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**THIRD SOUTH-EASTERN EUROPE CORPORATE GOVERNANCE ROUNDTABLE**

**"The responsibilities of the board and the role of stakeholders"**

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**Session 2: The structure and work of boards**

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OECD 3<sup>rd</sup> Corporate Governance Round Table South Eastern Europe

Zagreb, 20 November 2002

**SESSION ON THE STRUCTURE AND WORKING OF BOARDS**

Opening remarks by Leo Goldschmidt,  
Chairman, Corporate Governance Committee, APCIMS-EASD

OECD requested me to chair this morning's session on the Structure and the Working of Boards and to make a few introductory observations on three subjects : board independence, related party transactions and board committees. These remarks will serve as a backdrop to the main presentations that will follow.

Before doing that however, I would like to take some precaution in the matter of semantics that can pose difficulties when talking about corporate government across borders. Confusion often arises by using expressions that look and sound alike in various languages but have different meanings, or else it is their underlying concept that is often misunderstood.

I. Semantics.

1. First of all, let us take the concept of *boards* themselves : they have two basic functions :
  - monitoring of company activities, of management and of performance (and designation and removal of management);
  - actual stewardship, in defining and applying company strategy and participating in managerial decision-making albeit in the most general way : the higher administration of the company.

The manner of discharging these duties is not uniform between countries :

- some have one-tier or unitary boards that combine both functions; these are called "boards of directors" (conseil d'administration, Verwaltungsrat);
- others have two-tiered or dual boards : the "supervisory board" (conseil de surveillance, Aufsichtsrat) that is essentially concerned with the monitoring function, and the "executive" or "management board" (directoire, Vorstand) that as its name implies is charged with managerial activity.

The first type of unitary board is prevalent in the UK, the US and many southern countries of Europe. The dual board is mostly found in Germany, the Netherlands and other northern countries of Europe, especially in respect of their larger companies. Some countries, like France, give companies the choice but there the unitary form remains most common.

2. The *members* of the unitary board are called "directors" (administrateurs, Verwaltungsratsmitglieder). On the other hand, members of the executive or management board are called "executives" or "managers", (directeurs, Direktoren).

Jaap Winter, in his recent report to the European Commission, suggests calling the members of the dual board system "supervisory directors" and "executive directors" respectively.

In unitary boards, directors who *in addition* to their overall duties have executive functions are called "managing" or "executive directors" (administrateur-directeur or administrateur délégué). Those who don't are called "non executive directors" (NEDs), a subset of which are, if they meet given criteria of independence, "independent directors".

3. Another concept for which there is difficulty in transposing the meaning across borders is that of *responsibility*. The single French word "responsabilité" actually has three translations in English : "responsibility" (the duty to do - or not to do - something, by oneself or through others), "accountability" (answering for the way in which such duty is discharged) and "liability" (the fact that one may be called to indemnify if the duty isn't lived up to).

4. A last term that I would like to mention here is that of "*company interest*". Indeed, this concept comes up when prescribing that collectively and individually, a board should pursue the company interest. Some hold that this means looking after the interest of all shareholders taken as a whole (with no particular regard to the specific interest of the majority or controlling shareholders). Others maintain that company interest is broader and should also include all stakeholders' interests, including staff, creditors, clients, etc.) so much the more that a company exists as a legal person in its own right, separate from its stakeholders, and has its place and value per se in society.

Frequently it is said that the objective of a company is to build up value over time, being accountable to its shareholders with due regard to the interest of other stakeholders - thereby recognising a certain pre-eminence of shareholders over other stakeholders since shareholders are the owners and bear the residual risk of the company.

In any event, it is not for individual directors to put their personal interest or the interest of the constituency who got them elected (managers, a group of shareholders, staff in countries with "co-determination" (Mitbestimmung), the State, etc.) above the company interest. Once in the boardroom, they do not "represent" their original constituency, they should pursue the company interest, however defined.

## II. Board independence.

At the collective level, board independence implies the capacity to exercise objective judgement in decision-making, that should not be subordinate to any particular interest.

At the individual level, the same applies but it must be realised that this may be difficult to achieve when one has been elected by a particular constituency or when one has personal dealings with the company or its actors, their associates and families.

Hence the role which is increasingly recommended for "independent directors".

The cynics will say that there is no such thing as a really independent director. I am of the opinion that such independent directors do exist, but it is as much a matter of character, attitude and courage - that cannot be prescribed by law - as it is a matter of criteria and competence which are more readily definable in regulation.

There are many definitions of an independent director, but most of them boil down to the following (simultaneous) criteria :

- to be devoid of conflicting interests which could obscure judgement
- not to be part of management that has its own position and interest vis-à-vis the company
- not to be the controlling or a very important shareholder, in a position to extract private benefits from the company
- not to emanate from other constituencies that have their own interest vis-à-vis the company (e.g. the staff, the State)
- not to have a contractual or similar relationship with the company (e.g. suppliers, advisers, etc).

One notices that these definitions are all "negative" : i.e. not to belong to one of the above-mentioned categories.

As indicated previously, independent directors are a subset of non-executive directors, which means that all non-executive directors are not necessarily independent (e.g. a major shareholder, external legal counsel, etc).

I would like now to make three considerations with regard to independent directors.

1. Different countries place different emphases on the above-mentioned criteria :

In the US, where corporate ownership is generally very dispersed, the emphasis is on board independence from management, the latter exercising most of the power within the company.

In continental Europe as well as in Asia and Latin America, where concentrated ownership is common, emphasis is on independence from controlling shareholders whose dominant position can be used to their own advantage and thus to the detriment of the interests of minority shareholders.

This distinction came up when drafting the OECD corporate governance guidelines, and as presently written, it is essentially the US approach vis-à-vis management that has prevailed, with only a fleeting reference to other factors. This might be reconsidered in the impending review of the document foreseen in the coming months.

2. Should, in comparison to other directors, independent directors have a different responsibility, accountability and liability towards shareholders or other interested parties ?

This question is coming to the fore now that recommendations for the presence of independent directors -and instances of litigation - are increasing.

It is my view that for members of a collegiate body that takes its decisions collectively, it would be divisive and thus a mistake to single out independent directors by giving them special and different responsibilities - even if judges may in practice take into account the difference of knowledge that executives and non executives have of the activities and circumstances of the company. Nevertheless, the characteristics of independent directors do place them in an ideal position to play a special role in conducting oversight even more impartially than is expected from all directors, and in seeing to it that the other directors are not tempted to yield to

defending particular interests. The recognition of this position has led legislators of some countries to mandate the intervention of independent directors in the monitoring and management of conflict of interest situations (special procedures in deliberations and voting; presence in various committees, etc.).

It should be noted that one can be an independent director generally, but not independent in specific instances where an occasional particular interest is at stake (e.g. where the director is counterparty to the purchase or sale of an asset from or to the company).

3. Independent directors are a scarce resource, and ever more so with the increasing recommendations to generalise their presence on boards.

The possibility to recruit independent directors depends on two factors :

- the availability of persons of competence, experience and judgement - that can be increased with training and willingness of source groups to make available suitable candidates from their midst
- the existence of persons sufficiently motivated to accept the job - that will depend on appropriate financial rewards, professional advancement and social recognition when measured against the time required, reputational risk and the responsibility and potential liability incurred.

In the UK, this question is currently the subject of an inquiry - the Higgs report, that is due to be published shortly.

If countries deemed advanced in corporate governance recognise this to be a difficulty, it is evident that it is even more so in regions that are beginning to confront the problem.

### III. Related party transactions.

This is where a company is engaged in a transaction with someone close to it (board member, manager, shareholder, staff member, ...) and there is a risk that the price or other contractual conditions (maturity, guarantees, ...) are not "normal" or "at arm's length", unduly favouring that party to the detriment of the company and its other constituents.

Some examples are :

- inter-company pricing within the same group
- sale to/purchase from a manager
- loan from or deposit with a bank that is also a shareholder
- special service contract with a board member (e.g. company lawyer)

Various constraints are generally imposed for such transactions :

- outright prohibition
- disclosure at the appropriate level : to the chairman, the whole board, the general meeting of shareholders, special auditors' report
- specific decision-making procedure : abstention of the related party in voting, absence of the related party from the deliberation, particular role of independent directors in the process.

#### IV. Board Committees.

Two aspects of board committees are considered here :

1. The question of what actual decision-making powers board committees have is often posed : should they have any such powers or do they just examine and discuss the problems at hand and make recommendations for the full board ultimately to decide ?

To be noted that this question does not apply to the "executive committee" (comité de direction) of companies with a unitary boards - made up of the executive directors plus possibly some further company managers who don't sit on the board. Such a committee is obviously designed to make day to day decisions implementing the board's directives, although some countries do not allow the board of directors to delegate overall executive powers and the corresponding liabilities (Belgium only reversed this situation in 2002).

The question concerns other board committees such as the audit, nomination or remuneration committees. The answers are diverse : in some constituencies, it is still the board that takes full responsibility for the decisions that its committees may only prepare; in others, some decisions may or even must be made by the committee itself (US : audit committee, Sarbanes Oxley Act).

2. In some countries, legislation has not recognised the role and functions of board committees, but many countries make reference to them in subordinated regulation (e.g. stock exchange regulations) or in codes of best practice that contain non mandatory recommendations rather than hard and fast rules.

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But enough for now, it is time to let the main speakers of this session make their substantive presentations.