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**Definition and Enforcement of Main Directors Duties
in OECD Countries**

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DEFINITION AND ENFORCEMENT OF MAIN DIRECTORS DUTIES IN OECD COUNTRIES

by Kevin Fogarty

Preface

It is widely remarked that in OECD countries there is an emerging convergence in attitude and practice regarding corporate governance principles, including the duties of board members and the appropriate procedures and structures for implementing and enforcing them. This is attributed to the rise of equity markets fed by increasing capital needs, privatization, and increasing cross-border investment.

We should note at the outset, however, that the companies that are the subject of the “convergence” discussion, and so enable a semi-coherent discussion of practice in OECD countries as a group, are mainly companies that are listed or traded on organized securities markets.

This paper is not about privately held companies. But in economies that have tiny stock markets or where “listed” companies are either few or moribund, the business of economic growth may be likely to be done by “small and medium enterprises,” little companies or what the Germans call the *mittelstand*, medium-sized companies. In enterprises of this kind, the owners are likely to be much closer to the company and its decision-making processes than in large companies owned by numerous, small, scattered shareholders. The problems of collective action by or on behalf of numerous small holders become less urgent. The need for flexibility and a minimum of time-consuming, expensive or confusing regulations become more crucial. The need for preventing oppression of minority shareholders will remain, as will the need for a reliable system of adjudication to settle problems that cannot otherwise be worked out. Noting this reservation, let us proceed.

The central problem of corporate governance may be described as giving managers sufficient flexibility to run the company but not enough to loot the company – either on behalf of themselves, their friends or a controlling shareholder. The mechanisms that are appropriate to solve this problem will often depend on the number of shareholders, their sophistication and means, the extent of their involvement in the company’s business and their practical ability to enforce their rights in the existing legal and business environment.

Here we concentrate particularly on the company’s board, its duties and the means of enforcing them. The discussion below, besides noting specific tasks of board members, speaks of their general duties of “care” and “loyalty.” This formulation is specific to common-law jurisdictions and their legal concept of “fiduciary duties,” but the substance appears in the jurisprudence of civil law jurisdictions as well. As one commentator put it, only the nomenclature is Anglo-Saxon.¹ However, the ways in which these duties are enforced is often affected by whether a country has a civil-law or common-law legal tradition.

Sources of Rules

The duties of board members generally are found in the company’s home-country law and in the company’s own articles or by-laws. The latter, however, or at least the way they are implemented, can be strongly affected by the codes of conduct, codes of best practice and corporate governance principles that have proliferated throughout the OECD countries and beyond in the last 15 years. The OECD itself has

¹ See Paz-Ares, “Directors’ Duties and Directors’ Liabilities,” paper for the Third Meeting of the Latin American Corporate Governance Roundtable (Mexico City 2002) (available from the OECD), n. 1. Professor Paz-Ares’ paper in general is an excellent and comprehensive analysis of the current issues and arguments relevant to board member duties and liabilities.

such a set of principles, and it is a reasonably good summary of what is regarded as desirable practice in OECD countries.²

Although most of these codes are voluntary, some are backed up by requirements that companies either “comply or explain,” that is, state in their annual report or similar disclosure documents that they comply with each provision of the code or identify those provisions that they do not accept and explain why. The London Stock Exchange has had such a requirement for several years for companies listed there, and it has been a substantial incentive in getting companies to comply with the LSE’s “Combined Code” of corporate governance. Similar arrangements can be found in other OECD countries. The comply-or-explain obligation is imposed by law for those companies covered by the German Corporate Governance Code promulgated earlier this year. And in some countries, listing standards or securities law simply add obligations regarding board structure or duties, at least for publicly traded companies, for example, with respect to audit committees in the United States.

While the codes are aimed primarily at listed companies and compliance is more or less voluntary, they nonetheless have an impact on practice in the OECD countries, and will no doubt influence how legal duties such as loyalty and due care might be interpreted in a court.

Duty to Whom?

To understand the duties of members of the board, it is necessary to understand to whom those duties are owed. Commonly, they are said to be owed to “the company.” But this begs the question of who is “the company.” Is it just the shareholders, or might it sometimes include other “stakeholders” such as employees, creditors, suppliers, customers or the community where the company operates?

A French study of corporate governance issues implied that it was best not to try to go past the “company” idea. “The interests of the company,” said the 1995 Vienot Report,³ “may be understood as ... distinct from those of shareholders, employees, creditors, ... suppliers and customers. It nonetheless represents the common interest of all these persons, which is for the company to remain in business and prosper.”

There are several theoretical problems with this view. First, there is a fairness problem. It is the shareholders, after all, who own the company. Arguably, the disposition of their property in the interests of anyone but themselves is unjust. This view would preclude dilution of director duties to shareholders with duties to other interests. It would likewise disfavor employee representation on the board (which is required in certain OECD countries and permitted in several others), seeing it as no fairer than requiring employer representation on the board of a trade union. Unions, lenders, other counterparties and communities all are, or are represented by, entities that speak exclusively for their interests. Why not shareholders? There are other avenues besides company law by which other stakeholders can and do protect their interests – contract, labor law, consumer protection law, insolvency law. Perhaps the other stakeholders should be left to these.

Second, viewing the company’s interests as those common to all its stakeholders seems to ignore the extent to which stakeholders will have conflicting interests. It is usually in everyone’s interests for the company “to remain in business and prosper” but there are inevitable and ubiquitous issues about how much it shall prosper compared to its stakeholder counterparties, such as wage-earning employees, loan-collecting creditors, or dividend-receiving shareholders. And indeed, it is not necessarily in everyone’s interest even for the company to continue to exist. If the company has combined assets and factors in such a way that they are worth less combined than they are separately, it may be in the shareholders’ interest to liquidate the company and in the interests of society as well, since the company has now become a wealth-

² The OECD Principles of Corporate Governance are available from the OECD website – www.oecd.org .

³ See Marc Vienot et al, Association Francaise des Entreprises Privees and Conseil National du Patronat Francais, “Le Conseil d’Administration des Societes Cotees” (1995), page 5.

destroying rather than wealth-creating vehicle. However, this can rarely be in the interests, at least short-term, of many other stakeholders.

Granted, conflicting interests will exist even among shareholders, but this is a relatively manageable problem compared to an approach throwing everyone's interests into the pot.

This leads to the third problem with the notion of the company's interests being the common interest of its stakeholders – the impact on accountability. We don't want heartless, greed-crazed companies any more than we want individuals of that type. On the other hand, we don't want board members who are permitted to serve so many masters that in practice they cannot be held accountable for serving any one, or who invoke stakeholder interests only as a pretext for ignoring shareholder interests.

At the end of the 1980s, corporation laws in a large number of American states were revised to allow boards to consider the interests of stakeholders other than shareholders, at least in the context of a hostile take-over attempt. This certainly helped to entrench corporate managements, which lobbied heavily for those amendments, but it gave the stakeholders no real enforceable rights against a board that did not consider their interests. Even in jurisdictions where boards are required to take stakeholder interests into account, this obligation tends to be difficult to enforce without recourse to separate authorities, such as a contract or a law other than the company law. Yet blurring board obligations to serve shareholders surely makes it easier for boards to serve themselves.

Actually giving stakeholders practical rights to sue under company law, on the other hand, would seem to be a formula for endless litigation and in effect for the judicial administration of companies. Concern over such problems led the British government to reject a "pluralist" approach (strong stakeholder rights) in its "White Paper" proposals for reform of English company law. It opted rather for the "enlightened shareholder value" approach, which recognizes that the board's primary duty is to serve the shareholders but that in fulfilling this duty, it must take account of the interests of other stakeholders, as they may affect long-term shareholder value.⁴

This diluted kind of shareholder primacy is probably more diluted in systems where employees have a right to elect board members, since once on the board, these employee-representatives generally are required to serve the interests of "the company" like all the other members. For their purposes, a somewhat broader view of "the company" is clearly a more comfortable if not a well-defined one.

Besides employees, the law traditionally has paid the most attention to stakeholders who are creditors, in order to prevent abuse of the limited liability concept that is the heart of corporate law. Different legal systems approach this in different ways, some relying more heavily on required minimum capital, some not. The board will often be held to have duties to creditors where the company has become insolvent or insolvency is in prospect, although these duties might arise under insolvency law rather than company law per se. In ordinary times, a board member who owes his position to the influence of the company's bank is generally required, like any other member, to serve the interests of the company as a whole rather than the interests of those who got him onto the board.

The same holds for one who was elected by a large shareholder or block of shareholders. Thus even legal systems that do not require consideration of non-shareholder constituencies (other than to respect laws, regulations or contracts relating to them) may present board members with dilemmas when the interests of all shareholders are not the same as to a given decision. In this case it is usually necessary to try

⁴ See Select Committee on Trade and Industry, House of Commons, Sixth Report, point 3, "The Role of Directors" (2003), available at <http://www.parliament.the-stationary-office.co.uk>. The White Paper also favors an alternative way of addressing "community" stakeholder concerns by calling on the company to disclose its policy and practice with regard to areas of particular concern such as the natural environment. The disclosure could shame companies into compliance with accepted norms or furnish information for enforcement or compensatory actions by persons affected.

to imagine the interests of shareholders as a class or as a whole, respecting principles of “shareholder equality” and “fairness.”

In any case, insofar as the board is subordinated to the general shareholders meeting, its members can do only so much to protect the interests of shareholders as a class, including minorities, against the interests of a dominant shareholder or shareholder group. The minority’s remedy against the shareholders meeting usually depends upon specific provisions requiring super-majorities of shares for specified types of fundamental corporate actions or giving dissenting shareholders the right to redeem their shares from the company at a fair price; or upon general legal principles protecting minorities from “undue prejudice,” forbidding a dominant (or any) shareholder from voting on his own claims against the company or on transactions in which he has certain material interests or from taking actions that harm “the company,” or imposing fiduciary duties on dominant shareholders, similar to those of the board, to act in the interests of shareholders as a whole. These rules, of course, vary from jurisdiction to jurisdiction and in some jurisdictions are supplemented by or embodied in rules specifically addressing groups of affiliated companies.

Which Board?

Some OECD countries require companies to have a single board of directors responsible for managing the company and supervising its executives, while others permit or, particularly with larger companies, require a two-board structure: a management board concerned with management and a supervisory board concerned with supervising management. Others have hybrid forms.⁵

However, management functions generally are delegated to full-time executives even in countries with a unitary board; while supervisory boards in the two-tier system often must approve certain kinds of business decisions. And both the unitary board of directors and the supervisory board are usually responsible for appointing the people who do in practice if not in form establish and execute the company’s business plans. Most of our discussion applies to members of both types of boards, although a member’s specific tasks are clearly relevant when he is called to account for his behavior.

Tasks of the Board Member

The specific tasks of the board member may depend upon whether he belongs to a unitary board or to one or the other of the two boards in a two-board system; whether he also is a company executive; and whether he serves on a specific committee of his board. However, if we focus on board members whose only capacity with the company is that of board member – that is, the non-executive directors – certain standard tasks emerge.

Appointment and supervision of the executives. Unitary boards generally have responsibility for overall management of the company, and they usually delegate this in large part to the executives, leaving the board in an overall position not radically different from the supervisory board of a two-tier company. The unitary board or the supervisory board generally appoints the persons who manage the company and remove them when necessary and permissible – management board members in the two-tier scheme often are appointed for specific terms and can only be removed for “cause.” Boards also approve basic business decisions, though a supervisory board may be more circumscribed here.

⁵ Italy, for example, unless the company specifically elects a different structure, has a unitary board of directors supplemented by a board of auditors whose functions are more concentrated on financial control and reporting and conflict of interest problems than even the supervisory board of the standard two-board company. Portugal and Japan have variations of this. Danish companies have two boards, but the management board may be a single person, and he may also serve on the higher board of directors, which is not usually permitted in two-tier systems. See Weil Gotshal & Manges L.L.P., “Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States,” Annex IV, page 35 (2002). Available at www.ecgi.org/codes/comparative_summaries.htm.

Reporting, disclosure, legal compliance and conflicts-of-interest. Although executives may be better equipped to make business judgments, members of a supervisory board and non-executive directors of a unitary board are in a much better position to make sure that the executives are not lying, cheating or stealing. If they can do this much effectively, we should be happy. Rules and procedures may be more effective in these areas than in the area of guiding general business strategy not only because non-executive board members are better able to make judgments here but because, if it comes to that, so are courts.

Laws governing the tasks of supervisory boards tend to emphasize responsibility for review of the company's accounts and reports, for the legality of its actions and for other situations where conflicts of interest can more easily arise for executives. Rules or practice in countries with unitary board systems may not specifically assign these tasks to non-executive board members, but they sometimes do, and it is often believed that this is where the non-executive members make their real contribution to the company.

Other tasks. Boards commonly also are required to call general meetings, declare dividends, pass upon fundamental changes in the company's business capital structure or internal rules.

Standard of Conduct

The OECD Principles of Corporate Governance state that "Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company." This is a reasonably good summary of the legal standard to which board members are held in most OECD countries.

The formulation of this duty may differ between civil law jurisdictions and common law jurisdictions, where the notion of "fiduciary duty" developed from case law, but, as noted, the substance is much the same. We may thus translate the OECD principle into "fiduciary duty" terms by referring to the principle's phrases "fully informed basis" and "due diligence and care" collectively as "the duty of care," and to its "good faith" and "in the best interest of the company" phrases as "the duty of loyalty."

Board members are required to adhere to these standards of conduct when carrying out their tasks, including any special task assigned to a member or members as a committee of the whole board.

The "business judgment rule" is associated particularly with American jurisprudence. The rule establishes a presumption that board members have acted on an informed basis, in good faith and in an honest belief that they were serving the best interests of the company, unless a plaintiff can show otherwise or unless the action complained of was not merely negligent but actually "irrational" from the company's standpoint.

Plaintiffs can rebut the presumptions of the business judgment rule by making a positive showing that the board members did not exercise proper care in informing themselves of the relevant facts (implicating their duty of care) or that they acted in the presence of a conflict of interest (implicating their duty of loyalty). However, board members are also entitled to a "presumption of regularity" with respect to the actions of company executives and the information and reports received from executives, entitling them to rely on these unless they are aware of facts indicating that these may not be reliable. In addition, many American states allow corporations to adopt charter provisions restricting (non-executive) board member liability for breaching the duty of care absent intentional misconduct, or they apply standards that catch only the grossly negligent.

The duty of loyalty, on the other hand, is more robust. Where there is a conflict of interest between the board members and the company, the protections of the business judgment rule tend to fall away much more easily than where the duty of care alone is involved. When the protection of the rule is removed, the board must show the challenged transaction's "entire fairness" to the company. This can mean both that fair procedures were used in considering the transaction (for example, it was approved by a majority of the disinterested directors who consulted external, disinterested experts and who considered the possibility of

alternative transactions) and that the substantive terms of the transaction were themselves fair to the company. Generally, the weaker the showing on procedural fairness, the stronger it will have to be on substantive fairness.⁶

Civil law jurisdictions have sometimes been criticized for failing to make adequate distinction between the stricter standard that should be applied to cases involving the duty of loyalty as opposed to the duty of care⁷. Thus it is said that their courts have relied too heavily on the mere performance of the specific tasks set out in the laws, rather than on whether these are performed with the best interests of the company in mind, or that courts assume that literal compliance with a narrow or easily-circumvented specific conflict-of-interest provision precludes any serious further inquiry as whether the general duty of loyalty has been fulfilled.

Note that such tendencies may be reinforced by the allocation of the burden of proof. It is standard in civil-law countries for the board member to have the burden of justifying his action once a plaintiff shows a loss has been caused. Because the civil law code may not distinguish between the burden in “care” cases and “loyalty” cases, sympathetic treatment from the courts in the former sphere may have carried over into the latter.

But surely “care” cases deserve the more lenient treatment. They more often result from unintentional errors; they are far less profitable to the board member, and hence less in need of close scrutiny, than conflict-of-interest transactions are likely to be; judges unfamiliar with a given business are much less qualified to evaluate mere management errors than they are to recognize disloyal conduct; and the overly cautious attitudes board members might adopt to avoid any risk of liability can do much greater damage to a company when applied to all decisions requiring care – that is, all decisions – than an overly cautious attitude confined to conflict-of-interest situations.

It is also likely that the traditional prominence of large shareholders and banks in the corporate governance of companies in civil-law countries might have made judicial enforcement of corporate duties less urgent, since there were other entities on the scene substantial enough to deal with problems informally.

The requirement of “due care” most needs to be invoked when it is coupled with a loyalty issue, for example, when non-executive board members are reviewing a conflict-of-interest situation involving an executive.⁸ Whether or not, especially given recent trends, criticism of civil law handling of the loyalty

⁶ One American scholar has also discerned a duty of “special care” when a company is a hostile takeover target. See Black, “The Core Fiduciary Duties of Outside Directors,” published in the *Asia Business Law Review* 3-16 (July 2001) and available at <http://papers.ssrn.com/abstract=270749> . This duty is somewhat similar to the duty to show “entire fairness” in conflict-of-interest situations, and not surprisingly since a takeover bid creates a conflict by putting the board member’s place on the board in jeopardy. However, scrutiny of the non-executive board member’s conduct may be less searching than in the “entire fairness” context, since it is not the member’s main job that is under threat. Takeover situations are discussed generally further below. Professor Black also cites a special “duty of disclosure” enforceable against non-executive board members, as well as others, applying particularly with respect to conflict-of-interest transactions and matters involving a shareholder vote. This duty may be seen as both a prophylactic against violations of the duty of loyalty and as a borrowing from the extensive disclosure requirements of securities law.

⁷ See, for example, Paz-Ares, cited in note 1 above, and Johnson, La Porta, Lopez-de-Silanes and Shleifer, “Tunnelling,” available at www.ssrn.com .

⁸ The practical importance of the board’s supervision of the company’s general business policy is questionable. Part-time board members depend heavily on executives for the information and advice they receive. (Sometimes, as a practical if not formal matter, even a member’s continuation on the board is heavily influenced by executives.) Part-time board members simply don’t know as much about the company or its business or its prospects as the executives do, and the board members realize this. Accordingly, they usually are disinclined to object strenuously to the business plans proposed to them. If the board can just assure simple honesty, that may be accomplishment enough.

duty is entirely justified, it is likely that legal evolution in OECD countries will be toward greater concern with loyalty duties. As discussed further below, however, the effectiveness of this may depend on procedural reforms facilitating enforcement through lawsuits.

Enforcement – Internal Procedures

Lawsuits, or action by state authorities, are external enforcement mechanisms. So are the stock-exchange listing rules noted above with respect to “corporate governance codes.” So, we might add, is the “market for corporate control,” the ability of an outside bidder to oust incompetent or disloyal managers by buying a controlling block of a company’s stock.⁹ And so are control-block and other disclosure requirements of the securities laws that allow investors to see what’s happening in a company and to whose benefit, and then to take appropriate action.

However, a multitude of strategies, short of the lawsuit or resort to a state administrative agency, have evolved for enforcing the generally recognized duty “to act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company.”¹⁰ These are internal procedures or practices of one kind or another, some required by law, some required or encouraged by stock-exchange listing standards and some more purely voluntary, depending on the country involved. By and large they relate to assuring transparency and to structuring the board or its procedures in such a way as to avoid or neutralize conflicts of interest. They also, however, may involve attempts to improve performance and align interests by the structure and criteria of executive compensation.

Not all these procedures are employed in all OECD countries, or at least not to the same degree. For example, most publicly-traded companies in the United States have boards where a majority of directors are “independent” of the executives, while the tradition in Japan has been to elevate senior and long-serving executives to board membership, with most boards having no independent directors at all.¹¹

Board structure. Board structure is in fact one of the principle internal means of facilitating observance of board members duties. This is most obvious in the two-tier board structure, where the supervisory board includes none of the company’s serving executives. Executives with daily control over the company’s business are the most likely to be tempted to enrich themselves at its expense, and are also the most likely to be embarrassed by accurate and comprehensive financial reporting and other disclosure. It makes sense, therefore, that an entirely separate body supervise them, and this is what the dual board structure seeks to accomplish.

Even countries that employ the unitary board structure, however, often provide for committees of that board that are composed, in whole or in part, of non-executive board members and that have special responsibilities in areas where conflicts between the interests of executives and shareholders are most likely to arise.

These committees are particularly numerous with respect to audit, executive compensation and nomination for board membership.

This doesn’t mean they should (or should be allowed to) abandon their role in guiding business policy, only that we shouldn’t expect too much from it, except in extreme situations, or perhaps when the stock market or large shareholders already have signaled substantial and sustained displeasure with management policy.

⁹ As noted above, however, dominant stockholders can pose “loyalty” problems themselves, where there are insufficient remedies for unfair treatment of the minority.

¹⁰ OECD Principles of Corporate Governance, cited above.

¹¹ See the Japanese Ministry of Finance’s report “Progress in Corporate Governance Reforms and the Revitalization of Japanese Companies” (2003), summarized by Miyajima Hideaki, Waseda University School of Economics, at www.rieti.go.jp/cgj/en/columns/columns_011.htm ; see also GovernanceMetricsInternational press release (24 May 2003) in which a corporate governance rating agency announces its findings that only 3% of directors at companies included in the Nikkei Index of listed Japanese companies were independent; and see Black cited in footnote 6 above.

Audit committees have special responsibility for overseeing the company's financial reporting and internal control procedures. They are key in facilitating the board's general oversight of the company's business because this cannot be accomplished if the company's financial reports, and the record-keeping and control procedures underlying them, are incomplete, inaccurate or misleading. They are also key in controlling conflicts of interest since financial statements normally include notes on "related-party transactions," which cover significant transactions in which company insiders may have interests adverse to those of the company. Finally, they are key in assuring that the board fulfills its responsibility for the company's compliance with law, since accurate and complete reports to shareholders are usually required by company law, securities law or both. Audit committees are expected to work closely with the company's external auditor and may even be responsible for selecting that auditor, subject usually to approval of the shareholders.¹²

Compensation committees deal with the most obvious conflict-of-interest situation – setting the pay or other compensation of the company's executives or board members. These committees should be structured to minimize the participation of persons whose compensation is being set.¹³

Nominating committees should represent an attempt to remove nominations for executive or board positions from the hands of the company's executives. Although the shareholders almost always elect members of a supervisory board or a unitary board, in actual practice executives may have the decisive influence in determining who is proposed to the shareholders. In companies with numerous, widely dispersed shareholders, and few who hold large blocks of shares, this can mean in effect that the executives pick the boards that theoretically supervise their activities. This problem may represent the biggest conflict of interest of all within the company. Curiously, the Commission of the European Union in May of 2003 presented a corporate governance "action plan" recommending that nominating committees be composed mainly of board members who are executives.¹⁴

Whether the board has a two-tier structure that formally separates the management and oversight functions or a committee structure that attempts to achieve the same end, the effectiveness of the structure is increasingly believed to depend upon the degree of real independence that members of the supervisory board or the committee have from the executives running the company. Laws establishing two-tier structures often provide simply that members of the supervisory board not actually be executives, and rules relating to committees are sometimes similar. This does not necessarily preclude these non-executives

¹² Recent legislation in the United States (the Sarbanes-Oxley Act of 2002) reflected disillusionment with failures of the audit committee system there, where it is most strongly entrenched. Enron Corporation, for example, whose financial reporting was widely regarded as seriously misleading with respect to the company's financial condition, not only had an audit committee but had a distinguished accounting professor at the head of it. Sarbanes-Oxley responded by, among other things, increasing requirements regarding the audit committee's independence and expertise, and increasing regulation of external auditors – who also embarrassed themselves in the Enron debacle – particularly with a view to assuring their independence and objectivity. Sarbanes-Oxley also required the audit committees of listed companies to establish "whistle-blower" procedures within the company to encourage reporting of misconduct.

¹³ Compensation committees, even when composed of persons with no direct interest in the compensation under review, may be subject to a "secondary" conflict of interest in that a committee member is himself often an executive of some other corporation, and so views with favor the general notion of fat paychecks for executives.

¹⁴ See Communication from the Commission to the Council and the European Parliament, "Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward," 21 May 2003, p.15, available at <http://europa.eu.int>. This recommendation, based on the executive directors' knowledge of the company and of whom, including current employees, might be best suited to run it, makes more sense when the nomination of an executive is involved, rather than of a supervisory or non-executive board member. Britain's Higgs Review (a Government-requested study of the role and effectiveness of non-executive directors, published in January 2003) allowed for executives on the nominating committee, but as a minority.

from being retired executives of the company, relatives of executives or persons otherwise connected with or biased in favor of the company's executives.

Consequently, there is increasing emphasis on the role of "independent" board members, persons who, besides not being the company's executives, are also not likely to be subject to their influence. For example, listed companies in the United States are or soon will be required to have an audit committee of which every member is "independent" and to include at least one member who is a financial expert.¹⁵ The "comply-or-explain" German Code of Corporate Governance for listed companies calls for supervisory board members who, as a whole, are "sufficiently independent" as well as qualified by knowledge and expertise. No more than two should be former members of the management board.¹⁶

Still, several facts need to be remembered. Use of "independent," as opposed to merely non-executive, board or committee members is usually not compulsory in OECD countries, and what pressure there is for this relates mainly to listed companies.¹⁷ Furthermore, empirical research does not establish a clear link between the use of independent directors and returns to shareholders, although there is some reason to believe that they may be more useful in business cultures not historically sensitive to conflict-of-interest problems.¹⁸ Moreover, definitions of independence, both in the rules and in the research, do not necessarily capture its essence in reality.

External certification of internal controls and financial reporting. As implied in the discussion above of the board's tasks and those of any audit committee, assuring an adequate system of internal controls (internal records and procedures designed to protect the company's assets against loss, risk or fraud) and financial reports is a special responsibility of board members. This is relevant to the system for the company as a whole and to the board's own procedures. One important "internal procedure" for enforcing attention to these vital responsibilities is to retain external accountants to approve the company's system of internal controls and the presentation of its financial reports. The latter approval and sometimes the former may be legally required for companies with publicly traded securities.

Special audit. Enforcement of executive and board member duties also may be bolstered by legal rights of board members or shareholders (or some specified percentage of shareholders) to demand a special audit of company operations by an independent auditor.

Access to records. Board members, and in some circumstances shareholders, are provided with the right to review company records in order to carry out their supervisory duties.

Disclose, abstain and report procedures. OECD countries commonly require, one way or another, that board members who have a conflict of interest in a transaction that they must vote upon disclose the conflict to fellow members. Often, they will then be required either to abstain from the vote, to abstain from the vote or any other participation in the matter, to vote only with the approval of disinterested board members, to report the transaction to the shareholders or to receive the shareholders approval.¹⁹ The interesting questions here are how broadly a conflict of interest is defined and what is the status of

¹⁵ See Sections 301 and 407 of the Sarbanes-Oxley Act of 2002. Listing rules of the main stock markets bolster these requirements.

¹⁶ German Code of Corporate Governance (2003), article 5.4.1 and 5.4.2.

¹⁷ Audit committees are required for listed companies in the United States, virtually universal among them in England and widespread (80%) among Europe's largest companies as a group. See the Economist Group's CFO.com reporting (22 September 2003) in "Walking the Beat" a survey of Europe's 300 largest companies by the executive search firm of Heidrick & Struggles at www.cfo.com.

¹⁸ See Black, note 6 above, Hideaki, in note 11 above.

¹⁹ If a requirement to report such a transaction to shareholders does not appear expressly, it may still arise from financial reporting requirements, under either company law or securities law, since financial statements prepared under International Accounting Standards or American Generally Accepted Accounting Principles normally require disclosure of such "related-party transactions."

transactions that the board member does not vote upon, because they are decided at a lower level, but in which the board member may still receive unfair consideration by virtue of his position. These are resolved in different ways in different countries, and often differently for privately held versus publicly traded companies. And in some countries a handful of transactions for the benefit of board members, such as loans or guarantees, may simply be prohibited all together.

In jurisdictions where conflict-of-interest transactions can be approved by a shareholder vote, problems can arise if a dominant shareholder is also a beneficiary of the transaction, in which case rules concerning “oppression” by majority shareholders, noted above, can come into play. Sometimes, the board member’s burden of proving fairness to the company as a whole will simply be adjusted when a conflict-of-interest transaction has been approved by shareholders or disinterested shareholders.

As a rule, when conflicts are disclosed to the board or to the shareholders, they must be fully and truthfully disclosed if the subsequent approval is to be fully effective.

Private benefit, use or outside compensation. Specific bans as to board members making private use of or extracting personal benefit from corporate assets or business also exist, as well as restrictions on the acceptance of outside compensation in connection with company business.

Prohibitions on competing with the company. Prohibitions against board members participating in any substantial way in an enterprise that is a business competitor of the company, at least without the permission of other company authorities, are quite common in the commercial codes of civil law jurisdictions. Similar is the “corporate opportunity” doctrine of common law jurisdictions. The latter generally requires that before a board member can take advantage, for his own or a third party’s account, of an opportunity in the company’s line of business, he must first present it to the company.

Confidentiality. Requirements are common that board members keep information about the company’s plans and operations confidential. Where this restriction is tailored to protecting the company against competitors or premature disclosure of matters relevant to business negotiations, it makes sense. It should not be permitted to inhibit fulfillment of duties to provide information to shareholders, the markets or public authorities in appropriate situations.

Particular duties regarding take-over bids. There is a considerable amount of variety in this area. Some countries prescribe no particular rules for board members in the event of a takeover bid, apart from observing their general duty to act diligently in the best interest of the company. Most countries, however, in their securities laws or elsewhere, specifically address this important area where boards have a distinct tendency to oppose bids that could result in their replacement. Rules often call upon the board to maintain neutrality and not undertake measures opposing the bid unless they have been authorized by a shareholder vote, usually at a meeting called after the bid has become known. It is also common for the board to be required to publish an evaluation of the bid or retain outside financial experts to evaluate it. Even in jurisdictions, such as the United States, where boards may be permitted to adopt severe “defensive” measures, they may at the same time be subject to heightened scrutiny by courts to assure that they exercise this defensive power in a manner consistent with the interests of shareholders.²⁰

Insider trading prohibitions. Prohibitions now are almost universal in OECD countries against trading in the company’s shares or securities on the basis of non-public information, at least when the company’s securities are publicly traded. The common-law development of this prohibition was based on an extension of the fiduciary duty of loyalty from the company as a whole to individual shareholders who might trade with the insider. The prohibition may also be seen as related to private-use or confidentiality rules, although, strictly speaking, insider trading may involve an abuse rather than a release of confidential information. In any case, the prohibitions are codified many places now, usually in securities market law or

²⁰ As noted in an earlier section of this paper, state laws giving boards discretion to also consider the interests of other “stakeholders” can weaken this scrutiny. This can have potentially harmful results if defensive measures are not otherwise regulated.

rules, and often extend beyond company employees and board members to anyone with special access to information, but board members are always included. The bans apply both to trading and to passing information so that others may trade.

Share-trading reports. Ancillary to the insider trading prohibitions, requirements exist in some countries for board members in publicly traded companies to report to market authorities any trading by themselves or their families in the securities of the board member's company. These requirements may be bolstered by bans on the quick purchase-and-sale transactions that often accompany the abuse of inside information.

Performance-based compensation. This is generally not required but often employed or encouraged. It applies to board members who are executives and may in fact be prohibited for other board members since it could prejudice their review of financial reports. The notion here is to align the executive's duty to diligently pursue the best interests of the company with his personal interest in his own compensation. Board members who review such compensation, however, should be careful that it does not result in compensation that is excessive and that is not structured in such a way as to encourage executives, who usually have a leading role in the actual preparation of financial statements, to distort the reporting of the company's financial results. Grants of share options bear particular scrutiny here since their value is so sensitive to short-term movements in share prices.

Compensation for board members who are not executives is a separate question. Generally left to the company's own decision, it should be sufficient to attract able individuals and motivate them to take their responsibilities seriously but not so great as to make them feel financially dependent on their continuation as board members, since, as a practical matter, this may be influenced by their relationships with the executives they are supervising.²¹

Enforcement – Exposure to Liability

Board members in OECD companies generally bear legal responsibility in court (and sometimes to administrative agencies regulating the stock market) for discharge of their responsibilities. The real risk this poses to them as individuals depends on a variety of factors besides the definitions of their duties. These include

- the burden of proof to which they may be subject in defending their conduct,²²
- the remedies available,
- the persons with legal standing to bring suit,
- the procedural mechanisms available for bringing suits,
- the allocation of litigation costs under the laws of a given country,
- the existence of large shareholder blocks with the means and motive to litigate,
- the availability of indemnity or insurance covering liability,
- the litigiousness of the local culture,

²¹ See Black, cited above in note 8.

²² See the discussion above regarding the "business judgment rule" and contrasting it with rules in certain civil law jurisdictions.

- the attitudes, authority and resources of public authorities authorized to enforce applicable laws, and
- the ability of the local courts or other adjudicators to fairly and efficiently dispose of cases.

Board members, to different degrees in different countries, may be sued or prosecuted for violating duties to the company, based on company law, for violation of duties to securities owners under securities law and for assisting or permitting unlawful conduct by the company under general law. We are concerned here mainly with the first and to some degree the second of these.

Suits by the company itself, initiated by its internal authorities, are the most direct means of enforcing the duties of board members. The suit may be initiated by a member's fellow members, by one board against members of another in a two-tier structure or, in certain cases, by the general meeting of shareholders. Where there are no powerful shareholding blocks that can effectively influence the results of a general meeting or the conduct of board members, this is something we can expect to be reserved for egregious cases. Quite often – and often quite properly – board members are on friendly terms with each other. Consequently, they might prefer, if anything, simply to procure the retirement of an erring brother rather than actually to sue him. At worst, fellow board members may be participants in his misconduct.

Suits on behalf of the company by shareholders are also possible. In the United States, a “shareholder derivative action” can usually be brought by any shareholder, provided he can show that the company's internal authorities have failed to do their duty in this regard²³. In other countries, there may be a minimum shareholding requirement, for example, 5% of outstanding shares, before shareholders can prosecute the company's interest on their own initiative. In either case, money recovered will go to the company. The effectiveness of the procedure depends upon adequate arrangements for covering the shareholders' litigation expenses and whether the suit results in the removal of guilty board members since, if it does not, giving money recovered back to the company will in effect place it back in the hands of the people who lost it (or appropriated it) to begin with. Effectiveness can also depend on the existence of large blockholders, since even a small percentage requirement for a large company can be a huge amount.

Since the derivative plaintiff himself does not directly benefit from the suit, it has been suggested that his incentives might be improved if he individually could at least recover a portion of the damages award proportionate to his equity in the company. This is mainly just an idea at present, however.

The board member's financial exposure to a claim on behalf of the company, besides loss of pay if he is removed from the board, may also vary depending upon other standards of the given jurisdiction. For example, where a company is entitled to recover only its “losses” from a challenged transaction, the measurement of the amount involved may differ from where the defendant must hand over any additional “unfair profits” of his own. Civil law jurisdictions tend to focus on “losses.”

Suits by shareholders for recoveries on behalf of themselves may be available to enforce rights pertaining specifically to them. These may be rights arising under provisions regulating rights and duties within the company, such as the right to vote their shares or the right to sell back their shares to the company under certain circumstances. Sometimes, depending on the jurisdiction, they may also include complaints of “oppression” or “unfair prejudice” where actions taken benefit majority shareholders at the expense of a minority. Often cases brought in a shareholder's own right are as likely to include the company itself as defendant as they are the board members.

A most fertile source of shareholder litigation is the securities laws. Conduct that gives rise to no personal claim under company law may, if it is not appropriately disclosed, give rise to a claim for loss of share value under the securities laws. So may disclosure failure relating to any number of other facts about the company relevant to share value.

²³ England and other jurisdictions also allow for this action, although the procedural requirements in England have been characterized as so burdensome that the action is seldom used and is the subject of reform proposals.

There is a strong case, reflected by actual laws to varying degrees, for allowing shareholder suits against board members who are responsible for misleading disclosure that affects share prices, as opposed to placing the burden of compensation on the company, at least in cases where the company has itself received no benefit from the misinformation. Recoveries against the company indirectly are recoveries against the company's owners, that is, the other shareholders. In the case of a company faced with insolvency, a recovery against it may also in effect be a recovery against its creditors.

In lawsuits based on culpable mismanagement, however, this argument can be turned around, to favor recovery only on behalf of the company for damage to it, and not directly in favor of shareholders based on a consequent decline in share value. Arguably, the compensatory money should flow to the company in this case for the same reason that it should not flow out of the company in the other – to assure fairness to shareholders or creditors not involved in the lawsuit.

As noted above, board members may also become liable to suits by creditors when a company becomes or is becoming insolvent, and its assets must be preserved for the benefit of creditors. There are also a variety of laws that may make board members directly liable, at least to public authorities, for the company's failure to comply with tax laws, product liability standards, environmental laws and others.

The question of enforcing the board member's duties through liability for damages in turn raises the question of liability insurance or indemnification by the company. "Director and Officer" liability insurance for board members, like a direct indemnification guarantee from the company, obviously diminishes the board member's incentive for diligent and faithful service, although it is generally unavailable for intentional conduct. However, insurance has certain advantages over straight indemnification and may be permitted in places where the latter is forbidden. Mainly, this is because the liable board member's reimbursement comes from the assets of the insurance company, not the board member's company. Although the latter is usually the source of the premium payments, these should be considerably less than a damage award. Moreover, the insurer would have some incentive to act as an external monitor, charging higher premiums for dubious board candidates.

In any event, for large companies, where the actions of the board can have huge financial consequences, the potential for huge individual liability could lead either to extreme risk-aversion in the company's business decisions or an inability to recruit board members, concerned that even if they themselves do not err, the tribunal reviewing their conduct might.

A reasonable stance toward board member liability insurance may be the standard found in the German Corporate Governance Code, which allows for such insurance but provides that "a suitable deductible shall be agreed."²⁴ It is this deductible, the amount that the liable board member must pay before his insurance coverage begins, that will furnish an incentive for conscientious service. The deductible should be high enough to preserve a powerful incentive for proper conduct, but low enough to avoid deterring honest and able individuals from serving.

Note that liability for board members tends to be joint and several, at least for action taken by the board. This provides some incentive for board members to take care as to whom they are serving with, although there are often exculpatory provisions for board members who can prove that they opposed or at least did not participate in the alleged misconduct.

Claims by injured parties against board member for breach of duty are not the board member's only source of exposure, although they tend to be the most common one where the claims are based on company law. Action by agencies of the state, often (though not always, as noted above) under securities law, are also a factor, although where these involve liability for payment of fines or accounting for or "disgorging" unlawful profits, the state agency must usually present them to a court for determination.

²⁴ German Corporate Governance Code, article 3.8.

Action brought by public authorities is a common source for the enforcement of insider trading liabilities (often only a state organ will have the investigative resources and powers necessary to discover an insider trader), which can include levies of punitive amounts in addition to liability for the insider's profit made or loss avoided. Some jurisdictions also allow for suits by public prosecutors to seek recovery on behalf of broad segments of the public, although these are not common. Public prosecutors also are involved, of course, to enforce criminal laws, which, however, tend to be invoked mainly in cases of intentional and egregious misconduct.

It also is worth considering arbitration as a means of enforcing board member duties. Arbitration clauses are widely employed in ordinary business contracts, although this may not often result in liability for board members individually. There is less information as to use of arbitration in intra-corporate disputes. Its usefulness here will depend on whether it effectuates the law by providing a disinterested, fair and efficient tribunal. If instead arbitration tribunals are biased, inaccessible or lacking in sufficient powers to compel production of relevant evidence, they are not likely to make headway in this sphere.

Procedural Issues

Legal procedure in a given jurisdiction can have important practical impact, whatever the applicable standard of conduct may be. We have already noted this with respect to the burden of proof and derivative actions.

Plaintiffs' access to a company's or other defendant's documents or witnesses in the pre-trial phases of a lawsuit can also have great impact. The traditional liberality of these rules in the United States, for example, has helped support the huge volume of shareholder litigation there over the years, and undoubtedly resulted in many settlements aimed at escaping harassment. The more restrictive rules in Germany may in turn have reinforced the tradition of placing the burden of proof on a board member, since he was likely to have better access to relevant information and evidence.

The allocation of attorney fees and other litigation costs also has substantial practical effect. In many jurisdictions, there is a "loser pays" rule, which can be a disincentive both to unwarranted claims and to plaintiffs with few financial resources who are not absolutely confident of prevailing against an opponent who can spend freely on his or its defense. In light of the latter inhibition, American practice does not normally require an unsuccessful plaintiff to pay the defendant's legal costs and allows for a "contingency fee," agreed between the plaintiff and his attorney, in which the plaintiff pays the attorney nothing if he loses but a substantial portion of his own recovery if he wins.

The United States is also well-known for the "class action," which allows one plaintiff to represent all persons with a similar claim, in cases where the claims are of insufficient value to be prosecuted individually but in the aggregate are substantial. There are various restrictions allowing members of the class to opt out of the action and providing for distribution of any recovery. Much of it is distributed to lawyers, who are usually the moving force behind these suits, yet they must surely provide real disincentives to board or corporate misconduct. Most civil law jurisdictions do not recognize such a form of proceeding, although sometimes shareholder associations, for example, will seek recoveries on behalf of their members.

Culture

However, legal duties and legal mechanisms condition but do not fully determine what actually happens in the way people behave. To a significant extent, this is affected by the business and legal culture of the specific country and how it affects the conscience and expectations of board members and those dealing with them.

Consider, for example, the "structure regime" for the governance of many large Dutch corporations. Under this system, supervisory boards have been basically self-selecting, rather than being subject to shareholder election. In principle, this may not appear to be the optimal set-up for assuring board

accountability, and in fact shareholder groups have sometimes complained of a “Dutch discount” affecting share prices where the structure regime has been in place. Yet it is hard to argue that Dutch companies have been notorious sumps of corruption or mismanagement. That they are not may have as much to do with the habits of Dutch people and the business culture of the Netherlands as it does with alternative legal mechanisms for assuring responsible conduct.

Regional Issues

Transparency International, the non-governmental organization dedicated to promoting openness and honesty in business and government, has for a number of years been publishing surveys measuring how different countries compare regarding the perception of corruption – that is, people’s opinions of how widespread corruption is in a given country. The nations of the former Soviet Union have usually not done well in these surveys and have not in the most recent one²⁵. If the level of activity on regional stock exchanges is any indication, the perceptions of those covered in the surveys seem to be shared by domestic investors.

For this reason, it is of the utmost importance that regional enforcement efforts concentrate on transparency in corporate operations and protections against abusive self-dealing (related-party transactions or those involving conflicts of interest).

Many laws in the region today already have detailed provisions calling for special review of conflict-of-interest transactions.²⁶ For companies with numerous shareholders these are appropriate. However, it needs to be clear that these special approval rules are prophylactics, not “safe harbors.” That is, failure to comply will be grounds for complaint, but compliance will not save a transaction that is otherwise clearly a device for serving the interests of insiders at the expense of shareholders generally.

As to transparency, the development of an able and independent auditing profession is key. The securities laws may call for disclosure, but it is hard to achieve reliable disclosure without reliable auditors. Even where publicly traded companies are not involved, a reliable audit is a useful thing to have.

Finally, law depends on enforcement, and enforcement ultimately depends on courts. The development of a competent, honest and independent judiciary, as well as procedural mechanisms that allow meritorious claims to be redressed, is a critical need, not just for the sake of board members and shareholders but for the sake of the whole society.

²⁵ The most recent survey, released 7 October 2003, is available at www.transparency.org .

²⁶ The Kyrgyz Law on Joint Stock Companies has such provisions in its chapter IX. Moreover, if gaps appear, article 77.7 allows supplementation of chapter IX requirements by “normative legal acts of the Kyrgyz Republic.” If this includes rules issued by the securities commission, which is authorized by article 1.3 of the Law to regulate corporate legal relations under the Law, it is a very flexible and potentially useful tool to combat self-dealing.