the supervisory board being kept at a distance from the management board, because of the employee representation in the latter but not the former. Thus, apparently dysfunctional features of the supervisory board when view from the management/shareholder perspective (large size, infrequent meetings, caucusing of the employee and shareholder representatives in advance of board meetings) may prove functional when viewed from the company/employee perspective.

Finally, it should be noted that employee representation at board level is inconsistent with indifference on the part of the law towards the distribution of functions as between shareholders’ meeting and the board. If employee representation at board level is to function effectively, the law cannot leave the division of functions between these two bodies (or as between board and management) under the control of the shareholders. Instead, it will be necessary to specify it through mandatory rules of company law.

(b) Setting incentives

²⁵ Philip R Wood, *Principles of International Insolvency Law* (Sweet & Maxwell, London, 1995) especially pp 204-206.

²⁶ Hopt ‘The German Two-Tier Board: Experience, Theories, Reforms’ in Hopt et al (eds), above n 10 at p 225.

Structuring the incentives of board members so as to encourage them to advance the interests of non-shareholder stakeholders is a difficult task and seems to be undertaken only within the Dutch ‘structure’ regime which applies to medium and large-sized domestic companies. Here the board is a self-appointing body, but both the shareholders and works council have a limited right to challenge before a court appointees in whom they are not confident. In this unique arrangement, the management achieves a high degree of independence from both shareholders and employees, but is subject to some low-powered incentives to promote the interests of both these groups in order to retain their confidence.

(c) Liability rules

In countries which do not have employee representatives at board level, it is often proposed that a first step towards the protection of stakeholder interests is to relax the legal duties owed by directors to promote the interests of the shareholders as a class. Perhaps the best known example of this approach is the ‘constituency’ statutes in the United States which permit, but do not require, directors to take into account the interests of all stakeholders in the company when taking decisions, especially decisions in the face of take-over bids but sometimes more generally.²⁷ It is doubtful, however, whether such provisions deliver any substantial degree of protection to stakeholder interests, as opposed to the interests of incumbent management, except to the extent that stakeholder interests coincide with those of management.²⁸ It is unlikely that this assessment needs to be changed in the case of rules which *require* directors to have regard to a range of stakeholder interests. Unless the range of persons empowered to enforce the duty is extended to include members of the stakeholder groups and unless the courts adopt a bold and interventionist stance when reviewing management’s choice among the conflicting stakeholder interests, it is unlikely that a duty to promote a range of stakeholder interests will produce a bigger positive impact in practice on stakeholders than a discretion to promote their interests. In both cases, entrenchment of incumbent management is likely to be the largest effect of such rules.

On the other hand, amendment of the liability rules so as to replace the shareholders with a single other stakeholder group as the object of the directors’ discretion may have an impact, to the extent that liability rules are effective at all. All systems now recognise that, as the company nears insolvency, the residual claimants on the company become the creditors rather than the shareholders. This perception may be reflected in the liability rules applying to directors, as the

²⁷ For examples of such provisions see C. O’Kelly and R. Thompson, *Corporations and Other Business Associations: Selected Statutes, Rules and Forms 1998* (Aspen Law & Business, New York, 1998) pp 345-348.

²⁸ For an analysis see Lucian Arye Bebchuk and Allen Ferrell, ‘Federalism and Corporate Law: The Race to Protect Managers from Takeover’ (1999) 99 *Columbia Law Review* 1168.

company nears insolvency, so that the directors' primary duty becomes that of advancing the interests of the creditors. Alternatively, creditor protection may be made available by creating duties within insolvency law which nevertheless reach back into the pre-insolvency period and control the directors' actions in the interests of the creditors before any formal act of insolvency.²⁹

VI. *Current trends*

(a) The rise and fall of company/employee agency issues

There have been two main waves of reform of board rules in Europe in the post-war period. The first wave concentrated on the third set of principal/agent problems identified above and in particular on company/employee relationships. The best known expression of this reform movement was the extension in Germany of employee representation rights at supervisory board level from one third of the seats³⁰ to one half in the case of companies employing more than 2000 workers,³¹ although this was done in such a way as normally to retain the right of the shareholders to prevail in case of deadlock.³² The extension of co-determination rights in Germany in the 1970s was much more significant than the adoption of the one-third scheme in the early 1950s. This was not simply because the 1976 law gave the employees a greater proportion of board seats. The one-third scheme of 1952 (and the special provisions of 1951 for the iron, steel and coal industries) could be seen as part of a post-war social settlement which was particular to Germany, just as the introduction of life-long employment in Japan at approximately the same time could be viewed in this light.³³ However, the extension of employee representation rights in Germany in the 1970s was part of a much wider European movement in this direction. A number of countries introduced board level employee representation in this period (though not a more than the one-third level), among them Austria, Denmark, Luxembourg, Netherlands, Norway and Sweden.³⁴ The matter was even debated seriously in the UK, where the traditions of both company and labour law might have been thought to be hostile to such a development. A Government committee came up with a recommendation in favour of a British version of quasi-parity representation of employees at board level.³⁵ If the

²⁹ See, for example, the 'wrongful trading' provisions of the UK Insolvency Act 1986, s 214.

³⁰ As laid down in the *Betriebsverfassungsgesetz* of 1952.

³¹ *Mitbestimmungsgesetz* of 1976. For the purposes of brevity the special provisions operating in the iron, coal and steel industries are left on one side.

³² The casting vote is given to the chair of the supervisory board who is normally a shareholder representative. This aspect of the scheme was important for the constitutionality of the new law in the eyes of the *Bundesverfassungsgericht*: judgement of March 1, 1979, 50 BverfGE/90.

³³ See Ronald Gilson and Mark Roe, *Lifetime Employment: Labor Peace and the Evolution of Japanese Corporate Governance* (1999) 99 *Columbia Law Review*

³⁴ Eric Batstone and P L Davies, *Industrial Democracy: European Experience* (London: Her Majesty's Stationery Office, 1976) p 51.

³⁵ *Report of the Committee of Inquiry on Industrial Democracy* (Cmnd 7231, London: HMSO, 1978)

proposal had had greater support from the union movement and had aimed at a more modest starting point (say, one-third representation). It might well have been adopted.

The focus of board rules on company/employee agency relations did not survive the 1970s, presumably because, with the restructuring of industry, the onset of recession and the consequent decline in union membership and trade union power in most (though not all)³⁶ European countries, this set of problems became less pressing for policy-makers. The concerns of current labour law (flexibility, human capital development, work/life balance, partnership) tend not to direct attention particularly to board rules. The story of the move away from an exclusive focus on board rules is reflected rather nicely in the history of the various drafts of the EU proposals for a Fifth Company Law Directive and, even more so, for a European Company Statute. The drafts of these instruments from the late 1960s and early 1970s contemplated mandatory rules (based on the extant German or Dutch models) to provide some level of board representation for employees in all cases. These proposals were gradually made more flexible over the succeeding years so that board representation became just one of a number of techniques for providing employee representation in relation to the central management of the company (or group). Other techniques, which operate without reference to board rules or indeed to company law (such as works councils or collective bargaining), were given equal status.³⁷

Nevertheless, even in this more flexible form, some form of participation was mandatory in the SE. In the common position eventually adopted by the Council in December 2000, a big dose of relativism was introduced into the project: participation, in whatever form, would be obligatory only if a significant proportion of the workforces in the companies forming the SE were already subject to mandatory participation under national law.³⁸ The cost of this approach is, of course, that it reduces yet further the degree of commonality in the rules to which European Companies are subject, which is said to be one of the prime considerations for the creation of a federal form of incorporation.

Despite these changes of direction at Community level, individual countries which made changes in their board rules in the 1970s in order to introduce or extend employee representation seem to show no tendency to repeal these rules. Consequently, even if, as argued below, the focus of attention has move on in all European countries to the promotion of shareholder value, that policy needs to be

³⁶ Sweden is a notable exception.

³⁷ See [1982] OJ C 240/44 (draft Fifth Directive); [1989] OJ C 263/69 (draft SE).

³⁸ The text of the common position has not yet been published officially, but the outline of the proposals has been given in Press Releases from the European Commission, available on its web-site.

implemented in countries which have opted for board level representation of employees in the context of such representation. In short, this is an example of the well-known thesis of ‘path dependency’:³⁹ the most efficient reform of legal rules in response to change in context depends in part upon the current state of those rules, so that countries responding to the same change in context may do in different ways according to their different current sets of rules. If a Country A has committed itself to board level representation of employees as an effective way of addressing company/employee agency problems,⁴⁰ it may be efficient for it to address the new demands of shareholder value via changes other than in board rules; whereas Country B, which made the opposite choice at an earlier time in relation to board rules and employee agency problems, may identify board rules as a natural focus for changes responding to shareholder value. Thus, one might contrast the extensive regulation of the board in the interests of shareholders by the Combined Code of the UK Listing Authority⁴¹ with the failure to secure in Germany acceptance of even a modest proposal to reduce the size of the Supervisory Board of AGs because of the adverse impact this was thought to have upon employees’ codetermination rights.⁴²

It should be noted that this argument merely explains why in responding to shareholder value concerns it may be efficient for the UK to focus on board rules and for Germany not to do so or to do so to a lesser extent. It tells one nothing about which country, overall, can be said to have responded more effectively to shareholder value concerns, ie after the changes have been made. Still less does this argument tell one which country provides the more efficient system for responding to shareholder and employee agency problems taken together. The answer to these questions would require further analysis.

(b) The rise of shareholder value⁴³

The second main wave of reform in board rules in the post-war period has responded to the rise (or, better, resurrection) of the shareholder interest in companies. The reasons for the resurrection of the shareholder interest are tolerably clear. The capital markets now play a bigger role in financing business across the spectrum. In Europe the main competitor to capital market finance for large

³⁹ Lucian Ayre Bebchuk and Mark J Roe, ‘A Theory of Path Dependency in Corporate Ownership and Governance’ (1999) 52 *Stanford Law Review* 127.

⁴⁰ That board level rules do efficiently deal with company/employee agency problems has been argued by E Gerum and H Wagner, ‘Economics of Labor Co-determination in View of Corporate Governance’ in Hopt et al (eds), above n 10, at p 341.

⁴¹ Above n 3.

⁴² Hopt, above n 26 at p 255-256.

⁴³ A discussion of this issue from a UK perspective can be found in my paper, ‘Shareholder Value: Company and Securities Markets Law – A British View’ available from SSRN at http://papers.ssrn.com/paper.taf?abstract_id=250324

enterprises, namely the taxpayer, has substantially retreated from the scene. Privatisation, of course more advanced in some countries than in others, has made its mark everywhere, even in industries or services which are ‘natural monopolies’. Even the delivery of welfare state policies has been contracted out to some extent to the private sector, with the public service tending to concentrate on its core function of policy setting.

However, it is not simply a ‘taxpayers’ revolt’ or the need to meet the convergence criteria for the single currency which have produced greater recourse to capital markets. Businesses which have always been in the private sector need better access to capital markets for success, partly as a result of globalisation and the increased competition it generates and partly as a result of changes in technology. Three examples must suffice to make the points. Many countries have seen a ‘demutualisation’ of private sector companies, especially in financial services providers. Thus, in order to facilitate the raising of capital, businesses which were formed under a legal regime in which control rights were allocated to its customers (for example, policy-holders in insurance companies or depositors or borrowers in home loan associations) have reformed as standard companies with control rights allocated to shareholders who are not necessarily customers of the company. Second, a number of high profile European companies, especially from Germany, have sought listings on the US capital markets, usually the NYSE. This provides two advantages to them in their global ambitions. One is access to the world’s biggest capital market for the purpose of raising capital. The second, and equally if not more important, is access to a more liquid market which makes the company’s securities more marketable and, in turn, a better currency for financing acquisitions.⁴⁴ Finally, at the start-up end of the spectrum the willingness of venture capitalists to put money into high-tech companies depends crucially upon an effective exit route being available for the venture capitalist once the company is off the ground. Although not by any means the only conceivable exit route, an available public market on which young companies can be floated is an important bit of infrastructure for venture capitalists.⁴⁵

(c) Shareholder value and the management/shareholders-as-a-class agency problem

Our concern is with the implications of these developments, not just for company law, but for board rules. They show themselves most fully in the last decade’s ‘corporate governance’ reforms, though other examples could be taken. Let us look in turn at the first and second agency problems identified at the beginning of this paper. In the US, where the corporate governance movement

⁴⁴ See the discussion of the Daimler/Chrysler case by John C Coffee, ‘The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications’ (1999) 93 *Northwestern University Law Review* 641.

⁴⁵ Ronald Gilson and Bernard Black, ‘Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets’ (1998) *Journal of Financial Economics* 47.

began, and in the UK, where considerable attention has been given to this topic over the past decade by four high-powered committees,⁴⁶ it is clear that corporate governance reform is seen as being addressed to the principal/agent relationship between the management and the shareholders. Both the American Law Institute's *Principles of Corporate Governance* and the UK Listing Authority's Combined Code focus unambiguously on this problem. The issue, as stated, is how to provide an appropriate level of monitoring of management in a universe of dispersed shareholdings, given that even the rise of institutional shareholders in both the US and the UK has not generated the strong incentives to monitor management which block-holding provides.⁴⁷ The answers given in both these documents revolve around assigning a greater role for NEDs, especially independent NEDs, on the board, particularly in areas of likely acute conflict of interest between management and shareholders: audit, remuneration and board appointments. In particular, it is hoped to counteract the dominance of the company by a single powerful CEO.⁴⁸

Since these codes constitute a much greater interference in the internal governance arrangements than company law has traditionally contemplated, it is perhaps not surprising that they are not made legally binding through company law. At best core company law provides indirect backing for the codes, for example, as where a board decision not to initiate litigation against alleged wrongdoing by senior management is more likely to be upheld by the courts if the decision was taken by independent NEDs. Binding force is given to the codes, in so far as it is given at all, via stock exchange rules, ie by the institutions which are specifically designed to link investors with companies. Even so, in the case of the Combined Code the UK Listing Rules require merely that the company complies with the Combined Code or explains its non-compliance. Whether any action adverse to the board follows from its non-compliance is a matter for the shareholders of the

⁴⁶ Chronologically, the Cadbury (1992), Greenbury (1995), Hampel (1998) and Turnbull (1999) Committees.

⁴⁷ See the analysis by the Company Law Review, above n 12, paras 4.49 – 4.62..

⁴⁸ The salient features of the Combined Code are as follows:

- The board has a dual function, both to 'lead' and to 'control' the company.
- At least one third of the board as a whole should be non-executive directors [NEDs], most of whom should be independent. Independent means 'independent of management and free from any business or other relationship with the company which could materially interfere with the exercise of their independent judgement.' As with the board as a whole the NEDs have a role both in setting the company's strategy ('leading') and 'controlling' it. In the case of the non-executive directors, however, 'controlling' includes monitoring the performance of the company's executive directors.
- There should be introduced committees of the board to deal with certain specific matters on which the NEDs should be the only or the majority of the members. These are the audit, remuneration and appointment committees.
- In principle, the CEO and the chair of the board should not be the same person. However, the chair of the board need not be a NED, still less an independent NED, so that, as in Germany, the chairman of the board may be a former CEO of the company. The Company Law Review was not inclined to recommend reform on this point.⁴⁸ Whether the roles are combined or not, however, there should also be an identified senior independent NED on the board with whom the shareholders can liaise.
- There should be a formal statement of the matters on which the board's decision is necessary.
- The NEDs should have access to appropriate outside professional advice and to internal information from the company.

company, not for the stock exchange or listing authorities. A surprisingly high degree of compliance with the Combined Code has been achieved through this mechanism, mainly because the Combined Code has been taken up enthusiastically by institutional investors in the UK. It is becoming clear that non-compliance with the Combined Code is not sustainable over long periods of time, given the commitment by institutional shareholders to the precepts of the Code.⁴⁹ In sum, we should not underestimate the importance of the corporate governance codes on the grounds that they have not become part of traditional company law. If one takes a functional view, it is clear that the universe of board rules with which listed companies must comply has been significantly extended by the corporate governance rules.

Thus, the corporate governance codes have had a major impact on the board rules in those jurisdictions where the first agency problem (managers and shareholders) has been the traditional focus of company law. An interesting question is what impact they have had on jurisdictions (typically those of continental Europe) where the main agency problem is that between majority and minority shareholders. One form of impact might occur when companies incorporated in such jurisdictions choose to list on a foreign exchange where the codes are in force. However, the effectiveness of this step would depend upon how far foreign issuers are subject to the corporate governance provisions of the exchange in question.

This is a topic on which full-scale analysis has not been carried out, but, on a preliminary view, there seems to be a distinction between the approaches of the British Financial Services Authority, on the one hand, and the New York Stock Exchange and the Securities Exchange Commission on the other. The listing rules of the FSA seem to take the view that corporate governance is functionally a part of company law. That view is then reflected when drawing the traditional distinction between company law as a matter for the jurisdiction of incorporation or of the company's headquarters, and capital markets law as a matter for the jurisdiction where the securities are traded. Thus, the UK listing rules require compliance with the Combined Code only on the part of companies which are *both* listed on the London Exchange and incorporated in the UK.⁵⁰ In consequence, the UK corporate governance standards are of no concern to a company listed outside the UK.

⁴⁹ See 'Split in top jobs demanded', *Financial Times*, November 16, 2000.

⁵⁰ Above n 3, para 12.43A.

By contrast, although the US operates the same principle of private international law, so that foreign companies listed on the US exchanges do not become subject to US corporate law,⁵¹ nevertheless the listing agreements of the NYSE, AMEX and NASDAQ do require all issuers, even foreign ones, to accept certain corporate governance standards. In particular, the NYSE requires all issuers to have two outside directors and to establish an audit committee composed of independent directors.⁵² Thus, listing on a US exchange offers the opportunity for foreign companies to bond themselves to certain corporate governance standards in the way that a UK listing does not.

An alternative way in which the Anglo-American codes may have an impact in continental European countries is through their adoption and adaptation by exchanges or other bodies representative of large companies in those countries. In fact, in the wake of the Cadbury report a large number of continental European countries embarked upon similar initiatives, taking Cadbury as a starting point.⁵³ At first sight, this is a highly surprising development. For countries where the main problem is the second agency problem (majority/minority shareholders) to take as the starting point for a corporate governance code one designed for the situation where the first agency problem (management and shareholders) is the dominant one seems irrational. Indeed, this may well explain why the continental European initiatives with corporate governance codes have generally been less rigorous, especially at the point of enforcement, than have the Anglo-American codes.

Nevertheless, the wide adoption of such codes in continental Europe must tell us something about perceived principal/agent problems in those countries. It is suggested that two things emerge on analysis. First, some techniques for addressing the first principal/agent problem may also work to some degree in relation to the second principal/agent problem. Thus, independent directors might be thought to be a way of addressing both sets of issues. ‘Independent’ directors could operate to protect minority shareholders against company controllers as much as they do shareholders as a class as against management, though the emphases in the definition of ‘independence’ would be rather different in the two contexts.⁵⁴ Second, the attraction of domesticating the Anglo-American

⁵¹ If this were the case, there would be the additional tricky problem of working out which state’s rules applied.

⁵² Coffee, above n 44.

⁵³ These codes helpfully collected together on the European Corporate Governance Network web-site: www.ecgn.ulb.be. Prof Ferrarini has remarked: ‘On the whole, market discipline is breaking new ground in Continental Europe, as an essential supplement to corporate law, and the codes of best practice play an important role with respect to directors and investors.’: above n 16 at n 51.

⁵⁴ This contrast is nicely caught in the definitions of independence in the Combined Code and the first ‘Viénot’ report in France: only the latter specifically mentions independence from shareholders. Thus, the Combined Code: ‘The majority of the non-executive directors should be independent of management and free from any other business or other relationship which could materially interfere with the exercise of independent judgement’ (para A.3.2). Viénot: ‘C’est que la définition de l’administrateur “indépendant” ne l’oppose pas seulement aux directeurs généraux ou aux salariés de l’entreprise, mais également à tous ceux qui ont un intérêt particulier à leur relation avec celle-ci: actionnaires,

corporate governance model in continental European countries may be as a response to changes which can already be detected in share ownership patterns. In particular, increasing levels of investment by US and UK funds in continental European equities⁵⁵ may be seen as heralding a move towards more dispersed ownership patterns, especially when taken in conjunction with domestic moves in the same direction.⁵⁶ In any event, exchanges and others in continental Europe may wish to encourage this inward portfolio investment by providing a corporate governance environment which approximates to that to be found in the in the funds' home states.

(d) Shareholder value and majority/minority shareholder relationships

The thesis sketched above about the much enlarged role played by capital markets in company finance would lead one to expect that countries where the prevalent pattern of shareholding is one based on large blocks would take steps to enhance the levels of protection for minority shareholders. Without such enhancement investors might be unwilling to buy securities issued on the market by companies where ownership is concentrated in this way. It is possible to identify legislative trends which fit into this pattern. At EU level Directive 89/592 extends the prohibition on insider trading throughout the union and will, if the national laws are effectively enforced, deprive block-holders of one obvious way of diverting to themselves the private benefits of control. More far-reaching are legislative reforms at national level. A particularly good example of changes bolstering the position of minority shareholders are the recent 'Draghi' reforms in Italy. Amongst other things, these reforms gave minority shareholders representation on the supervisory board of internal auditors (*collegio sindacale*); improved shareholder rights to require the summoning of shareholder meetings, to secure court investigation of the company's affairs in the case of allegations of serious misconduct, and to bring derivative actions on behalf of the company; and introduced a mandatory bid rule in takeovers. Although an (or at least this) outsider cannot judge how effective these reforms are likely to be in practice, they clearly carry the potential to strengthen the position of minority shareholders, though in the case of the mandatory bid rule equal treatment of majority and minority shareholders in a take-over bid may have been purchased at the cost of reducing the incentives for block-holders to sell out to bidders, because they can no longer secure a premium for the sale of control in the company.⁵⁷ One should note too that, as indicated above, that

fournisseurs clients . . .' The first Viénot Report can be found in Hopt and Wymeersch (eds) *Comparative Corporate Governance* (Berlin: De Gruyter, 1997) at M-91.

⁵⁵ Thus, the Committee on Corporate Governance, *Recommendations on Corporate Governance in the Netherlands* (Amsterdam, 1997) gave at p 9 as one of the main reasons for its initiative: 'increasing interest from institutional investors on the international stock markets, the Netherlands included, and growing shareholder activism, further intensified by the increased ownership of Dutch shares by foreigners.'

⁵⁶ For example, recent proposed German tax changes which would make the disposal of blocks of shares more attractive and recent surge of interest in corporate governance principles in that country.

⁵⁷ The mandatory bid rule is a common feature of takeover regulation in Europe, though often with some differential between the highest price paid to acquire the controlling block and that contained in the public offer. The mandatory bid

these reforms do not limit themselves to board rules, even if for these purposes one takes the internal auditors as part of the board structure of large Italian companies. The Draghi reforms have recourse to provisions falling outside the scope of board rules, such as the rules relating to the summoning of shareholder meetings or those controlling the terms upon which a bidder may offer to purchase the shares of a target company.

VII. Conclusions

The argument has been advanced in this paper that board rules can in theory be used to address any or all of the three principal/agent problems with which core company law deals. These are those between management and shareholders as a class; those between controlling and non-controlling shareholders; and those between company controllers and non-shareholder stakeholders. It has been suggested, further, that in recent years reform of board rules has been influenced mainly by the need to ameliorate the first principal/agent problem. This is because of the rise to prominence of the goal of shareholder value which is associated with the greater role played by capital markets in financing large-scale enterprise. To be sure, shareholder value would suggest more security both for shareholders as a class (where shareholdings are dispersed) and for minority shareholders (where shareholdings are concentrated in the hands of block-holders). Across company law as a whole one can detect reforms aimed to promote both types of shareholder protection. However, it has been suggested that, as far as board rules are concerned, which are the topic of this paper, they are the natural focus of reform efforts which aim to address the first agency problem, whereas reforms aimed at dealing with the agency relationship between controlling and non-controlling shareholders spread themselves more widely across company law.

With regard to stakeholder agency problems, recent reforms of board rules have not touched on this issue to any significant degree. Improvements in the levels of protection for creditors and employees, the stakeholder groups traditionally recognised by company laws, seem not to be strong policy imperatives at the present time. Indeed, in the case of creditors there is some questioning in some countries as to whether the levels of protection afforded to secured creditors are too high. Employee representation at board level is well entrenched in some jurisdictions, but seems not to be the subject of proposals for extension.

rule will be extended to all EU countries by the proposed Directive on takeovers, if it is adopted in its present form. It is interesting that the Council's common position (above n 11) does not require the minority to be paid the same price as the block-holder but only an 'equitable' price, whereas the recommendations of the relevant committee of the European Parliament (*ibid*) insist on the same price. These divergences probably reflect different views on the desirability of encouraging takeovers.

However, it would be wrong, even confining one's focus to board rules, to conclude that the only policy imperative is the straightforward promotion of shareholder value. Those who argue for the proposition that company law in general, and board rules in particular, should place the interests of the shareholders at the centre of attention do not necessarily deny the proposition that the purpose of company law is to promote the wealth of society as a whole. How does one reconcile this broad goal with the narrow focus on the shareholder interest in the design of board rules? The answer can be given⁵⁸ that the interests of shareholders can be most efficiently protected by confining the board to the promotion of the shareholder interest, whilst non-shareholder interests can be most efficiently protected outside board rules and even outside company law altogether, for example, via self-help based upon private contracting (particularly important for creditors) or via mandatory rules located in other areas of law, such as labour law, consumer law or the law relating to commercial transactions. This approach makes it unnecessary to engage in the trade-offs which are inherent if board rules are used to promote the interests of those other than shareholders. Moreover, provisions outside the area of board rules may give non-shareholder interests greater protection than board rules would. Mandatory rules from labour, consumer and commercial law set the parameters within which board discretion is to be exercised and thus may give greater protection than simply requiring directors to take these stakeholders interests into account when exercising a discretion which, in the absence of the relevant labour law etc rules, would be broader. It follows from this analysis that the answer to the question of how a legal system deals with the company controller/stakeholder agency problem cannot be answered simply by analysing the rules of company law. Those rules must be assessed in the context of the contribution made to the issue by a number of other areas of law.

Finally, even if the force of the above arguments is acknowledged, it may be too categorical approach to conclude that company law, and board rules, have no contribution to make to the company/stakeholder agency problem. Company law may be well placed to *support* stakeholder-directed policies embodied elsewhere in the law, especially policies of stakeholder self-help. Certain techniques which company law has developed for the purposes of shareholder protection may be capable of extension so as to promote, albeit in a secondary way, stakeholder policies. Because these techniques are located within company law, it may be efficient, in terms of legislative effort, to use company law to promote stakeholder policies. The most obvious example of such a technique is disclosure. Because company law has developed highly sophisticated rules on disclosure in the interests of shareholders and creditors, it may be sensible to centralise within company law disclosure rules whose aim is to benefit primarily other groups. One can see this

⁵⁸ Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law', available from the Social Science Research Network Electronic Paper Collection.

policy in the use by the Company Law Review in the UK of disclosure obligations within company law to support stakeholder-oriented policies.

The Company Law Review⁵⁹ proposes to create in the UK a high-level statutory statement of directors duties, which previously had been embodied mainly in common law judicial decisions. In proposing its formulation the CLR has had to address the issues discussed in this paper and at first sight what it proposes is to focus board rules in the UK solely on the first agency problem. Thus, it proposes that the traditional formulation that the duties of directors are owed to ‘the company’ should be clarified so that ‘the company’ is made to mean the members (shareholders) as a whole.⁶⁰ So far, this appears as a pure shareholder value approach. However, the suggested formulation goes on to *require* the directors, in promoting the interests of the shareholders as a whole, to take into account ‘the company’s need to foster its business relationships, including those with its employees and suppliers and the customers for its products and services; the impact of its operations on the communities affected and on the environment; and its need to maintain a reputation for high standards of business conduct.’

It is not proposed that this ‘inclusive’ duty be enforced primarily by legal action. Although such action is available in principle, it is doubtful whether it is so in practice, except in egregious cases. This is because this part of the directors’ duties is formulated in a highly subjective manner: the director must exercise his discretion ‘in the way he believes in good faith is best calculated in the circumstances’ to promote the shareholders’ interest. The bite behind the requirement to take into account stakeholder interests when promoting the interests of the shareholders lies in an application of the disclosure principle. The CLR proposes to add to the documents which large companies must produce and make public on an annual basis an Operating and Financial Review⁶¹ which, where this is material, must include information relevant to the discharge by directors of their inclusive duty. The proposal for the reform of company law does not go beyond mandatory disclosure: what use is made of the information disclosed is then up to those who have an interest in it, whether shareholders, employees and their representatives, customers or suppliers, and will depend on the opportunities available to them to apply pressure, whether through legal mechanisms or otherwise.

⁵⁹ Company Law Review Steering Group, *Developing the Framework* (Department of Trade and Industry, London, March 2000) paras 3.9-3.86.

⁶⁰ The director must exercise his powers so as ‘to promote the success of the company for the benefit of its members as a whole.’ (para 3.40) This does not involve prioritising short term interests of the members over their long-term interests: *ibid.* The company as the members was probably the view of the common law, but this was not absolutely clear, and the situation has been further complicated by the introduction in 1980 of a provisions (now Companies Act 1985, s 309) requiring the directors to take account of the interests of the employees as well as of the shareholders.

⁶¹ *Ibid.*, paras 5.74-5.92. Such a report is not required by the companies legislation at present, though listed companies are required to produce a more narrowly focussed OFR than the CLR recommends.

The point for company law, however, is the efficiency of a proposal which uses the well-developed disclosure rules of company, elaborated historically with shareholders and creditors in mind, to support self-help on the part of a wider range of stakeholders.